



MANUAL TRANSMITTAL

Department of the Treasury
Internal Revenue Service

4.1.5

APRIL 18, 2023

EFFECTIVE DATE

(04-18-2023)

PURPOSE

- (1) This transmits a revision of IRM 4.1.5, Case Building, Classification, Storage and Delivery.

MATERIAL CHANGES

- (1) This IRM updates references and includes the Return Order and Delivery System (ROADS).
- (2) The following changes were made:

Reference	Change Details
IRM 4.1.5	Reviewed the IRM for editorial changes in accordance with the IRS Style Guide.
IRM 4.1.5	Clarified the language including rewording and restructuring throughout this section. Reviewed and updated all references and website addresses. Removed the exhibits which were no longer necessary based on procedural changes.
IRM 4.1.5.1	Updated Program Reports and Acronyms into the subsection titled Program Scope and Objectives.
IRM 4.1.5.2	Added additional items for case building to the subsection titled Case Building Overview.
IRM 4.1.5.2.4	Added additional resources to subsection titled Taxpayer Locator Services.
IRM 4.1.5.2.6	Added exception for clarity that folder color does not apply to electronic case files in subsection titled File Folder Color Guidelines.
IRM 4.1.5.3	Added automated classification, new classification guidelines, and new case grading procedures throughout subsection titled Classification.
IRM 4.1.5.3.2.11	Added subsection titled Identity Theft to address appropriate procedures during classification.
IRM 4.1.5.3.2.12	Added subsection titled Freeze Codes to address appropriate procedures during classification.
IRM 4.1.5.3.2.13	Added subsection titled Classification Criteria Criminal Restitution Returns to address appropriate procedures for classification.
IRM 4.1.5.3.4	Updated the subsection titled Identifying Issues on Individual Returns to include changes including legislative changes, Digital Assets terminology, and Carrybacks and Carryforwards information.
IRM 4.1.5.4	Updated the subsection titled Storage of Returns to change inventory storage preference to electronic storage rather than Campus storage.
IRM 4.1.5.4.1	Combined and revised Old IRM 4.1.5.4.1, AIMS Update Process for Centralized Storage, and Old IRM 4.1.5.4.2, Stored at the Campus.

Reference	Change Details
IRM 4.1.5.4.2	Updated the subsection titled Inventory Stored in PSP or CDE to better reflect return storage procedures and coding.
IRM 4.1.5.4.4.2	Updated the subsection titled Employee Returns Selected via CDE to align with CDE enhancements allowing transfer of cases between CDE EGCs.
IRM 4.1.5.5	Updated the subsection titled Delivery of Selected Returns based on revised Purpose Groups, procedure changes, and the incorporation of the Return Order and Delivery System (ROADS).

EFFECT ON OTHER DOCUMENTS

This IRM supersedes IRM 4.1.5 dated 09/21/2020.

AUDIENCE

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4.1.5

Case Building, Classification, Storage and Delivery

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4.1.5.1
(10-20-2017)
Program Scope and Objectives

- (1) Purpose. This IRM Section provides information for **case building, classification, storage, and delivery** of workload. Guidelines and procedures described below are to ensure uniform case building, classification, review, and delivery of returns.
- (2) Audience. These procedures apply to SB/SE Field Exam employees who are responsible for return identification, selection, and delivery in Planning and Special Programs (PSP).
- (3) Policy Owner. Exam Case Selection (ECS) is under Headquarters Examination.
- (4) Program Owner. Exam Case Selection is the office responsible for the selection of cases and delivery of inventory.
- (5) Contact Information. To recommend changes or make any other suggestions to this IRM section contact the senior program analyst in Field Case Selection (FCS) responsible for the PSP IRM Update. See <http://mysbse.web.irs.gov/examination/examorg/hq/ecs/fieldexamretsel/10461.aspx> for list of analysts in FCS.

4.1.5.1.1
(10-20-2017)
Background

- (1) PSP is responsible for identifying, selecting, and delivering returns to SB/SE Field Exam. Those returns can come from a variety of sources. This section addresses case building, classification, and delivery of the returns.

4.1.5.1.2
(09-21-2020)
Authority

- (1) IRM 1.1.16.5.5.3, Exam Case Selection.
- (2) IRM 1.2.1.2.36, Policy Statement 1-236, Fairness and Integrity in Enforcement Selection.
- (3) IRM 1.2.1.5.7, Policy Statement 4-9, Highest Integrity Expected.
- (4) IRM 1.2.1.5.10, Policy Statement 4-21, Selection of Returns for Examination.

4.1.5.1.3
(10-20-2017)
Responsibilities

- (1) Director, Exam Case Selection (ECS) is the executive responsible for providing policy guidance on the selection of cases and delivery of inventory for SB/SE Examination.
- (2) Program Manager, Field Case Selection is the program manager responsible for providing policy guidance on the selection of cases and delivery of inventory for SB/SE Field Exam.
- (3) The PSP Territory Manager is the territory manager responsible for the selection of cases and delivery of inventory within an SB/SE Exam Area.

4.1.5.1.4
(04-18-2023)
Program Reports

- (1) The following are systems or reports that may be used to monitor the classification, storage, and delivery of inventory.
 - A-CIS
 - Compliance Date Environment (CDE) Inventory Report
 - CDE select rates (CDE Select Rate Report)
 - Status 06 report of CDE inventory
 - Unstarted (Status 10 and below) returns by status code, Tables 36 and 37, SSIVL, or ERCS Tableau.

- Volume and timing of return orders (Classification/Order Plan)
- New starts (A-CIS Open and Closed Case databases or ERCS Tableau)
- Return Order and Delivery System (ROADS)
- Exam Plan
- Starts & DIF Mix Report (WPA)
- ERCS Tableau
- CDE Tableau
- Program Control Database data extract

4.1.5.1.5
(04-18-2023)

(1) This is a list of acronyms and their definitions.

Acronyms

Acronym	Definition
AAC	AIMS Assignee Code
A-CIS	AIMS Centralized Information System
AIMS	Audit Information Management System
AKA	Also Known As
AMDISA	Displays up to six screens of information about the taxpayer's account for a specific tax period. Refer to IRM 2.8.3-7, Command Code AMDISA.
AMT	Alternative Minimum Tax
BBA	Bipartisan Budget Act of 2015
BMF	Business Master File
BRTVU	BRTVU summary screens display associated returns/schedules/forms submitted by a specific filer. Refer to IRM 2.3.57-1, Command Code BRTVU
CCP	Centralized Case Processing
CDE	Compliance Data Environment
CDW	Compliance Data Warehouse
CF&S	Centralized Files and Scheduling
CGT	Case Grading Tool
CKGE	CDW Knowledge Graph Environment
CIP	Compliance Initiative Project
COLLSTCD26	Collection Status Code 26
CORR	Correspondence
CSDB	Centralized Scheduling Database
CTR	Currency Transaction Report
CURNOTCOLL	Currently Not Collectible
DBA	Doing Business As
D&B	Dun & Bradstreet

Acronym	Definition
DIF	Discriminant Function
DLN	Document Locator Number
EGC	Examination Group Code
ENMOD	Displays name, address, and other entity information. Refer to IRM 2.3.15-1, ENMOD Request.
ERCS	Examination Returns Control System
EUP	Employee User Portal
FBAR	Foreign Bank and Financial Accounts
FinCEN	Financial Crimes Enforcement Network
HINF	High Income Nonfiler
IDRS	Integrated Data Retrieval System
INOLES	Displays specific data for the account addressed. Refer to IRM 2.3.47-1, Command Code INOLE Input Screen
IRP	Information Reporting Program
IRPTR	Requests on-line payee transcripts of income reported on various document types. Refer to IRM 2.3.35, IDRS Terminal Responses, Command Code IRPTR, for more information.
LIFO	Last In First Out
MCC	Martinsburg Computing Center
MeF	Modernized E-File
NBTPI	Non-Business Total Positive Income
NRP	National Research Program
PDs	Position Descriptions
POD	Post of Duty
PSP	Planning and Special Programs
QP	Questionable Preparer
RA	Revenue Agent
SARP	State Audit Report Program
ROADS	Return Order and Delivery System
RPD	Return Preparer Database
RTVUE	Requests the transcribed line-by-line tax return information, which posted to the IMF. See IRM 2.3.52.2, Command Code (CC) RTVUE
SB/SE	Small Business Self-Employed
SC	Section Chief
SEID	Standard Employee Identifier

Acronym	Definition
SSIVL	Statistical Sample Inventory Validation Listing
TAS	Taxpayer Advocate Service
TCO	Tax Compliance Officer
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TGR	Taxable Gross Receipts
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
TM	Territory Manager
TP	Taxpayer
TPI	Total Positive Income
TRDBV	Retrieves a summary of the available tax information on Tax Return Data Base (TRDB). Refer to IRM 2.3.73.2, Command Code (CC) TRDBV.
TXMOD	Requests a display of tax information for a specific IMF or BMF module. Refer to IRM 2.3.11.3, Command Code TXMOD for more information.
UCC	Uniform Commercial Code
WPA	Workload Planning and Analysis
W&I	Wage and Investment

4.1.5.1.6
(10-20-2017)
Terms

- (1) See IRM 4.1.1.1.6, Terms for a listing of common terms used in PSP.

4.1.5.1.7
(10-20-2017)
Related Sources

- (1) IRM 4.1.1, Planning, Monitoring, and Coordination.
- (2) IRM 4.1.2, Workload Identification and Survey Procedures.

4.1.5.2
(04-18-2023)
Case Building Overview

- (1) Case building is the process of assembling available taxpayer specific research to identify possible compliance issues.
- (2) Various studies have been conducted throughout the years to determine the value of having certain information available during the pre-audit analysis of a tax return versus gathering the information during the audit process. These studies have concluded the resources expended gathering this information for the pre-audit (classification) phase are more than offset by the savings incurred in pursuing non-productive issues/returns.
- (3) The studies weighed the value of information available during the pre-audit stage and determined certain items should be made part of the case file for classification purposes. These items are:

- a. Charge out document, Form 5546, Examination Return Charge-Out Sheet, or Taxpayer Information Sheet from Compliance Data Environment (CDE) facsimile.
 - b. Original return (only in special circumstances such as potential fraud.)
 - c. Three year CDE facsimile print.
 - d. Integrated Data Retrieval System (IDRS) prints of various command codes.
 - e. Financial Crimes Enforcement Network (FinCEN) information: i.e. Cash Transaction Report (CTR), Foreign Bank Account (FBAR), Form 8300, Report of Cash Payments over \$10,000, etc.
 - f. Taxpayer locator data compiled from various public information agencies.
 - g. yK1 Link Analysis Tool or the CDW Knowledge Graph Environment (CKGE), in some cases, may also be provided. This tool is useful if there are related entities or tiered ownership issues. See <https://ckge.enterprise.irs.gov/yk1/> or <https://ckge.enterprise.irs.gov/> for more information.
 - h. Cover sheet, supplemental document, and/or supplemental directions, if appropriate.
 - i. Return Preparer Database reports of taxpayers selected for examination who are engaged in return preparation activities, including non-filers.
 - j. Form 8886 Disclosure
 - k. Schedule K-1
- (4) Additionally, there may be other related entities that may materially impact the taxpayer's tax liability. For instance, a material source of the taxpayer's income may be a partnership that is reflected as an entry on a schedule. This income may be offset with other non-related items. This makes it difficult to properly determine the taxpayer's correct liability without considering the items attributable to that taxpayer from the partnership. When this situation is identified, the information from the related entity should be gathered and associated with the taxpayer's file.

4.1.5.2.1
(10-20-2017)

Case Building Benefits

- (1) Case building tools help determine whether a return should be selected for audit, what issues should be audited, and how the audit should be conducted.
- (2) Case building data provides taxpayer specific research to identify possible compliance issues.
- (3) Case building data in conjunction with the return (original, CDE facsimile or Modernized E-File (MeF) print) provides a broader working knowledge of the taxpayer's financial activities to make an informed decision to accept or examine specific items on the return.
- (4) Case building data can corroborate items on the return so they don't have to be raised with the taxpayer.

4.1.5.2.2
(04-18-2023)

IDRS (Integrated Data Retrieval System)

- (1) IDRS is an internal database accessed by various command codes, each of which provides specific information.
- (2) IDRS can provide:
 - a. Current name, address, and filing status
 - b. Income sources and amounts
 - c. Audit activity
 - d. Filing requirements

- e. Bankruptcy/ Collectability indicators
- f. Filing status and number of dependents
- g. Prior names and addresses
- h. Filing and payment transactions
- i. Cross reference to other taxpayer identification numbers (TINS)
- j. Prior adjustment to the tax liability that could impact the exam issue

- (3) The IDRS information should be compared against the return information to determine if there are discrepancies, amended returns, or activity after the return was filed.
- (4) An IDRS Command Code Job Aid can be found at <http://serp.enterprise.irs.gov/job-aids/command-code/command-code.html>

4.1.5.2.3 (10-20-2017)

Financial Crimes Enforcement Network (FinCEN)

- (1) FinCEN provides an on-line database containing reports of cash transactions in excess of \$10,000. Cash transactions include deposits, withdrawals, check cashing, wire transfers, sales and redemption of money orders, travelers' checks or stored value, casino activity, payments for certain services and information on foreign bank accounts. In addition, FinCEN reports cash and/or other monetary instruments in excess of \$10,000 used as payment for certain goods.
- (2) FinCEN provides the *following forms*:
 - a. FinCEN Report 112, Currency Transaction Report, for cash transactions in excess of \$10,000, filed by financial institutions and non-bank financial institutions.
 - b. FinCEN/ IRS Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business, filed by businesses when cash and/or monetary instruments of \$10,000 or more are received for goods or services.
 - c. FinCEN Report 114, Foreign Bank Account Report filed by an individual, if the aggregate value of foreign accounts exceeds \$10,000.
- (3) FinCEN data can be used to generate leads for potential unreported income, money laundering transactions and other tax avoidance schemes.
- (4) Consider FinCEN activity in relation to the overall financial status of the taxpayer. FinCEN "hits" along with Information Returns Processing (IRP) documents, CDE 3 year facsimiles, and taxpayer locator data will provide a better picture of the taxpayer's financial situation. Compare the contents of these case building tools with the return.

4.1.5.2.4 (04-18-2023)

Taxpayer Locator Services

- (1) Taxpayer locator services (e.g. Accurant) provides information on an individual or business, and is designed as a general combination report with data from multiple sources to provide a snapshot of the subject's identity.
- (2) At least one consumer reporting agency is scanned and the information found is utilized to search over 2 billion public records and generate a single report that may include:
 - Complete name, Also Known As (AKA), Doing Business As (DBA)
 - Current and previous addresses
 - Social security number
 - Driver license number

- Phone numbers
- Date of birth
- Aliases
- Bankruptcies, liens, and judgments
- Corporate ownership
- UCC (Uniform Commercial Code) filings
- Real property ownership
- Professional licenses
- Aircraft and watercraft ownership
- Pilot licenses
- E-mail addresses
- Internet domains
- Recreational vehicles
- Hunting and fishing licenses
- Concealed weapons permit
- Financial information for businesses
- Possible criminal records
- Possible relatives
- Possible associates

(3) This information is useful in determining the taxpayer's lifestyle or business history and aids in determining net worth.

(4) Examples of public search data that could indicate audit potential include, but are not limited to:

- Deed transfer information could reflect sales not reported on tax return.
- Corporate affiliations where there are no indications of corporate earnings on the return
- Property ownership not reflected on the return as either personal residence or rental property
- Professional licenses could demonstrate income earning potential not reflected on the tax return
- Vehicle searches ownership data (type of vehicle, purchase price, owner name and address) could reflect high cost asset acquisition in excess of earnings reported on the tax return.
- Address history data contains up to five addresses for the taxpayer in the most recent to least recent order. This data could aid in the financial status analysis when determining high and low cost living areas.
- Boat and plane registration could reflect ownership of high cost assets in excess of earning potential reflected on the tax return.
- Possible family relationships for owners with different names

4.1.5.2.5
(04-18-2023)
**Return Preparer
Database (RPD)**

(1) The RPD is a repository of return preparers who prepare and sign 10 or more returns. It contains more than 500 data elements and can be used as an investigative tool when researching return preparers for compliance and misconduct issues.

(2) Some of the items RPD can provide (this list is not all-inclusive):

- Counts of returns filed
- PTIN information
- Outreach and prior return preparer contact
- Complaints, referrals and leads received
- Stats on the type of returns filed

- Phone number or software used
- EFIN information used
- Refund and refundable credit percentages based on returns filed

- (3) The RPD information could be used to determine potential discrepancy in income reporting, level of employee/employer relationship, and potential IRC 6694 and IRC 6695 penalty application.
- (4) Questions regarding RPD case building material or any additional information regarding a return preparer can be made to your Area RPC at <https://portal.ds.irsnet.gov/sites/vl051/Lists/Return%20Preparer%20Coordinators%20RPCs/AllItems.aspx>

4.1.5.2.6
(04-18-2023)
**File Folder Color
Guidelines**

- (1) Field Exam achieves national standards for processing by using file folder colors on cases. This subsection provides guidance to establish a uniform list of file folders colors exam will use to identify specific types of cases. The use of colored folders also helps Centralized Case Processing (CCP) when closing cases.

Exception: Electronic case files do not require file folder colors to be used.

- (2) For case building purposes, whether performed by area PSPs or at the campus, the following file folder color guidelines will be used:
 - a. **Red** – Case with a statute date expiring within 180 days or Prompt Determination
 - b. **Yellow** – Headquarter approved usage only. Purpose of use will change periodically as interim guidance is issued
 - c. **Orange** – IRS Employee audit
 - d. **Purple** – NRP
 - e. **Light Blue** – Claims (This includes innocent spouse; injured spouse; and any other type of claim)
- (3) The list above is not all-inclusive. From time to time, there will be various projects that will require the use of a particular color folder not listed above.
- (4) If a case falls into more than one of the above listed categories, place the folders in the color order listed above from outermost folder to innermost.

Example: A red folder would be on the outside of a purple folder.

4.1.5.3
(10-20-2017)
Classification

- (1) This subsection deals with classification of returns.
- (2) Classification is the process of determining whether a return should be selected for audit, the initial issues to be audited, and who should conduct the audit.

4.1.5.3.1
(04-18-2023)
Classification Overview

- (1) Classification should be conducted by an experienced examiner who has received appropriate tax law training. Examiners with specialized expertise may be used to classify business returns. Classification using online systems (such as CDE and Modernized E-file (MeF)) can be done at remote locations via approved procedures. See IRM 4.103.1.7, CDE Procedures.

Exception: When appropriate, an automated classification tool using data analytics (such as Issue Recommender) should be substituted for a human classifier.

- (2) National SB/SE Classification Guidelines provide guidance to enable greater classification consistency nationwide and to select returns for audit with issues that are material in scope. The classification guidelines can be found at: <http://mysbse.web.irs.gov/examination/tip/classification/default.aspx>.
- (3) Tax returns are to be selected and classified for audit by employees who will not be the examiner of the return.
- (4) DIF returns are scored using algorithms/models designed to score returns and delivered in descending DIF score order for classification.
- (5) All returns will be classified to select returns that contain significant issues likely to result in tax changes or that require audit to achieve voluntary compliance.
- (6) All returns will be identified for assignment to an RA, TCO Grade 09 or lower (TCO-09), or a TCO Grade 11 (TCO-11). The designation as RA, TCO-09, or TCO-11 will be based upon the complexity of the issues involved and the degree of accounting and auditing skills required to conduct a quality audit. See IRM 4.1.5.3.2.6, Grading Returns (RA, TCO-11, TCO-09 or below), for additional information.
- (7) Returns should be classified by examiners possessing experience commensurate with the type of return and activity code they are classifying.
- (8) Individual returns selected for audit for revenue agents should contain issues requiring accounting skills of a revenue agent. Individual returns selected for audit not requiring the accounting skills of a revenue agent may be selected for audit for revenue agents if tax compliance officers (TCOs) (including traveling TCOs) are not available in the geographic location of the taxpayer or if the returns are needed for training.

4.1.5.3.2
(10-20-2017)
**Classification
Background**

- (1) The primary objective in selecting returns for audit is to promote the highest degree of voluntary compliance on the part of taxpayers while making the most efficient use of finite examination staffing and other resources. Employees must exercise their professional judgment, not personal opinions, when making return selection decisions. The subsections below discuss the instructions for performing return classification.

4.1.5.3.2.1
(10-20-2017)
**Area Classification
Instructions**

- (1) Each Area should prepare Area specific classification instructions covering the following topics:
 - a. Local issues
 - b. Questionable practitioners

4.1.5.3.2.2
(04-18-2023)
**Campus Classification
Instructions**

- (1) It is important for the area Planning and Special Programs (PSP) staff to have frequent discussions with the Centralized Files and Scheduling (CF&S) management to keep abreast of the return orders and issues dealing with the area's inventory.

- (2) Classification will usually only involve local travel. Electronically filed returns can be classified remotely. Paper filed returns, on exceptions or as needed, can be mailed to the appropriate PSP office.
- (3) Ideally all status code 06 and 07 inventory will be classified in one classification detail. If not possible, then prior to each classification detail PSP will sort the area returns (using the Statistical Sample Inventory Validation Listing (SSIVL)) to be classified by:
 1. Activity codes needed for the exam plan
 2. Return post year
 3. Descending DIF score order

The reason for this sort is to ensure the highest DIF scores are classified for each activity code for each return posted year.

- (4) During the course of classification, returns should be categorized as follows:
 - a. Selected returns for RA.
 - b. Selected returns for TCO-11.
 - c. Selected returns for TCO-09 or below.
 - d. Returns accepted as filed. Paper returns not selected for audit will be appropriately stamped. See IRM 4.1.5.3.2.5, Classification Documentation, for reason codes.
 - e. Returns that are unusual in nature, such as returns where the exam return charge-out documents are missing or do not match the return or returns where the exam return charge-out contains special messages such as "Information Report Available" (if not in the case file).
 - f. Returns to be transferred.
 - g. Special program returns - International issues, etc.
 - h. Other returns as provided by area instructions.

4.1.5.3.2.3 (04-18-2023)

Electronic Classification

- (1) The following guidelines apply when returns are classified using an electronic source (e.g. Modernized E-File (MeF) or CDE):
 - a. When classifying returns, classifiers are required to get approval on BEARS at <https://bears.iam.int.for.irs.gov> for the Employee User Portal at https://eup.eps.irs.gov/eup_login/, CDE, and MeF (both IMF and BMF).
 - b. When determining whether a return should be selected for audit, the classifier should consider the return as a whole, not just the criteria which caused it to be identified.
 - c. When practical, the classifier should review the three-year comparison to identify trends on the return and to determine if issues are present on multiple years.
 - d. Additional data, if available, should be considered in the electronic classification process.
 - e. Checksheets, whether manual or electronic, are to be completed for each classified electronic return.
 - f. For returns that are not MeF, a three-year CDE facsimile of the return should be used in place of an original return. A copy of the return can be requested from the taxpayer at the beginning of the audit.
 - g. Review of electronic classified returns should follow the guidelines in IRM 4.1.5.3.3, Review of Classification.

4.1.5.3.2.4
(10-20-2017)
Employee Returns

- (1) Please refer to IRM 4.1.1.6.7, Employee Audits, for procedures related to employee audits. As a general rule when classifying returns, an employee is not treated differently than any other taxpayer.

4.1.5.3.2.5
(04-18-2023)
**Classification
Documentation**

- (1) All return classification decisions (selected or accepted as filed) must be documented. Returns that are selected for audit must have a classification check sheet (or equivalent) documenting the reason the return was selected. Returns that are not selected (accepted as filed) must also be documented. In CDE, the code is entered in the dropdown box for the accepted as filed reason code, and for non-CDE classification, the code should be entered in the comment box. The following standard reason codes should be used to document why the return was accepted as filed:

Letter	Description
A	No LUQs (Large, Unusual or Questionable items)
B	No change in prior year (repetitive audit on the same issues)
C	Beyond cycle (statute too short)
D	Resource issues (not applicable to classification - do not use)
E	Other
F	Collectability
G	Combat zone
H	Timing Issue
I	De minimus Tax

Note: If a program has alternate “accepted as filed” reason codes (e.g., State Audit Report Program (SARP)) then the alternate codes should be entered into the **General Comments** section of the classification checksheet replacing the above codes for non-CDE cases and supplementing the above codes within CDE.

4.1.5.3.2.6
(04-18-2023)
**Grading Returns (RA,
TCO-11, TCO-09 or
below)**

- (1) One of the key contributions to the success or failure of our exam program is the selection of the proper function to conduct the exam. To meet the exam plan, it is essential that returns most adaptable for office interviews are assigned to TCOs and those requiring the skills of a field agent are assigned to RAs. This decision is very important because the planned time of an audit for TCOs is substantially less than the planned time for RAs. However, substantial issues should not be excluded to convert what would be a RA assignment, to a TCO assignment. For returns that are selected for examination, the classifier determines what employee type should conduct the examination (TCO-09 or below, TCO-11, or RA).
- (2) Primary BMF returns are examined by RAs. However, according to Position Descriptions (PDs), TCO 11s can work targeted exams of small BMF taxpayers if related return issues are identified. All examiners are expected to evaluate the tax implications of related passthrough returns.

- (3) For IMF returns, the proper examiner type must be determined. This task is accomplished by completing the SB/SE Case Grading Tool (CGT) or the use of an automated methodology (e.g. Issue Recommender data loaded into CDE). The CGT can be found with the classification guidelines at: <http://mysbse.web.irs.gov/examination/tip/classification/default.aspx>. The CGT will determine the employee type based on differences in the position descriptions (PDs), assigning each return to the lowest appropriate grade of employee. The key differences in the PDs are accounting expertise and complexity. TCO-09s conduct exams typically involving direct verification of income or expense records and exhibit knowledge of basic accounting principles. TCO-11s conduct in-depth examinations of income and exhibit knowledge of intermediate accounting principles. RAs conduct exams of more than usual difficulty or complexity (e.g. controversial laws, sensitive issues, etc.) and exhibit knowledge of advanced accounting principles.
- (4) Complexity is assessed based on the return as a whole. This prevents returns from being assigned to lower graded examiners based solely on classified issues when additional issues may surface and go unidentified or unaddressed because they do not align with the employee's position description. It also prevents excess surveys and transfers.
- (5) In general, the amount reported (income or expense) should not determine the return complexity without considering other factors.
- (6) The SB/SE Case Grading Tool determines the grade based on the complexity factors present. The following are examples of items that add complexity. **This list is not all-inclusive.**
- a. Issues requiring an on-site inspection of the taxpayer's books, records, inventories, or assets
 - b. Apparent financial status imbalance
 - c. Improperly reported related entity transactions
 - d. Charitable deductions requiring a specialist referral
 - e. Accounting method other than Cash basis
 - f. Multiple Schedule Cs
 - g. Issues that could lead to/indicate a need to expand to a BMF examination
 - h. Business with a high number of transactions (income or expense) that can't be verified using Form 1099s or 3rd party summaries
 - i. Business that lends itself to a high incidence of cash transactions
 - j. Potential worker classification issues
 - k. More than 3 rental properties reported on Schedule E
 - l. Passthrough entity losses with potential basis or at-risk issues
 - m. Foreign transactions
 - n. Cryptocurrency transactions or digital assets
 - o. Substantial Net Operating Loss Deduction claimed
- (7) If an on-site inspection is required, the return is assigned to an RA. An on-site inspection should be considered when the following items are present. **This list is not all inclusive.**
- a. Significant inventory exists (e.g. retail business)
 - b. Assets require verification (e.g. manufacturing business, questionable depreciation)
 - c. Potentially fictitious business
 - d. Voluminous records or complex accounting systems

- e. Substantial casualty loss
- (8) Typically, combinations of factors are evaluated to determine when the return becomes more complex than should be worked by a lower graded employee type. However, there are some complexity factors that are overarching (e.g. the need for an on-site visit, if the return being classified is a BMF return, financial status, etc.). Regardless of other issues on the return, if these factors exist, a return is assigned to a higher graded examiner based on PDs. In addition, other factors raise the return to a level of accounting expertise that would require the return to be worked by a higher graded examiner based on the PDs (e.g. complicated related entity situations, sale of a business ownership interest, substantial NOLD, at-risk issues, accounting methods other than cash, emerging issues such as marijuana industry or digital assets, etc.).
- (9) The availability of examiners should not impact the selection of a return for examination. If the appropriate level of examiner is not available at the taxpayer's POD (including circuit riders), select the return for correspondence examination or the next level of examiner (TCO 9 to TCO 11 to RA) available in that POD. This practice creates a fair and equitable treatment of taxpayers regardless of where they reside.
- (10) For effective use of our resources, the classifier must decide which returns are most in need of audit, and through audit, will promote the highest degree of voluntary compliance.
- (11) Classifiers should:
 - a. Be alert to items that would result in potential over-assessments as well as items that would result in potential deficiencies.
 - b. Bring to the attention of the manager any return where the classifier's relationship with the taxpayer may create a potential conflict of interest.
 - c. Bring to the attention of the manager any return where the type, industry, or potential issue is unfamiliar to the classifier.
 - d. Be alert to fraudulent refund schemes.
 - e. Be alert to potential preparer project returns.
 - f. Be alert to return preparers who are non-filers.
- (12) All returns received for classification will be reviewed for international issues. Refer to IRM 4.1.9, International Features. If international issues are present, the classifier should discuss with reviewer or individual overseeing the classification to determine how to send a referral to an international examiner and how to proceed with the classification. See IRM 4.46.3, LB&I Examination Process, Planning the Examination.
- (13) The following reference material should be available for classifiers, along with this IRM:
 - a. Document 6209, IRS Processing Codes and Information
 - b. Document 6036, Examination Division Reporting Codes Booklet
 - c. Area Classification Instructions
 - d. National SB/SE Classification Guidelines & Case Grading Tool (<http://mysbse.web.irs.gov/examination/tip/classification/default.aspx>)

4.1.5.3.2.7
(04-18-2023)

**Form 5546, Examination
Return Charge-Out
Sheet or CDE Taxpayer
Information Sheet**

- (1) Before classifying a return, Form 5546, Examination Return Charge-Out Sheet, or the CDE Taxpayer Information Sheet on a CDE facsimile return, should be reviewed for information, if available.
- (2) The relevant items for the classifier on Form 5546 or the CDE Taxpayer Information Sheet (also known as Taxpayer Identifying Information page) are as follows:
 - a. Year, form number, form type, activity code, and DIF score.
 - b. Special messages (e.g., Modernized E-File return, employee return, collectability indicators).
 - c. Previous audit results — This item will show the results of the two most recent returns closed by examination, including disposal code and amount of tax change. This information, along with information from the no-change issue codes (only found on the Form 5546), can affect the classifier's decision to select or accept the return under consideration.
 - d. IMF No change — If the last audit of the taxpayer occurred in one of the two preceding tax years and the audit resulted in a no-change (disposal code 01 or 02), only select the return for audit if issues present on the return are different than those previously no-changed.
 - e. Collectability Indicators — See IRM 4.1.5.3.2.10, Returns With Collectability Indicators.
- (3) Definitions of the following codes referenced on the Form 5546 or CDE Taxpayer Information Sheet can be found in IRM 4.4.1-1, Reference Guide:
 - Activity (Abstract) Codes
 - DIF Reason Codes
 - Disposal Codes
 - Employee Group Code
 - Form Number, Master File and Non-Master File Tax Codes Valid on AIMS
 - Push Codes
 - Source Codes
 - Sort Codes
 - Special Messages on Form 5546, Examination Return Charge Out
 - Status Codes
 - Taxpayer Identification Number

4.1.5.3.2.8
(04-18-2023)

**Classification
Checksheets**

- (1) The following checksheets have been developed to assist examiners in performing their duties. A classification checksheet should be completed for each return classified.

Type of Return	Form
1040 Individual	Form 6754, Examination Classification Checksheet
Form 1065, 1120, 1120S, and 1041 (BMF returns)	Form 10264, Revenue Agent - Classification Checksheet

- (2) Classifiers must provide their Standard Employee Identifier (SEID) on each checksheet to ensure the person who classified the return is not the examiner of the return.

Reminder: If a subject matter expert was the classifier, they cannot assist the examiner with the examination.

- (3) Include the checksheet with the return.
- (4) Classifiers should include comments in the remarks section to convey the classification information to the examiner.

4.1.5.3.2.8.1
(04-18-2023)
**Instructions for
Preparation of Form
6754, Examination
Classification
Checksheet**

- (1) It is important to note the Form 6754, Examination Classification Checksheet, is designed for both non-business and business issues and allows for write-in issues (issue numbers 33–35).
- (2) It is important to accurately classify each return, because the taxpayer will be requested to bring in certain records to the initial appointment based on the items classified.
- (3) All classified issue blocks should be marked with an “X” and not check marked, to reduce the possibility of marking through more than one box.

4.1.5.3.2.8.2
(04-18-2023)
**Special Instructions (All
Returns) for Form 6754**

- (1) Form 6754, Examination Classification Checksheet, is composed of three sections:
 - Non-business issues, other taxes and tax credits (left side)
 - Schedule C, E, or F issues (right side)
 - Write-in issues (bottom)
- (2) Classifiers will complete the following blocks for each selected return:

Block	Description	Instructions
A	Taxpayer Name, SSN, and Tax Period	If available, affix an “Examination Label” with Check Digit (2 Alpha Characters). Otherwise, enter required information manually.
B	Type of Examination	Returns will be identified as either Pre-contact Analysis (TCO) or Field Examination (RA). For area classification “Correspondence” is not applicable and should not be checked.
C	Special Inventory	If the return is classified as a TCO-11 return then check Box 9
D, E, F, G	Priority, POD, Reserved, ADP Hash Total	These blocks are not completed by the area classifiers.

- (3) See IRM 4.1.5.3.2.6, Grading Returns (RA, TCO-11, TCO-09 or below) to determine the grade level of the return (TCO-09 or below, TCO-11, or RA.)
- (4) Block H — Issue numbers generally appear in the same order on the tax return, Form 1040, U.S. Individual Income Tax Return. Below is additional information for completing issue numbers:
 - a. Number 10, IRMF — Blue Tab Criteria is obsolete.
 - b. Numbers 50 through 82 are for business issues. There are three columns available for each issue. Use Column C–01 if the issue appears on Schedule C, Column E–02 if the issue appears on Schedule E, and

Column F–03 if the issue appears on Schedule F. The same issue may be used for more than one schedule.

- c. Numbers 33–35 are to be used for issues that do not fit any of the pre-printed categories on the checksheet. The write-in should not duplicate or overlap other items identified on the checksheet. Whenever possible, the language used on the tax return should be used for the write-in. The use of general phrases should be avoided.
 - d. If all books and records are needed, or if gross receipts is a classified item, Issue Number 50, Gross Receipts Schedule C or F Issues, should be marked with an “X.”
 - e. The classification of gross receipts should not be automatic. Gross receipts should not be classified on those returns where the potential for unreported income is not substantial.
- (5) For **all returns**, select only those issues that warrant audit. **Limit the number of issues to the “vital few”, preferably no more than 3 issues.**
 - (6) The remarks section should be used for any comments, explanations, or observations the classifier would like to provide to the examiner. Do not enter any information that would be inappropriate for disclosure to the taxpayer.
 - a. This may include comments about the Schedule C, E, or F.
 - b. Examples of appropriate comments are: “Income does not appear to support standard of living”, “Schedule C appears to be fictitious/false”, “Possible personal expenses being deducted”, “questionable preparer.”
 - (7) Block I — Classifier’s Standard Employee Identifier (SEID).
 - (8) Block J — Date classified.
 - (9) Block K — Reviewer’s SEID will be shown if reviewed.
 - (10) Block L — Date reviewed.

4.1.5.3.2.9
(04-18-2023)
**Information Return
Processing (IRP)
Documents**

- (1) The information returns master file (IRMF) transcript is a listing of the information returns processed (IRP) for the taxpayer. The IRMF transcript summary is a summation by various payment groups of the information returns printed on the IRP transcript.
- (2) IRM 2.3.35, IDRS Terminal Responses, Command Code IRPTR, contains the format of the IRP transcript with an explanation of the items shown on the transcript.

4.1.5.3.2.9.1
(04-18-2023)
**Classifying Returns With
IRP Transcripts**

- (1) As part of classification of an individual return, the classifier will review the IRP transcript to identify discrepancies between the return and the IRP transcript.
- (2) If the return meets the criteria of repetitive audit procedures according to IRM 4.10.2.13, Repetitive Audits, and there is a discrepancy as outlined above, the return will be selected for audit of the IRP issue only.

4.1.5.3.2.9.2
(04-18-2023)
CTR Screening/Matching

- (1) The IRP transcripts also contain currency transaction report (CTR) data. IRM 2.3.35-57, Payee online Transcript Document Display Screen: Form FinCEN CTR 112 (DOC CODE 89), gives an explanation of the CTR data contained on the IRP transcript.

- (2) The information contained on the IRP transcript relating to CTRs should assist the classifier in making decisions on the need to recommend the use of special auditing techniques, or to question sources of income not subject to withholding tax.
- (3) The CTR screening/matching program does not replace the normal IRP screening procedures.

4.1.5.3.2.10
(04-18-2023)

**Returns with
Collectability Indicators**

- (1) The purpose of the Internal Revenue Service is to collect the proper amount of tax revenues at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency and fairness.
- (2) Cases audited by exam impact other functions (e.g. collection, appeals, counsel, etc.) throughout the IRS.
- (3) Assessments made by exam often result in an increase in the inventory of cases in collection. A significant number of these assessments result in uncollectable accounts.
- (4) In the continuing effort to reduce the collection inventory and currently not collectible (CNC) accounts, the IRS must strive for quality assessments and promote an increased emphasis on early collections. Taxpayers should be educated as to the benefits of paying a proposed tax deficiency in full or informed as to the availability of other arrangements (e.g., installment payments).
- (5) A CNC account is a taxpayer account determined to be uncollectable for one or more of the following reasons:
 - Hardship
 - Insolvency/defunct corporation
 - Bankruptcy
 - Decedents (having no assets)
 - Unable to locate taxpayer
 - Unable to contact taxpayer
 - In business (hardship)
 - Other (de minimus/ statute expired while in active status)
- (6) The goal of the CNC initiative is to constrain the growth of accounts receivable and uncollectable accounts and to promote a more effective organizational operation by maximizing time and resources devoted to productive efforts.
- (7) See IRM 4.20.1.2.1, Collectability Considerations, for more guidance.

4.1.5.3.2.10.1
(04-18-2023)

**Classification
Procedures —
Collectability Indicators**

- (1) PSP Territory Managers must ensure classification checksheets are documented for selected returns with low collection potential to reflect the compliance justification.
- (2) Collectability indicators appear on Form 5546, Examination Return Charge-Out Sheet, CDE Taxpayer (TP) Information Sheet, or on an AMDISA print. Definitions and locations of each indicator are as follows:

Form 5546	CDE TP Info Sheet	Definition
BANKRUPTCY	B	Taxpayer is currently in bankruptcy or bankruptcy discharge in a prior period.
CURNOTCOLL	N	Prior period was closed as Currently Not Collectible. See Document 6209, IRS Processing Codes and Information, for a complete list and explanation of Taxpayer Delinquent Account (TDA) closing codes, or http://serp.enterprise.irs.gov/content/6209/section-11-8-3.html
COLLSTCD26	C	Open Collection status (e.g. assigned to revenue officer, Automated Collection, or is in Collection queue).
OIC	O	Offer-in-Compromise Pending (TC480 on an IMFOLT or TXMOD.)

Document	Location of Indicators:
Form 5546	Line 18, left side of page. Display: BANKRUPTCY, CURNOTCOLL, COLLSTCD26, or OIC
AMDISA Print	Line 22 of Page 1. Display: BANKRUPTCY, CURNOTCOLL, or COLLSTCD26, or OIC
CDE Taxpayer Information Sheet	Line 2, Collectability Indicator. Display: B, N, C, or O

- (3) The following actions should be taken if a collectability indicator is reflected on the examination return charge-out document, an AMDISA, or the CDE Taxpayer Information Sheet. These procedures apply to classification of any type of inventory (except National Research Project (NRP) inventory, TEFRA partnerships, and Abusive Transaction (AT) investigations).

- a. Returns will be classified and either accepted as filed or selected for audit based upon the potential for tax change. **On returns selected for exam, the classifier must document the consideration of the collectability indicator in the remarks section of the classification check sheet.** A statement such as "Collectability Indicator considered in selecting this return for audit." should be included on the checksheet. If there is a TC 780 on the IMFOLT or TXMOD, **DO NOT SELECT FOR AUDIT.**

Note: A TC 780 posted to an account means the IRS has accepted an offer (almost always Doubt as to Collectability) and the account is closed. No additional assessments or abatements can be made.

- b. The collection indicators are systemic flags to alert the examiner and classifier to consider collection potential. In some instances, the indicator may not be based on current information (for example, bankruptcy discharge 7 years prior). The classifier or coordinator may need to obtain additional IDRS research to make a selection decision.

- (1) Identity Theft can cause a return which was not filed by the taxpayer to be shown during classification. Special procedures are required to ensure classification occurs of returns that actually belong to the taxpayer.

- (2) For IMF returns, review ENMODA and IMFOLE to identify ID Theft indicators via transaction code 971 with action code 522. If the ID Theft action code is present, review the secondary date (SCNDRY-DT) field to identify the affected year.
- (3) For BMF returns, review TXMOD and BMFOLT to identify ID Theft indicators via transaction code 971 and action code 522 for the year being classified.
- (4) If the year with an ID Theft indicator on the module is different than the year being classified, proceed as normal. If ID Theft is identified for the year being classified, provide the return information (taxpayer's name, TIN, tax period, CDE Case File ID, and CDE Workload Set ID) to the PSP contact assigned to the detail. The PSP contact will coordinate with the Area ID Theft Coordinator who will determine the appropriate actions to take on the case. Continue with classification, but do not finalize the Workload Set until direction is received from the PSP contact or ID Theft Coordinator.

4.1.5.3.2.12
(04-18-2023)
Freeze Codes

- (1) Certain freeze codes indicate that a return should not be examined. CDE is programmed to prevent including cases with the impacted freeze codes into a Workload Set, but the classifier should also be aware in case a freeze code is added after the creation of the Workload Set.
- (2) Returns with a "-C" (combat zone), "-V" (bankruptcy), "-W" (IRS Litigation), or "-Z" (Criminal Investigation) freeze codes should be classified as "Accept as Filed".

4.1.5.3.2.13
(04-18-2023)
**Classification Criteria
Criminal Restitution
Returns**

- (1) Once a criminal case has been completed, the closing documents (case closing package) will be sent to Technical Services. For additional information, see IRM 4.8.11.7, Special Features for Civil Resolution Cases With Restitution-Based Assessments. If the case is not in fraud or grand jury suspense, the case will be sent to the SEP Grade 14 SME for field classification.
- (2) The SEP Grade 14 SME should consider the following factors in their aggregate, and the case facts and circumstances when classifying such returns.
 - a. **Collectability** - Is there any chance of collection? Is there enough economic potential to pursue? Has the court ordered restitution to third-party victims?
 - b. **Asset forfeiture case** - Have all the assets been identified and have they been seized by the IRS or other agencies?
 - c. **Full Paid** - Has the court ordered restitution been paid in full? Has the taxpayer fully cooperated with the IRS? What is the intent of the taxpayer? Is it worthwhile for us to pursue the Civil Fraud Penalty only?
 - d. **Sentence** - How long is the taxpayer's sentence? What is the age of the taxpayer? After incarceration, will the taxpayer be able to make regular payments toward an outstanding liability?
 - e. **Deminimis tax** - Are the additional tax and penalties material enough to reopen the case and expend field resources? If reopening for the Civil Fraud Penalty is it material enough?
 - f. **Public Records** - Is there a sufficient amount of information to determine the taxpayer's liability in available public records? Does the Service have documentation to support the Civil Fraud Penalty if applicable?

- g. **Original Tax Return** - Do we have the original return? If not, can the SME obtain the original returns? Some Area Counsels will not provide approval of the Civil Fraud Penalty if the original return is not available.
- h. **Rule 6(e)** - Is there enough non-grand jury information available to determine the correct tax liability and sustain the civil fraud penalty?

4.1.5.3.3
(04-18-2023)

Review of Classification

- (1) The PSP Territory Manager (or designee) has primary responsibility for assuring the quality of returns selected for audit whether classification is done at the campus or electronically. This is accomplished by assuring all classifiers have received appropriate training on tax law and area classification instructions. During each classification detail, the PSP Territory Manager (or designee) should review a representative sample of selected and accepted returns for each classifier and provide appropriate feedback to the classifier and PSP Classification Section Chief. See IRM 4.1.5.3.3.2, Review of Performance.
- (2) For national or centralized classification details, the headquarters representative is responsible for assuring the quality of returns selected for audit. During each classification detail the headquarters representative should review a representative sample of selected and accepted returns for each classifier and provide appropriate feedback.
- (3) Form 5126, Classification Quality Review Record, may be used to provide feedback.

4.1.5.3.3.1
(04-18-2023)

Standards for Classification

- (1) DIF returns are identified for classification by an algorithm/model designed to score returns.
- (2) All returns will be classified by experienced examiners to select returns that contain significant issues. Classifiers must use their skills, technical expertise, local knowledge, and experience to identify issues. The classifier will determine whether the return should be examined, and if so, whether by an RA, TCO-09 (or below), or TCO-11. Returns not selected for audit will be accepted as filed.

Exception: When appropriate, an automated classification tool using data analytics (such as Issue Recommender) should be substituted for a human classifier.

- (3) The classifier should first review the entire return. This action is important as it allows the classifier to:
 - a. evaluate the overall financial status of the taxpayer
 - b. create materiality thresholds for line items
 - c. identify relationships of reported (or unreported) items on the return
- (4) Where appropriate, returns should be classified by examiners with subject matter expertise. If a subject matter expert classifies a return, they may not subsequently assist with the examination.

Example: Revenue agents in a flow thru group may classify partnership and S Corp returns as long as they will not subsequently work the return or be requested to assist in the examination.

- (5) During the classification process, the preliminary scope of the audit will be determined for all returns. The number of issues should be limited to no more than three.
- (6) Financial status must be considered on all returns. SB/SE taxpayers are responsible for two-thirds of the tax gap and two-thirds of that amount is attributable to unreported income. If it appears the taxpayer has insufficient income for the lifestyle indicated on the return, financial status is a potential issue. Consider family size and personal living expenses in relationship to the income stated on the return.
- (7) Classifiers may use all available data during classification to help identify the most non-compliant taxpayer including, but not limited to:
 - MeF
 - IDRS
 - Internet
 - yK1/CKGE
 - Accurint or any other third party research data
 - Return Preparer Database (Return Preparer Program)

4.1.5.3.3.1.1 (04-18-2023)

Materiality-Significance of the Issue

- (1) Classifiers should compare the potential benefits to be derived from examining a return to the resources required to perform the exam. Although some potentially good issues may be identified on the return, if they would not yield a significant adjustment, the return should be accepted as filed.
- (2) There are several factors that must be considered when determining whether an item is significant:
 - a. Comparative size of the item (e.g., A questionable expense item of \$6,000 with total expenses of \$30,000 would be significant. However, if total expenses are \$300,000, ordinarily the item would not be significant.)
 - b. Inherent character of the item - Although the amount of an item may be insignificant, the nature of the item may be significant (e.g., airplane expenses claimed on a plumber's Schedule C).
 - c. Evidence of intent to mislead - This may include incorrectly showing an item on the return or missing, misleading, or incomplete schedules.
 - d. Beneficial effect of the manner in which an item is reported (e.g., Expenses claimed on a business schedule rather than claimed as an itemized deduction may be significant.)
 - e. Relationship to other item(s) on a return (e.g., Business expenses without corresponding income or the lack of dividends reported when Schedule D shows sales of stocks are indicators of potential issues.)
 - f. Permanency of the potential adjustment - A permanent adjustment is more material than one that will reverse itself in subsequent years.
 - g. Timing adjustments - The longer the deferral/acceleration period, the more material the item.

4.1.5.3.3.1.2 (04-18-2023)

Fraud Potential

- (1) Classifiers should be alert to indications of fraud on the returns being classified which may include the following:
 - a. The presence of questionable credits indicating refund schemes and abusive transactions.

- b. Typed or handwritten W-2 Forms showing a large business corporation or government agency could indicate a potential fraudulent refund scheme. Large corporations or government agencies normally would use computer generated W-2 forms.
- c. Three-year comparison of return could show significant changes.
- d. Altered Forms W-2 and 1099 could indicate a potential fraudulent refund scheme.

- (2) See IRM 25.1.2, Fraud Handbook, Recognizing and Developing Fraud, for a list of fraud indicators.

4.1.5.3.3.2 (04-18-2023)

Review of Performance

- (1) A manager (see paragraph 4 below) or headquarters representative will conduct reviews of each classifier. Reviews should be performed for each detail to which an examiner is assigned and on a regular basis for permanent classifiers. A 10% sample of the classifier's returns is required to be reviewed. The sample can be expanded as needed. The sample should include a balanced review of the return types being classified. Through these reviews the manager or headquarters representative will determine if:

- a. Returns are selected for exam or accepted as filed by classification in accordance with established procedures.
- b. Accepted returns have little or no audit potential or if examined would probably result in no change cases.
- c. Classification checksheets are properly completed.
- d. Returns are properly selected for RA, TCO-09 (or below), or TCO-11 exams.
- e. The potential tax change is sufficient to warrant selection, especially on returns with a negative taxable income.
- f. Classifiers are maintaining a high level of technical proficiency, exercising good judgment in accepting and selecting returns, and effectively using their time.
- g. Classifiers need additional training for classifying DIF returns or classification of other returns.

Exception: Some types of examination may not require a classification and therefore will not require a 10% review (e.g. HQ CIPs). A flow chart to aid in determining which returns require review is provided in Appendix 2 of the National SB/SE Classification Guidelines which can be found at: <http://mysbse.web.irs.gov/examination/tip/classification/default.aspx>.

- (2) Classification reviews will be documented and discussed with the classifier prior to the end of the detail. Form 5126, Classification Quality Review Record, is provided for this purpose and will be retained for two years by the PSP Territory Manager or headquarters analyst. A copy of Form 5126 will be forwarded to the classifiers' group manager.
- (3) A concurrent documented review of returns "selected for exam by classification" and returns "accepted as filed by classification" is important. Real time feedback ensures the most accurate classification. The review will determine if there is a need for additional guidance to be provided to the classifier.
- (4) For area classification details if the reviewing manager is other than the PSP Territory Manager or Classification Section Chief, the PSP Territory Manager will be responsible for orientation of the manager regarding classification objectives, instructions to classifiers, quality review procedures, and the

documentation to be maintained. The PSP Territory Manager will retain overall responsibility for the quality of the returns selected which includes the work performed by other managers. In order to ensure the desired quality of selections, the PSP Territory Manager must maintain open communication with the Classification Section Chief.

- (5) For headquarters centralized classification details, the headquarters analyst responsible for the classification detail will be responsible for the classification objectives, instructions to classifiers, quality review procedures, and the documentation to be maintained.

4.1.5.3.4 (04-18-2023) **Identifying Issues on Individual Returns**

- (1) The goal of the classification guidelines is to achieve greater efficiency in the classification and examination processes. Select specific issues and do not select “all” expenses. “Other” expenses should only be selected when identifying the line with that name or when the expense details aren’t available (e.g., classification from a CDE print or transcript when large expense aren’t transcribed). When appropriate, the classifier should make a remark/comment explaining to the examiner that the classified issue is the non-transcribed expenses..
- (2) The classifier should review IRM 4.1.5.3.4.2, Potentially Productive Issues on an Individual Business Return, to identify questionable business schedules during the classification process.
- (3) Classify the appropriate income or expenses when a Schedule C, E, or F doesn’t appear to be a legitimate business. Notate the **Remarks** with **Is this a legitimate business?**.
- (4) Hobby Loss – When a Schedule C, E, or F does not appear to be a business engaged in for profit (Hobby Loss), the examination should focus on whether the taxpayer has a profit motive. Classify Hobby Loss (Section 183) via **Other Issue** selection and explain in the **General Comments**. Review additional years using the 3-year CDE return, MeF, or IDRS prior to selecting Hobby Loss as an issue.
- (5) Questionable Preparer - If a potential questionable preparer is identified, prepare Form 14719, SB/SE Return Preparer Referral and submit to the PSP contact assigned to the classification detail with a list of CDE Case File IDs and Workload Set IDs (or equivalent for non-CDE classifications). The PSP contact will coordinate with the area Return Preparer Coordinator who will decide if any further consideration of a program action against the preparer is warranted. Continue to classify the appropriate income or expenses on the return.
- (6) Classify the appropriate income or expenses when there is a questionable preparer known to inflate expenses, understate income, or include fictitious schedules. Notate the “Remarks” section with “Questionable preparer.”

4.1.5.3.4.1 (10-20-2017) **Potentially Productive Issues on an Individual Return**

- (1) The following are potentially productive issues on individual returns.

4.1.5.3.4.1.1
(04-18-2023)

Unreported Income

- (1) Is the income sufficient to support the exemptions claimed?
- (2) Is there an Installment sale of property but no interest has been reported?
- (3) Is all tip income reported if the taxpayer's occupation is listed as waiter, cab driver, porter, barber, hair stylist, etc.?
- (4) Are there substantial interest expenses with no apparent source of funds to repay the loans?
- (5) Does the taxpayer claim business expenses for an activity that shows no income on the return (e.g., beautician supplies, but no Form 1099 or Form W-2, Wage and Tax Statement, for that occupation)?
- (6) Is there a Form 1099-K, Payment Card and Third Party Network Transactions, on IRPTR that exceeds the income reported on the return?

Reminder: Form 1099-K filings may result in taxpayers reporting payment card amounts in their gross receipts, but they may not include all of the cash and checks. Certain businesses are cash intensive. Depending on the type of business, there may be substantial cash receipts in addition to the reportable payment card transactions.

- (7) Has the farmer received any farming subsidies, grants, or land leases (tenant farmer) that aren't reported on the return?
- (8) Is there a potential of inflated income in order to claim credits. (e.g. EITC)?

4.1.5.3.4.1.2
(04-18-2023)

Filing Status/Exemptions

- (1) Exemptions claimed by the non-custodial parent have proven to have high potential for adjustment. Consider Head of Household requirements.
- (2) When married persons file separately, both taxpayers are required to make the same election for standard or itemized deductions. If dependent children are claimed, the other spouse may also be claiming them.

4.1.5.3.4.1.3
(04-18-2023)

Capital Transactions

- (1) Gains on sales of rental and other depreciable property where the taxpayer has been using an accelerated method of depreciation should be questioned because the taxpayer may have to report ordinary income.
- (2) Loss on the sale of rental property recently converted from a personal residence is usually productive.
- (3) Carefully scrutinize current year installment sales and exchanges of property because taxpayers frequently make errors in computing the recognized gain.
- (4) Check to see if the gain on a sale is large enough to require the alternative minimum tax computation.

4.1.5.3.4.1.4
(10-20-2017)

Pension and/or Annuity

- (1) Check whether the taxpayer received a premature distribution from a pension/profit sharing plan.
- (2) Check whether distribution qualifies as a lump sum distribution.

4.1.5.3.4.1.5
(04-18-2023)
Rental Properties

- (1) Consider fair rental value.
- (2) If the rental property is located at the same address as the taxpayer's residence, consider whether the allocation is proper between the rental portion and the portion used personally by the taxpayer.
- (3) Repairs may be capital improvements.
- (4) Consider whether the cost of land is included in the basis.
- (5) Scrutinize the rental of vacation/resort homes.
- (6) Consider passive activity rules if rental losses are greater than \$25,000.
- (7) Consider Self-Rental. A property leased to a business in which the taxpayer materially participates is not passive.

4.1.5.3.4.1.6
(04-18-2023)
Schedule K-1

- (1) Returns containing only TCO type issues will be selected for office exam even if distributive income from Forms 1065, 1120S, or 1041 is present. However, if the Schedule K-1 requires the examination of a related BMF entity or other complex passthrough issues are present, the return will be assigned to a Revenue Agent.
- (2) Items of self-employment income shown on Schedule K-1 should be matched to Schedule SE to ensure the amounts are properly included in the self-employment tax computation.
- (3) Limitations for basis, at-risk, and passive activities should be considered.

4.1.5.3.4.1.7
(04-18-2023)
Moving Expenses

- (1) After December 31, 2017 and through January 1, 2026 no deduction is allowed for moving expenses. There is an exception for military-related moving expenses.
- (2) Review Form W-2 for address and other compensation. Also, consider sale of residence.
- (3) Did the taxpayer move more than 50 miles? Sources to identify the previous address include: INOLES, ENMOD, MeF, RTVUE, IRP, or locator service (Lexis Nexus or Accurant). Members of the Armed Forces do not have a requirement to move more than 50 miles.
- (4) Moving expenses should not be classified if the taxpayer has reported income from reimbursement from his employer. The reimbursement should be identified on the Form W-2 and included in income from wages and salaries. Reimbursed military-related moving expenses by the government are not included in income and are not deducted.

4.1.5.3.4.1.8
(04-18-2023)
Itemized Deductions

- (1) Important! Look first at overall potential based on the amount by which the itemized deductions exceed the standard deduction.
- (2) Verify itemized deductions are not claimed elsewhere on the return when the standard deduction has been elected (e.g., personal real estate taxes and mortgage interest deducted on rental schedule).

- (3) If filing status is Married Filing Separate, verify consistency between the returns (e.g., if one spouse itemizes then the other cannot take the standards deduction).

4.1.5.3.4.1.8.1
(10-20-2017)

Medical Expenses

- (1) High medical expenses for large families, deceased taxpayers, or older taxpayers are usually not productive.

4.1.5.3.4.1.8.2
(10-20-2017)

Taxes

- (1) Consider changes in address when reviewing real estate taxes (e.g., Form W-2, Form 1040, Form 8949, Sales and Other Dispositions of Capital Assets).

4.1.5.3.4.1.8.3
(04-18-2023)

Interest Expense

- (1) Productive issues could come from payments to individuals and closing costs on real estate transactions.
- (2) Home mortgage interest varies by locality. Special attention should be paid to those areas where housing costs are high (over \$1,000,000). Taxpayers are only allowed to deduct mortgage interest on qualifying loans up to \$1,000,000 on tax returns filed for tax years 2017 or earlier, or for tax returns filed for tax years 2018 or later if the taxpayer incurred the underlying acquisition indebtedness on or before December 15, 2017, or entered into a written binding contract on or before December 15, 2017, to close on the purchase of the principal residence before January 1, 2018. Starting with the 2018 tax year, the mortgage interest deduction is generally limited to interest on aggregate acquisition indebtedness of \$750,000 or less.

4.1.5.3.4.1.8.4
(04-18-2023)

Charitable Contributions

- (1) Check to see if contributions exceed 50 percent of adjusted gross income (AGI) or 60 percent of AGI for cash contributions. However, check tax years if contributions exceed 50 percent (or 60 percent for cash contributions) and were qualified contributions for disaster relief.
- (2) Check large donations if they appear questionable. Organization's charitable status can be checked via the IRS Tax Exempt Organization Search at <https://apps.irs.gov/app/eos/>
- (3) Check for payments which may represent tuition.
- (4) Check for large dollar non-cash contributions.

4.1.5.3.4.1.8.5
(10-20-2017)

Casualty or Theft Loss

- (1) Watch for business assets, valuation methods, and statutory limitations.
- (2) Erroneous claims may be identified when there is a declaration of disaster for the area.

4.1.5.3.4.1.8.6
(04-18-2023)

Miscellaneous Deductions

- (1) Scrutinize large, unusual, or questionable items.
- (2) Gambling losses should not exceed gambling income under "Other Income" on page 1 of Form 1040.

4.1.5.3.4.1.8.7
(04-18-2023)
Employee Business Expenses

- (1) No employee business expenses shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026 unless the taxpayer is an Armed Forces reservist, qualified performing artist, fee-basis state or local government official, employee with impairment-related work expenses or eligible educator. If EBE is reported and the taxpayer does not fall under one of these categories, this may be productive.
- (2) Amounts should be reasonable when compared to the taxpayer's occupation and income level.
- (3) Avoid auto expenses as an issue where the standard mileage computation is used and the mileage shown does not appear excessive.
- (4) Transportation expenses for construction workers, carpenters, etc., who appear to have several different employers at different locations, have not proven to be productive. However, be alert for expenses claimed for travel to a remote job site(s).
- (5) Expenses incurred on or before December 31, 2017 for clubs, yachts, airplanes, etc., must meet the facilities definition of IRC 274 and therefore, are usually productive issues. After December 31, 2017, generally no deduction is allowed for entertainment expenses, including facilities.

4.1.5.3.4.1.9
(10-20-2017)
Alternative Minimum Tax (AMT)

- (1) If AMT is paid, the materiality of the adjustment should be considered since an increase to the regular tax would cause a decrease to the AMT.

4.1.5.3.4.1.10
(04-18-2023)
Credits

- (1) Below is a chart of potential issues for each credit.

Credits	Look for
Child and Dependent Care Expenses	<ul style="list-style-type: none"> • Duplicate dependents • Dependents > age 12 • TP claiming credit without claiming the dependent (some exceptions for divorced, etc.) • Adjustments to the credit when employer provides payments or benefits (shown on W-2)
Education Credits	<ul style="list-style-type: none"> • MFS return, TP being claimed as a dependent on another return, or non-resident alien which makes them ineligible • Credit phase-out over certain income levels • Students under age 24 as they have some additional requirements for the refundable portion of the AOTC credit. • Multiple credits taken as only one education credit per student per year is allowed • Form 1098-T, Tuition Statement, on IRP from the institution on qualified expenses (credit can be higher than this form)

Credits	Look for
Foreign Tax Credit (FTC)	<ul style="list-style-type: none"> Foreign corporations, nonresident alien individuals, and bona fide residents of certain U.S. possessions that are not engaged in a U.S. trade or business are not subject to tax on non-U.S. source income. Accordingly, they are not entitled to the FTC. The following are examples of payments not creditable as taxes: <ul style="list-style-type: none"> Penalties, interest, fines, and custom duties, Compulsory loans, and Amounts reasonably certain to be refunded, credited, rebated, abated, or forgiven.
Low Income Housing	<ul style="list-style-type: none"> Form 8823, Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition Recapture rules if the building is sold when determining basis
Premium Tax Credit (PTC)	<ul style="list-style-type: none"> Eligibility for PTC can be found at https://www.irs.gov/affordable-care-act/individuals-and-families/eligibility-for-the-premium-tax-credit. Health care coverage under Medicare, Medicaid, TRICARE or CHIP are not allowed, so look for age of TP and if military or retired military. MFS return or if the TP is claimed as a dependent on another return as they are not usually eligible
Residential Energy Credits	<ul style="list-style-type: none"> Year placed in service as the credit is only available for certain property placed in service after 2017 and prior to 2024. Subsidy provided by any public utility for the purchase or installation of an energy conservation product as the credit must be reduced by the subsidy
Small Employer Health Insurance (Form 8941)	<ul style="list-style-type: none"> Years the credit is claimed because after 2014, only two consecutive years of credit can be claimed Properly applied phase-outs for employers with >10 full time employees and average annual wages of \$25,000 or less Situations where >25 employees and average annual wages >\$50,000 are present as no credit is allowed SHOP marketplace checkbox as this is required starting in 2014 Flow-through shareholders/partners' Schedule K-1

4.1.5.3.4.1.11

(04-18-2023)

Other Taxes

(1) 10% penalty on early withdrawal from qualified retirement plans

(2) Health care individual responsibility

4.1.5.3.4.1.12

(04-18-2023)

Digital Assets

(1) Review gains on sales of digital assets to determine if the taxpayer reported taxable transactions as ordinary income or capital gains, as appropriate.

(2) Verify Form 1099-K, Payment Card and Third Party Network Transactions, is reported on the return.

(3) Consider tax implications if the taxpayer's occupation is listed within the digital assets industry, gig economy, etc.

4.1.5.3.4.1.13
(04-18-2023)
**Carrybacks and
Carryforwards**

- (1) The tax effect of carrybacks and carryforwards of losses and/or credits should be considered when applying the criteria in IRM 4.19.11.2.1, Procedures for Screening Individual Returns.

4.1.5.3.4.2
(10-20-2017)
**Potentially Productive
Issues on an Individual
Business Return**

- (1) The following are potentially productive issues on Schedule Cs or Fs.

4.1.5.3.4.2.1
(04-18-2023)
Net Profit

- (1) Is the taxpayer engaged in a type of business or profession normally considered more profitable than reflected on the return?
- (2) Do the address, real estate taxes, and/or mortgage interest indicate a higher standard of living than justified by the reported income?
- (3) Does the return reveal large amounts of interest and dividend income not commensurate with current sources of income?

4.1.5.3.4.2.1.1
(04-18-2023)
**Section 183, Activities
Not Engaged in For
Profit**

- (1) Taxpayers who have significant income from other sources may try to reduce their taxable income by reporting losses from activities that may or may not be engaged in for profit.
- (2) Does the taxpayer have losses in three out of the last five years, or two out of the last seven years for breeding, training, showing, or racing horses? If so, it may indicate a hobby.
- (3) There are certain types of activities that lend themselves to hobbies/activities not engaged in for profit:
 - Rental properties have many rules and material participation is one that is hard to overcome if the TP is just an investor and not a real-estate professional.
 - Collecting antiques, collecting cars, etc.
 - Part-time activities for entertainment or to pass time such as racing, farming, etc.
 - Personal products for personal use
- (4) IRC section 183 generally limits the deductibility of expenses to the amount of income reported if an activity (business or rental) is not engaged in for profit. IRC 183 is a permanent disallowance provision.
- (5) Each activity must be evaluated separately. Multiple activities cannot be combined to determine profitability.

4.1.5.3.4.2.2
(10-20-2017)
Cost of Goods Sold

- (1) Check for the possibility of withdrawal of items for personal use.
- (2) Is the ending inventory inclusive of all costs, direct and indirect?

4.1.5.3.4.2.3
(10-20-2017)
Bad Debt Deduction

- (1) Is it a cash business?
- (2) Is it disproportionate for the indicated value of sales?

4.1.5.3.4.2.4
(10-20-2017)
Depreciation

- (1) Does the schedule contain an adequate description of the asset?
- (2) Are personal assets being depreciated?
- (3) Consider sales of property simultaneously with depreciation issues.

4.1.5.3.4.2.5
(10-20-2017)
Sale of Assets

- (1) Is there a sale of business assets during the year without depreciation recapture?
- (2) Is the gain large enough to require the alternative minimum tax computation?

4.1.5.3.4.2.6
(04-18-2023)
Farm Returns

- (1) In the analysis of a Schedule F, the classifier should keep in mind the unique features of a farm return. The farmer may be engaged in a specialized area of dairy cattle, beef cattle, grain, swine, vegetables, poultry, or a multiple of these items. The operation may vary from that of a few acres to several thousand acres. The operator of the farm may rent all the land farmed or may own all or a portion of it. The variety of farms require the classifier to consider appropriateness of income and expenses based on the other amounts present on the return. Consider whether the farm is an actual business operation or a hobby.
- (2) Consider whether payments from farmers' cooperatives are reported.

4.1.5.3.4.2.7
(04-18-2023)
Net Operating Loss Deduction

- (1) Be aware of the taxable income on the return. Use judgment to determine if a net operating loss (NOL) carryback or carryforward should be examined. There are instances where the current year NOL as well as the NOL carry forward is not accurate and therefore the NOL deduction should be selected as an issue. If the loss cannot be substantiated, it can be disallowed.

4.1.5.3.4.2.8
(04-18-2023)
Self-Employment Tax

- (1) All returns should be screened for self-employment tax issues, including returns with Schedule SE attached. Look for non-wage income such as director's fees, contracting services, miscellaneous income, partnership income, etc., which may be subject to self-employment tax.
- (2) Some items of income earned by independent contractors may be reported as wages or other income. Where the income appears to be personal service income, it must be considered for self-employment tax purposes.

4.1.5.3.5
(04-18-2023)
Corporate Classification—General

- (1) Corporate returns are identified by three categories; DIF, non-DIF, and automatics. Returns which do not meet automatic criteria, are scored under the DIF system. Returns which meet automatic criteria, regardless of size, are not computer scored. Automatic criteria are contained in IRM 3.11.16.10.1, Audit Codes.
- (2) Screening procedures for DIF-scored 1120 returns are essentially the same as for other DIF returns.
- (3) The corporate DIF system includes returns in Activity Codes 203 through 217. All other corporate returns are Non-DIF.
- (4) Classification of the corporation return must include the balance sheet and Schedule M items. Substantial change in accounts receivable, reserve for bad debts, loans to or from stockholders, accounts payable, treasury stock, capital stock, or retained earnings would indicate an audit of these items may be

warranted. In addition, such potential issues such as “Thin Corporation,” IRC 531, substantial changes in accruals, and decreases in assets which are not accounted for on Schedule D of the return may be identified from an inspection of the balance sheet.

- (5) All Schedule M items should be scrutinized to determine the difference between income shown on the books and taxable income shown on the tax return.
- (6) The following general items must also be considered during classification:
 - a. Overall composition of the return. Is the return complete, containing all necessary information and schedules? Who prepared the return?
 - b. Data reported on the return compared to the norms and standards of the business or industry of the taxpayer.
 - c. Location of the business. This could have a bearing on the volume of business.
 - d. Prior Audit results as indicated on Form 5546, Examination Return Charge-Out Sheet.
 - e. The existence of controlled groups, interests in foreign corporations, deductions for facilities, or convention expenses.
- (7) Significant issues identified on manually classified Form 1120 returns will be reflected on Form 10264, Revenue Agent - Classification Checksheet.

4.1.5.3.5.1
(04-18-2023)
**Potentially Productive
Issues on a Corporate
Return**

- (1) Experience has shown the following characteristics result in potentially productive issues:
 - New corporation that incorporated an ongoing business and reflects goodwill, other boot, or accelerated depreciation
 - International features: a copy of a National Office approved technical ruling attached, but all conditions set forth in the ruling have not been met
 - Liquidation under IRC 331, IRC 332, IRC 336, IRC 337 (generally trigger recapture under the provisions of IRC 47, IRC 1245, and IRC 1250)
 - A consolidated return, especially one that does not contain schedules showing each member's respective share of income, expense, assets, liabilities, and capital
 - A short period return
 - Credits and/or losses carried forward when information on the return indicates the item(s) should have been carried back
 - A member of a controlled group, claiming the full amount of the surtax exemption, etc., and not including a properly executed election
 - Last-in, first-out (LIFO) inventory method being used for the first time
 - Manufacturing concern not using the full-absorption accounting method to value inventory
 - Substantial passive income which may indicate a personal holding company
 - A low asset return reflecting a net operating loss
 - Returns with minimum tax issues
 - Foreign tax credit claimed on the return

4.1.5.3.5.2
(04-18-2023)

Profit and Loss Method

- (1) Some of the items to be considered under the profit and loss approach are:
- a. Large or unusual changes in inventories or no inventory reflected for non-service type business
 - b. Sales of assets without a Form 4797, Schedule D or Supplemental Schedule of Gains and Losses, attached
 - c. No amount claimed as amortization on a newly formed corporation
 - d. Amounts claimed as other deductions without supporting schedules attached
 - e. Questionable bad debt, either under the specific write-off or reserve method
 - f. Expenses that may be high or unusual for the type of business

4.1.5.3.5.3
(04-18-2023)

Balance Sheet Method

- (1) A balance sheet approach, paying particular attention to substantial changes between opening and closing balances, can disclose a number of potential issues. Some issues which may be identified include:
- a. Cash - a large ending balance could indicate an IRC 531 issue or a negative balance could indicate improper accruals
 - b. Trade Notes and Accounts Receivable - a change in accounting method, premature write-offs, excessive deduction for bad debts, or interest income unreported could indicate issues
 - c. Inventories - look for a change in method of valuation, change in nature of business, or possible write-down
 - d. Investments - interest income and dividend income understated or omitted, expense(s) of tax-free income deducted, unreported sales, erroneous basis, installment election, stockholder loans buried, or related party issues could indicate issues
 - e. Other current assets — look for deferred expenses
 - f. Loans to stockholders — could indicate a dividend or officer compensation issue
 - g. Building and other depreciable assets - unreported sales, investment credit recapture, or incorrect basis may be issues
 - h. Intangible assets - look for goodwill written-off or sale of license or patent
 - i. Loans from stockholders - thin corporation or interest deduction versus dividend may be issues
 - j. Other liabilities - look for improper accruals, deferred income accounts, or reserve for contingencies
 - k. Capital accounts - unreported sale, stock issued for services, or thin corporation may be issues
 - l. Paid-in surplus - diversion of earned income or IRC 351 issues may be present
 - m. Retained earnings — look for IRC 351
 - n. Treasury Stock - Potential dividend to stockholders or bargain purchase by a stockholder issues may be present
 - o. Schedules M-1 and M-2 - all items should be reviewed for proper tax treatment

4.1.5.3.6
(10-20-2017)

**Form 1120S
Classification - General**

- (1) Form 1120S returns are identified by three categories; DIF, non-DIF, and automatics. Returns which do not meet automatic criteria, are scored under the DIF system. Returns which meet automatic criteria, regardless of size, are not computer scored. Automatic criteria are contained in IRM 3.11.217.13.1, Audit Codes.

- (2) Screening procedures for DIF scored 1120S returns are essentially the same as for other DIF returns.
- (3) Significant issues identified on 1120S returns will be reflected on Form 10264, Revenue Agent - Classification Checksheet.

4.1.5.3.6.1
(04-18-2023)
**Potentially Productive
Issues on a S
Corporation Return and
Shareholder Returns**

- (1) Allocation of loss and deduction items claimed in excess of basis.
- (2) Diversion of income by the shareholder or payment of shareholder expenses by the corporation.
- (3) Repayment of shareholder's loans by the corporation where basis has been reduced by loss and deduction items.
- (4) Distributions and/or dividend payments made to shareholders in lieu of wages to avoid employment taxes. Rev. Rul. 74-44, 1974-1 C.B. 287, Small Business Corporation Dividends Paid Instead of Salaries.

4.1.5.3.7
(10-20-2017)
**Form 1065 Partnership
Classification - General**

- (1) Partnership returns are identified by three categories; DIF, non-DIF, and automatics. Returns which do not meet automatic criteria, are scored under the DIF system. Returns which meet automatic criteria, regardless of size, are not computer scored. Automatic criteria are contained in IRM 3.11.15.19.1, Audit Codes.
- (2) Screening procedures for DIF scored partnership returns are essentially the same as for other DIF returns.
- (3) Significant issues identified on partnership returns will be reflected on Form 10264, Revenue Agent - Classification Checksheet.

4.1.5.3.7.1
(04-18-2023)
**Potentially Productive
Issues on a Partnership**

- (1) The returns must be scrutinized both as to line items and the return as a whole to select returns with the highest audit potential.
- (2) Initial or first year returns are often productive. Common issues are:
 - a. Contributions to capital for possible recognition of gain or loss at the partners' level
 - b. Partners with no contributed capital where services may have been performed in exchange for the partnership interest
 - c. Large loss claimed on returns commencing business late in the year
 - d. Large loss claimed in relation to investment
 - e. Loss claimed in excess of investment through non-recourse financing. Loan and prepaid interest costs should be amortized over the life of the loan
 - f. Large depreciation deduction where property may not have been placed in service during the year
 - g. Start-up expenses (management fees, license fees, etc.) which should be capitalized
- (3) Final year returns are often productive. Common issues are:
 - a. Negative capital account considerations
 - b. Resolution of liabilities
 - c. Proper consideration of distribution of assets
- (4) Other areas applicable to partnerships:

- a. Additional contributions by a partner which could constitute a sale or exchange
- b. Special allocation of losses or specific deductions to partners
- c. Determine if there has been a change of ownership and consider proper allocations of distributive share items and potential basis adjustments
- d. Withdrawal by partners may include “phantom gain” through assumption of liabilities by others
- e. The sale or exchange of partnership assets may result in recapture of ordinary income
- f. Component or other depreciation method resulting in shorter than guideline lives
- g. Disguised sales or mixing bowl transactions (contributions of appreciated or depreciated property) triggered by improper use of contribution and distribution benefits

4.1.5.3.8
(04-18-2023)

Employment Tax issues

- (1) Be cognizant of potential employment tax issues when classifying income tax returns.

Caution: Because the relief provisions of Section 530 of the Revenue Act of 1978 can impact future employment tax audits, use caution when making worker classification determinations since prior audits can create a safe harbor from proper classification for taxpayers incorrectly treating their workers as non-employees.

- (2) Known or probable areas on non-compliance are listed in IRM 4.23.3, Employment Tax - Examination Programs and Examination Planning Procedures.

4.1.5.3.9
(04-18-2023)

Excise Tax Issues

- (1) Be cognizant of potential excise tax liabilities when screening income tax returns. Be alert for:

- a. Gasoline tax credit for aviation gasoline or gasoline used for non-highway purposes. The first credit is not allowable. The second instance indicates the taxpayer could be liable for highway use tax.
- b. Taxpayers with trucking operations may be liable for highway use tax, the excise tax on heavy trucks and trailers, the excise tax on certain tires, and/or certain fuel excise taxes.
- c. Returns indicating issuance of policies by foreign insurers. This would involve returns of insurance agencies, brokers, etc.
- d. Returns reporting manufacturing or use of pistols, revolvers, and firearms.

Example: Gun shops, target ranges, etc.

- e. Returns reporting flying services or aircraft sales.

Example: Charter service, flying schools, airplane repairs, etc.

- (2) Excise classification procedures can be found in IRM 4.24.18.13, Classification.

4.1.5.3.10
(04-18-2023)

Fiduciary Returns

- (1) Screening of fiduciary returns requires consideration of issues specific to fiduciary returns. While income tax issues will not be overlooked, quality classification requires consideration of the following issues and areas:

- a. Estate unduly prolonged (should not be more than 5 years unless very large) (Treas. Reg. 1.641(b)–3(a))
 - b. Business trust taxable as a corporation (IRC 7701(a)(3)) and Rev. Rul. 75–258. Or, it could be treated as a sham and the income is taxable to the grantor
 - c. Exemption — estate \$600; simple trust \$300; complex trust \$100
 - d. Indication of multiple trusts, which may be taxable as one trust (Treas. Reg. 1.663(c)–1(b))
 - e. Minimum tax (IRC 56) — tax preference items and/or exemption not apportioned between the estate or trust and beneficiaries based on share of income; also, prorate for short year
 - f. Wrong tax rate schedule used
 - g. Foreign tax credit and job tax credit not apportioned between estate or trust and beneficiaries based on income
 - h. Trusts normally cannot show Subchapter S income (IRC 643(a))
 - i. Indication of income taxable to grantor or another (IRC 671 through IRC 678) (e.g., sale and leaseback among related parties)
 - j. Error in computation of distributable net income (DNI) (IRC 643(a))
 - k. Rental or other income (e.g. from non-probate assets) may be taxable to devisees (IRC 691)
 - l. Partnership income; decedent's death before close of partnership taxable year. Share of partnership income erroneously included on Form 1040 instead of Form 1041
 - m. Special tax for trusts electing to report gain realized on the sale of property acquired from a transferor under installment method (IRC 691)
- (2) Distributions to Beneficiaries should be considered including:
- a. Beneficiaries not listed may not have picked up income
 - b. Estates are normally not required to distribute all income currently. No deduction is allowable if amount was not actually distributed
 - c. Estates and simple trusts normally do not distribute capital gains
 - d. Simple trusts must distribute all ordinary income (IRC 651) except income allocable to corpus (typically, capital gains)
 - e. Final year—all income deemed distributed, including capital gains (IRC 643(a)(3) and IRC 662(a)(2))
 - f. Losses or excess deductions are not distributable except in final year (IRC 642(h))
 - g. Distribution deduction may include: Specific legacy — not deductible (IRC 663(a)); or widow's allowance — deductible if from current income (Treas. Reg. 1.661(a)–2(c)) and taxable to widow
 - h. Excess (accumulated) distribution may indicate a complex trust. A separate Schedule J may be missing — reported by beneficiaries (Throwback Rule IRC 665(b))
 - i. Administrative and other expenses may actually be a disguised distribution to beneficiary. Failure to file Form K–1 (e.g., family allowance)
 - j. Excess distributions may indicate payment of specific legacies on which estate may have realized a gain
 - k. Nonresident alien beneficiary — where Form 1042S, Foreign Person's U.S. Source Income Subject to Withholding filed and required amounts of tax withheld
 - l. Terms of governing instrument (local law issues)
 - m. Consider if the return is for a family trust
- (3) Capital Transactions should be considered including:

- a. Significant capital losses normally should not occur in the first year of an estate
- b. Capital loss (net) is limited to a maximum of \$3,000
- c. Deduction limited to fiduciary's portion of capital gains (IRC 1202)
- d. Basis of assets: Estate of testamentary trust— inter-vivos trust—usually the donor's basis (IRC 1015) or income in respect of a decedent (IRC 691)
- e. Redemption of closely held stock may be dividend unless IRC 303 is complied with (IRC 302)
- f. Sale or exchange between related parties for inadequate consideration
- g. Estate tax marital deduction — executor satisfies pecuniary bequest with appreciated assets, thus triggering a capital gain
- h. Specific bequest — executor satisfies with appreciated assets, thus triggering a capital gain

(4) Expenses and Deductions:

- a. Allocation of expenses to tax-free income not made (IRC 265)
- b. Depreciation taken (basis)
- c. Allocation of expenses
- d. Funeral and medical expenses not deductible (IRC 641(b) and IRC 162(a))
- e. Other personal expenses and losses not deductible (IRC 641(b) and IRC 162(a)) (e.g. child care, funeral costs, medical expenses)
- f. Administrative expenses (e.g. attorney and CPA fees, and executor commissions) not deductible unless waiver for estate tax purposes made (IRC 642(g)). Also, no "double deduction" allowed for selling expenses used to offset the sales price on a sale of property in determining gain or loss if deducted for federal estate tax purposes
- g. Federal estate tax on income in respect of a decedent (computation omitted or erroneous) (IRC 691(c)). Estate tax examination will affect the computation
- h. Inheritance taxes are not deductible (IRC 164(b)(4))
- i. Charitable contributions — "set aside" amount is generally not deductible (IRC 642(c)(1)) unless the trust was created prior to October 10, 1969
- j. Executor commissions or attorney fees appear unreasonable under local law guidelines

4.1.5.4

(04-18-2023)

Storage of Returns

- (1) The PSP territory manager is responsible for monitoring return inventories. Lean inventories should be maintained to limit costly excess surveys and to allow for changing workload priorities. However, a high percentage of unstarted inventory may be warranted at specific times. For example:
 - a. Providing returns for training
 - b. When major computer programming changes are scheduled to occur that may delay the filling of return orders (e.g. implementation of major changes to Audit Information Management System (AIMS) or Examination Records Control System (ERCS), etc.)
- (2) AIMS Centralized Information System (A-CIS), Table 37, Statistical Sampling Inventory Validation (SSIVL), or ERCS data should be used to monitor aging of status 08 and status 10 returns. Two months of Status 08 inventory in Compliance Data Environment (CDE) should be sufficient. Excess inventory could indicate inefficient use of the return order and delivery system.

- (3) The inventory of selected returns may be stored electronically, in the area office, or in the campus.

Reminder: CDE returns are virtual inventory and no storage is required at the campus or area office.

4.1.5.4.1
(04-18-2023)
Inventory Stored at the Campus

- (1) Area Office work physically located in the Campus are stored in Employee Group Codes (EGCs) in the 10XX and 20XX series with returns separated based on type and status.
- (2) For a current EGC listing with definitions, see the **Employee Group Code (EGC) Contacts** by selecting the **AIMS Assignee Code (AAC) Contact Listings** located at <https://portal.ds.irsnet.gov/sites/vl091/lists/aims/contacts.aspx>.
- (3) Returns awaiting classification in Status 06 are stored in EGCs separated by paper filings and Mod e-File.

Caution: PSPs are responsible to monitor unclassified inventory within the area. Excess inventory may prevent proper ordering calculations.

- (4) As selected returns are received by CF&S from centralized classification, the AIMS status will be updated to **Status 08** and the case updated to the appropriate EGC based on the direction provided by the PSP contact.
- (5) If selected returns are maintained at the Campus, the selected returns will be placed inside a file folder and filed in AIMS serial number sequence.
- (6) The PSP Territory Manager has sole authority to approve the survey of inventory stored at the Campus. The PSP Territory Manager will send written authorization instructing the surveys. CF&S will pull the surveyed returns, stamp them with a survey stamp, and package them for closing. CF&S will apply disposal code 35 to close the returns off AIMS.

4.1.5.4.2
(04-18-2023)
Inventory Stored in PSP or CDE

- (1) The PSP and CDE Employee Group Codes (EGCs) are in the 1850 to 1999 and 2850 to 2999 ranges with returns separated based on type as shown in the following table:

Employee Group Code Ranges	Description
1850 to 1899 and 2850 to 2899	Non-CDE case files stored electronically (e.g., RGS, Shared Drive, etc.) or paper files in the PSP offices
1900 to 1905 and 2900 to 2905	Reserved for PSP employee time charges
1906 to 1989 and 2906 to 2989	CDE case files stored virtually
1990 to 1999 and 2990 to 2999	Miscellaneous special purposes

- (2) For a current EGC listing with definitions, see the **Employee Group Code (EGC) Contacts** by selecting the **AIMS Assignee Code (AAC) Contact Listings** located at <https://portal.ds.irsnet.gov/sites/vl091/lists/aims/contacts.aspx>.

- (3) Returns awaiting classification are in a CDE Workload Set or Status 06.

Caution: PSPs are responsible to monitor unclassified inventory within the area. Excess inventory may prevent proper ordering calculations.

- (4) CDE returns selected for examination are moved to Virtual Inventory which causes the establishment of the case on AIMS in Status 08.
- (5) Non-CDE returns selected for examination during classification are updated to Status 08 through ERCS or AIMS.

4.1.5.4.3 (04-18-2023)

Special Requests for Returns Assigned to CF&S

- (1) Periodically, there will be requests for returns assigned to an area office in status 08 EGC 2050, which indicates the return is part of the Centralized Scheduling Database (CSDB). These requests may come from exam personnel in the area or from functions other than exam, such as criminal investigation.
- (2) Area personnel should be instructed to contact a PSP Territory Manager (or designee) if they need a return which is currently assigned to CF&S. In addition, area personnel should be instructed never to update a record from status 08 EGC 2050 even if they are working from a copy.
- (3) Specific returns requested by an area examination function must be deleted from the CSDB. The return will be updated on AIMS to the requesting status and EGC by CF&S and forwarded to the area.
- (4) Requests for returns from area functions other than exam are handled differently. The returns are assigned on AIMS to a specific area. The returns will be deleted from the CSDB and forwarded to exam in an area office for coordination with the requesting function. A copy will be provided to the requester until the original return is received in the area office.

4.1.5.4.4 (10-20-2017)

Employee Returns

- (1) Employee returns require special processing depending on what system was used to classify the return.

4.1.5.4.4.1 (04-18-2023)

Employee Returns Selected via MCC (Campus)

- (1) When an employee return generated through the DIF system is classified and selected for exam, it will be forwarded to the PSP Territory Manager or their designee.
- (2) Employee returns selected for exam will not be stored at the campus.

4.1.5.4.4.2 (04-18-2023)

Employee Returns Selected via CDE

- (1) Returns classified in CDE will need to be transferred within CDE to the Employee Audit coordinator's assigned EGC. Deliver or transfer the cases after classification and prior to assignment to an exam group to ensure employees are not audited in their POD.

4.1.5.4.5
(10-20-2017)
**Coordination With
Centralized Files and
Scheduling**

- (1) Problems identified with returns received from CF&S should be brought to the immediate attention of the CF&S manager by either the PSP Territory Manager or the group manager.
- (2) It is important for the area PSP Territory Manager to have frequent discussions with CF&S management to keep abreast of the return orders and other issues.

4.1.5.4.6
(04-18-2023)
**Miscellaneous Items for
Centralized Storage**

- (1) Centralized storage related return(s) are two or more returns for the same taxpayer where one or more of the taxpayer's returns are being maintained in centralized storage (status 08), while another return is open in an exam status 10 or 12.
- (2) For returns located in the area office, the CF&S will pull the centralized stored return, update AIMS to status 10 for the same EGC as the other return(s) located in the area, and mail the return to that group for association.
- (3) For returns located in correspondence examination (EGC 5XXX) no action will be taken.
- (4) Multiple Returns: Multiple returns occur when two or more returns for the same taxpayer are concurrently maintained in centralized storage (status 08). CF&S will match the primary return to the multiple return, cross reference the folders, and file both returns in the file by the respective AIMS serial number.
- (5) Survey of returns from centralized storage: It is the responsibility of the area PSP staff to inform the campus when it is time to survey returns from centralized storage. See IRM 4.1.2.11, Procedures for Surveying Inventory in PSP, for more information. Returns should be surveyed as they become out-of-cycle or more frequently if needed.
- (6) EGC 2066 will also be used to store certain office examination returns with errors. Area PSP staff should review the EGC 2066 inventory to ensure these returns are properly addressed. There should be a minimum number of these returns.

4.1.5.5
(04-18-2023)
**Delivery of Selected
Returns**

- (1) The selection of returns should follow the outline of the examination plan which details the starts by purpose groups (formerly strategies) and workstreams within the purpose groups. There is no ranking among the purpose groups (e.g. purpose group 1 is not required to be delivered before purpose group 2). Instead, the exam plan is designed as a mix, and consequently, non-DIF work should be delivered to meet pro-rata volume for each purpose group and workstream in the exam plan. Return category and activity code are of no consequence for non-DIF work. Deviations in pro-rata starts by purpose group or workstream are expected, but the cause of any material deviation should be identified and documented by the Area. The PSP Territory Manager is responsible for ensuring primary returns are available for examination by the groups in a manner that accomplishes the plan. The current Purpose Group/Workstream/Strategy Coding List can be found at <https://organization.ds.irsnet.gov/sites/SBSEExamPPA/FS/Field/Priority%20Coding%20List/Forms/AllItems.aspx>. As of Fiscal Year 2022 the purpose groups are as follows:
 - a. **Training** examinations focus on preparing examiners to audit specific returns or issues. The examinations include IMF returns for Tax Compliance Officer and Revenue Agent, BMF returns for Revenue Agents, etc.

- b. **Policy** driven examinations align to the Service's rules or procedures including Employee Audits, Audit Reconsiderations, Innocent Spouse, etc.
- c. **Nonfiler** examinations are conducted to address instances where a Taxpayer should have filed a return, but they failed to do so.
- d. **Strengthen Compliance** examinations are focused on areas where there is fraudulent behavior, abusive transactions, or special types of compliance issues such as Research and Experimentation Credits, Digital Assets, Micro Captive Insurance, Syndicated Conservation Easement, etc.
- e. **Preparer or Promoter** examinations focus on the compliance of the return preparing community or those promoting particular tax positions. This purpose group includes Program Action Cases/Return Preparer Projects (PAC), Promoter projects, etc.
- f. **Research** studies provide the Service with information regarding compliance as well as the effectiveness of audit case selection methodologies. This Purpose Group currently contains National Research Project (NRP), Legislative Changes, Passthrough Selection Models, various selection techniques using Artificial Intelligence, Planned Corrective Actions resulting from TIGTA or GAO audits, etc.
- g. **Protection or Yield** driven examinations focus on the productivity of examinations and include Claims, Informant Claims, various referrals, etc.
- h. **Coverage** examinations provide a minimum number of audits for particular segments of the population to ensure compliance or act as filler work for additional examination resources not allocated to another Purpose Group. Coverage examinations include Coverage Mandates, DIF, etc.

Note: The focus of the exam plan information above is the primary return, but related pickups may occur to ensure compliance. The related pickups may not be examined for the same reason as the primary return, but they will typically fall within the same purpose group as the primary return.

- (2) To ensure consistent treatment when delivering returns, PSP coordinators will consider returns stored in CDE, PSP, and/or campus EGCs.
- (3) The Return Order and Delivery System (ROADS) should be used throughout the PSP process. ROADS assists when ordering DIF returns and determining the need for additional inventory at the exam groups. Additionally, ROADS supports assigning the appropriate returns to the exam groups to fulfill their need for inventory while meeting the exam plan. See <https://organization.ds.irsnet.gov/sites/SBSEfeEPD/ROandD/SitePages/Home.aspx> for a current copy of ROADS.

4.1.5.5.1 (04-18-2023)

ROADS Group Delivery Form

- (1) The ROADS Group Delivery Form determines the projected inventory needs within each Post of Duty (POD) within each Exam Group Code (EGC).

Note: Certain types of examinations or other circumstances (e.g. COVID-19) may warrant disregarding the POD.

- (2) The Group Delivery Form calculates the projected inventory needs to cover a period of time, normally 2 months. The inventory needs are calculated as follows.
 - 1. The total need for returns to start is calculated by multiplying the number of examiners times the number of months of inventory times the average primary starts per month. See IRM 4.1.2.2.1, Return Starts Analysis.

2. The current primary status 10 inventory is calculated by adding the exam group's primary status 10 inventory assigned to examiners in the POD to the primary status 10 unassigned inventory available for the POD.
 3. The projected inventory need is calculated by subtracting the current primary status 10 inventory (step 2) from the total need for returns (step 1).
- (3) The Return Classification coordinator (also known as Spigot or DIF coordinator) prepares the Group Delivery Form during the ordering cycle which typically occurs on a monthly basis. Once the Group Delivery Form is prepared, it is distributed to the Group Managers of the exam groups which typically occurs through e-mail. The Group Managers are then provided a period of time to provide any adjustments to the calculation before the inventory needs are fulfilled. Additionally, Territory Managers receive summary information via e-mail.

4.1.5.5.2
(04-18-2023)
ROADS Delivery Model

- (1) The ROADS Delivery Model determines the cases to deliver to the exam groups. The cases selected satisfy the inventory needs determined in the ROADS Group Delivery Form.
- (2) The Delivery Model selects returns from Status 08 optimizing the area's delivery to the exam plan's return mix. The necessary returns to support the Exam Plan mix are determined at the purpose group or workstream level. Additionally, for DIF inventory, the optimal mix is broken down to the Activity Code level. For each mix within the exam plan, the calculation of optimal returns is calculated by first finding the planned starts from the exam plan for the fiscal year to date through the cycle when the delivered returns will be started. Then, subtract the sum of the Fiscal Year to date primary starts and the current Status 10 inventory from the planned starts.
- (3) The Return Classification coordinator (also known as Spigot or DIF coordinator) prepares the Delivery Model once any adjustments are received from the Group Delivery Form. Once the Delivery Model is used to determine the cases to be assigned to the exam groups, digital communications are sent to respective coordinators or systems providing the required information to deliver the identified inventory to the exam group. Subsequently, the Delivery Model creates e-mails to notify the exam group of the inventory they should expect to receive as well as communicating the originating coordinator, office, and/or system (e.g. CDE) which will deliver the cases.

4.1.5.5.3
(04-18-2023)
Delivery of Returns From Campus

- (1) Returns are assigned from Central Storage and Centralized Files and Scheduling as outlined in IRM 4.1.5.4.1, Inventory Stored at the Campus.
- (2) Field Exam cases are generally assigned to the receiving group in status 10 from Central Storage. Office exam cases are generally assigned to the receiving group from Centralized Files and Scheduling in status 10 as "Pre-contact" cases.

4.1.5.5.4
(04-18-2023)
Control and Management of Tax Return and Return Information

- (1) All tax return information must be transferred via a Form 3210, Document Transmittal. The Form 3210 should be used to transfer returns outside of PSP or when a return is transferred from one coordinator's EGC to another coordinator's EGC. The sender must retain a copy of the Form 3210 for group control to monitor the transmittal. If acknowledgement is not received within 10 days, immediate follow-up should be made by phone, secured e-mail, or mail.

The Form 3210 requirement applies to all tax returns and associated information despite the source, including but not limited to, the following:

- Original return
 - Copy of original return
 - Return facsimiles including: Compliance Data Environment (CDE) prints, TRDBV, and RTVUE/BRTVU
 - Amended returns
 - Other prints from IRS systems
 - Documentation or prints from outside IRS systems
- (2) If Form 3210 is generated by ERCS, the control copy must be monitored in ERCS until the Form 3210 is acknowledged by the recipient. Once acknowledged, the Form 3210 is retained on ERCS for one year.