# Improvements to the Electronic Return Originator Monitoring Program Are Needed

**January 2003**

**Reference Number: 2003-30-039**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**

INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 15, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements to the Electronic Return Originator Monitoring Program Are Needed (Audit # 200230023)

This report presents the results of our review of the Internal Revenue Service's (IRS) Electronic Return Originator (ERO) Monitoring Program. The overall objective of this review was to determine if the IRS' program for annually monitoring the performance of the ERO Program effectively ensures ERO compliance with IRS policy and procedures for originating tax returns electronically and maintaining required documentation.

The Congress has mandated that the IRS significantly increase the number of taxpayers who file their returns electronically. In particular, Title II of the IRS Restructuring and Reform Act of 1998 (RRA 98)[1] provides that:

- Paperless filing is the preferred and most convenient means of filing Federal tax and information returns.
- The goal of the IRS is to have at least 80 percent of all such returns filed electronically by Calendar Year (CY) 2007.
- The IRS should cooperate with and encourage the private sector to increase electronic filing of such returns.

[1] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

According to the IRS' document, *Electronic Tax Administration – A Strategy For Growth* (December 2000), to the extent practicable, all returns prepared electronically should be filed electronically for taxable years beginning after 2001 (i.e., by CY 2003). Since approximately 60 percent of all individual tax returns are prepared electronically, this establishes a formidable goal of about 80 million returns being filed electronically by CY 2003.

At present, the majority of tax returns filed in the IRS electronic filing (*e-file*) Program are through Authorized IRS *e-file* Providers. An ERO is the Authorized IRS *e-file* Provider that originates the electronic submission of a return to the IRS. Over 119,000 EROs are authorized to participate in the IRS *e-file* Program.

One of the IRS' major controls over the *e-file* Program is the ERO Monitoring Program. The purpose of monitoring visits is to verify EROs' compliance with the requirements for participating in the IRS *e-file* Program. In Fiscal Year (FY) 2001, the IRS issued new procedures for monitoring visits and set a goal of conducting monitoring visits to 1 percent of all EROs.

In summary, the ERO Monitoring Program can be improved to better evaluate, document, and ensure the compliance of EROs. Specifically, the IRS has not established a performance measure to determine the ERO Monitoring Program's impact on ERO compliance, implemented a planning process for the ERO Monitoring Program that provides for timely training and use of effective case building information, or developed a risk-based methodology for selecting monitoring visits. Further, program coordinators and monitors have difficulty determining the level of infractions, and are not ensuring case documentation is complete.

We recommended that the IRS establish a meaningful performance goal and measurement for the ERO Monitoring Program, ensure follow-up visitations are made, establish a planning process to ensure timely training and case preparation, and enhance the use of the database of EROs. The IRS also needs to better determine the mix of random and mandatory ERO visits, and develop risk-based selection criteria using a data-driven process for selecting random monitoring visits. Finally, we recommended that the IRS develop more detailed guidance on sanctions, consider due diligence compliance in the sanction program, and improve monitoring case documentation.

<u>Management's Response</u>: The Commissioner, Small Business/Self-Employed (SB/SE) Division, has planned or taken full or partial corrective actions for eight of our nine recommendations. The analyst responsible for the ERO Monitoring Program will also be responsible for planning, training, and case building, and the IRS will issue a memorandum providing additional guidance and direction on ERO monitoring case documentation. CY 2002 train-the-trainer classes included training on all pertinent *e-file* systems, and guidance will be issued to coordinators who did not attend the training. In addition, the IRS will provide written guidance to all coordinators to consider the best balance of geographic coverage possible when choosing the location of random visits, and the IRS will also issue guidance on using available information to pinpoint EROs for visitations. ERO Monitoring Program training materials were revised to include additional examples of infraction and sanction guidelines, and complete case

documentation was emphasized during training. The IRS also instructed monitors to pursue due diligence penalties when appropriate, and will provide written guidance on and reinforce the importance of complete case documentation.

The Commissioner, SB/SE Division, disagreed with our recommendation to establish a goal and method for measuring program effectiveness in improving ERO compliance. He stated that although the SB/SE Division could track and measure the results on specific cases, types of cases, or trends, it would be impossible to measure the effect on voluntary compliance for all Authorized IRS *e-file* Providers. According to the Commissioner, factors other than IRS visitations may influence compliance of the Providers. He further stated that if the SB/SE Division established a goal and measures to track the results of follow-up visits, the results would not be significant in determining the effect on voluntary compliance.

Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: We are concerned about the IRS' response to two of our nine recommendations. First, regarding the IRS' decision not to establish a goal and method for measuring program effectiveness in improving ERO compliance, the *President's Management Agenda*[2] includes a requirement to link performance with the budgeting process. Further, the Government Performance and Results Act,[3] the General Accounting Office's *Standards for Internal Control in the Federal Government*, and the Office of Management and Budget's *Circular A-123, Management Accountability and Control,*[4] all discuss the need to set performance goals and report annually on actual performance compared to goals. These activities are designed to ensure that (i) programs achieve their intended results; (ii) resources are used consistent with the agency's mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision-making. The goal of the ERO Monitoring Program is to ensure and improve compliance with *e-file* requirements. Without measuring the impact monitoring visits are having on compliance, it is impossible to determine if budget expenditures made for those visits are contributing to the goal. Therefore, taxpayers and the Congress cannot be assured that monitoring activities they are paying for are economically and efficiently achieving the goal of improving ERO compliance. We recognize that indicators may be difficult to develop, but believe the benefits will far outweigh the costs in linking performance with the budget process, and in allocating resources where they will have the most impact.

Second, while the IRS agreed to ensure that monitors and coordinators are sufficiently trained on all *e-file* systems, this is only partial corrective action to our recommendation. Our recommendation also included ensuring that future *e-file* systems meet user requirements. The IRS did not respond to that portion of our recommendation.

---

[2] The President's Management Agenda FY 2002, Office of Management and Budget.
[3] Pub. L. No. 103-62, 107 Stat. 285 (1993).
[4] Federal Register, Vol. 60, No. 125, June 29, 1995, p. 33876 – 33882.

While we still believe these recommendations are worthwhile, we do not intend to elevate our disagreement concerning these matters to the Department of Treasury for resolution.

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 Parker F. Pearson, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (410) 962-9637.

# Table of Contents

## Background

The Congress has mandated that the Internal Revenue Service (IRS) significantly increase the number of taxpayers who file their returns electronically. In particular, Title II of the IRS Restructuring and Reform Act of 1998 (RRA 98)[1] provides that:

- Paperless filing is the preferred and most convenient means of filing Federal tax and information returns.
- The goal of the IRS is to have at least 80 percent of all such returns filed electronically by Calendar Year (CY) 2007.
- The IRS should cooperate with and encourage the private sector to increase electronic filing of such returns.

According to the IRS' document, *Electronic Tax Administration – A Strategy For Growth* (December 2000), to the extent practicable, all returns prepared electronically should be filed electronically for taxable years beginning after 2001 (i.e., by CY 2003). Since approximately 60 percent of all individual tax returns are prepared electronically, this establishes a formidable goal of about 80 million returns being filed electronically by CY 2003. About 47 million tax returns were filed electronically in CY 2002.

The majority of tax returns filed in the IRS electronic filing (*e-file)* Program are through Authorized IRS *e-file* Providers. According to the IRS, the best opportunity for increasing the number of electronically filed tax returns is to encourage more tax return preparers to become *e-file* Providers. An Authorized *e-file* Provider is a business authorized by the IRS to participate in the IRS *e-file* Program. The business may be a sole proprietorship, partnership, corporation, or other organization.

An Electronic Return Originator (ERO) is the first point of contact for most taxpayers filing a tax return through the IRS *e-file* Program. An ERO is the Authorized IRS *e-file* Provider that originates the electronic submission of an income tax return to the IRS. EROs may originate the

[1]Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

electronic submission of income tax returns they either prepared or collected from taxpayers. There are over 119,000 authorized EROs, by far the largest category of *e-file* Provider.

One of the IRS' major controls over the *e-file* Program is the ERO Monitoring Program. The purpose of monitoring is to verify compliance with the requirements for EROs participating in the IRS *e-file* Program. In Fiscal Year (FY) 2001, the IRS issued new procedures for monitoring and set a goal of conducting monitoring visits to 1 percent of all EROs.

*E-file* Monitoring Coordinators (EMC) in field offices are responsible for the monitoring of EROs' operations. Monitoring is accomplished through visits to EROs' establishments either by EMCs or by multi-functional team members trained by EMCs to perform visits and monitoring functions. Violations of IRS ERO requirements may result in a verbal or written warning, written reprimand, suspension, or expulsion of the ERO from the IRS *e-file* Program, depending on the seriousness of the infraction.

The IRS has two categories of ERO monitoring visits: random and mandatory. Random visits are used to determine general compliance within the IRS *e-file* Program, and mandatory visits are used to investigate allegations and complaints submitted against EROs. During monitoring visits, EMCs or team members should take appropriate measures to ensure compliance with *e-file* requirements.

We performed this audit from April to August 2002 in the IRS' Small Business/Self-Employed (SB/SE) Division's Atlanta, Georgia; Brooklyn, New York; Dallas, Texas; and Nashville, Tennessee field offices. The audit was performed in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

**Program Goals and Measurements Should Be Results-Oriented, Annual Planning Processes and Training Should Be More Timely, and Database Research Capabilities Should Be Improved**

Although the ERO Monitoring Program has only been in the SB/SE Division for 2 years, the Program has made significant strides with its monitoring efforts. Management developed and revised procedures and training materials and provided train-the-trainer sessions for EMCs who, in turn, trained monitors. The Program also defined mandatory and random visits and established a goal to visit 1 percent of all EROs, which the Program achieved in both CYs 2001 and 2002. There are, however, three areas where the ERO Monitoring Program can be improved.

**There is no meaningful goal and method to measure program results**

In CYs 2001 and 2002, the principal measurable goal for the ERO Monitoring Program was the number of visits conducted. In both years, the IRS set a goal of conducting visits to 1 percent of all EROs. However, the IRS had no corresponding goal for measuring the impact that the Program had on improving ERO compliance.

According to the General Accounting Office's (GAO) *Standards for Internal Control in the Federal Government* and the Government Performance and Results Act of 1993 (GPRA),[2] management should establish and review performance measures. Performance measures should assess not only relevant outputs (i.e., number of visits completed), but also program outcomes (i.e., the impact of the ERO Monitoring Program on compliance). Program measures should be expressed in an objective, quantifiable, and measurable form.

Performance measures for the ERO Monitoring Program should focus on results and the desired program achievements of determining and improving the compliance of EROs. One method of measuring the ERO Monitoring Program's impact on compliance is through follow-up visits to EROs who were sanctioned in the prior year. The IRS already classifies these visits as mandatory.

Overall, the number of follow-up visits is small compared to the total number of visits conducted in the four offices reviewed. Specifically, the 4 offices reviewed conducted a

[2] 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.).

total of 359 monitoring visits, of which only 23 (6 percent) were follow-up visits. Two of the four offices reviewed did not conduct any follow-up visits to EROs. Of the 23 follow-up visits conducted:

- Twenty-one were from one office and the other two from a second office.
- Eight were to EROs visited in CY 2001, and 15 were to EROs already visited once before in CY 2002.

Follow-up visits were not conducted primarily because EMCs considered follow-up visits lower priority than new complaint and referral visits for CY 2002. Additionally, in three of four offices visited, historical files for prior year visits were not associated with current year visits, so monitors may not have been aware of ERO case histories.

The 23 follow-up visits resulted in the following:

- Eleven reprimands.
- Two warnings.
- Three suspensions.
- One "no additional sanctions" determination.
- Six "in compliance" determinations.

Results of follow-up visits from the two offices indicate that initial monitoring visits did not always result in improved ERO compliance. In 70 percent of the follow-up cases reviewed, EROs were subsequently issued reprimands or warnings, or suspended from the ERO Monitoring Program. The IRS, however, did not assess the impact the ERO Monitoring Program had on ERO compliance because it did not establish such a performance measure. By establishing a meaningful goal and measure, and ensuring that the ERO Monitoring Program conducts required follow-up visits, the IRS can better manage the Program and also assess the impact monitoring has on improving ERO compliance.

**The planning process is not timely**

The ERO Monitoring Program runs from mid-January through mid-April, corresponding with the filing season.[3] While management issued revised monitoring guidelines and delivered training to EMCs and monitors, the planning

[3] The filing season is the period from January through mid-April when most individual income tax returns are filed.

process for the 2002 Filing Season did not allow sufficient time for EMCs to train new monitors and also select and prepare monitoring cases for field visits. The ERO Monitoring Program guidelines require EMCs to solicit volunteers and train them as monitors prior to the start of the filing season. EMCs should also identify and perform research for cases requiring follow-up visits from prior years, and identify and select EROs for random visits.

As with other parts of the IRS, the reorganization of the IRS from functional lines to business divisions affected the ERO Monitoring Program. For example, CY 2002 was the National Headquarters Senior Analyst's first year in charge of the ERO Monitoring Program, and two of the four EMCs interviewed during our audit did not work in the ERO Monitoring Program in CY 2001 or in prior years.

After selection, EMCs were trained in October 2001 and directed to train monitors by January 2, 2002, prior to the start of the 2002 Filing Season. The IRS starts accepting electronically filed tax returns in mid-January. However, in all four offices we reviewed, EMCs did not train monitors by January 2, 2002, as directed. In fact, in one office, training for monitors was not completed until April 2, 2002.

As a result of the late training, monitors were not prepared to begin visits at the start of the filing season. By the beginning of April, the IRS had already received approximately 87 percent of all electronic returns filed by EROs during the 2002 Filing Season. Because of the large percentage of electronic tax returns received early in the filing season, it is important that the ERO Monitoring Program is prepared at the start of the filing season for visits to have maximum impact.

Monitoring visits should be conducted as early as possible during the filing season because it is important to identify noncompliant EROs as soon as possible. The earlier in the filing season monitors visit EROs, the sooner noncompliant EROs may be identified and brought into compliance or appropriately sanctioned. Early identification of noncompliant EROs should improve the overall quality of the IRS *e-file* Program.

**Database research capabilities and training need improvement**

At the start of the 2002 Filing Season, some EMCs received numerous complaints and referrals on EROs but did not have sufficient time to prepare comprehensive case files for monitoring visits. EMCs' planning efforts were limited in part by the On-Line Applicants (OLA) Database, the new *e-file* database used by field operations to research EROs. The OLA Database contains information from *e-file* Provider applications, as well as information on *e-file* firms' responsible officials.

The OLA Database is not searchable by either name or address. It is, however, searchable by Electronic Filing Identification Number (EFIN),[4] state, and zip code. According to our discussions with EMCs, many of the referrals received during the 2002 Filing Season were from taxpayers who did not know an ERO's EFIN but only the name and/or address. Queries of the OLA Database by zip code, for example, returned all EROs in the zip code area. EMCs told us they had to manually sort through the EROs in a zip code area to find potential matches to referred names or addresses. They concluded that it was difficult to use the OLA Database to research these referrals.

Results of OLA Database queries may be downloaded into other computer software programs on EMCs' computers and then queried on different database fields, such as EFIN and name. However, EMCs were unfamiliar with downloading and importing data from the OLA Database into other computer applications. Downloading from the OLA Database was not included in the training program for EMCs and monitors; therefore, EMCs were unable to effectively use the information contained in the database.

The OLA Database replaced the former District Office Applicants Database (DOADB), but does not have the same functionality as the DOADB. According to IRS management, the OLA Database is a temporary research tool and will eventually be replaced by the IRS' Third Party Data Store. Because of the OLA Database's limitations and not receiving the necessary training, EMCs and monitors

---

[4] A unique identification number assigned by the IRS to a person applying to the *e-file* Program.

did not have as much information as possible when planning their monitoring visits. Easier access to key information would help EMCs and monitors better plan and prepare monitoring visits.

## Recommendations

The Director, Compliance, SB/SE Division, should:

1. Establish a goal and method for measuring program effectiveness for improving ERO compliance, such as results of follow-up visits.

Management's response: The Commissioner, SB/SE Division, disagreed with our recommendation to establish a goal and method for measuring program effectiveness in improving ERO Compliance. He stated that although the SB/SE Division could track and measure the results on specific cases, types of cases, or trends, it would be impossible to measure the effect on voluntary compliance for all Authorized IRS *e-file* Providers.

Office of Audit Comment: The *President's Management Agenda*[5] includes a requirement to link performance with the budgeting process. Further, the GPRA, the GAO's *Standards for Internal Control in the Federal Government*, and the Office of Management and Budget's *Circular A-123, Management Accountability and Control,*[6] all discuss the need to set performance goals and report annually on actual performance compared to goals. We recognize that indicators may be difficult to develop, but believe the benefits will far outweigh the costs in linking performance with the budget process, and in allocating resources where they will have the most impact.

2. Ensure that historical case documentation is associated with current year cases and reinforce that the purpose of follow-up visits is to measure the impact of the ERO Monitoring Program on compliance.

Management's response: The Director, Reporting Compliance Policy, SB/SE Division will issue a

---

[5] The President's Management Agenda FY 2002, Office of Management and Budget.
[6] Federal Register, Vol. 60, No. 125, June 29, 1995, p. 33876 – 33882.

memorandum providing additional direction and guidance on documentation.

3. Establish a planning process that allows sufficient time for training and case building.

Management's response: The IRS plans to conduct training prior to the new fiscal year. Also, the analyst responsible for the program will be responsible for the planning, training, and case building.

4. Ensure that the functionality of the OLA Database's replacement meets user requirements and that EMCs and monitors are sufficiently trained on all pertinent *e-file* systems.

Management's response: All new EMCs were trained on all pertinent *e-file* systems in the 2002 train-the-trainer classes. Guidance will be provided to EMCs who did not attend training.

Office of Audit Comment: While the IRS agreed to ensure that monitors and coordinators are sufficiently trained on all *e-file* systems, this is only partial corrective action to our recommendation. Our recommendation also included ensuring that future *e-file* systems meet user requirements, but the IRS did not respond to this.

### Visit Selection Criteria Should Use Available Data and Ensure Broad Coverage

The ERO Monitoring Program conducted approximately 850 randomly selected and approximately 620 mandatory monitoring visits nationwide in CY 2002. Per the IRS Strategic Plan 2000-2005, since the IRS has limited resources, it is essential that it apply them where they will be of most value in reducing noncompliance while ensuring fairness, observing taxpayer rights, and reducing the need to burden those who do comply. Consequently, this would suggest that the IRS use a risk-based, data-driven process to select the potentially most non-compliant EROs for these monitoring visits.

Three of the four offices we reviewed performed random visits, but the EMCs did not use available information and data in the visit selection process. In these 3 offices, 26 of their 94 monitoring visits were randomly selected, but these random visits were not selected according to compliance-oriented factors. Instead, these offices based their selections on other factors, such as the physical location of monitors. None of the four IRS offices reviewed had established selection criteria for random monitoring visits, and only one of the four offices reviewed used an objective criterion to help select EROs for random visits.

During discussions with IRS management, we identified several sources of data and information that could contribute to the development of a data-driven random visit selection process. For example, information is available on how timely EROs submit their U.S. Individual Income Tax Declarations for an IRS *e-file* Return (Form 8453) to the IRS, the percentage of rejected electronically filed tax returns for each ERO, and the volume of each Error Reject Code[7] for EROs. Additionally, the Electronic Fraud Detection System (EFDS)[8] contains detailed information on electronically filed returns. All of these data may be potential sources for establishing ERO visit selection criteria.

In fact, experts in the area of risk management advocate the concept of "risk intelligence," which requires data and good management information systems to create a risk "nervous system" of information. The information the IRS already has available would help lay the groundwork for such a risk "nervous system" in this area. Focusing on potentially non-compliant EROs may be more beneficial for improving compliance than a strictly random selection process.

Without determining indicators of potential ERO non-compliance and using them for random visit selection, the IRS will not be able to effectively focus its ERO Monitoring Program resources. While the IRS should focus its resources where potential ERO non-compliance is greatest, ERO monitoring visit selection criteria should also consider geographic coverage. According to the IRS Strategic Plan 2000-2005, one indicator of success is the uniformity of compliance across different geographic areas and different demographic segments. Uniformity across sectors is important for actual and perceived fairness of the tax

---

[7] Error Reject Codes are assigned explanations included on Acknowledgement Reports sent to EROs for electronically filed tax returns that are rejected by the IRS.

[8] The EFDS accesses all electronically filed tax returns that have been scored for potential fraud by the Electronic Filing (ELF) programs. The EFDS provides an automated tool to assist in the systemic and immediate detection of potentially fraudulent, electronically filed tax returns.

administration system. However, IRS management did not establish nationwide standard criteria for selecting random visits in the ERO Monitoring Program.

### Recommendations

The Director, Compliance, SB/SE Division, should:

5. Develop a process to determine the proper mix of random and mandatory ERO monitoring visits that also provides for broad geographic coverage.

Management's response: Management will provide written guidance to coordinators advising them to consider balance of geographic coverage when selecting random visits.

6. Develop uniform risk-based selection criteria that take advantage of available information and data for selecting EROs for random monitoring visits.

Management's response: The Director, Reporting Compliance Policy, SB/SE Division, will provide guidance to Coordinators on using available information to select EROs whose filing statistics show potential problems.

## Monitoring Program Sanctions Should Be Clarified and Earned Income Tax Credit Due Diligence Should Be Considered

The IRS imposes sanctions on EROs found in violation of IRS *e-file* Program requirements. Some examples of violations are: failure to timely submit required documents to the IRS, misleading advertising, improper record keeping, convictions involving monetary or fiduciary crimes, and conduct indicative of potential fraudulent acts. Infractions of IRS *e-file* requirements are categorized as Levels One, Two, and Three. (See Appendix IV for complete definitions.) We identified two areas where the administration of sanctions could be improved.

**Definition of infractions**

According to the EMCs we interviewed, the Handbook for Authorized IRS *e-file* Providers of Individual Income Tax Returns (Publication 1345) and the *e-file* Monitoring Program guidelines do not provide sufficient detail in defining the three levels of infractions for EMCs and monitors to consistently apply them. While the *e-file* Monitoring Program guidelines provide some examples of infractions and corresponding sanctions, the examples do not address sanctions for the multiple and varying infractions identified during actual monitoring visits.

Without clear guidance, monitors may classify the same infractions differently, resulting in inconsistent treatment of EROs. Our review of 94 judgmentally selected monitoring cases identified 9 cases where, in our assessment, EROs with similar or similar-level infractions were given different sanctions. Five of them were issued written reprimands, two were given warnings, and two were not sanctioned at all.

Inconsistent treatment of EROs could be detrimental to the IRS *e-file* Program because of perceived or actual disparate treatment. The focus of the reorganized IRS is on helping people comply with the tax laws and ensuring the fairness of compliance. Fair compliance means that the IRS should apply rules and regulations consistently and uniformly.

**Earned Income Tax Credit due diligence compliance**

The *e-file* Monitoring Program guidelines require monitors to review ERO compliance with due diligence requirements for tax returns claiming the Earned Income Tax Credit (EITC).[9] EROs who are also tax return preparers must comply with Internal Revenue Code Section 6695-2 (2000), which details due diligence requirements for determining EITC eligibility. Return preparers may be assessed penalties for failure to satisfy these due diligence requirements. To comply with these requirements, preparers must complete an EITC eligibility checklist and a computation record, and have no knowledge that a taxpayer is not eligible for EITC. Preparers must retain copies of the eligibility checklist and computation record for 3 years.

If EMCs or monitors identify EITC due diligence problems during monitoring visits, they are to conduct due diligence penalty examinations and assess due diligence penalties when appropriate. However, according to the ERO Monitoring Program's Senior Analyst in Headquarters, due diligence determinations are not to be considered when making determinations about ERO compliance with IRS *e-file* requirements.

[9] The EITC is a refundable tax credit available to certain low and moderate-income taxpayers. Only taxpayers with earned income are eligible to claim the EITC. The amount of the EITC depends on the taxpayer's income and number of qualifying children.

Due diligence is very important to the IRS' efforts to help ensure EITC compliance. Of the estimated $31.3 billion in EITC claims made by taxpayers who filed returns in CY 2000 for Tax Year 1999, an IRS study estimated that between $8.5 and $9.9 billion (27.0 percent to 31.7 percent) should not have been paid. EROs who are also tax return preparers must be particularly diligent while acting in their capacity as the first contact with taxpayers. The EITC is a popular target for fraud and abuse schemes, and safeguarding the IRS *e-file* Program is the shared responsibility of the IRS and all Authorized *e-file* Providers.

Because of the extent of EITC overpayments, one action for improving EITC and ERO compliance may be for the IRS to take due diligence into consideration when making compliance determinations about EROs who are also tax return preparers. This would result in more severe sanctions than current procedures that only provide for penalties being assessed against preparers.

### Recommendations

The Director, Compliance, SB/SE Division, should:

7. Provide clear and unambiguous ERO Monitoring Program infraction and sanction guidelines for EMCs and monitors.

Management's response: Management revised training materials to include additional examples of infraction and sanction guidelines.

8. Revise *e-file* Monitoring Guidelines to consider EITC due diligence when determining ERO compliance with IRS *e-file* Program requirements.

Management's response: The IRS instructed monitors to pursue due diligence penalties when appropriate.

## Documentation of Monitoring Visits Should Be More Complete

According to the *e-file* Monitoring Program guidelines, at the conclusion of monitoring visits monitors should submit complete case files to EMCs. The case files should include the following items:

- Time and Action Report.
- Original Summary Of Findings, signed and dated.
- Daily Activity Record.
- Copy of the Appointment Letter (if applicable).

- IRS *e-file* Monitoring Visit Checksheet.
- Year-to-Date Totals by Territory and EFIN Report (ELF 1541 Report).[10]
- Information from the Application to Participate in the IRS *e-file* Program (Form 8633).[11]
- Missing Form 8453 Report (ELF 6540 Report).[12]
- Integrated Data Retrieval System (IDRS)[13] research data or other internal compliance reports used in supplementing the monitoring visit.
- Any other workpapers used to determine ERO compliance.

Review of the 94 ERO Monitoring Program case files identified areas where case documentation can be improved. In most of these cases, we could not assess the quality or full impact of the monitoring visit because of missing case documentation. As shown in Figure 1, the information missing from case files ranged from 14 to 100 percent of the cases, depending upon the item.

[10] An IRS ELF report, by IRS Territory or EFIN, with year-to-date electronic filing totals.
[11] Individuals, businesses, and organizations that wish to participate in the IRS *e-file* Program must submit Form 8633 and must be accepted by the IRS before they may electronically file.
[12] The ELF 6540 Report has information on electronic returns which were accepted at least 30 days earlier, but their corresponding Forms 8453 have not been processed.
[13] The IDRS is the IRS' computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

**Figure 1. Frequency of Missing and Present ERO Monitoring Program Visit Documentation**

| Document | Present | Missing |
|---|---|---|
| Time and Action Report | 81 | 13 (14%) |
| Summary of Findings | 71 | 23 (24%) |
| Daily Activity Record | 78 | 16 (17%) |
| Appointment Letter[14] | 8 | 18 (69%) |
| Visit Checksheet | 81 | 13 (14%) |
| ELF 1541 Report | 14 | 80 (85%) |
| Form 8633 Information | 42 | 52 (55%) |
| Missing Form 8453 Report | 0 | 94 (100%) |
| IDRS Research Results | 62 | 32 (34%) |
| OLA Research Results | 47 | 47 (50%) |

*Source: Treasury Inspector General for Tax Administration analysis of 94 ERO monitoring cases.*

ERO visitation procedures require that monitoring visits be properly documented, and managers should ensure that quality monitoring visits are performed. Once monitoring visits are completed, monitors should review case files and ensure all necessary items are fully documented and assembled correctly. Monitors should then transmit case files to EMCs.

Monitors and EMCs did not always prepare required documents or ensure they were included in monitoring case files, and managerial reviews did not identify documentation deficiencies. Without complete case documentation, the IRS cannot determine if all visits were performed in accordance with IRS procedures or fully assess the quality of visits.

## Recommendation

9. The Director, Compliance, SB/SE Division, should issue a memorandum reinforcing the importance of complete case documentation of ERO monitoring visits.

---

[14] If applicable.

Management's response:  Management will issue written guidance to reinforce the importance of complete case documentation of ERO Monitoring visits.

## Appendix I

### Detailed Objective, Scope, and Methodology

The overall objective of our audit was to determine if the Internal Revenue Service's (IRS) program for annually monitoring the performance of Electronic Return Originators (ERO) effectively ensures ERO compliance with IRS policy and procedures for originating tax returns electronically and maintaining required documentation.

To accomplish our objective, we:

I. Determined if the IRS effectively planned for and monitored the ERO Monitoring Program by:

   A. Interviewing IRS management and stakeholders.

   B. Determining if appropriate authorities, responsibilities, and resources were assigned to the officials responsible for the ERO Monitoring Program.

   C. Determining the extent and quality of coordination between Electronic Tax Administration (ETA) and *e-file* Monitoring Coordinators (EMC) in planning and executing the ERO Monitoring Program by interviewing ERO Monitoring Program and ETA officials to obtain their perspectives on coordination.

   D. Determining whether the selection process for ERO monitors provided the appropriate resources to the Program.

   E. Assessing the quality of the training for monitors.

   F. Determining if the ERO Monitoring Program Management Information System provided meaningful and useful information for effectively managing the Program.

II. Determined if the monitoring visit selection criteria effectively identified EROs with the highest potential for errors, violations, or abuse by:

   A. Interviewing management to determine the rationale for mandatory visits and the prescribed process for selection of random visits to EROs.

   B. Obtaining documentation, if any, on visit selection criteria.

   C. Reviewing the source (leads) of mandatory visits and their results.

   D. Comparing ERO Monitoring Program resources to results to determine the productivity of mandatory visits.

   E. Interviewing four EMCs from three IRS Area Offices and reviewing and analyzing their random visit selection criteria for uniformity and consistency.

   F. Determining follow-up visit requirements, if any.

G. Determining if additional data-driven criteria could be applied to better target monitoring efforts.

III. Determined if ERO monitoring visits were performed in accordance with established procedures, and if non-compliant EROs were administered appropriate sanctions by:

A. Interviewing management and discussing the process for performing monitoring reviews and obtained monitoring procedures and guidelines.

B. Assessing the quality of the monitoring visits by selecting and analyzing a judgmental sample of 94 ERO monitoring cases.[1] We selected four offices in the IRS Small Business/Self-Employed Division that, in the IRS Senior Management Analyst's assessment, were a representative cross-section of the nationwide ERO Monitoring Program. We then selected our case sample from CY 2002 inventory listings provided by each of these offices. We purposely selected monitoring cases with infractions and sanctions to ensure sufficient data for analyzing those two areas. While these cases were judgmentally selected, they represent approximately 6 percent of all ERO monitoring visits conducted in CY 2002.

[1] Our audit fieldwork started at the end of the 2002 Filing Season (the period from January through mid-April when most individual income tax returns are filed), while offices were still performing monitoring visits. Because of on-going visits and in-process referrals on EROs, we were unable to determine the precise population of Calendar Year (CY) 2002 monitoring cases when selecting our sample. However, we did not plan to project our results nationwide, so a judgmentally selected sample of cases was sufficient for our objective.

**Appendix II**

## Major Contributors to This Report

Parker F. Pearson, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
Amy L. Coleman, Acting Director, Small Business Compliance
Preston Benoit, Audit Manager
Cynthia Dozier, Senior Auditor
Rashme Sahwney, Auditor
Erlinda Foye, Management Assistant

## Appendix III

### Report Distribution List

Acting Commissioner  N:C
Deputy Commissioner, Small Business/Self-Employed Division  S
Deputy Commissioner, Wage and Investment Division  W
Director, Compliance, Small Business/Self-Employed Division  S:C
Chief Counsel  CC
National Taxpayer Advocate  TA
Director, Legislative Affairs  CL:LA
Director, Office of Program Evaluation and Risk Analysis  N:ADC:R:O
Office of Management Controls  N:CFO:F:M
Audit Liaisons:
    Commissioner, Small Business/Self-Employed Division  S
    Commissioner, Wage and Investment Division  W
    Director, Compliance Policy, Small Business/Self-Employed Division  S:C
    Director, Electronic Tax Administration, Wage and Investment Division  W:ETA

## Appendix IV

### Electronic Return Originator Monitoring Program Infractions and Sanctions

The Internal Revenue Service (IRS) categorizes infractions as Level One, Level Two, and Level Three Infractions. Sanctions that the IRS may impose range from a written reprimand to expulsion from the IRS electronic filing (*e-file*) Program, depending on the seriousness of the infraction.

**Level One Infractions—**Level One Infractions are violations of the rules governing the IRS *e-file* Program that, in the opinion of the IRS, have little or no adverse impact on the quality of electronically filed returns or on the IRS *e-file* Program. The IRS may issue a letter of reprimand for a Level One Infraction.

**Level Two Infractions—**Level Two Infractions are violations of the rules governing the IRS *e-file* Program that, in the opinion of the IRS, have an adverse impact upon the quality of electronically filed returns or on the IRS *e-file* Program. Level Two Infractions include continued Level One Infractions after the IRS has brought the Level One Infraction to the attention of the Authorized IRS *e-file* Provider. Depending on the infractions, the IRS may either restrict participation in the IRS *e-file* Program or suspend the Authorized IRS *e-file* Provider from the Program. The period of suspension includes the remainder of the calendar year in which the suspension occurs plus the next calendar year.

**Level Three Infractions—**Level Three Infractions are violations of the rules governing the IRS *e-file* Program that, in the opinion of the IRS, have a significant adverse impact on the quality of electronically filed returns or on the IRS *e-file* Program. Level Three Infractions include continued Level Two Infractions after the IRS has brought the Level Two Infraction to the attention of the Authorized IRS *e-file* Provider. Commission of a Level Three Infraction may result in suspension from the Program and, depending on the severity of the infraction, such as fraud or criminal conduct, could result in expulsion from the Program without the opportunity for future participation. If the IRS suspends an Authorized IRS *e-file* Provider from the Program for a Level Three Infraction, the period of suspension includes the remainder of the calendar year in which the suspension occurs plus the next 2 calendar years. The IRS reserves the right to suspend or expel an Authorized IRS *e-file* Provider prior to administrative review for Level Three Infractions.

## Appendix V

## Management's Response to the Draft Report

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEC 30 2002

RECEIVED
DEC 30 2002

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: for Joseph G. Kehoe
Commissioner Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Improvements to the Electronic Return Originator Monitoring Program Are Needed

I reviewed your draft audit report. I was pleased you recognized our significant strides to improve our monitoring efforts. We developed and revised training materials, and provided train-the-trainer sessions for E-File Monitoring Coordinators. In addition, we defined mandatory and random visits and established a goal to visit one percent of all electronic return originators (ERO). We achieved our goals, in both CY 2001 and CY 2002.

Our monitoring program is administered by the Return Preparer Coordinators (RPC) located in each Area in the Planning and Special Programs (PSP) office. Monitoring visits to verify compliance with the requirements for ERO's participating in the IRS e-file program are conducted by selected revenue agents, tax compliance officers, and revenue officers. The sample size will be determined by the number of registered e-file Providers in each area, and the individual providers will be determined by external referrals we receive alleging misconduct, internal referrals, follow-ups from prior year, and random selections. External referrals and follow-ups are mandatory visits and it is possible that all visits in an area would be from these referrals. Last year we completed over 1400 visits. Prior to FY 2001 Electronic Tax Administration was responsible for the program.

We are continuing our efforts to improve the ERO monitoring program; however, we recognize there are still areas that require improvements. I agree with several of your recommendations and we are working to implement them.

If you have any questions, please call me at (202) 622-0600, or Joseph R. Brimacombe Deputy Director, Compliance Policy, Small Business/Self-Employed Division, at (202) 283-2200.

2

**Recommendation # 1**

Establish a goal and method for measuring program effectiveness for improving ERO compliance such as results of follow-up visits.

**Assessment of Cause**
We designed our program to perform visitations on one percent of the total number of electronic filers in each area. This sample included referrals alleging misconduct, internal referrals, follow-ups from the prior year, and random referrals. However, the overall ERO program goal is to encourage voluntary compliance with the e-file rules by all Authorized IRS E-file Providers (even those never visited by the IRS).

**Corrective Action**
We disagree with this recommendation. Although SB/SE could track and measure the results of its actions on specific cases, types of cases, or trends, it would be impossible to measure the affect of voluntary compliance for all Authorized IRS E-file Providers. Factors other than IRS visitations may influence compliance of the Providers. These factors may include attendance at seminars, reading of publications and other communications, and other interactions with the IRS or industry groups. If we established a goal and measures to track the results of follow-up visits, the results would not be of significant value in determining the affect on voluntary compliance.

**Recommendation # 2**
Ensure that historical case documentation is associated with the current year cases and reinforce that the purpose of follow-up visits is to measure the impact of the ERO Monitoring Program on compliance.

**Assessment of Cause**
When the IRS reassigned the program to PSP, we instructed ETA Coordinators to turn over their historical files from 1998 to the present, however, many ETA Coordinators did not turn over the files. During our training we emphasized the requirement that the historical case documentation be associated with the current year cases.

**Corrective Action**
We will issue a memorandum providing additional direction and guidance on documentation.

**Implementation Date**
March 1, 2003

**Responsible Official**
Director, Reporting Compliance Policy, Small Business/Self-Employed Division

3

**Corrective Action Monitoring Plan**
The Director, Reporting Compliance Policy, Small Business/Self-Employed Division, will ensure the Office of General Exam Processes completes the corrective action.

**Recommendation # 3**
Establish a planning process that allows sufficient time for training and case building.

**Assessment of Cause**
This was our second year of responsibility for the program. Before performing the monitoring visits, we developed all training materials, revised procedures, and provided a train-the-trainer session to all E–file Monitoring Coordinators (EMCs). These actions were time-consuming and contributed to the delay of the training.

**Corrective Action**
The analyst responsible for the program is now responsible for planning, training, and case building. We plan to conduct training before the new fiscal year, to the extent our resources will allow.

**Implementation Date**
October 1, 2003

**Responsible Official**
Director, Reporting Compliance Policy, Small Business/Self-Employed Division

**Corrective Action Monitoring Plan**
The Director, Reporting Compliance Policy, Small Business/Self-Employed Division, will insure the Office of General Exam Processes completes the corrective action.

**Recommendation # 4**
Ensure that the functionality of the On-Line Applicants (OLA) Database's replacement meets user requirements, and that EMCs and monitors are sufficiently trained on all pertinent *e-file* systems.

**Assessment of Cause**
The OLA database was a stop-gap measure. We are to replace the database with a web-based system this year, however, the development of a new system has been delayed.

**Corrective Action**
In our 2002 train-the-trainer classes, we ensured training for all newly selected EMCs on all pertinent e-file systems. In addition, we will provide guidance to coordinators who did not attend the training.

4

**Implementation Date**
Completed

**Recommendation # 5**
Develop a process to determine the proper mix of random and mandatory ERO monitoring visits that also provides for broad geographic coverage.

**Assessment of Cause**
We cannot choose the location of mandatory visits since they are made based on the location of the complaint. We must plan the location of random visits before the filing season. Since we cannot predict the sites of the mandatory visits, an overlap with the random visits may occur.

**Corrective Action**
We will provide written guidance to all coordinators to consider the best balance of geographic coverage as possible when choosing the location of random visits.

**Implementation Date**
March 1, 2003

**Responsible Official**
Director, Reporting Compliance Policy, Small Business/Self-Employed Division

**Corrective Action Monitoring Plan**
The Director, Reporting Compliance Policy, Small Business/Self-Employed Division, will ensure the Office of General Exam Processes completes the corrective action.

**Recommendation # 6**
Develop uniform risk-based selection criteria that take advantage of available information and data for selecting ERO's for random monitoring visits.

**Assessment of Cause**
We have not established standard criteria for selecting random visits in the ERO Monitoring Program.

**Corrective Action**
The Director, Reporting Compliance Policy, Small Business/Self-Employed Division will provide guidance to Area Coordinators on using available information to pinpoint EROs whose filing statistics show potential problems (high reject rates, history of missing Forms 8453 over several years, multiple missing Forms 8453 in one given year) and other criteria to consider in determining when to conduct random or targeted visitations.

**Implementation Date**
March 1, 2003

**Responsible Official**
Director, Reporting Compliance Policy, Small Business/Self-Employed Division

**Corrective Action Monitoring Plan**
The Deputy Director, Reporting Compliance, Small Business/Self-Employed Division, will ensure the Office of Reporting Compliance Policy completes the corrective action.

**Recommendation # 7**
Provide clear and unambiguous ERO Monitoring Program infraction and sanction guidelines for EMCs and monitors.

**Assessment of Cause**
Monitors could classify the same infraction differently, resulting in inconsistent treatment of ERO's.

**Corrective Action**
We have revised training materials to include additional examples of infraction and sanction guidelines; however, it is impossible for examples to be all-inclusive. Every case must stand on its own merits, and monitors must exercise their judgment based on the history, facts, and circumstances of each case.

**Implementation Date**
Completed

**Recommendation # 8**
Revise e-file Monitoring Guidelines to consider EITC due diligence when determining ERO compliance with IRS *e-file* Program requirements.

**Assessment of Cause**
The IRS *e-file* Program requirements allow for due diligence considerations when determining ERO compliance. However, there are several considerations that must be made when using this information, for example:

- Individual income tax return preparers are responsible for due diligence. The ERO and the income tax return preparer is one and the same only if the ERO is a sole proprietor preparing returns. Treasury Regulation 1.6695-2 addresses due diligence as the responsibility of individual income tax return preparers. In other words, the due diligence penalty is assessed against individual income tax return preparers, not against the

ERO (firm) that employs the individual. We cannot hold the ERO (firm) responsible under *e-file* rules when the Treasury regulation places responsibility for due diligence with the individual preparer.

- The consideration could result in an *e-file* compliance action against the ERO prior to the ERO having due process for the due diligence noncompliance. Treasury regulations entitle income tax return preparers to due process for assertion of penalties. Also, the Congress determined the appropriate action for due diligence noncompliance was a fine and that preparers are entitled to due process.

- Addressing due diligence as an *e-file* compliance matter may result in less than appropriate action. Suspension or even expulsion from IRS *e-file* Program does not prevent an income tax return preparer from continuing to file tax returns, just not electronic returns. Due diligence is a preparer matter and should be addressed as such. A serious due diligence matter should result in the IRS securing an injunction against the preparer, restricting his preparation of all income tax returns.

**Corrective Action**
During training, we instructed monitors to pursue due diligence penalties when appropriate. Publication 1345 clearly states that penalties assessed against e-file Providers will cause them to fail suitability requirements.

**Implementation Date**
Completed

**Recommendation # 9**
The Director, Compliance, Small Business/Self-Employed, should issue a memorandum reinforcing the importance of complete case documentation of ERO monitoring visits.

**Assessment of Cause**
Monitors did not always prepare the required documents or ensure they were included in monitoring case files.

**Corrective Action**
We emphasis complete case documentation of ERO monitoring visits in the train-the-trainer class. In addition, we will provide written guidance to reinforce the importance of complete case documentation of ERO monitoring visits.

**Implementation Date**
March 1, 2003

7

**Responsible Official**
Director, Reporting Compliance Policy, Small Business/Self-Employed Division

**Corrective Action Monitoring Plan**
The Deputy Director, Reporting Compliance, Small Business/Self-Employed Division, will ensure the Office of Reporting Compliance Policy completes the corrective action.