
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



***The Internal Revenue Service Needs to
Evaluate Tolerance Levels to Ensure That
Program Objectives Are Met***

September 16, 2008

Reference Number: 2008-30-158

TDP 15-71

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 16, 2008

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Needs to Evaluate Tolerance Levels to Ensure That Program Objectives Are Met (Audit #200830007)

This report presents the results of our review of Internal Revenue Service (IRS) correspondence tolerance levels. The overall objective of this review was to evaluate the effects that IRS tolerance levels have on voluntary compliance and taxpayer burden. This audit was included in the Treasury Inspector General for Tax Administration Fiscal Year 2008 Annual Audit Plan.

Impact on the Taxpayer

The IRS determines and adjusts tolerance levels¹ for various tax forms and schedules in order to increase taxpayer compliance, reduce processing costs, and use limited resources effectively. However, the IRS does not maintain documentation detailing the methodology used to determine tolerance levels and could not provide any evidence to show that it monitors the effectiveness of established tolerance levels. Consequently, the IRS might be needlessly expending limited resources and incurring unnecessary costs. This could result in the loss of revenue to the Federal Government and inequitable treatment of taxpayers.

¹ Tolerance levels are dollar figures established by the IRS that trigger an action such as corresponding with taxpayers for forms and schedules.



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Synopsis

For many of the credits, deductions, payments, and taxes due claimed by taxpayers on their U.S. Individual Income Tax Returns (Form 1040), the IRS requires taxpayers to provide substantiation by attaching certain forms and schedules to their tax returns. The IRS does not have the resources to address every identified case of potential taxpayer noncompliance and must apply its limited resources to areas in which noncompliance is greatest, while still maintaining adequate coverage in other areas. Therefore, the IRS sets tolerance levels to control the volume of cases requiring follow-up actions by IRS employees so that all selected cases can be handled. Tolerance levels are considered and changed, if warranted, annually by the IRS. However, the IRS was unable to provide documentation to support any reviews or analysis performed during this process.

In response to our questions regarding the process for establishing tolerance levels, the IRS stated that it considers Congressional legislation, programming requirements, taxpayer instructions, and requests from Compliance functions when determining tolerance levels. By not gathering and analyzing empirical data when establishing tolerance levels—and by not using such data to periodically evaluate the effectiveness of established tolerance levels—the IRS is unable to determine whether it is meeting its goals of reducing processing costs and using limited resources effectively, while maximizing taxpayer compliance.

Based on our analysis, the IRS does not always take into account the overall level of taxpayer compliance with the requirements to provide additional forms and schedules or the associated cost/benefit when setting the tolerance levels for issuing correspondence to taxpayers requesting missing forms and schedules. In addition, the IRS does not maintain data showing the results of its correspondence with taxpayers for these forms and schedules. As a result, the IRS is using its limited resources and incurring additional costs by requesting missing forms and schedules from highly compliant taxpayers while allowing the unsubstantiated deductions of far less compliant taxpayers. Further, the IRS is burdening some taxpayers for substantiation to support insignificant entries (in some cases (b)(3);26 U.S.C. 6103.(b)(7)(E)) on their tax returns, while allowing other more significant entries with no substantiation.

Recommendations

We recommended that the Commissioner, Wage and Investment Division, evaluate tolerance levels to ensure that they are meeting established goals, document the methodology used to establish and revise tolerance levels, and adjust tolerance levels based upon the cost/benefit and degree of taxpayer compliance with the requirement to attach supporting documentation.



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Response

IRS management agreed with one of the two recommendations and partially agreed with the other. IRS management agreed to evaluate and document the methodology used to establish and revise tolerance levels. They plan to enhance their evaluation of tolerance levels by 1) requesting that emphasis be placed on review of the tolerance amounts as part of their 2008 review process, 2) developing a method of capturing the methodology used to establish all new correspondence tolerances, as well as tolerances for review by downstream organizations, and 3) forwarding the tolerances annually for review by downstream organizations and documenting the methodology used in any revisions once the system is developed.

IRS management agreed that the cost/benefit should be factored into decisions to correspond with taxpayers for missing information and stated that the IRS currently considers this information. However, they did not agree that the IRS should track the results of correspondence with taxpayers, stating that such data would only provide the percentage of taxpayers that reply. Further, the IRS stated that tolerances are generally set to ensure compliance with statutory or regulatory requirements for the filing of accurate or processable tax returns and to ensure protection of the revenue. Management's complete response to the draft report is included in Appendix IV.

Office of Audit Comment

Although we agree that tracking taxpayer compliance with correspondence might not be beneficial in all cases, we continue to believe that it would be beneficial to the IRS in many instances. Low compliance rates might indicate when changes are necessary to the wording in the correspondence, the IRS' follow-up procedures, or the actions the IRS takes when no response is received. For example, in some instances, if taxpayers ignore the IRS' correspondence, it will prepare dummy forms or schedules for the taxpayers and process the returns as filed. If the taxpayer response rate to correspondence in these cases is low, it might not be cost-beneficial for the IRS to correspond when the dollar amounts in question are low. Further, when corresponding to protect the revenue, contacting highly compliant taxpayers for substantiation to support very minimal amounts might not be an effective use of the IRS' limited resources, and it might therefore make sense to raise tolerances in those cases to free resources to focus on more significant amounts.

In the response, the Commissioner, Wage and Investment Division, stated that our report did not factor in correspondence for refund and even-balance tax returns. Our sample returns were, in fact, randomly selected from all types of returns, including even-balance and refund returns.

The Treasury Inspector General for Tax Administration has designated this audit report as Sensitive But Unclassified pursuant to Chapter III, Section 23 of the Treasury Security Manual



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(TD P 71-15) entitled, "Sensitive But Unclassified Information." Because this document has been designated as Sensitive But Unclassified, it may be made available only to those officials who have a need to know the information contained within this report in the performance of their official duties. This report must be safeguarded and protected from unauthorized disclosure; therefore, all requests for disclosure of this report must be referred to the Disclosure Branch within the Treasury Inspector General for Tax Administration Office of Chief Counsel.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8510.

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The Internal Revenue Service Needs to Evaluate Tolerance Levels to Ensure That Program Objectives Are Met

Abbreviations

IRS

Internal Revenue Service

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The Internal Revenue Service Needs to Evaluate Tolerance Levels to Ensure That Program Objectives Are Met

Background

Recent Treasury Inspector General for Tax Administration audits on non-cash charitable contributions¹ and the telephone excise tax refund program² found that even though legislation or Internal Revenue Service (IRS) regulations required taxpayers to provide specific documentation to substantiate certain entries on their tax returns, the IRS' tolerance level was so high that many noncompliant taxpayers were never questioned further by the IRS.

The IRS uses tolerance levels³ as an administrative control throughout a range of programs and functions. The IRS establishes tolerance levels for assessing tax, issuing refunds, assigning cases for collection, and corresponding for forms and schedules. These tolerance levels have different rationales behind them. For instance, the IRS does not have the resources to address every identified case of potential taxpayer noncompliance and must apply its limited resources to areas in which noncompliance is greatest. Therefore, the IRS sets tolerance levels to control the volume of cases requiring follow-up actions and to more effectively use limited resources.

The IRS Submission Processing function processes paper and electronic submissions, ensures that tax returns are complete, corrects errors, and forwards data to the Computing Centers for analysis and posting to taxpayer accounts. When taxpayers make entries on their tax returns requiring additional forms as substantiation but do not provide those additional forms, the Submission Processing function will correspond with the taxpayers to obtain the substantiating forms. Generally, if taxpayers do not provide the requested data, the questioned entries on their tax returns are disallowed. Based on established tolerance levels, the Submission Processing function might allow certain entries without required substantiation in order to conserve resources needed to correspond with taxpayers for forms, schedules, and other documentation required to process tax returns.

This review was performed in the Submission Processing and Compliance functions of the Wage and Investment Division during the period January through June 2008. Our review included a review of taxpayer account information nationwide. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the

¹ *The Internal Revenue Service Needs to Improve Procedures to Identify Noncompliance With the Reporting Requirements for Noncash Charitable Contributions* (Reference Number 2007-30-049, dated March 5, 2007).

² *Although Strong Efforts Were Made, a Significant Amount of the Telephone Excise Tax Overcollected From Individual Taxpayers May Never Be Refunded* (Reference Number 2007-30-178, dated September 26, 2007).

³ Tolerance levels are dollar figures established by the IRS that trigger an action such as corresponding for forms and schedules.



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evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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Results of Review

Empirical Data Should Be Analyzed to Establish and Revise Tolerance Levels to Ensure That Program Goals Are Met

The Internal Revenue Manual contains information associated with Submission Processing function correspondence tolerance levels and Compliance function tolerance levels⁴ and is reviewed annually by both functions, as well as by other affected stakeholders, during the document clearance process.⁵ Tolerance levels are considered and changed, if warranted, at that time. However, the IRS was unable to provide documentation to support any reviews or analysis performed during this process.

Although the IRS has periodically revised some tolerance levels for corresponding for a required schedule or other documentation to support an entry on a tax return, no documentation detailing the methodology used to determine the tolerance levels has been maintained. The IRS does not maintain an audit trail⁶ for individual tolerance level changes and could not provide any evidence to show that it monitors the effectiveness of the established tolerance levels. In addition, the IRS does not maintain data associated with correspondence sent to taxpayers to obtain missing documentation. For instance, the IRS does not have data on the number of taxpayers who respond to correspondence or the number of taxpayers who provide missing documentation in response to correspondence.

We reviewed the correspondence tolerance levels over an 11-year time period for 14 forms and schedules required to be filed with U.S. Individual Income Tax Returns (Form 1040) to substantiate various credits, deductions, payments, or taxes due. The IRS tolerance levels to correspond with taxpayers for these forms and schedules in Tax Year 2006 ranged from [REDACTED] (b)(7)(E) U.S.C. 5103, (b)(7)(E)

[REDACTED] For 11 of the 14 forms, we could find no indication that the tolerance level had ever been revised. For the three forms for which tolerance levels for corresponding with taxpayers were adjusted, the IRS could provide no documentation to support the changes. Figure 1 shows additional details regarding the tolerance levels for the 14 forms and schedules.

⁴ Internal Revenue Manual Section 3.11.3, Individual Master File Code and Edit and Internal Revenue Manual Section 3.12.3, Individual Master File Error Resolution

⁵ The process performed in preparation for the following year's publication of the Internal Revenue Manual.

⁶ A record of a sequence of events (as actions performed by a computer) from which a history may be reconstructed.



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Figure 1: Tolerance Levels for Required Forms on Individual Income Tax Returns

Description	Form Number	Tolerance Level ⁷	Tolerance Revisions ⁸
(b)(3):26 U.S.C. 6103.(b)(7)(E)	(b)(3):26 U.S.C. 6103.(b)(7)(E)	(b)(3):26 U.S.C. 6103.(b)(7)(E)	No
			No
			No
			No
			Yes
			No
			No
			No
			Yes
			Yes
			No
			No
			No
			No

Source: Internal Revenue Manual Sections 3.11.3 and 3.12.3.

In response to our questions regarding the process for establishing tolerance levels, the IRS stated that it considers Congressional legislation, programming requirements, taxpayer instructions, and requests from Compliance functions when determining correspondence tolerance levels. By not gathering and analyzing empirical data when establishing tolerance levels, and by not using such data to periodically evaluate the effectiveness of established tolerance levels, the IRS is unable to determine whether it is meeting its goals of reducing processing costs and using limited resources effectively, while maximizing taxpayer compliance.

(b)(3):26 U.S.C. 6103.(b)(7)(E)

⁷ Tolerance levels in effect for Tax Year 2006. Tolerance levels for [redacted] were lowered in 2008.

⁸ Established tolerance levels from Calendar Years 1998 through 2008.



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Recommendation

Recommendation 1: The Commissioner, Wage and Investment Division, should evaluate the tolerance levels for various credits, deductions, payments, or taxes due to ensure that they are meeting agency goals. In addition, a system should be created to provide permanent records and data that would document the methodology used to establish or to revise tolerance levels.

Management's Response: The Commissioner, Wage and Investment Division, agreed with this recommendation and plans to enhance the evaluation of tolerance levels by 1) requesting that emphasis be placed on review of the tolerance amounts as part of their 2008 review process, 2) developing a method of capturing the methodology used to establish all new correspondence tolerances, as well as tolerances for review by downstream organizations, and 3) forwarding the tolerances annually for review by downstream organizations and documenting the methodology used in any revisions once the system is developed.

The Submission Processing Function Should Make Better Use of Limited Resources When Corresponding With Taxpayers for Missing Forms and Schedules

From our review of the tolerance levels for 14 forms and schedules required to support entries on Form 1040, we identified 6 in which the IRS tolerance level for issuing correspondence to taxpayers was set [REDACTED] while the overall taxpayer compliance rate for attaching the required documentation was greater than 99 percent. Figure 2 shows that for the 6 items only 165,000 (.33%) of approximately 50 million taxpayers did not provide the required documentation.

© 2010 U.S.C. 6103.(b)(7)(D)



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Figure 2: Noncompliance Rate for Filing Required Forms

Description	Form Number	Noncompliance Rate ⁹	Correspondence Tolerance Level	Total Returns Filed	Returns Missing Forms
(b)(3):26 U.S.C. 6103,(b)(7)(E)	(b)(3):26 U.S.C. 6103,(b)(7)(E)	0.81%	(b)(3):26 U.S.C. 6103,(b)(7)(E)	381,311	3,071
		0.39%		4,018,911	15,803
		0.24%		6,391,501	15,240
		0.24%		7,744,807	18,811
		0.70%		15,192,607	105,649
		0.04%		16,063,426	6,816
Totals		.33%		49,792,563	165,390

Source: Treasury Inspector General for Tax Administration analysis of Tax Year 2006 Individual Income Tax Returns.

Conversely, we identified 3 other instances in which the IRS tolerance level for issuing (b)(3):26 U.S.C. 6103,(b)(7)(E) correspondence to taxpayers to support an entry on Form 1040 was set at [redacted] and the taxpayer noncompliance rate for attaching the required documentation was as high as 61 percent. Figure 3 shows that for the 3 items, more than 3.97 million (55%) of approximately 7.18 million taxpayers did not provide the required documentation. Using the specific correspondence tolerance levels contained in the Internal Revenue Manual, we determined that the IRS should have corresponded with more than 34,500 of these noncompliant taxpayers. The remaining 3.93 million noncompliant taxpayers would be allowed to claim more than \$237 million in credits without complying with the current tax law requirements.

⁹ Percentage of tax returns filed without required form or schedule.



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Figure 3: Noncompliance Rate for Filing Required Forms

Description	Form Number	Noncompliance Rate ¹⁰	Correspondence Tolerance Level	Total Returns Filed	Returns Missing Forms
(b)(3):26 U.S.C. 6103,(b)(7)(E)	(b)(3):26 U.S.C. 6103,(b)(7)(E)	60.52%	(b)(3):26 U.S.C. 6103,(b)(7)(E)	6,370,215	3,854,948 ¹²
		18.55%		459,764	85,271
		8.19%		349,168	28,584
Totals		55.28%		7,179,147	3,968,803

Source: Treasury Inspector General for Tax Administration analysis of Tax Year 2006 Individual Income Tax Returns.

The IRS needs to collect the correct amount of tax at the least cost to the taxpayers and ensure that the tax law is applied with integrity and fairness. Based on our analysis, the IRS does not always take into account the overall level of taxpayer compliance with the requirements to provide additional forms and schedules or the associated cost/benefit when setting the tolerance levels for issuing correspondence to taxpayers requesting missing forms and schedules. In addition, the IRS does not maintain data showing the results of its correspondence with taxpayers for these forms and schedules.

As a result, the IRS is using its limited resources and incurring additional costs by requesting missing forms and schedules from highly compliant taxpayers while allowing the unsubstantiated deductions of far less compliant taxpayers. Further, the IRS is burdening some taxpayers for substantiation to support insignificant entries on their tax returns, while allowing other more significant entries with no substantiation. This could result in a loss of revenue to the Federal Government as well as inequitable treatment of taxpayers. Also, without data showing the results of its correspondence with taxpayers, the IRS cannot make informed decisions regarding where to apply its limited resources.

¹⁰ Percentage of tax returns filed without required form.

¹¹ For taxpayers (b)(3):26 U.S.C. 6103,(b)(7)(E)

¹² The Internal Revenue Code provides specific limited instances where (b)(3):26 U.S.C. 6103,(b)(7)(E) Neither the IRS nor Treasury Inspector General for Tax Administration were able to determine how many of these taxpayers met the criteria (b)(3):26 U.S.C. 6103,(b)(7)(E)



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Recommendation

Recommendation 2: The Commissioner, Wage and Investment Division, should take the following actions to make better use of resources when corresponding with taxpayers for missing forms and schedules:

- Include the degree of taxpayer compliance with the specific documentation requirement and the cost/benefit of corresponding with taxpayers in decisions to adjust the tolerance levels for various credits, deductions, payments, and taxes due. This will allow the IRS to focus its limited resources on the most egregious cases.
- Track the results of correspondence with taxpayers for missing documentation and use the data in analysis to determine future tolerance levels.

Management's Response: IRS management partially agreed with this recommendation. The Commissioner, Wage and Investment Division, agreed that the cost/benefit should be factored into decisions to correspond with taxpayers for missing information and stated that the IRS currently considers this information. However, management did not agree that the IRS should track the results of correspondence with taxpayers, stating that such data would only provide the percentage of taxpayers that reply. Further, the IRS stated that tolerances are generally set to ensure compliance with statutory or regulatory requirements for the filing of accurate or processable tax returns and to ensure protection of the revenue.

Office of Audit Comment: Although we agree that tracking taxpayer compliance with correspondence may not be beneficial in all cases, we continue to believe that it would be beneficial to the IRS in many instances. Low compliance rates might indicate when changes are necessary to the wording in the correspondence, the IRS' follow-up procedures, or the actions the IRS takes when no response is received. For example, in some instances, if taxpayers ignore the IRS' correspondence, it will prepare dummy forms or schedules for the taxpayers and process the returns as filed. If the taxpayer response rate to correspondence in these cases is low, it might not be cost beneficial for the IRS to correspond when the dollar amounts in question are low. Further, when corresponding to protect the revenue, contacting highly compliant taxpayers for substantiation to support very minimal amounts might not be an effective use of the IRS' limited resources, and it might therefore make sense to raise tolerances in those cases to free resources to focus on more significant amounts.

In the response, the Commissioner, Wage and Investment Division, stated that our report did not factor in correspondence for refund and even-balance tax returns. Our sample returns were, in fact, randomly selected from all types of returns, including even-balance and refund returns.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the effects that IRS tolerance levels have on voluntary compliance and taxpayer burden. To accomplish our objective, we:

- I. Evaluated current IRS tolerance level policies for entries on U.S. Individual Income Tax Returns (Form 1040) that required substantiation for credits, deductions, payments, or taxes due claimed by taxpayers.
 - A. Reviewed current and historic Internal Revenue Manuals to identify correspondence tolerance levels that were in affect for Forms 1040 for Tax Years 1998 through 2008.
 - B. Developed and issued questionnaires to the IRS to 1) verify whether the tolerance levels we identified from the current Internal Revenue Manuals were accurate, 2) determine whether a specific line item and/or form is transcribed, and 3) determine whether any action is taken by the IRS if no response is received from the taxpayer.
 - C. Determined the IRS' rationale for current tolerance levels for various tax forms and schedules.
 - D. Determined the procedures and time periods used when the Error Resolution System¹ either disallows the deduction or credit, or if a Taxpayer Notice Code² is issued to the taxpayers who do not provide the required documentation.
 - E. Performed a risk assessment to identify any internal control weaknesses that needed to be included in our audit tests.
 - F. Determined whether tolerances are adjusted for items in the tax law specifically indexed for cost of living adjustments (e.g., [REDACTED] (b)(3); 26 U.S.C. 6103.(b)(7)(E))
 - G. Determined whether the responsibility for establishing processing tolerance levels was centralized or decentralized.
- II. Evaluated the processing of individual income tax returns with credits, deductions, payments, and taxes due captured on the Individual Return Transaction File.³

¹ The Error Resolution System provides for the correction of errors associated with the input of taxpayer data.

² Taxpayer Notice Codes are used when a math error is present involving the tax liability or balance due/overpayment.

³ The Individual Return Transaction File contains line items transcribed during return processing and other fields such as math calculations.



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- A. Determined the number and corresponding dollar amount of taxpayers claiming credits, deductions, payments, or taxes due.
 - B. Determined whether taxpayers provided the required documentation to substantiate certain line items on their tax returns.
 - C. Determined how the IRS used the additional information it requested/required.
 - D. Determined whether the IRS took steps to obtain the documentation and what additional steps, if any, were taken if the taxpayer failed to respond or to provide any additional substantiation/documentation.
- III. Tested the validity and reliability of our computer-generated data.
- A. Coordinated with a Treasury Inspector General for Tax Administration information technology specialist to identify the volume of various credits, deductions, payments, and taxes due reported on Tax Year 2006 Forms 1040. The computer extract was run from the Individual Return Transaction File on the Treasury Inspector General for Tax Administration Data Center Warehouse.⁴
 - B. Requested a random sample of 280 cases to test the validity of the computer extract. We validated the reliability of the computer-processed data by verifying the sample cases against the information on the Integrated Data Retrieval System⁵ and on the tax returns.

⁴ The Data Center Warehouse provides data and data access services; centralizes storage, security, and administration of files; and develops uniform and user-friendly interfaces for users to access data.

⁵ The Integrated Data Retrieval System allows IRS employees working active tax cases to take specific actions on taxpayer account issues, track status, and post transaction updates back to the Master Files. The Master Files are IRS databases that store various types of taxpayer account information. These databases include individual, business, and employee plans and exempt organizations data.



The Internal Revenue Service Needs to Evaluate Tolerance Levels to Ensure That Program Objectives Are Met

Appendix II

Major Contributors to This Report

Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
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 Commissioner, Wage and Investment Division SE:W

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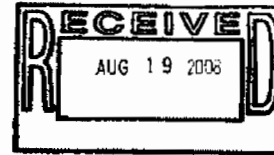
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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30309



AUG 15 2008

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr. *Richard Byrd*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report -- The Internal Revenue Service Needs to Evaluate Tolerance Levels to Ensure Program Objectives Are Met (Audit # 200830007)

I reviewed the subject draft report and appreciate your observations regarding correspondence tolerance levels. Your report focuses on tolerance amounts used by Submission Processing when corresponding with taxpayers for missing forms and/or schedules that are necessary to substantiate a claimed credit or other tax benefit. In addition, your report addresses the compliance percentages associated with taxpayer responses to this correspondence and suggests there is an opportunity for reducing processing costs while maximizing taxpayer compliance.

However, your report does not factor in correspondence for refund and even balance tax returns. These returns constitute the highest volume of correspondence. It also does not provide any analysis or information on safeguarding revenue, such as other validations that take place on many of the [redacted] tolerances designed to ensure compliance with statutory or regulatory requirements for the filing of accurate or processable tax returns. These validations include such things as required signatures, Social Security Numbers required to qualify for particular credits or tax benefits, as well as protecting against unallowable dual benefits such as claims for education credits and the tuition and fees deduction. In other cases, tolerances are set intentionally low to deter fraud. Our current process protects revenue while providing the taxpayer the opportunity to submit a processable return, to substantiate claimed credits and other tax benefits, to self-correct errors, and to avoid unnecessary downstream compliance issues. In all of these cases, if the taxpayer fails to respond to the IRS request for documentation or substantiation, they lose the ability to claim those credits or tax benefits.

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We agree with the finding that we do not currently document the methodology or organizations involved when setting tolerance amounts and will implement actions to capture this information. As part of the 2008 review process, we will request that emphasis be placed on review of current tolerance amounts and will forward the list of tolerances annually to downstream organizations for their review.

With regard to your recommendations that we include the degree of taxpayer compliance with specific documentation requirements and the cost/benefit of corresponding with taxpayers in decisions to set or adjust tolerances, we already consider the budgetary implications of such correspondence. Issues considered include the cost/benefit of correspondence, as well as the impact on resources, personnel, space and property, processing timeframes, and prevention of refund schemes. The IRS also considers Congressional legislation, Treasury regulations, programming requirements, taxpayer instructions, and requests from Examination, Criminal Investigation, and other downstream compliance organizations.

However, we do not agree that it is necessary to track and consider the degree of taxpayer compliance with IRS documentation requests when setting or adjusting correspondence tolerance levels. Your report provides no quantifiable benefits from doing so and the collection of data for taxpayer response rates for each of the over 40 correspondence conditions concerning missing forms/schedules alone would be difficult and expensive to secure. This is especially true in those cases where the return is sent back to the taxpayer with the request for the missing information. In this situation the only method to track if such returns were re-filed with the requested documentation would be in Code & Edit, where returns are first screened. This would require creation of a new database and the manual look up of each account to determine if a previously missing schedule or other information was submitted with a return. While it may be of some limited use to know the taxpayer response rate in these situations, capturing this data would be a burdensome and costly process with little known or quantifiable benefits. Further, as discussed above, many tolerances are set to assure compliance with legislative or regulatory requirements, or to deter fraud, and would not be adjusted based on percentages of taxpayers that comply or fail to comply with IRS documentation requests.

Our responses to your specific recommendations are attached. If you have any questions regarding this response, please call me at (404) 338-7060, or members of your staff may contact Peter J. Stipek, Director, Customer Account Services, at (404) 338-8910.

Attachment



The Internal Revenue Service Needs to Evaluate Tolerance Levels to Ensure That Program Objectives Are Met

Attachment

RECOMMENDATION 1

The Commissioner, Wage and Investment Division, should evaluate the tolerance levels for various credits, deductions, payments or taxes due to ensure they are meeting agency goals. In addition, a system should be created to provide permanent records and data that would document the methodology used to establish or to revise tolerance levels.

CORRECTIVE ACTION

We agree with this recommendation. Tolerance levels are currently evaluated on an annual basis through the Internal Review Manual (IRM) review process that includes all major IRS organizations, including Chief Counsel. Additionally, tolerance amounts are evaluated when downstream organizations provide a business case or if Submission Processing cost/benefit and other analyses determine a tolerance level should be created, deleted or adjusted.

- a) As part of the 2008 IRM review process, we will request that emphasis be placed on review of the tolerance amounts.
- b) In addition, Submission Processing will develop a method of capturing the methodology used to establish all new correspondence tolerances, as well as tolerances for review by downstream organizations, but will not include the original methodology used.
- c) Once the system is developed, we will forward the tolerances annually for review by downstream organizations and document the methodology used in any revisions

Through these processes, Submission Processing will ensure correspondence tolerances are meeting their intended purposes. It will also enable the organization to document and maintain records regarding the methodology used to establish or revise these tolerances.

IMPLEMENTATION DATE

- a) December 15, 2008
- b) September 15, 2009
- c) September 15, 2009

RESPONSIBLE OFFICIAL

Director, Submission Processing, Wage and Investment Division



The Internal Revenue Service Needs to Evaluate Tolerance Levels to Ensure That Program Objectives Are Met

2

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal managerial control system. The Director, Submission Processing will report progress to the Director, Customer Account Services.

RECOMMENDATION 2

The Commissioner, Wage and Investment Division, should take the following actions to make better use of resources when corresponding with taxpayers for missing forms and schedules:

1. Include the degree of taxpayer compliance with the specific documentation requirement and the cost/benefit of corresponding with taxpayers in decisions to adjust the tolerance levels for various credits, deductions, payments and taxes due. This will allow the IRS to focus its limited resources on the most egregious cases.
2. Track the results of correspondence with taxpayers for missing documentation and use the data in analysis to determine future tolerance levels.

CORRECTIVE ACTION

1. We partially agree with this recommendation. Taxpayer response rates are generally not a component in setting tolerance amounts for correspondence where the validation is designed to ensure compliance with statutory or regulatory requirements for filing an accurate and processable return, or to prevent fraud and protect the revenue. However, we agree that tolerance levels should, and currently do consider budgetary implications. These include the cost/benefit of correspondence, as well as the impact on resources, personnel, space and property, processing timeframes, and prevention of refund schemes. We also consider Congressional legislation, Treasury regulations, programming requirements, taxpayer instructions, and requests from Examination, Criminal Investigation and other downstream compliance organizations. However, we do not agree that it is necessary to track and consider the degree of taxpayer compliance with IRS documentation requests when setting or adjusting correspondence tolerance levels.
2. We do not agree with this recommendation. Tracking taxpayer compliance in returning correspondence to the IRS only provides the percentage of taxpayers that reply. Such a percentage would be a very limited factor in setting tolerance amounts. Also, there is no indication the compliance percentages would not remain relatively constant regardless of the tolerance amount. And, as noted earlier, tolerances are generally set to ensure compliance with statutory or regulatory requirements for the filing of an accurate or processable tax return and to ensure



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protection of the revenue. To collect and use the necessary response rate information would be difficult and costly with little known or quantifiable benefit.

IMPLEMENTATION DATE

1. N/A
2. N/A

RESPONSIBLE OFFICIAL

Director, Submission Processing, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

N/A

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