The Return Delinquency Notice Program Could Be Used More Effectively to Promote Filing Compliance and Reduce the Tax Gap

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

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

SUBJECT: Final Audit Report - The Return Delinquency Notice Program Could Be Used More Effectively to Promote Filing Compliance and Reduce the Tax Gap (Audit # 200230037)

This report presents the results of our review of the Return Delinquency Notice Program. The overall objective of this review was to determine whether the Return Delinquency Notice Program in the Compliance Services Collection Operations (CSCO)[1] function is effectively designed, managed, and operated to achieve the desired program results and to promote compliance with Federal tax laws.

In summary, the Internal Revenue Service (IRS) has implemented or undertaken several initiatives in recent years to improve filing compliance with the goal of closing more return delinquency cases through efficiency improvements.[2] At the same time, however, the IRS has faced the significant challenge of working an increasing inventory of nonfiled returns with fewer resources. The number of potential individual nonfiler cases identified by the IRS increased from 6.1 million for Tax Year (TY) 1994 to 8.9 million for TY 2001,[3] while the amount of resources applied to the Return Delinquency Notice Program has moved in the opposite direction. Although the IRS

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[1] The CSCO (formerly called the Service Center Collection Branch) handles taxpayer responses to return delinquency notices. Those cases that are not resolved may be referred to the Automated Substitute for Return Program, the Automated Collection System, or the Collection Field function for further action. Appendix V of the report contains a Glossary of Terms.

[2] The scope of this audit did not include determining the effect of the IRS organizational modernization on the Return Delinquency Notice Program.

[3] In discussing a draft of this report, IRS management advised that an additional 2.5 million low priority cases were inadvertently included in the TY 2001 nonfiler inventory from which work was ultimately selected.

has begun to reverse this trend, the overall reduction in resources is particularly evident when comparing the Full-Time Equivalents (FTE) applied in Fiscal Year (FY) 2002 to FY 1997 FTE levels. During this 6-year period, the FTEs applied by the CSCO to working taxpayer responses to return delinquency notices declined by 50 percent.[4]

Primarily because of these declining resources, the ability of the Return Delinquency Notice Program to effectively promote filing compliance and maximize tax collections has been significantly affected. One impact of the declining resources is that the number of potential individual nonfilers identified by the IRS that are not sent a return delinquency notice increased from about 4.8 million for TY 1994 to 6.7 million for TY 2001. More than 1.1 million of these 6.7 million unworked TY 2001 cases were from various selection code categories that could have been expected to produce an average net tax due per return ranging from $518 to $5,309. The total potential net tax value of these cases was more than $1 billion. Another impact of the declining resources is that only about 1.9 million of the 2.7 million taxpayers who were sent return delinquency notices in FY 2003 received further IRS compliance treatments if the nonfiling situation was unresolved. Also, the number of individual returns secured during FY 2002 was only 51 percent of the number secured during the FY 1999 peak performance year.

We identified two opportunities to use the IRS' limited resources in a more efficient manner. First, the high work priority assigned to return delinquency cases involving Federal Government employees or retirees[5] prevents the IRS from fully addressing other categories of nonfiler cases that offer greater potential for maximizing tax collections. While the IRS generally sets its nonfiler workload by selection categories that represent the greatest risk for filing and payment noncompliance, an exception to this rule is made for Federal Employees/Retirees Delinquency Initiative (FERDI) cases. The reason for this is because of the sensitivity for Federal Government employees and retirees to meet their ethical and legal tax obligations.[6] As a result, IRS procedures require that all FERDI cases identified be given the full range of compliance treatments. For TY 2001, the IRS identified and worked almost 109,000 FERDI cases that produced an average net tax due[7] per return of $772.[8] If the resources used on the TY 2002 FERDI cases selected by the Wage and Investment (W&I) Division had been applied to the same number of nonfiler cases that were not worked from other, more productive, nonfiler selection categories (which produced an average net tax due ranging from $970 to $1,352 for TY 2001), total net taxes due could have been potentially increased by over $87.3 million.

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[4] The scope of this review was limited to CSCO operations that comprise only one segment of the total FTEs the IRS applies to various nonfiler programs.

[5] The IRS began the Federal Employees/Retirees Delinquency Initiative in 1993 to address noncompliance with Federal tax laws by Federal Government employees and retirees.

[6] 5 C.F.R. Part 2535.101 (b) (12) Oct. 2, 2002.

[7] Net tax due represents tax, penalty, and interest assessments less prepaid credits.

[8] Weighted average based on 10,216 cases completed by the Small Business/Self-Employed Division that produced an average net tax due per return of $1,819, and 17,127 cases completed by the Wage and Investment Division that produced an average net tax due per return of $148.

One problem with Federal Government agencies addressing their employees with Federal tax problems is the IRS is legally prevented from sharing information on Federal tax delinquencies involving Federal Government employees with the employing agencies. As a result, Federal Government agencies, other than the IRS, are unaware when their employees are not in compliance with Federal Government ethical standards that require the filing and payment of Federal taxes.

Second, at the time we completed our review, the IRS may not have been realizing the full potential of the Refund Hold Program[9] as a tool for encouraging taxpayers to file delinquent returns. For TY 2001, refunds totaling an estimated $51.3 million were released on more than 11,000 cases after the freeze period expired without securing delinquent returns or determining that the delinquent returns involved no tax liability. In discussing a draft of this report, IRS management advised that criteria existed to limit taxpayer burden and release refunds based on taxpayer hardship and declared disasters. Although it is unknown how many of the 11,000 TY 2001 refunds were released because of these criteria, IRS management believes the number was substantial due to the terrorist attacks that occurred on September 11, 2001. Because of declining resources, the IRS has increased its administrative dollar tolerance for identifying refund hold cases by more than 600 percent since the Program was started in 1993. For TY 1999, the IRS increased its administrative dollar tolerance for refund hold cases by nearly 70 percent. This caused the number of refund hold cases to decline from 125,974 for TY 1998 to 59,316 for TY 1999[10] and contributed to a decline in the number of delinquent returns secured through the Refund Hold Program from 58,850 for TY 1998 to 36,736 for TY 1999. For TY 2000, the IRS again increased its administrative tolerance by an additional 300 percent.

The IRS has made significant changes to the Refund Hold Program since we completed our review. In discussing a draft of this report, IRS management advised that both the Small Business/Self-Employed (SB/SE) and W&I Divisions began working the Refund Hold Program as the top priority in the Automated Substitute for Return (ASFR) Program in January 2004. In addition to helping ensure all cases meeting refund hold criteria are worked, this change also allows the IRS to resolve the refund during the freeze period by offsetting it to liabilities on the delinquent return or applying it to the proposed deficiency when a Statutory Notice of Deficiency is issued. In addition, the SB/SE Division has also centralized its Refund Hold Program into one campus location to increase efficiency.

Since the IRS FY 2004 budget proposal for the Return Delinquency Notice Program provided for additional FTEs, we made no formal recommendations to address the

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[9] The Refund Hold Program identifies individual taxpayers that have filed a current year tax return entitling them to a refund but have not filed tax returns for a previous tax year for which the IRS has third-party information documents (e.g., Wage and Tax Statement (Form W-2)) indicating that a tax liability may exist that is equal to or greater than the refund amount. The IRS freezes the issuance of the current year refund for a specified time period while it attempts to resolve the prior year tax return delinquency.

[10] In discussing a draft of this report, IRS management stated that the number of selected refund hold cases may or may not be affected by the increase in the administrative tolerance.

declining resources. To address the FERDI cases that pose minimal risks for payment noncompliance, we recommended that the Commissioner, W&I Division, replace the IRS' policy of working all FERDI cases with a risk-based approach that applies tailored compliance treatments based on the potential taxes due. We also recommended that the Commissioners, SB/SE and W&I Divisions, coordinate with the Office of Government Ethics (OGE) and the Office of Management and Budget (OMB) to explore the potential of developing better approaches for ensuring that Federal Government employees are held more accountable for filing all required Federal tax returns. To further improve the effectiveness of the Refund Hold Program for protecting tax revenue and closing the return filing gap, we recommended the Commissioners, SB/SE and W&I Divisions, consider reevaluating the administrative dollar tolerance for freezing refunds to determine if it can be reset at a lower level, given the available resources, now that the Refund Hold Program is being worked as part of the ASFR Program. We also recommended expanding the management information reports for the Refund Hold Program to provide data for measuring program effectiveness and results and for setting workload selection tolerance levels.

Management's Response: The Commissioner, SB/SE Division, provided a detailed response that disagreed with our recommendations pertaining to the FERDI Program. However, the Commissioner, SB/SE Division, agreed with our recommendations to reevaluate the dollar tolerance for freezing refunds and expand the management information reports for the Refund Hold Program.

While the Commissioner, SB/SE Division, believes there is considerable merit to our recommendation to subject FERDI cases to a risk-based approach, the IRS has taken steps to improve the efficiency and effectiveness of the FERDI Program, and other factors, such as public policy and public confidence in tax administration, outweigh revenue potential as determinative factors in whether to work these cases. The Commissioner, SB/SE Division, stated the Congress and the general public expect a higher degree of compliance among Federal employees and advised that failure to address noncompliance in the FERDI population undermines public confidence in the IRS' ability to administer the tax laws fairly and effectively. The adoption of a risk-based approach would selectively target specific segments of the FERDI population, which could result in adverse public criticism of the IRS' enforcement efforts while resulting in a negative impact on overall compliance.

The Commissioner, SB/SE Division, did not concur with our estimate that total net taxes due could have been potentially increased by over $87.3 million by reapplying the resources used to work certain TY 2002 FERDI cases. The Commissioner, SB/SE Division, stated the projection is based on the premise that all FERDI inventory is low yielding and advised that the W&I Division currently uses the Collection Optimum Potential Yield Score (COPYS) as a risk-based approach for case selection. As part of the case creation process, a COPYS is computed to provide a ranking mechanism to stratify and select nonfiler work. Cases with higher COPYSs are more likely to result in a higher net tax due than cases with lower COPYSs. The Commissioner, SB/SE

Division, stated over 75 percent of the FERDI cases met the criteria as higher-yield cases and these cases would have been selected over other non-FERDI cases.

The Commissioner, SB/SE Division, advised that, as noted in our report, Internal Revenue Code (I.R.C.) § 6103 (2003) does not allow the IRS to disclose specific employee tax delinquency information to other agencies so that they may effectuate appropriate disciplinary action under Government-wide ethics regulations. Therefore, while the IRS can work with the OGE and OMB to identify other approaches for holding Federal employees more accountable, the IRS' inability to disclose employee-specific tax information to other agencies constrains its ability to effectuate any disciplinary action for failing to meet new accountability requirements. The IRS does share general statistics with agencies each year regarding the compliance rates of their employees and will continue to explore opportunities to further improve compliance within the FERDI population. The Commissioner, SB/SE Division, stated it was important to note that as of October 2003, the overall FERDI noncompliance rate was 3.06 percent, down from 3.47 percent in the previous year. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comments: We continue to believe our recommendations relative to the FERDI Program have merit. The SB/SE Division Commissioner's position that "public policy and public confidence in tax administration outweigh revenue potential as determinative factors in whether to work these cases" represents a departure from the IRS' recent efforts in this area. Due in part to the use of several new risk-based criteria, for example, the average net tax due for FERDI cases increased from a $649 refund in TY 1998 to a balance due of $148 for W&I Division cases and a balance due of $1,819 for SB/SE Division cases in TY 2001. One new initiative was to select only those cases that have the potential to exceed a specific net tax due threshold amount. In addition, the SB/SE Division incorporated a filter into the return delinquency case creation process that eliminated those FERDI cases that were "predicted" to be not liable.

Regarding the SB/SE Division Commissioner's concern that the adoption of a risk-based approach would selectively target specific segments of the FERDI population and could result in adverse public criticism of the IRS' enforcement efforts while resulting in a negative impact on overall compliance, we believe that using a risk-based approach to select FERDI nonfiler cases for compliance enforcement treatment would allow the IRS to apply some type of notice treatment to all FERDI cases while reserving the most intensive compliance treatments for those FERDI cases that represent the most egregious type of nonfiler. Given its scarce resources, the IRS' current practice of applying its most intensive compliance treatments to thousands of low dollar FERDI cases invites, in our opinion, public criticism of its decision-making process, especially at a time when the tax gap[11] exceeds $300 billion. Also, the comprehensive pursuit of low dollar cases raises concerns about the fairness and cost-effectiveness of this policy.

Our estimate concerning additional tax revenue was based on the average net tax due of $148 yielded by 17,127 FERDI closures, or 24 percent of the W&I Division's total

[11] The difference between total tax liability and the taxes paid voluntarily and timely.

TY 2001 FERDI inventory. If the majority of these cases met the IRS' criteria as higher yield cases that would have been worked regardless of their selection category, as the SB/SE Division Commissioner states in the response, it raises questions about the effectiveness of the COPYS as a risk-based approach for return delinquency case selection. It also raises questions about whether more than 75 percent of the W&I Division's FERDI cases were actually high yielding cases.

We are pleased the IRS will continue to explore opportunities to improve compliance among the FERDI population. While the SB/SE Division Commissioner noted that the overall FERDI noncompliance rate has improved, it is also important to note that the number of nonfiler FERDI cases has grown from 106,566 for TY 2000 to 116,064 in TY 2002. We believe this continued growth in the number of nonfilers among the FERDI population underscores the need for new approaches in dealing with this customer segment. However, we doubt that significant improvement can be realized as long as active Federal employees can continue to escape disciplinary action because their noncompliance is hidden from their employing agencies by the privacy laws. In working with the OGE and OMB to identify approaches for holding Federal employees more accountable, we encourage the IRS to determine whether there is support for changing I.R.C. § 6103 to allow the IRS to share Federal employee tax delinquency information with the employing agencies.

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

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 Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

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Background

Taxpayers that fail to file income tax returns when required pose a serious threat to voluntary compliance. Nonfilers impair tax administration and undermine public confidence in the fairness of the system, and the population of nonfilers is growing. For Tax Year (TY) 1992, the Internal Revenue Service (IRS) estimated the nonfiler portion of the gross individual tax gap[1] was $10.2 billion. For TY 1998, the IRS estimated the gross tax gap attributable to the nonfiling of individual income tax returns was $22.6 billion.

The IRS must proactively identify and investigate potentially nonfiled returns to maintain public confidence in the voluntary tax system and to ensure the tax laws are applied fairly to all taxpayers. The mission of the IRS' nonfiler program is to ensure taxpayers that are legally required to file do so and to address those individuals that are not required to file but may be due refunds or credits.

The Return Delinquency Notice Program identifies individual and business taxpayers that may not have filed tax returns. The IRS uses risk assessment tools in the return delinquency case creation and treatment decision processes to identify and work the most serious types of filing noncompliance. The responsibility for administering the Return Delinquency Notice Program for individual taxpayers is shared by the Small Business/Self-Employed (SB/SE) and Wage and Investment (W&I) Divisions. The Return Delinquency Notice Program for business taxpayers is the responsibility of the SB/SE Division. For TY 2001,[2] the IRS identified approximately 8.9 million individual nonfilers.

In recent years, the Government Accountability Office (GAO)[3] has expressed concern with the decline in various IRS compliance programs. In one report,[4] the GAO noted that between 1996 and 2001, these programs generally

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[1] The difference between total tax liability and the taxes paid voluntarily and timely. The IRS made no estimate of the tax gap attributable to the nonfiling of business returns.
[2] The TY 2001 return delinquency cases were processed in Fiscal Year 2003.
[3] Formerly the General Accounting Office.
[4] *Major Management Challenges and Program Risks: Department of the Treasury* (GAO-03-109, dated January 2003).

experienced larger workloads, reduced staffing, and fewer numbers of cases closed per employee. Another GAO report[5] stated that some available, but very limited, data suggest that voluntary compliance may have begun to deteriorate. This report noted the number of apparent individual nonfilers had increased about 3.5 times faster than the individual tax filing population.

To perform this audit, we interviewed IRS managers and program analysts and reviewed management information system reports and other documentation related to return filing compliance. Some of the data used in this report came from various IRS reports. We did not verify the accuracy of the information from those sources. This review was performed during the period January through June 2003 at the SB/SE and W&I Division offices in New Carrollton, Maryland. We performed additional analyses during the period April through June 2004 to include new information provided by the IRS in response to a draft of this report. 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. A Glossary of Terms is provided in Appendix V.

Ongoing Efforts to Improve the Return Delinquency Notice Program May Be Negated by Declining Resources

At the time we completed this review, the IRS had implemented or was undertaking several initiatives to improve filing compliance with the goal of closing more return delinquency cases through efficiency improvements. These initiatives included:

- Analyzing the use of various filters in the return delinquency work selection process in order to focus limited resources on the most productive cases.

[5] *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers* (GAO-02-674, dated May 2002).

- Incorporating income from Schedule K-1[6] cases into the return delinquency selection process.
- Performing delinquency checks for corporate returns later in the return delinquency process to avoid working unproductive cases, since IRS studies have found these taxpayers have a tendency to file their tax returns late.
- Expanding and centralizing the work process for individual Automated Substitute for Return (ASFR) Program cases to improve efficiency and increase collections. A study found 60 percent of taxpayers whose nonfiler cases are worked in the ASFR Program timely file their tax returns in the subsequent year.
- Centralizing the work process for 6020(b)[7] Program cases.
- Incorporating balanced measures into the return delinquency process. The measurements will include quantity measures, quality measures, and a new customer service satisfaction survey. The balanced measures are expected to be operational in Fiscal Year (FY) 2004.

Reduced resources have limited the effectiveness of the Return Delinquency Notice Program

The IRS does not have the resources to address every identified case of potential taxpayer noncompliance and, therefore, must apply its limited resources to areas in which noncompliance is greatest, while still maintaining adequate coverage in other areas. When budget cuts are required

[6] Partner's Share of Income, Credits, Deductions, etc. (Schedule K-1) is used to show each partner's share of the income from a partnership. Shareholder's Share of Income, Credits, Deductions, etc. Schedule K-1 is used to show each shareholder's share of the income from a Subchapter S corporation.

[7] Internal Revenue Code (I. R. C.) § 6020(b) (2000) gives the IRS the authority to prepare and process returns for nonfiling taxpayers. The 6020(b) Program prepares and processes Employer's Quarterly Federal Tax Return (Form 941) or Employer's Annual Federal Unemployment Tax Return (From 940).

(e.g., the FY 2003 shortfall[8]), the Return Delinquency Notice Program traditionally is one of the compliance programs affected. The Return Delinquency Notice Program is vulnerable to staffing cuts since the IRS can limit the number of cases selected to match the resources available to work them.

In recent years, the Return Delinquency Notice Program has faced the challenge of having fewer resources to work the significantly increasing inventory of nonfiled returns. Management has attempted to meet this challenge by refining the case selection process and matching selections to resources. Figure 1 shows the number of Full-Time Equivalents (FTE) applied by the Compliance Services Collection Operations (CSCO)[9] to working taxpayer responses to return delinquency notices from FY 1997 through FY 2002. While the number of FTEs applied in FY 2002 was only 50 percent of the number applied in FY 1997, it represented an increase from FY 2001. Although FTE data for FY 2003 was not available at the time we completed our review, IRS management advised during the discussion of this report that 138 FTEs had been applied, thereby continuing the recent upward trend.

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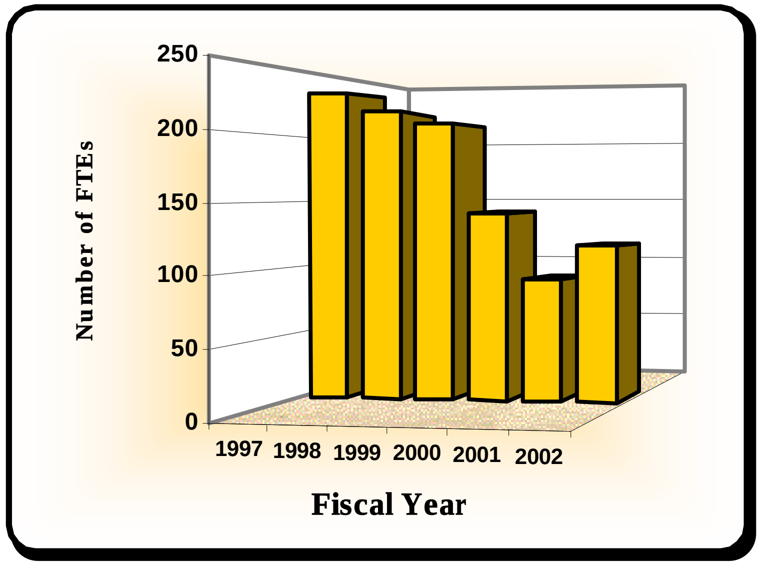
[8] The IRS' FY 2003 budget shortfall was caused by an unfunded increase in the FY 2002 annual employee pay raise; postage increases above initial budget projections; and an unfunded increase in security costs after the September 11, 2001, terrorist attacks.
[9] The CSCO was formerly called the Service Center Collection Branch.

Figure 1: Direct FTEs Realized by the CSCO for the Return Delinquency Notice Program[10]
FYs 1997 – 2002



Source: IRS SB/SE Division.

<u>While compliance treatments are increasing, they have not kept pace with the growth in nonfilings</u>

Identifying potential nonfilers is the first step in the Return Delinquency Notice Program. For individual taxpayers, potentially nonfiled returns are primarily identified by using computer programs that match data on information returns[11] with the IRS records of filed tax returns. Based on the predominate type of income or the nature of the case, each potential nonfiler case is assigned to one of several selection codes that determines the risk level of the case and the type of compliance action to be taken. The range of compliance treatment actions for individual nonfiler cases includes:

- Taxpayer Delinquency Investigation (TDI) – Taxpayers are mailed two return delinquency notices requesting that they file their tax returns or explain why they are

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[10] The data represents FTEs allocated by both the SB/SE and W&I Divisions.

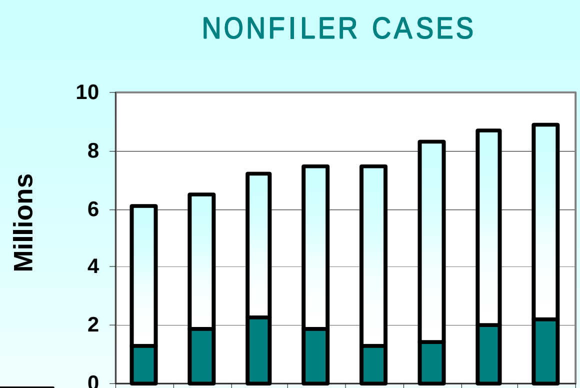
[11] Employers, financial institutions, and other business entities are required to submit information returns to the IRS reporting wages, interest, dividends, nonemployee compensation, and other types of income.

not liable to file. Tax examiners in the CSCO process the responses to return delinquency notices. Those cases that are not resolved through the notice process may be referred to the ASFR Program, the Automated Collection System, or the Collection Field function for further compliance action.

- Primary Code B (PC-B) – Taxpayers are mailed one return delinquency notice. No further action is taken on these cases if the taxpayers do not respond to the notice or satisfactorily resolve the nonfiling condition.
- Taxpayers are not contacted at all.

The number of return delinquency notices sent by the IRS is constrained by the available CSCO FTEs to work the related taxpayer correspondence. Figure 2 shows that while the total growth in individual nonfiler cases from TYs 1994 to 2001 (the last year for which data were available at the time we completed our review) has been substantial, the number of potential nonfilers that received return delinquency notices from the IRS has fluctuated. While the number of notices sent the last 2 years was near the highest level attained in 1996, the data shows that, overall, an increasing number of potential nonfilers have not received return delinquency notices from the IRS.

Figure 2: Potential Individual Nonfilers Receiving Return Delinquency Notices from the IRS[12]
TYs 1994 – 2001[13]



Tax Year	1994	1995	1996	1997	1998	1999	2000	2001
Nonfilers Not Sent Notices	4.8	4.6	4.9	5.6	6.2	6.9	6.7	6.7
Nonfilers Sent Notices	1.3	1.9	2.3	1.9	1.3	1.4	2.0	2.2

Source: IRS Potential Nonfiler Data Files.

The data for this 8-year period shows that:

- The total number of potential individual nonfiler cases identified by the IRS increased by 46 percent from TY 1994 to TY 2001.
- The percentage of the potential individual nonfilers that received return delinquency notices from the IRS

[12] The data in this table represent return delinquency notices sent to individual (including self-employed) taxpayers only. Return delinquency activity involving other types of taxpayers (e.g., corporate, partnership) was outside the scope of this review.

[13] In discussing a draft of this report, IRS management advised that exact year-to-year comparisons cannot be made because the identification process can change on a yearly basis. IRS management also stated that an additional 2.5 million low priority cases were inadvertently included in the TY 2001 nonfiler inventory from which work was ultimately selected. These cases are not reflected in the above graph.

declined from 32 percent for TY 1996 to only 25 percent for TY 2001.

- The number of potential individual nonfilers that received no return delinquency notices from the IRS increased from about 4.8 million for TY 1994 to about 6.7 million for TY 2001.

The IRS applies case creation criteria to prioritize the inventory of identified nonfilers. The IRS works those cases that are judged to have the best potential to result in significant net taxes due. Therefore, many of the 6.7 million individual nonfiler cases for TY 2001 that were not sent return delinquency notices were considered low priority cases.

However, Table 1 shows that there were more than 1.1 million TY 2001 nonfiler cases that were not worked from various selection code categories that could have been expected to produce an average net tax due per return ranging from $518 to $5,309. The total potential net tax value of these cases was more than $1 billion.

Table 1: Potential Net Tax Value of Certain Nonfiler Cases That Were Not Worked (TY 2001)

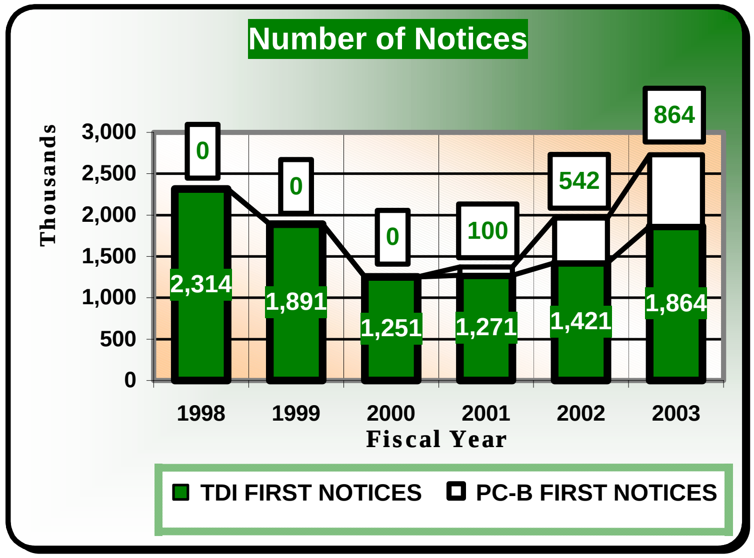
Case Selection Code (A)	Number of Cases Worked (B)	Number of Cases Not Worked (C)	Average Net Tax Due Per Return (D)[14]	Potential Net Tax Value of Cases Not Worked (C) X (D)
04	10,930	1,557	$5,309	$ 8,266,113
10	44,259	42,543	$2,959	$ 125,884,737
09	594,448	77,860	$2,726	$ 212,246,360
16	21,335	9,136	$2,104	$ 19,222,144
13	544,693	305,229	$1,028	$ 313,775,412
14	4,631	683,078	$ 518	$ 353,834,404
Totals	1,220,296	1,119,403		$1,033,229,170

Source: Treasury Inspector General for Tax Administration (TIGTA) Analysis of TY 2001 Nonfiler Inventory Selection Code Selections.

While the number of return delinquency notices issued by the IRS has increased for the most recent tax years that were available at the time we completed our review, Figure 3 shows that an increasing percentage of the taxpayers sent return delinquency notices met PC-B treatment criteria. The use of the PC-B treatment allows the IRS to send return delinquency notices to larger numbers of lower priority nonfilers while, at the same time, conserving scarce IRS resources. However, the PC-B treatment criteria also means that no further compliance actions are taken by the IRS if the taxpayers do not respond to the notices or otherwise satisfactorily resolve their nonfiling conditions.

[14] The average net tax due per return is based on the IRS Nonfiler Effectiveness Reports for TY 1997 through TY 2000, cycle 200026. The TY 2000 data reflected only partial results since only about 50 percent of the notices had been issued. The net tax due amounts are the average of 2, 3, or 4 years of results, although some selection codes did not have case selections each year.

Figure 3: Type of Individual Return Delinquency Notice
FYs 1998 – 2003



Source: IRS Collection Activity Report (CAR) 5000-4.

The data for this 6-year period show:

- The number of return delinquency notices sent to potential individual nonfilers that met TDI treatment criteria declined from more than 2.3 million for FY 1998 to less than 1.3 million for both FYs 2000 and 2001.
- The downward trend in the total number of return delinquency notices sent was reversed starting in FY 2001. The number of return delinquency notices that met TDI treatment criteria had increased to almost 1.9 million for FY 2003, but it was still only 81 percent of the FY 1998 level.
- Most of the increase in return delinquency notices sent for FYs 2002 and 2003 involved nonfiler cases that met PC-B treatment criteria. About 864,000 (32 percent) of the approximately 2.7 million return delinquency notices sent for FY 2003 met PC-B treatment criteria. This means only 68 percent of the 2.7 million nonfilers that were sent notices received further IRS treatments if their nonfiling situations continued to be unresolved.

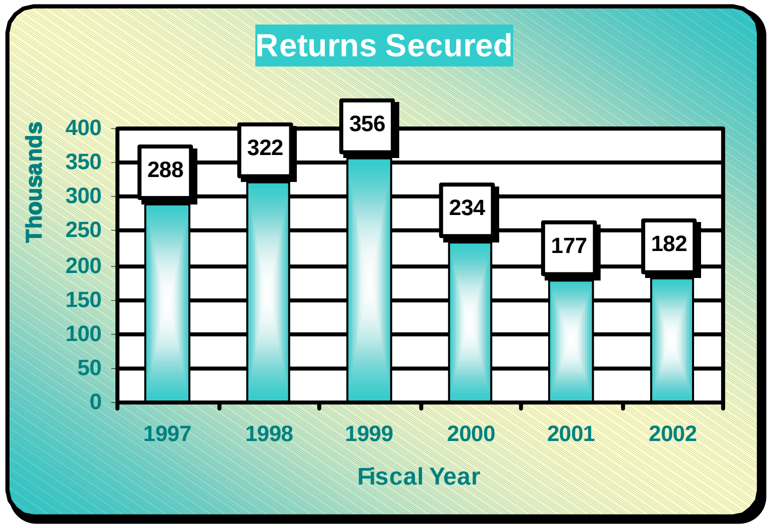
We were advised that, for FYs 1998 - 2000, PC-B notices were not sent to taxpayers because IRS management at that time was not comfortable with sending taxpayers only one notice and not following up when appropriate with additional compliance actions. In discussing a draft of this report with IRS management, they advised that a W&I Division analysis revealed that prior selections were systemically closed due to resource constraints and that the W&I Division chose to increase PC-Bs to "treat" a higher volume of nonfilers with at least one notice.

The number of returns secured has significantly declined since FY 1999

According to several IRS managers we interviewed, the number of returns secured is a key measurement of success for the Return Delinquency Notice Program. Despite the increasing number of nonfiled returns identified by the IRS, Figure 4 shows that the number of individual income tax returns secured by return delinquency notices in FYs 2000 – 2002 was substantially lower than during recent peak performance years.

In discussing a draft of this report, IRS management stated that year-to-year comparisons of the number of returns secured is not a valid measurement of the "effectiveness" of the Return Delinquency Notice Program because the number of returns secured is related to the number of notices sent. Therefore, the decline in return delinquency notices sent for FYs 2000 and 2001 (as shown in Figure 3) significantly contributed, in all likelihood, to the decline in returns secured.

Figure 4: Individual Income Tax Returns Secured by Return Delinquency Notices FYs 1997 – 2002



Source: IRS CAR 5000-3.

The data for the 6-year period shows that:

- The number of delinquent individual returns secured by delinquency notices in FY 2002 was only 51 percent of the number secured in FY 1999. The decline in delinquent returns secured in FYs 2000 - 2002 was directly related to fewer notices mailed to taxpayers (see Figure 3).
- During both FYs 1999 and 2000, delinquent returns secured, as a percentage of the number of taxpayers sent return delinquency notices, was 19 percent. In FYs 2001 and 2002, the rate of returns secured declined to 13 percent and 9 percent, respectively. The reduced percentage of returns secured in FYs 2001 and 2002 may have been attributable to the fact that approximately 7 percent of the notices sent in FY 2001 and almost 28 percent of the notices sent in FY 2002 were PC-Bs. This meant these taxpayers received no further compliance treatments if their nonfiling condition was unresolved as a result of the return delinquency notice.

Increased funding is needed to keep pace with nonfiled returns

While the various initiatives underway may improve the efficiency of the return delinquency process, we believe it is likely the IRS will continue to face enormous challenges in closing the filing compliance gap unless additional resources are made available. The IRS managers we interviewed had no readily available data on the number of additional FTEs that would be needed to effectively close the noncompliance filing gap. Some of the IRS managers stated a reasonable level of voluntary filing compliance could be achieved if the FTEs allocated to the Return Delinquency Notice Program were restored to the level realized in the mid-1990s.

Since the IRS FY 2004 budget proposal for the Return Delinquency Notice Program provided for additional FTEs, we are making no formal recommendations. The IRS Oversight Board has also been supportive of the initiative to increase Return Delinquency Notice Program funding.

Changes Are Needed in Working Return Delinquency Cases Involving Federal Government Employees and Annuitants

Executive Orders 11222[15] and 12731[16] and Office of Government Ethics (OGE) regulations require Federal Government employees to satisfy all of their just financial obligations, especially those such as Federal, state, and local taxes imposed by law. In 1992, the Office of Management and Budget (OMB) proposed legislation to require the IRS to annually determine whether any Federal Government employees were delinquent with Federal tax filing and payment requirements and to take appropriate follow-up action.

Although the OMB's proposed legislation was never enacted, the IRS quickly moved forward to implement policy, procedural, and system changes in January 1993 to identify and address tax delinquencies involving Federal Government employees and annuitants. These changes became known as the Federal Employees/Retirees

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[15] Standards of Ethical Conduct for Government Officers and Employees, dated May 8, 1965.
[16] Principles of Ethical Conduct for Government Officers and Employees, dated October 6, 1990.

Delinquency Initiative (FERDI).[17] As part of the FERDI, the IRS performs an annual computer match of its filing and payment records to identify noncompliant Federal Government employees and retirees.

Working all FERDI cases may divert resources from more productive return delinquency cases

Generally, the IRS prioritizes its nonfiler workload by selection categories that represent the greatest risk for filing and payment noncompliance. An exception to this general rule is made for FERDI cases because of the sensitivity for Federal Government employees and retirees to meet their ethical and legal tax obligations.

Since the inception of the FERDI, IRS procedures have prevented the tax delinquency cases identified involving Federal Government employees or retirees from being placed in a nonwork status. In other words, the IRS works all of the FERDI cases identified regardless of the amount of taxes owed or, in the case of nonfiled tax returns, the potential amount of taxes owed. The IRS gives each FERDI case its full range of compliance treatments, including return delinquency notices, TDIs, and ASFR Program assessments.

The IRS identified and worked 108,987 FERDI return delinquency cases for TY 2001. Through January 6, 2004, the IRS had completed more than 27,000 of these cases. The results suggest that all FERDI cases do not warrant the high-work priority the IRS assigns to this nonfiler segment. In particular, Table 2 shows that the 17,127 TY 2001 FERDI nonfiler cases closed by the W&I Division resulted in an average net tax due[18] per return of only $148.

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[17] The FERDI includes both active and retired civil service and military employees.

[18] Net tax due represents tax, penalty, and interest assessments less prepaid credits.

Table 2: TY 2001 FERDI Cases Completed by the IRS

Business Division	Number of Cases Selected	Total Net Tax Due	Average Net Tax Due Per Return	Number of Cases Completed
SB/SE	35,113	$18,581,941	$1,819	10,216
W&I	73,874	$ 2,526,780	$ 148	17,127
Total	108,987	$21,108,721	$ 772	27,343

Source: SB/SE and W&I TY 2001 Nonfiler Inventory Selection Reports and IRS Nonfiler Effectiveness Reports (January 6, 2004).

By working all FERDI nonfiler cases regardless of the potential tax consequences, the IRS is using resources that, in some cases, could be more productively used to address other categories of nonfiler cases involving significantly larger potential net tax due amounts that are not being worked.

For example, Table 3 shows the W&I Division did not work nearly 1 million TY 2001 return delinquency cases from 2 other nonfiler selection categories that resulted in an average net tax due per return ranging from $808 to $970. Both were significantly larger than the average net tax due per return of $148 produced by the 17,127 TY 2001 FERDI cases completed by the W&I Division.

Table 3. W&I Return Delinquency Cases Not Worked by the IRS That Were Potentially More Productive Than FERDI Cases[19]
TY 2001

Case Selection Code	Average Net Tax Due Per Return (A)	Number of Cases Worked	Number of Cases Not Worked (B)	Potential Value of Cases Not Worked (A) X (B)
14	$970	4,631	**683,078**	**$662,585,660**
13	$808	544,693	**305,229**	**$246,625,032**
Totals		549,324	**988,307**	**$909,210,692**

Source: TIGTA analysis of W&I TY 2001 Nonfiler Inventory Selection Report and IRS Nonfiler Effectiveness Report (January 6, 2004).

The potential opportunity costs of working all FERDI cases are significant. For TY 2001, if the IRS had worked 73,874 more cases from Selection Code 14, in lieu of the 73,874 FERDI cases worked by the W&I Division that produced an average of only $148 per case,[20] an additional $60.7 million in tax revenue may have been realized.

The potential opportunity costs of working all TY 2002 FERDI cases may have been considerably higher. While the W&I Division selected and worked 75,228 TY 2002 FERDI cases, Table 4 shows the W&I Division did not work a like number of TY 2002 return delinquency cases from other selection categories that could have been expected to produce, based on TY 2001 results, significantly higher tax revenue than the W&I Division FERDI cases.

[19] In addition to the cases not worked shown in Table 2, there were an additional 131,096 TY 2001 return delinquency cases that were not worked from 4 other selection codes that, for TY 1999, had produced an average net tax due per return ranging from $2,104 to $5,309. However, IRS management stated that the resources required to work the FERDI inventory had no impact on the decision not to work these cases and that the W&I Division did not work them because the cases were in SB/SE Division campuses.

[20] The average net tax due of $148 per case is based on the 17,127 cases closed by the W&I Division through January 6, 2004. In discussing a draft of this report, IRS management advised that these closures may not include "hard core" cases that require enforcement action.

Table 4. Return Delinquency Cases Not Worked by the IRS That Were Potentially More Productive Than W&I Division FERDI Cases – TY 2002

Case Selection Code	Average Net Tax Due Per Return (A)	Number of Cases Worked	Number of Cases Not Worked (B)	Potential Value of Cases Not Worked (A) X (B)
09	$1,352	338,767	66,762	$ 90,262,224
14	$ 970	0	778,300	$754,951,000
04	$ 895	54,559	2,984	$ 2,670,680
13	$ 808	757,449	789	$ 637,512
Total		1,150,775	848,835	$848,521,416

Source: TIGTA Analysis of IRS TY 2001 Nonfiler Effectiveness Report (January 6, 2004) and W&I Division TY 2002 Nonfiler Inventory Selection Report.

If the IRS had worked 75,228 of these cases in lieu of the same number of W&I Division FERDI cases, an additional $87.3 million in tax revenue may have been realized.[21] See Appendix IV for details.

The heart of the issue with working FERDI cases involves balancing conflicting priorities to achieve the appropriate administration of the tax laws. When the FERDI tax policy was implemented in the 1990s, the amount of IRS resources allocated to working return delinquency cases was significantly larger than it is today. For example, the IRS Collection function expended about 1.1 million direct hours on nonfiler activities in FY 1993 as compared to only 453,000 direct hours in FY 2002. As fewer FTEs have been allocated to the Return Delinquency Notice Program over the years, the issue of working nonfiler cases with lower risks for tax payment noncompliance has become much larger, since the IRS currently does not have the resources to work all return delinquency cases that involve significantly more potential tax revenue than W&I Division FERDI cases.

[21] Potential tax value of the cases not worked less the actual tax value of the FERDI cases that were worked. Assumes that the TY 2002 FERDI cases worked by the IRS will produce the same average next tax due per return as the TY 2001 FERDI cases.

<u>IRS actions alone have not been sufficient to ensure compliance with ethics guidelines and reduce nonfiler cases involving Federal Government employees</u>

As of September 30, 2000,[22] approximately 423,000 Federal Government employees and annuitants owed $2.5 billion in delinquent taxes. This represented an increase of approximately $200 million in delinquent Federal taxes over the 1997 annual match. Twenty percent of these 423,000 taxpayers were nonfilers. The IRS identified and worked 106,566 FERDI return delinquency cases for TY 2000, 108,987 cases for TY 2001, and 116,064 cases for TY 2002. These data suggest that the IRS' longstanding policy of working all FERDI cases is not enough to reduce nonfiling among this customer segment and that additional measures are needed.

Although Federal Government employee compliance with tax laws is required by Federal policy, the IRS cannot share tax delinquency information on specific Federal Government employees with their employing agencies because of privacy restrictions contained in I.R.C. § 6103 (2003). On at least two prior occasions, in 1993 and 1998, the OMB and IRS proposed changes to existing laws that would have allowed more information sharing by Federal Government agencies. These proposals, which covered a broad range of issues, were never enacted into law.

Other than the IRS, which has its own Employee Tax Compliance Program, Federal Government agencies are not aware when their employees are not compliant with standards of ethical conduct requiring the filing and payment of Federal taxes. Because tax delinquency information is not shared with the employing agency, Federal Government employees that fail to meet their ethical responsibilities to file and pay their Federal taxes do so with limited fear of any administrative or disciplinary actions from their employing agency.

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[22] IRS study, *Profiling Tax Delinquency of Federal Employees and Retirees*, FERDI 2000 Final Report, Project #2-00-02-3-004, dated August 2002.

Achieving an appropriate balance between Federal Government employees' privacy rights and their ethical responsibility to file and pay Federal taxes is a significant policy challenge. The employee/taxpayer privacy rights currently outweigh the agencies' right to know about tax delinquencies involving their employees. As a result, Federal Government agencies do not have information available to them to enforce the ethical standards requiring all Federal Government employees to file and pay their taxes. Intervention by the employing agencies to address Federal tax noncompliance by their employees could complement actions taken by the IRS and have a positive impact on reducing the number of FERDI cases the IRS annually identifies.

Recommendations

We believe the IRS needs to continue to ensure its own employees fully comply with Federal, state, and local filing requirements. To ensure other FERDI nonfiler cases receive compliance treatments that are consistent with the risks they pose to balanced tax administration and appropriate given the IRS' limited resources, and to increase the effectiveness of the FERDI for reducing tax noncompliance among Federal Government employees, the Commissioner, W&I Division, should:

1. Replace the IRS' policy of working all FERDI return delinquency cases with a risk-based approach that applies tailored compliance treatments to the cases based on the potential taxes due.

<u>Management's Response:</u> The Commissioner, SB/SE Division, stated the IRS does not plan to pursue this recommendation at this time. While the Commissioner, SB/SE Division, believes there is considerable merit to our recommendation to subject FERDI cases to a risk-based approach, the IRS has taken steps to improve the efficiency and effectiveness of the FERDI Program, and other factors, such as public policy and public confidence in tax administration, outweigh revenue potential as determinative factors in whether to work these cases. The Commissioner, SB/SE Division, stated the Congress and the general public expect a higher degree of compliance among Federal

employees and advised that failure to address noncompliance in the FERDI population undermines public confidence in the IRS' ability to administer the tax laws fairly and effectively. The adoption of a risk-based approach would selectively target specific segments of the FERDI population, which could result in adverse public criticism of the IRS' enforcement efforts while resulting in a negative impact on overall compliance.

The Commissioner, SB/SE Division, also did not concur with our estimate that total net taxes due could have been potentially increased by over $87.3 million by reapplying the resources used to work certain TY 2002 FERDI cases. The Commissioner, SB/SE Division, stated the projection is based on the premise that all FERDI inventory is low yielding and advised that the W&I Division currently uses the Collection Optimum Potential Yield Score (COPYS) as a risk-based approach for case selection. As part of the case creation process, a COPYS is computed to provide a ranking mechanism to stratify and select nonfiler work. Cases with higher COPYSs are more likely to result in a higher net tax due than cases with lower COPYSs. The Commissioner, SB/SE Division, stated over 75 percent of the FERDI cases met the criteria as higher-yield cases and these cases would have been selected over other non-FERDI cases.

<u>Office of Audit Comments</u>: We continue to believe our recommendation has merit. The SB/SE Division Commissioner's position that "public policy and public confidence in tax administration outweigh revenue potential as determinative factors in whether to work these cases" represents a departure from the IRS' recent efforts in this area. For TY 1998, when all FERDI cases were worked, the average result was a $649 refund. For TY 2001, the average net tax due for FERDI cases increased to a balance due of $148 for W&I Division cases and $1,819 for SB/SE Division cases due, in part, to the use of several new risk-based criteria. One initiative was to select only those cases that have the potential to exceed a specific net tax due threshold amount. In addition, the SB/SE Division incorporated a filter into the return delinquency case creation process that eliminated those FERDI cases that were "predicted" to be not liable.

Regarding the SB/SE Division Commissioner's concern that the adoption of a risk-based approach would selectively target specific segments of the FERDI population and could result in adverse public criticism of the Service's enforcement efforts while resulting in a negative impact on overall compliance, we believe that using a risk-based approach to select nonfiler cases for compliance enforcement treatment would allow the IRS to apply some type of notice treatment to all FERDI cases while reserving the most intensive compliance treatments for those FERDI cases that represent the most egregious type of nonfiler. Given its scarce resources, the IRS' current practice of applying its most intensive compliance treatments to thousands of low dollar cases invites, in our opinion, public criticism of its decision-making process, especially at a time when the tax gap exceeds $300 billion. Also, the comprehensive pursuit of low dollar cases raises concerns about the fairness and cost-effectiveness of this policy.

Our estimate of the additional tax revenue that could be realized by diverting resources used by the W&I Division to work its TY 2002 FERDI inventory was based on the average net tax due of $148 yielded by the W&I Division's TY 2001 FERDI cases. This $148 average yield is based on 17,127 closures, or 24 percent of the W&I Division's total FERDI inventory of 70,148 cases. If the majority of these cases met the IRS' criteria as higher yield cases that would have been worked regardless of their selection category, as the SB/SE Division Commissioner states in the response, it raises questions about the effectiveness of the COPYS score as a risk-based approach for return delinquency case selection. It also raises questions about whether more than 75 percent of the W&I Division's FERDI cases were actually high yielding cases.

2. Coordinate with OGE and OMB officials to explore the potential of developing better approaches for ensuring that Federal Government employees are held more accountable for filing all required Federal tax returns.

<u>Management's Response:</u> The Commissioner, SB/SE Division, stated the IRS does not plan to pursue this recommendation at this time. The Commissioner, SB/SE Division, advised, as noted in our report, that I.R.C. § 6103

does not allow the IRS to disclose specific employee tax delinquency information to other agencies so that they may effectuate appropriate disciplinary action under Government-wide ethics regulations. Therefore, while the IRS can work with the OGE and OMB to identify other approaches for holding Federal employees more accountable, the IRS' inability to disclose employee-specific tax information to other agencies constrains its ability to effectuate any disciplinary action for failing to meet new accountability requirements. The IRS does share general statistics with agencies each year regarding the compliance rates of their employees and will continue to explore opportunities to further improve compliance within the FERDI population. The Commissioner, SB/SE Division, stated it was important to note that as of October 2003, the overall FERDI noncompliance rate was 3.06 percent, down from 3.47 percent in the previous year.

Office of Audit Comments: We are pleased the IRS will continue to explore opportunities to improve compliance with the FERDI population. While the Commissioner, SB/SE Division, noted that the overall FERDI noncompliance rate had improved, it is also important to note that the number of FERDI nonfiler cases has grown from 106,566 for TY 2000 to 116,064 in TY 2002. We believe this continued growth in the number of nonfilers among the FERDI population underscores the need for new approaches in addressing this customer segment. However, we doubt that significant improvement can be realized as long as active Federal employees who do not fulfill their ethical obligations to file tax returns can continue to escape disciplinary action because their noncompliance is hidden from their employing agencies by the privacy laws. In working with the OGE and OMB to identify approaches for holding Federal employees more accountable, we encourage the IRS to determine whether there is support for changing I.R.C. § 6103 to allow the IRS to share Federal employee tax delinquency information with the employing agencies.

Recent Improvements to the Refund Hold Program May Present Opportunities for Increased Revenue Protection by Lowering the Administrative Dollar Tolerance

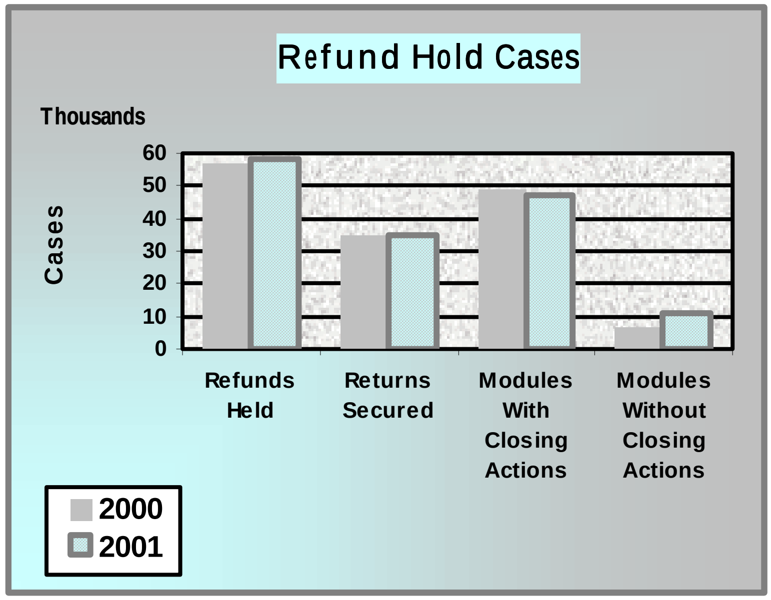
The Refund Hold Program identifies individual taxpayers who have filed a current year tax return entitling them to a refund, but have not filed tax returns for a previous tax year for which the IRS has third-party information documents[23] that indicate a tax liability may exist that is equal to or greater than the refund amount. The objective of the Refund Hold Program is to investigate return delinquencies and encourage taxpayer compliance through the withholding of current year tax refunds pending the filing of delinquent tax returns. The IRS freezes the issuance of the current year refund while it investigates the prior year tax return delinquency.

At the time we completed our review, the IRS may not have been realizing the full potential of the Refund Hold Program as a compliance tool for encouraging taxpayers to file delinquent returns. Thousands of identified cases were not being resolved within the refund freeze period, resulting in millions of dollars in refunds being released to taxpayers who had not filed required tax returns or provided other documentation to resolve the nonfiling conditions. In addition, a decreasing number of cases were being identified for the Refund Hold Program because the IRS had increased its administrative dollar tolerance to accommodate its limited available resources.

Figure 5 presents the Program results for the last 2 tax years available at the time we completed our review.

[23] Information documents include the Wage and Tax Statement (Form W-2) for wages earned, Dividends and Distributions (Form 1099-DIV) for dividends earned, Interest Income (Form 1099-INT) for interest earned, and Miscellaneous Income (Form 1099-MISC) for nonemployee compensation.

**Figure 5: Refund Hold Program Results[24]
TYs 2000 and 2001**



Source: IRS SB/SE Division.

For TY 2001, the IRS held 58,176 refunds totaling almost $270 million, an average of more than $4,600 per case. The Program resulted in 34,958 delinquent returns being filed (secured) and in other closing actions being taken on another 12,163 delinquent tax modules. In addition to the taxes offset by the held refunds, almost $1.9 million in taxes was collected with the delinquent returns that were filed. However, the IRS released the remaining 11,055 refunds after the freeze period expired without securing delinquent returns or determining that the delinquent returns involved no tax liability. In discussing a draft of this report, IRS management advised that criteria existed to limit taxpayer burden and release refunds based on taxpayer hardship and declared disasters. Although it is unknown how many of the 11,055 TY 2001 refunds were released because of these criteria, IRS management believes the number was substantial due to the terrorist attacks that occurred on September 11, 2001.

[24] The Figure 5, Column 3, totals include 34,958 delinquent returns that were filed and other closing actions on another 12,163 delinquent tax modules. A module is a specific tax period within a taxpayer's account.

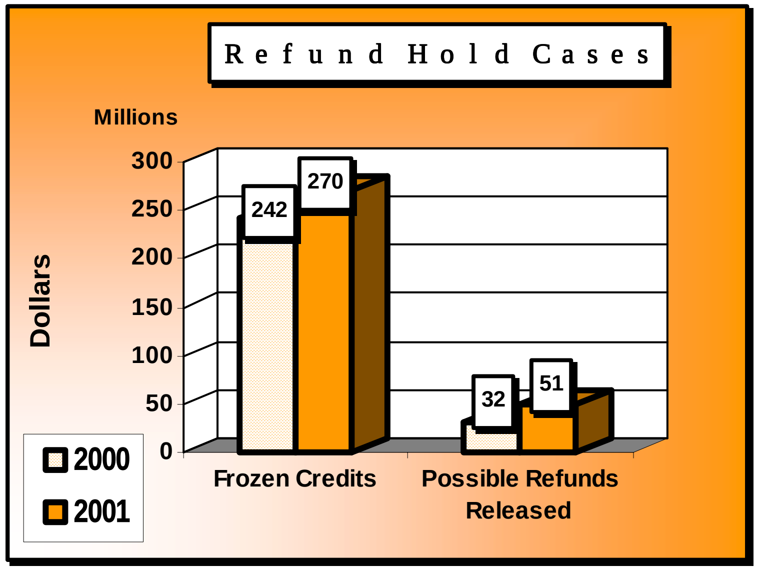
A comparison of the Program results for TY 2001 with those for TY 2000 showed:

- The number of refunds held increased by almost 3 percent, from 56,506 to 58,176.
- The number of delinquent returns secured increased by less than 1 percent, from 34,703 to 34,958.
- The number of cases with successful closing actions (i.e., delinquent return secured or delinquent condition resolved) declined by almost 4 percent, from 49,052 to 47,121.
- The number of cases with no successful closing actions during the refund freeze period increased by more than 48 percent, from 7,454 to 11,055.[25] For each of these cases, the refunds were released to the taxpayers.

The IRS had no management information reports that specifically showed the number or total dollar amount of those refunds that were released after the freeze period expired without successful resolution of the nonfiling condition. Therefore, to arrive at an estimate of the total refunds released by the IRS, we applied the average refund amount of the TY 2001 refund hold cases ($4,639) to the 11,055 cases with no successful closing actions. This approach suggests the IRS may have released refunds totaling almost $51.3 million to taxpayers whose return delinquencies were still unresolved. As shown in Figure 6, this represented an increase of more than 60 percent from the $31.9 million in refunds that may have been released for TY 2000 on unresolved return delinquencies.

[25] In discussing a draft of this report with SB/SE Division management, they stated that inventory changes must be taken into account when comparing year-to-year results. In their view, the number of cases with no successful closing action increased by only 6 percent from TY 2000 (13 percent of refunds held) to 2001 (19 percent of refunds held).

Figure 6: Dollar Value of Refund Hold Cases[26]
FYs 2000 and 2001



Source: IRS SB/SE Division.

The I.R.C. does not set a specific time period in which the IRS must refund an overpayment.[27] Under the Refund Hold Program, the IRS freezes a refund for a specified time period while it tries to resolve a nonfiling condition. At the time we performed our review, the IRS was releasing refunds after the freeze period expired if the taxpayers did not respond to notices requesting that they file the prior year returns or provide information to satisfactorily resolve the return delinquency. Under these procedures, taxpayers were sent their refunds even though they may not have been cooperating with the IRS to resolve their nonfiling condition.

[26] This chart does not necessarily represent the actual dollar value of the refunds released to taxpayers without successful resolution of the nonfiling condition. Since the IRS had no data on the dollar value of the refunds that were released, we had to assume, for illustrative purposes, that the average refund amount of all frozen refunds was typical of those that may have been released without resolution.

[27] I.R.C. § 6611(e) (2000) requires the IRS to pay interest on the overpayment when it does not issue a refund within 45 days of the return due date or return received date, whichever is later.

The IRS has made significant changes to the Refund Hold Program

In discussing a draft of this report, IRS management advised that the SB/SE and W&I Divisions both began working the Refund Hold Program as the top priority in the ASFR Program in January 2004. In addition to helping ensure all cases meeting refund hold criteria are worked, ASFR guidelines allow the IRS to resolve the refund by offsetting it to liabilities on the delinquent return or applying it to the proposed deficiency when a Statutory Notice of Deficiency is issued.

Since we completed our review, the SB/SE Division has also centralized its Refund Hold Program into one campus[28] location. In proposing this change, the Director, Filing Compliance, SB/SE Division, stated the efficiency of the Refund Hold Program would be increased by eliminating the need for frequent reassignment of the cases between the business operating divisions. The W&I Division is currently working its Refund Hold Program at each of its campus sites and may centralize the program at some point in the future.

In our view, the above changes should strengthen the Refund Hold Program to ensure that millions of dollars in current-year tax refunds are not released without successful resolution of the prior-year nonfiling conditions.

Lowering the administrative dollar tolerances for the Refund Hold Program would present opportunities for increased revenue protection

The organizational efficiency gained by the IRS as a result of the recent changes to the Refund Hold Program may provide opportunities to identify more cases by lowering the administrative dollar tolerances.

Since the Refund Hold Program was first implemented in 1993, the IRS has increased its administrative dollar tolerance for identifying Refund Hold Program cases by more than 600 percent to accommodate its limited available resources. For TY 1999, the IRS increased its

[28] A campus is an IRS location that houses customer service, compliance, and returns processing functions.

administrative dollar tolerance for refund hold cases by nearly 70 percent. This caused the number of refund hold cases to decline from 125,974 for TY 1998 to 59,316 for TY 1999[29] and contributed to the number of delinquent returns secured also declining from 58,850 for TY 1998 to 36,736 for TY 1999. For TY 2000, the IRS again increased its administrative tolerance by an additional 300 percent.

We could not determine the exact number or dollar value of potential refund hold cases that were not identified as a result of these increases in the dollar tolerance because the IRS had no management information reports that stratified the number of potential refund hold cases by dollar range. As a result, we cannot estimate the monetary effect of the administrative tolerances on protecting tax revenues.

Recommendations

To further improve the effectiveness of the Refund Hold Program for protecting tax revenue and closing the return filing gap, the Commissioners, SB/SE and W&I Divisions, should:

3. Reevaluate the administrative dollar tolerance for freezing refunds to determine if it can be reset at a lower level, given the available resources, now that the Refund Hold Program is being worked as part of the ASFR Program and has been centralized in one location by the SB/SE Division.

Management's Response: The Commissioner, SB/SE Division, advised that the SB/SE and W&I Divisions will reevaluate the administrative tolerance for freezing refunds.

4. Expand the management information reports to provide data for measuring program effectiveness and results and for setting workload selection tolerance levels.

Management's Response: The Commissioner, SB/SE Division, advised that revisions to the Refund Hold management information reports are already in progress.

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[29] In discussing a draft of this report, IRS management stated that the number of selected refund hold cases may or may not be affected by the increase in the administrative tolerance.

The IRS is currently working to revise the ASFR Management Information System report to include specific Refund Hold data. This report will include information regarding the dollar amounts offset due to potential liability, releases, and the reason for those releases.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the audit was to determine whether the Return Delinquency Notice Program is effectively designed, managed, and operated to achieve the desired program results and to promote compliance with Federal tax laws. The audit was performed by interviewing Internal Revenue Service (IRS) managers and program analysts and by reviewing and evaluating management information system reports and other documentation related to return filing compliance. Some of the data used in this report came from assorted IRS reports. We did not verify the accuracy of that information. The audit focused on the individual nonfiler case creation and compliance treatment process and the analysis of select statistical data for the Compliance Services Collection Operations (CSCO).[1] The audit did not evaluate the case creation and compliance treatment process for business taxpayers, or detailed work processes for the Automated Substitute for Return Program, Automated Collection System, Collection Field function, 6020 (b) Program, Service Center Examination Branch, or Examination Area Office programs due to time and resource constraints.

To accomplish our objective, we:

I. Determined whether the IRS' strategies, plans, policies, procedures, and controls were effectively designed to direct Return Delinquency Notice Program operations toward the attainment of desired objectives.

   A. Determined whether IRS management had developed a clear statement of the Return Delinquency Notice Program objectives against which the annual Program results could be effectively measured.

   B. Determined whether the annual performance goals for the Return Delinquency Notice Program were objective and quantifiable, and included measurement criteria such as cost, quality, and timeliness.

   C. Determined whether the objectives and annual performance goals established for the Return Delinquency Notice Program reflect the strategic goals and mission of the IRS.

   D. Determined whether the activity-level objectives flowed from and were linked to the overall return delinquency objectives and strategic plans.

   E. Evaluated the process for determining how many return delinquency cases will be created each year and how many resources will be allotted to the Return Delinquency Notice Program each year.

[1] The CSCO was formerly called the Service Center Collection Branch.

F. Assessed whether sufficient resources were allotted to the Return Delinquency Notice Program to achieve Program objectives.

G. Evaluated the basis for the selection codes and other prioritization criteria the IRS uses to generate return delinquency notices.

II. Assessed the adequacy of the means, methods, and management information systems the IRS uses to monitor and evaluate the Return Delinquency Notice Program results.

A. Obtained and evaluated internal documents that reflect IRS management's assessments of the Return Delinquency Notice Program.

B. Identified and evaluated the performance standards, information sources, and performance indicators IRS management uses to measure the effectiveness of the Return Delinquency Notice Program.

C. Evaluated whether the performance standards and indicators for the Return Delinquency Notice Program adequately reflect the intended program results and provide a comprehensive measure of effectiveness.

D. Determined how IRS management uses and adjusts work standards and measurements to achieve the overall Return Delinquency Notice Program objectives.

E. Determined whether the IRS identifies the necessary data to routinely assess the performance of the Return Delinquency Notice Program, including a mixture of outcome, output, and efficiency measures linked to the Return Delinquency Program's strategic goals.

F. Determined whether sufficient management controls have been developed to ensure the timely and quality delivery of the Return Delinquency Notice Program by the campus sites.

III. Assessed the actions IRS management has taken or planned to further improve the effectiveness and efficiency of the Return Delinquency Notice Program to close the return filing gap.

A. Gathered and evaluated IRS management information reports and studies about return filing noncompliance.

B. Determined whether IRS assessments of the Return Delinquency Notice Program showed the effectiveness of the various return filing delinquency selection categories and whether the Program produced the overall intended results.

C. Determined whether the Program assesses whether the processes used affect any taxpayer behavioral changes.

D. Determined whether the IRS has a risk assessment plan that considers relevant sources of risk (internal and external), undertakes a thorough and complete analysis of the possible effects, and establishes a control structure to address those risks.

Appendix II

Major Contributors to This Report

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Appendix III

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Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Director, Office of Legislative Affairs CL:LA
Audit Liaisons:

Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $87,340,500 per year; $436.7 million over 5 years (see page 12).

Methodology Used to Measure the Reported Benefit:

The increased revenue projection is based on the premise that other nonfiler selection code (SC) categories offer the potential for significant additional revenue in comparison to Federal Employee/Retirees Delinquency Initiative (FERDI) cases selected by the Wage and Investment (W&I) Division and that significant numbers of FERDI cases could be given less-comprehensive compliance treatments. Under this premise, rather than all FERDI nonfiler cases being handled through the Automated Substitute for Return (ASFR) Program, only the ones with significant risks would receive this treatment. Other FERDI cases would receive less resource-intensive compliance treatments such as Taxpayer Delinquency Investigation notices, Primary Code B notices, or reminder notices, which would need to be developed, for refund cases.

The volume of FERDI nonfiler cases for future years was based upon Internal Revenue Service (IRS) data on the number of FERDI case for Tax Year (TY) 2002, which will be processed in Fiscal Year (FY) 2004. Reliable annual growth rates for the FERDI nonfiler SC categories could not be determined, although there was a definite upward trend in the number of FERDI cases from TY 2000 to TY 2002. The volume of FERDI nonfiler cases was 109,868 for TY 1999, 106,566 for TY 2000, 108,987 for TY 2001, and 116,064 for TY 2002.

Based on the average net tax due[1] per return for TY 2001 shown on IRS treatment reports, Table 1 shows the potential net tax due for the W&I Division TY 2002 SC categories that offered significantly higher revenue potential than W&I Division FERDI cases but were not worked by the IRS.

[1] Net tax due represents tax, penalty, and interest assessments less prepaid credits.

Table 1: W&I Division Cases Not Worked With Higher Tax Potential Than W&I FERDI Cases TY 2002

Case Selection Code	Cases Worked (A)	Cases Not Worked (B)	Average Net Tax Due Per Return (C)	Total Potential Net Tax Due of Cases Not Worked (B) X (C)
09	338,767	66,762	$1,352	$ 90,262,224
14	0	778,300	$ 970	$754,951,000
04	54,559	2,984	$ 895	$ 2,670,680
13	757,449	789	$ 808	$ 637,512
Total	1,150,775	848,835		$848,521,416

Source: Treasury Inspector General for Tax Administration (TIGTA) Analysis of IRS TY 2001 Nonfiler Effectiveness Report (January 6, 2004) and W&I Division TY 2002 Nonfiler Inventory Selection Report.

Of the 848,835 cases from Table 1 that were not worked, the total potential net tax due of the 75,228 highest-valued cases is $98,474,244 or an average of $1,309 per case. If the W&I Division had worked these cases in lieu of the 75,228 FERDI cases, potential additional revenue of $87,340,500 may have been realized ($98,474,244 less the $11,133,744 value of the FERDI cases). Assuming the numbers of FERDI nonfiler cases and other SC category cases remain constant over the next 5 years, the 5-year value of working the higher-value SC category cases, in lieu of the FERDI nonfiler cases, is $436,702,500 (5 x $87,340,500). This amount may represent the upper limit of the potential increased revenue since some higher-value FERDI nonfiler cases would still be worked and the average net tax due per case can vary for cases within each SC category. Conversely, this amount may be conservative since the total number of FERDI cases increased by about 9 percent from TY 2000 to TY 2002.

For TY 2002, the W&I Division selected 75,228 FERDI cases that received ASFR compliance treatments. The W&I Division's nonfiler treatment reports for TY 2001 showed the average net tax due per FERDI case was $148 as of January 6, 2004. Table 2 uses TY 2002 nonfiler inventory data and TY 2001 average-net-tax-due-per-return data to show the total potential net tax due of the 75,228 next highest (after considering Table 1 data) valued TY 2002 nonfiler cases that were not worked.

Table 2: Cases Not Worked With Higher Tax Potential Than W&I Division FERDI Cases TY 2002

Case Selection Code	Cases Worked (A)	Cases Not Worked (B)	Average Net Tax Due Per Return (C)	Total Potential Net Tax Due of Cases Not Worked (B) X (C)
09	338,767	66,762	$1,352	$90,262,224
14	0	8,466	$ 970	$ 8,212,020
Totals	338,767	75,228	$1,309	$98,474,244

Source: TIGTA analysis of the W&I Division's TY 2002 Nonfiler Inventory Selection Codes and the W&I Division's TY 2001 Nonfiler Effectiveness Report.

Table 3 combines data for TY 2002 nonfiler cases with higher tax potential than FERDI cases that were not worked by the W&I Division (see Table 2) with the data for the FY 2002 FERDI cases that were worked by the W&I Division, to arrive at the potential net tax due for the 75,228 highest valued cases that were not worked. The estimates of total potential net tax due are shown for 1-year and 5-year periods.

Table 3: Computation of Potential Additional Net Tax Due in Nonfiler Cases Not Worked W&I Division Cases Only

	Cases Worked (A)	Cases Not Worked (B)	Average Net Tax Due Per Return (C)	Total Potential Net Tax Due of Cases Not Worked
SC 09 and 14 Cases	**338,767**	**75,228**	**$1,309**	**$ 98,474,244** **(B) X (C)**
Less: Value of TY 2001 W&I FERDI Cases	**75,228**	**0**	**$ 148**	**$ 11,133,744** **(A) X (C)**
1-Year Value of Potential Additional Net Tax Due			**$1,161**	**$ 87,340,500**
5-Year Value of Potential Additional Net Tax Due				**$436,702,500**

Source: TIGTA analysis.

Appendix V

Glossary of Terms

6020(b) Program – Internal Revenue Code Section 6020(b) gives the Internal Revenue Service (IRS) the authority to prepare and process returns for nonfiling taxpayers. The 6020(b) Program prepares and processes Employer's Quarterly Federal Tax Return (Form 941) or Employer's Annual Federal Unemployment Tax Return (Form 940).

Area Office – A geographic sub-section of the business operating division. Employees assigned to Area Offices generally perform the IRS compliance activities that involve face-to-face interaction with taxpayers.

Automated Collection System (ACS) – The ACS is a telephone contact function where assistors attempt to secure nonfiled tax returns from taxpayers that have not responded to the initial notices and/or do not meet the criteria for Automated Substitute for Return **(**ASFR) Program assignment.

Automated Substitute for Return Program – The ASFR Program is an automated deficiency assessment process for nonfiled individual income tax returns. A notice of proposed assessment, based on information return data, is sent to the taxpayer. Taxpayers may respond to the proposed assessment notice by filing a return, explaining why they are not liable to file, or agreeing to the assessment as proposed or with changes to the filing status and/or the number of dependents.

Campus – The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

Compliance Services Collection Operations (CSCO) – The CSCO handles taxpayer responses to return delinquency notices. Those cases that are not resolved may be referred to the ASFR Program, the ACS, or the Collection Field function (CFf) for further action.

Collection Field function - The CFf is the unit in Area Offices consisting of revenue officers who handle personal contacts with taxpayers to collect delinquent accounts or secure nonfiled returns. A return delinquency case assigned to the CFf is either placed in the queue (i.e., unassigned inventory) or assigned to a revenue officer for potential face-to-face contact with the taxpayer.

Federal Employees/Retirees Delinquency Initiative (FERDI) - The FERDI is the IRS program to identify Federal Government employees and retirees that fail to comply with Federal tax laws. The FERDI includes both active and retired civil service and military employees.

Full-Time Equivalent (FTE) - An FTE is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For Fiscal Year 2002, for example, 1 FTE was equal to 2,088 staff hours.

Service Center Examination Branch (SCEB) – The SCEB located in IRS campuses uses correspondence examination techniques to verify the accuracy of uncomplicated tax returns with straightforward issues.

Appendix VI

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
JUL 21 2004

July 21, 2004

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown KMB
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Return Delinquency Notice Program Could Be Used More Effectively to Promote Filing Compliance and Reduce the Tax Gap (Audit #200230037)

I reviewed your report and appreciate your recognition of our ongoing and completed initiatives to improve filing compliance, as well as the efficiency of our return delinquency program. While we believe there is considerable merit to your recommendation to subject delinquency cases involving Federal employees and retirees to a risk-based approach, other factors warrant consideration in addition to the potential taxes due. In our opinion, public policy and public confidence in the tax system demand that we address Federal employee and retiree noncompliance, which outweigh the potential revenue considerations your report describes.

The Federal Employee/Retiree Delinquency Initiative (FERDI) program incorporates the purpose and intent of an Executive branch-wide ethics regulation promulgated by the Office of Government Ethics (OGE). This regulation, 5 C.F.R. § 2635.809, addresses the responsibility of Federal employees to "satisfy in good faith their obligations as citizens, including all just financial obligations, especially those such as Federal, State, or local taxes that are imposed by law.... In good faith means an honest intention to fulfill any just financial obligation in a timely manner." This policy was reiterated in a January 2001 memorandum issued by President Bush to the heads of federal agencies and departments.

Congress and the general public expect a higher degree of compliance among federal employees. Failure to address non-compliance in the FERDI population undermines public confidence in the Service's ability to administer the tax laws fairly and effectively The adoption of a risk-based approach would selectively target specific segments of the FERDI population, which could result in adverse public criticism of the Service's enforcement efforts while resulting in a negative impact on overall compliance.

That said, we continue to pursue more efficient and effective ways to work the FERDI cases. We centralized our FERDI operation in the Jacksonville Automated Collection System (ACS) call site in November 2001, thus freeing our revenue officers to work more egregious cases. Tax assessments on Federal employees and retirees made through our Automated Substitute for Return (ASFR) Program are subject to systemic collection through our Federal Payment Levy Program (FPLP). The FPLP enables us to collect any balance due at a lower cost.

In addition, the IRS's Wage & Investment (W&I) Division currently employs a risk-based approach for case selection through the use of the Collection Optimum Potential Yield Score (COPYS). As part of the case creation process, a COPYS score is computed to provide a ranking mechanism to stratify and select non-filer work. Cases with higher COPYS scores are more likely to result in a higher net tax due than cases with lower COPYS scores. About 56,000 of the 73,874 FERDI cases created in Tax Year 2001 had higher COPYS scores. These cases would have been selected over other non-FERDI cases in any event. Because over 75 percent of the FERDI cases did meet our criteria as higher yield cases, we do not concur with the projected increased revenue of $87.3 million, as this projection is based on the premise that all FERDI inventory is low-yielding.

Your report also identified the Refund Hold Program as an area in which IRS could make more efficient use of its resources. This program identifies individual taxpayers who have filed a tax return entitling them to a refund, but have not filed returns for a previous tax year. If a potential tax liability exists for the non-filed return, we suspend the issuance of the refund while attempting to resolve the non-filed return with the taxpayer. At the same time, we must balance this action with the need to release refunds, when appropriate, even when a potential liability exists. Refunds are released when a taxpayer hardship exists, or in cases of local or national disasters. For example, in the aftermath of September 11, 2001, suspended refunds were released to those impacted by this disaster.

The Refund Hold Program is used by both the Small Business/Self-Employed (SB/SE) Division and W&I. Both divisions are aware of the impact that the Refund Hold Program has on compliance and have worked jointly to make significant improvements, as recognized in your report, to increase the effectiveness of the program. Your report cited two changes to the Program: making refund hold a priority in the ASFR program, where the majority of refund hold cases are worked, and applying the refund to proposed deficiencies. These changes were completed in January 2004. In addition, we are continuing our revisions to the Refund Hold management reports to better gauge program effectiveness and further develop criteria for case selection and case disposition. We are also working on program upgrades to ASFR to decrease the need for manual intervention in transferring refund hold credits.

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Our comments on your specific recommendations follow.

RECOMMENDATION 1
Replace the IRS' policy of working all FERDI return delinquency cases with a risk-based approach that applies tailored compliance treatments to the cases based on the potential taxes due.

CORRECTIVE ACTION
As stated above, we have taken steps to improve the efficiency and effectiveness of FERDI but believe other factors, such as public policy and public confidence in tax administration, outweigh revenue potential as determinative factors in whether to work these cases. Thus, we do not plan to pursue this recommendation at this time.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL(S)
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 2
Coordinate with OGE and OMB officials to explore the potential of developing better approaches for ensuring that Federal Government employees are held more accountable for filing all required Federal tax returns.

CORRECTIVE ACTION
As noted in your report, section 6103 of the Internal Revenue Code does not allow the IRS to disclose specific employee tax delinquency information to other agencies so that they may effectuate appropriate disciplinary action under government-wide ethics regulations. While we can work with OGE and the Office of Management and Budget (OMB) to identify other approaches for holding Federal employees more accountable, our inability to disclose employee-specific tax information to other agencies constrains our ability to effectuate any disciplinary action for failing to meet new accountability requirements. Accordingly, we do not plan to pursue your recommendation at this time. However, we do share general statistics with agencies each year regarding the compliance rates of their employees, and will continue to explore opportunities to further improve compliance within the FERDI population. It is important to note that, as of October 2003, the overall FERDI non-compliance rate was 3.06 percent, down from 3.47 percent in the previous year.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL(S)
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 3
Reevaluate the administrative dollar tolerance for freezing refunds to determine if it can be reset at a lower level, given the available resources now that the Refund Hold Program has been centralized in one campus location and is being worked as part of the ASFR program.

CORRECTIVE ACTION
Small Business/Self-Employed Division and Wage and Investment Division will reevaluate the administrative tolerance for freezing refunds.

IMPLEMENTATION DATE
December 15, 2004

RESPONSIBLE OFFICIAL(S)
Director, Filing and Campus Compliance, Small Business/Self-Employed Division
Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Return Delinquency will advise the Director, Filing and Campus Compliance, of any delays.

RECOMMENDATION 4
Expand the management information reports to provide data for measuring program effectiveness results and setting workload selection tolerance levels.

CORRECTIVE ACTION
Revisions to the Refund Hold management information reports are already in progress. We are currently working to revise the ASFR Management Information Systems (MIS) report to include specific Refund Hold data. This report will include information regarding the dollar amounts offset due to potential liability, releases, and the reason for those releases

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IMPLEMENTATION DATE
June 15, 2005

RESPONSIBLE OFFICIAL(S)
Director, Filing and Campus Compliance, Small Business/Self-Employed Division
Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Return Delinquency will advise the Director, Filing and Campus Compliance, of any delays.

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