



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

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MEMORANDUM FOR SECRETARY SNOW

FROM:

J. Russell George
Inspector General

SUBJECT:

Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2006

The Reports Consolidation Act of 2000¹ requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2005*, our perspective on the most serious management and performance challenges currently confronting the Internal Revenue Service (IRS).

The TIGTA's assessment of the major IRS management challenge areas for Fiscal Year (FY) 2006 has not changed substantially from the prior year. While the IRS has continued to address each challenge area, we were unable to remove any challenge area at this time. We have, however, used two subcategories, Computerized Systems and Business Structure, to further describe the challenge of modernization of the IRS. We believe these both play a crucial part in the modernization efforts. We have also rephrased one challenge, "Using Performance and Financial Information for Program and Budget Decisions," to more accurately portray our concerns. The ten current challenges, in order of priority, are:

Modernization of the Internal Revenue Service

Modernization of the IRS includes both computer systems modernization and business structure (reorganization) modernization. Although both issues have their own sets of challenges, they must both succeed to fully modernize the IRS.

Computerized Systems

Business Systems Modernization (BSM) involves integrating thousands of hardware and software components over 15 years. The program is in its seventh year and

¹ 31 U.S.C. § 3516(d).

has allocated approximately \$1.9 billion for contractor and integrator activities. The IRS and its contractors have deployed projects that provide value to taxpayers and have built the infrastructure needed to support these projects. However, since the start of the modernization effort, the BSM program has experienced cost overruns and schedule delays in its project development and deployment. Over the past three fiscal years, our annual BSM program assessments have cited four primary challenges that the IRS and its contractors must meet to achieve program success: 1) implement planned improvements in key management processes and commit the necessary resources to enable success; 2) manage the increasing complexity and risks of the BSM program; 3) maintain the continuity of strategic direction with experienced leadership; and 4) ensure contractor performance and accountability are effectively managed. In the past year, we reported that weaknesses continue to exist in critical program management and system development processes.

Business Structure

The IRS Restructuring and Reform Act of 1998 (RRA 98)² mandated that the IRS reorganize to better meet the needs of taxpayers. On October 1, 2004, the Small Business/Self-Employed (SB/SE) Division Customer Account Services (CAS) operating unit realigned to the Wage and Investment Income (W&I) Division CAS function. As a result of this merger, the IRS' W&I Division will be the only division responsible for processing tax returns, both individual and business. While there are similarities between individual and business tax returns, there are also many differences. For example, the mix of electronic and paper returns for businesses is much different than that for individuals. Additionally, large corporations and tax exempt organizations will soon be required to file tax returns electronically, while individuals have the option to file either electronically or via paper. The IRS is also continuing with its plan to consolidate individual tax returns processing into fewer sites. Changes such as these present challenges to the IRS to ensure tax returns are processed effectively and efficiently.

Tax Compliance Initiatives

The completion of the initial phases of the National Research Project (NRP) allowed the IRS recently to release an updated estimate of the tax gap.³ As a result of the NRP, the IRS now estimates that taxpayers with self-employment income underreport between \$51 billion and \$56 billion in employment tax. The IRS recently received authority and will begin testing the use of contract staff to work some collection cases. It is too early to tell if the contract resources will be able to resolve a significant number of cases or whether they will continue to go unresolved. During the last few years, the IRS has

² 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.).

³ THE IRS HAS INITIATED THE NATIONAL RESEARCH PROGRAM TO MEASURE TAXPAYERS' VOLUNTARY COMPLIANCE, TO BETTER APPROXIMATE THE TAX GAP, AND TO DEVELOP UPDATED FORMULAS TO SELECT NONCOMPLIANT RETURNS FOR EXAMINATION. THE FIRST PHASE OF THIS PROGRAM ADDRESSES REPORTING COMPLIANCE FOR INDIVIDUAL TAXPAYERS, AND DATA FROM THIS PHASE WERE USED TO PRODUCE THE RECENTLY UPDATED ESTIMATES OF THIS PORTION OF THE TAX GAP.

been implementing reengineering suggestions aimed at increasing effectiveness of enforcement efforts. We have conducted several reviews of these initiatives; however, it is too early to evaluate the full impact.

Security of the Internal Revenue Service

The IRS relies upon critical computer systems to account for more than \$2 trillion in revenue annually. Significant disaster recovery program weaknesses continue to be unresolved. These recurring weaknesses include: modernization systems being placed in production without a disaster recovery capability; insufficient disaster recovery capacity; roles and responsibilities not being assigned and employees not being trained; and annual tests not being conducted or not being effective. In addition, control weaknesses, such as failure to close user accounts when employees leave the IRS, inadequate documentation of user access authorizations, and insufficient documentation that employees have acknowledged their security responsibilities, continued to exist, even with the implementation of a new automated system to authorize system access. These weaknesses continue to occur because managers and system administrators have not adhered to the system procedures.

Complexity of the Tax Law

Through the years, the Federal tax system has become more complex, less transparent, and is frequently revised. The scope and complexity of the Internal Revenue Code make it virtually certain that taxpayers will face procedural, technical and bureaucratic obstacles in meeting their tax obligations. For example, in 2001, the Joint Committee on Taxation conducted a study on the complexity of the tax law and found that, at that time, the tax code consisted of nearly 1.4 million words. There were 693 sections of the code applicable to individuals, 1,501 sections applicable to businesses, and 445 sections applicable to tax exempt organizations, employee plans, and governments. At that time, a taxpayer filing an individual income tax return (Form 1040) could be faced with a 79 line return, 144 pages of instructions, 11 schedules totaling 443 lines (including instructions), 19 separate worksheets embedded in the instructions, and the possibility of having to file numerous other forms. For the 2005 tax filing season, the IRS estimates it should take, on average, over 19 hours to complete and file a Form 1040 and the associated Schedule A.

Although the IRS has consistently and commendably sought to ease the process for all taxpayers, each tax season brings new problems. The complexities of the tax law affect the ability of the IRS to administer the nation's tax system. The IRS' efforts to provide assistance to taxpayers are hampered because of these complexities.

Using Performance and Financial Information for Program and Budget Decisions

Measuring the IRS' productivity, the efficiency with which inputs are used to produce outputs, is difficult.⁴ The IRS has made some progress, but using performance and financial information for program and budget decisions is still a major challenge. The absence of accurate and complete management information hinders the IRS' ability to make appropriate decisions when determining the locations and services it provides taxpayers seeking face-to-face assistance. The IRS' financial statements and related activities continue to be of concern to IRS stakeholders. In its audit of the IRS' FY 2004 financial statements, the Government Accountability Office (GAO) concluded that the records were fairly presented in all material respects.⁵ The GAO, however, identified some continuing serious deficiencies in the IRS' financial systems. Without a financial management system that can produce timely, accurate and useful information needed for day-to-day decisions, the IRS' financial stewardship responsibilities continue to be one of the most serious challenges facing IRS management.

Providing Quality Taxpayer Service Operations

Each year, millions of taxpayers contact the IRS seeking assistance in understanding the tax law and in meeting their tax obligations by either calling the various toll-free telephone assistance lines, accessing the IRS Internet site or visiting an IRS Taxpayer Assistance Center (TAC). Walk-in assistance has proven to be particularly helpful for lower-income taxpayers and those with limited or no English language proficiency.⁶ The IRS discontinued its TeleFile service, used by nearly 4 million taxpayers, in August 2005. Earlier this year, the IRS stated that it planned to close 68 TACs, to reduce costs and create efficiencies while maintaining a commitment to customer service. Currently, the IRS has suspended the closure of the 68 TACs pending further study. The TIGTA is reviewing the methodology used to select the TACs for closure. The Small Business/Self-Employed (SB/SE) Division Taxpayer Education and Communication (TEC) organization has made significant progress in reaching out to the small business taxpayer community to educate small business taxpayers on their tax and compliance responsibilities. However, the TEC organization needs to better market its products, especially for business taxpayers who are not served by the tax practitioner community.

Erroneous and Improper Payments

An improper payment is any payment that should not have been made or that was made in an incorrect amount under a statutory, contractual, administrative or other legally applicable requirement. For the IRS, improper and erroneous payments are generally associated with erroneous refunds and filing fraud issues as well as vendor or

⁴ GOVERNMENT ACCOUNTABILITY OFFICE, PUB. NO. 05-671, TAX ADMINISTRATION: IRS CAN IMPROVE ITS PRODUCTIVITY MEASURES BY USING ALTERNATIVE METHODS (JULY 2005).

⁵ GOVERNMENT ACCOUNTABILITY OFFICE, PUBL. NO. 05-103, FINANCIAL AUDIT: IRS'S FISCAL YEARS 2004 AND 2003 FINANCIAL STATEMENT (NOV. 10, 2004).

⁶ IRS OVERSIGHT BOARD, FY2006 IRS BUDGET SPECIAL REPORT (MARCH 2005).

contractor overpayments. Some tax credits, such as the Earned Income Tax Credit (EITC), and the Education Credit, provide opportunities for abuse in income tax claims. In Tax Year (TY) 2003, the IRS reported that approximately 21.7 million taxpayers received EITC totaling \$38.1 billion. The IRS estimated that between 27 percent and 32 percent of the \$31 billion in EITC claimed on TY 1999 returns should not have been paid.⁷ Single taxpayers with no dependents are receiving a “dual benefit” by claiming both the tuition and fees deduction, and education credits. We reported this condition during the 2004 filing season, and in the 2005 filing season, we identified 18,776 single taxpayers claiming no dependents who were allowed both an education credit, and a tuition and fees deduction because the IRS had yet to initiate action to identify and disallow “dual benefits.” Our analysis showed that these taxpayers claimed education credits of more than \$13 million, and tuition and fees deductions of nearly \$39 million. TIGTA reviews have also identified payment issues in the contract area. For example, a recent report on a contract to support the IRS’ modernization efforts identified questionable award fees of more than \$2 million and questionable charges, which consisted of unsupported, unreasonable, and inaccurately recorded charges.

Taxpayer Protection and Rights

The IRS continues to dedicate significant resources and attention to implementing the taxpayer rights provisions of RRA 98. Audit reports TIGTA issued in FY 2005 found the IRS was in full compliance with the following taxpayer rights provisions:

- *Notice of Levy*
- *Restrictions on the Use of Enforcement Statistics to Evaluate Employees*
- *Fair Debt Collection Practices Act Violations*

The IRS, however, did not remove all *Illegal Tax Protester Designations* from its records, did not always address all *Collection Due Process* issues, and sometimes improperly *Denied Taxpayer Requests for Information*. In addition, the IRS did not always properly notify taxpayers in situations involving:

- *Notice of Lien*
- *Seizures*
- *Assessment Statute of Limitations*

IRS management information systems do not track specific cases so neither the TIGTA nor the IRS could evaluate the IRS’ compliance with certain RRA 98 provisions. The TIGTA issued reports on two of the subject RRA 98 provisions:

- *Restrictions on Directly Contacting Taxpayers Instead of Authorized Representatives*
- *Separated or Divorced Joint Filer Requests*

⁷ TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-40-093, THE EARNED INCOME TAX CREDIT INCOME VERIFICATION TEST WAS PROPERLY CONDUCTED (2005).

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

The IRS had a successful 2005 filing season, timely processing over 117.5 million individual income tax returns (including 66.6 million processed electronically) that were received through May 27, 2005. This was the first year that more than half of all taxpayers filed an electronic return. Key tax law changes for the 2005 filing season were generally correctly implemented. However, the TIGTA identified some tax law changes that were not effectively implemented during the 2005 filing season, which may cause taxpayers to lose entitlements or receive erroneous tax credits. For example, military taxpayers may not be receiving the full amount of EITC they are entitled to and not all taxpayers are benefiting from the new sales tax deduction. Also, some taxpayers are being allowed erroneous education credits, and taxpayers are receiving “dual benefit” by claiming both the tuition and fees deduction and education credits.

Human Capital

The IRS continues to be challenged with traditional workforce issues, such as training, recruitment and employee retention, along with issues specific to the IRS. These issues include reorganizations and potential restructuring from competitive sourcing results. For example, according to its FY 2006 strategic assessment, the Large and Mid-Size Business Division (LMSB) is continuing to lose highly skilled technical employees, primarily through retirement, and it is replacing fewer technical employees than those who have separated. The loss of human capital, combined with the increasing complexity of LMSB examinations, will have a negative effect on audit coverage and business results. Additionally, the IRS Tax Exempt and Government Entities Division has indicated that current staffing is still not sufficient to adequately cover the volume of calls received.⁸ Although the IRS has training assessment and development procedures, these procedures are generally not followed by its operating divisions. While each operating division followed its own processes, they were generally not able to provide documentation to substantiate whether assessments were performed.

These are the ten major IRS management challenge issues for FY 2006. The TIGTA's Office of Audit's [FY 2006 Annual Audit Plan](#) categorizes the planned audits by these issues. If you have questions or wish to discuss our views on these management and performance challenges in greater detail, please contact me at (202) 622-6500.

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

⁸TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-10-149, THE INTERNAL REVENUE SERVICE DOES NOT ADEQUATELY ASSESS THE EFFECTIVENESS OF ITS TRAINING (2005).