DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20005

INSPECTOR GENERAL
FOR TAX
ADMINISTRATION

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MEMORANDUM FOR SECRETARY GEITHNER

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SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2011

The *Reports Consolidation Act of 2000*[1] requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2010,* its perspective on the most serious management and performance challenges confronting the Internal Revenue Service (IRS). The issues described in this document are derived from a variety of activities conducted and reviewed by TIGTA. In addition to external factors, such as those that will be discussed that relate to recent attacks and threats to the IRS, each year TIGTA strategically evaluates IRS programs, activities, and functions to identify the areas of highest vulnerability to the Nation's tax system. For Fiscal Year 2011, the top 10 challenges in order of priority are:

1. Security;
2. Modernization;
3. Tax Compliance Initiatives;
4. Implementing Health Care and Other Tax Law Changes;
5. Providing Quality Taxpayer Service Operations;
6. Human Capital;
7. Erroneous and Improper Payments and Credits;
8. Globalization;
9. Taxpayer Protection and Rights; and
10. Leveraging Data to Improve Program Effectiveness and Reduce Costs.

While TIGTA's assessment of the major IRS management challenge areas for Fiscal Year 2011 has remained relatively unchanged from the prior fiscal year, one significant change did occur. Due to recent events at IRS facilities and the potentially expanding role of the IRS, Security has replaced Modernization as the top challenge facing the IRS. Notwithstanding this change, Modernization remains a major challenge for the IRS. For Fiscal Year 2011, we have also expanded the Implementing Tax Law

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[1] 31 U.S.C. Section 3516(d).

Changes challenge to include the tax-related health care provisions of the *Patient Protection and Affordable Care Act*.[2]

Although not listed, complexity of the tax law remains a serious, underlying issue that has wide-ranging implications for both the IRS and taxpayers. This complexity, including frequent revisions to the Internal Revenue Code, makes it increasingly difficult for the IRS to explain and enforce the tax laws and more costly and time consuming for taxpayers who want to comply. As elected officials continue to effect broad policy changes using the Internal Revenue Code, the IRS will continue to face the challenge of responding quickly by shifting resources and altering established plans.

The following is a discussion of each of the most serious management and performance challenges facing the IRS during Fiscal Year 2011.

SECURITY

In addition to safeguarding a vast amount of sensitive financial and personal data, the IRS must also protect approximately 100,000 employees and more than 700 facilities throughout the country. Attacks and threats against IRS employees and facilities have risen steadily in recent years. The February 2010 attack on an IRS facility in Austin, Texas, is a stark reminder of the dangers that IRS employees face every day in trying to perform their jobs. Animosity towards the tax collection process is nothing new, but the Austin incident and other recent events point to a surge of hostility towards the Federal Government. According to the Anti-Defamation League, the militia movement has almost quadrupled in size in the past two years, growing to more than 200 groups across the country.[3] The Southern Poverty Law Center has reported that anti-government and hate groups have grown from 149 groups in 2008 to 512 groups in 2009, a 244 percent increase.[4] The ongoing public debate regarding the recently enacted health care legislation may also lead to increased threats against IRS employees and facilities, underscoring the need for continuing vigilance in the area of physical security.

As a result of these and other threats, the IRS is developing the Threat Information and Critical Incident Response Center (TIRC), which will be supported by TIGTA and other law enforcement agencies. The TIRC will encourage effective review and dissemination of threat information to IRS stakeholders in support of the critical employee-safety mission, an unprecedented effort to marshal resources and potentially lifesaving information in real time. The TIRC will also serve as a focal point for the timely and efficient sharing of threat information, including cyber- and Internet-based threats, to maximize the IRS's ability to engage in appropriate threat mitigation.

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[2] Pub. L. 111-148, 124 Stat. 119 (2010), as amended by the Health Care and Education Reconciliation Act of 2010 (Pub. L. 111-152, 124 Stat. 1029).
[3] Anti-Defamation League, *The Militia Movement in 2010: A Snapshot,* http://www.adl.org/main_Extremism/Hutaree_Militia_Facts.htm?Multi_page_sections=sHeading_2 (posted March 29, 2010).
[4] Mark Potok, *Rage on the Right: The Year in Hate and Extremism*, Southern Poverty Law Center Intelligence Report, Spring 2010.

Concurrent with the IRS's monitoring of threats against its employees and facilities, the IRS must also remain vigilant with regard to computer security, particularly as it relates to safeguarding the privacy of confidential taxpayer information. As computer usage continues to be inextricably integrated into core business processes, the need for effective information system security becomes essential to ensure the confidentiality, integrity, and availability of data. The IRS relies extensively on its computer systems to carry out the demanding responsibilities of administering the Nation's tax laws, including processing Federal tax returns and collecting Federal taxes. IRS computer systems process hundreds of millions of tax returns and contain confidential tax information for over 100 million taxpayers. From a security standpoint, the IRS is responsible for maintaining effective information security controls to protect confidential taxpayer information from inadvertent or deliberate misuse, improper disclosure, or destruction.

The IRS is specifically required by Federal law to keep taxpayer data confidential and prevent unauthorized disclosure or browsing of taxpayer records.[5] Each tax return contains Personally Identifiable Information, such as the filer's name, address, Social Security Number, and other personal information. Because of the volume and type of data it maintains, the IRS is an attractive target for criminals with the intent to commit identity theft by stealing and using someone's personal information for their own financial gain. In February 2010, the Federal Trade Commission reported that, for the 10th year in a row, identity theft was the number one consumer complaint nationwide.[6]

From a law enforcement perspective, the migration of Federal tax administration operations into the Internet and electronic environment increases internal and external vulnerabilities that can be exploited by criminals. For example, we have seen attacks on the integrity of the system launched from around the world, and we have also seen the amount of exposure and damage that can be done by a single individual employee whether intentional or accidental.[7] Hackers and foreign governments increasingly attempt sophisticated intrusions into computer networks. If an intrusion is successful, it could result in substantial economic disruption.

The *Federal Information Security Management Act* (FISMA)[8] requires each Federal Government agency to report annually to the Office of Management and Budget and to the Congress on the effectiveness of its security programs and to perform an annual independent evaluation of its information security program and practices. The IRS has made steady progress in complying with FISMA requirements since the law's enactment in 2002 and continues to place a high priority on efforts to improve its security program. However, the IRS still needs to take additional actions in the areas of certification and accreditation and configuration management to better secure its systems and data.

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[5] 26 U.S.C. Sections 6103, 7213, 7213A, 7431 (2006).

[6] *Consumer Sentinel Network Data Book for January – December 2009*, Federal Trade Commission, dated February 2010.

[7] Recently, in a case worked jointly with the IRS Criminal Investigation Division, individuals were arrested for their participation in an online international phishing scheme to steal income tax refunds intended for U.S. taxpayers. After taxpayers uploaded their tax information seeking refunds for Federal and State taxes, co-conspirators in Belarus collected the data and altered the returns so that legitimate tax refund payments would be redirected to U.S. bank accounts under their control.

[8] 107 Pub. L. 347, 116 Stat. 2899 (2002), codified as amended in 44 U.S.C. Sections 3541 – 3549.

Additionally, we have reported that the IRS prematurely closed the security roles and responsibilities component of its computer-security material weakness.[9] As a result, the IRS cannot ensure all IRS and contract employees will carry out their responsibilities to protect the confidentiality, integrity and availability of taxpayer data

<u>MODERNIZATION</u>

The Business Systems Modernization Program (Modernization Program or Program) is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system. The IRS originally estimated that the Modernization Program would last up to 15 years and incur contractor costs of approximately $8 billion. The Program is now in its 12th year and has received approximately $3.24 billion for contractor services, plus an additional $474 million for internal IRS costs.[10] These amounts represent increases of approximately $540 million (20 percent) in contractor services and approximately $121 million (34 percent) in internal IRS costs from Fiscal Year 2009. The total amount for contractor services and for internal IRS costs increased by approximately $661 million (22 percent) from Fiscal Year 2009.

Factors that characterize the IRS's complex information technology environment include widely varying inputs from taxpayers (from simple concise records to complex voluminous documents), seasonal processing with extreme variations in processing loads, transaction rates on the order of billions per year, and data storage measured in trillions of bytes. The Modernization Program is working toward providing improved benefits to taxpayers that include:

- Issuing refunds, on average, five days faster than existing legacy systems;
- Offering electronic filing capability for large corporations and small businesses, tax-exempt organizations, and partnerships, with dramatically reduced processing error rates;
- Delivering web-based services for tax practitioners, taxpayers, and IRS employees; and
- Providing IRS customer service representatives with faster and improved access to taxpayer account data with real-time data entry, validation, and updates of taxpayer addresses.

The Modernization Program has continued to help improve IRS operations and is refocusing its efforts to improve business practices with new information technology solutions. However, project development activities have not always effectively implemented planned processes or delivered all planned system capabilities to achieve the Program's expectations. Management of the Program's cost and schedule has

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[9] Treasury Inspector General for Tax Administration, Ref. No. 2010-20-084, *More Actions Are Needed to Correct the Security Roles and Responsibilities Portion of the Computer Security Material Weakness* (2010).

[10] Treasury Inspector General for Tax Administration, Ref. No. 2010-20-094, *Annual Assessment of the Business Systems Modernization Program* (2010).

improved since the previous year, but more attention must be paid to the development and management of Program requirements.

Further, resolution has not yet been completely achieved for security vulnerabilities affecting two significant systems. The IRS revised its Modernization Program and is currently testing a prototype[11] database concept for all taxpayer data. The new approach will require the IRS to increase its employees' information technology-related skills, tools, and operations to effectively deliver the revised program.

Since November 2001, TIGTA has reported nine assessments on annual accomplishments and activities of the Modernization Program. In developing the assessments, TIGTA formulated four primary challenges the IRS must overcome to be successful:

1. Implement planned improvements in key management processes and commit necessary resources to enable success;
2. Manage the increasing complexity and risks of the Program;
3. Maintain the continuity of strategic direction with experienced leadership; and
4. Ensure effective management of contractor performance and accountability.

Notwithstanding recent progress made by the IRS, TIGTA continues to take the position that these four challenges still need to be met to achieve program success. We are encouraged by the actions the IRS has planned and taken to refocus the Program; however, we believe the IRS should consider the overall Modernization Program a material weakness at this time.

TAX COMPLIANCE INITIATIVES

Another serious challenge confronting the IRS is tax compliance. Despite an estimated voluntary compliance rate of 84 percent and IRS enforcement efforts, a significant amount of income remains unreported and unpaid. Tax compliance initiatives include the administration of tax regulations, collection of the correct amount of tax from businesses and individuals, and the oversight of tax-exempt and government entities. Increasing voluntary taxpayer compliance and reducing the Tax Gap[12] continue to be the focus of many IRS initiatives. The IRS continues to face significant challenges in obtaining complete and timely compliance data, and in developing methods necessary to interpret the data. Even with improved data collection, however, the IRS needs broader strategies and more research to determine what actions are most effective in addressing taxpayer noncompliance. The IRS's strategy for reducing the Tax Gap is largely dependent on funding for additional compliance resources and legislative changes. In its Fiscal Year 2011 budget submission, the IRS has requested a 5.3 percent increase in enforcement funds over its Fiscal Year 2010 request.

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[11] This prototype is an approach to system development using an iterative process of discovering requirements, designing, and building a trial model, examining the results, and repeating the process until the desired solution is attained.

[12] The IRS defines the Tax Gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely paid for a tax year.

Businesses and Individuals

The IRS estimated the gross Tax Gap for Tax Year 2001 – the most current figures to date – to be approximately $345 billion. Underreporting of taxes, which is comprised of four major components (individual income tax, employment tax, corporate income tax and estate and excise taxes), is estimated at $285 billion and accounts for the largest portion of the Tax Gap. Overall, the underreporting of individual income tax and employment tax constitute over 70 percent of the gross Tax Gap. The misclassification of millions of employees as independent contractors is a nationwide problem that continues to grow and contribute to the Tax Gap. In a report issued in Fiscal Year 2010,[13] we determined that the IRS has opportunities to enhance compliance in its Employment Tax Program by 1) taking measures to ensure employment tax forms are not misused to avoid paying taxes, and 2) regularly sharing the results of worker classification examinations to ensure the greatest possible use of the agency's resources when addressing the underreporting Tax Gap. Our audit identified over 74,000 taxpayers who may have avoided paying approximately $26 million in Social Security and Medicare taxes.

Tax-Exempt Entities

The IRS continues to face challenges in administering programs focused on ensuring that tax-exempt organizations comply with applicable laws and regulations to qualify for tax-exempt status. Legislative changes and judicial decisions contribute to a constantly changing environment affecting today's non-profit or tax-exempt organizations. For example, the January 2010 Supreme Court decision *Citizens United v. Federal Election Commission*,[14] could lead to additional expenditures by those tax-exempt organizations that advocate the election or defeat of Federal candidates.

Since more than $15 trillion in United States assets are currently controlled by tax-exempt organizations or held in tax-exempt retirement programs and financial instruments, the IRS recognized in its most recent strategic plan that careful oversight over the non-profit and tax-exempt sector is more important than ever before. In its Fiscal Year 2011 budget submission, the IRS reemphasized the importance of maintaining a strong enforcement presence in the tax-exempt sector to ensure that charitable organizations are compliant with the Internal Revenue Code and not used for non-charitable or illegal purposes.

In a report issued in Fiscal Year 2010,[15] we determined that the IRS has taken significant actions to identify Section 527 political organizations[16] that do not timely notify the IRS of their existence or timely submit reports of their contributions and

[13] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-025, *Employment Tax Compliance Could Be Improved With Better Coordination and Information Sharing* (2010).
[14] 130 S.Ct. 876 (2010).
[15] Treasury Inspector General for Tax Administration, Ref. No. 2010-10-018, *Improvements Have Been Made, but Additional Actions Could Ensure That Section 527 Political Organizations More Fully Disclose Financial Information* (2010).
[16] Political organizations include political parties; campaign committees for candidates for Federal, State, or local office; and political action committees. 26 U.S.C. Section 527 (2006).

expenditures. However, the IRS has not fully addressed noncompliance among political organizations. For example, one out of every four Political Organization Report of Contributions and Expenditures (IRS Form 8872) that we reviewed had incomplete or missing contributor or recipient information. While some of these filings may later be deemed acceptable, we determined the IRS is not reviewing these filings to determine if they are complete or if penalties should be assessed.

Also, the IRS is not always timely issuing notices that include all information needed by political organizations to become compliant. Lastly, the IRS is not following up on information it has requested from political organizations to verify compliance.

Tax Return Preparers

An increasing number of taxpayers are turning to tax return preparers for assistance. In Calendar Year 2009, the IRS processed approximately 83.1 million individual Federal income tax returns prepared by paid preparers. However, these preparers were not required to meet or comply with any national standards before selling tax preparation services to the public.

A series of reports strongly suggesting a need to regulate those who prepare Federal tax returns, including reviews conducted by TIGTA, the Government Accountability Office and other agencies, led the IRS to launch its Return Preparer Review in June 2009. The following December, after its own six-month study of the problem, the IRS announced a suite of proposed reforms to improve oversight of the return preparer community. The reforms proposed by the IRS include the development of requirements for registration, competency testing, continuing professional education, ethical standards, and enforcement. The new preparer requirements will take several years to implement, and will be phased in through Calendar Year 2014, at which time all preparers will be subjected to suitability and competency tests. In the meantime, the IRS plans to develop and implement a management information system to gather data on preparers and establish a database to assist taxpayers in identifying qualified preparers. Further, the IRS is planning to ensure that taxpayers understand the new requirements and the importance of using only registered preparers to prepare their tax returns.[17]

IMPLEMENTING HEALTH CARE AND OTHER TAX LAW CHANGES

Each filing season tests the IRS's ability to implement tax law changes made by the Congress. Most individual taxpayers file their income tax returns during this annual January through April period and contact the IRS with questions about specific tax laws or filing procedures. Correctly implementing late tax law changes remains a significant challenge because the IRS must often act quickly to assess the changes and determine the necessary actions to ensure all legislated requirements are satisfied. In addition, the IRS must often create new or revise existing tax forms, instructions and publications; revise internal operating procedures; and reprogram major computer systems used for processing tax returns. For example, on November 6, 2009, the

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[17] Treasury Inspector General for Tax Administration, Ref. No. 2010-40-127, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (2010).

Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA)[18] was enacted. The WHBAA, among other things, extended the First-Time Homebuyer Credit to May 1, 2010. In order to implement this legislation for the 2010 Filing Season, the IRS organized an executive task group to oversee revisions to the Form 5405 (First-Time Homebuyer Credit), its related instructions, and the extensive computer programming changes necessary to process the tax returns claiming the credit. The IRS completed revisions and released the Form 5405 and Instructions on January 15, 2010. However, due to the extensive programming changes required to process tax returns claiming the credit, the IRS had to postpone processing these returns until February 15, 2010. Refunds for these returns were subsequently delayed until mid-March 2010.

The Congress frequently changes the tax laws, so some level of change has become a normal part of the IRS's operating environment. Although the IRS has generally been able to adapt and react to tax law changes, the new laws do have a major effect on how the IRS conducts its activities, determines resource requirements, and progresses toward meeting its strategic goals. While the IRS has recognized the increasing complexity of tax administration in formulating its strategic plan, it has also acknowledged the impossibility of predicting with 100 percent accuracy the timing and extent of the impact of changes in the tax laws. As such, the IRS will continue to face significant challenges in its efforts to respond quickly, accurately, and effectively to tax law changes.

Health Care

The recently enacted health care reform legislation[19] contains an extensive array of tax law changes that will be a continuing source of challenge for the IRS in the coming years. While the Department of Health and Human Services will have the lead role in the policy provisions of the *Patient Protection and Affordable Care Act*, the IRS will administer the law's numerous tax provisions. The IRS estimates that at least 42 provisions will either add to or amend the tax code and at least eight will require the IRS to build new processes that do not exist within the current tax administration system. Examples of new IRS responsibilities resulting from this law include:

- Providing tax credits to businesses and individuals to assist in covering the cost of health coverage;
- Administering the mandate for individuals to purchase health coverage or be subject to a penalty on their individual Federal tax returns; and
- Administering multiple tax provisions designed to raise revenues to offset the cost of health care reform.

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[18] *Worker, Homeownership, and Business Assistance Act of 2009,* Pub. L. No. 111-92, 123 Stat. 2984.
[19] *Patient Protection and Affordable Care Act*, Pub. L. 111-148, 124 Stat. 119 (2010), as amended by the *Health Care and Education Reconciliation Act of 2010*, Pub. L. 111-152, 124 Stat. 1029.

American Recovery and Reinvestment Act

The *American Recovery and Reinvestment Act of 2009* (Recovery Act)[20] was enacted on February 17, 2009. The Recovery Act presents significant challenges to all Federal agencies as they move to implement provisions quickly while attempting to minimize risk and meet increased standards for transparency and accountability. With its 56 tax provisions (20 related to individual taxpayers and 36 related to business taxpayers), the Recovery Act poses significant challenges to the IRS as the Nation's tax collection agency and administrator of the tax laws. These provisions will continue to challenge the IRS as it implements the required changes over multiple filing seasons.

TIGTA has issued numerous reports related to the IRS's efforts to implement Recovery Act tax provisions. Some examples include:

- In a review of the IRS's implementation of mandated Health Coverage Tax Credit provisions, we determined that the IRS executed the provisions appropriately, but some project management practices need improvement.[21]
- In a review of the IRS's controls surrounding the First-Time Homebuyer Credit, we determined that although the IRS had taken positive steps to strengthen controls, 1) weaknesses allowed fraudulent claims filed by prison inmates to be processed, 2) multiple claims for the same home were allowed, and 3) claims were allowed for homes purchased prior to the dates allowed by law.[22]
- In a review of the IRS's 2010 Filing Season, we identified inadequate controls and incomplete and inaccurate programming related to certain Recovery Act tax benefits. Although the IRS executed an aggressive outreach campaign to alleviate confusion and prevent errors with the First-Time Homebuyer and the Making Work Pay Credits, we identified over 120,000 taxpayers claiming nearly $100 million in erroneous credits.[23]
- In a review of the IRS's readiness to implement the planning, awarding and reporting of Recovery Act-funded procurements, we determined that although the IRS took proactive steps prior to the enactment of the Recovery Act, it still does not have the necessary controls in place to ensure future procurements will comply with Recovery Act requirements.[24]
- In a review of the IRS's controls to ensure that direct subsidies for Build America Bonds were accurate and timely and whether controls prevented disbursement of erroneous payments, we determined that, generally, all complete requests for

[20] *American Recovery and Reinvestment Act of 2009* (Pub. L. No. 111-5, 123 Stat. 115).
[21] Treasury Inspector General for Tax Administration, Ref. No. 2010-21-057, *Recovery Act Provisions for the Health Coverage Tax Credit Were Implemented, but Development Processes Could Be Improved* (2010).
[22] Treasury Inspector General for Tax Administration, Ref. No. 2010-41-069, *Additional Steps Are Needed to Prevent and Recover Erroneous Claims for the First-Time Homebuyer Credit* (2010).
[23] Treasury Inspector General for Tax Administration, Ref. No. 2010-41-128, *Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season* (2010).
[24] Treasury Inspector General for Tax Administration, Ref. No. 2010-11-071, *Additional Actions Are Needed to Ensure Readiness to Comply With the American Recovery and Reinvestment Act of 2009 Procurement Requirements* (2010).

payment of the Build America Bond Federal subsidies were processed accurately, timely and without indications of fraudulent or erroneous disbursement.[25]

TIGTA continues to support the Recovery Accountability and Transparency Board (Recovery Board) in fulfilling its responsibilities for providing transparency for Recovery Act-related funds and for preventing and detecting fraud, waste and mismanagement. We also continue to evaluate the IRS's compliance with Recovery Act and Office of Management and Budget guidance. Additionally, we have evaluated multiple Recovery Board leads that contain allegations of misuse of Recovery Act funds.

Other Tax Law Changes

Implementing legislation for the 2010 Filing Season required the IRS to update many tax products and perform extensive programming in an effort to ensure that tax returns would be processed accurately. We identified 71 tax products (33 tax forms, 12 instructions, and 26 publications) requiring updates due to new legislation. Although tax law changes challenged the IRS during the 2010 Filing Season, the IRS still completed the processing of tax returns on schedule and issued taxpayer refunds within 45 calendar days of the April 15, 2010, due date. However, implementation of some new tax law provisions did cause problems resulting in increases in error inventories from taxpayer errors, payment of erroneous claims, and the inability to identify and prevent erroneous claims at the time tax returns were processed.[26]

PROVIDING QUALITY TAXPAYER SERVICE OPERATIONS

In July 2005, the Congress requested that the IRS develop a five-year plan, including an outline of how the IRS will improve the service it provides to taxpayers and a detailed list of which services the IRS should provide. The IRS developed the plan – the Taxpayer Assistance Blueprint – which focuses primarily on services that support the needs of taxpayers who file or should file the Form 1040 series tax returns.[27] The Blueprint includes performance measures, service improvement initiatives and an implementation strategy for improving future service investment decisions. The IRS has begun implementing the Blueprint, but much of its implementation depends on the availability of future funding.

The Department of the Treasury and the IRS recognize that the delivery of effective taxpayer service has a significant impact on voluntary tax compliance. Answering taxpayers' questions to assist them to correctly prepare their returns reduces the need to send notices and correspondence when taxpayers make errors. Taxpayer service

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[25] Treasury Inspector General for Tax Administration, Ref. No. 2010-11-083, *Initial Build America Bond Subsidy Payments Were Processed Accurately and Timely* (2010).
[26] Treasury Inspector General for Tax Administration, Ref. No. 2010-41-128, *Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season* (2010).
[27] The Form 1040 series tax returns include any IRS tax forms that begin with "1040" such as the U.S. Individual Income Tax Return (Form 1040), U.S. Individual Income Tax Return (Form 1040-A), and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ).

also reduces unintentional noncompliance and shrinks the need for future collection activity. The IRS continues to focus on the importance of improving service by emphasizing it as a main goal in its strategic plan, including seeking innovative ways to simplify or eliminate processes that unnecessarily burden taxpayers or government resources.

HUMAN CAPITAL

Human capital is the Federal Government's most critical asset. At a time when the Federal Government is preparing for increased retirements and taking on such challenges as health care reform, the recruitment of new employees and retention of existing employees plays a key role in ensuring the maintenance of a quality workforce capable of meeting the needs of the American public. Like many Federal agencies, the IRS is faced with the major challenge of replacing existing talent because of a large number of retirements expected over the next several years. Of the approximately 100,000 employees, including 9,100 managers that the IRS employs, more than half have reached age 50 and can retire within 10 years. In addition, 39 percent of IRS executives are already eligible for retirement. Replacing these employees represents a significant challenge since many possess unique skills and institutional knowledge that will be difficult to replace.

The IRS has taken significant actions to improve its ability to recruit qualified candidates. These improvements have enabled the IRS to report that it is on target to meet its mission-critical occupational,[28] geographic and diversity hiring goals. However, improving recruiting activities will require long-term commitment and focus, as some improvements are still in process.

The IRS's challenge of having the right people in the right place at the right time is made more difficult by many complex internal and external factors. The work performed by IRS employees continually requires greater expertise as tax laws become more complex, manual systems used to support tax administration become computer-based, and attempts by taxpayers and tax practitioners to evade compliance with the tax laws become more sophisticated. The IRS must also compete with other government agencies and private industry for the same human resources, which becomes more complicated as younger generations of employees move between jobs more frequently than employees in the past. Furthermore, budget constraints, legislative changes and economic shifts can create unforeseen challenges for the IRS in addressing its long-term human capital issues.

ERRONEOUS AND IMPROPER PAYMENTS AND CREDITS

As defined by the *Improper Payments Information Act of 2002*,[29] an improper payment is any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative or other legally applicable requirements. Improper payments include any payment to an ineligible recipient, any payment for an ineligible service, any duplicate

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[28] Mission-critical occupations are those positions critical to front-line enforcement and direct support to front-line operations needed to meet the stated IRS goals.
[29] Pub. L. No. 107-300, 116 Stat. 2350.

payment, payments for services not received and any payment that does not account for credit for applicable discounts. The Administration has emphasized the importance of reducing improper payments. In November 2009, the President issued Executive Order 13520, which included a strategy to reduce improper payments by increasing transparency, holding agencies accountable and creating strong incentives for compliance.[30] Recently, the *Improper Payments Elimination and Recovery Act of 2010*[31] placed additional requirements on Federal agencies to reduce improper payments. Erroneous and improper payments involving the IRS generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors.

Refundable Credits

The IRS administers numerous refundable tax credits. These refundable credits allow individual taxpayers to reduce their tax liability below zero and, thus, receive a tax refund even if no income tax was withheld or paid. Two significant refundable credits are the Earned Income Tax Credit (EITC) and the Additional Child Tax Credit. The Recovery Act also authorized several new refundable credits, examples of which include the First-Time Homebuyer Credit and the Making Work Pay Credit.

The EITC remains the main refundable credit and continues to be vulnerable to a high rate of noncompliance, including incorrect or erroneous claims caused by taxpayer error and resulting from fraud. Each year a substantial number of taxpayers claim the EITC. For example, in a population of 154 million Tax Year 2007 individual income tax returns, 24.5 million returns claimed $48.5 billion in Earned Income Tax Credits. Although numerous changes have been made to the EITC qualifications to reduce the amount of fraud associated with the claims, recent estimates indicate an EITC improper payment rate between 23 percent and 28 percent, or roughly $11 billion to $13 billion each year.[32]

In a recent review of the IRS's EITC Paid Preparer Strategy,[33] we determined that the IRS has made strides in its effort to increase EITC tax return preparer compliance. However, the IRS could further improve the effectiveness of identifying high-risk EITC tax return preparers by expanding risk factors and using the computed probability score. Although the IRS developed a process that appropriately weighs the significance of risk factors used to compute a probability

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[30] Executive Order 13520, 74 Fed. Reg. 62201 (Nov. 25, 2009). TIGTA has an ongoing audit related to assessing the IRS's efforts to implement this Executive Order. We initiated this audit to comply with the requirement under the Executive Order to evaluate the IRS's methodology for quantifying, preventing and recovering Earned Income Tax Credit improper payments. This audit is included in our Fiscal Year 2011 Annual Audit Plan.
[31] Pub. L. No. 111-204, 124 Stat. 2224.
[32] http://www.paymentaccuracy.usaspending.gov/content/programs-not-reported (last visited October 14, 2010).
[33] Treasury Inspector General for Tax Administration, Ref. No. 2010-40-116, *Actions Can Be Taken to Improve the Identification of Tax Return Preparers Who Submit Improper Earned Income Tax Credit Claims* (2010).

score to identify potentially noncompliant tax return preparers, the score was not used exclusively when identifying and selecting preparers for a due diligence visit.[34]

Contract and Other Payments

Federal contract spending has more than doubled since 2002. In Fiscal Year 2008, the Federal Government spent approximately $540 billion to acquire goods and services. Similarly, contract spending by the IRS represents a significant outlay of funds. As of March 2010, the IRS administered more than 839 contracts with a value of approximately $48 billion over the life of the contracts. Numerous past TIGTA audits have identified millions of dollars in questioned costs and several instances of contractor fraud.

We recently analyzed TIGTA audit findings related to the IRS's acquisition process from audit reports that were issued from January 1999 through June 2009. We identified several findings that continued to exist throughout the 10-year period, and which, if not corrected, could affect the IRS's ability to effectively prevent erroneous and improper payments and credits. Among TIGTA's findings: 1) the IRS did not have sufficient monitoring controls or processes to ensure contractors were meeting the contract terms and conditions; 2) contractors did not provide adequate documentation to support invoice charges; and, 3) invoices included unallowable labor and travel charges.[35]

GLOBALIZATION

The scope, complexity, and magnitude of the international financial system present significant enforcement challenges for the IRS. International business holdings and investment in the United States have grown from nearly $188 billion in 1976 to over $14.5 trillion in 2007, while U.S. business and investment grew from nearly $368 billion to nearly $15 trillion over the same period. As technology continues to advance and cross-border transactions rise, the IRS is increasingly challenged by economic globalization. Technological advances have provided opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

The number of taxpayers who conduct international business transactions – individuals, businesses and tax-exempt organizations – continues to grow. The IRS is challenged by a lack of information reporting on many cross-border transactions. In addition, the varying legal requirements imposed by different jurisdictions result in complex business structures that make it difficult to determine the full scope and effect of cross-border transactions.

Over the past few years, the Federal Government has taken actions to better coordinate international tax compliance issues. The IRS has developed a strategic plan specifically for international tax issues with two major goals: 1) enforce the law to ensure all taxpayers meet their obligation to pay taxes and 2) improve service to make voluntary compliance less burdensome. The IRS has also worked with the U.S. Department of

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[34] A due diligence visit is an examination to determine whether a paid preparer is in compliance with all four due diligence requirements. 26 U.S.C. Section 6695.
[35] Treasury Inspector General for Tax Administration, Ref. No. 2010-10-088, *Procurement Audit Results Indicate Problems Continue to Exist After Corrective Actions Were Implemented* (2010).

Justice on tax evasion cases that involve foreign countries with bank secrecy laws that prevent the U.S. from obtaining information on taxpayer transactions. Additionally, the President's Fiscal Year 2010 budget contained several proposals to change offshore tax strategies.[36] The proposals targeted both businesses and individuals with a particular emphasis on increasing transparency. This year, the IRS announced that it would realign and rename its Large and Mid-Size Business division to create a more centralized organization dedicated to improving international tax compliance. The IRS expects that the realigned division, now referred to as the Large Business and International division, will improve international tax compliance by allowing the IRS to focus on high-risk issues and cases with greater consistency and efficiency.

As capital markets become increasingly global, U.S. investors may be able to benefit from a corresponding increase in international investment opportunities. In this environment, the Securities and Exchange Commission (SEC) believes that U.S. investors would benefit from an enhanced ability to compare financial information of U.S. companies with that of non-U.S. companies. The SEC believes the International Financial Reporting Standards (IFRS)[37] have the potential to best provide the common platform on which companies can report and investors can compare financial information. In November 2008, the SEC proposed a "Roadmap" that would potentially require U.S. domestic issuers of annual reports to the SEC to use the IFRS. The "Roadmap" sets forth several milestones that, if reached, could lead to the mandatory use of the IFRS by U.S. issuers in their filings with the SEC in Calendar Year 2015 at the earliest. In Fiscal Year 2010, we assessed the IRS's progress in preparing for the tax issues and implications of potentially converting from United States Generally Accepted Accounting Principles to the IFRS. Our report noted the IRS's progress in this area.[38]

In another recent audit related to globalization, we reviewed the processing of U.S. Nonresident Alien Income Tax Returns (Form 1040NR) to determine whether controls were in place to ensure that taxpayers receiving refunds are entitled to those refunds. Our audit revealed significant control weaknesses in the processing of refunds claimed on Forms 1040NR. If the IRS does not take immediate steps to address these control weaknesses, the problem could increase significantly. We also found a lack of consistency by the IRS when applying tax treaty provisions regarding the taxability of gambling income and a need for clarification regarding the designation of certain income earned through U.S.-based, multi-level marketing companies as "U.S. Source Income." [39]

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[36] *General Explanations of the Administration's 2010 Budget Proposal*. Department of the Treasury (Issued May 2009).

[37] The IFRS, issued by the International Accounting Standards Board, are a set of accounting standards that serve as a framework for financial reporting. The IFRS are rapidly gaining worldwide acceptance and are now used for public reporting purposes in more than 100 countries.

[38] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-112, *Actions Are Being Taken to Address the Impact That International Financial Reporting Standards Will Have on Tax Administration* (2010).

[39] Treasury Inspector General for Tax Administration, Ref. No. 2010-40-121, *Improvements Are Needed to Verify Refunds to Nonresident Aliens Before the Refunds Are Sent Out of the United States* (2010).

TAXPAYER PROTECTION AND RIGHTS

The IRS must ensure that tax compliance activities are balanced against the rights of taxpayers to receive fair and equitable treatment. The IRS continues to dedicate significant resources and attention to implementing the taxpayer rights provisions of the *IRS Restructuring and Reform Act of 1998* (RRA 98).[40] Annual audit reports are mandated for the following taxpayer rights provisions:

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

In general, the IRS has improved its compliance with these statutory taxpayer rights provisions. The IRS has shown improvement over prior years when documenting that taxpayers were informed of their rights. However, the IRS did not fully comply with requirements concerning the use of records of tax enforcement results to evaluate employees,[41] and did not always follow procedures for mailing notices to taxpayers or their representatives in Federal tax lien cases.[42]

Some IRS management information systems do not track cases that require mandatory annual audit coverage.[43] Thus, neither TIGTA nor the IRS could evaluate the IRS's compliance with certain RRA 98 provisions.

LEVERAGING DATA TO IMPROVE PROGRAM EFFECTIVENESS AND REDUCE COSTS

While the IRS has made progress in using its data to improve program effectiveness and reduce costs, this area continues to be a major challenge. The IRS lacks a comprehensive, integrated system that provides accurate, relevant and timely financial and operating data that can be used to evaluate performance measures, productivity and the associated costs of IRS programs. In addition, the IRS cannot produce timely,

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[40] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[41] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-076, *Fiscal Year 2010 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results* (2010).
[42] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-072, *Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (2010).
[43] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-026, *Fiscal Year 2010 Statutory Review of Disclosure of Collection Activity With Respect to Joint Returns* (2010) and Treasury Inspector General for Tax Administration, Ref. No. 2010-30-060, *Fiscal Year 2010 Statutory Review of Restrictions on Directly Contacting Taxpayers* (2010).

accurate and useful information needed for day-to-day decisions, hindering its ability to address financial management and operational issues to fulfill its responsibilities.

TIGTA and GAO have continued to report that various IRS management information systems are insufficient to enable IRS management to measure costs, determine if performance goals have been achieved, or monitor progress in achieving program goals. In its most recent financial statement audit,[44] GAO reported that the IRS's financial management systems do not comply with *Federal Financial Management Improvement Act of 1996* (FFMIA)[45] requirements. In addition, GAO noted that the IRS continues to have material weaknesses in internal controls over information security and unpaid assessments.

While the IRS has made measurable progress in addressing the issues causing its noncompliance with the FFMIA, our review of the IRS's September 30, 2009, FFMIA remediation plan identified that the IRS continues to experience difficulties in developing resource estimates for remediation actions related to information security. In addition, the IRS informed us that it does not expect to become compliant with the FFMIA and address the material weakness relating to unpaid assessments until approximately November 2014.[46]

CONCLUSION

These are the 10 major management and performance challenges for the IRS in Fiscal Year 2011. TIGTA's *Fiscal Year 2011 Annual Audit Plan* and *Inspections and Evaluations Plan* contain our proposed reviews and are organized by these challenges. If you have questions or wish to discuss TIGTA's views on the challenges in greater detail, please contact me at (202) 622-6500.

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

[44] U.S. Government Accountability Office, GAO-10-176, *Financial Audit: IRS's Fiscal Years 2009 and 2008 Financial Statements* (2009).
[45] Pub. L. No. 104-208, 110 Stat. 3009.
[46] Treasury Inspector General for Tax Administration, Ref. No. 2010-10-065, *Measurable Progress Has Been Made in Addressing Federal Financial Management Improvement Act Noncompliance; However, Significant Challenges Remain* (2010).