TESTIMONY

HEARING BEFORE THE

SUBCOMMITTEE ON TREASURY, POSTAL SERVICE AND GENERAL
GOVERNMENT

COMMITTEE ON APPROPRIATIONS

U.S. HOUSE OF REPRESENTATIVES

MARCH 21, 2001

STATEMENT FOR THE RECORD

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Mr. Chairman and members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss the accomplishments and challenges of the Treasury Inspector General for Tax Administration (TIGTA) and the Internal Revenue Service (IRS).

Treasury Inspector General for Tax Administration Accomplishments and Challenges

TIGTA is fairly new to the Inspector General community. To provide effective oversight to the IRS, TIGTA developed an organizational alignment that is best suited to address the demands and challenges of the IRS. The Office of Audit is aligned with the IRS' business unit structure that allows focused audit coverage of the highest priority tax administration issues. The Office of Investigations (OI) reports directly to the Headquarters Office through geographically dispersed field offices. Additionally, its Strategic Enforcement Division (SED) proactively identifies and investigates unauthorized accesses by employees and illegal intrusions by outsiders into computerized tax data. This Division also investigates outside attempts to interfere with the operation and security of Treasury-owned computer networks.

One of TIGTA's major statutory requirements is to respond to acts of violence directed against IRS personnel and to investigate domestic terrorism. In the past 2 years, we have conducted over 1,400 assault investigations, some of which involved anti-government groups. Currently, we are investigating the mailings of suspicious powder substances to IRS Service Centers as well as two fire- bombings at an IRS facility.

TIGTA has achieved good accomplishments in its first full year of operations. TIGTA management and personnel have placed great emphasis on adding value through the timely delivery of high-quality audits and investigations. As a result, TIGTA's financial accomplishments totaled over $1.5 billion in Fiscal Year (FY) 2000. Thus, TIGTA returned almost $14 for every budget dollar appropriated, 5 times more than in FY 1999.

In FY 2000, OI special agents closed 43 percent more investigations than in the prior year. The number of criminal referrals accepted for prosecution during FY 2000 increased by 6 percent over FY 1999. The Office of Audit issued 162 audit reports in FY 2000, a 119 percent increase over FY 1999. These reports accounted for almost

all of TIGTA's $1.5 billion financial accomplishments claimed. Audit reports contained recommendations that improved tax administration involving almost 11.4 million taxpayer accounts, a 25 percent increase from FY 1999.

Since 1997, TIGTA has initiated over 1,300 unauthorized access investigations, resulting in the removal or resignation of 373 IRS employees, which include 65 successful criminal prosecutions. Overall, 20 percent of the unauthorized access investigations also identified evidence of other criminal violations.

Internal Revenue Service Accomplishments and Challenges

The IRS is experiencing success in its administration of the nation's tax system. For the first time, the General Accounting Office (GAO) has issued an unqualified or "clean" opinion on all of the IRS' financial statements. In addition, the IRS is currently experiencing a successful filing season. As of February 23, 2001, the number of returns filed electronically has increased by about 7 percent. In addition, the IRS continues to increase the number of tax forms that taxpayers can file electronically. Approximately 23 new forms (for electronic filing) were added in 2001 with an additional 40 to be added in 2002. The IRS has also developed a website that provides taxpayers with convenient access to tax forms and information. Despite its success in these areas, the IRS recognizes improvements in its operations are necessary.

To address its need to improve, the IRS is in the midst of a number of complex and interrelated reform and restructuring initiatives. There is a broad consensus for the IRS' plan to transform itself as a more customer-focused organization and to modernize its computer systems, while continuing to implement tax law changes and collect approximately $1.9 trillion in tax revenue.

In response to the IRS Restructuring and Reform Act of 1998 (RRA 98), the IRS is transforming itself so that it will operate better and service its customers more efficiently. It has successfully initiated the process of restructuring the organization into four new customer-focused business units. Even though changes have been made toward a restructured IRS, it must continue to address the management and operational issues that surface to provide first-rate customer service and ensure compliance with the tax laws.

Organizational Restructuring

The most significant challenge the IRS will face over the next few years is modernization. IRS modernization includes both organizational restructuring and implementation of new computer systems and technology. The RRA 98 mandated a restructured IRS organization and revamped business practices. The ability to achieve the IRS' modernization concept is largely dependent on restructuring the organization to better meet taxpayer needs and developing new technology to correct deficient and obsolete systems.

On October 1, 2000, the IRS achieved its first milestone toward modernization by putting into effect (or standing up) a new organizational structure. The four major components of the new IRS are: the Wage and Investment (W&I) Division, the Small

Business/Self Employed (SB/SE) Division, the Large and Mid-Size Business (LMSB) Division and the Tax Exempt and Government Entities (TE/GE) Division.

The stand up of the new business unit structure was an important first step in the IRS' restructuring, though it is far from the last step of this long-term endeavor. The IRS must continue to address management and operational issues such as taxpayer access to "walk-in" and "toll-free" services; accuracy of responses provided to taxpayers; the ability to hire, train and retain a qualified workforce; and, reversing the decline in enforcement rates.

TIGTA audits showed that all four business units were successful in substantially completing the five critical elements needed for standing up. Specifically, most key management positions were filled, most employees had been realigned, finance offices and budgets were established, many delegations of authority were revised, and detailed plans of workarounds were developed. However, additional actions were needed in the area of staffing unfilled positions in the W&I Division and minimizing the inherent risks associated with implementing the TE/GE Division's modernization vision.

Restructuring the IRS is a long-term effort, with probably a decade remaining of updating technology, revamping business practice, and refining balanced measures of organizational performance. The success of the restructuring effort is interdependent with the IRS' ongoing systems modernization effort. For example, current systems have not yet been reprogrammed to provide IRS executives the information they need to make decisions in the IRS' new operating environment, which focuses on serving distinct taxpayer market segments. The executives rely on the information generated from its systems to plan, execute and evaluate programs. Until this realignment of management information is achieved, executives may not have all the data they need to effectively manage resources and to evaluate whether taxpayers are receiving the best service possible.

Systems Modernization

The IRS has made some significant progress towards its governance structure and processes to support and oversee the modernization of its computer systems. The IRS has entered into a contract with a consortium of technology and business service providers, led by a major integrator, which will enable it to achieve its modernization goals. This contract is commonly referred to as the PRIME contract, and is a multi-billion dollar contract over a 15-year period.

About $400 million has been spent on systems modernization since it began about 2 years ago. While significant progress has been made, thus far, most of the ongoing systems modernization projects have taken longer and cost more than originally planned. As a result, benefits to taxpayers have yet to be realized. A contributing factor is that the IRS is in a steep learning curve in its systems modernization effort, and the roles and responsibilities of the IRS and the PRIME contractor were inadequately defined during the early phases of the modernization. In addition, some projects were started before the IRS' updated "Blueprint" for modernization was completed and detailed business needs were clearly defined. Also, established processes have not been fully implemented. While these growing pains are not

uncommon for major systems development projects, the result is that the goals of the restructured IRS may take longer to realize.

The IRS will continue to face risks throughout the life of its technology modernization projects, and TIGTA will continue to assess its efforts. Thus far, TIGTA has identified six areas of concern that could have serious implications on the success of computer modernization, if not properly managed. These areas are:

- A lack of tangible benefits delivered to taxpayers.
- Potential funding problems.
- Problems implementing key systems development processes such as the Enterprise Life Cycle, project management, configuration management and risk management.
- Inappropriate sequencing of projects.
- Projects being over budget and behind schedule.
- Business needs not always being well defined.

In addition, TIGTA has reported to IRS management the need for all systems development activities to be consolidated and monitored under the Chief Information Officer (CIO). TIGTA believes that managing systems development initiatives outside the CIO's organization increases the risk of inconsistent and ineffective project management processes and fragmented systems modernization initiatives, which could lead to delays, cost overruns and rework. Overall, there is still a steep learning curve and there are many issues that remain to be addressed.

Computer Security

The IRS maintains a significant amount of valuable and sensitive information. As such, computer security will continue to be a risk for the IRS. The IRS faces external threats and risks from within as unethical employees have improperly viewed and manipulated taxpayer records. In response to these risks, TIGTA maintains an approach to overseeing the IRS' computer security efforts that address detection and prevention activities.

In 1997, the IRS initiated a major education program to alert all employees to the Taxpayer Browsing Protection Act of 1997 and to the IRS' policy of "Zero Tolerance" for unauthorized access to, and inspection of, taxpayer records. The IRS' objective is to eliminate unauthorized access. The IRS conducts annual awareness programs to reinforce this policy and requires all employees to acknowledge, in writing, that they attended and understood the presentations.

To address unauthorized access to taxpayer information by employees, TIGTA uses detection criteria that search the IRS' tax administration files. The SED uses computer technology and forensic data analysis techniques to investigate unauthorized access leads identified by the criteria and complaints received by field special agents.

Over the past several years, TIGTA has recommended that the IRS improve controls in its computer systems to protect confidential taxpayer information from unauthorized employee accesses because the IRS continues to have difficulty protecting such information from misuse. Recent TIGTA audits have identified significant security

weaknesses in other areas such as:

- Intrusion detection.
- Disaster recovery.
- Physical security of facilities and systems.
- Certification of security controls for sensitive systems.

TIGTA is also working closely with the IRS to develop a cadre of dedicated computer specialists and criminal investigators who will rapidly respond to computer intrusion incidents, investigate IRS network problems when indicators of intentional disruption are present, and conduct recurring systems penetration tests to detect new vulnerabilities.

Financial Management

As mentioned earlier, the GAO has given the IRS an unqualified (clean) opinion on its financial statements, which is an improvement over FY 1999. However, the GAO continues to report that internal controls at the IRS are not effective, and that the IRS' financial management systems lack substantial compliance with the Federal Financial Management Improvement Act.

While the IRS was able to produce financial statements that were fairly stated in all material respects using compensating processes, this approach does not produce the reliable, useful, and timely financial and performance information the IRS needs for decision-making on an ongoing basis.

Tax Law Changes

The filing season impacts every American taxpayer and is, therefore, always a highly critical program for the IRS. Many programs, activities, and resources have to be planned and managed effectively for the filing season to be successful. For example, more than 250 computer-programming changes were required for the 2000 Filing Season. These were further complicated by the IRS' modernization efforts to update and replace its core tax processing systems.

The IRS must confront the challenge of ensuring that telecommunications and system capacity will accommodate the new electronic filing requirements to ensure the accuracy and utility of information received and processed. The IRS had initially planned to validate all secondary Social Security Numbers (SSN) processed during the 2000 Filing Season. However, the IRS subsequently approved computer-programming changes to bypass the validation based on the early volume of returns received.

The IRS also lost $211 million in revenue by failing to stop taxpayers from claiming erroneous child credits for 1998 and 1999. The IRS had not programmed its computer system to properly process changes related to the Child Tax Credit and the Additional Child Tax Credit.

The IRS needs additional procedural and organizational changes to further reduce tax form complexity and taxpayer burden. The IRS currently does not have a toll-free

telephone number that would provide individual taxpayers with a convenient method to provide the IRS with tax form improvement comments. In addition, the IRS should strengthen the system of controls over the tax form development process to ensure compliance with Federal internal control standards.

Customer Service and Tax Compliance Initiatives

The IRS has embarked on a course to re-engineer its business processes and technology to focus on providing world-class service to taxpayers. The theory is that the overall rate of voluntary compliance with the tax laws will increase if the IRS provides the right mix of education and support to taxpayers.

Revenue receipts processed by the IRS increased from $1.5 trillion in FY 1996 to $1.9 trillion in FY 1999. However, revenue collected as a result of compliance activity decreased by $5 billion and gross accounts receivable increased by $41 billion during this same period. IRS management and many stakeholders have been concerned about the reduction in resources allocated to compliance activities and the related decrease in business results. To help address this issue, Treasury's FY 2001 budget submission included a request for 2,800 new positions over the next 2 fiscal years. These additional resources would be dedicated to enforcing tax laws and improving service to taxpayers.

Decreased enforcement has also been attributed to IRS employees' concerns over the mandatory termination provision in Section 1203 of the RRA 98. To help address these concerns, TIGTA has continued to brief the IRS staff on investigations related to Section 1203 violations. In addition, TIGTA continues to be dedicated and involved in the IRS' efforts to comply with the legislative changes required by the RRA 98 through representation on an IRS task force with the focus on Section 1203 processes.

Customer Service

Providing a quality customer service operation remains a top priority for the IRS. Telephone and Internet technology, in particular, afford the IRS many opportunities to dramatically improve its customer service. The IRS has made some strides in its use of such technology. However, inadequate systems design and planning hinder some of these efforts, and put some of them at risk of not being completed when promised.

For example, the IRS has been planning to implement an Internet-based refund status application since 1996 and currently intends to have it available by the 2002 Filing Season as part of its overall business systems modernization efforts. While we observed some general planning and analysis had been accomplished, detailed design and development was still needed. To be postured for the 2002 Filing Season, the IRS must define and complete a substantial amount of critical design requirements and development work, including analyzing and defining the business and functional requirements of the refund application, ensuring the application meets all security and privacy requirements, and integrating/ interfacing the web application with the modernized or legacy computer systems.

The Electronic Tax Law Administration (ETLA) Program is a program that is intended to revolutionize how taxpayers transact and communicate with the IRS. However,

significant improvements are needed to raise the quality of answers. The IRS responded correctly to only 54 percent of the SB/SE Division questions TIGTA submitted through the *Digital Daily*. Commercial web sites offering free tax advice provided correct answers only 47 percent of the time. Our analysis of response times showed that the commercial web sites provide responses faster than the IRS, but taxpayers were generally satisfied with the IRS' response times.

Also, during a current review of the Tax Assistance Centers, 90 contacts were made with IRS representatives. In seven of these instances, service was denied to our reviewers (i.e., reviewers were merely provided forms or instructions, but not given the opportunity to speak with an assistor). When service was provided, inaccurate answers were received 48 percent of the time.

Revenue Protection

The IRS must continually seek opportunities to protect revenue and minimize tax-filing fraud in its programs and operations. A highly visible area of concern and potential fraud is in the Earned Income Credit (EIC) Program. An August 2000 IRS EIC compliance study reported that the amount of overclaims submitted was approximately 31 percent of the amount claimed. The IRS' weaknesses related to the EIC are in three primary areas:

- Achieving full participation by eligible taxpayers.
- Ensuring compliance through verification of taxpayers' eligibility.
- Reducing inherent vulnerabilities (multiple use of dependent SSNs).

The IRS has launched promising new compliance initiatives. For example, partnerships with the Department of Health and Human Services and the Social Security Administration (SSA) will permit the IRS to cross-check information regarding how the child is related to the taxpayer, the age of the child, and whether the taxpayer is the child's custodial parent. In 2001, the IRS began checking all secondary SSNs in addition to primary and qualifying child SSNs on EIC returns. The IRS is rejecting returns if the names and numbers do not match Social Security records. Another initiative that improves the detection and prevention of erroneous EIC claims before tax refunds are paid allows the IRS to deny EIC claims when a return is first received if the taxpayer's EIC claim was denied the previous year and the taxpayer did not follow recertification requirements that were enacted in 1997.

Despite extensive IRS programs and efforts it has made to detect and stop fraudulent claims, relatively little effort has been made to systematically identify refund schemes involving business returns and associated credits. A few business schemes have been identified but it has generally been through labor intensive manual procedures. The IRS is concerned that fraudulent refund claims may be expanding to include business returns and that scheme perpetrators continue to develop new methods to defraud the system.

Taxpayer Protection and Rights

The IRS is making progress in its implementation of the RRA 98 provisions. As of September 30, 2000, the IRS had improved its compliance with some of the RRA 98

provisions that TIGTA has reviewed. However, the IRS needs to continue to focus its efforts on several additional taxpayers' rights provisions. These provisions include:

- Restricting the use of enforcement statistics to evaluate IRS employees.
- Not designating taxpayers as illegal tax protesters.
- Providing proper and timely notice that a federal tax lien has been filed.
- Not withholding information in response to taxpayers' written requests for information under the Freedom of Information Act of 1988 or the Privacy Act of 1974.

TIGTA assists in the protection of taxpayers and their rights by investigating allegations of misconduct by IRS employees. Since the passage of the RRA 98, over 2,700 complaints alleging Section 1203 violations have been received. Shortly after the passage of Section 1203, there was an initial surge in what both the public and IRS employees thought were valid Section 1203 violations. TIGTA is currently receiving about half of the complaints it initially received.

Consistently, since the enactment of the statute almost 3 years ago, the vast majority of Section 1203 complaints received by TIGTA have alleged an IRS employee violated a provision of the IRS Manual or Internal Revenue Code in order to retaliate against, or harass someone. Approximately 35 percent of these complaints were made by IRS employees against other IRS employees or supervisors. The second category, by volume, concerns constitutional and civil rights/Equal Employment Opportunity (EEO) violations. Again, many of the civil rights/EEO complaints were made by IRS employees against other IRS employees or supervisors.

Implementation of the Government Performance and Results Act of 1993

Within the last 2 years, the IRS has developed a Strategic Plan and provided budget justifications that include the Annual Performance Plan(s). Collectively, these documents satisfy major requirements of the Government Performance and Results Act of 1993 (GPRA) by identifying the IRS' mission, strategic objectives, goals, and strategies. The documents also describe the IRS' priorities for the next 6 years and the key performance indicators (measures) used in assessing achievement of those goals.

The IRS Commissioner has indicated that it will take years to achieve a fully acceptable set of balanced measures that can be used at all levels of the organization. While the new operating units concentrate on implementing the new organizational structure, performance measures may not be a high priority. Based on our audits to date, TIGTA believes that the IRS can improve its measures, the data quality of its measures, and its reporting of annual accomplishments.

As part of a balanced measurement system, the IRS conducts surveys of taxpayers to gauge their satisfaction with IRS customer services. The results of these surveys are also used for GPRA reporting purposes. The IRS conducted surveys in various functions, including the toll-free telephone, walk-in, collection, examination, and appeals operations. Our reviews of the controls and processes used in conducting these surveys indicated that survey data may not be statistically reliable. Specifically, the surveys did not always include all taxpayer interactions, the sampling

methodologies did not ensure equal and unbiased opportunities for taxpayer participation, and the survey response rates were too low, thereby increasing the risk that the results may not be representative of the overall population.

<u>Impact of the Global Economy on Tax Administration</u>

The GAO and TIGTA have previously reported serious internal control and systemic weaknesses in the IRS' administration of its international programs. The IRS continues to struggle to increase compliance in an ever-growing international economy. Significant improvements are needed in international compliance programs to focus on nonfiling, transfers of assets by United States citizens to foreign trusts, foreign tax credit claims, and foreign-sourced income.

A recent TIGTA audit found that the IRS is in no better position today to determine taxpayers' compliance levels in reporting foreign-sourced income than it was in 1997. Despite the foreign-sourced income information that tax treaty partners provide, the IRS' processes to measure compliance and identify non-compliance are inadequate.

In closing, the IRS is working intensely to address these vulnerabilities and concerns in order to ensure that its efforts to reform and restructure are successful.