

**The Internal Revenue Service Needs to
Improve Its Coordinated Oversight of the
Substitute for Return Process**

March 2000

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DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

March 28, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in black ink that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Internal Revenue Service Needs to Improve Its Coordinated Oversight of the Substitute for Return Process

This report presents the results of our review of the Internal Revenue Service's (IRS) Substitute for Return (SFR) process. The primary objective of this review was to determine if the IRS could measure the effectiveness of its strategy to bring nonfiling taxpayers into compliance by assessing income tax through the SFR process.

In summary, we found that the IRS' oversight of the SFR process is fragmented and does not provide uniform policies and procedures to ensure equitable treatment to all taxpayers. In addition, the IRS has not positioned itself to gather the necessary information to be able to effectively manage and measure the SFR process.

We recommended the IRS establish uniform policies and procedures to ensure coordination of its efforts among the functions processing the SFR accounts. The IRS should also develop a process to monitor the future filing compliance of taxpayers with SFR tax assessments while tracking and measuring SFR revenues, costs, and account resolutions.

The draft for this report was issued February 10, 2000. IRS management was given 30 calendar days to respond with comments and corrective action. Management's comments were not available as of the date this report was released.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 455-2478.

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Substitute for Return Process**

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Executive Summary

The Internal Revenue Service (IRS) has projected that the number of taxpayers who do not file required individual income tax returns will increase from approximately 7 million in Tax Year (TY) 1996 to over 9 million by TY 2002. To successfully meet this challenge, the IRS must implement a process that will enable management to make informed business decisions. The IRS should also provide national oversight to coordinate Substitute for Return (SFR)-related policies and activities among the Customer Service, Examination, and Collection functions.

The primary objective of this review was to determine if the IRS could measure the effectiveness of its strategy to bring nonfiling taxpayers into compliance by assessing income tax through the SFR process. The Treasury Inspector General for Tax Administration (TIGTA) is conducting a series of reviews to evaluate the effectiveness of the IRS' process for delivering an effective National Nonfiler Strategy.¹ In separate audit reports, the TIGTA plans to provide assessments of the National Nonfiler Strategy, audit reconsiderations, and collectibility issues. This report specifically addresses the SFR process.

Results

The IRS' oversight of the SFR process is fragmented and does not provide uniform policies and procedures to ensure equitable treatment of all taxpayers. In addition, IRS management does not gather the necessary information to be able to effectively manage and measure the SFR process. To successfully meet the challenge of a rapidly increasing population of nonfiling taxpayers, the IRS needs to take immediate, corrective action to address these issues.

The Internal Revenue Service Should Improve Its Coordination Among Functions Processing Substitute for Return Accounts

The IRS' oversight of the SFR process does not provide uniform policies and procedures among the Customer Service, Examination, and Collection functions. Although the IRS' National Nonfiler Strategy and its Nonfiler Executive Steering Committee provide a good start, these are recent components that have not had time to implement any new control

¹ The IRS' National Nonfiler Strategy is a comprehensive plan to bring nonfiling taxpayers into the tax system and encourage their future filing compliance. It was developed to provide guidance and direction to the various facets of the existing Nonfiler Program.

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processes. There are conflicts in the IRS' cross-functional efforts to form policy and make business decisions. Further, disparate treatment of taxpayers may have occurred because the functions did not coordinate their policy decisions.

The Internal Revenue Service Needs a Process to Determine if the Substitute for Return Process Is Achieving Its Intended Results

IRS management does not have the necessary information to effectively manage the SFR process or ensure the process has achieved its intended results. The IRS cannot determine how many SFR tax assessments were finally resolved through abatements of tax or written off as uncollectible. Also, the amount of revenues and costs generated by the SFR tax assessments are not readily available to IRS management. These components are necessary to enable IRS management to make sound program and business decisions.

Summary of Recommendations

To support the IRS' mission of providing taxpayers top-quality service by applying the tax law with integrity and fairness to all, the IRS should establish uniform policies and procedures to ensure coordination of its efforts among the functions processing the SFR accounts. The IRS should also develop a process to monitor the future filing compliance of taxpayers with SFR tax assessments while tracking and measuring SFR revenues, costs, and account resolutions.

Management's Response:

Management's comments were not available as of the date this report was released.

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Objective and Scope

This audit was initiated as part of the Treasury Inspector General for Tax Administration's coverage to evaluate the effectiveness of the Internal Revenue Service's (IRS) process for delivering an effective strategy to bring nonfiling taxpayers into compliance. This report specifically addresses the Substitute for Return (SFR) process.

Our objective was to determine if the IRS could measure the effectiveness of the SFR process in its strategy to bring nonfiling taxpayers into compliance.

The primary objective of this review was to determine if the IRS could measure the effectiveness of its strategy to bring nonfiling taxpayers into compliance by assessing income tax through the SFR process. We evaluated the oversight provided by the National Office by interviewing analysts from the Chief Operations Officer and the Customer Service, Examination, and Collection functions. We reviewed and analyzed operating plans, guidance documents, directives, and management reports to determine if the IRS had the organization, policies, and procedures to reasonably ensure the SFR process achieves its intended results.

We conducted our fieldwork in the National Office from August 1999 through November 1999. This audit was performed in accordance with *Government Auditing Standards*. Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The SFR process is a critical component of the IRS' strategy for dealing with taxpayers who fail to file required income tax returns.

The SFR process is a critical component of the IRS' strategy for dealing with taxpayers who fail to file required income tax returns. Its purpose is to establish a tax liability for nonfiling taxpayers based on available income and expense information. The SFR process was designed to encourage compliance with the filing requirements established under the Internal Revenue

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When taxpayers fail to file requested income tax returns, the IRS has the authority to assess a tax liability based on available third-party information.

Code (I.R.C.),¹ thereby instilling public confidence in the fairness of the IRS' enforcement practices.

Under current guidelines, the IRS provides the opportunity for nonfiling taxpayers to file a return or provide information on why they are not liable to file. When taxpayers fail to respond, the IRS invokes its authority under I.R.C. § 6020(b) and assesses a tax liability based on information provided by third parties (e.g., employers, banks).

The Collection function has ownership of the Nonfiler Program² and has authority under I.R.C. § 6020(b) to prepare SFRs for business nonfilers. The Customer Service function³ primarily uses the Automated Substitute for Return (ASFR) system to prepare SFRs for simpler types of cases where individuals have not filed income tax returns. The Examination function prepares SFRs for income tax returns for more complex individual nonfiler cases. Ultimately, when these income tax assessments are not paid by the taxpayer, they become part of the Collection function's inventory.

Results

Oversight of the SFR process is fragmented.

The IRS needs to improve its coordinated oversight of the SFR process. Currently, this oversight is fragmented among the Customer Service, Examination, and Collection functions. Each function has established its own policies and procedures for assessing tax with the SFR process. To improve its coordinated oversight:

- The IRS should improve its coordination among functions processing SFR accounts.

¹ 26 U.S.C. § 6012 (1986)

² The IRS' Nonfiler Strategy was developed to provide guidance and focus to the various facets of the existing Nonfiler Program.

³ The Customer Service function includes an Examination section that makes SFR assessments on accounts that do not meet ASFR criteria.

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- The IRS needs a process to determine if the SFR process is achieving its intended results.

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IRS oversight of the SFR process does not provide uniform policies and procedures.

The IRS' oversight of the SFR process is fragmented and does not provide uniform policies and procedures to ensure equitable treatment for all taxpayers. This is caused by a lack of cross-functional coordination among the Customer Service, Examination, and Collection functions with respect to the SFR process. Although the National Nonfiler Strategy⁴ and the Nonfiler Executive Steering Committee provide a good start, these are very recent components that have not had time to implement any new control processes.

Although both were issued in October 1999, the Customer Service function's Operating Guidelines present a business decision that conflicts with the IRS' National Nonfiler Strategy vision statement.

There are conflicts in cross-functional efforts to form policy and make business decisions

For example, the Customer Service function issued its Operating Guidelines in October 1999. These guidelines outline a business decision limiting the Customer Service function's SFR workload due to a lack of funds. Also, in October 1999, the Assistant Commissioner (Collection) issued the IRS' National Nonfiler Strategy with a vision statement in which "the Service will stress filing compliance without regard to the dollar amount of an assessment or its ultimate collectibility." The amount of a tax assessment and its ultimate collectibility are both factors that are meaningful considerations when limited funding affects enforcement policy decisions. Conflicts of policy and business decisions among the functions responsible for nonfiler accounts have resulted in inconsistent program goals.

⁴ The IRS' National Nonfiler Strategy is a comprehensive plan to bring nonfiling taxpayers into the tax system and encourage their future filing compliance.

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There may be disparate treatment of taxpayers depending on the function processing the SFR accounts

To reduce taxpayer burden, the Taxpayer Advocate made a recommendation to discontinue the policy of making SFR tax assessments against unlocated, nonfiling taxpayers. This recommendation was given to the Chief Operations Office in July 1998.

The IRS' Customer Service and Examination functions have inconsistent SFR tax assessment policies.

The Customer Service function responded to the Taxpayer Advocate's recommendation and changed its policy of making SFR tax assessments against unlocated, nonfiling taxpayers in April 1999. As of November 1999, the Examination function still had not changed its policy of making SFR tax assessments against unlocated, nonfiling taxpayers.

The IRS has defined its mission as providing taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. In its *Guide to the IRS for Congressional Staff*, the IRS reported the SFR Program contacts over 1 million taxpayers each year. The IRS will not realize its goal of providing top-quality service to these taxpayers without uniform policies and procedures that ensure consistent and equitable treatment.

Recommendation

1. The Chief Operations Officer should establish uniform policies and procedures to ensure coordination of IRS efforts among the functions processing SFR accounts.

Management's Response: Management's comments were not available as of the date this report was released.

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The Internal Revenue Service Needs a Process to Determine if the Substitute for Return Process Is Achieving Its Intended Results

IRS management does not have the necessary information to effectively manage the SFR process.

IRS management does not have the necessary information to effectively manage the SFR process or ensure the process has achieved its intended results. The IRS does not have a system in place to determine if the SFR process is successfully bringing nonfiling taxpayers into compliance. In addition, it does not have a process to track and monitor eventual SFR case resolution. As a result, the IRS cannot determine how many SFR tax assessments were finally resolved through abatements of tax or were written off as uncollectible. Also, the amounts of revenues and costs generated by the SFR tax assessments are not readily available to IRS management. These components are necessary for IRS management to make sound program and business decisions.

The IRS does not have an effective process to measure the success of the SFR in achieving its primary goal.

Both the Customer Service and Examination functions process SFRs for individual income tax. Each function primarily tracks, measures, and monitors inventory movement. This traditional approach to inventory management has limited the establishment of meaningful measures to gauge the effectiveness of the SFR in achieving its primary goal of bringing taxpayers into filing compliance.

The Customer Service function receives reports about the resolution of SFR tax assessments from the Enforcement Revenue Information System.⁵ Further, the Customer Service function has access to database information that would show if taxpayers with SFR tax assessments complied with future filing requirements. However, we could find no evidence that the Customer Service function used this information in formulating plans or making business decisions.

⁵ A system designed to collect information about revenues collected and costs incurred as a result of IRS enforcement activities.

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The Examination function reports do not gather or isolate information that would show management how SFR tax assessments were eventually resolved. The Examination function tracks and monitors case closures by various programs, but does not isolate SFR case closures within those programs. Further, the Examination function does not have a process to track, monitor, or measure future filing compliance for taxpayers with SFR tax assessments.

The Collection function cannot isolate the cost of resolving SFR tax assessments through its collection activities.

The Collection function cannot isolate the cost of resolving SFR tax assessments through its collection activities. Also, the IRS does not have a process to determine the impact of the SFR on the Nonfiler Program. The Collection function has proposed baselining and measuring filing compliance; however, this proposal does not specifically measure the performance of the SFR process and is not scheduled for completion until December 2001. In addition, this proposal projects defining nonfiler measures by July 2000, but it does not specifically propose defining measures for SFR tax assessments.

Recommendations

2. The Chief Operations Officer should coordinate the development of a process to monitor the future filing compliance of taxpayers with SFR tax assessments regardless of which function processed the account. In addition, the costs of processing and resolving SFR tax assessments should be tracked and measured by IRS management.

Management's Response: Management's comments were not available as of the date this report was released.

3. The Chief Operations Officer should coordinate the design of a process to profile SFR tax assessments and their resolution regardless of processing function. The IRS should know:
 - The amount of total SFR tax assessments.

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- The amount of revenue collected on SFR tax assessments.
- The amount of SFR tax assessments eventually abated.
- The amount of SFR tax assessments determined to be uncollectible.

Management's Response: Management's comments were not available as of the date this report was released.

Conclusion

The IRS must take action to successfully meet the challenge of a rapidly increasing population of taxpayers who do not file required income tax returns. The IRS should improve its national oversight to coordinate SFR-related policies and activities among the Customer Service, Examination, and Collection functions. Processes should be implemented to enable management to make informed business decisions.

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Appendix I

Detailed Objective, Scope, and Methodology

The primary objective of this review was to determine if the Internal Revenue Service (IRS) could measure the effectiveness of its strategy to bring nonfiling taxpayers into compliance by assessing income tax through the Substitute for Return (SFR) process. Specifically, we:

- I. Identified, analyzed, and evaluated the IRS' process for measuring the performance, efficiency, effectiveness, and yield of its SFR process.
 - A. Identified the overall IRS policy/mission/objective statements (program goals) along with those from specific functions involved with the SFR process (e.g., Customer Service, Examination, and Collection) and analyzed them for thoroughness, completeness, and compatibility with each other and the overall IRS mission.
 1. Determined the Chief Operations Officer's role in providing oversight for the SFR process.
 2. Determined if individual function objectives were coordinated to build a cohesive overall SFR objective.
 3. Determined why function objectives were not coordinated, were not in writing, and did not specify increasing taxpayer compliance or minimizing taxpayer burden through education.
 - B. Identified through interviews and analyzed any IRS management information system that provides performance information on the SFR process for completeness, accuracy, efficiency, timeliness, and usefulness.
 - C. Identified through interviews and reviews of documentation the IRS process and control system used to ensure success in bringing taxpayers who do not file the required income tax returns into compliance while protecting taxpayer rights and reducing taxpayer burden.
- II. Determined if the Collection function had an effective, controlled, and organized plan to measure the success of the SFR process as it relates to the National Nonfiler Strategy and if any information gathered was used to reduce taxpayer burden and direct taxpayer education.
 - A. Determined if there was an approved National Nonfiler Strategy and evaluated the roles of the Customer Service and Examination functions in ensuring its success.

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- B. Determined if the Collection function coordinated with the Customer Service and Examination functions to ensure equitable treatment of all taxpayers. Determined how policies, practices, and processes in the other functions affected the success of the National Nonfiler Strategy and if patterns or trends that could be addressed through taxpayer education were identified.
 - 1. Interviewed the Collection function's national nonfiler analyst to identify steps taken to coordinate with the SFR processors (i.e., the Customer Service and Examination functions).
 - 2. Secured and analyzed memoranda, directives, and other documentation coordinating policies, practices, and procedures among the Customer Service, Examination, and Collection functions to determine if coordination efforts were effective in ensuring:
 - a. Equitable treatment of taxpayers.
 - b. Meaningful taxpayer education.
 - c. Overall program success.
- C. Identified and analyzed the Collection function's measurements for success of the SFR process.
 - 1. Interviewed the Collection function's national nonfiler analyst to identify the process for developing SFR success measurements and how the information is gathered and reported.
 - 2. Identified the Collection function's SFR success measurements and determined if they were complete and meaningful. Determined if the measurements included:
 - a. Future voluntary compliance.
 - b. Nonfiler profile information (e.g., industry type, geographic location, age, level of education, etc.).
 - c. Total SFR assessments in the Collection function's queued inventory (e.g., number of taxpayers, modules, and dollars).
 - d. Total SFR assessments collected.
 - e. Cost of collecting SFR assessments.
 - f. Total SFR assessments abated or put in uncollectible status.
- D. Determined if information gathered is used to reduce taxpayer burden and direct taxpayer education.

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1. Interviewed the Collection function's national nonfiler analyst to identify the process for identifying and determining the cause of problematic trends or patterns within the SFR population.
 2. Identified and evaluated the effectiveness of the Collection function's process to resolve issues in a manner that reduces taxpayer burden and provides nonfiling taxpayers the information they need to comply with their filing requirements.
 3. Identified and evaluated the Collection function's process for coordinating, monitoring, and measuring the success of its efforts to reduce taxpayer burden and educate nonfiling taxpayers.
- III. Determined if the Customer Service and Examination functions had an effective, controlled, and organized plan to ensure equitable treatment to all taxpayers and measure the success of the SFR process. Also determined if any information gathered was used to reduce taxpayer burden and direct taxpayer education.
- A. Determined if the Customer Service and Examination functions coordinate with each other and the Collection function to ensure equitable treatment of all taxpayers. Determined how policies, practices, and processes in the other functions affected the success of the Customer Service and Examination functions' SFR process and if patterns or trends that could be addressed through taxpayer education were identified.
1. Interviewed the national Customer Service and Examination SFR analysts to identify steps taken to coordinate with each other and the Collection function.
 2. Secured and analyzed memoranda, directives, and other documentation coordinating policies, practices, and procedures among the Customer Service, Examination, and Collection functions to determine if coordination efforts were effective in ensuring:
 - a. Equitable treatment of taxpayers.
 - b. Meaningful taxpayer education.
 - c. Overall program success.
- B. Identified and analyzed the Customer Service and Examination functions' measurements for success of their SFR process.
1. Interviewed the national Customer Service and Examination SFR analysts to identify the process for developing SFR success measurements and how the information is gathered and reported.

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2. Identified the Customer Service and Examination functions' SFR success measurements and determined if they were complete and meaningful. Determined if the measurements included:
 - a. Future voluntary compliance.
 - b. Nonfiler profile information (e.g., industry type, geographic location, age, level of education, etc.).
 - c. Total SFR assessments.
 - d. Cost of assessing SFR returns.
- C. Determined if information gathered is used to reduce taxpayer burden and direct taxpayer education.
 1. Interviewed the national Customer Service and Examination SFR analysts to identify the process for identifying and determining the cause of problematic trends or patterns within the SFR population.
 2. Identified and evaluated the effectiveness of the Customer Service and Examination functions' processes to resolve issues in a manner that reduces taxpayer burden and provides nonfiling taxpayers the information they need to comply with their filing requirements.
 3. Identified and evaluated the Customer Service and Examination functions' processes for coordinating, monitoring, and measuring the success of their efforts to reduce taxpayer burden and educate nonfiling taxpayers.

Major Contributors to This Report

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Appendix III

Report Distribution List

Deputy Commissioner Operations C:DO
Chief Operations Officer OP
Assistant Commissioner (Collection) OP:CO
Assistant Commissioner (Customer Service) OP:C
Assistant Commissioner (Examination) OP:EX
Director, Collection Redesign OP:CO:R
Director, Office of Program Evaluation and Risk Analysis M:O
National Director, Compliance Specialization OP:EX:CS
National Director, Customer Service Compliance, Accounts and Quality OP:C:A
National Director for Legislative Affairs CL:LA
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Audit Liaisons:
 Chief Operations Officer OP
 Assistant Commissioner (Collection) OP:CO
 Assistant Commissioner (Customer Service) OP:C
 Assistant Commissioner (Examination) OP:EX

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Finding and recommendation # 1:

The Internal Revenue Service's (IRS) oversight of the Substitute for Return (SFR) process does not ensure equitable treatment for all taxpayers. Its oversight is fragmented among the Customer Service, Examination, and Collection functions. There is a lack of cross-functional coordination among these functions that has resulted in conflicting efforts to form policy and make business decisions. In addition, disparate treatment of taxpayers may occur when policies are not coordinated among the functions before implementation. To ensure coordination of efforts among the functions processing the SFR accounts, the IRS should establish uniform policies and procedures (see pages 3 and 4).

Type of Outcome Measure:

- Taxpayer Burden
- Taxpayer Rights and Entitlements

Value of the Benefit:

Over 1 million taxpayers contacted annually.

Methodology Used to Measure the Reported Benefit:

The value of the benefit is based on the total number of taxpayers contacted by the SFR Program. The number of SFR taxpayer contacts was reported by the IRS in its *Guide to the IRS for Congressional Staff* (1999).