DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

October 29, 2007

MEMORANDUM FOR SECRETARY PAULSON

FROM: J. Russell George
Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2008

The Reports Consolidation Act of 2000[1] requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2007,* its perspective of the most serious management and performance challenges confronting the Internal Revenue Service (IRS or Service). The top 10 challenges in order of priority are:

1. Modernization;
2. Tax Compliance Initiatives;
3. Security;
4. Providing Quality Taxpayer Service Operations;
5. Complexity of the Tax Law;
6. Human Capital;
7. Erroneous and Improper Payments;
8. Taxpayer Protection and Rights;
9. Processing Returns and Implementing Tax Law Changes During the Tax Filing Season; and
10. Using Performance and Financial Information for Program and Budget Decisions.

TIGTA's assessment of the major IRS management challenge areas for Fiscal Year 2008 has not changed substantially from the prior year. While the IRS has continued to address each challenge area, TIGTA was unable to remove any challenge areas at this time. However, TIGTA did make one important change to the priority of the challenges.

[1] 31 U.S.C. § 3516(d) (2000).

Human Capital moved from last place to sixth in terms of importance in our view and Using Performance and Financial Information for Program and Budget Decisions moved from sixth place to tenth.

One reason for this change is last year, the Office of Personnel Management reported that approximately 60 percent of the Federal Government's 1.6 million white-collar employees and 90 percent of about 6,000 Federal executives will be eligible for retirement over the next 10 years. Along with a retiring workforce, the IRS faces gaps in talent because of changes in the knowledge, skills, and competencies in occupations needed to meet its mission. The IRS needs to strengthen its efforts and use of available flexibilities to acquire, develop, motivate, and retain talent. Strategic human capital management must be the centerpiece of the IRS's change management strategy.

The following is a discussion of each of the challenges:

Modernization of the Internal Revenue Service

The Business Systems Modernization (Modernization) program is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system.

The Modernization program is in its ninth year and has received approximately $2.3 billion for contractor services. Additionally, the IRS had spent $220 million through Fiscal Year 2006 and planned to spend an additional $45 million in Fiscal Year 2007 to manage the Modernization program. According to the IRS's original plan, the Modernization program should be near the halfway point in Calendar Year 2007. However, due to receiving less funding than initially anticipated and having difficulties in managing contractor work, the IRS has not completed as many Modernization projects as planned. For example, the Customer Account Data Engine is the foundation of the Modernization program. The IRS originally planned to complete replacement of its Individual Master File with the Customer Account Data Engine in 2005.[2] The current estimated completion date for this replacement is 2012.

Although the IRS has made advances in its Modernization effort, it has not maintained anticipated progress. TIGTA has previously reported that inconsistent compliance with project development controls has contributed to delays in project deliveries, increased development costs, and reduced capabilities.[3] Since Fiscal Year 2002, TIGTA's Modernization program annual assessments have cited the following four specific challenges the IRS needs to overcome to deliver a successful modernization effort:

1. Implement planned improvements in key management processes and commit necessary resources to enable success;

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[2] The Individual Master File is the IRS database that stores individual taxpayer account information.
[3] Treasury Inspector General for Tax Administration, Ref. No. 2007-20-121, *Annual Assessment of the Business Systems Modernization Program* (2007).

2. Manage the increasing complexity and risks of the Modernization program;
3. Maintain the continuity and strategic direction with experienced leadership; and
4. Ensure that contractor performance and accountability are effectively managed.

These challenges continue to exist.

Accordingly, since solutions to the IRS's serious and intractable financial management problems largely depend upon the success of the IRS's Modernization efforts, in January 2005 the financial management risk was combined with the Modernization risk into the Business Systems Modernization high-risk area.[4] Modernization remains a high risk for the IRS.

Tax Compliance Initiatives

A similarly compelling challenge confronting the IRS is tax compliance. Tax compliance initiatives include the administration of tax regulations, collection of the correct amount of tax for businesses and individuals, and oversight of tax-exempt and government entities. Late in Fiscal Year 2007, the Department of the Treasury (Department) issued a report on improving voluntary compliance.[5] The report outlines steps that the IRS plans to take to increase voluntary compliance and reduce the tax gap.

Business and Individual

The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. The IRS estimated that the gross tax gap for Tax Year 2001 was $345 billion. TIGTA evaluated the reliability of the IRS-developed tax gap figures and concluded that the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and voluntary compliance rate.[6] The IRS has significant challenges in both obtaining complete and timely data, and developing the methods for interpreting the data. Although better data will help the IRS further identify noncompliant segments of the population, broader strategies and better research are also needed to determine what actions are most effective in addressing noncompliance.

The IRS must continue to seek accurate measures of the various components of the tax gap and the effectiveness of actions taken to reduce it. This information is critical to the IRS for strategic direction, budgeting, and staff allocation. Additionally, the IRS Oversight Board has adopted an 86 percent voluntary

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[4] In January 2005, the Government Accountability Office (GAO) combined its two previous high-risk areas, IRS Business Systems Modernization and IRS Financial Management, into one Business Systems Modernization high-risk area. See U.S. Gov't Accountability Office, GAO-05-207, *High Risk Series: An Update* (2005).

[5] Internal Revenue Service, U.S. Dep't of the Treasury, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (2007).

[6] Treasury Inspector General for Tax Administration, Ref. No. 2006-50-077, *Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections* (2006).

compliance goal by 2009, and Senate Finance Committee Chairman Max Baucus has asked for a 90 percent voluntary compliance goal by 2017.

As the IRS takes steps to improve compliance, TIGTA's reviews will help gauge the IRS's progress in achieving the specific long-term compliance objectives. The Department also needs these measures for tax policy purposes, and Congress needs this information to help develop legislation that improves the effectiveness of the tax system. For example, the IRS may never significantly reduce the number of miscellaneous income and wage statements with mismatched names and identification numbers without legislative changes. TIGTA reports and those of the Government Accountability Office (GAO) have long called for legislative changes to address fundamental and systemic problems associated with inaccurate identification numbers on miscellaneous income and wage statements. In a recent review, TIGTA was successful in manually matching 50 percent of the sampled information documents containing incorrect names and identification numbers to taxpayer accounts.[7] Based on that sample, TIGTA projected that approximately 6,000 individuals had not filed tax returns, although the statements reported they had earned, on average, about $104,000.

Tax-Exempt Entities

The IRS continues to face challenges in administering programs focused on tax-exempt organizations to ensure that they comply with applicable laws and regulations to qualify for tax-exempt status. The IRS has noted that the nonprofit community has not been immune from the recent trends toward bad corporate practices that have been highlighted in the for-profit area.[8] Recent concerns involve a highly noncompliant credit counseling industry, differentiating tax-exempt hospitals from for-profit hospitals, and seemingly excessive compensation and loans to executives of charitable organizations.

TIGTA has made recommendations that would improve the IRS's oversight of filing compliance by political entities and State and local governments, enhance its ability to identify and address abusive tax-avoidance transactions within the tax-exempt sector, and identify potential terrorist activities related to tax-exempt organizations. Furthermore, TIGTA recommended additional improvements to assure that timely, accurate, and complete information returns are received for employee benefit plans and that referrals of noncompliance are examined timely. We also noted that the IRS must develop better research tools, improve training to trace funds through complex transactions, and develop the ability to analyze data to determine high-risk

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[7] Treasury Inspector General for Tax Administration, Ref. No. 2007-30-159, *Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap* (2007).

[8] Written Statement of Mark W. Everson, Commissioner of Internal Revenue, Before the Committee on Finance, United States Senate Hearing on Exempt Organizations: Enforcement Problems, Accomplishments, and Future Direction, April 5, 2005.

noncompliant areas. The IRS agreed with TIGTA's recommendations and initiated corrective actions to address these concerns.

Security of the Internal Revenue Service

Millions of taxpayers entrust the IRS with sensitive financial, personal and other data that are processed by and stored on IRS computer systems. Reports of identity thefts from both the private and public sectors have heightened awareness of the need to protect this data. The risk that sensitive data or computer systems could be compromised and computer operations disrupted continues to increase. These vulnerabilities are due to internal factors, such as the increased connectivity of computer systems and increased use of portable laptop computers; and external factors, such as the volatile threat environment resulting from increased terrorist and hacker activity. The IRS has designated computer security as a material weakness under the Federal Managers' Financial Integrity Act of 1982.[9]

Section 301 of the Federal Information Security Management Act (FISMA)[10] requires each Federal agency to report annually to the Office of Management and Budget and Congress on the effectiveness of its security programs and to perform an annual independent evaluation of its information security program and practices. During 2007, the IRS Modernization and Information Technology Services organization and representatives from each IRS operating unit have partnered to improve the IRS's compliance with FISMA. Efforts continued this year to develop an enterprise-wide approach to help employees understand their responsibilities for securing IRS systems and data.

The IRS has made steady progress in complying with FISMA requirements since the law's enactment in 2002 and states it continues to place a high priority on efforts to improve its security program. However, the Service still needs to do more to adequately secure its systems and data. The most significant areas of concern are annual testing of security controls and contingency plans, implementation of configuration management standards,[11] and privacy requirements for protecting personally identifiable information. Additionally, phishing schemes are a growing security

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[9] 31 U.S.C. §§ 1105, 1106, 1108, 1113, 3512 (2000). The Federal Managers' Financial Integrity Act (FMFIA) requires that agency management establish and maintain effective internal controls to achieve the objectives of: 1) effective and efficient operations; 2) reliable financial reporting; and 3) compliance with applicable laws and regulations. The FMFIA also requires the head of each Executive agency to report annually to the President and the Congress on the effectiveness of the internal controls and any identified material weaknesses in those controls. Reporting material weaknesses under FMFIA is not limited to weaknesses over financial reporting.

[10] Pub. L. No. 107-347, tit. III, 116 Stat. 2899, 2946 (2002) (codified as amended at 44 U.S.C. §§ 3541-49).

[11] Configuration management is a collection of processes and tools that promote network consistency, track network change, and provide up-to-date network documentation and visibility. By building and maintaining configuration management standards, several benefits may be achieved, such as increased security, improved network availability and lower costs.

concern.[12] In Fiscal Year 2006, TIGTA worked closely with the IRS to create a joint IRS-TIGTA reporting site. By September 30, 2007, approximately 18,700 complaints had been received and 435 different phishing schemes had been identified. TIGTA's FISMA evaluations and other audits led to the conclusion that sufficient attention is not yet being given by the IRS to the security of sensitive systems.

Providing Quality Taxpayer Service Operations

Since the late 1990s, the IRS has increased its delivery of quality customer service to taxpayers. The first goal in the IRS's current strategic plan is to improve taxpayer service. However, since the late 1990s, the IRS has allocated over time more resources to its collection, examination, and criminal investigation functions and fewer resources to taxpayer service functions. As a result of this resource shift and other factors, in July 2005, Congress requested that the IRS develop a five-year plan, including an outline of which services the IRS should provide and how it will improve services for taxpayers. The IRS developed the plan, the Taxpayer Assistance Blueprint, in two phases.

The focus of the Blueprint is on services that support the needs of individual filers who file or should file the Form 1040 series tax returns.[13] The plan states that the initiative will address the challenges of effectively and efficiently aligning service content, delivery, and resources with taxpayer and partner expectations.[14] The Phase I report identified strategic improvement themes by researching IRS services relative to taxpayers' needs and preferences. The Phase II report was designed to validate those themes through further research of taxpayers' service preferences and to create the strategic plan for service delivery.

The IRS is already facing challenges with its Blueprint. For the Phase I report, the conclusions and strategic improvement themes were valid; however, not all information was accurate or consistent. Given the importance of this plan as the IRS moves forward, inaccuracies and inconsistencies will put the plan at risk of improperly aligning service content, delivery, and resources with taxpayer and partner expectations.

Complexity of the Tax Law

Simplicity, transparency, and ease of administration are interrelated and desirable features of a tax system. Over the years, the Federal tax system, especially the Federal income tax, has become more complex, less transparent, and subject to frequent revision. Tax complexity and frequent revisions to the Internal Revenue Code make it more difficult and costly for taxpayers who want to comply with the system's

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[12] Phishing is the act of sending an email to a user falsely claiming to be an established legitimate enterprise in an attempt to scam the user into surrendering private information that could be used for identity theft.

[13] The Form 1040 series tax returns include any IRS tax forms that begin with "1040" such as the U.S. Individual Income Tax Return (Form 1040), U.S. Individual Income Tax Return (Form 1040-A), and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ).

[14] Partners encompass all service providers including community-based stakeholders, practitioners, commercial preparers, and software vendors.

requirements and for the IRS to explain and enforce the tax laws. Tax law complexity results in higher costs for both tax administration and tax compliance. Simplification and reform have the potential of reducing the tax gap by billions of dollars.

Tax law complexity continues to challenge the IRS and taxpayers. For example, TIGTA recently determined that the IRS regulations for like-kind exchanges are complex and may be unclear to taxpayers.[15] Little published information exists regarding the IRS's position on like-kind exchanges involving second and vacation homes. This absence of clarification leaves unrebutted the sales pitch of like-kind exchange promoters who may encourage taxpayers to improperly claim deferral of capital gains through "tax-free" exchanges.[16] These complexities hamper IRS efforts to provide assistance to taxpayers. Without meaningful simplification, the complexities of the current tax code will likely continue to contribute to the tax gap.

<u>Human Capital</u>

The Government Performance and Results Act of 1993[17] was enacted to bring more accountability to Federal agencies for how they spent their budget and how well they fulfilled their public service roles. In 2001, the President's Management Agenda designated Strategic Management of Human Capital as the first of its five governmentwide initiatives. Despite significant focus and progress over the past few years, the GAO has designated human capital as a "high risk" governmentwide concern and recently reported that ample opportunities exist for agencies to improve. The GAO also reported that a governmentwide framework to advance human capital reform is needed.[18]

The Federal workforce is aging, and agencies are dealing not only with retirements and staff turnover, but also with the unique challenges of the 21st Century. The IRS recognizes that it must be prepared to respond to an increasing and more demanding population, a more global and multi-lingual environment, and an increasing number of taxpayers who have complex financial holdings and the means and motive to resist paying their taxes.[19] In addition, the IRS, along with other Federal agencies, is slowly moving toward changing pay, classification, and performance management systems to transition to a more market-based and performance-oriented culture. While the IRS has made some progress in these areas, the strategic management of human capital remains one of the IRS's major management challenges.

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[15] A like-kind exchange is also known as a "1031 exchange," referring to Section 1031 of the Internal Revenue Code. In essence, a like-kind exchange is a way of deferring capital gains taxes by reinvesting proceeds from a sale into a similar asset.
[16] As reported in Treasury Inspector General for Tax Administration, Ref. No. 2007-30-172, *Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance* (2007), many promoters of like-kind exchanges refer to them as "tax-free" exchanges, not "tax-deferred" exchanges.
[17] Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).
[18] U.S. Gov't Accountability Office, GAO-07-310, *High Risk Series: An Update* (2007).
[19] Internal Revenue Service, Publ'n No, 3744, *IRS Strategic Plan: 2005 -2009* (revised 6-2004).

TIGTA has conducted audits in areas such as recruiting, workforce planning, training delivery, and employee turnover. As a result of these audits, we have made a significant number of recommendations for improvement. The IRS has agreed with these recommendations and stated it plans to take corrective actions. In 2008, TIGTA will begin executing a broad strategy for assessing human capital initiatives at an IRS agency-wide level and will focus on key portions of the IRS's Human Capital strategy.

Erroneous and Improper Payments

As defined by the Improper Payments Information Act of 2002,[20] an improper payment is any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It includes any payment to an ineligible recipient, any payment for an ineligible service, any duplicate payment, payments for services not received, and any payment that does not account for credit for applicable discounts. For the IRS, improper and erroneous payments generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors. Some tax credits, such as the Earned Income Tax Credit and the Education Credit, provide opportunities for abuse in income tax claims. The IRS estimated that between 27 percent and 32 percent of the $31 billion in Earned Income Tax Credits claimed on TY 1999 returns should not have been paid.[21] The IRS's Criminal Investigation function is responsible for detecting and combating tax refund fraud through its Questionable Refund Program, which was established to address the serious problem of refund fraud, now estimated to exceed $1 billion annually. On September 29, 2006, the Criminal Investigation function reported that during Processing Year 2006, it had identified more than 44,700 fraudulent refund returns claiming approximately $232.3 million in refunds during Processing Year 2006. In contrast, through September 13, 2007, the Criminal Investigation function identified approximately 200,900 fraudulent returns claiming about $1.3 billion in refunds during Processing Year 2007.

Although the IRS has taken actions to improve the Questionable Refund Program, TIGTA continues to have concerns with many of the procedures that have been implemented. For example, in January 2006 the National Taxpayer Advocate reported that automatically preventing a future year's tax return refund was a significant problem with the Questionable Refund Program.[22] According to the National Taxpayer Advocate, future refunds were being frozen until taxpayers filed a certain number of legitimate returns even though there was little evidence to suggest that taxpayers were likely to repeat refund fraud after the initial attempts. As a result, the IRS Office of Refund Crimes discontinued placing a freeze on future years' refund returns and instead identified certain high-risk categories as exceptions to this process. This revised procedure concerns us because we believe the future year freeze is an effective

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[20] Pub. L. No. 107-300, 116 Stat. 2350 (2002).
[21] Treasury Inspector General for Tax Administration, Ref. No. 2005-40-093, *The Earned Income Tax Credit Income Verification Test Was Properly Conducted* (2005).
[22] 1 National Taxpayer Advocate, *2006 Annual Report to Congress* (2006).

means for protecting revenue, when considered along with the procedural changes to notify taxpayers of refund freezes.

Taxpayer Protection and Rights

The IRS continues to dedicate significant resources and attention toward implementing the taxpayer rights provisions of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).[23] Annual audit reports are mandated for the following taxpayer-rights provisions:

- *Notice of Levy*
- *Restrictions on the Use of Enforcement Statistics to Evaluate Employees*
- *Fair Debt Collection Practices Act Violations*
- *Notice of Lien*
- *Seizures*
- *Illegal Protestor Designations*
- *Assessment Statute of Limitations*
- *Restrictions on Directly Contacting Taxpayers Instead of Authorized Representatives*
- *Separated or Divorced Joint Filer Requests*

In general, the IRS has improved its compliance with these statutory taxpayer rights provisions. For example, TIGTA believes the IRS's efforts to ensure that managers are not using enforcement statistics, production goals or quotas to evaluate employees are generally effective and are helping protect the rights of taxpayers. Nonetheless, there is still room for improvement with respect to certain provisions. TIGTA continues to identify instances in which there is no documentation that taxpayers were advised of their rights when agreeing to extend the period of time the IRS has to assess taxes. TIGTA also continues to identify instances in which IRS employees refer to taxpayers as Illegal Tax Protesters or similar designations.

Some IRS management information systems do not track cases that require mandatory annual audit coverage.[24] Thus, neither TIGTA nor the IRS could evaluate the Service's compliance with certain RRA 98 provisions.

Processing Returns and Implementing Tax Law Changes During the Tax Filing Season

Each filing season tests the IRS's ability to implement tax law changes made by Congress. It is during the filing season that most individuals file their income tax returns and call the IRS with questions about specific tax laws or filing procedures. Correctly

[23] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. App., 16 U.S.C., 19 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[24] Treasury Inspector General for Tax Administration, Ref. No. 2007-40-119, *Fiscal Year 2007 Statutory Review of Disclosure of Collection Activity With Respect to Joint Returns* (2007); Treasury Inspector General for Tax Administration, Ref. No. 2007-40-118, *Fiscal Year 2007 Statutory Review of Restrictions on Directly Contacting Taxpayers* (2007).

implementing tax law changes is a continuing challenge because the IRS must identify the tax law changes; revise the various tax forms, instructions, and publications; and reprogram the computer systems used for processing returns. Changes to the tax laws have a major effect on how the IRS conducts its activities, what resources are required, and how much progress can be made on strategic goals. Congress frequently changes the tax laws; thus, some level of change is a normal part of the IRS environment. However, certain types of changes can significantly impact the IRS in terms of its quality and effectiveness of service and in how taxpayers perceive the Service. For example, the 2007 Filing Season was successful but demanding for the IRS. Before the filing season began, the IRS Commissioner told Congress that the IRS was at high risk due to high-profile administrative changes such as the Telephone Excise Tax Refund and the Split Refund option. Late enactment of the Tax Relief and Health Care Act of 2006[25] added additional risk to the 2007 Filing Season.

Potential changes to the Alternative Minimum Tax (AMT) may pose a significant challenge for the IRS for the 2008 Filing Season. The AMT originally was created as a parallel tax system in 1969 to prevent 155 wealthy people from avoiding taxes through excessive exemptions, credits and other deductions. Because it was not indexed for inflation, the AMT increasingly affects people with more modest incomes by denying deductions such as personal exemptions, property taxes and medical expenses.

Unless Congress acts, the AMT will gradually impose $1.35 trillion in additional taxes on U.S. households over the next decade, including as many as 23 million families for Tax Year 2007. A series of temporary measures that index the AMT for inflation have limited the tax's reach to about 4 million households annually. Lawmakers have not yet renewed the temporary fix for Tax Year 2007. A delay in legislation renewing the temporary fix could significantly disrupt the tax filing season because the IRS would need time to print new tax forms and reprogram computers.

Using Performance and Financial Information for Program and Budget Decisions

While the IRS has made some progress in using performance and financial information for program and budget decisions, this area is still a major challenge. The IRS lacks a comprehensive, integrated system that provides accurate, relevant, and timely financial and operating data that describes performance measures, productivity, and associated costs of IRS programs. In addition, the IRS cannot produce timely, accurate, and useful information needed for day-to-day decisions, which inhibits its ability to address financial management and operational issues in order to fulfill its responsibilities. TIGTA has continued to report that various IRS management information systems are insufficient to enable IRS management to measure costs, determine if performance goals have been achieved, or monitor progress in achieving program goals. For example, TIGTA reported that progress is being made in addressing the reliability of Trust Fund Recovery Penalty (TFRP) transaction information recorded in taxpayer accounts (a

[25] Pub. L. No. 109-432, 120 Stat. 2922.

long-term material weakness); however significant work remains. Specifically, as of May 2007, there were nearly 50,000 TFRP-related errors in taxpayers' accounts that the IRS needs to correct before implementing the systemic posting of payments on TFRP assessments beginning in March 2008.[26]

Conclusion

These are the 10 major IRS management challenges issues for the IRS in Fiscal Year 2008. TIGTA's FY 2008 Annual Audit Plan contains our planned audits, inspections, and evaluations and is organized by these challenges. If you have questions or wish to discuss TIGTA's views on these management and performance challenges in greater detail, please contact me at (202) 622-6500.

cc: The Deputy Secretary
Assistant Secretary for Management and Chief Financial Officer
Acting Commissioner of Internal Revenue

[26] Treasury Inspector General for Tax Administration, Ref. No. 2007-10-183, *Progress Has Been Made in Improving the Accuracy of Trust Fund Recovery Penalty Transactions; However, Significant Work Remains* (2007).