



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

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MEMORANDUM FOR SECRETARY PAULSON

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FROM: J. Russell George
Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal
Revenue Service for Fiscal Year 2007

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 2006*, its perspective of the most serious management and performance challenges currently confronting the Internal Revenue Service (IRS).

TIGTA's assessment of the major IRS management challenge areas for Fiscal Year (FY) 2007 has not changed substantially from the prior year. While the IRS has continued to address each challenge area, TIGTA was unable to remove any challenge area at this time. This year, TIGTA has divided the category of Tax Compliance Initiatives into two subcategories – Business and Individual and Tax-Exempt Entities. TIGTA believes that these subcategories better define the need to administer tax regulations and collect tax dollars for businesses and individuals and to oversee compliance issues for tax-exempt entities. Both play a crucial role in the IRS' compliance efforts.

The 10 current challenges, in order of priority, are:

Modernization of the Internal Revenue Service

The Business Systems Modernization (BSM) program is a complex effort to modernize the IRS' technology and related business processes. According to the IRS, this effort will involve integrating thousands of hardware and software components. All of this must be done while replacing outdated technology and maintaining the current tax

¹ 31 U.S.C. § 3516(d) (2000).

system. The BSM program is in its eighth year and has received approximately \$2.1 billion for contractor services. This past year, the IRS began taking actions to restructure and redesign significant areas within the BSM program. For example, the IRS took over the role of systems integrator from the PRIME contractor² and changed its approach from completely replacing current business systems to using current business systems to accomplish modernization.

While the IRS and its contractors have completed modernization projects that provide significant benefits to taxpayers, since FY 2002, TIGTA's annual assessments of the BSM program have cited four specific challenges the IRS needs to overcome to deliver a successful modernization effort: 1) implement planned improvements in key management processes and commit necessary resources to enable success; 2) manage the increasing complexity and risks of the BSM program; 3) maintain the continuity and strategic direction with experienced leadership; and 4) ensure that contractor performance and accountability are effectively managed. TIGTA continues to believe the eventual success of the modernization effort will depend on how well the IRS addresses these four specific challenges.

Tax Compliance Initiatives

Tax compliance initiatives include the need to administer tax regulations and collect the correct amount of tax for businesses and individuals, as well as to oversee tax-exempt and government entities for compliance.

Business and Individual

Increasing compliance with the tax code is at the heart of IRS enforcement programs. The IRS is targeting its casework and enforcement activities to deliver better results and to better target those corporations and high-income individual taxpayers who fail to report or pay what they owe. Despite actions the IRS has taken to improve its enforcement efforts, TIGTA continues its designation of tax compliance initiatives as a major management challenge for the IRS. The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year, and estimated the gross tax gap for Tax Year 2001 at \$345 billion. TIGTA's evaluation of the reliability of the IRS-developed tax gap figures concluded that the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and voluntary compliance. The IRS has significant challenges in both obtaining complete and timely data, and developing the methods for interpreting the data.

² The PRIME contractor is the Computer Sciences Corporation, which heads an alliance of leading technology companies brought together to assist with the IRS' efforts to modernize its computer systems and related information technology.

Tax-Exempt Entities

The IRS continues to face challenges in administering programs focused on tax-exempt organizations to ensure that they comply with applicable laws and regulations to qualify for tax-exempt status. While the IRS has noted that the nonprofit community has not been immune from the recent trends toward bad corporate practices that have been highlighted in the for-profit area, it has only recently begun to re-emphasize this area since suffering a decline in staffing during the late 1990s. TIGTA has made recommendations for improving the IRS' oversight of filing compliance by political organizations and ensuring abusive tax avoidance transactions in the tax-exempt sector are being identified and addressed. Further, TIGTA recommended additional improvements to assure that timely, accurate, and complete information returns are received for employee benefit plans. TIGTA also noted that the IRS must develop better research tools, improve training to trace funds through complex transactions, and develop the ability to analyze data to determine the high-risk noncompliant areas. The IRS agreed with the TIGTA recommendations and initiated corrective actions to address these concerns.

Security of the Internal Revenue Service

Millions of taxpayers entrust the IRS with sensitive financial and personal data stored and processed by IRS computer systems. Recent reports of identity thefts from both the private and public sectors have heightened awareness of the need to protect this data. The risks that sensitive data or computer systems could be compromised and computer operations could be disrupted continue to increase. These risks are due to internal factors, such as the increased connectivity of the computer systems and the increased use of portable laptop computers, and external factors, such as the volatile threat environment resulting from increased terrorist and hacker activity. The IRS has designated computer security as a material weakness under the Federal Managers' Financial Integrity Act of 1982.³ Section 301 of the Federal Information Security Management Act (FISMA)⁴ requires each Federal agency to report annually to the Office of Management and Budget and Congress on the effectiveness of its security programs and to perform an annual independent evaluation of its information security program and practices. During FY 2006, the IRS developed a corporate approach to FISMA by elevating its FISMA processes and procedures into an enterprise-wide program. Recognizing that it will take time to achieve long-term improvements, the process changes made by the IRS have not yet had a positive effect on some measurements provided in the President's Management Agenda, including certification and accreditation and tracking the resolution of security vulnerabilities. TIGTA's FISMA evaluations and other audits lead to the conclusion that sufficient attention is not yet being given to the security of sensitive systems.

³ 31 U.S.C. §§ 1105, 1113, 3512 (2000).

⁴ Pub. L. No. 107-347, tit. III, Stat. 2899, 2946 (2002) (codified as amended at 44 U.S.C. §§ 3541-49).

Providing Quality Taxpayer Service Operations

Since the late 1990s, the IRS has increased its delivery of quality customer service to taxpayers. In fact, in its current strategic plan, the IRS' first goal is to improve taxpayer service. There are recent signs, however, that this trend may be reversing as the IRS proposes to allocate more resources to its collection, examination, and criminal investigation functions and fewer resources to taxpayer service functions. Moreover, the IRS' FY 2006 budget request proposed a 1 percent reduction in funding for taxpayer service activities at the same time it proposed an 8 percent increase in funding for enforcement activities.⁵ The Senate Committee on Appropriations recently noted that the IRS lacks a concrete plan to provide adequate alternative services to replace the services proposed for reduction or elimination.⁶ In response, the IRS developed a five-year Taxpayer Assistance Blueprint that will help it focus on providing the appropriate types and amounts of service. TIGTA continues to identify the need for improvements in taxpayer services provided through toll-free, face-to-face, and electronic methods.

Complexity of the Tax Law

Simplicity, transparency, and ease of administration are interrelated and desirable features of a tax system. Over the years, the Federal tax system, especially the Federal income tax, has become more complex, less transparent, and subject to frequent revision. Tax system complexity and frequent revisions to the Internal Revenue Code make it more difficult and costly for taxpayers who want to comply to do so and for the IRS to explain and enforce the tax laws. Tax law complexity results in higher costs for both tax administration and tax compliance. Simplification and reform have the potential to reduce the tax gap by billions of dollars. Although the IRS has consistently sought to ease the tax compliance process for all taxpayers, tax law complexity remains a problem. The complexities of the tax laws 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. Without meaningful simplification, it is likely that the complexities of the current tax code will continue to contribute to the tax gap.

Using Performance and Financial Information for Program and Budget Decisions

While the IRS has made some progress in using performance and financial information for program and budget decisions, this area is still a major challenge. The IRS lacks a comprehensive, integrated system that provides accurate, relevant, and timely financial and operating data describing the performance measures, productivity, and associated costs of IRS programs. During FY 2005, the IRS collected about \$2.3 trillion in Federal tax revenue, which constituted approximately 95 percent of all Federal revenue. However, the IRS' Federal tax revenue financial management systems have serious internal control and systems deficiencies, which require the IRS to rely extensively on

⁵ *The Budget in Brief: Internal Revenue Service* (Feb. 2005).

⁶ U.S. Congress. Senate. Senate Report 109-109. *Transportation, Treasury, the Judiciary, Housing And Urban Development, And Related Agencies Appropriations Bill, 2006* 109th Cong.

resource-intensive compensating processes to prepare its financial statements. Due to these serious conditions, the IRS did not, in the Government Accountability Office's opinion, maintain effective internal controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations. Thus, the IRS could not provide reasonable assurance that losses, misstatements, and noncompliance with laws material to the financial statements would be prevented or detected on a timely basis.⁷ In addition, the IRS cannot produce timely, accurate, and useful information needed for day-to-day decisions, which inhibits the IRS' ability to address financial management and operational issues to fulfill its responsibilities. TIGTA has continued to report that various IRS management information systems are insufficient to enable IRS management to measure costs, determine if performance goals have been achieved, or monitor progress in achieving program goals.

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 generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors. Some tax credits, such as the Earned Income Tax Credit (EITC) and the Education Credit, provide opportunities for abuse in income tax claims. The IRS estimated that between 27 percent and 32 percent of the \$31 billion in EITC claimed on TY 1999 returns should not have been paid.⁸ The IRS' Criminal Investigation function is responsible for detecting and combating tax refund fraud through its Questionable Refund Program (QRP), which was established to address the serious problem of refund fraud, now estimated to exceed \$500 million annually. In past years, it has been repeatedly reported that additional controls and procedures were necessary not only to identify additional instances of potential fraud, but also to properly and timely release refunds that are determined not to be fraudulent.⁹ Recently, the National Taxpayer Advocate criticized the IRS for unnecessarily stopping refunds properly owed to taxpayers.¹⁰ In response to the National Taxpayer Advocate's concern, on February 6, 2006, the IRS announced that it is taking steps to improve the QRP and reduce the number of taxpayers subject to frozen refunds. TIGTA is

⁷ Government Accountability Office (GAO), Pub. No. GAO-06-137, Financial Audit: IRS's Fiscal Years 2005 and 2004 Financial Statement (Nov. 2005).

⁸ Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2005-40-093, The Earned Income Tax Credit Income Verification Test Was Properly Conducted (May 2005).

⁹ Audit reports previously issued by TIGTA: Ref. No. 2004-40-018, The Internal Revenue Service Can Improve the Effectiveness of Questionable Refund Detection Team Activities (Dec. 1999); Ref. No. 2001-40-025, Revised Questionable Refund Program Procedures Were Not Consistently Implemented (Jan. 2001); Ref. No. 2003-10-094, Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected (Mar. 2003); and Ref. No. 2005-10-164, The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners (Sept. 2005).

¹⁰ National Taxpayer Advocate 2005 Annual Report to Congress (Dec. 2005).

extremely concerned about this and believes that a necessary balance must be struck between allowing sufficient time to detect fraudulent claims and issuing timely refunds.

Taxpayer Protection and Rights

The IRS continues to dedicate significant resources and attention toward implementing the taxpayer rights provisions of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)¹¹. Audit reports are mandated for the following taxpayer rights provisions:

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

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

Some IRS management information systems do not track specific cases. Thus, neither TIGTA nor the IRS could evaluate the IRS' compliance with certain RRA 98 provisions.

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

Each filing season tests the ability of the IRS to implement tax law changes made by Congress. It is during the filing season that most individuals file their income tax returns and call the IRS if they have questions about specific tax laws or filing procedures. Correctly implementing tax law changes is a continuing challenge because the IRS must identify the tax law changes; revise the various tax forms, instructions, and publications; and reprogram the computer systems used for processing returns. Changes to the tax laws can have a major effect on how the IRS conducts its activities,

¹¹ Pub. L. No. 105-206, 112 Stat. 685 (Codified as amended in scatter sections of 2 U.S.C., 5 U.S.C. App., 16 U.S.C., 19 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

how many resources are required, and how much progress can be made on strategic goals. Congress frequently changes the tax laws, so some level of change is a normal part of the IRS environment. However, certain types of changes can significantly impact the IRS in terms of the quality and effectiveness of service and in how taxpayers perceive the IRS. For example, the 2006 Filing Season was an unusually difficult one for the IRS because there were many late tax law changes in response to the hurricanes that struck the United States. Disaster relief provisions were enacted into law for taxpayers affected by Hurricanes Katrina, Rita, and Wilma. The Gulf Opportunity Zone (GO Zone) Act of 2005,¹² was signed into law on December 21, 2005. The late timing of this legislation gave the IRS very little time to revise the necessary tax forms and computer programs before the start of the 2006 Filing Season.

Human Capital

Human capital is a major challenge facing many agencies, and the President's Management Agenda identifies Strategic Management of Human Capital as the first of five Government-wide initiatives for improving Government performance. Like many other Federal agencies, over the past several years the IRS has experienced workforce challenges. Those challenges include recruiting, training and retaining employees, as well as an increasing number of employees who are eligible to retire. The Small Business/Self-Employed and the Large and Mid-Size Business Divisions reported in their FY 2006 strategic assessments that the human capital crisis continues to intensify as employees in key occupational series increasingly become eligible to retire, are lost through attrition, or migrate to other business divisions. While the IRS has made some progress, the strategic management of human capital remains one of the IRS' major management challenge areas. TIGTA has made a significant number of recommendations for improvement in the areas of recruiting, workforce planning, delivery of training, and employee turnover. The IRS agreed with TIGTA recommendations and is taking corrective actions. TIGTA will continue to provide coverage of this major management challenge.

Conclusion

These are the 10 major IRS management challenge issues for FY 2006. TIGTA's [FY 2007 Annual Audit Plan](#) categorizes its planned audits by these challenges. If you have questions or wish to discuss TIGTA's views on these management and performance challenges in greater detail, please contact me at (202) 622-6500.

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

¹² Pub. L. No. 109-135, 199 Stat. 2577.