December 1, 1999

The Honorable Richard K. Armey

Majority Leader

House of Representatives

Washington, D.C. 20515

Dear Mr. Armey:

Enclosed is the Treasury Inspector General for Tax Administration's (TIGTA) input on the major challenges facing Internal Revenue Service (IRS) management in Fiscal Year (FY) 2000. I am also enclosing the Annual Audit Plan for FY 2000 which reflects the planned audits and overall objectives for the year.

The challenges facing IRS management in FY 2000 have not changed substantially from last year. We have added two new issues to the list. First, the IRS must address equally important issues: providing first-rate customer service and ensuring compliance with the tax laws. The challenge for the IRS is to execute both of these activities within the constraints of existing resources. For example, a significant number of Examination and Collection resources have been reassigned to Customer Service and to implement the Restructuring and Reform Act of 1998. As a result, the inventory of delinquent cases in the collection process is increasing and the amount of tax assessments is decreasing.

Second, the global economy is rapidly growing and generating increasingly sophisticated business transactions. The IRS must develop effective customer service and compliance programs, including pre and post filing, to meet the tax administration needs of this expanding taxpayer segment.

The one challenge from last year that has been removed for FY 2000 is selecting and controlling returns for examination. Although we continue to view the issue as a risk, the IRS has agreed to take corrective actions based on findings and recommendations reported in FY 1999 and early FY 2000. We do not plan to conduct audit work on this issue in FY 2000 to allow the IRS adequate time to implement the corrective actions, but we will follow up to evaluate the effectiveness of these actions in FY 2001.

TIGTA believes the major management challenges facing the IRS in FY 2000 are:

- Financial Management
- Modernization of the Internal Revenue Service
    - Organizational Restructuring
    - Technology Modernization
    - Year 2000 Compliance
- Security of Internal Revenue Service's Information Systems
- Processing Returns and Implementing Tax Law Changes During the Tax Filing Season
- Customer Service and Tax Compliance Initiatives
- Providing Quality Customer Service Operations
- Revenue Protection - Minimizing Tax Filing Fraud

- Taxpayer Protection and Rights
- Implementation of the Government Performance and Results Act of 1993
- Impact of the Global Economy on Tax Administration

A summary of each issue, including comments on progress the IRS has made toward resolving the challenge or the vulnerabilities the IRS continues to face in achieving results, is included, where appropriate. Significant open audit recommendations are listed in the Appendix.

If we can provide additional information, please contact me at (202) 622-6500, or your staff may contact Pamela J. Gardiner, Deputy Inspector General for Audit, at (202) 622-6510.

Sincerely,

/s/ David C. Williams

David C. Williams

Inspector General

Enclosure

Enclosure

Fiscal Year 2000

Major Management Challenges

Facing the Internal Revenue Service

FINANCIAL MANAGEMENT

Financial management continues to be a concern for the Internal Revenue Service (IRS). The Senior Council for Management Controls' 1999 Annual Assurance Review included financial accounting of revenue as an open material weakness. Specifically, the Revenue Accounting Control System (RACS) does not conform to generally accepted financial standards of the federal government. This issue has been outstanding since 1995.

The General Accounting Office (GAO) has also expressed concerns over the past several years regarding the IRS' financial management. As related to the IRS' Fiscal Year (FY) 1998 principal financial statements, the GAO rendered an "unqualified" opinion on the statement of custodial activity. However, they noted that this achievement required extensive, costly and time-consuming ad hoc procedures to overcome pervasive and long-standing internal control and systems weaknesses. They rendered a "qualified" opinion on the balance sheet due to insufficient evidence about the reliability of the fund balance with Treasury and accounts payable. There was also evidence that led them to conclude that the property and equipment account was likely to be materially understated.

The GAO was unable to render an opinion on the statement of net cost, statement of changes in net position, statement of budgetary resources, and statement of financing due to limitations on the scope of its work resulting from insufficient evidence about nonpayroll expenses and budgetary balances.

In addition, the GAO reported six material weaknesses relating to the IRS' financial reporting process, supporting subsidiary ledger and documentation for unpaid assessments, controls over refunds, controls over fund balance with Treasury, controls over property and equipment, and computer security.

The Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, requires the Inspector General to audit agency financial statements in accordance with generally accepted government auditing standards. In FY 2000, the GAO, with support from us, will again exercise its prerogative to conduct the financial statement audit of the IRS' FY 1999 statements.

The Internal Revenue Service Has Made Progress Toward Resolving This Challenge

The IRS has taken actions to respond to GAO recommendations. The IRS has an acting Chief Financial Officer on loan from the Treasury Department; has replaced managers in the unit responsible for Administrative Accounting; reassigned staff to perform and review monthly fund balance reconciliations with the Financial Management Service; reduced the suspense account; and, engaged a contractor to do a sample of property in order to provide a valuation of the FY 1999 Financial Statement.

The Internal Revenue Service Continues to Face Risks in Resolving This Challenge

The financial management operation has been a long-standing problem for the IRS. The IRS recently identified a series of long-term actions directed to developing a sound financial management plan. However, neither the GAO nor the Treasury Inspector General for Tax Administration (TIGTA) have yet analyzed any of these initiatives (e.g., redesign of the existing master files to address revenue accounting issues, establish a Payment Information Data Base and Financial Reporting Data Warehouse). Also, many of the systems changes necessary to bring IRS' financial systems into conformance with accepted financial standards will take several years to implement (RACS).

MODERNIZATION OF THE INTERNAL REVENUE SERVICE

Implementing the IRS Restructuring and Reform Act of 1998 (RRA 98) and other legislative provisions will result in approximately 800 changes to the Internal Revenue Code, which represents the most extensive restructuring of the IRS and its governing laws in the last 40 years. Among these diverse changes are provisions for Roth Individual Retirement Accounts, expanded relief for innocent spouses, and confidentiality in discussing tax matters with an accountant, families, businesses, and corporations. Other changes affect IRS procedures and practices, such as the shift in burden of proof from the taxpayer to the agency.

Modernization of the IRS includes the restructuring of the organization, modernization of technology, and Year 2000 (also known as Y2K) compliance. Challenges for the three issues follow.

ORGANIZATIONAL RESTRUCTURING

The IRS Commissioner's vision for the IRS and RRA 98 both call for the reorganization of the IRS into operating units that serve groups of taxpayers with similar needs. This restructuring reflects a shift to a customer service oriented organization similar to changes that major corporations have put into place. The four major groupings of taxpayers that the IRS will serve are: wage and investment, small business, middle and large corporations, and exempt organizations. The IRS has begun revising its business processes and its organizational structure to better serve the specialized needs of these groups.

It is important to oversee management's actions to ensure it is adequately planning for, and implementing, the required changes. We will initiate appropriate audits to assess the IRS' organizational restructuring.

TECHNOLOGY MODERNIZATION

Modernization of the IRS' computer systems and security of taxpayer information have been major concerns over the past several years. For more than a decade, at a cost of $4 billion, the IRS has been attempting to modernize its antiquated tax systems. These efforts have fallen far short of what is required to prepare the IRS for the next century. Modernization of the IRS' technology is crucial to implementing the new business vision, espoused by the IRS Commissioner and the Congress, of providing world-class service to taxpayers. Key goals, such as 80 percent of tax returns being filed electronically by Year 2007 and significantly improving levels of service in answering taxpayers questions, are contingent on the development of new technology. While the development of new technology evolves, existing operations must continue and improvements must be made to meet the needs of tax administration and to demonstrate to taxpayers the IRS' commitment to improved service.

The Internal Revenue Service Has Made Progress Toward Resolving This Challenge

The IRS has taken steps to address these risks, including expanding the role of the Chief Information Officer as the Business Systems Modernization Executive, establishing an Enterprise Program Management Office which is co-led by Information Systems and Business Executives, and establishing a governance structure to review and approve projects at various points in the Enterprise Life Cycle. The IRS has also entered into a contract with a consortium of technology and business service providers, led by a major integrator, which will enable the IRS to achieve its modernization goals. This contract is commonly referred to as the PRIME contract, and is worth up to $10 billion over a 15-year period.

The IRS has taken many positive strides towards improving its processes and abilities at managing large modernization projects. The IRS has hired executives and top managers from the private industry to plan and oversee these projects, and it has hired outside contractors to assist in the technical aspects of the projects.

The IRS is also using a vendor obtained through the Federally Funded Research and Development Center to assist in overseeing the PRIME contract. These steps are a good first step at correcting the problems that were widespread during the Tax Systems Modernization projects.

The Internal Revenue Service Continues to Face Risks in Resolving This Challenge

There are still obstacles that the IRS will have to overcome to be successful at technology modernization. The major obstacle is the ability of the IRS executives and managers to oversee a project as large as the IRS modernization, while effectively transitioning Information Systems employees and processes into a new organization. In addition, the IRS executives and managers will have to coordinate the relationships between the IRS and the PRIME contractors and private vendors, and assure the contractors and vendors deliver products that can be used by the IRS.

YEAR 2000 COMPLIANCE

Currently, one of the biggest concerns in the area of information technology is the effect the century date change (also known as Y2K) will have on agency systems. Virtually every aspect of tax administration could be affected by the century date change since all the IRS functions rely to some degree on automated computer processes. The Y2K project is estimated to cost the IRS approximately $1 billion through FY 1999, and it requires the updating and testing of about 75,000 computer application programs, 1,400 minicomputers, over 100,000 desktop computers, over 80 mainframe computers, and data communications networks comprising more than 50,000 individual product components. IRS management estimates the number of lines of programming code to be reviewed for possible changes to be 50 million.

If mission critical code is not made Y2K compliant, tax administration systems may not run, causing the processing of returns to be halted. If this happens, taxpayers may not timely receive refunds or notices, and account adjustments may not be processed properly. As the date approaches, it is imperative that all major tax-processing systems are made Y2K compliant to avoid processing shutdowns.

The Internal Revenue Service Has Made Progress Toward Resolving This Challenge

We have conducted numerous audits of the IRS' efforts to ensure systems, applications, and infrastructure are compliant with Y2K requirements. IRS management is aggressively managing the Y2K issue and significant progress has been made. IRS actions include conducting wall-to-wall inventory reviews at all Service Centers, Computing Centers and large Districts; conducting Independent Assessment and Readiness Visits at over 30 offices to validate Tier 2, Tier 3, and Telecommunications components; and, conducting an independent verification effort by a contractor who compared actual hardware configurations against IRS inventory records to identify potential problems and risks.

The Internal Revenue Service Continues to Face Risks in Resolving This Challenge

Two issues increase the risk of Y2K problems after December 31, 1999. First, inaccurate inventories hamper the IRS' ability to identify, track, and monitor all components that need to be made Y2K compliant. Second, several aspects of the Y2K conversion effort are behind schedule, and the time to make the needed changes and to deal with unexpected problems is growing shorter.

SECURITY OF THE INTERNAL REVENUE SERVICE'S INFORMATION SYSTEMS

The IRS Commissioner has stated that protecting taxpayer information and the systems used to deliver services to taxpayers are key to the success of a customer-focused IRS. In the past, the security of taxpayer data has been an Achilles heel for the IRS, particularly in the area of unauthorized browsing of taxpayer records. Recently, GAO reports have identified serious weaknesses in the IRS' computer systems that put sensitive personal tax information at risk.

We will evaluate the IRS' progress toward resolving this challenge during its planned audits for FY 2000. When additional audit work is completed, we will be in a better position to describe any problems in achieving results.

PROCESSING RETURNS AND IMPLEMENTING TAX LAW CHANGES DURING THE TAX FILING SEASON

The IRS' Year 2000 filing season will be impacted by numerous legislative and operational changes. In preparation for the 1999 filing season, the IRS had to accommodate the most extensive and complicated legislative changes since the Tax Reform Act of 1986. The 2000 filing season legislative problems will primarily be of short time frames to react to legislation enacted late in the year, legislation extending provisions of previous laws concerning expiring tax credits, and the impact of the alternative minimum tax on certain tax credits. Late passage of legislation could create programming problems and increase the risk of processing errors.

The RRA 98 imposes extensive restructuring of the IRS and its governing laws. Planned improvements in customer service, such as expanded telephone service and revisions to forms and publications, will be implemented over the next few years. Such changes require additional planning and work to prepare for processing returns. In addition, the Taxpayer Relief Act of 1997 contains numerous changes to the Internal Revenue Code, and pending tax cut legislation could require significant last minute revisions to tax forms, publications, and computer programs. In addition, many of these legislative changes affect business returns that are filed throughout the year. The 2000 filing season will be further complicated by ongoing efforts to avoid Y2K glitches. The IRS' schedule to consolidate mainframe computer processing operations may cause unexpected operating problems in preparing tax return data, correcting unprocessable transactions, and obtaining reports to reconcile production. In addition, the IRS plans to fully implement several new processing systems without back-up capabilities. For example, the IRS' new payment processing system will become fully operational. As a result, the IRS will rely upon new, unproven systems.

The Internal Revenue Service Has Made Progress Toward Resolving This Challenge

In a significant processing change for the 2000 filing season, taxpayers will be asked to assist the IRS in sorting the mail when filing their return. Taxpayers will get two labels with their tax return package and be told to use the label that corresponds to whether they have a refund or balance due. Taxpayers not receiving a tax package will be instructed on where to mail the tax return, depending on whether they have a refund or balance due. This should reduce the mail sorting at the service centers considerably and improve overall processing efficiency.

The IRS, working with a private corporation (Xerox), undertook a major effort to improve certain tax forms and publications in the 2000 filing season for taxpayers who claim either the earned income tax credit or the child tax credit. If the effort proves successful in reducing errors made by taxpayers, the methods used may be expanded to other tax forms.

CUSTOMER SERVICE AND TAX COMPLIANCE INITIATIVES

The IRS has embarked on a course to re-engineer its business processes and technology to focus on providing world-class service to taxpayers. The theory is that, if the IRS provides the right mix of education and support to taxpayers, the overall rate of voluntary compliance with the tax laws will increase. This focus on providing better service has been blamed, by some stakeholders, for the drop in traditional compliance activities, such as auditing returns and collecting delinquent taxes. Implementation of RRA 98 also has been considered a contributing factor. Furthermore, some employees are reluctant to take appropriate enforcement actions because of provisions in RRA 98 Section 1203, which specify that an IRS employee must be charged with misconduct and terminated from federal service if the employee willfully commits certain acts in the performance of the employee's official duties.

The inventory of delinquent cases in the collection process is increasing while the resources available to work these cases are decreasing. Significant numbers of Examination and Collection resources were reassigned to Customer Service and restructuring activities. Overall, the resources committed to tax compliance programs have dropped by about 25 percent since 1996. The number of tax returns examined for the first six months of this year was down 30 percent compared to FY 1998, and tax audit assessments have dropped by $1.05 billion. The number of Taxpayer Delinquency Account dispositions has decreased significantly from 5 million in FY 1997 to 4.3 million in FY 1998, and to 1.5 million for the first six months of FY 1999. While collection of delinquent taxes and the use of enforcement tools have dropped, accounts receivable remain at over $244 billion at the end of the first six months of FY 1999. At the end of FY 1998, accounts receivable was $247 billion and $236 billion in FY 1997.

The Internal Revenue Service Continues to Face Risks in Resolving This Challenge

In the area of the reduction of compliance activities, the IRS is aware of the drop in enforcement statistics and overall compliance numbers. The IRS Commissioner has testified, on numerous occasions, about the drop in compliance numbers and has cited some reasons for the reduction, including: attrition of compliance resources with no hiring initiatives, implementation of the RRA 98, modernization efforts, and redirecting resources to Customer Service from traditional compliance activities.

On April 13, 1999, the GAO Director of Tax Policy and Administration Issues testified before the Subcommittee on Oversight House Committee on Ways and Means on the IRS' FY 2000 Budget Request and 1999 filing season. The report of the testimony stated there is insufficient information for the IRS or the Congress to assess the overall impact of a diversion of resources from compliance activities to Customer Service. The testimony concluded that without a measure of voluntary compliance, there is no way for the Congress, the IRS, or others to assess the impact of the diversions of resources to RRA 98 and Customer Service.

A New York Times article, dated October 10, 1999, notes that compliance is becoming an even more serious issue as the IRS works to improve customer service and deals with restrictions imposed by RRA 98. Of particular concern to the Wage and Investment Income Unit is the number of employers who are not depositing withheld payroll taxes. The article also notes that IRS tax collectors and various tax professionals around the country were provided this information on employers. The IRS Commissioner acknowledged that there had been a significant increase in the number of small businesses failing to turn over withheld taxes.

The staffing decreases for Compliance activities, plus the Compliance staffing assigned to Customer Service activities, particularly during the filing season, make it extremely difficult to adequately work cases, such as employers not turning over withholding taxes.

PROVIDING QUALITY CUSTOMER SERVICE OPERATIONS

The IRS has invested heavily in technology but has not improved telephone service to taxpayers. Recent statistics indicate that only 53 percent of taxpayers using the IRS' various telephone services receive the level of service they need. Providing better service to taxpayers is the key concept behind the IRS Commissioner's plans to modernize the IRS.

In addition, RRA 98 requires the IRS to place greater emphasis on serving the public and meeting taxpayer needs. As a result, the IRS expanded telephone service in 1999 to seven days a week, 24 hours a day. Over the next several years, the IRS will be consolidating offices currently handling taxpayer service toll-free calls, the automated collection system, service center compliance, and service center account work. The majority of taxpayer issues will be resolved, via telephone, with emphasis on automated self-service applications.

Although the IRS is working to provide better telephone service, face-to-face service remains an important part of providing quality customer service. The need to provide better face-to-face service with taxpayers was identified through the Vice President's National Performance Review initiatives. As a result, the IRS plans to expand and improve walk-in service during the next few years.

The Internal Revenue Service Continues to Face Risks in Resolving This Challenge

Effective October 1, 1999, the Customer Service Operations for telephone and correspondence sites were consolidated into one management structure in Atlanta, Georgia. The responsibility for processing tax returns will remain with the Submission Processing sites and continue to be headquartered in Cincinnati, Ohio. This change is designed to improve service by creating a clearer line of management authority. However, the taxpayer walk-in sites will not be realigned until Phase II of the IRS restructuring. At this time, these sites remain under Compliance in the districts.

The IRS was not able to satisfactorily handle the level of customer demand on its toll-free telephone lines during the 1999 filing season. This occurred despite the implementation of a major technological change and numerous initiatives that were intended to enhance customer service. Far too many taxpayers received busy signals or abandoned their calls after being placed on hold. For example, about 19.5 million calls resulted in busy signals during the 1999 filing season -- almost 16 million more than during the previous filing season. Another 6.5 million calls were abandoned before reaching a Customer Service Representative (CSR). The level of service provided to taxpayers declined from 69 percent for the 1998 filing season to 53 percent for the 1999 filing season.

Examples of the difficulties the IRS faces are:

- The cost to provide toll-free telephone service during the 1999 filing season increased while productivity decreased.
- The IRS' labor costs to handle toll-free calls during the first six months of FY 1999 was more than $175 million as compared to about $145 million during the same period in FY 1998.
- During this same six-month period, the productivity of the individual CSRs decreased by approximately 16 percent from the prior year. As a result, the IRS' labor costs increased by $1.30 per call.
- In addition to the Customer Service costs, enforcement resources used to supplement the toll-free program cost the government in excess of $216 million in lost revenue collected.

REVENUE PROTECTION – MINIMIZING TAX FILING FRAUD

The integrity of Earned Income Tax Credit (EITC) payments has been a concern to the IRS as well as outside stakeholders for many years. Massive EITC scams have been identified in the past and have included conspiracies in which hundreds of taxpayers' Social Security Numbers (SSN) were used by perpetrators of fraud. A draft IRS management study showed that the latest (1995 tax returns) and best available indicator of the EITC overpayment rate suggests a 32.08 to 34.28 percent overpayment rate, which translates into inappropriate payments in excess of $8 billion per year.

The Internal Revenue Service Has Made Progress Toward Resolving This Challenge

The IRS has significantly increased its efforts to guard against fraudulent refund claims over the past several years. The efforts include improved validation of taxpayer numbers (SSNs, Individual Taxpayer Identification Numbers, Adoption Taxpayer Identification Numbers), research and analysis of data to understand fraud, and EITC awareness and assistance.

For FY 2000, the key to the Revenue Protection efforts will be the Preparer Outreach Campaign that will involve IRS visits to thousands of tax preparers prior to the 2000 filing season to educate them on the requirements when preparing returns claiming the EITC. These preparers were computer identified with 100 or more EITC returns in the prior tax year.

Another significant change for the 2000 filing season will be the disallowance of exemptions and the EITC as math errors if the secondary SSN is found invalid during returns processing. This validation check is already in place for primary SSNs and was made possible by the Welfare Reform Act of 1996.

The Internal Revenue Service Continues to Face Risks in Resolving This Challenge

Much of the IRS' Revenue Protection efforts have focused on individual taxpayers reporting wages and withholding rather than business taxpayers. There are indications that fraudulent refund claims may be migrating to business returns. A refund scheme of over $250 million involving fiduciary returns was identified in 1999. In addition, fraudulent Quarterly Federal Excise Tax Returns (Form 720) have been filed to obtain refunds of federal excise taxes. Taxpayers have also filed fraudulent forms for Profit or Loss from Business (Schedule C) reporting false income to maximize their EITC.

TAXPAYER PROTECTION AND RIGHTS

The Senate Finance Committee held hearings in late 1997 that uncovered a wide array of taxpayer abuses by the IRS. As a result, RRA 98 imposes many auditing and reporting requirements in relation to improving the treatment of taxpayers. TIGTA is required to report on specific areas, which are summarized in our semiannual report to the Congress. We conducted audits in each of these areas, except where noted, for the first time in FY 1999. The results indicate that the IRS still has some work to do to meet the requirements of the provisions. For example, the IRS does not have effective systems or processes to ensure compliance with the law for six of the provisions audited. For FY 2000, we will follow up on identified weaknesses, as well as, provide coverage when possible, in areas not previously audited.

The Internal Revenue Service Has Made Progress Toward Resolving This Challenge

IRS management has initiated the following actions to improve taxpayer protection and prevent abuses of taxpayer rights:

Enforcement Statistics – The IRS issued a revised Managing Statistics Handbook, which incorporates guidance from RRA 98 and 26 Code of Federal Register Part 801, and provides additional examples that the IRS stated would address several concerns. The IRS also designated one executive to oversee the certification process.

Contacting Taxpayers – The IRS is revising its customer satisfaction surveys to include feedback on this issue. In addition, the IRS will issue instructions to field managers and Quality Review staffs to consider this issue during periodic case reviews.

Liens – The IRS will reprogram its system to reissue notices and recalculate the time period for requesting a hearing based on manual input of certain items. The IRS will also issue new guidance to employees to address the issues included in our Report Number 19991074.

Seizures – The IRS will revise its seizure checklists, incorporate them in the Seizure and Sale Handbook, cover them in training sessions, and will review the identified cases to determine if returning the money received as a result of the seizure would be the appropriate action to take.

Levies – The IRS has changed the system for issuing levies to ensure the letter has been issued and the proper time period has elapsed. The IRS has also revised its procedures to address the issues included in our Report Number 199910071. In addition, the IRS will explore the issue of restitution with the IRS District Counsel.

Taxpayer Designations – The IRS will have all offices certify that the Illegal Tax Protestor designations have been removed or destroyed.

Joint Filer Notifications – The IRS will contact the congressional legislative committees and will revise its procedures, if warranted, to be consistent with congressional intent. The IRS will also conduct an analysis of the volume of written joint filer requests it receives.

Complaints – The IRS has initiated a project to integrate complaint data from its current information systems and will form a Steering Committee to coordinate and oversee this initiative. The IRS' short-term objective is to extract data from current systems, reconcile the data for accuracy, and store the resulting information on an integrated database. The IRS also intends to develop the architecture that will allow the appropriate electronic interfaces between the current systems to provide the necessary coordination of incoming and outgoing data. The IRS has plans to expand the use of the IRS Intranet to provide the means for employees to obtain information and report allegations of misconduct and to deliver additional training to employees.

IMPLEMENTATION OF THE GOVERNMENT PERFORMANCE AND RESULTS ACT OF 1993

The Government Performance and Results Act (GPRA) of 1993 imposes significant changes to the IRS' budgeting and policy-making culture. The GPRA requires government agencies to set goals, measure performance, and report on their accomplishments through the development of strategic plans and annual performance plans. The IRS Strategic Plan and Budget, which includes the Annual Performance Plan, satisfies a major requirement of the GPRA. It identifies the IRS' mission, strategic objectives, goals, and strategies to achieve those goals. It also describes the IRS' priorities for the next five years, key performance indicators (measures), and the Business Review process used in assessing achievement of those goals.

Due to the IRS' modernization efforts, however, the measures are being re-evaluated. The IRS is developing a new balanced performance measurement system that will focus on accomplishments in three major areas: business results, customer satisfaction, and employee satisfaction. The IRS Commissioner has indicated that it will take several years to achieve a fully acceptable set of balanced measures that can be used at all levels of the organization.

The Internal Revenue Service Continues to Face Risks in Resolving This Challenge

The GAO's coverage of GPRA implementation indicates that agencies are facing challenges in developing useful plans, specifically in identifying performance measures and obtaining data needed to establish goals and assess performance. Overall, the plans could be improved to better support congressional and agency decision making.

IMPACT OF THE GLOBAL ECONOMY ON TAX ADMINISTRATION

The global economy is growing rapidly and has resulted in sophisticated business transactions. United States (U.S.) exports nearly tripled from 1985 to 1996, growing to over $1 trillion. Imports more than doubled during the same period to over $1.1 trillion. At the same time, significant numbers of foreign controlled corporations pay no U.S. taxes, and many individuals with income from other countries do not file tax returns to report it.

The GAO and the TIGTA have previously reported serious internal control and systemic weaknesses in the IRS' administration of its international programs. The IRS continues to struggle to increase compliance in an ever-growing international economy. Significant improvements are needed in international compliance programs to focus on nonfiling, transfers of assets by U.S. citizens to foreign trusts, foreign tax credit claims, and foreign-sourced income.

The Internal Revenue Service Has Made Progress Toward Resolving This Challenge

The IRS' new Large and Mid-Size Business Division (L&MSB) organization will have a strong emphasis on international issues. The approved L&MSB structure will attempt to integrate international expertise throughout the entire business unit and major industry segments. The rationale is that this will provide more consistent taxpayer treatment across industry lines. In addition, International Tax Examination Specialists will migrate to specific industries. The IRS has indicated that it has undertaken several international tax administration and compliance programs to address our concerns in areas such as transfer pricing, tax credits, foreign trust, non-filers, and foreign-sourced income reporting issues. However, we have just begun evaluating these initiatives.

As a result of the L&MSB organization, the number of international examiners and industry specialists will increase. The IRS continues to face challenges in getting the right people with the right skills in the right places. Training and development of these employees will continue to be a major challenge.

Challenge Area Removed from Major Management Challenges Facing

the Internal Revenue Service

SELECTING AND CONTROLLING RETURNS FOR EXAMINATION

Actions taken by IRS employees and managers in identifying, selecting, and conducting examinations of individual taxpayers should not in any way violate or abridge taxpayer rights or unnecessarily increase taxpayer burden. However, the Federal Managers' Financial Integrity Act process identified material weaknesses in relation to the examination of returns, including reporting of tax assessments and controls over case inventories and assignments. In 1997, the Senate Finance Committee heard testimony that addressed the misuse of enforcement statistics and abuse of taxpayer rights. During 1999, the IRS took steps to redesign the Examination Quality Measurement System and the Quality Review process to help identify and prevent these problems.

Although we continue to view the selecting and controlling of returns for examination as a risk, the IRS has agreed to take corrective actions based on findings and recommendations reported in FY 1999 and early FY 2000. We do not plan to conduct audit work in FY 2000 to allow the IRS time to implement the corrective actions. We will follow up to evaluate the effectiveness of these actions in FY 2001. For these reasons, this area is not listed as a major challenge for IRS management in FY 2000. In FY 2000, the following planned reviews are being conducted to assess the IRS' processes to prevent unnecessary assessments on taxpayers:

- Review of the IRS' Process for Addressing Requests to Change Decisions on Tax Return Audits.
- Review of the IRS' Process to Measure the Consideration of Collectibility Before Opening an Examination.

The Internal Revenue Service Has Made Progress Toward Resolving This Challenge

The following actions should have been taken based on management's responses to prior reports:

- New instructions and procedures have been issued for controlling compliance projects and other Midwest Audit Classification System (MACS) requests.
- Separation of duties has been discussed with design teams for the four new business units.
- The MACS audit trail has been enhanced and employees have been trained on using it.
- Field offices have been trained on procedures for conducting correspondence examinations in district offices.
- The Examination Return Control System audit trail should now be enhanced and users trained to use it.
- Acting managers have been instructed not to approve actions on their own cases.
- Integrated Data Retrieval System capabilities have been taken away from employees who do not need them to conduct their regular duties.

Appendix

Significant Open Audit Recommendations

FINANCIAL MANAGEMENT - None

MODERNIZATION OF THE INTERNAL REVENUE SERVICE

ORGANIZATIONAL RESTRUCTURING - None

TECHNOLOGY MODERNIZATION

Readiness for Service Center Mainframe Consolidation *(Report Reference No. 085812, September 1998*)

Unless assurances can be made that experienced Internal Revenue Service (IRS) personnel can be relocated when and where needed, IRS management should develop a contingency plan to provide needed staffing for critical positions at all affected sites. The Project Management Office should announce jobs with moving expenses and relocation bonuses. A Letter of Understanding should be signed with the National Treasury Employees Union that provides for directed reassignments, if needed. Vendor support should also be considered. The Project Management Office should also ensure vendor site surveys are completed, issued within the 15-day requirement per the Service Center Support System contract, and reviewed by Information Systems personnel for accuracy and completeness.

Review of the Service's Electronic Federal Tax Payment System Implementation and Enhancements *(Report Reference No. 083008, April 1998)*

For the long-term, management should use the authority given by the Taxpayer Bill of Rights 2 (TBOR2) for alternative forms of authorizations to re-engineer the enrollment and authorization processes in the Electronic Federal Tax Payment System, substantially reducing, and perhaps eliminating, paper enrollments and authorizations.

Review of the Controls over the Service's ADP Resources *(Report Reference No. 075008, September 1997)*

National Office management needs to perform periodic summary level comparisons, by type of asset, between the Integrated Network and Operations Management System (INOMS) Property Management System and the administrative general ledger.

A Review of Cyberfile *(Report Reference No. 072303, April 1997)*

Management needs to ensure that IRS guidelines are strengthened to specify project management procedures regarding tracking funds paid to vendors for services and vendor purchases/leases of IRS-funded equipment.

YEAR 2000 COMPLIANCE

Increased Validation and Oversight of Year 2000 Minicomputer Conversion Efforts Are Needed to Strengthen Testing and to Avoid Further Delays *(Report Reference No. 199920054, August 1999)*

The Century Date Change (CDC) Project Office should independently validate milestone dates for systems that did not make the January 1999 target date for systems to be Year 2000 (Y2K) compliant. The CDC Project Office needs to ensure that formal contingency planning procedures cover all systems that did not meet the March 1999 Office of Management and Budget target date for developing contingency plans for systems that are not Y2K compliant.

Review of the Internal Revenue Service's Year 2000 Contingency Planning *(Report Reference No. 092705, March 1999*)

The IRS should review and correct Y2K inventory files on a recurring basis to ensure information used to identify the need for contingency plans is accurate and complete; establish validity checks for the Y2K inventory files; and assign responsibility for the IRS' overall contingency management strategy, including Y2K, and the coordination of resources to one area.

Review of the Internal Revenue Service's Year 2000 Efforts to Inventory Telecommunications and Commercial Off-the-Shelf Products (*Report Reference No. 092402, February 1999*)

The CDC Project Office should independently verify that the INOMS inventory of commercial-off-the-shelf (COTS) products is complete for all Tier I systems.

Review of Phase IV Year 2000 Conversion and Testing *(Report Reference No. 090403, October 1998)*

The CDC Project Office should ensure that the Product Assurance Division monitors organizational efforts to re-certify the data on the Application Program Registry (APR), ensuring also that components tracked and reported on the APR are linked with the correct phase and status.

SECURITY OF THE INTERNAL REVENUE SERVICE'S INFORMATION SYSTEMS

The General Controls Environment Over the Internal Revenue Service's Unisys 2200 Systems Can Be Improved *(Report Reference No. 199920063, August 1999)*

All files with taxpayer information should be identified and secured; control settings for production mainframes should be standardized; and security plans and risk assessments should be developed and maintained in preparation for the mainframe consolidation.

Review of the Electronic Fraud Detection System *(Report Reference No. 093009, June 1999)*

Password changes should be systemically enforced and included on audit trails; terminals should be disabled after a selected number of failed login attempts; audit trails should record all accesses to taxpayer data; and the ability to analyze audit trail data should be enhanced.

PROCESSING RETURNS AND IMPLEMENTING TAX LAW CHANGES DURING THE TAX FILING SEASON

The Internal Revenue Service Can Improve Customer Service By Accelerating Refund Payments *(Report Reference No. 093903, August 1999)*

Responsible IRS functions should work together to accelerate refunds to satisfy customer needs and reduce costs. Several short-term, low-cost, non-reengineering changes could significantly reduce refund issuance time frames. This will require cooperating with other federal agencies, which is also in accordance with National Performance Review initiatives. Long-term changes could further accelerate refund issuance and lower costs.

The Internal Revenue Service Should Improve Procedures to Identify and Resolve Incorrect and Missing Taxpayer Identification Numbers *(Report Reference No. 091104, July 1999)*

The IRS should improve its system to process and validate taxpayer identification numbers (TINs), by implementing computer controls to identify returns claiming Head of Household filing status without dependents and by revising processing procedures to ensure that returns with errors are corrected. The IRS should also develop specialized training to ensure that problems regarding incorrect TINs are resolved. *Note: This audit is also included under the challenge area Revenue Protection - Minimizing Tax Filing Fraud Initiatives.*

Executive Compilation and Interpretation of the 1998 Filing Season *(Report Reference No. 091903, December 1998)*

The IRS should provide taxpayers, whose main source of income is from wages, a simpler shorter tax return and should consider developing a taxpayer profile database to allow for quicker verification of taxpayer account information.

Math Error Processing for Revenue Protection Issues *(Report Reference No. 083322, May 1998)*

The IRS should request processing changes to improve the math error detection and notice issuance process. Due to the programming resources currently devoted to making high priority century date and legislatively mandated changes, the implementation of some of these corrective actions (such as the validation of secondary TINs, the transcription of child care provider information, and the programming of new error codes) have been rescheduled for January 2000. *Note: This audit is also included under the challenge area Revenue Protection - Minimizing Tax Filing Fraud Initiatives.*

Review of the Service's Electronic Federal Tax Payment System Implementation and Enhancements *(Report Reference No. 083008, April 1998)*

For the long term, management should use the authority given by the TBOR2 for alternative forms of authorizations to re-engineer the enrollment and authorization processes in the Electronic Federal Tax Payment System, and substantially reduce, and perhaps eliminate, paper enrollments and authorizations. In addition, IRS management should provide a process for electronic submission of authorization data to eliminate manual transcription.

Review of the Initial System Development Activities on the Integrated and Remittance Processing System *(Report Reference No. 082204, January 1998)*

The IRS should ensure that the pilot system's actual productivity gains are sufficiently evaluated and that it has properly assessed the risks associated with not having the system's developer under contract during the Year 2000.

Quality of Information Document Processing *(Report Reference No. 071304, March 1997)*

The IRS should review Martinsburg Computing Center Report 405-02-12 to determine whether large variances exist between processing years in the volume and dollars of information documents.

CUSTOMER SERVICE AND TAX COMPLIANCE INITIATIVES

The Internal Revenue Service Has Not Fully Implemented Procedures to Notify Taxpayers Before Taking Their Funds for Payment of Tax *(Report Reference No. 199910071, September 1999)*

IRS management should develop methods to ensure taxpayers are notified of their right to a hearing and of the IRS' intent to levy before the levy is issued, and that notices are not issued unless the levy is the next planned action. In addition, the IRS should determine, from a legal standpoint, what steps should be taken regarding any money received from a levy that was not conducted in accordance with the law. *Note: This audit is also included under the challenge area Taxpayer Protection and Rights Initiatives.*

The Internal Revenue Service Needs to Improve Compliance with Legal and Internal Guidelines When Taking Taxpayers' Property for Unpaid Taxes *(Report Reference No. 199910072, September 1999)*

IRS management should include pertinent IRS Restructuring and Reform Act of 1998 (RRA 98) and Internal Revenue Manual (IRM) requirements in its seizure and post-seizure checklists, and should ensure employees are aware of the new checklists and are following them. Also, the IRS should determine from a legal standpoint what steps should be taken regarding any money received from a seizure that was not conducted in accordance with the law. *Note: This audit is also included under the challenge area Taxpayer Protection and Rights Initiatives.*

The Internal Revenue Service Should Improve Its Federal Tax Lien Procedures *(Report Reference No. 199910074, September 1999*)

IRS management should change its systems to automatically reissue undeliverable notices and to send the notice to all responsible spouses and appropriate business partners and should revise procedures to ensure employees are complying with the law. *Note: This audit is also included under the challenge area Taxpayer Protection and Rights Initiatives.*

The Internal Revenue Service Needs to Enhance Guidance on and Monitoring of Compliance with Procedures for Directly Contracting Taxpayers and Their Representatives *(Report Reference No. 199910076, September 1999)*

IRS management should complete efforts to clarify national guidance to ensure taxpayers' requests to consult with their representatives are treated consistently. In addition, the IRS should develop a process to determine whether employees are complying with the law on this issue. *Note: This audit is also included under the challenge area Taxpayer Protection and Rights Initiatives.*

Internal Revenue Service Procedures Responding to Written Request for Collection Activity From Joint Return Filers Vary From Statutory Requirements *(Report Reference No. 199910077, September 1999)*

The IRS should contact the appropriate congressional liaison committees to ensure that its practice of allowing oral responses to written joint filer requests complies with the intent of the law. The IRS should also determine the volume of joint filer requests and whether IRS employees are properly responding to taxpayers. *Note: This audit is also included under the challenge area Taxpayer Protection and Rights Initiatives.*

Improvements Can Be Made In Providing Assistance to Taxpayers *(Report Reference No. 199940065, September 1999)*

IRS management could further its goals of improving treatment of taxpayers by ensuring prompt distribution of new tax law material to telephone assistors and by establishing a process that ensures all telephone assistors are adequately trained. In addition, IRS management should establish uniform policies and procedures that will ensure quality responses to taxpayers' e-mail questions.

The New Jersey District Needs to Execute Levy Actions Consistent with Sound Tax Administration and Concern for Taxpayer Treatment *(Report Reference No. 199930069, September 1999)*

The New Jersey District should emphasize policy and procedural requirements on the use of levy authority, and review levy actions taken during the past nine months to identify instances that meet criteria requiring remedies to taxpayers.

Improving Internal Revenue Service Processes For Evaluating and Publicizing Walk-In Services *(Report Reference No. 094106, May 1999)*

IRS management should modify how the customer satisfaction survey is administered, allow customer comments, and identify specific walk-in offices. IRS management should also fully publicize walk-in services, ensure that Saturday service is provided at sites based on taxpayer demand, and plan special emphasis days earlier in the year.

Productivity of the Underreporter Program *(Report Reference No. 071404, February 1997)*

A Gross Assessment Method should be used to calculate yield to cost ratios, determine productivity rankings, and select inventory for the Underreporter Program. Actual site costs should be used when calculating productivity to increase the accuracy of productivity rankings and obtain a more precise measurement of efficiency.

PROVIDING QUALITY CUSTOMER SERVICE OPERATIONS

Taxpayer Walk-In Program for the 1997 Filing Season *(Report Reference No. 081004, December 1997)*

The IRS should develop a customer-based strategy and a related program with applicable goals and measures to evaluate performance of the Walk-In Program.

REVENUE PROTECTION – MINIMIZING TAX FILING FRAUD

The Internal Revenue Service Can Improve its Electronic Return Preparer Fraud Activities *(Report Reference No. 199940062, September 1999)*

IRS management should: ensure that adequate resources are provided for the identification and development of return preparer schemes; develop procedures that clearly establish Criminal Investigation as the lead office for the Return Preparer Program (RPP) to better ensure those activities can be effectively coordinated cross-functionally; prepare a memorandum of understanding, or similar document, to specify cross-functional responsibilities and to obtain functional commitment to the RPP; ensure that Criminal Investigation assigns the responsibility for monitoring and coordinating the RPP to a national program analyst on a full-time and on going basis; and assign responsibility for the removal of noncompliant return preparers to someone other than the district Electronic Tax Administration Coordinator.

The Internal Revenue Service Should Improve Procedures to Identify and Resolve Incorrect and Missing Taxpayer Identification Numbers *(Report Reference No. 091104, July 1999)*

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TAXPAYER PROTECTION AND RIGHTS

The Internal Revenue Service Has Not Fully Implemented Procedures to Notify Taxpayers Before Taking Their Funds For Payment of Tax *(Report Reference No.*

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IRS management should develop methods to ensure taxpayers are notified of their right to a hearing and of the IRS' intent to levy before the levy is issued, and that notices are not issued unless the levy is the next planned action. In addition, the IRS should determine, from a legal standpoint, what steps should be taken regarding any money received from a levy that was not conducted in accordance with the law. *Note: This audit is also included under the challenge area Customer Service and Tax Compliance Initiatives.*

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The Internal Revenue Service Is Addressing the Use of the Illegal Tax Protestor and Nonfiler Designations *(Report Reference No. 199910080, September 1999)*

The IRS should monitor the remaining changes to remove the Illegal Tax Protestor designations from the IRS instruction manuals and from various IRS computer systems, as well as, the planning and implementation of the newly proposed frivolous nonfiler designations.

The Internal Revenue Service Can Further Improve Its Complaint Processing Procedures and Systems *(Report Reference No. 199910070, September 1999)*

The IRS should ensure that appropriate interfaces exist between the multiple complaint processing systems during the development of its centralized and integrated complaint information system. Also, the IRS should identify and provide any additional training needed on the complaint processing procedures and periodically survey employees to determine the employees' willingness to report taxpayer complaints and allegations.

IMPLEMENTATION OF THE GOVERNMENT PERFORMANCE AND RESULTS ACT OF 1993

The Internal Revenue Service Should Improve Its Process to Ensure That All Government Performance and Results Act Requirements Are Satisfied *(Draft Report Dated October 1999)*

This report provided an assessment of the IRS' Government Performance and Results Act of 1993 (GPRA) activities, Interim Strategic Plan, and FY 2000 Annual Performance Plan. We reported that some improvement was needed in the processes that the IRS was using to accomplish GPRA. The response from the IRS Commissioner has not yet been received. Potential challenges to the IRS will be to ensure that the data used to establish the IRS' benchmark is valid, and that the data collected in FY 1999 can be used as baselines for the new business units. If the data are not accurate or are not transportable to the business units, the IRS may face another year of gathering baseline data for some business units.

IMPACT OF THE GLOBAL ECONOMY ON TAX ADMINISTRATION

Review of Service Efforts to Ensure Compliance of Taxpayers Receiving Foreign Sourced Income *(Report Reference No. 072208, April 1997)*

The Assistant Commissioner (International) should work in coordination with the Executive Officer for Customer Service to measure the overall impact of Foreign Information Returns Program (FIRP) documents, and the role FIRP should play in relation to overall compliance efforts. The Assistant Commissioner (International) should also coordinate efforts with the Executive Officer for Customer Service and the National Director, Submission Processing, to ensure that late filed and prior year FIRP documents are processed and available for inclusion in the Information Returns Program initiative when it becomes operational. IRS management should commit to the development of a system to process foreign information records received magnetically in the standard Organization for Economic Cooperation and Development format.

Review of Nonresident Alien Information Documents *(Report Reference No. 041403, January 1994)*

The IRS management should ensure that obvious noncompliance with applicable tax laws and regulations are identified during processing.