

**HEARING BEFORE THE  
COMMITTEE ON APPROPRIATIONS  
SUBCOMMITTEE ON  
FINANCIAL SERVICES AND GENERAL GOVERNMENT  
U.S. HOUSE OF REPRESENTATIVES**

**“Budget Hearing with the  
Treasury Inspector General for Tax Administration”**



**April 15, 2011**

**Washington, D.C.**

**Testimony of  
The Honorable J. Russell George  
Treasury Inspector General for Tax Administration**

TESTIMONY OF  
THE HONORABLE J. RUSSELL GEORGE  
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION  
*before the*  
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Chairwoman Emerson, Ranking Member Serrano, and Members of the Subcommittee, I thank you for the opportunity to testify on accountability over the Internal Revenue Service (IRS) in administering the Nation’s tax laws. My comments will focus on how the Treasury Inspector General for Tax Administration (TIGTA) provides accountability for the IRS and oversight of its budget as well as the most significant challenges currently facing the IRS.

TIGTA plays a critical role in ensuring the accountability of the IRS. In accordance with the *Inspector General Act of 1978*, as amended, we conduct independent and objective audits, investigations, and reviews of IRS programs and operations.<sup>1</sup> TIGTA provides leadership and develops recommendations to promote economy, efficiency, and effectiveness and to detect and prevent fraud, waste, and abuse in IRS programs and operations. TIGTA reports the results of its investigations, audits, and reviews semiannually to the Congress, the Secretary of the Treasury, the IRS Commissioner, and the American people to maintain current awareness of the programmatic and operational challenges facing the IRS. We refer criminal matters to the United States (U.S.) Department of Justice and other law enforcement entities for prosecution and also investigate and refer allegations of misconduct by IRS employees and contractors to the IRS for administrative action. Appendix I provides a statistical summary of selected TIGTA accomplishments from Fiscal Year 1999 to Fiscal Year 2010.

Another important way TIGTA provides accountability is through the identification of the major challenges facing the IRS. The *Reports Consolidation Act of 2000*<sup>2</sup> requires TIGTA to summarize for inclusion in the *Department of the Treasury*

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<sup>1</sup> 5 U.S.C. App. 3 §§ 2(1), 4(a)(1).

<sup>2</sup> 31 U.S.C. § 3516(d).

*Accountability Report* our perspective on the most serious management and performance challenges facing the IRS. This list of challenges forms the basis of our audit work concerning IRS programs and activities. The *Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2011* memorandum is included as Appendix II.

## **OVERVIEW OF THE IRS'S FISCAL YEAR 2012 BUDGET REQUEST**

The IRS is the largest component of the Department of the Treasury and has primary responsibility for administering the Federal tax system. Since the Federal tax system is a system that relies upon voluntary compliance, almost everything the IRS does is in some way related to fostering compliance with tax laws. The IRS provides taxpayer service programs that help millions of taxpayers to understand and meet their tax obligations and administers enforcement programs aimed at deterring taxpayers who are inclined to evade their responsibilities. The IRS is charged with vigorously pursuing those who violate tax laws.

The IRS must strive to enforce the tax laws fairly and efficiently while balancing service and education to promote voluntary compliance and reduce taxpayer burden. To accomplish these efforts, the proposed Fiscal Year 2012 IRS budget requested appropriated resources of \$13.3 billion.<sup>3</sup> The total appropriations amount is an increase of \$1.138 billion, or approximately 9.4 percent, more than the Fiscal Year 2010 enacted level. The budget request includes a net increase in staffing for the IRS of over 5,100 employees, to total over 100,500 IRS employees.

The Administration seeks to increase funding over the Fiscal Year 2010 enacted operating levels for all five appropriation accounts, ranging from 3 to 26 percent increases (see following chart).

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<sup>3</sup> The 2012 budget request also includes approximately \$138 million from reimbursable programs and \$204 million from user fees for a total program operating level of \$13.6 billion.

**IRS Fiscal Year 2012 Budget Request Increase  
Over Fiscal Year 2010 Enacted Budget  
(in Thousands)**

<b>Appropriation Account</b>	<b>Fiscal Year 2010 Enacted</b>	<b>Fiscal Year 2012 Request</b>	<b>\$ Change</b>	<b>% Increase</b>
Taxpayer Services	\$2,278,830	\$2,345,133	\$66,303	2.91%
Enforcement	\$5,504,000	\$5,966,619	\$462,619	8.41%
Operations Support	\$4,083,884	\$4,620,526	\$536,642	13.14%
Business Systems Modernization	\$263,897	\$333,600	\$69,703	26.41%
Health Coverage Tax Credit Administration	\$15,512	\$18,029	\$2,517	16.23%
<b>Total Budget Appropriated Resources</b>	<b>\$12,146,123</b>	<b>\$13,283,907</b>	<b>\$1,137,784</b>	<b>9.37%</b>

Generally, the five appropriation accounts fund the following IRS tax administration functions. The three primary appropriation accounts are Taxpayer Services, Enforcement, and Operations Support. The Taxpayer Services account provides funding for programs which focus on helping taxpayers understand and meet their tax obligations, while the Enforcement account supports the IRS's examination and collection efforts. The Operations Support account provides funding for functions that are essential to the overall operation of the IRS, such as infrastructure and information services. Finally, the Business Systems Modernization account provides funding for the development of a new taxpayer account database and investments in electronic filing, and the Health Insurance Tax Credit Administration account supports the administration of this credit.

**ANALYSIS OF THE FISCAL YEAR 2012 BUDGET REQUEST**

**Changes to the Base**

Adjustment to Reach Fiscal Year 2011 President's Budget Level<sup>4</sup> – \$402 million increase (including a \$123 million increase related to the Modernization appropriation).

<sup>4</sup> The initiatives included in the Fiscal Year 2011 budget submission are separate from the \$839 million in program increases included in the Fiscal Year 2012 budget submission.

The Fiscal Year 2012 Budget Request does not specify which initiatives are included in the \$402 million increase.

Maintaining Current Levels – \$86 million increase to fund the non-labor inflation adjustments and an increase in Federal Employment Retirement System participation. Non-labor inflation adjustments include rent, postage, supplies, and equipment. No inflation adjustment is requested for pay in Fiscal Year 2012.

Program Reinvestment – \$1.5 million increase (one-time cost) to fund one-time separation costs associated with the September 30, 2011, closure of the Atlanta submission processing site. Increased use of electronic filing has led to the consolidation of sites that process individual returns.

These increases are offset by a decrease of \$190 million in Efficiencies and Savings (including a \$1 million decrease related to the Modernization appropriation). The four largest areas of cost savings include reducing information technology infrastructure (\$75 million decrease); reducing training, travel, and programs (\$27.3 million decrease); increasing e-File savings (\$22.4 million decrease); and non-recurring savings (\$22 million decrease).

## **Program Increases**

The Fiscal Year 2012 budget request includes program increases of \$839 million. This includes an increase of \$52 million in the Operations Support appropriation for costs related to maintenance of deployed modernization efforts. This increase is offset by a corresponding decrease of \$52 million for the Business Systems Modernization (BSM) appropriation for Fiscal Year 2012.

The largest component of this \$839 million increase is \$606 million related to Enforcement Initiatives. The IRS remains committed to finding ways to increase compliance and reduce the Tax Gap,<sup>5</sup> while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

- IRS Enforcement Initiatives – Increase of \$606 million focuses on activities targeted at improving compliance through nine multi-year initiatives. These increases form the backbone of the IRS's multi-year approach to make progress against the Tax Gap.
- Infrastructure Initiatives – Increase of \$119 million focuses on enhancing employee security, developing disaster recovery system capability, and

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<sup>5</sup> The Tax Gap is the difference between the estimated amount taxpayers owed and the amount they voluntarily and timely paid each year.

developing systems to implement various provisions of the *Patient Protection and Affordable Care Act of 2010*<sup>6</sup> (Affordable Care Act).

- Taxpayer Service Initiatives – Increase of \$114 million focuses on improving taxpayer service and the IRS.gov website.
- Business Systems Modernization Initiatives – Net Increase of \$0 The initiative to continue migration from the aging tax administration system includes a \$52 million program increase for the Operations Support appropriation account for the operations and maintenance of deployed Modernization project releases. However, that increase is also subtracted from the BSM appropriation account, for a \$0 net increase.

## **Business Systems Modernization**

The IRS is required to submit an annual BSM expenditure plan that justifies the projects for which resources are requested. The Fiscal Year 2012 budget request indicates a total BSM budget of \$333.6 million. This funding will improve taxpayer service and enforcement, and reduce the costs and risks of operating parallel tax processing systems.<sup>7</sup> The IRS plans to update and settle individual taxpayer accounts in 24 to 48 hours with current, complete, and authoritative data, and plans to facilitate expanded opportunities for compliance, increase analytical capabilities, and accelerate the identification of fraudulent trends.

## **TIGTA SERVES THE AMERICAN PEOPLE BY ASSISTING CONGRESS IN PROVIDING ACCOUNTABILITY FOR TAX ADMINISTRATION**

TIGTA assists the Congress in ensuring accountability for the IRS through its audits, investigations, and reviews of IRS programs and operations. The IRS is a highly complex organization that collects more than \$2 trillion in tax revenue each year and touches the lives of every American. As such, TIGTA's oversight of IRS programs and operations is multi-faceted, including audits, criminal and administrative investigations, and other reviews. These reviews are designed to promote the economy, efficiency, and effectiveness of tax administration and to protect the integrity of tax administration.

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<sup>6</sup> Pub. L. No. 111-148, 124 Stat. 119 (2010).

<sup>7</sup> The IRS operates parallel tax processing systems that require updates to all systems when tax legislation is changed or updated. These parallel systems include Customer Account Data Engine (CADE), CADE 2, and the Individual Master File.

## Audit Oversight

TIGTA audit reports provide IRS management with recommendations on ways to improve their operations. These recommendations include enhancing management practices and procedures, offering ways to better use agency funds, and questioning the actual spending of funds. The following table lists the amounts of potential cost savings<sup>8</sup> and inefficient use of resources<sup>9</sup> identified by TIGTA during Fiscal Year 2010. The table is followed by recent examples of audit oversight involving erroneous and improper payments.

<b>Fiscal Year 2010 Potential Cost Savings and Inefficient Use of Resources</b>	
Funds Put to Better Use	\$2,818,631,262
Questioned Costs	\$412,527
Inefficient Use of Resources	\$36,227,181
Cost Savings and Inefficient Use of Resources Total	\$2,855,270,970

The IRS administers appropriations which are much larger than its own budget. These are the appropriations for refundable credits. Refundable credits can result in refunds even if no income tax is withheld or paid; that is, the credits can exceed the liability for the tax. The two largest refundable tax credits are the Earned Income Tax Credit (EITC) and the Additional Child Tax Credit (ACTC). For the 2011 Filing Season, the maximum EITC is \$5,666; the ACTC is generally limited to 15 percent of earned income in excess of \$3,000.<sup>10</sup> The appropriations for these credits in Fiscal Year 2010 were \$54.7 billion for the EITC and \$22.7 billion for the ACTC.

The IRS continues to report that 23 percent to 28 percent of EITC payments are issued improperly each year. In Fiscal Year 2009, this equated to \$11 billion to \$13 billion in improper EITC payments, which is approximately the size of the IRS's entire operating budget. The IRS has made little improvement in reducing EITC improper payments since it began reporting estimates of these improper payments to the Congress in 2002. The IRS's effort to balance its compliance/enforcement

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<sup>8</sup> Potential cost savings includes both (1) funds put to better use defined as funds that could be used more efficiently if management took actions to implement and complete recommended actions and (2) questioned costs defined as those costs questioned because of an alleged violation of a provision of a law, regulation, contract, or other requirement; a finding that such cost is not supported by adequate documentation; or, an expenditure of funds for the intended purpose is unnecessary or unreasonable.

<sup>9</sup> Values of efficiencies gained from recommendations to reduce costs while maintaining or improving the effectiveness of specific programs.

<sup>10</sup> The ACTC is the refundable portion of the Child Tax Credit. This credit phases out for taxpayers depending upon their income level. Taxpayers with earned income of less than \$3,000 may be eligible for a refundable credit if they have three or more qualifying children and have paid Social Security taxes that exceed their EITC.

resources among all income groups and its inability to implement alternative processes to address erroneous claims has hindered the IRS's ability to reduce the billions of dollars in erroneous claims for refundable credits.

As we reported in December 2008, the IRS has developed processes to identify successfully billions of dollars in erroneous EITC payments. However, the IRS did not have the resources to address many of these cases. The IRS needs to develop an alternative process that is less costly than an audit to protect revenue associated with erroneous EITC claims.<sup>11</sup>

In 2009, we reported a significant increase in ACTC claims by filers who were unable to obtain a Social Security Number or were not eligible to receive a Social Security Number. These individuals were not authorized to work in the U.S. They filed tax returns using an Individual Taxpayer Identification Number (ITIN).<sup>12</sup> The refundable credit claims made by these filers have grown substantially. For Tax Year<sup>13</sup> 2000, these individuals received \$62 million in ACTCs. For Tax Year 2007, these individuals received almost \$1.8 billion in ACTCs.

Prior to 1996, filers using an ITIN were entitled to claim the EITC. However, concerns were raised by the Government Accountability Office, the IRS, and the Congress regarding noncompliance with EITC requirements. The law was subsequently changed to deny the EITC to individuals who file a tax return without a Social Security Number that is valid for employment.<sup>14</sup> As such, filers using an ITIN are not eligible for the EITC. We believe the situation today with the ACTC is similar to the situation which preceded the prohibition of the EITC to ITIN filers. Billions of dollars in ACTCs were provided to ITIN filers without verification of eligibility, and IRS employees have raised concerns about the lack of an adequate process for identifying and addressing improper claims.<sup>15</sup>

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<sup>11</sup> *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (Reference Number 2009-40-024, dated December 31, 2008).

<sup>12</sup> An Individual Taxpayer Identification Number (ITIN) is available to individuals who are required to have a taxpayer identification number for tax purposes, but do not have and are not eligible to obtain a Social Security Number because they are not authorized to work in the U.S.

<sup>13</sup> The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.

<sup>14</sup> The Social Security Administration will issue a Social Security Card that notes "NOT VALID FOR EMPLOYMENT" to individuals from other countries who: (1) are lawfully admitted to the U.S. without work authorization but with a valid nonwork reason for needing a Social Security Number, or (2) need a number because of a Federal law requiring a Social Security Number to get a benefit or service.

<sup>15</sup> *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Reference Number 2009-40-057, dated March 31, 2009).



The change in the law was made prior to the establishment of the ACTC. However, the language of the law is such that it could be interpreted to apply to the ACTC or any refundable credit. It prohibits individuals residing without authorization in the U.S. from receiving most Federal public benefits with the exception of certain emergency services and programs. Nonetheless, IRS management's view is that the law does not provide sufficient legal authority for the IRS to disallow the ACTC to ITIN filers. In addition, the Internal Revenue Code does not require a Social Security Number to claim the credit and does not provide the IRS math error authority to deny the credit without an examination.<sup>16</sup> As such, legislation would be needed to clarify whether or not refundable tax credits such as the ACTC may be paid to filers without a Social Security Number and, if these credits may not be paid, to provide the IRS math error authority to disallow associated claims for the credits. In our March 2009 report, we estimated that allowing the ACTC only to those filers who are eligible to live and work in the U.S. (*i.e.*, those with a Social Security Number that is valid for employment) would reduce Federal outlays by approximately \$1.8 billion annually.<sup>17</sup> However, recent analysis shows that claims for this credit by ITIN filers have increased substantially. In Processing Year<sup>18</sup> 2010, ITIN filers received \$4.2 billion in ACTCs.

The IRS's Taxpayer Assurance Program, formerly known as the Questionable Refund Program, is set up to identify and stop fraudulent refunds. As of April 17, 2010, the IRS identified 249,185 tax returns with \$1.51 billion being claimed in fraudulent refunds and was able to prevent the issuance of \$1.48 billion (98 percent) of the fraudulent refunds claimed. This represented a 50 percent increase in the number of fraudulent tax returns identified in the same period of the previous processing year. This increase is in part the result of the Accounts Management function effectively monitoring its case workload and adjusting thresholds during the filing season to increase the identification of potentially fraudulent tax returns for screening. For example, it lowered tolerances for some of its criteria to increase the number of potentially fraudulent tax returns for screening.

While the IRS has shown a significant increase in the number of fraudulent tax returns identified and refunds stopped, it needs expanded and expedited access to wage and withholding information during the filing season. This information would significantly increase the IRS's ability to efficiently and effectively verify wage and withholding information reported on a tax return at the time a tax return is processed.

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<sup>16</sup> Math error authority is a program in which the IRS contacts taxpayers through the mail or by telephone when it identifies mathematical errors or mismatches of taxpayer information that would result in a tax change.

<sup>17</sup> *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Reference Number 2009-40-057, dated March 31, 2009).

<sup>18</sup> The year in which tax returns and other tax data are processed by the IRS.

Our analysis of the 151,776 Tax Year 2008 tax returns sent to an examiner for screening and then released for processing identified that 96,178 (63 percent) of these tax returns had valid wages reported. TIGTA estimates that the IRS needlessly expended 22,110 hours screening these tax returns. Currently, the law limits the IRS's access to the U.S. Department of Health and Human Services' wage information. In addition, processes have not been developed to expedite the use of wage and withholding data received from the Social Security Administration. We believe that legislation is needed to expand the IRS's access rights to the U.S. Department of Health and Human Services wage information. We also recommended that the IRS obtain wage information for paper tax returns with EITC claims and develop a process to expedite the availability of wage and withholding information received from the Social Security Administration. The IRS agreed with most of our recommendations, but only agreed to examine the benefits of obtaining wage information for paper tax returns with EITC claims.<sup>19</sup>

In our review of the IRS's processes to identify potentially fraudulent tax returns for screening, TIGTA found that the majority of tax returns the IRS identified as being filed by prisoners were not screened to assess fraud potential. Our review identified that 253,929 (88 percent) of the 287,918 tax returns filed by prisoners as of March 24, 2010, were not selected for screening. Of those tax returns not screened, 48,887 individuals had no wage information reported to the IRS by employers. These 48,887 prisoners claimed refunds totaling more than \$130 million, including EITC claims of \$78.5 million. Some of these refunds may have been stopped by other compliance activities. For example, we determined that the IRS prevented the issuance of nearly \$18.1 million in EITC claims for 4,532 of the 48,887 prisoner tax returns.<sup>20</sup>

Further, our review of the IRS's compliance with the *Inmate Tax Fraud Prevention Act of 2008*<sup>21</sup> found that, as of October 2010, the IRS had not completed required agreements to allow the IRS to disclose prisoner tax return information to prison officials. As a result, no information has been disclosed to either the Federal Bureau of Prisons or State Departments of Corrections. We also found that the Calendar Year<sup>22</sup> 2009 Report to Congress on prisoner fraud is incomplete. The report stated that the IRS identified 44,944 fraudulent prisoner tax returns during Calendar Year 2009. However, the processes the IRS uses to identify prisoner tax returns cause the IRS to understate the amount of prisoner fraud. Our review of the process used by

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<sup>19</sup> *Expanded Access to Wage and Withholding Information Can Improve Identification of Fraudulent Tax Returns* (Reference Number 2010-40-129, dated September 30, 2010).

<sup>20</sup> *Ibid.*

<sup>21</sup> Pub. L. No. 110-428, 122 Stat. 4839, (codified as amended at 26 U.S.C. Section 6103 (k)(10)).

<sup>22</sup> Time period beginning of January 1 of a given year and ending on December 31 of the same year.

the Criminal Investigation Division to compile the 2009 prisoner data file identified a lack of managerial oversight to ensure the accuracy and reliability of this file.

TIGTA recommended that the IRS work with the Department of the Treasury to seek legislation to extend the period of time the IRS has to disclose prisoner tax return data to the Federal Bureau of Prisons and State Departments of Corrections. We have also made a number of other recommendations related to prisoner fraud, which include ensuring all tax returns filed by prisoners are processed through the Electronic Fraud Detection System and receive a prisoner indicator, revising prisoner filters to validate wages and withholding associated with prisoners incarcerated for the year in which the tax return is filed claiming a refund, and developing a process to assess the reliability of data received from Federal and State prisons. The IRS partially agreed to our recommendations, but work remains before the IRS is fully in control of this issue.<sup>23</sup>

## **Investigative Oversight**

TIGTA protects Federal tax administration and holds the IRS accountable through investigative initiatives focused on three core components that expose the IRS to risk: employee integrity; employee and infrastructure security; and external attempts to corrupt tax administration. Our statutory mandate is substantially broader than that which applies to most Offices of Inspector General. While all Offices of Inspector General combat fraud, waste, and abuse, TIGTA is also statutorily charged with protecting the integrity of Federal tax administration. A key aspect of protecting Federal tax administration is the oversight and investigation of IRS employees and contractors.

Integrity lapses by IRS employees, real or perceived, erode public trust in the IRS's ability to enforce tax laws effectively, efficiently, and in the best interest of the Nation. TIGTA investigates the unauthorized access of tax information (UNAX) or disclosure of taxpayer information, bribery, extortion, theft of Government property and taxpayer remittances, taxpayer abuses, financial fraud, and misuse of IRS computer systems. One example of a UNAX investigation is an IRS employee in Kentucky who accessed the accounts of at least 202 taxpayers without authorization, all but five of whom were celebrities, spouses of the celebrities, sports figures, and well-known individuals.<sup>24</sup> Another example is a supervisory IRS employee who exceeded her authorized access to IRS computers approximately 250 times for private financial gain.<sup>25</sup>

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<sup>23</sup> *Significant Problems Still Exist With Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud* (Reference Number 2011-40-009, dated December 29, 2010).

<sup>24</sup> TIGTA September 2008 Semiannual Report to Congress, page 3.

<sup>25</sup> TIGTA September 2006 Semiannual Report to Congress, page 32.

A key characteristic of UNAX cases is the opportunity for the investigation to lead to the discovery of other violations. For example, a UNAX investigation in New York was begun based on an internal lead of an IRS employee inappropriately accessing family members' IRS records. Ultimately, the IRS employee was charged with stealing Government funds totaling \$160,863 and fraud in connection with computers.<sup>26</sup>

Bribery is also a serious risk for the IRS and a serious concern to TIGTA. If unchecked, bribery and extortion would substantially undermine the integrity of Federal tax administration and could lead to the growth of the Tax Gap. An example of a bribery investigation is a taxpayer who offered a \$600,000 and a 2003 BMW 745LI to an IRS revenue officer to abate all outstanding tax liabilities.<sup>27</sup> A second example of bribery investigation is a taxpayer who paid \$30,000 in bribe monies to a revenue agent to zero out the tax liability.<sup>28</sup> An example of an extortion investigation involved an IRS revenue agent attempted to extort \$9,700 in cash from a taxpayer in order to make a tax liability go away.<sup>29</sup> Another example of an extortion investigation involved an IRS revenue agent who attempted to extort \$5,000 from a taxpayer in exchange for a no change audit result.<sup>30</sup>

TIGTA promotes employee integrity by conducting proactive investigative initiatives to detect criminal and administrative misconduct in the administration of IRS programs. Additionally, TIGTA special agents conduct awareness presentations to remind IRS employees of our oversight responsibility. These presentations help employees identify ways in which they can prevent fraud, waste, and abuse.

## **Procurement Fraud Oversight**

TIGTA is continuing to address the risk of financial loss due to procurement-related fraud and is increasing efforts to identify and prosecute offenders who would cheat the American taxpayer. TIGTA is dedicated to ensuring that contractors working for the IRS are scrutinized, and we will not tolerate any scheme that denies the American people the best value for their tax dollars. We are launching new strategic initiatives to detect and deter fraud, waste, and abuse in IRS procurements. As of February 11, 2011, the IRS had 891 active procurements worth approximately \$31.5 billion. It is estimated that five percent of an organization's annual revenue is at risk of

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<sup>26</sup> District Court of New York, Indictment filed on December 13, 2010.

<sup>27</sup> District Court of California, Indictment filed on October 2, 2008.

<sup>28</sup> District Court of California, Indictment filed on April 7, 2010.

<sup>29</sup> TIGTA September 2010 Semiannual Report to Congress, page 44.

<sup>30</sup> United States Attorney's Office, Southern District of New York press release.

fraud.<sup>31</sup> As part of our oversight responsibility, TIGTA has recently realigned its resources to enhance its investigation and audit efforts in the procurement fraud area.

The Office of Investigations Procurement Fraud Division has had ongoing efforts addressing multiple aspects of procurement fraud. For example, they have initiated investigations and expanded their outreach and education with IRS procurement personnel to educate them on potential fraud indicators. Their efforts have been increasingly successful, as court ordered settlements on procurement fraud cases have grown from approximately \$18 million in Fiscal Year 2007 to almost \$157 million in Fiscal Year 2010. These results have been achieved with a relatively small staff. Compared to all TIGTA Office of Investigations' financial recoveries, the two percent of TIGTA agents investigating procurement fraud brought in 59 percent of the recoveries. During Fiscal Year 2010, our Procurement Fraud Division participated in investigations that have resulted in settlements of more than \$156 million to the Department of the Treasury. In one example, TIGTA worked with the Department of Justice, the General Services Administration, and other Federal agencies to investigate kickbacks and defective pricing schemes by the EMC Corporation and related Government contractors, which resulted in the corporation's repaying \$87.5 million to the Department of the Treasury.<sup>32</sup>

The procurement fraud investigations have focused primarily on IRS procurements that originate at the national level. However, half of all IRS contracts originate in and are administered by the IRS's four regional procurement centers. To address this additional area of high risk, TIGTA's Procurement Fraud Division has developed a pilot program that will station agents at the four centers to develop investigations and audit referrals. The pilot program will initially place one agent at the IRS Dallas Procurement Center. If given additional resources, the other procurement center sites (Atlanta, New York, and San Francisco) will be staffed. Increased physical interaction and visibility of procurement fraud agents will increase investigations and audits, legal actions, recoveries, and will ultimately act as a deterrent to procurement fraud in the IRS.

The Office of Audit has focused its efforts regarding procurement fraud on three areas: invoice verification reviews; acquisition program reviews and non-contract acquisitions; and information technology procurements. Several referrals to the Office of Investigations have been made as a result of these reviews. The Office of Audit has

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<sup>31</sup> The Association of Certified Fraud Examiners Report to the Nation in 2010 estimated that organizations lose 5 percent of their annual revenues to (employee) "occupational" fraud and abuse. The term "occupational fraud" may be defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets.

<sup>32</sup> TIGTA September 2010 Semiannual Report to Congress, page 5.

recently increased its focus on procurement fraud by expanding ongoing reviews of systems development and other technology services (e.g., maintenance contracts) to look for potential fraud indicators or fraud risks. The Office of Audit is also developing a cross-cutting procurement fraud audit strategy to support the conduct of audits and issuance of reports focusing on procurement fraud detection and deterrence.

During the course of these efforts, TIGTA has also identified systemic weaknesses in IRS procurement, which leave the IRS vulnerable to fraud. One example of a systemic weakness is the IRS's method for assigning a contracting officer's technical representative (COTR) to manage and oversee IRS contracts. COTRs are assigned contracts irrespective of their access to the deliverables or technical expertise. In one investigation, a COTR resubmitted invoices totaling approximately \$600,000, which had already been paid the prior year. Another example of a systemic weakness is COTRs being directed by their supervisors to accept invoices for payment when those COTRs do not possess the technical knowledge and skills to determine whether the contractor actually delivered the product. In one investigation, the COTR accepted information technology-related invoices relying solely on the contractor's word that the work had been completed. TIGTA also conducted an audit of COTRs in 2009 and identified many of the same vulnerabilities and control weaknesses. We made several recommendations to the IRS to strengthen the COTR position.

## **SELECTED MAJOR CHALLENGES FACING THE IRS**

As the IRS continues to deliver multiple programs and services to the American public, it faces a number of significant challenges:

### **Security**

Concurrent with the IRS's monitoring of threats to its employees and facilities and from international criminals, the IRS must also remain vigilant with respect to computer security, particularly as it relates to safeguarding the privacy of confidential taxpayer information. The IRS is an attractive target for criminals who intend to commit identity theft by stealing Personally Identifiable Information<sup>33</sup> for their own financial gain or for hackers seeking to attack and disrupt the IRS's operations by exploiting security weaknesses within the IRS's computer architecture. According to the *IRS's Fiscal Year 2010 Data Book*, the IRS received more than 230 million tax returns, of which 141 million returns were from individual taxpayers. All of these taxpayers essentially entrust the IRS with their sensitive financial and Personally Identifiable Information that

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<sup>33</sup> This is information that can be used to distinguish or trace an individual's identity, alone or when combined with other personal or identifying information.

are processed by and stored on IRS computer systems. To support and encourage voluntary compliance with tax filing requirements, the IRS has a fiduciary responsibility to ensure that sensitive data in its possession is protected from inadvertent or deliberate misuse, improper disclosure, destruction, and that computer operations supporting our Nation's tax administration system are secured against disruption or compromise.

To help protect taxpayers' Personally Identifiable Information, the IRS has implemented a plan to reduce its use of Social Security Numbers. However, as we reported in August 2010, it will not be eliminating or reducing the use of taxpayers' Social Security Numbers in the immediate future.<sup>34</sup> The IRS focused first on internal forms using Social Security Numbers and eliminating employees' Social Security Numbers from its systems. The IRS has many systems, notices, and forms that use Social Security Numbers that require significant analysis before Social Security Number use can be eliminated or reduced. As the IRS moves forward to reduce and eliminate the use of taxpayer Social Security Numbers, it needs to improve internal controls to ensure all planned actions are appropriately and timely accomplished. The IRS needs to maintain a complete list of systems, notices, and forms for monitoring purposes. It also needs to ensure milestones are established and updated when necessary. We are currently conducting an audit of the Disclosure Notification Process to determine if the IRS is making appropriate decisions to promptly and properly notify taxpayers of inadvertent disclosures of their Personally Identifiable Information, including tax return information.

The IRS has many processes and regulations that protect taxpayer information, but there are instances when taxpayer information is inadvertently disclosed. When this happens, if the IRS determines that there is a significant risk of identity theft or other harm, it must notify the taxpayer that his or her Personally Identifiable Information has been inadvertently disclosed. A recent report illustrates the importance of reducing the use of Personally Identifiable Information such as Social Security Numbers. We reported that during 2009, there was an increase in reports of potential disclosure of Personally Identifiable Information.<sup>35</sup> Inappropriate disclosure of Personally Identifiable Information can place individuals at a higher risk of identity theft and may erode public confidence in the Nation's tax system, which is built upon the principle of voluntary compliance with the provisions of the tax code. We have also reported that the IRS could improve the way it monitors security weaknesses identified at State government

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<sup>34</sup> *Target Dates Have Not Been Established to Eliminate or Reduce Taxpayer Social Security Numbers From Outgoing Correspondence* (Reference Number 2010-40-098, dated August 13, 2010).

<sup>35</sup> *Revised Procedures Preceded Significant Increases in Reports of Potential Disclosure of Personally Identifiable Information* (Reference Number 2010-IE-R005, dated May 18, 2010).

agencies and ensure the timely and effective correction of these weaknesses.<sup>36</sup> In another review, we found that current IRS processes were not effective at identifying all contractors handling IRS taxpayer data who may have been subject to required security reviews. Further, we found that current processes were not followed to ensure weaknesses identified at contractor facilities were timely corrected.<sup>37</sup>

The IRS initially reported its computer security material weakness<sup>38</sup> in 1997. Their original declaration of the computer security material weakness consisted of five material weaknesses: computing center security; field office security; service center security; other IRS facility security; and system certification. In October 2002, the IRS combined these five security material weaknesses that were primarily based on facility types into one material weakness. Its goal was to address computer security from an enterprise-wide approach and to better align the weakness areas with the new organizational structure. The IRS further categorized the computer security material weakness into nine areas: 1) network access controls; 2) key computer applications and system access controls; 3) software configuration; 4) functional business, operating, and program units' security roles and responsibilities; 5) segregation of duties between system and security administrators; 6) contingency planning and disaster recovery; 7) monitoring of key networks and systems; 8) security training; and 9) certification and accreditation. The IRS has closed the segregation of duties between system and security administrators, security training, and certification and accreditation components. All other components remain open.

During Fiscal Year 2010, the IRS requested that TIGTA validate the IRS's closure of the functional business, operating, and program units' security roles and responsibilities component of the computer security material weakness. Our review of the IRS's completed actions on this component found that the IRS did not effectively complete four of its six corrective action objectives. Specifically, the IRS did not: 1) document all information technology (IT) security roles and responsibilities in the Internal Revenue Manual; 2) develop and document day-to-day IT security procedures and guidelines; 3) properly conduct compliance assessments to test IT procedures; and 4) establish effective metrics for measuring compliance.<sup>39</sup>

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<sup>36</sup> *While Effective Actions Have Been Taken to Address Previously Reported Weaknesses in the Protection of Federal Tax Information at State Government Agencies, Additional Improvements Are Needed* (Reference Number 2010-20-003, dated November 10, 2009).

<sup>37</sup> *Taxpayer Data Used at Contractor Facilities May Be at Risk for Unauthorized Access or Disclosure* (Reference Number 2010-20-051, dated May 18, 2010).

<sup>38</sup> The Department of the Treasury has defined a material weakness as "shortcomings in operations or systems which, among other things, severely impair or threaten the organization's ability to accomplish its mission or to prepare timely, accurate financial statements or reports."

<sup>39</sup> *More Actions Are Needed to Correct the Security Roles and Responsibilities Portion of the Computer Security Material Weakness* (Reference Number 2010-20-084, dated August 26, 2010).



Computer security weaknesses also affect the IRS's financial systems, which do not comply with the *Federal Financial Management Improvement Act of 1996*.<sup>40</sup> The IRS informed TIGTA in 2010 that it does not believe it will become compliant until approximately November 2014, pending the successful implementation of its strategy to modernize the processes used to account for the records of individual taxpayers.<sup>41</sup>

The IRS is, however, making steady progress over information security. For example, one of the major trends affecting the IRS is the “*explosion in electronic data, online interactions, and related security risks*.”<sup>42</sup> Another example of the IRS's commitment toward information security is the IRS's IT Security Program Plan, issued in September 2009. The Plan serves as a roadmap and a basis for benchmarking information security performance toward attaining security objectives. Senior IRS leaders will be able to use the IT Security Program Plan as input to their strategic business planning process.

All Federal Government agencies are required to establish and implement security controls on their computer systems. In addition, the *Federal Information Security Management Act (FISMA)*<sup>43</sup> requires agencies to report to the Office of Management and Budget (OMB) and the Congress on the effectiveness of their information security program and practices. During the 2010 reporting period, we determined that the IRS's information security program was generally compliant with the FISMA legislation, OMB information security requirements, and related information security standards. Specifically, the IRS met the level of performance for certification and accreditation, incident response and reporting, and remote access management. While the IRS information security program is generally compliant with the FISMA legislation, the program was not fully effective as a result of conditions identified in configuration management, security training, plans of action and milestones, identity and access management, continuous monitoring management, contingency planning, and contractor systems/financial audit.

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<sup>40</sup> Pub. L. No. 104-208, 110 Stat. 3009, (codified in a note to 31 U.S.C. § 3512).

<sup>41</sup> *Measurable Progress Has Been Made in Addressing Federal Financial Management Improvement Act Noncompliance; However, Significant Challenges Remain* (Reference Number 2010-10-065, dated June 4, 2010).

<sup>42</sup> IRS Pub. 3744, *IRS Strategic Plan 2009-2013* (April 2009) page 9.

<sup>43</sup> Pub. L. No. 107-347, 116 Stat. 2899 (2002), (codified as amended in 44 U.S.C. § 3541–3549).

## **The Implementation of Health Care Poses Multiple Challenges for the IRS**

At least 42 of the 514 *Patient Protection and Affordable Care Act of 2010* (Affordable Care Act)<sup>44</sup> provisions add to or amend the Internal Revenue Code, and at least eight require the IRS to establish new operations. Taken together, these provisions represent the largest set of tax law changes in 20 years. The Affordable Care Act contains \$438 billion worth of revenue provisions in the form of new taxes and fees. It also contains credits, which provide incentives for medical research and for businesses to offer employees health care insurance. Additionally, new reporting requirements have been established for certain business transactions. The Affordable Care Act further imposes penalties administered through the tax code for individuals and businesses that do not obtain health coverage for themselves or their employees. Other provisions raise revenue to help pay for the overall cost of health insurance reform.

Certain aspects of implementing health care reform are of concern for the security risks they may pose to IRS employees and infrastructure. Historically, implementation of a new Government program increases the risk of new avenues for fraud, waste, and abuse. The number and type of risks are typically proportional to the size and complexity of the program. Due to the size and nature of the program, the potential for new types of fraud is present with health care reform.

To address these risks, TIGTA has developed an oversight strategy to evaluate the IRS's planning and implementation of the Affordable Care Act provisions. Some provisions required immediate implementation. We have initiated reviews of the implementation of the Small Business Health Care Tax Credit as well as the Qualifying Therapeutic Discovery Project. Our reviews of the IRS's overall implementation plans will include new and expanded operations and information systems, as well as the IRS's development of the forms, publications, and outreach necessary to implement provisions as they become effective. While many of the provisions do not take effect for some time, the IRS's efforts to implement these provisions must start well in advance.

### **Risks Continue with Modernization Efforts**

BSM is a complex and costly 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 BSM effort would last up to 15 years and

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<sup>44</sup> *Patient Protection and Affordable Care Act* (Pub. L. No. 111-148, 124 Stat. 119 (2010)), (as amended by the *Health Care and Education Reconciliation Act of 2010* (Pub. L. No. 111-152, 124 Stat. 1029)).

incur contractor costs of approximately \$8 billion. However, due to receiving less funding than initially anticipated and having difficulties in managing contractor work, the IRS has not completed as many modernization projects as planned.

In 1995, after encountering numerous problems, the IRS declared the modernization efforts as a material weakness under the *Federal Managers' Financial Integrity Act* (FMFIA)<sup>45</sup> and established a control system to manage the necessary improvement processes. In 1997, the IRS established BSM and began improving the controls and processes used to direct and manage current modernization activities. The current BSM has received \$3.24 billion for contractor services, plus an additional \$474 million for internal IRS costs. Since that time, BSM has established a comprehensive process to address management controls in 15 key areas. This includes identifying gaps and weaknesses, establishing corrective actions, monitoring progress, and identifying continuous improvement opportunities.

BSM is intended to address the Congress's interest in improving taxpayer service, including issuing faster refunds; offering expanded electronic filing capability; delivering web-based services for tax practitioners, taxpayers, and IRS employees; and providing IRS employees with faster and improved access to taxpayer account data.

However, the IRS is at a critical junction in its BSM efforts with respect to the demands for achieving success and has refocused BSM to deliver the modernized systems sooner. Based on our annual assessments, TIGTA has formulated four primary challenges the IRS must overcome to be successful:

- Implementing planned improvements in key management processes and committing necessary resources to enable success;
- Managing the increasing complexity and risks of BSM;
- Maintaining the continuity of strategic direction with experienced leadership; and
- Ensuring effective management of contractor performance and accountability.

While the IRS has made recent progress, we believe that these four challenges still need to be met to achieve program success. I am encouraged by the actions the IRS has planned and taken to refocus BSM; however, we believe the IRS should consider the overall BSM efforts a material weakness at this time.

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<sup>45</sup> 31 U.S.C. §§ 1105, 1113, 3512 (2006).

## Tax Gap Challenges Continue

Another serious challenge confronting the IRS is the Tax Gap, which, as I noted earlier, is defined as the difference between the estimated amount taxpayers owed and the amount they voluntarily and timely paid for a tax year. Despite an estimated voluntary compliance rate of 84 percent and IRS enforcement efforts, a significant amount of income remains unreported and unpaid. The IRS estimated the gross Tax Gap for Tax Year 2001 – the most current figures to date – to be approximately \$345 billion. The IRS also faces significant challenges in obtaining complete and timely compliance data and in developing methods necessary to interpret the data. Even with improved data collection, 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 as well as legislative changes.

TIGTA continues to assess the IRS's efforts to address the Tax Gap. 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 constitutes more than 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,<sup>46</sup> 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 between IRS compliance functions to ensure the greatest possible use of the agency's resources when addressing the underreporting Tax Gap. Our audit identified more than 74,000 taxpayers who may have avoided paying approximately \$26 million in Social Security and Medicare taxes in Processing Year 2008.

Individual Retirement Accounts (IRA) are a key tax-preferred way for individuals to save for retirement and are an important way for individuals to roll over savings from pension plans. TIGTA's review of Tax Years 2006 and 2007 IRA information showed that individual noncompliance with IRA contribution limits and minimum distribution requirements continued to grow since the previous review. TIGTA identified potential revenue losses associated with:

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<sup>46</sup> *Employment Tax Compliance Could Be Improved With Better Coordination and Information Sharing* (Reference Number 2010-30-025, dated March 23, 2010).

- 295,141 individuals improperly making excess contributions totaling \$812 million for Tax Year 2006 and \$757 million for Tax Year 2007. Estimated tax revenue losses are \$94.2 million in excise tax<sup>47</sup> and \$17.6 million in income tax<sup>48</sup> for these two tax years.
- 255,498 individuals not taking required minimum distributions totaling \$348 million for Tax Years 2006 and 2007. The estimated tax revenue loss is \$174 million in excise tax for these two tax years.<sup>49</sup>

TIGTA recommended that the IRS develop a service-wide strategy to address retirement provision noncompliance. IRS management agreed that a service-wide strategy is warranted. Senior IRS officials agreed to share responsibility for the development of this long-term strategy. This strategy will not only address compliance, but will also include plans for outreach and guidance for individual taxpayers and employee plan organizations.<sup>50</sup>

Estimates by the IRS show that the underreporting of income by sole proprietors constituted \$68 billion of the \$345 billion Tax Gap in 2001. TIGTA evaluated closed correspondence audits of individual returns reporting sole-proprietor operations and found that significant tax issues were not addressed during these audits.<sup>51</sup> Sole proprietors who underreport their income can create an unfair burden on honest taxpayers and diminish the public's respect for the tax system.

TIGTA recommended that the IRS require examiners to conduct and document verification in the audit case files for unfiled employment tax and information returns and the results of automated preliminary cash transactions analyses, including consideration given to transferring the audit to the field if issues are identified. In addition, TIGTA recommended that controls be expanded to ensure that examiners are properly performing checks for unfiled employment tax and information returns and are conducting preliminary cash transaction analyses so that corrective actions can be identified and taken, if needed. By taking these actions, the IRS could increase potential tax and interest assessments by \$82.6 million over five years.

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<sup>47</sup> Generally, if the excess contribution for the year is not withdrawn by the due date of the tax return (including extensions), there is a 6 percent excise tax on the amount of excess contributions.

<sup>48</sup> This estimate is based on income from unreported interest on excess contributions to IRAs.

<sup>49</sup> Any portion of the required minimum distribution not taken by the individuals by the end of the year may be subject to a 50 percent excise tax.

<sup>50</sup> *A Service-wide Strategy Is Needed to Address Growing Noncompliance With Individual Retirement Account Contribution and Distribution Requirements* (Reference Number 2010-40-043, dated March 29, 2010).

<sup>51</sup> *Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors* (Reference Number 2010-30-024, dated February 24, 2010).

IRS management partially agreed with the recommendations by responding with alternate corrective actions. TIGTA agreed that the IRS's alternate corrective actions may help reduce the number of significant tax issues that are not addressed during correspondence audits of sole proprietors. However, the absence of a specific commitment from the IRS requiring that examiners conduct a preliminary cash transaction analysis during sole-proprietor audits is a concern. A preliminary cash transaction analysis can identify considerable differences between expenditures and income. These differences raise very serious questions about whether expenses may be overstated on the return and whether there may be additional sources of income that should have been reported.

Efforts to increase voluntary taxpayer compliance and reduce the Tax Gap continue to be the focus of many of the IRS's tax compliance initiatives. Those initiatives include the administration of tax regulations, the collection of the correct amount of tax from businesses and individuals, and the oversight of tax-exempt and government entities. One of the highest priorities, as identified by the IRS, is combating tax avoidance transactions.<sup>52</sup> There are tax returns with tax avoidance transaction issues that do not warrant examination before taxpayer contact, a process known as surveying. Surveying tax returns with a tax avoidance transaction issue without proper justification or approval could be counterproductive to the IRS's goal to combat abusive schemes. In addition, this approach can erode the public's confidence in the IRS's ability to enforce tax laws in an equitable and consistent manner. As a result, TIGTA recommended that the IRS:

- Develop internal controls and train employees to ensure that justification is in the case files to survey tax returns with a tax avoidance transaction issue;
- Have an independent function review the tax return for concurrence with the group manager's decision;
- Ensure that tax returns with tax avoidance transaction issues (surveyed as excess inventory) can be readily identified, and examinations are completed once taxpayers are contacted; and
- Develop procedures to ensure surveyed tax returns are included as part of the quality review process.

IRS management disagreed with the two recommendations related to strengthening existing controls and developing procedures to include surveyed tax returns as part of the quality review process. TIGTA continues to believe that the

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<sup>52</sup> A tax avoidance transaction is generally a specific tax transaction or promotion that reduces tax liability by taking a tax position that is not supported by tax law. These strategies may be organized and marketed, often through the Internet. The definition is not merely limited to activities that improperly reduce tax, but may also include transactions that conceal assets and income.

breakdown in controls for the approval process indicates that tax returns surveyed without documentation may have yielded additional revenue for the Federal treasury..

The IRS also 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. Because more than \$15 trillion in 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 of the non-profit and tax-exempt sector is more important than ever before.<sup>53</sup> The IRS also 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.

TIGTA also has a strong oversight presence in the tax-exempt area. For example, in a report issued in February 2010,<sup>54</sup> we determined that while the IRS has taken significant actions in response to our prior report to identify noncompliant Section 527 political organizations,<sup>55</sup> the IRS has not fully addressed noncompliance in this area. One out of every four Forms 8872 (*Political Organization Report of Contributions and Expenditures*) that we reviewed had incomplete or missing contributor or recipient information, although some of the filings may later be deemed acceptable. TIGTA recommended that the IRS: 1) conduct periodic reviews to determine whether political organizations are submitting complete filings; 2) develop procedures for reviewing responses and following up on nonresponses to notices, including assessing additional tax or penalties as appropriate; 3) correct untimely and missing notices; and 4) revise forms and instructions to improve compliance. The IRS agreed with our recommendations. In another example, we reported in Fiscal Years 2003 and 2005 that the Tax Exempt and Government Entities Division's approach to addressing fraud in the tax-exempt sector was disjointed and needed improvement. The IRS took corrective action to improve its fraud program and, in Fiscal Year 2009, we determined the number of fraud cases in the tax-exempt sector referred for criminal development had quadrupled. In addition, the IRS held individuals committing fraud through tax-exempt entities accountable by making approximately \$10 million in tax, fraud penalty, and other assessments, with the potential to assess another \$37 million.<sup>56</sup>

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<sup>53</sup> IRS Pub. 3744, *IRS Strategic Plan 2009-2013* (April 2009) page 23.

<sup>54</sup> *Improvements Have Been Made, but Additional Actions Could Ensure That Section 527 Political Organizations More Fully Disclose Financial Information* (Reference Number 2010-10-018, dated February 4, 2010).

<sup>55</sup> Political organizations include political parties; campaign committees for candidates for Federal, State, or local office; and political action committees. 26 U.S.C. § 527 (2006).

<sup>56</sup> *A Corporate Approach Is Needed to Provide for a More Effective Tax-Exempt Fraud Program* (Reference Number 2009-10-096, dated July 6, 2009).

## The IRS Needs to Monitor Paid Tax Return Preparers to Improve Compliance

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 we issued strongly suggested the need to regulate those who prepare Federal tax returns. These reports 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 slate 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.

Immediately after announcing the Return Preparer Review, the IRS established a Return Preparer Implementation Project Office. The Project Office will support the IRS in implementing key Return Preparer Program functions for the 2011 Filing Season and lay the foundation for long-term Program institutionalization. The IRS held public hearings, proposed rules around the new preparer requirements, and finalized regulations requiring all paid preparers to register for a Preparer Tax Identification Number (PTIN) in order to file tax returns after January 1, 2011.<sup>57</sup> Preparers began registering for the Program in September 2010.

In September 2010, TIGTA completed the first review of its Return Preparer Strategy.<sup>58</sup> We reported that when the decision was made to register paid preparers in September 2010, the IRS had only begun to implement the Return Preparer Program and had not established all Program requirements. The IRS also had not established the organizational structure of the Return Preparer Program or determined how it would test to ensure all preparers met the requirements. The IRS also has not determined how it will enforce Program requirements and has not developed the system(s) and

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<sup>57</sup> The Return Preparer Program requirements apply only to paid return preparers.

<sup>58</sup> *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (Reference Number 2010-40-127, dated September 30, 2010).



processes necessary to administer and oversee the Program. Because the IRS does not have the resources, systems, or processes in place to appropriately screen applicants and conduct suitability checks on preparers applying for PTINs in Calendar Year 2010, there will not be any assurance until Calendar Year 2014 that all paid preparers meet Program requirements.

TIGTA is monitoring preparers in the 2011 Filing Season to evaluate whether they are compliant with the new PTIN requirements, as well as the new e-File mandate that requires preparers who anticipate preparing 100 or more Federal individual or trust tax returns during the year to start using IRS e-File.

### **Globalization Provides Challenges for the IRS**

A major shift in the tax administration environment has occurred since TIGTA stood up in 1999. Global business is rapidly expanding, and the IRS Commissioner has stated that combating offshore tax evasion is a priority. The Congress, the Department of the Treasury, and the IRS are concerned about the International Tax Gap – that is, whether U.S. and nonresident persons conducting cross-border transactions comply with U.S. tax laws. The IRS has not estimated the size of the International Tax Gap, but non-IRS estimates range from \$40 billion to \$123 billion<sup>59</sup> annually. While there might be overlap between the IRS Tax Gap estimate and the International Tax Gap estimate, it is doubtful that the \$345 billion Tax Gap estimate includes the entire International Tax Gap. Recent legislative changes and Department of Justice and IRS activities are increasing awareness about international tax compliance.

Several recent actions illustrate the increased emphasis on international tax administration. First, the IRS developed a plan called the “Servicewide Approach to International Tax Administration.” The plan is designed to improve voluntary compliance with international tax provisions and to reduce the Tax Gap attributable to cross-border transactions. Second, the IRS conducted a voluntary disclosure program to allow noncompliant taxpayers to self-report offshore accounts. The program resulted in about 14,700 voluntary disclosures. Third, the Fiscal Year 2011 IRS budget requested an additional \$121 million for international tax compliance enhancements. Fourth, the Fiscal Year 2012 IRS budget requested an additional \$73 million for international tax compliance enhancements. The IRS also has reorganized and increased the size of the Deputy Commissioner (International) within the Large Business & International Division. Successful strategic implementation requires aligning

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<sup>59</sup> *A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap* (Reference Number 2009-IE-R001, dated January 27, 2009).

the strategy, structure, operational processes, performance measures, and human capital components.

Another factor that holds potential in addressing the International Tax Gap is recent legislation on foreign-tax reporting and disclosure of financial assets, which may require some taxpayers to file the *Report of Foreign Bank and Financial Accounts* (FBAR) form and the new foreign-financial-assets disclosure statement with their income tax return. These reporting requirements will potentially add to both taxpayer burden and the complexity of tax law changes. Specifically, U.S. citizens, residents, and domestic entities that have a financial interest in or signature or other authority over a foreign-financial account that exceeds \$10,000 in the aggregate at any time during the calendar year are required to file the FBAR. New legislation will require individual taxpayers with an aggregate balance of more than \$50,000 in foreign financial assets to file a disclosure statement with their income tax return. The IRS is working to address the impact that these legislative requirements have on U.S. citizens and residents.<sup>60</sup>

Like the IRS, TIGTA is also making a commitment to provide comprehensive oversight of IRS international programs and operations through the creation of a new international programs office. The oversight of international tax administration requires nimble, flexible, and proficient work teams that can provide both rapid responses and comprehensive oversight of all aspects of the IRS's international programs and operations. A final strategy and implementation plan are being developed, but our goal is to provide enhanced oversight of these programs.

TIGTA recently reported that taxpayers excluded \$19.2 billion in foreign earned income on Tax Year 2008 tax returns.<sup>61</sup> Our review identified 23,334 tax returns with erroneous foreign earned income tax exclusions totaling \$675 million, with an estimated revenue loss of \$90 million. Over five years, TIGTA estimated erroneous claims could result in a total revenue loss of \$450 million. Some of the recommendations that TIGTA provided were that the IRS:

- Review the tax returns of those individuals that TIGTA identified as incorrectly claiming the foreign earned income exclusion;
- Establish a unit to address taxpayers identified as erroneously claiming the foreign earned income exclusion;

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<sup>60</sup> *New Legislation Could Affect Filers of the Report of Foreign Bank and Financial Accounts, but Potential Issues Are Being Addressed* (Reference No. 2010-30-125, dated September 29, 2010).

<sup>61</sup> *Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims* (Reference Number 2010-40-091, dated August 16, 2010).

- Assess whether compliance project criteria can be used to identify erroneous claims during tax return processing; and
- Include programming to forward tax returns (both electronically filed and paper) for correction when individuals incorrectly compute their foreign earned income exclusion.

IRS management agreed with most of the recommendations, but they stated that substantial barriers prevented the implementation of certain recommendations at the time of the review. TIGTA is concerned that the lack of corrective actions will allow continued revenue loss.

### **Increasing International Threats Also Pose a Challenge**

In addition to risks to the system associated with employee integrity and physical security, TIGTA has identified a risk to the IRS from crimes that are international in scope. The migration of Federal tax administration operations into the electronic environment increases internal and external vulnerabilities that can be exploited by criminals. The relative anonymity of the Internet has provided a virtual breeding ground for modern-day scams and schemes, which capitalize on IRS name recognition. In recent years, our Office of Investigations' Electronic Crimes and Intelligence Division has observed a steady increase in cybercentric fraud schemes which either target Federal tax administration directly, resulting in losses to the Department of the Treasury, or indirectly through schemes involving the impersonation of IRS employees to intimidate or entice victims into providing sensitive personal data, financial data, or in some cases, payments directly to the scammers.

Some of the most common countries of origin of these scams include Russia, China, Romania, Nigeria, and Jamaica. Although the specifics of these fraudulent schemes vary depending on the individuals or group behind them, broad categories include IRS phishing, fraudulent IRS e-File websites, stock scams, lottery scams, and *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*, Form W-8BEN scams. The common thread in these scams, which makes them effective, is the repeated impersonation of the IRS. For instance, in IRS phishing scams, victims receive an e-mail indicating that the IRS has identified them for a refund or similar purpose. Victims are then asked to follow an included link which, if clicked, will take the victim to a fraudulent website that is often an electronic copy of the actual IRS.gov website frequently hosted on a compromised (hacked) web server. The victims will be prompted to provide a great deal of personal information, including items such as their Social Security Numbers, as well as financial data such as a credit card number or bank account information and associated security features such as passwords. This information is often bundled with similar information and then sold on the digital

underground in a method analogous to how a stolen vehicle is processed in a “chop shop.” Since 2008, more than 10,400 IRS phishing sites have been identified. TIGTA and the IRS Office of Online Fraud Detection and Prevention (OFDP) work around the clock to contact Internet hosting providers and request the shutdown of illegal sites, which impersonate the IRS. These sites are normally taken off line within hours, however, may remain online for a period of days, depending upon the cooperation of the hosting provider, which in some cases, reside in countries with governments unwilling to assist. OFDP provides data to TIGTA regarding this criminal activity which, in concert with the U.S. Department of Justice, is evaluated for investigative potential and pursued accordingly. All 10,400 sites identified have been shut down.

Impersonations in lottery and stock scams involve demands for payments from the “IRS” for capital gains and often target elderly victims who have been identified by the scammers through commercial “sales lead” services. There have also been documented instances involving fraudulent websites that impersonate IRS authorized e-File services that are utilized by scammers to intercept and steal tax refunds.

### **Physical Security of Employees and Facilities Poses Major Challenges to the IRS**

Physical violence, harassment, and intimidation of IRS employees pose some of the most significant challenges to the implementation of a fair and effective system of tax administration. Threats of violence directed at the IRS have increased at the same time that many individuals face financial challenges. The IRS is frequently a target for citizens’ issues with taxation, authority, and government. From Fiscal Years 2008 to 2010, TIGTA’s Office of Investigations has experienced a 37 percent increase in the number of threat and assault cases it has initiated – a total of 1,631 such cases in Fiscal Year 2010 alone. From October 1, 2010 through March 31, 2011, the number of initiated threat and assault investigations is 723. The number of investigations initiated in Fiscal Year 2011, compared to the previous fiscal years of 2008 and 2009, indicates that our threat and assault investigations are trending up.

The growing threat to the safety of the IRS workforce was demonstrated in February 2010 in Austin, Texas, when a pilot flew his plane into a building partially occupied by the IRS, resulting in the death of an IRS employee.<sup>62</sup> This attack illustrates the environment in which the IRS is operating. Subsequent to the Austin attack, TIGTA reviewed 251 complaints of threatening behavior wherein taxpayers made statements referencing or supporting the Austin incident. Threat-related work trended upwards for the remainder of the fiscal year. We are monitoring security measures that the IRS initiated after the Austin incident at the majority of its buildings nationwide. TIGTA will

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<sup>62</sup> TIGTA March 2010 Semiannual Report to Congress, page 31.

continue to place a priority on our oversight of IRS employee safety and physical security.

## **The IRS Needs to Continuously Deliver Quality Taxpayer Service to Increase Tax Compliance**

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 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. It is also seeking innovative ways to simplify or eliminate processes that unnecessarily burden taxpayers or Government resources.

Despite other options available to taxpayers, the telephone remains the number one choice for taxpayers to make contact with the IRS. One of the IRS's goals for Fiscal Year 2011 is to increase taxpayers' access to its toll-free telephone assistors, which the IRS calls its Level of Service.<sup>63</sup> Access to telephone assistors in the 2010 Filing Season was 75.3 percent. While the 2010 Level of Service was better than that for the 2009 Filing Season (which was 64 percent), it was lower than the 2007 and 2008 Filing Seasons.

The IRS has determined that the Fiscal Year 2011 \$20.9 million budget initiative will increase the toll-free base program budget to the level needed to achieve a 75 percent Level of Service.

However, there has been no program increase since the IRS is currently operating under a continuing resolution. Thus, the 2011 Filing Season goal is 71 percent. The last time the IRS achieved a Level of Service of more than 80 percent was during the 2007 Filing Season, when the Level of Service was 83 percent.

As of March 5, 2011, approximately 39 million taxpayers contacted the IRS by calling the various Customer Account Services function toll-free telephone assistance lines.<sup>64</sup> IRS assistors have answered 8.4 million calls. The Level of Service is 71.7 percent, with taxpayers waiting approximately 11 minutes to speak to an assistor.

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<sup>63</sup> Level of Service is the IRS's primary measure of providing taxpayers with access to an assistor. It is the percentage of callers who wish to speak to an assistor and who are able to speak with one.

<sup>64</sup> The IRS refers to the suite of 26 telephone lines to which taxpayers can make calls as "Customer Account Services Toll-Free."

More taxpayers are abandoning calls, and the IRS is also blocking more calls than last year's filing season. A blocked call occurs either because 1) no line is available at the time the call arrives (*i.e.*, the taxpayer receives a busy signal), or 2) the system is programmed to block calls because the queue is beyond a pre-defined threshold (*i.e.*, the taxpayer receives a recorded announcement to call back at a later time).

Many taxpayers seeking assistance with their taxes choose to visit one of the IRS's 401 walk-in offices, called Taxpayer Assistance Centers. The IRS plans to assist more than 6.5 million taxpayers in Fiscal Year 2011. Between October 1, 2010, and February 26, 2011, the Taxpayer Assistance Centers served 2.3 million walk-in taxpayers, which includes 1.2 million walk-in taxpayers for the 2011 Filing Season.

As part of a 2011 Filing Season audit to assess the quality of customer service the IRS provides to taxpayers who seek assistance when filing their tax returns, TIGTA auditors posed as taxpayers and visited 26 Taxpayer Assistance Centers to ask tax law questions. During the visits, assistants answered 35 of 35 (100 percent) tax law questions accurately. However, auditors waited an average of 62 minutes before they received assistance. The wait times ranged from none to four hours. On five occasions, auditors who visited three different Taxpayer Assistance Centers were turned away or denied services and asked to return another day.

The Volunteer Program also plays an important role in achieving the IRS's goal of improving taxpayer service and facilitating participation in the tax system. TIGTA has been conducting audits of this Program since the 2004 Filing Season when auditors, posing as taxpayers, had 35 tax returns prepared with a zero percent accuracy rate. Subsequently, the IRS has taken numerous actions to increase the accuracy of tax returns prepared by volunteers, including the implementation of a quality assurance program that is producing positive results. In the 2010 Filing Season, of the 39 tax returns prepared for TIGTA auditors, 35 (90 percent) were prepared correctly. However, during the 2011 Filing Season, as of March 5, 2011, auditors have had 9 (60 percent) of 15 tax returns prepared correctly.<sup>65</sup> We will report our final results in August 2011.

As part of its Volunteer Program, the IRS awarded matching grants to 111 organizations for the 2009 Filing Season and 147 organizations for the 2010 Filing Season. However, the number of tax returns prepared by volunteers increased by only 1 percent (from 2.98 to 3.02 million) from the 2009 to the 2010 Filing Season. The number of tax returns prepared is only one measure with which the IRS plans to gauge

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<sup>65</sup> *Improvements to the Volunteer Program Are Producing Positive Results, but Further Improvements Are Needed to the Quality Assurance Process* (Reference Number 2010-40-109, dated September 3, 2010).

the Volunteer Program. The second measure is whether the Program also meets its geographic and target populations. TIGTA conducted an audit of the Volunteer Program in 2009 and reported that the IRS established the 2009 Filing Season as the baseline for the Volunteer Program's performance goals.<sup>66</sup> We are conducting a follow-up audit this year to evaluate the IRS's success with the Volunteer Program.

### **Tax Law Changes Present Challenges to Filing Season Activities**

Changes to the tax law have a major impact on how the IRS conducts its activities, how many resources are required, and how quickly the IRS can meet strategic goals. Problems with tax return processing can delay refunds, affect the accuracy of accounts, and generate incorrect notices. Along with the usual required updates, the *Housing and Economic Recovery Act of 2008*,<sup>67</sup> the *Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010*,<sup>68</sup> and the Affordable Care Act created additional challenges for the 2011 Filing Season.

During the 2011 Filing Season, the IRS expects to receive 141 million individual tax returns including 106 million (75 percent) electronically filed (e-Filed) tax returns. Due to legislation enacted in late 2010, individuals filing Forms 1040, *U.S. Individual Income Tax Return*, with Schedule A, *Itemized Deductions*, and those claiming certain deductions had to wait until February 14, 2011, to file their individual tax returns. The delay impacted both individuals who file via paper and e-File. The IRS reported that it held approximately 6.5 million e-File tax returns that were transmitted prior to February 14th (not including e-Filed tax returns that tax preparers were holding). In addition, as of February 11, 2011, the IRS had received and held for processing approximately 100,000 paper tax returns. The IRS has been able to efficiently process the paper and e-Filed tax returns that were held.

The IRS also has developed processes and procedures to assist individuals with the First-Time Homebuyer Credit (Homebuyer Credit) repayment requirements. Individuals who purchased a home between April 9 and December 31, 2008, and claimed the Homebuyer Credit are required to begin repaying their credit on their 2010 tax return. To assist these individuals, the IRS issued notices to 1.5 million individuals who must repay the credit over 15 years beginning in 2010. This notice will be sent to individuals each year until the Homebuyer Credit is fully repaid. The notice lists the amount of the credit the individuals received and the amount the individuals have to repay as additional tax.

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<sup>66</sup> *Internal Controls for the Volunteer Income Tax Assistance Grant Program Are in Place but Could Be Strengthened* (Reference Number 2009-40-125, dated August 19, 2009).

<sup>67</sup> Pub. L. No. 110-289, 122 Stat. 2654 (2008).

<sup>68</sup> Pub. L. No. 111-312, 124 Stat. 3296 (2010).

However, implementing some provisions included in new tax legislation is presenting challenges for the IRS. These challenges are resulting in payments of erroneous claims, and the inability to identify and prevent erroneous claims at the time tax returns are processed. Specifically, as of March 4, 2011, we identified:

- 54 individuals were allowed \$331,557 in erroneous Homebuyer Credits based on an ineligible purchase date. These resulted from tax examiner errors;
- 51,185 individuals were allowed in excess of \$34.4 million in erroneous Non-Business Energy Property Credits; and
- 166 (88 percent) of the 189 individuals who claimed the Qualified Plug-in Electric Drive Motor Vehicle Credit reported non-qualifying makes of vehicles. The amount erroneously claimed totals \$498,688.

In addition, the IRS recognized that the changes to the Adoption Credit (which increased from \$12,150 to \$13,170 and is now refundable) could increase the risk for erroneous claims and developed a strategy in an attempt to address these risks. However, our analysis of the IRS's Adoption Credit processing controls identified that while the IRS requires individuals to attach documentation to their tax return in support of an adoption, it does not have math error authority to deny the Adoption Credit if the documentation is not provided. Without this authority, the IRS cannot deny the credit during processing of the tax return, but must instead deny the credit post-processing through the examination process, which is a much more costly and resource-intensive process.

On October 29, 2010, we alerted the IRS management and recommended that they work with the Department of the Treasury to make a request for such authority from the Congress. However, the IRS did not agree with this recommendation. As of March 4, 2011, the IRS had received returns from 9,859 individuals claiming over \$124 million in Adoption Credits. Of the 9,859 Adoption Credit claims, 6,974 (71 percent) of the claims either had no required documentation attached to their tax return or the documentation was invalid or insufficient. According to IRS procedures, each of these claims will be sent to the Examination function for further review.

Finally, as of March 4, 2011, the IRS had identified 335,341 tax returns with \$1.88 billion being claimed in fraudulent refunds and prevented the issuance of \$1.82 billion (97 percent) of the fraudulent refunds being claimed. This represents a 181 percent increase in the number of tax returns identified for this same period during the



2010 Filing Season. Furthermore, in a prior TIGTA review<sup>69</sup> assessing the IRS fraudulent tax return screening process we reported that the majority of tax returns identified as being filed by prisoners are not sent to a tax examiner for screening to assess the potential that the tax return is fraudulent. As of March 4, 2011, the IRS had selected 63,501 tax returns filed by prisoners for screening. This represents an 88 percent increase in the number of prisoner tax returns identified for this same time period during the 2010 Filing Season that were sent to a tax examiner to assess fraud potential.<sup>70</sup>

## **OTHER RECENT TIGTA ACCOUNTABILITY OVERSIGHT**

### **Recovery Act Oversight**

The Recovery Act was enacted on February 17, 2009, and presents significant challenges to Federal agencies as they move to implement provisions quickly while attempting to minimize risk and meet higher 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 specific challenges to the IRS as the Nation's tax collector and administrator. These provisions will continue to challenge the IRS over multiple filing seasons. Since September 2009, TIGTA has issued 21 reports addressing various Recovery Act provisions. These reports have identified 41 recommendations to address identified fraud, waste, and abuse involving more than \$189 million and affecting approximately 13.5 million taxpayers.

As part of our Recovery Act oversight, we addressed the IRS's administration of the Homebuyer Credit. The *Worker, Homeownership, and Business Assistance Act of 2009*<sup>71</sup> revised, extended, and expanded the Homebuyer Credit to a broader range of home purchases and added new documentation requirements. For example, long-time residents of the same main home may claim the Homebuyer Credit if they purchase new principal residences. New documentation requirements mean that taxpayers claiming the Homebuyer Credit may not file their tax returns electronically and must file paper tax returns. In Processing Years 2009 and 2010, the IRS reported issuing Homebuyer Credits of more than \$12.3 billion and \$13.7 billion, respectively.

We reported that three key controls were not in place before claims for the Homebuyer Credit were processed. Specifically:

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<sup>69</sup> *Expanded Access to Wage and Withholding Information Can Improve Identification of Fraudulent Tax Returns* (Reference Number 2010-40-129, dated September 30, 2010).

<sup>70</sup> *Interim Results of the 2011 Filing Season* (Reference Number 2011-40-032, dated March 31, 2011).

<sup>71</sup> Pub. L. No. 111-92, 123 Stat. 2984 (2009).

- Documentation was not required to substantiate claims for the Homebuyer Credit;
- Filters to identify erroneous claims for the Homebuyer Credit were not implemented until late into the filing season, and the filters were missing some components; and
- Information provided on Form 5405, *First-Time Homebuyer Credit and Repayment of the Credit*, was not entered into IRS computers from paper returns and date of purchase information from paper and electronic returns was not immediately utilized to verify eligibility for the Homebuyer Credit.<sup>72</sup>

IRS management initially stated that a requirement to supply documentation during the processing of returns would be burdensome for the taxpayers and the IRS. In addition, the IRS stated that it did not have math error authority to disallow the Homebuyer Credit during processing even if it did ask for documentation but none was provided. The IRS initially took no steps to obtain this math error authority. After the issuance of TIGTA's first interim report, the Congress passed legislation requiring documentation for the Homebuyer Credit and providing the IRS with math error authority to disallow the Credit if the documentation was not provided. In response to TIGTA's report, the IRS required taxpayers claiming the Credit after November 6, 2009, to attach a copy of their Form HUD-1, *U.S. Department of Housing and Urban Development Settlement Statement*, to support their claim. Because of the extensive requirements for programming and the late passage of the first bill containing the Homebuyer Credit, IRS management did not request or implement the transcription of the Form 5405.

Today we are releasing the results of the last phase of our review of the IRS's controls to identify erroneous claims for the Homebuyer Credit.<sup>73</sup> The report discusses additional erroneous claims for the Homebuyer Credit that were paid by the IRS. Overall, we estimate that more than \$513 million in potentially erroneous claims were issued with no IRS scrutiny. Based on this and other TIGTA work, we believe the IRS should require taxpayers to provide documentation to support eligibility for all refundable tax credits. If such documentation is required, the IRS will also need math error authority to deny other refundable credits when supporting documentation is not provided.

The Recovery Act also includes provisions that encourage the purchase of motor vehicles that operate on clean renewable sources of energy. Individuals claimed more

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<sup>72</sup> *The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit* (Reference Number 2009-41-144, dated September 29, 2009).

<sup>73</sup> *Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits* (Reference Number 2011-41-035, dated March 31, 2011).

than \$163.9 million in plug-in electric and alternative motor vehicle credits from January 1 through July 24, 2010. As of July 24, 2010, TIGTA identified 12,920 individuals who electronically filed their tax returns and erroneously claimed \$33 million in plug-in electric and alternative motor vehicle credits. Further, 1,719 of the 12,920 individuals also erroneously reduced the amount of Alternative Minimum Tax owed by almost \$5.3 million. The IRS took corrective actions to reduce erroneous claims when we brought process weaknesses to its attention. These actions have resulted in an estimated \$3.1 million in revenue protected.<sup>74</sup>

Another significant provision of the Recovery Act is the Making Work Pay Credit, which applied to most taxpayers with earned income. The Making Work Pay Credit was advanced to taxpayers through their wages by a decrease in Federal income tax withholding. The Making Work Pay Credit was in effect for Tax Years 2009 and 2010 and was implemented through new income tax withholding tables issued by the IRS. We advised the IRS in a report issued in November 2009 that the reduced withholding associated with the Making Work Pay Credit would make some taxpayers vulnerable to under-withholding of taxes for Tax Years 2009 and 2010.<sup>75</sup> Taxpayers who were advanced more of the Making Work Pay Credit than they were entitled to owed taxes when filing their Tax Year 2009 returns and may again owe when filing their Tax Year 2010 tax returns.

The IRS initiated significant outreach to inform taxpayers about the Making Work Pay Credit and its potential effects. Despite these actions, TIGTA estimates that approximately 13.4 million taxpayers were or will be negatively affected by the Making Work Pay Credit when filing their returns for Tax Years 2009 and 2010. The changes to the withholding tables did not take the following situations into consideration:

- 1) dependents who receive wages;
- 2) single taxpayers with more than one job;
- 3) joint filers when both spouses work or either spouse has more than one job;
- 4) individuals who file a return with an ITIN;
- 5) taxpayers who receive pension payments; and
- 6) Social Security recipients who receive wages.

A survey of the taxpayers who may have been negatively affected by the reduced withholding associated with the Making Work Pay Credit indicated that most were not aware of the Credit or its effect on their taxes. Further, TIGTA estimates that approximately 108,000 taxpayers may have been assessed the Estimated Tax Penalty as a result of the Making Work Pay Credit and that an additional 1.02 million taxpayers may have had their Estimated Tax Penalty amount increased. TIGTA recommended

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<sup>74</sup> Revenue protected results from proper denial of claims for refunds, including the prevention of erroneous refunds or efforts to defraud the tax system.

<sup>75</sup> *Millions of Taxpayers May Be Negatively Affected by the Reduced Withholding Associated With the Making Work Pay Credit* (Reference Number 2010-41-002, dated November 4, 2009).

that in the case of future credits implemented through changes in the withholding tables, the IRS consider including simplified withholding adjustment instructions on the IRS website for specific scenarios that could result in under-withholding. We also recommended the IRS identify those taxpayers who owed any Estimated Tax Penalty as a result of the Making Work Pay Credit and notify them of their right to have the portion of the Penalty related to the Credit abated. The IRS responded that it plans to continue outreach efforts but declined to contact taxpayers that owed any Penalty based on the Making Work Pay Credit. We are concerned about the IRS's response because we believe any portion of the Penalty associated with the Making Work Pay Credit should be identified and abated.

### **Troubled Asset Relief Program Oversight**

As part of our broad-reaching oversight responsibilities, TIGTA reviewed the tax compliance of participants in the Troubled Asset Relief Program (TARP).<sup>76</sup> The TARP is a large expenditure of public funds that required participants to indicate in agreements with the Department of the Treasury that all material Federal taxes were paid. IRS records showed 130 of the 558 institutions included in this audit had unpaid taxes totaling \$530.8 million when agreements were signed between the Department of the Treasury's Assistant Secretary for Financial Stability and the institutions' representatives. However, IRS records also showed that 97 percent of the unpaid taxes were resolved by December 2009.

It is important to recognize that when the agreements were signed, the Department of the Treasury was in the beginning stages of establishing the TARP. As a result, the focus on stabilizing the financial system may have taken priority over establishing the controls needed to identify unpaid taxes. At the time of our review, IRS officials were collaborating across functional areas and adapting traditional collection processes to accelerate the identification and resolution of unpaid taxes. It is equally important to add perspective on the amount of unpaid taxes. According to IRS records, the five publicly traded institutions that received the most TARP funds (of the institutions included in this audit) voluntarily paid \$16 billion of corporate income and employment tax liabilities during the time their accounts contained \$227 million of unpaid taxes. Records also showed that, as of their respective agreement execution dates, the accounts of those institutions contained nearly \$17 billion of credits.

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<sup>76</sup> *Most Unpaid Taxes of Participants in the Troubled Asset Relief Program Have Been Resolved* (Reference Number 2010-30-050, dated April 28, 2010).

## TIGTA's Budget Request and Justification

The President's Fiscal Year 2012 budget request for TIGTA strikes a balance in addressing the critical needs of the Nation. Included in the request is an additional 29 Full-time Equivalents (FTE)<sup>77</sup> provided for the oversight of the IRS's implementation of the Affordable Care Act. This budget authority totals \$5,600,000 that will see that the IRS implements the law effectively. It is important to note that no portion of this request will be used to support traditional "overhead" positions such as human capital, finance, or information and technology support. However, TIGTA's budget reduces existing programs by \$3,474,000 below the President's Fiscal Year 2011 request. These cuts reflect the tough choices that the Nation's current economic situation demands. TIGTA is reviewing all of its functions and pledges to reduce only those programs that will have the smallest impact on its critical mission. The President's Fiscal Year 2012 budget request for TIGTA of \$157,831,000 meets both the challenges of implementing robust oversight of the Affordable Care Act as well as the expectation that the Government do more with fewer resources.

Given the unique responsibilities TIGTA has among the Inspectors General, specifically protecting the integrity of tax administration, TIGTA's Fiscal Year 2012 budget request represents an increase of 1.5 percent above the Fiscal Year 2011 requested level. These requested resources will finance critical audit, investigative, and inspection and evaluation services, protecting the integrity of tax administration on behalf of the Nation's taxpayers. TIGTA's audit, investigative, and inspection and evaluation priorities include:

- Adapting to the IRS's continuously evolving operations and mitigating intensified risks associated with security, modernization, addressing the Tax Gap, and human capital challenges facing the IRS in domestic and international operations;
- Responding to domestic and foreign threats and attacks against IRS employees, property, and sensitive information;
- Improving the integrity of IRS operations by detecting and deterring fraud, waste, abuse, or misconduct by IRS employees;
- Conducting comprehensive audits, inspections, and evaluations that include recommendations for monetary benefits and enhancing the IRS's service to taxpayers;
- Informing the American people, the Congress, and the Secretary of the Treasury of problems and progress made to resolve them; and

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<sup>77</sup> A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year.

- Overseeing the IRS's efforts to administer tax provisions of the Recovery Act and Affordable Care Act.

In Fiscal Year 2012, TIGTA faces the challenge of adapting its oversight activities to address increasingly complex and high-risk issues associated with IRS operations. This is particularly true in adapting to the renewed focus of the IRS to close the International Tax Gap. This effort will be in addition to TIGTA's continuing work, including assessing IRS tax compliance initiatives, evaluating the IRS's efforts to administer tax provisions in the Recovery Act and Affordable Care Act, detecting and investigating fraud and electronic crime, reviewing procurement activities, safeguarding taxpayer privacy, evaluating IRS human capital activities, and providing IRS program reviews requested by the Congress and other IRS stakeholders.

Since Fiscal Year 2001, TIGTA has achieved its performance and quality expectations by implementing several efficiency-enhancing and cost-saving measures. In addition, through incremental FTE losses and implementation of cost-cutting initiatives in non-labor expense categories, TIGTA has been able to finance annual pay and labor-related benefit increases (health care, pensions, and retirement) while also maintaining the FTE level necessary to meet performance and quality expectations. However, TIGTA's efficiency-enhancing and cost-cutting initiatives are largely exhausted. The impact of any budget reductions will fall almost exclusively on labor and would affect TIGTA's capability to provide comprehensive oversight of IRS operations.

Over the past 12 years, TIGTA's employee population has declined 14 percent. Authorized FTEs have declined from 1,000 in 1999 to a current level of 835. Compounding the steady loss of authorized FTEs is the ongoing retirement wave. Approximately 34 percent of all TIGTA employees will be eligible to retire by September 30, 2013. This is especially troubling since the responsibilities of TIGTA's auditors, investigators, information technology specialists, and systems specialists require unique skill sets.

The Department of the Treasury included a total Fiscal Year 2012 budget request for TIGTA in the amount of \$157,831,000. This request includes \$2,692,000 for training and \$380,000 needed to support the Council of the Inspectors General on Integrity and Efficiency.

TIGTA also faces the challenge of meeting additional requests from the Congress and other IRS stakeholders in a timely and efficient manner. In recent years, TIGTA has reallocated resources to perform congressionally requested audits and to comply with new statutory provisions.

TIGTA's FY 2012 request proposes eliminating certain reviews conducted to comply with reporting requirements in the IRS Restructuring and Reform Act of 1998 (RRA 98). These statutory reviews yield little in the way of improving performance measures and are of relatively low value. TIGTA would prefer to redirect resources

applied to these reviews to conducting high-risk audits. TIGTA recommends legislative changes, supported by the Department of the Treasury, eliminating reporting requirements in the following areas:

- The requirement to report information regarding any administrative or civil actions related to Fair Tax Collection Practices violations in one of TIGTA's Semiannual Reports. This pertains to Internal Revenue Code § 7803 (d)(1)(G). In TIGTA's 2009 and 2010 audits,<sup>78</sup> we did not identify any Fair Tax Collection Practices that were substantiated. The IRS has taken action based on a prior TIGTA recommendation to more accurately code cases on the system it uses to track employee behavior that might warrant IRS management administrative actions.
- The requirement to review and certify annually that the IRS is complying with the requirements of 26 U.S.C. § 6103(e)(8) regarding information on joint filers. In TIGTA's 2009 and 2010 audits,<sup>79</sup> we found that IRS procedures provide employees with sufficient guidance for handling joint filer collection activity information requests. However, we cannot determine if the IRS is fully compliant because its management information systems do not separately record or monitor joint filer requests, and there is no legal requirement for the IRS to do so.
- The requirement to annually report on the IRS's compliance with Internal Revenue Code §§ 7521(b)(2) and (c) requiring IRS employees to stop a taxpayer interview whenever a taxpayer requests to consult with a representative and to obtain their immediate supervisor's approval to contact the taxpayer instead of the representative if the representative has unreasonably delayed the completion of an examination or investigation. In TIGTA's 2009 and 2010 audits,<sup>80</sup> we found that IRS procedures provide employees with sufficient guidance to follow in their day-to-day contacts with taxpayers and their representatives. We, however, continue to report on our inability to give an opinion on how well the IRS is complying with the legal restrictions on direct contact because of limitations in IRS's management information systems.
- The annual reporting requirement for the remaining RRA 98 provisions should be revised to a biennial reporting requirement.

A continued decline in personnel strength threatens TIGTA's overall ability to effectively fulfill its core mission. An inability to fill vacated positions with skilled

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<sup>78</sup> *Collection Employees Adhered to Fair Tax Collection Practices in Calendar Year 2008* (Reference Number 2009-10-101, dated July 23, 2009) and *Collection Employees Adhered to Fair Tax Collection Practices From January 2009 Through September 2009* (Reference Number 2010-10-037, dated March 17, 2010).

<sup>79</sup> *Fiscal Year 2009 Statutory Review of Disclosure of Collection Activity With Respect to Joint Filers* (Reference Number 2009-30-046, dated March 12, 2009) and *Fiscal Year 2010 Statutory Review of Disclosure of Collection Activity With Respect to Joint Filers* (Reference Number 2010-30-026, dated February 19, 2010).

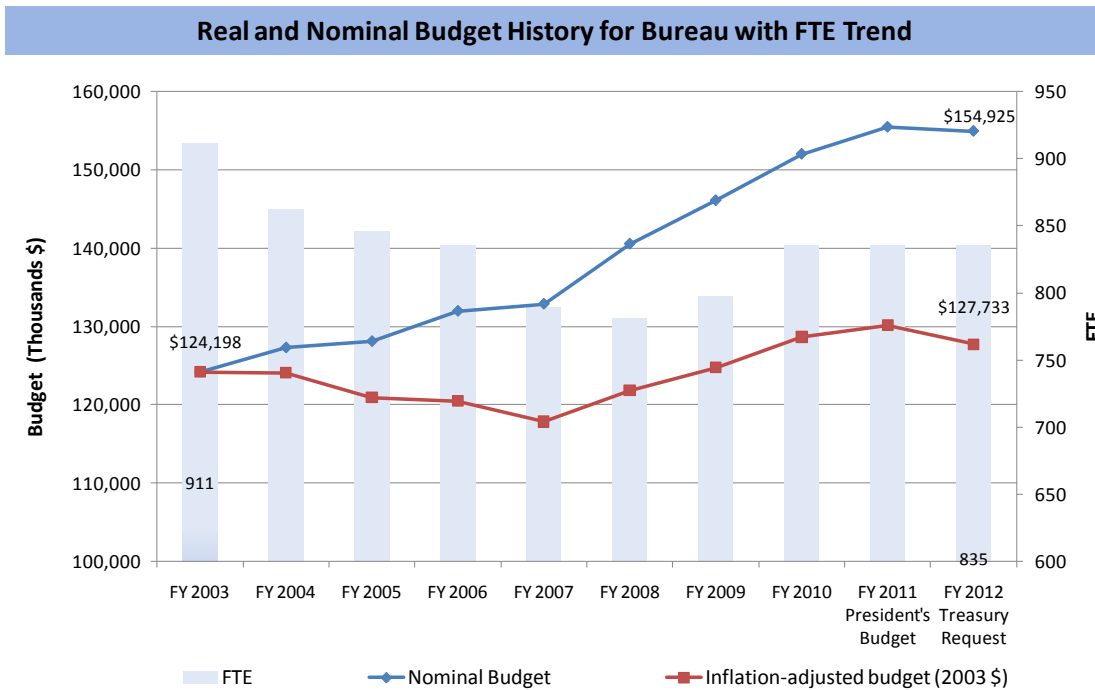
<sup>80</sup> *Fiscal Year 2009 Statutory Review of Restrictions on Directly Contacting Taxpayers* (Reference Number 2009-30-054, dated March 24, 2009) and *Fiscal Year 2010 Statutory Review of Restrictions on Directly Contacting Taxpayers* (Reference Number 2010-30-060, dated June 3, 2010).

investigators will reduce TIGTA's enforcement capacity and limit its efforts to combat IRS employee misconduct as well as to investigate external threats to the security and integrity of IRS personnel and infrastructure. Anticipated increased attrition rates will further reduce opportunities to devote resources to high-risk areas and thereby may shrink financial benefits derived from audit recommendations and lessen TIGTA's ability to identify cost savings and protect the integrity of the Federal revenue stream.

TIGTA's Fiscal Year 2011 budget request of \$155,452,000 represented an increase of 2.3 percent above the Fiscal Year 2010 enacted level. The Department of the Treasury included in TIGTA's Fiscal Year 2011 budget request \$2,572,000 for training and \$332,000 needed to support the Council of the Inspectors General on Integrity and Efficiency.

Overall, TIGTA has been very successful in generating financial benefits and making critical recommendations to the IRS that greatly improve its revenue collection efforts. For example, during Fiscal Year 2010, TIGTA achieved financial accomplishments of more than \$11.69 billion, representing a return on investment of \$74 for each dollar invested in TIGTA. Our financial accomplishments include cost savings, increased revenue, revenue protection, taxpayer rights and entitlements, inefficient use of resources, protection of dollars, and financial recoveries. Through these accomplishments, TIGTA has consistently provided a return on investment. In Fiscal Year 2008 and Fiscal Year 2009, our accomplishments yielded \$14.68 billion, respectively. As our accomplishments show, the need for TIGTA's oversight has never been greater. The following chart shows that TIGTA has provided these successful results with funding that has remained relatively flat when adjusted for inflation.





We at TIGTA take seriously our mandate to provide independent oversight of the IRS, including efficient and effective operation of our Nation’s tax system. I hope my discussion of some of the major challenges facing the IRS and how TIGTA assists the Congress in ensuring accountability over the IRS and its budget assists you with your oversight duties.

Chairwoman Emerson, Ranking Member Serrano, and Members of the Subcommittee, thank you for the opportunity to share my views.

**Select TIGTA Accomplishments  
Fiscal Year 1999 through Fiscal Year 2010**

Accomplishment	Cumulative Totals
Investigative Recoveries (embezzlement/theft funds recovered, court ordered fines, penalties/restitution, out of court settlements)	\$493,896,089
Increased Revenue/Revenue Protection	\$137,130,618,734
Funds Put to Better Use	\$31,941,695,000
Reports with Questioned Costs	\$189,787,000
Reports with Additional Quantifiable Impact on Tax Administration	\$53,151,217,000
<b>Total Financial Accomplishments</b>	<b>\$222,907,213,823</b>
Number of Reports Issued	2,002
Number of Recommendations Made	2,724
Number of Recommendations Open as of 9/30/2010	142
Number of Corrective Actions Open as of 9/30/2010	151
Closed Investigations	46,792
Referrals to Department of Justice Accepted for Prosecution	3,192
Number of Convictions	3,071



INSPECTOR GENERAL  
FOR TAX  
ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20005

October 15, 2010

MEMORANDUM FOR SECRETARY GEITHNER

FROM: J. Russell George *J. Russell George*  
Inspector General

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

The *Reports Consolidation Act of 2000*<sup>1</sup> 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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<sup>1</sup> 31 U.S.C. Section 3516(d).

IRS MANAGEMENT CHALLENGES MEMORANDUM  
Page Two

Changes challenge to include the tax-related health care provisions of the *Patient Protection and Affordable Care Act*.<sup>2</sup>

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.<sup>3</sup> 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.<sup>4</sup> 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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<sup>2</sup> 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).

<sup>3</sup> 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](http://www.adl.org/main/Extremism/Hutaree/Militia_Facts.htm?Multi_page_sections=sHeading_2) (posted March 29, 2010).

<sup>4</sup> Mark Potok, *Rage on the Right: The Year in Hate and Extremism*, Southern Poverty Law Center Intelligence Report, Spring 2010.

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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.<sup>5</sup> 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 10<sup>th</sup> year in a row, identity theft was the number one consumer complaint nationwide.<sup>6</sup>

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.<sup>7</sup> 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)<sup>8</sup> 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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<sup>5</sup> 26 U.S.C. Sections 6103, 7213, 7213A, 7431 (2006).

<sup>6</sup> *Consumer Sentinel Network Data Book for January – December 2009*, Federal Trade Commission, dated February 2010.

<sup>7</sup> 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.

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

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Additionally, we have reported that the IRS prematurely closed the security roles and responsibilities component of its computer-security material weakness.<sup>9</sup> 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

**MODERNIZATION**

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.<sup>10</sup> 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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<sup>9</sup> 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).

<sup>10</sup> 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<sup>11</sup> 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<sup>12</sup> 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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<sup>11</sup> 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.

<sup>12</sup> 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,<sup>13</sup> 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*,<sup>14</sup> 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,<sup>15</sup> we determined that the IRS has taken significant actions to identify Section 527 political organizations<sup>16</sup> that do not timely notify the IRS of their existence or timely submit reports of their contributions and

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<sup>13</sup> Treasury Inspector General for Tax Administration, Ref. No. 2010-30-025, *Employment Tax Compliance Could Be Improved With Better Coordination and Information Sharing* (2010).

<sup>14</sup> 130 S.Ct. 876 (2010).

<sup>15</sup> 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).

<sup>16</sup> 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.<sup>17</sup>

#### **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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<sup>17</sup> 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)*<sup>18</sup> 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<sup>19</sup> 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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<sup>18</sup> *Worker, Homeownership, and Business Assistance Act of 2009*, Pub. L. No. 111-92, 123 Stat. 2984.

<sup>19</sup> *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)<sup>20</sup> 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.<sup>21</sup>
- 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.<sup>22</sup>
- 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.<sup>23</sup>
- 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.<sup>24</sup>
- 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

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<sup>20</sup> *American Recovery and Reinvestment Act of 2009* (Pub. L. No. 111-5, 123 Stat. 115).

<sup>21</sup> 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).

<sup>22</sup> 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).

<sup>23</sup> 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).

<sup>24</sup> 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.<sup>25</sup>

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.<sup>26</sup>

#### **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.<sup>27</sup> 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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<sup>25</sup> Treasury Inspector General for Tax Administration, Ref. No. 2010-11-083, *Initial Build America Bond Subsidy Payments Were Processed Accurately and Timely* (2010).

<sup>26</sup> 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).

<sup>27</sup> 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,<sup>28</sup> 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*,<sup>29</sup> 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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<sup>28</sup> 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.

<sup>29</sup> 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.<sup>30</sup> Recently, the *Improper Payments Elimination and Recovery Act of 2010*<sup>31</sup> 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.<sup>32</sup>

In a recent review of the IRS's EITC Paid Preparer Strategy,<sup>33</sup> 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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<sup>30</sup> 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.

<sup>31</sup> Pub. L. No. 111-204, 124 Stat. 2224.

<sup>32</sup> <http://www.paymentaccuracy.usaspending.gov/content/programs-not-reported> (last visited October 14, 2010).

<sup>33</sup> 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.<sup>34</sup>

#### **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.<sup>35</sup>

#### **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

<sup>34</sup> 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.

<sup>35</sup> 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).

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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.<sup>36</sup> 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)<sup>37</sup> 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.<sup>38</sup>

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."<sup>39</sup>

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<sup>36</sup> *General Explanations of the Administration's 2010 Budget Proposal*. Department of the Treasury (Issued May 2009).

<sup>37</sup> 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.

<sup>38</sup> 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).

<sup>39</sup> 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).<sup>40</sup> 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,<sup>41</sup> and did not always follow procedures for mailing notices to taxpayers or their representatives in Federal tax lien cases.<sup>42</sup>

Some IRS management information systems do not track cases that require mandatory annual audit coverage.<sup>43</sup> 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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<sup>40</sup> 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.).

<sup>41</sup> 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).

<sup>42</sup> Treasury Inspector General for Tax Administration, Ref. No. 2010-30-072, *Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (2010).

<sup>43</sup> 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).

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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,<sup>44</sup> GAO reported that the IRS's financial management systems do not comply with *Federal Financial Management Improvement Act of 1996* (FFMIA)<sup>45</sup> 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.<sup>46</sup>

**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

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<sup>44</sup> U.S. Government Accountability Office, GAO-10-176, *Financial Audit: IRS's Fiscal Years 2009 and 2008 Financial Statements* (2009).

<sup>45</sup> Pub. L. No. 104-208, 110 Stat. 3009.

<sup>46</sup> 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).