



MANUAL TRANSMITTAL

Department of the Treasury
Internal Revenue Service

4.1.5

JANUARY 21, 2026

EFFECTIVE DATE

(01-21-2026)

PURPOSE

- (1) This transmits revised IRM 4.1.5, Planning and Special Programs, Case Building, Classification, Storage and Delivery.

MATERIAL CHANGES

- (1) The following changes were made:

Reference	Change Details
IRM 4.1.5.1	Added primary stakeholders
IRM 4.1.5.1.1	Updated to include ECS role in identifying, selecting, and delivering returns
IRM 4.1.5.1.5	Added Program Controls section
IRM 4.1.5.1.6	Updated table to remove acronyms with few or no references in this section. Incorporated former IRM 4.1.5.1.6, <i>Terms</i>
IRM 4.1.5.2.3	Corrected FinCEN form names
IRM 4.1.5.3, IRM 4.1.5.3.1, IRM 4.1.5.3.2, IRM 4.1.5.3.2.6	Reorganized information from former IRM 4.1.5.3.1, <i>Classification Overview</i> , former IRM 4.1.5.3.2, <i>Classification Background</i> , former IRM 4.1.5.3.2.6, <i>Grading Returns (RA, TCO-11, TCO-09 or below)</i> , and former IRM 4.1.5.3.3.1, <i>Standards of Classification</i> , removing duplication and re-aligning information to improve flow
IRM 4.1.5.3.2.1	Moved from former IRM 4.1.5.3.3, <i>Review of Classification</i> , to improve flow. Incorporated former IRM 4.1.5.3.4.1.13, <i>Carrybacks and Carryforwards</i> , and former IRM 4.1.5.3.4.1.9, <i>Alternative Minimum Tax (AMT)</i> , to improve flow.
IRM 4.1.5.3.2.3	Removed outdated procedures related to local travel and the SSIVL
IRM 4.1.5.3.2.6	Replaced outdated procedures imposing geographic restrictions with procedures for remote examinations. Incorporated case grading information related to pass-through entities from former IRM 4.1.5.3.4.1.6, <i>Schedule K-1</i> .
IRM 4.1.5.3.2.8	Moved subsection from former IRM 4.1.5.3.2.5, <i>Classification Documentation</i> , to improve flow
IRM 4.1.5.3.2.9.1, IRM 4.1.5.3.2.9.2	Reorganized information between these two subsections to improve flow
IRM 4.1.5.3.2.11	Streamlined to focus on information relevant to classification
IRM 4.1.5.3.2.13	Removed -C from the list of freeze codes that cause CDE to remove a return from a workload set

Reference	Change Details
IRM 4.1.5.3.2.14	Moved this subsection from former IRM 4.1.5.3.3, <i>Review of Classification</i> , to improve flow
IRM 4.1.5.3.2.15	Removed outdated procedures to incorporate IGM SBSE-04-0825-0009, <i>Interim Guidance for Classification of Criminal Restitution Returns</i>
IRM 4.1.5.3.3, IRM 4.1.5.3.3.1	Reorganized information between these two subsections and restructured to improve flow
IRM 4.1.5.3.4	Updated subsections under IRM 4.1.5.3.4, <i>Identifying Issues on Individual Returns</i> , to incorporate legislative changes, update Digital Asset terminology, and realign carrybacks/carryforwards, AMT, and case grading of Schedule K-1 information to other subsections to improve flow
IRM 4.1.5.4.1	Moved PSP TM responsibility for surveys from IRM 4.1.5.4.6, <i>Miscellaneous Items for Centralized Storage</i> , to improve flow
IRM 4.1.5.5	Updated IRM 4.1.5.5, <i>Delivery of Selected Returns</i> , (and subsections thereunder) to incorporate return segments and updated policies which shift the responsibility of the Delivery Model from PSP to FCS. Added verbiage to clarify PSP responsibility.
IRM 4.1.5	Reviewed the IRM for editorial changes in accordance with the IRM Style Guide and plain language standards
IRM 4.1.5	Clarified language including rewording and restructuring throughout. Reviewed and updated all references and website addresses.

EFFECT ON OTHER DOCUMENTS

This IRM supersedes IRM 4.1.5, *Planning and Special Programs, Case Building, Classification, Storage and Delivery*, dated 04/18/2023 and incorporates Interim Guidance Memorandum SBSE-04-0825-0009, *Interim Guidance for Classification of Criminal Restitution Returns*, dated 08/11/2025.

AUDIENCE

Planning and Special Programs (PSP) in SB/SE Examination - Field

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Small Business/Self-Employed

4.1.5

Case Building, Classification, Storage and Delivery

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4.1.5.1
(01-21-2026)
Program Scope and Objectives

- (1) Purpose. This IRM Section provides guidelines and procedures to ensure uniform case building, classification, review, storage, and delivery of workload.
- (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) under Headquarters (HQ) Examination.
- (4) Program Owner. ECS is the office responsible for the selection of cases and delivery of inventory.
- (5) Primary Stakeholders. SB/SE HQ Exam Field Case Selection (FCS) and SB/SE Field Exam PSP
- (6) Contact Information. To recommend changes to this IRM section, contact the senior program analyst in FCS responsible for PSP IRM updates. See *Exam Procedures Knowledge Base – Headquarters Field Case Selection Contacts* for a list of FCS analysts.

4.1.5.1.1
(01-21-2026)
Background

- (1) ECS and PSP partner to identify, select, and deliver 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)
Roles and Responsibilities

- (1) Director, Exam Case Selection 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 Field Exam area.

4.1.5.1.4
(04-18-2023)
Program Management and Review

- (1) The following are resources that may be used to monitor the classification, storage, and delivery of inventory. This list is not all-inclusive.
 - A-CIS
 - Compliance Date Environment (CDE) (inventory report, select rate report, status 06 report)
 - Unstarted (Status 10 and below) returns by status code (available from Tables 36 and 37, SSIVL, or ERCS Tableau)
 - Volume and timing of return orders (Classification/Order Plan)

- New starts (available from A-CIS Open and Closed Case databases or ERCS Tableau)
- Return Order and Delivery System (ROADS)
- Exam Plan
- Starts & DIF Mix report (prepared by Workload, Planning, and Analysis (WPA))
- ERCS and/or CDE Tableau
- Program Control Database

4.1.5.1.5
(01-21-2026)

Program Controls

- (1) SB/SE Examination case selection functions operate under a framework of internal controls designed to ensure that examinations are selected with fairness and integrity in accordance with laws, regulations, and IRS policies. Key controls include the following.

- FCS periodically reviews procedural IRMs and revises them when content vital to tax law administration is no longer accurate.
- Managers review classifier decisions during manual classifications to ensure case selection quality.
- FCS regularly evaluates existing programs, considers emerging issues, assesses risk, and balances staffing changes to promote the highest degree of taxpayer voluntary compliance and ensure the most efficient use of examination resources.
- FCS reviews system access at least quarterly to verify the accuracy of system permissions where access is granted by FCS.

4.1.5.1.6
(01-21-2026)

Terms and Acronyms

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

Acronym	Definition
A-CIS	AIMS Centralized Information System
AIMS	Audit Information Management System
AMDISA	IDRS command code which displays up to six screens of information about the taxpayer's account for a specific tax period. Refer to IRM 2.8.3-7, <i>Command Code AMDISA</i> .
BMF	Business Master File
BRTVU	IDRS command code which displays associated returns/schedules/forms submitted by a specific filer. Refer to IRM 2.3.57-1, <i>Command Code BRTVU</i> .
CDE	Compliance Data Environment
CDW	Compliance Data Warehouse
CF&S	Centralized Files and Scheduling
CGT	Case Grading Tool
CKGE	CDW Knowledge Graph Environment
CTR	Currency Transaction Report
DIF	Discriminant Function

Acronym	Definition
DM	ROADS Delivery Model
ECS	Exam Case Selection
EGC	Examination Group Code
ENMOD	IDRS command code which displays name, address, and other entity information. Refer to IRM 2.3.15-1, <i>ENMOD Request</i> .
ERCS	Examination Returns Control System
FCS	Field Case Selection
FinCEN	Financial Crimes Enforcement Network
GAO	Government Accountability Office
GDF	ROADS Group Delivery Form
IDRS	Integrated Data Retrieval System
IMF	Individual Master File
INOLES	IDRS command code which displays specific data for the account addressed. Refer to IRM 2.3.47-1, <i>Command Code INOLE Input Screen</i> .
IRP	Information Reporting Program
IRPTR	IDRS command code which displays on-line payee transcripts of income reported on various document types. Refer to IRM 2.3.35, <i>Command Code IRPTR</i> .
MeF	Modernized E-File
NRP	National Research Program
PDs	Position Descriptions
POD	Post of Duty
PSP	Planning and Special Programs
RA	Revenue Agent
ROADS	Return Order and Delivery System
RPD	Return Preparer Database
RTVUE	IDRS command code which displays the transcribed line-by-line tax return information posted to IMF. Refer to IRM 2.3.52.2, <i>Command Code (CC) RTVUE</i> .
SB/SE	Small Business Self-Employed
SEID	Standard Employee Identifier
SSIVL	Statistical Sample Inventory Validation Listing
TCO	Tax Compliance Officer
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number

Acronym	Definition
TM	Territory Manager
TP	Taxpayer
TRDBV	IDRS command code which displays a summary of the available tax information on Tax Return Data Base (TRDB). Refer to IRM 2.3.73.2, <i>Command Code (CC) TRDBV</i> .
TXMOD	IDRS command code which displays tax information for a specific IMF or BMF module. Refer to IRM 2.3.11.3, <i>Command Code TXMOD</i> .

- (2) See IRM 4.1.1.1.6, *Terms*, for a list of common terms used in PSP and their definitions.

4.1.5.1.7
(10-20-2017)

Related Resources

- (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) Studies have been conducted to determine the value of having certain information available during the case selection phase of a tax return versus gathering the information during the audit process. These studies concluded the resources used to gather this information for the case selection phase are more than offset by the savings incurred by not pursuing unproductive 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, when applicable. These items are:
- Charge out document, Form 5546, *Examination Return Charge-Out Sheet*, or taxpayer information sheet from Compliance Data Environment (CDE) facsimile
 - Original return (only in special circumstances such as potential fraud)
 - Three-year CDE facsimile print
 - Integrated Data Retrieval System (IDRS) prints of various command codes
 - Financial Crimes Enforcement Network (FinCEN) information: i.e. Currency Transaction Report (CTR), Report of Foreign Bank and Financial Accounts (FBAR), Form 8300, *Report of Cash Payments over \$10,000 Received in a Trade or Business*, etc.
 - Taxpayer locator data compiled from various public information agencies
 - yK1 link analysis tool or CDW Knowledge Graph Environment (CKGE)
- Note:** These tools are useful if there are related entities or tiered ownership issues. They can be accessed at *yK1 application* or *CKGE*.
- Cover sheet, supplemental document, and/or supplemental directions, if appropriate
 - Return Preparer Database reports of taxpayers selected for examination who are engaged in return preparation activities, including non-filers

- Form 8886, *Reportable Transaction Disclosure Statement*
- Schedule K-1

- (4) There may be related entities that materially impact the taxpayer's tax liability. If reporting of related entity information makes it difficult to determine the taxpayer's correct liability without considering the items attributable to the taxpayer from the related entity, the information from the related entity should be gathered and associated with the taxpayer's file.

Example: A material source of the taxpayer's income is from a partnership reflected as an entry on a schedule where the income is offset with other non-related items.

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 allow for 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 the following data about the taxpayer and their account:
 - Current name, address, and filing status
 - Income sources and amounts
 - Audit activity
 - Filing requirements
 - Bankruptcy/Collectability indicators
 - Filing status and number of dependents
 - Prior names and addresses
 - Filing and payment transactions
 - Cross reference to other taxpayer identification numbers (TINs)
 - Prior adjustment to the tax liability that could impact the exam issue
- (3) IDRS information should be compared to 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 *SERP IDRS Command Code Job Aid*.

4.1.5.2.3

(01-21-2026)

**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 *BSA forms*:
 - FinCEN CTR Form 112, *Currency Transaction Report* – filed by financial institutions to report cash transactions in excess of \$10,000
 - FinCEN/IRS Form 8300, *Report of Cash Payments Over \$10,000 Received in a Trade or Business* – filed by businesses to report cash and/or monetary instruments of \$10,000 or more received for goods or services
 - FinCEN Form 114, *Report of Foreign Bank and Financial Accounts (FBAR)* – 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) report information on an individual or business, providing a snapshot of the subject's identity by combining data from multiple sources.
- (2) At least one consumer reporting agency is scanned. The information found is used to search over 2 billion public records and generate a single report that may include the following information.

Category of information	Potentially available data
Personal information	<ul style="list-style-type: none"> • Complete name • "Also known as" (AKA) and "doing business as" (DBA) names • Aliases • Social security number • Date of birth
Contact information	<ul style="list-style-type: none"> • Current and previous addresses • Phone numbers • E-mail addresses
Licenses/Permits	<ul style="list-style-type: none"> • Driver license number • Professional licenses • Pilot licenses • Hunting and fishing licenses • Concealed weapons permit

Category of information	Potentially available data
Legal information	<ul style="list-style-type: none"> • Bankruptcies, liens, and judgments • Possible criminal records
Assets	<ul style="list-style-type: none"> • Real property ownership • Aircraft and watercraft ownership • Recreational vehicle ownership
Associations	<ul style="list-style-type: none"> • Corporate ownership • Possible relatives • Possible associates
Other	<ul style="list-style-type: none"> • Uniform Commercial Code (UCC) filings • Internet domains • Financial information for businesses

- (3) This information is useful to determine 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 reflecting sales not reported on the tax return
 - Corporate affiliations where there are no indications of corporate earnings on the tax return
 - Property ownership not reflected on the tax return as either personal residence or rental property
 - Professional licenses that demonstrate income-earning potential not reflected on the tax return
 - Vehicle, boat, and/or plane registration (type of vehicle, purchase price, owner name, and address) that reflects high-cost asset acquisition in excess of earnings reported on the tax return
 - Address history that indicates high-cost living areas not supported by the financial status analysis
- Note:** Data contains up to five addresses for the taxpayer in the order of most to least recent.
- Possible family relationships for owners with different names

4.1.5.2.5 (04-18-2023) Return Preparer Database

- (1) The Return Preparer Database (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 data RPD can provide includes:
- Counts of returns filed
 - Preparer Tax Identification Number (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
 - Electronic Filing Identification Number (EFIN) information used
 - Refund and refundable credit percentages based on returns filed

- (3) RPD information can be used to determine potential discrepancies 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 directed to your area return preparer coordinator (RPC) at *Exam Procedures Knowledge Base – PSP Return Preparer Coordinators (RPCs) – Area*.

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

- (1) Field Exam uses colored file folders on cases to achieve national standards for processing and to help Centralized Case Processing (CCP) when closing cases.

Exception: Electronic case files do not require colored file folders.

- (2) When cases are built by area Planning and Special Programs (PSPs) or at the campus, the following file folder colors are used to identify specific types of cases.
 - **Red** – Case with a statute date expiring within 180 days or a Prompt Determination
 - **Yellow** – Headquarter approved usage only (definition will change as interim guidance is issued)
 - **Orange** – IRS employee audit
 - **Purple** – National Research Project (NRP)
 - **Light Blue** – Claims (including innocent spouse, injured spouse, etc.)

Note: Occasionally, there will be projects that require the use of a specific color file folder not listed here.

- (3) 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 will be on the outside of a purple folder.

4.1.5.3
(01-21-2026)
Classification Overview

- (1) 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.
- (2) Returns are classified to identify those with issues likely to result in significant tax changes or that require audit to increase voluntary compliance. To effectively use resources, the classifier must decide which returns are *most* egregious and/or which audits will promote the highest degree of voluntary compliance.
- (3) National SB/SE Classification Guidelines provide guidance to maximize classification consistency nationwide and to identify returns with issues that are material in scope. The classification guidelines can be found at: *Exam Procedures Knowledge Base – Field Case Selection – 02 Classification*.
- (4) Classification using online systems (such as CDE and MeF) can be done at remote locations using approved procedures. See IRM 4.103.1.7, *CDE Procedures*.
- (5) Discriminant Function (DIF) returns use algorithms/models designed to score returns and are identified for classification in descending DIF score order.

- (6) The following reference material should be available for classifiers, along with this IRM:
- Document 6209, *IRS Processing Codes and Information*
 - Document 6036, *Examination Division Reporting Codes Booklet*
 - Area classification instructions
 - National SB/SE Classification Guidelines & Case Grading Tool (*Exam Procedures Knowledge Base – Field Case Selection – 02 Classification*)

4.1.5.3.1
(01-21-2026)
Selection of Classifiers

- (1) Classifiers must use their skills, technical expertise, local knowledge, and experience to select returns and identify issues. Therefore, classification should be conducted by examiners who have received appropriate tax law training and are experienced with the type of return and activity code being classified. Examiners with specialized expertise may be used to classify business returns.

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

- (2) Where appropriate, returns should be classified by examiners with subject matter expertise. However, if a subject matter expert classifies a return, they may not subsequently assist with the examination.

Example: Revenue Agents in a pass-through group may classify Partnership and S Corporation returns as long as they will not subsequently work the return or be requested to assist in the examination.

- (3) Tax returns must be selected and classified for audit by employees who will not be assigned to examine the return.

4.1.5.3.2
(01-21-2026)
Classification Instructions

- (1) The primary objective of case selection 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. Classifiers must exercise their professional judgment – not personal opinions – when making return selection decisions.

- (2) During the classification process, the classifier will determine the preliminary scope of the audit for all returns.

Note: The number of classified issues is typically limited to three.

- (3) Classifiers must:
- 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 projects.
- (4) The classifier must first review the entire return 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
- (5) The classifier must consider financial status 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. Consider family size and personal living expenses in relationship to the income stated on the return. If it appears the taxpayer does not have sufficient income for the lifestyle indicated on the return, financial status is a potential issue.
- (6) Review all returns received for classification for international issues. Refer to IRM 4.1.9, *International Features*. If international issues are present, the classifier should discuss with the 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*.
- (7) To help identify the most non-compliant taxpayers, classifiers may use all data available during classification including, but not limited to:
 - MeF
 - IDRS
 - Internet
 - yK1/CKGE
 - Accurint or any other third party research data
 - Return Preparer Database (for use in the Return Preparer program)
- (8) For all returns, the classifier will assign an examiner type (TCO-09 (or below), TCO-11, or RA) based on the complexity of the return and the degree of accounting and auditing skills required to conduct a quality audit. See IRM 4.1.5.3.2.6, *Grading Returns*, for additional information.

4.1.5.3.2.1 (01-21-2026)

Materiality – Significance of the Issue

- (1) Classifiers must compare the potential benefits of examining a return to the resources required to perform the exam. If potentially good issues identified on a return 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:
 - 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.)
 - Inherent character of the item – Even if the amount of an item is insignificant, the nature of the item may make the item significant. (e.g. airplane expenses claimed on a plumber's Schedule C)
 - Evidence of intent to mislead – This may include missing, misleading, or incomplete schedules or incorrectly reporting an item on the return.
 - 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)
 - Relationship to another 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)
 - Permanency of the potential adjustment – A permanent adjustment is more material than one that will reverse itself in subsequent years.

- Timing adjustments – The longer the deferral/acceleration period, the more material the item.

- (3) The tax effect of carrybacks and carryforwards of losses and/or credits should be considered in determining the materiality of an adjustment.
- (4) If alternative minimum tax (AMT) is paid, consider the impact of an adjustment to the AMT when determining the materiality of the adjustment (an increase to regular tax would cause a decrease to the AMT).

4.1.5.3.2.2
(10-20-2017)
Area Classification

- (1) Each area should prepare area-specific classification instructions incorporating the National SB/SE Classification Guidelines and covering the following topics:
 - Local issues
 - Questionable practitioners

4.1.5.3.2.3
(01-21-2026)
Campus Classification

- (1) It is important for the area PSP staff to have frequent discussions with Centralized Files and Scheduling (CF&S) management to keep abreast of the return orders and issues dealing with the area's inventory.
- (2) Electronically filed returns can be classified remotely. Paper-filed returns can be mailed to the appropriate PSP office, as needed.
- (3) Ideally, all status code 06 and 07 inventory will be classified in one classification detail. If this is not possible, PSP will sort the returns to be classified prior to each classification detail. To ensure the returns with the highest DIF scores are classified for each activity code for each processing year, returns should be sorted by:
 1. Activity code (as needed for the exam plan)
 2. Return processing year
 3. DIF score (in descending order)
- (4) During the course of classification, returns should be categorized as follows:
 - Selected returns for Revenue Agent (RA)
 - Selected returns for Grade 11 Tax Compliance Officer (TCO-11)
 - Selected returns for Grade 09 or below Tax Compliance Officer (TCO-09)
 - Returns accepted as filed
 - Returns that are unusual in nature, such as returns where the exam return charge-out documents: are missing, do not match the return, or contain special messages such as "Information Report Available" (if the indicated report is not in the case file)
 - Returns to be transferred
 - Special feature returns – international issues, etc.
 - Other returns as directed by area instructions
- (5) Paper returns not selected for audit must be appropriately stamped. See IRM 4.1.5.3.2.8, *Classification Documentation*, for reason codes.

4.1.5.3.2.4
(04-18-2023)
Electronic Classification

- (1) The following guidelines apply when returns are classified using an electronic source (e.g. MeF or CDE).

- a. When classifying returns, classifiers must request access through BEARS for the Employee User Portal (EUP), CDE, and MeF (both IMF and BMF). These systems can all be accessed via the *EUP login page*.
- b. Unless otherwise directed, when determining whether a return should be selected for audit, the classifier must consider the return as a whole, not just the criteria which caused it to be identified for classification.
- 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 – must be considered in the electronic classification process.
- e. Checksheets (manual or electronic) must be completed for each classified electronic return.
- f. For returns that are not MeF, a three-year CDE facsimile of the return must be used in place of an original return.

Note: A copy of the return can be requested from the taxpayer at the beginning of the audit.

- g. Review of electronic classified returns must follow the guidelines in IRM 4.1.5.3.3, *Review of Classification*.

4.1.5.3.2.5
(10-20-2017)
**Classification of
Employee Returns**

- (1) Refer to IRM 4.1.1.6.7, *Employee Audits*, for procedures related to employee audits. Generally, an employee is not treated differently than other taxpayers when classifying returns.

4.1.5.3.2.6
(01-21-2026)
Grading Returns

- (1) For returns that are selected for audit, the classifier determines what employee type should conduct the examination (TCO-09 or below, TCO-11, or RA). Selecting the proper function to conduct an audit is a key contribution to the success or failure of the exam program. It is essential that returns adaptable for office interviews are assigned to TCOs and those requiring the auditing and/or accounting skills of a field agent are assigned to RAs because the planned time of an audit for TCOs is substantially less than the planned time for RAs.

Note: Substantial issues should not be excluded to divert a higher graded return to a lower graded employee type.

- (2) All examiners are expected to evaluate the tax implications of related pass-through returns. This means all examiners can work returns where distributive income from Forms 1065, 1120-S, or 1041 is present. According to position descriptions (PDs), TCO-11s can work targeted exams of small BMF taxpayers if related return issues are identified, but if an in-depth examination of a related BMF entity or other complex pass-through issues are present, the return will be assigned to an RA. Primary business returns (BMF) are examined by RAs.
- (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: *Exam Procedures Knowledge Base – Field Case Selection – 02 Classification*. The CGT determines the employee type based on differences in the 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.

Note: Although returns selected for audit should be graded based on complexity, exceptions can be made to address training needs.

- (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, which could cause additional issues that may surface to go unidentified or unaddressed because the new issues do not align with the employee's position description. It also prevents excess surveys and transfers.
- (5) In general, the amount reported on the return (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.**

Complexity Factors
Issues requiring an on-site inspection of the taxpayer's books, records, inventories, or assets
Apparent financial status imbalance
Improperly reported related entity transactions
Charitable deductions requiring a specialist referral
Accounting method other than cash basis
Multiple schedule Cs
Issues that could lead to/indicate a need to expand to a BMF examination
Business with a high number of income transactions that can't be verified using Form 1099s or 3rd party summaries
Business with a high number of expense transactions that can't be verified using 3rd party summaries
Business that lends itself to a high incidence of cash transactions
Potential worker classification issues
More than 3 rental properties reported on Schedule E
Pass-through entity losses with potential basis or at-risk issues
Foreign transactions
Digital assets (e.g. cryptocurrency transactions)
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.**

- Significant inventory exists (e.g. retail business)
- Assets require verification (e.g. manufacturing business, questionable depreciation)
- Potentially fictitious business
- Voluminous records or complex accounting systems
- 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 over-arching (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 require the return to be worked by a higher-graded examiner based on 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 identified employee type is not available at the taxpayer's post of duty (POD) (including circuit riders), select the return for remote examination. This practice creates a fair and equitable treatment of taxpayers regardless of where they reside.

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, must be reviewed for information, if available. The relevant items for the classifier are:
- Year, form number, form type, activity code, and DIF score
 - Special messages (e.g. MeF return, employee return, collectability indicators)
 - Previous audit results – This item shows the results of the two most recent returns closed by examination, including disposal code and amount of tax change. This information along with 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.
 - 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.
 - Collectability Indicators – See IRM 4.1.5.3.2.11, *Returns With Collectability Indicators*.
- (2) Definitions of the following codes referenced on the Form 5546, *Examination Return Charge-Out Sheet*, or the 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 Audit Information Management System (AIMS)
 - Push Codes

- Source Codes
- Sort Codes
- Special Messages on Form 5546
- Status Codes
- Taxpayer Identification Number

4.1.5.3.2.8
(01-21-2026)
**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 checksheet (or equivalent) documenting the reason for selection. Returns that are accepted as filed must document the reason for acceptance. In CDE, this is accomplished by selecting a reason code from the drop down box for the accepted as filed reason code. For non-CDE classification, the reason code should be entered in the “General Comments” section of the classification checksheet. 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)), the alternate codes should be entered in the “General Comments” section of the classification checksheet – replacing the above codes for non-CDE cases and supplementing the above codes within CDE.

4.1.5.3.2.9
(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
Form 1040 (individual returns)	Form 6754, <i>Examination Classification Checksheet</i>
Form 1065, 1120, 1120-S, and 1041 (business returns)	Form 10264, <i>Revenue Agent – Classification Checksheet</i>

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

4.1.5.3.2.9.1
(01-21-2026)

**Form 6754, Examination
Classification
Checksheet**

- (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 business issues (right side)
 - Write-in issues (bottom)
- (2) It is important to accurately classify each return, because the taxpayer will be requested to bring certain records to the initial appointment based on the items classified.

4.1.5.3.2.9.2
(01-21-2026)

**Instructions for Form
6754, Examination
Classification
Checksheet**

- (1) All classified issue blocks should be marked with an “X” instead of a check mark, to reduce the possibility of marking through more than one box.
- (2) For each selected return, complete the checksheet according to the following instructions.

Block	Description	Instructions
A	Taxpayer Name, SSN, and Tax Period	If available, affix an “Examination Label” with Check Digit (2 Alpha Characters). Otherwise, enter manually.
B	Type of Examination	Identify the return as either Pre-contact Analysis (TCO) or Field Examination (RA). For area classification, “Correspondence” is not applicable and should not be checked. See IRM 4.1.5.3.2.6, <i>Grading Returns</i> to determine the grade of the return (TCO-09 or below, TCO-11, or RA).
C	Special Inventory	If the return is classified as a TCO-11 return, check Box 9.
D, E, F, G	Priority, POD, Reserved, ADP Hash Total	These blocks are not completed by area classifiers.
H	Issues	Issue numbers generally appear in the same order as on Form 1040, <i>U.S. Individual Income Tax Return</i> . Select only issues that warrant audit. Limit the number of issues to the “vital few”, preferably no more than 3 issues. For more information, see the remainder of this subsection.
I	Classifier	Input the classifier’s standard employee identifier (SEID).

Block	Description	Instructions
J	Date Classified	Input the date classified.
K	Reviewed	The reviewer will input their SEID, if reviewed.
L	Date Reviewed	The reviewer will input the date reviewed, if applicable.

(3) Below is additional information for completing issue numbers in Block H:

- Number 10 (IRMF – Blue Tab Criteria) is obsolete.
- 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.
- Numbers 33-35 are for issues that do not fit any pre-printed categories on the checksheet. Do not duplicate or overlap issues that already exist on the checksheet. When possible, use the language on the tax return for the write-in and avoid general phrases.
- Do not automatically classify gross receipts. Gross receipts should only be classified where the potential for unreported income is substantial. If all books and records are needed or if gross receipts is a classified item, Number 50 (Gross Receipts Schedule C or F), should be selected.

(4) The remarks section should be used for 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.

Example: Appropriate comments include: “income does not appear to support standard of living”, “Schedule C appears to be fictitious/false”, “possible personal expenses being deducted”, or “questionable preparer”, etc.

4.1.5.3.2.10
(04-18-2023)
**Information Return
Processing (IRP)
Documents**

- (1) IDRS command code IRPTR allows users to request information returns processing (IRP) transcripts from the information returns master file (IRMF).
- (2) IRM 2.3.35, *Command Code IRPTR*, contains the format of the IRP transcript with an explanation of the items shown on the transcript.

4.1.5.3.2.10.1
(04-18-2023)
**Classifying Returns With
IRP Transcripts**

- (1) As part of classification of an individual return, the classifier must review the IRP transcript to identify discrepancies between the return and filed information returns.
- (2) If the return meets the criteria of repetitive audit procedures according to IRM 4.10.2.13, *Repetitive Audits*, but there is a significant discrepancy indicated by the IRP transcript, the return will be selected for audit of the IRP issue only.

4.1.5.3.2.10.2
(04-18-2023)
**Currency Transaction
Report 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 IRP CTR information assists the classifier in making recommendations to the examiner to use special auditing techniques or to question sources of income not subject to withholding tax.
- (3) CTR screening/matching does not replace normal IRP screening procedures.

4.1.5.3.2.11 (01-21-2026)

Returns with Collectability Indicators

- (1) The purpose of the IRS is to collect the proper amount of tax revenue at the least cost to the public in a manner that warrants the highest degree of public confidence in our integrity, efficiency, and fairness.
- (2) Cases audited by Exam impact other IRS functions (e.g. Collection, Appeals, Counsel, etc.) and the impact to these functions should be evaluated throughout the exam – beginning with classification.
- (3) Assessments made by Exam often result in an increase in the inventory of cases in Collection – a significant number of which result in uncollectable accounts. To reduce Collection inventory and currently not collectible (CNC) accounts, collectability must be considered during classification.
- (4) 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 (deminimus/statute expired while in active status)
- (5) See IRM 4.20.1.2.1, *Consider Collectability*, for more guidance.

4.1.5.3.2.11.1 (04-18-2023)

Classification Procedures for Returns with Collectability Indicators

- (1) If returns with low collection potential are selected for audit, PSP Territory Managers must ensure classification checksheets are documented 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, <i>IRS Processing Codes and Information</i> , or <i>SERP TDA Closing Codes</i> for a complete list and explanation of Taxpayer Delinquent Account (TDA) closing codes.
COLLSTCD26	C	Open collection status (e.g. assigned to revenue officer, automated collection, or is in collection queue).

Form 5546	CDE TP Info Sheet	Definition
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, CURN-OTCOLL, 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. These procedures apply to classification of any type of inventory (except NRP inventory, Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnerships, and abusive transaction (AT) investigations).
- Returns will be classified and either accepted as filed or selected for audit based on 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 checksheet.** 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.
- 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 (e.g. bankruptcy discharge 7 years prior). The classifier or coordinator may need to obtain additional IDRS research to make a selection decision.

4.1.5.3.2.12
(04-18-2023)
Identity Theft

- 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.
- 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.
- 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.
- 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.

4.1.5.3.2.13
(01-21-2026)
Freeze Codes

- (1) Certain freeze codes indicate that a return should not be examined. Returns with the following freeze codes on the classified tax year should be classified as "Accepted as Filed".
 - –C (combat zone)
 - –V (bankruptcy)
 - –W (IRS litigation)
 - –Z (Criminal Investigation)
- (2) Except for –C freeze, 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.

4.1.5.3.2.14
(01-21-2026)
Fraud Potential

- (1) Classifiers must be alert to indications of fraud on the returns being classified. These may include the following:
 - Significant changes on a three-year return comparison
 - Questionable credits (can indicate refund schemes and abusive transactions)
 - Typed or handwritten Form W-2 from a large business corporation or government agency (can indicate fraudulent refund schemes because large corporations and government agencies typically use computer-generated W-2 forms)
 - Altered W-2 and/or 1099 forms (can indicate fraudulent refund schemes)
- (2) See IRM 25.1.2, *Fraud Handbook, Recognizing and Developing Fraud*, for a more comprehensive list of fraud indicators.

4.1.5.3.2.15
(01-21-2026)
**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*.

4.1.5.3.3
(01-21-2026)
Review of Classification

- (1) For each area classification detail (whether electronic or at the campus), the PSP territory manager (TM) (or designee) has primary responsibility for:
 - Ensuring quality return selection
 - Ensuring all classifiers are appropriately trained on tax law and receive area classification instructions
 - Orienting reviewing managers (if other than the PSP TM or classification section chief) to classification objectives, classifier instructions, quality review procedures, and documentation requirements
 - Reviewing a representative sample of selected and accepted returns for each classifier (see IRM 4.1.5.3.3.1, *Classification Review Standards*)
 - Providing appropriate review feedback to the classifier and PSP classification section chief

Note: Form 5126, *Classification Quality Review Record*, may be used to provide review feedback

- Maintaining open communication with the classification section chief
- (2) For each national or centralized classification detail, the headquarters representative is responsible for:
- Ensuring quality return selection
 - Reviewing a representative sample of selected and accepted returns for each classifier
 - Providing appropriate review feedback to the classifier
 - Providing classification objectives, classifier instructions, quality review procedures, and documentation requirements

4.1.5.3.3.1
(01-21-2026)
**Classification Review
Standards**

- (1) Reviews should be performed for each detail to which an examiner is assigned and on a regular basis for permanent classifiers. The review will determine if additional guidance needs to be provided. Feedback should be given to the classifier as early as is practical to ensure the most accurate classification. Reviews must accomplish the following objectives.
- a. Verify returns are selected for exam or accepted as filed in accordance with established procedures.
 - b. Confirm accepted returns have little or no audit potential (i.e. if examined would probably result in no change to tax liability) and selected returns have potential tax change sufficient to warrant selection (especially on returns with a negative taxable income).
 - c. Ensure classification checksheets are properly completed.
 - d. Determine if returns are properly selected for RA, TCO-09 (or below), or TCO-11 exams.
 - e. Ensure classifiers maintain a high level of technical proficiency, exercise good judgment in accepting and selecting returns, and effectively use their time.
 - f. Identify if classifiers need additional training for classifying DIF returns or classification of other returns.
- (2) A minimum 10% sample of the classifier's returns is required to be reviewed, but the sample can be expanded as needed. The sample should include a balanced review of the return types being classified. It should also include a balanced review of returns "selected for exam" and returns "accepted as filed".

Exception: Some types of examinations may not require a classification and therefore will not require a 10% review (e.g. headquarters compliance initiative projects (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: *Exam Procedures Knowledge Base – Field Case Selection – 02 Classification*.

- (3) 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 TM or headquarters analyst. A copy of Form 5126 will be forwarded to the classifiers' group manager.

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 expenses 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 4.1.5.3.4.1, *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) IRC 183 Activities not engaged in for profit (hobby loss) – When a Schedule C, E, or F does not appear to be an activity engaged in for profit, the examination should focus on whether the taxpayer has a profit motive. Classify 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 Section 183 as an issue.
- (5) Questionable Preparer – 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”.

Note: If a potential questionable preparer is identified, prepare Form 14719, *SB/SE Return Preparer Referral*, and submit it 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.

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

- (1) The following subsections contain 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 appropriately 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 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. Earned Income Tax Credit)?

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. Ensure only one spouse claims dependent children.

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 a productive issue.
- (3) Carefully scrutinize current year installment sales and exchanges of property because taxpayers frequently make errors in computing the recognized gain.
- (4) Determine 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 the 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
(01-21-2026)
Schedule K-1

- (1) 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.
- (2) Limitations for basis, at-risk, and passive activities should be considered.

4.1.5.3.4.1.7
(01-21-2026)
Moving Expenses

- (1) After December 31, 2017, no deduction is allowed for moving expenses except in certain cases for members of the military and intelligence communities.
- (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 services (Lexis Nexus or Accurint).

Exception: 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.

Note: 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) It is important to first look at overall potential for tax change 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 (MFS), verify consistency with the spouse's return (e.g. if one spouse itemizes the other cannot take the standard deduction).

4.1.5.3.4.1.8.1
(10-20-2017)
Medical Expenses

- (1) High medical expense for large families, deceased taxpayers, or older taxpayers is not usually a productive issue.

4.1.5.3.4.1.8.2
(10-20-2017)
Taxes

- (1) Consider changes in address when reviewing real estate taxes. (Review Form W-2, Form 1040, Form 8949, *Sales and Other Dispositions of Capital Assets*, etc. to identify changes in address.)

4.1.5.3.4.1.8.3
(01-21-2026)
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. Pay special attention to areas where housing costs are high (over \$750,000).

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.

Exception: Contributions may be allowed to exceed these limitations if qualified contributions are 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 *irs.gov Tax Exempt Organizations*.
- (3) Check for payments which may represent tuition.
- (4) Consider valuation of 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 reported 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 (EBE) 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 a productive issue.
- (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 issues. 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 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
(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 (this makes TP ineligible) • Credit phase-out over certain income levels • Students under age 24 (because they have additional requirements for the refundable portion of the American Opportunity Tax Credit) • Multiple credits taken (only one education credit per student per year is allowed) • Form 1098-T, <i>Tuition Statement</i>, from the institution on IRP reporting qualified expenses <p>Note: Reported qualified expenses can be legitimately higher than the amount reported on this form.</p>
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 (because they are not subject to tax on non-U.S. source income and accordingly are not entitled to the FTC) • Payments not creditable as taxes: <ul style="list-style-type: none"> • Penalties, interest, fines, and custom duties • Compulsory loans • Amounts reasonably certain to be refunded, credited, rebated, abated, or forgiven
Low Income Housing	<ul style="list-style-type: none"> • Form 8823, <i>Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition</i> • Recapture rules if the building is sold
Premium Tax Credit (PTC)	<ul style="list-style-type: none"> • Eligibility for PTC (see <i>irs.gov PTC Eligibility</i>) • Age of TP and if military or retired military (health care coverage under Medicare, Medicaid, TRICARE or Children's Health Insurance Program (CHIP) are not allowed) • MFS return or TP being claimed as a dependent on another return (this usually makes TP ineligible)
Residential Energy Credits	<ul style="list-style-type: none"> • Year placed in service (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 (credit must be reduced by the subsidy)

Credits	Look for
Small Employer Health Insurance (Form 8941)	<ul style="list-style-type: none"> • Years the credit is claimed (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 (no credit is allowed) • Small Business Health Options Program (SHOP) marketplace checkbox (required starting in 2014) • Shareholder's/partner's Schedule K-1

4.1.5.3.4.1.10
(04-18-2023)

Other Taxes

- (1) Verify 10% penalty is reported on early withdrawal from qualified retirement plans.
- (2) Consider health care individual responsibility.

4.1.5.3.4.1.11
(01-21-2026)

Digital Assets

- (1) Review gains on sales of digital assets to determine if the taxpayer appropriately reported taxable transactions as ordinary income or capital gains.
- (2) Verify income from 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. (e.g. assessment of self-employment tax on cryptocurrency miners).

4.1.5.3.4.2
(10-20-2017)

Potentially Productive Issues on an Individual Business Return

- (1) The following subsections contain potentially productive issues on Schedules C or F.

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)

IRC 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. IRC 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.
- (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 an activity not engaged in for profit.

- (3) There are certain types of activities that lend themselves to hobbies/activities not engaged in for profit:
 - Collecting antiques, collecting cars, etc.
 - Part-time activities for entertainment or to pass time (e.g. racing, farming, etc.)
 - Rental properties (material participation is a rental rule that is hard to overcome if the TP is just an investor and not a real-estate professional)
 - Sale of personal products that lend themselves to personal use
- (4) 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.
- (2) Consider whether the farm is an actual business operation or a hobby.
- (3) Consider whether payments from farmer's 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)
Identifying Issues on Corporate Returns

- (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:
 - Overall composition of the return. Is the return complete, containing all necessary information and schedules? Who prepared the return?
 - Data reported on the return compared to the norms and standards of the business or industry of the taxpayer.
 - Location of the business. This could have a bearing on the volume of business.
 - Prior audit results as indicated on Form 5546, *Examination Return Charge-Out Sheet*.
 - 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 Checklist*.

4.1.5.3.5.1
(04-18-2023)

- (1) Experience has shown the following characteristics result in potentially productive issues.

**Potentially Productive
Issues on a Corporate
Return**

Issue	Details
New corporation that incorporated an on-going business...	...where the return reflects goodwill, other boot, or accelerated depreciation.
International features...	...where a copy of a national office approved technical ruling is attached, but all conditions set forth in the ruling have not been met.
Liquidation under IRC 331, IRC 332, IRC 336, or IRC 337	These liquidations 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	n/a
Credits and/or losses carried forward...	...where information on the return indicates the item(s) should have been carried back.
A member of a controlled group...	...where the full amount of the surtax exemption, etc. is claimed and a properly executed election is not included.
Last-in, first-out (LIFO) method used to value inventory...	...when this method is being used for the first time.
Valuation of inventory for a manufacturing concern...	...where the taxpayer is not using the full-absorption accounting method.
Substantial passive income	This may indicate a personal holding company.
A low asset return reflecting a net operating loss	n/a
Returns with minimum tax issues	n/a
Foreign tax credit claimed on the return	n/a

4.1.5.3.5.2
(04-18-2023)

- (1) Some of the items to be considered under the profit and loss approach are:

Profit and Loss Method

- Large or unusual changes in inventories or no inventory reflected for a non-service type business
- Sales of assets without a Form 4797, *Sales of Business Property*, attached
- No amount claimed as amortization on a newly formed corporation
- Amounts claimed as other deductions without supporting schedules attached
- Questionable bad debt – either under the specific write-off or reserve method
- 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 the following.

Balance Sheet Item	Indicators of Potential Issue(s)
Cash	<ul style="list-style-type: none"> • A large ending balance could indicate an IRC 531 issue • A negative balance could indicate improper accruals
Trade notes and accounts receivable	<ul style="list-style-type: none"> • Change in accounting method • Premature write-offs • Excessive deduction for bad debts • Unreported interest income
Inventory	<ul style="list-style-type: none"> • Change in valuation method • Change in nature of business • Possible write-down
Investments	<ul style="list-style-type: none"> • Interest and/or dividend income understated or omitted • Expense(s) of tax-free income deducted • Unreported sales • Erroneous basis • Installment election • Buried stockholder loans • Related party issues
Other current assets	Deferred expenses
Loans to stockholders	Dividend or officer compensation issue
Building and other depreciable assets	<ul style="list-style-type: none"> • Unreported sales • Investment credit recapture • Incorrect basis
Intangible assets	<ul style="list-style-type: none"> • Goodwill written off • Sale of license or patent
Loans from stockholders	<ul style="list-style-type: none"> • Thin corporation • Interest deduction versus dividend
Other liabilities	<ul style="list-style-type: none"> • Improper accruals • Deferred income accounts • Reserve for contingencies
Capital accounts	<ul style="list-style-type: none"> • Unreported sale • Stock issued for services • Thin corporation
Paid-in surplus	<ul style="list-style-type: none"> • Diversion of earned income • IRC 351
Retained earnings	IRC 351
Treasury stock	<ul style="list-style-type: none"> • Potential dividend to stockholders • Bargain purchase by a stockholder
Schedules M-1 and M-2	Review all items for proper tax treatment

- 4.1.5.3.6
(10-20-2017)
Identifying Issues on S Corporation Returns
- (1) Form 1120-S, *U.S. Income Tax Return for an S Corporation*, 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 1120-S returns are essentially the same as for other DIF returns.
 - (3) Significant issues identified on 1120-S returns will be reflected on Form 10264, *Revenue Agent – Classification Checksheet*.
- 4.1.5.3.6.1
(04-18-2023)
Potentially Productive Issues on an 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. See 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)
Identifying Issues on Partnership Returns
- (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 Return
- (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:
 - Contributions to capital for possible recognition of gain or loss at the partners' level
 - Partners with no contributed capital where services may have been performed in exchange for the partnership interest
 - Large loss claimed on returns commencing business late in the year
 - Large loss claimed in relation to investment
 - Loss claimed in excess of investment through non-recourse financing (loan and prepaid interest costs should be amortized over the life of the loan)
 - Large depreciation deduction where property may not have been placed in service during the year
 - Start-up expenses (management fees, license fees, etc.) which should be capitalized

- (3) Final year returns are often productive. Common issues are:
- Negative capital account considerations
 - Resolution of liabilities
 - Proper consideration of distribution of assets
- (4) Other potentially productive partnerships issues:
- Additional contributions by a partner which could constitute a sale or exchange
 - Special allocation of losses or specific deductions to partners
 - Change of ownership – allocations of distributive share items and potential basis adjustments
 - Withdrawal by partners may include “phantom gain” through assumption of liabilities by others
 - Sale or exchange of partnership assets which may result in recapture of ordinary income
 - Component or other depreciation method resulting in shorter than guideline lives
 - 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. Prior audits can create a safe harbor for taxpayers incorrectly treating their workers as non-employees.

- (2) Known or probable areas of 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:
- 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.
 - 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.
 - Returns indicating issuance of policies by foreign insurers. This would involve returns of insurance agencies, brokers, etc.
 - Returns reporting manufacturing or use of pistols, revolvers, and firearms (e.g. gun shops, target ranges, etc.).
 - Returns reporting flying services or aircraft sales (e.g. charter service, flying schools, airplane repairs, etc.).
- (2) Excise classification procedures can be found in IRM 4.24.18.12, *Classification*.

4.1.5.3.10
(04-18-2023)

Fiduciary Returns

- (1) Screening of fiduciary returns requires consideration of issues specific to fiduciary returns in addition to income tax issues. Quality classification requires consideration of the following items.

Item to Consider	Additional Information	Reference
Estate unduly prolonged	Should not be more than 5 years unless very large	Treas. Reg. 1.641(b)-3(a)
Business trust taxable as a corporation or it could be treated as a sham and the income is taxable to the grantor	n/a	IRC 7701(a)(3) and Rev. Rul. 75-258
Exemption	Estate \$600, simple trust \$300, complex trust \$100	n/a
Indication of multiple trusts which may be taxable as one trust	n/a	Treas. Reg. 1.663(c)-1(b)
Minimum tax	<ul style="list-style-type: none"> Tax preference items and/or exemption not apportioned between the estate or trust and beneficiaries based on share of income Prorate for short year 	IRC 56
Wrong tax rate schedule used	n/a	n/a
Foreign tax credit and job tax credit not apportioned between estate or trust and beneficiaries based on income	n/a	n/a
Trusts normally cannot show Subchapter 5 income	n/a	IRC 643(a)
Indication of income taxable to grantor or another	e.g. sale and leaseback among related parties	IRC 671 through IRC 678
Error in computation of distributable net income (DNI)	n/a	IRC 643(a)
Rental or other income (e.g. from non-probate assets) may be taxable to devisees	n/a	IRC 691
Partnership income	<ul style="list-style-type: none"> Decedent's death before close of partnership taxable year Share of partnership income erroneously included on Form 1040 instead of Form 1041, <i>U.S. Income Tax Return for Estates and Trusts</i> 	n/a
Special tax for trusts electing to report gain realized on the sale of property acquired from a transferor under installment method	n/a	IRC 691

(2) Distributions to beneficiaries should be considered including the following.

Item to Consider	Additional Information	Reference
Beneficiaries not listed may not have reported the income	n/a	n/a
No deduction is allowable if the amount was not actually distributed	Estates are normally not required to distribute all income currently	n/a
Estates and simple trusts normally do not distribute capital gains	n/a	n/a
Simple trusts must distribute all ordinary income except income allocable to corpus (typically, capital gains)	n/a	IRC 651
Final year	All income is deemed distributed, including capital gains	IRC 643(a)(3) and IRC 662(a)(2)
Losses or excess deductions are not distributable except in the final year	n/a	IRC 642(h)
Distribution deduction may include: specific legacy	Not deductible	IRC 663(a)
Distribution deduction may include: widow's allowance	Deductible if from current income and taxable to the widow	Treas. Reg. 1.661(a)-2(c)
An excess (accumulated) distribution may indicate a complex trust	A separate Schedule J may be missing – reported by beneficiaries	Throwback rule IRC 665(b)
Administrative and other expenses may actually be a disguised distribution to a beneficiary	Failure to file Schedule K-1 (e.g. family allowance)	n/a
Excess distributions may indicate payment of specific legacies on which the estate may have realized a gain	n/a	n/a
Nonresident alien beneficiary	Where Form 1042-S, <i>Foreign Person's U.S. Source Income Subject to Withholding</i> , filed and required amounts of tax withheld	n/a
Terms of governing instrument (local law issues)	n/a	n/a
Consider if the return is for a family trust	n/a	n/a

(3) Capital transactions should be considered including:

- Significant capital losses normally should not occur in the first year of an estate
- Capital loss (net) is limited to a maximum of \$3,000
- Deduction limited to fiduciary's portion of capital gains (IRC 1202)
- 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)

- Redemption of closely held stock may be dividend unless IRC 303 is complied with (IRC 302)
- Sale or exchange between related parties for inadequate consideration
- Estate tax marital deduction – executor satisfies pecuniary bequest with appreciated assets, thus triggering a capital gain
- Specific bequest – executor satisfies with appreciated assets, thus triggering a capital gain

(4) Expenses and deductions:

- Allocation of expenses (including to tax-free income (IRC 265))
- Depreciation taken (basis)
- Personal expenses and losses not deductible (IRC 641(b) and IRC 162(a)) (e.g. child care, funeral costs, medical expenses)
- Administrative expenses (e.g. attorney and CPA fees, executor commissions, etc.) 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.
- Federal estate tax on income in respect of a decedent (computation omitted or erroneous) (IRC 691(c)). Estate tax examination will affect the computation.
- Inheritance taxes are not deductible (IRC 164(b)(4))
- Charitable contributions – “set aside” amount is generally not deductible (IRC 642(c)(1)) unless the trust was created prior to October 10, 1969
- Executor commissions or attorney fees appear unreasonable under local law guidelines

4.1.5.4

(04-18-2023)

Storage of Returns

- (1) The PSP TM 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:
 - Providing returns for training
 - When major computer programming changes are scheduled to occur that may delay the filling of return orders (e.g. implementation of major changes to AIMS or Examination Records Control System (ERCS), etc.)
- (2) AIMS Centralized Information System (A-CIS), Table 37, SSIVL, or ERCS data should be used to monitor aging of status 08 and status 10 returns. Two months of status 08 inventory in 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

(01-21-2026)

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 file at *Exam Systems Knowledge Base – AIMS Assignee Code (AAC) Contact Listings*.
- (3) Returns awaiting classification in status 06 are stored in EGCs separated by paper filings and MeF.

Caution: PSPs are responsible to monitor unclassified inventory within the area. Excess inventory may prevent proper order 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 TM (or designee) has sole authority to approve the survey of inventory stored at the campus. Returns should be surveyed as they become out-of-cycle or more frequently, if needed. The PSP TM (or designee) will send written authorization to CF&S instructing the surveys. CF&S will pull the indicated 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. See IRM 4.1.2.9, *Procedures for Surveying Inventory in PSP*, for more information.

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

- (1) The PSP and CDE 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 file at *Exam Systems Knowledge Base – AIMS Assignee Code (AAC) Contact Listings*.

- (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 order 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 TM (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. CF&S will update the return on AIMS to the requesting status and EGC and forward it 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 Martinsburg Computing Center (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 TM 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 TM or the group manager.
 - (2) It is important for the area PSP TM to have frequent discussions with CF&S management to keep abreast of the return orders and other issues.
- 4.1.5.4.6
(01-21-2026)
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, CF&S will pull the centralized storage return, update AIMS to status 10 for the same EGC as the 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) EGC 2066 will be used to store certain office examination returns with errors. Area PSP staff should review EGC 2066 inventory to ensure these returns are properly addressed. There should be a minimal number of these returns.

4.1.5.5
(01-21-2026)
**Delivery of Selected
Returns**

- (1) Selection of returns should follow the outline of the examination plan which details the starts by return segments, purpose groups, and workstreams. 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 should be delivered to meet pro-rata volumes. Deviations in pro-rata starts are expected, but the cause of any material deviation should be identified and documented. Under the direction of FCS, the PSP TM 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 *WPA SharePoint – SB Field Exam Workload, Planning and Analysis*. Starting with fiscal year 2022 the purpose groups are as follows:
 - **Training** examinations focus on preparing examiners to audit specific returns or issues. The examinations include IMF returns for TCO and RA, BMF returns for RA, etc.
 - **Policy** examinations align to the IRS' rules or procedures including Employee Audits, Audit Reconsiderations, Innocent Spouse, etc.
 - **Nonfiler** examinations address instances where a taxpayer should have filed a return, but failed to do so.
 - **Strengthen Compliance** examinations focus 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.
 - **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 (PACs), promoter projects, etc.
 - **Research** examinations provide the IRS with information regarding compliance as well as the effectiveness of case-selection methodologies. This purpose group currently contains NRP, Legislative Changes, Passthrough Selection Models, various selection techniques using artificial intelligence, Planned Corrective Actions (PCAs) resulting from TIGTA or GAO audits, etc.
 - **Protection or Yield** examinations focus on the productivity of examinations and include Claims, Informant Claims, various referrals, etc.
 - **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 inventory delivery 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 *Return Ordering and Delivery SharePoint* for a current copy of ROADS.

4.1.5.5.1 (01-21-2026)

ROADS Group Delivery Form

- (1) The ROADS group delivery form (GDF) determines the projected inventory needs within each POD within each EGC.

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

- (2) The GDF calculates the projected inventory needs to cover a period of time, normally 1 or 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 GDF during the ordering cycle which typically occurs on a monthly basis. Once the GDF is prepared, it is distributed to the exam group managers (GMs) (typically via e-mail). The GMs have a period of time to provide any adjustments to the calculation before the inventory needs are fulfilled. Additionally, TMs receive summary information via e-mail.

Note: The classification coordinator must review the calculated orders and the GM adjustments to ensure the submitted orders are reasonable and adhere to leadership directives. If orders are not reasonable or do not adhere to leadership directives, the classification coordinator or PSP TM should resolve these concerns with the field GMs or TMs prior to submission of the order to FCS.

4.1.5.5.2 (01-21-2026)

ROADS Delivery Model

- (1) The ROADS delivery model (DM) determines the cases to deliver to the exam groups. The cases selected satisfy the inventory needs determined in the ROADS GDF.
- (2) The DM 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, subtracting the sum of the fiscal year to date primary starts and the current status 10 inventory from the planned starts.

- (3) The Field Case Selection (FCS) senior program analyst prepares the DM after any adjustments are received from the GDF. Once the DM is used to determine the cases to be assigned to the exam groups, the return classification coordinator (also known as spigot or DIF coordinator) sends digital communications to respective coordinators or systems providing the required information to deliver the identified inventory to the exam group. Subsequently, the DM 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 CF&S 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 CF&S 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: 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.

