INSPECTOR GENERAL
FOR TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20005

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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 2013

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 2013*, its perspective on the most serious management and performance challenges confronting the Internal Revenue Service (IRS).

Each year, TIGTA evaluates IRS programs, operations, and management functions to identify the areas of highest vulnerability to the Nation's tax system. For Fiscal Year 2013, the top management and performance challenges in order of priority are:

1. Security for Taxpayer Data and Employees;
2. Tax Compliance Initiatives;
3. Modernization;
4. Implementing the Affordable Care Act and Other Tax Law Changes;
5. Fraudulent Claims and Improper Payments;
6. Providing Quality Taxpayer Service Operations;
7. Human Capital;
8. Globalization;
9. Taxpayer Protection and Rights; and
10. Achieving Program Efficiencies and Cost Savings.

While TIGTA's assessment of the major IRS management challenge areas for Fiscal Year 2013 has remained relatively unchanged from the prior fiscal year, we decided to distinguish the significance of Tax Compliance Initiatives from Modernization. Last year, Tax Compliance Initiatives and Modernization were both ranked as number two. However, with the demand for accountability to the American taxpayer, we believe it is more important than ever for the IRS to efficiently and effectively collect taxes owed to the Federal Government. Lastly, the Implementing Tax Law Changes challenge area was expanded to encompass the *Patient Protection and Affordable Care Act* (Affordable

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[1] 31 U.S.C. § 3516(d) (2006).

Care Act),[2] and is now titled Implementing the Affordable Care Act and Other Tax Law Changes.

Although not listed, complexity of the tax laws 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 trying to comply.

The following information detailing these management and performance challenges is being provided to promote economy, efficiency, and effectiveness in the IRS's administration of the Nation's tax laws.

SECURITY FOR TAXPAYER DATA AND EMPLOYEES

As our Nation's tax collector and administrator of the Internal Revenue Code, the IRS received more than 234 million tax returns, of which 143 million were from individual taxpayers, and collected more than $2.4 trillion in revenue in Fiscal Year 2011. Information from these tax returns is converted into electronic format, processed, and maintained in 178 computer system applications for use by IRS employees.

The IRS faces the daunting task of securing its computer systems against the growing threat of cyberattacks. Effective information systems security becomes essential to ensure that data are protected against inadvertent or deliberate misuse, improper disclosure or destruction, and that computer operations supporting tax administration are secured against disruption or compromise. According to the Department of Homeland Security's U.S. Computer Emergency Readiness Team, Federal agencies reported 43,889 cyberattacks in Fiscal Year 2011, an increase of about five percent since Fiscal Year 2010.[3]

Computer security has been problematic for the IRS since 1997, when the IRS initially reported computer security as a material weakness during its annual evaluation of internal accounting and administrative controls under the *Federal Managers' Financial Integrity Act of 1982*.[4] TIGTA continues to identify significant security weaknesses in this area. In addition, the Government Accountability Office reported that security deficiencies identified in conjunction with its review of the IRS's financial statement audits for Fiscal Years 2010 and 2011 are the basis of its determination that the IRS had a material weakness in internal controls over financial reporting related to

[2] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

[3] Office of Management and Budget, Fiscal Year 2011 Report to Congress on the Implementation of The Federal Information Security Management Act of 2002 (Mar. 2012).

[4] 31 U.S.C. §§ 1105, 1113, and 3512. The *Federal Managers' Financial Integrity Act* (FMFIA) requires that agency management establish and maintain effective internal controls to achieve the objectives of: 1) effective and efficient operations, 2) reliable financial reporting, and 3) compliance with applicable laws and regulations. The FMFIA also requires the head of each Executive agency to report annually to the President and Congress on the effectiveness of the internal controls and to identify any material weaknesses in those controls. Reporting material weaknesses under the FMFIA is not limited to weaknesses over financial reporting.

information security.[5] While the IRS has made progress in the area of computer security, it still needs to continue to place a high priority on improvements.

Beyond safeguarding a vast amount of sensitive financial and personal data, the IRS must also protect approximately 100,000 employees and contractors working in approximately 630 facilities throughout the country. The IRS has enhanced security nationwide, including acquiring new or additional guard services at IRS facilities. Additionally, the IRS obtained the services of an outside consultant to provide an independent review of its physical security. However, TIGTA determined that the IRS did not receive the in-depth, independent assessment regarding the security posture of its facilities as required by the contract, and the contractor declined to provide a validation of the acceptability of the IRS's security posture.[6]

During the last three years, threats to the IRS have increased 24 percent. Physical violence, harassment, and intimidation of IRS employees continue to pose significant challenges to the implementation of a fair and effective system of tax administration.

During Fiscal Year 2011, TIGTA evaluated in excess of 2,700 threat-related complaints. This resulted in the initiation of 1,400 threat investigations that required TIGTA Special Agents to promptly respond to mitigate those threats and to determine whether criminal prosecutions of the perpetrators making the threats were warranted.

Additionally, the ongoing public debate regarding the health care law and continued concern over the country's economy could fuel threats against the Federal Government, including IRS employees and facilities. These are challenging operating conditions for the IRS that underscore the need for continued vigilance in the area of physical and personnel security.

TAX COMPLIANCE INITIATIVES

Another serious challenge confronting the IRS is tax compliance. Despite an estimated voluntary compliance rate of approximately 83 percent in the IRS's January 2012 updated Tax Gap[7] estimates 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 oversight of tax-exempt and government entities.

Increasing voluntary taxpayer compliance and reducing the Tax Gap are the focus of many IRS initiatives. Although the IRS reported that the Tax Gap is caused by both unintentional taxpayer errors (whether due to tax law complexity, confusion, or carelessness) and willful tax evasion or cheating, the IRS does not have sufficient data to distinguish the amounts attributable to each. The IRS also reported that a meaningful improvement in the voluntary compliance rate requires a long-term, focused effort

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[5] GAO, Ref. No. GAO-12-165, *Financial Audit: IRS's Fiscal Years 2011 and 2010 Financial Statements* (Nov. 2011).

[6] TIGTA, Ref. No. 2012-10-075, *An Independent Assessment of Facility Physical Security Was Not Performed in Compliance With Contract Requirements* (July 2012).

[7] 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.

involving taxpayer service, modernization, and enforcement. 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 2013 budget submission, the IRS requested a 7.6 percent increase in enforcement funds over its Fiscal Year 2012 enacted level.

Businesses and Individuals

The IRS estimated the gross Tax Gap for Tax Year 2006 to be approximately $450 billion. The underreporting of taxes, which is comprised of four major components (individual income tax, employment tax, corporate income tax, and estate and excise taxes), was estimated at $376 billion and accounted for the largest portion (approximately 84 percent) of the Tax Gap. The underpayment of taxes was approximately 10 percent, and the nonfiling of taxes was approximately six percent. The IRS will need to address the following impediments to more effectively address the Tax Gap:

- **Incomplete compliance research** that does not identify all the sources of noncompliance so that IRS resources can be targeted properly.
- **Insufficient compliance strategies** that do not always address the areas of highest risk of noncompliance. The IRS reported it is working to reengineer examination and collection procedures based on improved data from its National Research Project study of individual taxpayers.
- **Incomplete document matching programs** because the IRS does not have reliable third-party data for all taxpayer sectors and for all types of tax returns, most notably income earned by the self-employed. The IRS reported that, without these data, it cannot easily detect errors or potential fraud except through expensive and intrusive examinations.
- **Insufficient enforcement resources** to handle a growing caseload. The IRS has identified noncompliance and potential fraud cases it did not have the resources to work, allowing billions of dollars to be fraudulently refunded each year.

Tax-Exempt Entities

The IRS's challenge related to tax-exempt and government entities is providing assistance to those entities that provide a societal benefit while ensuring that the entities remain in compliance with the tax laws associated with their tax-exempt status. Legislative changes and judicial decisions contribute to a constantly changing environment affecting today's nonprofit and tax-exempt organizations. The *Pension Protection Act of 2006*[8] mandates that tax-exempt organizations file certain information electronically with the IRS. Previously, these organizations were not required to file an annual information return unless their gross receipts exceeded certain dollar thresholds. The Act further requires the IRS to publish and maintain a list of organizations whose tax-exempt status has been automatically revoked.

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[8] Pub. L. No. 109-280, 120 Stat. 780.

TIGTA reported that the Exempt Organizations function educated tax-exempt organizations on the requirements of the Act and identified and informed organizations that their tax-exempt status had been automatically revoked. However, the Exempt Organizations function did not identify all organizations that should have been informed about their revocations and did not clearly inform organizations on how to regain their tax-exempt status if they were still operating.[9] TIGTA also reported that while the Exempt Organizations function has greatly improved its timeliness with regard to acknowledging complaints against tax-exempt organizations, referrals were not always controlled or processed timely. If referrals are not properly accounted for or worked timely, the Exempt Organizations function may not identify tax-exempt organizations that are potentially in violation of Federal tax law or have referrals ready when new examination cases are needed.[10]

Tax Return Preparers

Every year, more than half of all taxpayers pay someone else to prepare their Federal income tax returns. During the 2012 Filing Season,[11] the IRS processed approximately 71 million individual Federal income tax returns prepared by paid tax return preparers.

In December 2009, the IRS announced a suite of proposed reforms to improve oversight of the return preparer community. In September 2010, TIGTA reported that it will take years for the IRS to implement the Return Preparer Program and to realize its impact.[12] In December 2011, TIGTA reported that improvements are ongoing to ensure that the preparer registration process has effective controls and system validations.[13] However, not until January 2014 will all preparers be subjected to all suitability and competency tests.

MODERNIZATION

The Business Systems Modernization Program (Modernization 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 completion of the Modernization Program would take up to 15 years and incur contractor costs of approximately $8 billion. The Modernization Program was funded for $330.2 million for Fiscal Year 2012 and the President's Budget request for Fiscal Year 2013 was also $330.2 million. The Modernization Program's goals include:

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[9] TIGTA, Ref. No. 2012-10-027, *Appropriate Actions Were Taken to Identify Thousands of Organizations Whose Tax-Exempt Status Has Been Automatically Revoked, but Improvements Are Needed* (Mar. 2012).
[10] TIGTA, Ref. No. 2012-10-058, *Implementing Better Management Controls Would Improve the Exempt Organizations Function's Ability to Oversee and Timely Process Referrals* (June 2012).
[11] The period from January 1 through April 15 when most individual income tax returns are filed.
[12] TIGTA, Ref. No. 2010-40-127, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (Sept. 2010).
[13] TIGTA, Ref. No. 2012-40-010, *More Tax Return Preparers Are Filing Electronically, but Better Controls Are Needed to Ensure All Are Complying With the New Preparer Regulations* (Dec. 2011).

- Issuing refunds, on average, five days faster than existing legacy systems;
- Offering electronic filing capability for individuals, large corporations, small businesses, tax-exempt organizations, and partnerships, with dramatically reduced processing error rates;
- Delivering web-based services for tax practitioners, taxpayers, and IRS employees;
- Implementing data analytics to reduce improper payments and fraudulent refunds; 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 IRS's modernization efforts continue to focus on core tax administration systems designed to provide more sophisticated tools to taxpayers and IRS employees. These efforts will provide the foundation for implementing a real-time tax system, reducing improper payments and fraudulent refunds, and providing the technology infrastructure and architecture that will enable taxpayers and other stakeholders the capability to securely access tax account information. These complex efforts continue to pose significant technological and business challenges for the IRS.

Since January 2012, the IRS has implemented daily updating of taxpayer accounts and daily processing of returns; however, the implementation of the Customer Account Data Engine 2 (CADE-2) relational database designed to replace the 1960s-era Individual Master File is at risk of not meeting timeframes for providing data to other systems. Additionally, while the IRS has upgraded the Modernized e-File system to accept and process over 125 new individual tax forms, performance issues threaten goals to retire the legacy electronic filing system and have delayed the implementation of employment-related business forms. Modernizing legacy tax administration systems to receive and process CADE-2 data and to process new legislative changes, such as the Affordable Care Act, will continue to be a major challenge for the IRS.

The IRS has identified and reported the Modernization Program as a material weakness since 1995. However, in a June 2011 memorandum to the Department of the Treasury, the IRS Commissioner stated that the previously identified internal and management control issues have been fully addressed and that the Modernization Program no longer warranted being identified as a material weakness. The Department of the Treasury agreed to downgrade the material weakness. While we support the IRS's decision, we believe the Modernization Program remains a major management challenge, and the IRS should continue to stress improvements in its overall processes and performance.

IMPLEMENTING THE AFFORDABLE CARE ACT AND OTHER TAX LAW CHANGES

Each filing season tests the IRS's ability to implement tax law changes made by Congress. 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 that 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 computer systems to accurately and timely process tax returns affected by the new tax law changes. Sometimes, despite all of its efforts, the IRS may have to delay the processing of some tax returns or quickly correct computer programming if early processing errors surface. Effective implementation of tax-related provisions of the Affordable Care Act and changes to tax laws will continue to challenge IRS resources.

Affordable Care Act

The Affordable Care Act contains an extensive array of tax law changes that will present a continuing source of challenges 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 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 provisions will require the IRS to build new processes that do not exist within the current system of tax administration. 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;
- Administering multiple tax provisions designed to raise revenues to offset the cost of health care reform; and,
- Protecting additional data entrusted to the IRS from the risk of loss or identity theft.

Results of TIGTA audits illustrate the need for continued oversight of the IRS's administration of many of these tax-related provisions. TIGTA recently reported that the IRS did not require sufficient information to determine whether taxpayers claiming Small Business Health Care Tax Credits filed required employment taxes when these taxpayers entered into a contractual relationship with professional employment organizations to manage human resources.[14] TIGTA also determined that the IRS did not take adequate steps to ensure that taxpayers potentially liable for the indoor tanning excise tax were aware of the new tax law, particularly after the number of taxpayers filing tax returns reporting the excise tax for tanning services was much lower than expected.[15]

TIGTA also reported that taxpayers erroneously received millions of dollars in Adoption Credits. A provision in the Affordable Care Act increased the Adoption

[14] TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (Sept. 2011).
[15] TIGTA, Ref. No. 2011-40-115, *Affordable Care Act: Number of Taxpayers Filing Tanning Excise Tax Returns Is Lower Than Expected* (Sept. 2011).

Credit and made the tax credit refundable.[16] Although the IRS requires taxpayers to attach documentation to their tax returns supporting Adoption Credit claims, it does not have the authority to deny the credits if documentation is not provided. As a result, tax returns without required documentation must be sent to the Examination function. As of December 23, 2011, the IRS had received 101,627 Adoption Credit claims totaling more than $1.2 billion for Fiscal Year 2010. We reported that 4,258 taxpayers received almost $49.3 million in Adoption Credits without sufficient supporting documentation.[17] Of these 4,258 taxpayers, TIGTA estimated that 953 tax returns claiming more than $11 million in Adoption Credits were erroneous.

Other Tax Law Changes

More than 1.5 million taxpayers who purchased a home between April 9 and December 31, 2008, and claimed the First-Time Homebuyer Credit (Homebuyer Credit), were required to begin repaying the credit on their Tax Year 2010 tax return. The credit is intended to be repaid over 15 years, in equal annual installments. However, the IRS experienced difficulties in implementing the repayment process. As of May 2, 2012, the IRS had inaccurately processed 66 percent (3,819 of 5,756) of taxpayer accounts for which the taxpayer filed a joint tax return with his or her spouse when the Homebuyer Credit was claimed but the ownership of the property was later transferred as part of a divorce settlement. As a result of incorrectly overstating the new Homebuyer Credit repayment obligation, the IRS incorrectly assessed more than $650,000 in additional tax for 136 tax accounts. The IRS also understated the net Homebuyer Credit repayment obligation for 3,683 taxpayers and erroneously reduced the amount these taxpayers were required to repay by more than $13.1 million.[18]

FRAUDULENT CLAIMS AND IMPROPER PAYMENTS

The *Improper Payments Information Act of 2002*[19] defines an improper payment as any payment that should not have been made or that was made in an incorrect amount (both overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. The Administration has emphasized the importance of reducing improper payments. On November 20, 2009, the President signed Executive Order 13520,[20] which included a strategy to reduce improper payments by increasing transparency, holding agencies accountable, and creating strong incentives for compliance. In addition, the *Improper Payments Elimination and Recovery Act of 2010*[21] placed additional requirements on Federal agencies to reduce

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[16] A refundable tax credit is a tax credit that is treated as a payment and can be refunded to the taxpayer. Refundable credits can create a Federal tax refund that is larger than the amount a person actually paid in taxes during the year.
[17] TIGTA, Ref. No. 2012-40-065, *Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals* (June 2012).
[18] TIGTA, Ref. No. 2012-40-119, *The Majority of Individual Tax Returns Were Processed Timely, but Not All Tax Credits Were Processed Correctly During the 2012 Filing Season* (Sept. 2012).
[19] Pub. L. No. 107-300, 116 Stat. 2350.
[20] Executive Order No. 13,520, 74 Fed. Reg. 62201 (Nov. 25, 2009), *Reducing Improper Payments and Eliminating Waste in Federal Programs.*
[21] Pub. L. No. 111-204, 124 Stat. 2224.

improper payments. Erroneous and improper payments issued by the IRS generally involve improperly paid refunds, tax-return filing fraud, or improper payments to vendors or contractors.

Refundable Credits

The IRS administers numerous refundable tax credits. These refundable credits allow individual taxpayers to reduce their tax liability to 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 and the Additional Child Tax Credit.

During Tax Years 2006 through 2009, taxpayers claimed almost $470 billion in refundable credits. Due to post-refund examinations, taxpayers were required to repay more than an estimated $2.3 billion in erroneous credits. By the end of December 2011, the IRS had recovered an estimated $1.3 billion, of which more than 70 percent was collected through refund offsets.

Refunds for the Additional Child Tax Credit processed in Fiscal Year 2010 totaled $28.3 billion, and TIGTA reported that the IRS paid $4.2 billion for this credit in Processing Year 2010 to individuals who were not authorized to work in the United States. Taxpayers also repeatedly claimed erroneous Additional Child Tax Credits after being disallowed the credit in the previous year. TIGTA determined that the IRS could have saved an additional $108 million by reviewing claims made by taxpayers who were previously disallowed the credit. In addition, the IRS could have prevented issuance of approximately $419 million in erroneous Additional Child Tax Credit refunds had it reviewed the Additional Child Tax Credit at the same time the Earned Income Tax Credit was being reviewed.[22]

Fraudulent Payments

Identity theft is escalating and poses significant challenges for the IRS. In Calendar Year 2011, the IRS identified over 1.1 million incidents of identity theft that affected the Nation's tax system.[23] The IRS has stepped up its efforts against refund fraud and identity theft. These efforts include designing new identity-theft-screening filters that the IRS believes will improve its ability to identify false tax returns before they are processed and before fraudulent refunds are issued. As of April 19, 2012, the IRS reported that it has stopped the issuance of $1.3 billion of potentially fraudulent tax refunds as a result of the new identity-theft filters. However, TIGTA determined that the impact of identity theft on tax administration is significantly higher than the amount the IRS detects and prevents. Our analysis of Tax Year 2010 tax returns

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[22] TIGTA, Ref No. 2012-40-105, *Expansion of Controls Over Refundable Credits Could Help Reduce the Billions of Dollars of Improperly Paid Claims* (Aug. 2012).
[23] This includes incidents in which taxpayers contacted the IRS alleging that they were victims of identity theft, as well as instances where the IRS identified identity theft. Many of the taxpayers that the IRS identified were not aware they were victims of identity theft because they either did not file tax returns or did not have filing requirements.

identified more than $5.2 billion in tax refunds issued to individuals filing tax returns with characteristics of identity-theft cases confirmed by the IRS.[24]

Contract and Other Payments

The IRS expends approximately $2.1 billion annually in contract spending, an area which continues to experience several risks for fraud and abuse. Previous TIGTA investigations and audits have identified millions of dollars in questioned costs and several instances of contractor fraud. During Fiscal Years 2010 and 2011, TIGTA's criminal investigative efforts contributed to court-ordered civil settlements which required Government contractors to pay $156 million and $113 million, respectively, to the U.S. treasury. These payments were the result of Federal procurement law violations that occurred with work contracted with multiple Federal agencies, including the IRS.

During these investigations, two recurring trends emerged: contracting officer's representatives were frequently overwhelmed by their workloads, and current business practices have not enhanced the IRS's ability to identify anomalies warranting additional review.

TIGTA recently performed an assessment of the IRS's controls over contract invoice review, approval, and payment processes to identify whether improper payments were made to contractors. TIGTA reported that the IRS did not have documentation supporting $384,430 of the invoiced labor hours that were paid. Applying the results to the population of labor charges, we estimate a total of $927,992 may have been erroneously paid.[25]

Another TIGTA review identified that the IRS is not always charging other entities for the full costs of the work performed on reimbursable agreements. We identified more than $28 million in costs incurred by the IRS that were not reimbursed. When the IRS is reimbursed less than the cost of performing reimbursable work, it must fund this work using its own operating budget, thereby reducing the funds available for tax administration.[26]

PROVIDING QUALITY TAXPAYER SERVICE OPERATIONS

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 in correctly preparing their returns reduces the need to send notices and correspondence when taxpayers make errors. Taxpayer service 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

[24] TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (July 2012).
[25] TIGTA, Ref. No. 21012-11-101, *Deficiencies Continue to Exist in Verifying Contractor Labor Charges Prior to Payment* (Aug. 2012).
[26] TIGTA, Ref. No. 2011-10-076, *The Full Costs of Work Performed on Reimbursable Agreements Are Not Always Charged, Resulting in Reduced Funds Available for Tax Administration* (July 2012).

simplify or eliminate processes that unnecessarily burden taxpayers or Federal Government resources.

Although the number of identity-theft cases is increasing, TIGTA found that the IRS is not effectively providing assistance to victims of identity theft. Identity-theft cases are not worked timely and can take more than a year to resolve. Communications between the IRS and victims are limited and confusing, and victims are asked multiple times to substantiate their identity, increasing the burden to these taxpayers. IRS guidelines are inconsistent and not all functions within the IRS have guidelines for handling identity-theft issues. In November 2011, the IRS established a Taxpayer Protection Unit to manage identity-theft cases. However, during the 2012 Filing Season, taxpayers found it difficult to reach employees in this unit. The unit received more than 86,000 calls during the Filing Season, but was only able to answer about 21,000 of these calls. The average wait time for taxpayers was almost one hour.

The IRS assisted approximately 2 million individuals at its walk-in Taxpayer Assistance Centers during the 2012 Filing Season. In addition, more taxpayers are calling the IRS's toll-free telephone lines every year, with approximately 90 million calls attempted to the various toll-free telephone assistance lines during the 2012 Filing Season. However, as a result of budget constraints, tax return preparation was provided only on a limited number of days per week, and the IRS did not provide the planned extended hours for the Taxpayer Assistance Centers. Additionally, a reduction in funding for toll-free telephone and correspondence services resulted in a Level of Service goal for Fiscal Year 2012 of 61 percent, compared to the 70 percent the IRS achieved in Fiscal Year 2011.

Furthermore, our recent review of the Taxpayer Advocate Service's toll-free telephone lines determined that the Taxpayer Advocate Service does not have a formalized process to track or analyze the calls received by the ASK-TAS1 toll-free line to assess the effectiveness of its outreach efforts in generating cases meeting Taxpayer Advocate Service case criteria. Taxpayers specifically requesting Taxpayer Advocate Service assistance have several telephone options, including the ASK-TAS1 toll-free line staffed by Taxpayer Advocate Service personnel. Additional documentation and analysis is necessary to evaluate the impact of the ASK-TAS1 toll-free line and ensure that proposed changes to the line provide the expected benefits without adversely affecting taxpayers.[27]

HUMAN CAPITAL

Human capital is the Federal Government's most critical asset. At a time when agencies are preparing for increased retirements and taking on such challenges as implementing the numerous health care tax provisions, the recruitment and retention of employees plays a key role in maintaining a quality workforce. Like many Federal agencies, the IRS is faced with the major challenge of replacing existing talent caused by a large number of retirements expected over the next several years. In five years, about one-third of the IRS's workforce of approximately 100,000 employees will be

[27] TIGTA, Ref. No. 2012-10-052, *The Taxpayer Advocate Service's ASK-TAS1 Toll-Free Line Has Evolved Over Time, but Additional Steps Are necessary to Evaluate Its Impact* (June 2012).

eligible to retire. In the leadership ranks, over two-thirds of IRS executives will be eligible for retirement in five years. Adding to this challenge, the IRS offered early retirement and buyouts to more than 2,200 employees in Fiscal Year 2012.

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 and as attempts by taxpayers and tax practitioners to evade compliance with the tax laws grows and becomes more sophisticated. The IRS must also compete with other Federal agencies and private industry for the same human resources, which becomes more complicated as younger generations of employees move between jobs more frequently than their predecessors. Further, budget constraints, legislative changes, and economic shifts can create unforeseen challenges for the IRS in addressing its long-term human capital issues.

While the IRS is improving its human capital management practices and has developed a comprehensive agency-wide recruitment strategy, there is still much work to be done. TIGTA recently reported that the IRS has improved its process for onboarding new employees; however, managers interviewed by TIGTA indicated they were not following best practices, as identified in the comprehensive guidance the IRS developed for them. As a result, some best practices that would help new employees become more productive were not fully implemented. Improved processes would reduce the substantial cost of replacing employees who leave the IRS and would help the IRS meet its mission by ensuring that employees quickly become productive.[28]

The IRS is also at risk when the workforce turns over at a high rate resulting in the loss of experience. This loss of experience needs to be offset by strong managerial oversight and internal controls or it can foster an environment where employee misconduct and criminal acts can go unreported and undetected. All employees need to be aware and vigilant in their responsibilities for maintaining the highest degree of integrity within the Federal Government.

GLOBALIZATION

The scope, complexity, and magnitude of the international financial system presents 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 during the same period. The number of taxpayers conducting international business transactions continues to grow as technological advances provide opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

As technology continues to advance and cross-border transactions rise, the IRS is increasingly challenged by economic globalization. The IRS is confronted with a lack of

[28] TIGTA, Ref. No. 2012-10-091, *The Onboarding Process Has Improved, but Additional Steps Should Be Taken to Ensure Employees Have the Tools, Resources, and Knowledge to be Successful and Productive* (Aug. 2012).

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.

The IRS has developed a strategic plan specifically for international tax issues with two major goals: (1) enforce the law to ensure that all taxpayers meet their obligation to pay taxes and (2) improve service to make voluntary compliance less burdensome. The IRS continues to realign and expand its international efforts under its Large Business and International Division. The IRS expects that these efforts will improve international tax compliance by allowing it to focus on high-risk issues and work cases with greater consistency and efficiency.

A top priority for the IRS has been to stop offshore tax cheating and bring these taxpayers, especially high net-worth individuals, back into the tax system. The IRS offered Offshore Voluntary Disclosure Initiatives in 2009 and 2011 to encourage taxpayers with hidden offshore assets and income to come back into the tax system using the IRS's Voluntary Disclosure Program. According to the IRS, these initiatives have resulted in the collection of over $4 billion. Due to the success of the first two initiatives, the IRS offered a third opportunity in 2012 for delinquent taxpayers to disclose their hidden offshore assets. In a review of the IRS's 2009 Offshore Voluntary Disclosure Initiative, TIGTA determined that the IRS's disclosure practices increased taxpayer compliance. However, additional oversight is necessary to ensure that information obtained from the voluntary disclosures is accurate and complete to assist the IRS in identifying additional taxpayers and promoters who continue to defraud the Federal Government with their offshore activities.[29]

Another challenge that the IRS currently faces is the implementation of the *Foreign Account Tax Compliance Act* (FATCA).[30] The FATCA was enacted to combat tax evasion by U.S. persons holding investments in offshore accounts. Under this Act, a U.S. taxpayer with financial assets outside the United States will be required to report those assets to the IRS. In addition, foreign financial institutions will be required to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. The FATCA is being phased in by the IRS over several years. Individual taxpayers with an aggregate balance of more than $50,000 in foreign financial assets are required to file a disclosure statement with their income tax return.

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).[31] The following audits related to

[29] TIGTA, Ref. No. 2011-30-118, *The 2009 Offshore Voluntary Disclosure Initiative Increased Taxpayer Compliance, but Some Improvements Are Needed* (Sept. 2011).
[30] Pub. L. No. 111-147, Subtitle A, 124 Stat 71, *96-116 (2010)(codified in scattered sections of 26 U.S.C.).
[31] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered section 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.).

taxpayer rights provisions are mandated annually: Notices of Levies; Restrictions on the Use of Enforcement Statistics to Evaluate Employees; *Fair Debt Collection Practices Act*[32] Violations; Notices of Liens; Seizures; Illegal Protestor Designations; Assessment Statute of Limitations; Collection Due Process Appeals; Denial of Requests for Information; 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 and in documenting that taxpayer rights were protected. However, TIGTA continues to identify the same deficiencies in the IRS's processing of collection due process cases. TIGTA reported in July 2012[33] that the Office of Appeals did not always classify taxpayer requests properly and, as a result, some taxpayers received the wrong type of hearing. TIGTA also identified an increase in errors relating to the determination of the Collection Statute Expiration Data on taxpayer accounts. In addition, TIGTA reported that Appeals personnel continue to fail to document their impartiality in all cases. These deficiencies may result in taxpayers not receiving their full rights during an appeal hearing.

As previously noted, the IRS is seeing a significant growth in identity-theft cases. Identity theft remains the single largest type of complaint submitted to the Federal Trade Commission's Consumer Sentinel Network.[34] The Federal Trade Commission estimates that as many as nine million Americans have their identities stolen each year. Identity theft affects the IRS and tax administration in two ways – fraudulent tax returns and misreporting of income.[35] Both can potentially harm taxpayers who are the victims of identity theft.

ACHIEVING PROGRAM EFFICIENCIES AND COST SAVINGS

Given the current economic environment and the increased focus by the Administration, Congress, and the American people on Federal Government accountability and efficient use of resources, the American people must be able to trust that their Government is taking action to stop wasteful practices and ensure that every tax dollar is spent wisely. During the Fall of 2011 through Summer 2012, numerous Department of the Treasury, Office of Management and Budget, and Presidential Executive Orders and other guidance documents were issued to ensure that the Government is a good steward of taxpayer money by identifying opportunities to promote efficient and effective spending and eliminating excess spending on conferences and travel.

This management challenge is even more compelling given the IRS's Fiscal Year 2012 budget, which was reduced over $300 million from Fiscal Year 2011, approximately a 2.5 percent cut. As a result, the IRS reduced its administrative costs, offered early outs

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[32] 15 U.S.C. §§1601 note, 1692-1692o (2006).
[33] TIGTA, Ref. No. 2012-10-077, *Office of Appeals Errors in the Handling of Collection Due Process Cases Continue to Exist* (July 2012).
[34] The Federal Trade Commission's Consumer Sentinel Network is an investigative cyber tool and complaint database, restricted to law enforcement use, that provides civil and criminal enforcement organizations immediate and secure access to identity theft and other consumer-related complaints.
[35] The Federal Trade Commission's Identity Theft website, *What is Identity Theft?* (http://www.ftc.gov/bcp/edu/microsites/idtheft/consumers/about-identity-theft.html#Whatisidentitytheft).

and buy outs, and made difficult decisions in taxpayer service and enforcement operations.

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. In a recent audit, we assessed the IRS's progress in achieving real estate cost savings to meet the President's Fiscal Year 2012 Federal real estate cost savings goals. On June 10, 2010, President Obama directed Government agencies to eliminate excess properties and achieve $3 billion in savings by the end of Fiscal Year 2012. Our review found that the IRS achieved some cost savings in support of the President's goal. However, these efforts are impeded by the lack of an established policy and effective strategy on implementing workstation sharing by IRS employees who telework. A policy requiring employees who telework to share workstations would allow the IRS to further reduce its long-term office space needs and achieve additional cost savings. This would allow the IRS to reduce its office space needs by almost 1 million square feet, resulting in potential rental savings of approximately $111.4 million over five years.[36]

CONCLUSION

This memorandum is provided as our annual summary of the most serious major management and performance challenges confronting the IRS in Fiscal Year 2013. TIGTA's *Fiscal Year 2013 Annual Audit Plan* contains our proposed reviews, which are organized by these challenges. If you have any questions or wish to discuss our views on the challenges in greater detail, please contact me at (202) 622-6500.

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

[36] TIGTA, Ref. No. 2012-10-100, *Significant Additional Real Estate Cost Savings Can be Achieved by Implementing a Telework Workstation Sharing Strategy* (Aug. 2012).