INSPECTOR GENERAL
FOR TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20005

October 14, 2011

MEMORANDUM FOR SECRETARY GEITHNER

FROM: J. Russell George
Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2012

The *Reports Consolidation Act of 2000*[1] requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2011*, 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.

Each year, TIGTA evaluates IRS programs, operations, and management functions to identify the areas of highest vulnerability to the Nation's tax system. For Fiscal Year 2012, the top 10 management and performance challenges in order of priority are:

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

TIGTA's assessment of the major IRS management challenges for Fiscal Year 2012 has changed from the prior fiscal year. Due to the mission-critical nature of both modernization and tax compliance initiatives, TIGTA considers tax compliance and modernization as serious enough management challenges to jointly rank at number two, following security. However, the current status of the United States economy and the watchful eye of the American public on the management of our Nation's Government are driving the need more than ever for the IRS to efficiently and effectively collect taxes

[1] 31 U.S.C. § 3516(d) (2006).

owed to the Federal Government. In addition, the IRS recently downgraded its longstanding material weakness[2] status of the Modernization Program. As such, tax compliance is listed before the ongoing major challenge of modernization. Also note that the prior Erroneous and Improper Payments and Credits challenge has expanded to become Fraudulent Claims and Improper Payments and has moved from the seventh to the fifth most significant challenge facing the IRS.

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. When the Internal Revenue Code is used as a vehicle for implementation of policy changes, the IRS will continue to face the challenge of responding quickly by shifting resources and altering established plans.

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

SECURITY FOR TAXPAYER DATA AND EMPLOYEES

As our Nation's tax collector and administrator of the Internal Revenue Code, the IRS received more than 230 million tax returns, of which 141 million were from individual taxpayers, and collected more than $2.3 trillion in revenue in 2010. Information from these tax returns is converted into electronic format, processed, and maintained in over 190 computer system applications for use by IRS employees. As computer use continues to be inextricably integrated into the IRS's core business processes, effective information systems security becomes essential to ensure that data are protected against inadvertent or deliberate misuse, improper disclosure, or destruction, and that computer operations supporting tax administration are secured against disruption or compromise.

The IRS faces the daunting task of securing its computer systems against the growing threat of cyberattack. According to the Department of Homeland Security's U.S. Computer Emergency Readiness Team, cyberattacks against Federal websites and networks increased almost 40 percent in 2010. More recently, in July 2011, the Pentagon acknowledged a serious data breach when a Department of Defense contractor suffered one of its largest cyberattacks ever and more than 24,000 files containing sensitive data were stolen by a foreign government.

Computer security has been problematical for the IRS since 1997, when the IRS initially reported computer security as a material weakness during its annual evaluation of internal accounting and administrative controls under the *Federal Managers Financial*

---

[2] In the event that an agency determines the existence of shortcomings in operations or systems which severely impair or threaten its ability to accomplish its mission or to prepare timely and accurate financial statements, the Department of the Treasury directs its bureaus to declare a material weakness on that particular area.

Integrity Act of 1982.[3] The IRS further divided this 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 unit 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.

As of April 2011, the IRS had officially closed three of the nine areas: segregation of duties between system and security administrators (closed in September 2005), security training (June 2008), and certification and accreditation (December 2008). In addition, the IRS completed all corrective actions on two other areas: network access controls (completed in July 2010) and functional business, operating, and program unit security roles and responsibilities (March 2009). The other four material weakness areas remain open and are actively being resolved. While the IRS has made progress in the area of computer security, it needs to continue to place a high priority on its improvement.

In addition, identity theft continues to be a significant problem for taxpayers and the IRS. Identity thieves are filing fraudulent tax returns and obtaining refunds. The IRS usually does not become aware of a problem until after the legitimate taxpayer files a tax return. At that time, the IRS often determines that two tax returns have been filed using the same name and Social Security Number. The legitimate taxpayer's refund is then delayed while the IRS attempts to determine who the legitimate taxpayer is. Meanwhile, the identity thief has obtained a fraudulent tax refund, which the IRS is unlikely to recover. As such, effectively authenticating legitimate taxpayers is a pressing challenge for the IRS as it develops and implements updates to its mission-critical systems and processes.

Beyond safeguarding a vast amount of sensitive financial and personal data, the IRS must also protect approximately 100,000 employees and contractors working in over 700 facilities throughout the country. The February 2010 attack on an IRS facility in Austin, Texas, was a stark reminder of the dangers that IRS employees face each day in trying to perform their jobs. Animosity towards the tax collection process is nothing new, but the Austin incident highlights a surge in hostility towards the Federal Government. Also, the ongoing public debate regarding the new health care law and continued concerns over the country's economy could fuel threats against the Federal Government, including IRS employees and facilities. These are challenging operating conditions for the IRS that underscore the need for continued vigilance in the area of physical and personnel security.

---

[3] 31 U.S.C. §§ 1105, 1106, 1108, 1113, 3512 (2006). The *Federal Managers' Financial Integrity Act* (FMFIA) requires that agency management establish and maintain effective internal controls to achieve the objectives of: 1) effective and efficient operations, 2) reliable financial reporting, and 3) compliance with applicable laws and regulations. The FMFIA also requires the head of each Executive agency to report annually to the President and Congress on the effectiveness of the internal controls and any identified material weaknesses in those controls. Reporting material weaknesses under the FMFIA is not limited to weaknesses over financial reporting.

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.

The IRS's challenge related to tax-exempt and government entities is providing assistance to those entities that provide a valued societal benefit while ensuring that these entities remain in compliance with the tax laws associated with their tax-exempt status. The various types of tax-exempt entities include exempt organizations, sponsors of retirement plans, Indian tribal governments, issuers of tax-exempt and other tax-advantaged bonds, and Federal, State, and local governments.

Increasing voluntary taxpayer compliance and reducing the Tax Gap[4] are 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 2012 budget submission, the IRS requested a 2.9 percent increase in enforcement funds over its Fiscal Year 2011 request.

Businesses and Individuals

The IRS estimated the gross Tax Gap for Tax Year 2001 (the most current figures available) to be approximately $345 billion. Underreporting of taxes, which comprises 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 (over 80 percent) of the Tax Gap. In fact, the underreporting of individual income tax and employment tax combined constitutes over 70 percent of the gross Tax Gap.

The absence of laws to prevent Federal agencies, including the IRS, from awarding contracts to businesses that have delinquent tax liabilities is contributing to the Tax Gap. During Fiscal Year 2010, President Obama directed the Department of the Treasury and the Office of Management and Budget to evaluate agencies' contract award processes and make recommendations to ensure that Federal contractors with serious tax delinquencies do not receive new work from Federal agencies. In a Fiscal Year 2011 report,[5] we determined that the IRS has opportunities to improve the use of the Federal Payment Levy Program[6] to collect delinquent tax liabilities

---

[4] 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.

[5] TIGTA, Ref. No. 2011-30-013, *Existing Practices Allowed IRS Contractors to Receive Payments While Owing Delinquent Taxes* (2011).

[6] The Federal Payment Levy Program is an automated process that issues tax levies to collect delinquent Federal taxes through the Financial Management Service from Social Security payments, Federal agency salaries, retirement, and contract awards.

from IRS contractors. Our audit identified that the IRS blocked 11 contractors with delinquent liabilities totaling approximately $4.3 million from inclusion in the Program. These contractors received more than $356 million in payments from the IRS and approximately $3.7 billion in payments from other Federal agencies. For eight of these contractors, the amount of delinquent taxes that could have been collected if the tax accounts had not been blocked from inclusion totaled $3.8 million.

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 their exempt status. Legislative changes and judicial decisions contribute to a constantly changing environment affecting today's nonprofit and tax-exempt organizations. For example, the *Patient Protection and Affordable Care Act* (Affordable Care Act)[7] added several new requirements for tax-exempt hospitals to maintain their exempt status.

Since more than $15 trillion in U.S. assets are currently controlled by tax-exempt organizations or held in exempt retirement programs and financial instruments, the IRS recognized in its most recent strategic plan that careful oversight of the nonprofit and exempt sector is more important than ever before. In its Fiscal Year 2012 budget submission, the IRS stated that it must continue focused oversight of the tax-exempt sector.

In a report issued in Fiscal Year 2011,[8] we reviewed the IRS process that allows public employers who determine they are not in compliance with various employment and income tax laws to step forward and be accountable by entering into an agreement with the IRS to become compliant. While this assists the IRS in improving compliance in the government sector without using scarce resources to uncover noncompliance, the IRS did not always properly control, process, and monitor all requests for agreements received from its customers. As a result, TIGTA found inconsistencies, inaccuracies, potential taxpayer rights violations, and weak internal controls that increased the risk of error, fraud, or abuse. In addition, TIGTA identified changes that could lead to an increase in the number of agreements being requested, heightening the need to begin building a more defined agreement program.

Tax Return Preparers

Greater numbers of taxpayers are turning to tax return preparers for assistance. In Calendar Year 2010, the IRS processed approximately 81.5 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.

---

[7] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of 18 U.S.C., 20 U.S.C., 21 U.S.C., 25 U.S.C., 26 U.S.C., 28 U.S.C., 29 U.S.C., 30 U.S.C., 31 U.S.C., 35 U.S.C., and 42 U.S.C.).
[8] TIGTA, Ref. No. 2011-10-042, *Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers* (2011).

A series of reports (including reviews conducted by TIGTA, the U.S. Government Accountability Office, and other agencies) strongly suggested a need to regulate those who prepare Federal tax returns and 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 IRS began implementing the new preparer requirements in Fiscal Year 2011, but we reported in September 2010 that it will take years for the IRS to implement the Return Preparer Program and to realize its impact.[9] When the decision was made to register preparers in September 2010, the IRS had only begun to implement the Return Preparer Program and had not established all of its requirements. The IRS also had not established the organizational structure of the Program, determined how it will test to ensure all preparers met the requirements, determined how it will enforce Program requirements, or developed the system(s) and processes necessary to administer and oversee the Program. It will not be until Calendar Year 2014 that all preparers will be subjected to all suitability and competency tests. In the meantime, the IRS will develop and implement an enforcement strategy. Currently, the IRS does not have a sufficient management information system to gather data on preparers. Further, the IRS will need to ensure that taxpayers understand the new requirements and the importance of using only registered preparers to prepare their tax returns.

MODERNIZATION

The Business Systems Modernization Program (Modernization Program) is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system. The IRS originally estimated that the Modernization Program would last up to 15 years and incur contractor costs of approximately $8 billion. The Program is going on its 14th year and has received approximately $3.46 billion for contractor services, plus an additional $554 million for internal IRS costs.

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 individuals, large corporations, small businesses, tax-exempt organizations, and partnerships, with dramatically reduced processing error rates;

---

[9] TIGTA, Ref. No. 2010-40-127, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (2010).

- 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 IRS's modernization efforts continue to focus on core tax administration systems designed to provide more sophisticated tools to taxpayers and to IRS employees. The Modernization Program provides new information technology capabilities and the related benefits. Since January 2011, the IRS has implemented new versions of the current Customer Account Data Engine,[10] the Modernized e-File system,[11] and the Account Management Services system.[12] Additionally, the IRS has continued making progress in preparing for the deployment of the Customer Account Data Engine 2 system.[13]

The Modernization Program has continued to help improve IRS operations and has demonstrated successes in improving business practices by implementing new information technology solutions. Management of project costs and schedules has shown dramatic improvement since the previous year, but some systems development disciplines continue to need attention.

Since 1995, the IRS had identified and reported the Modernization Program as a material weakness. In June 2011, the IRS Commissioner certified, in a memorandum to the Department of the Treasury's Assistant Secretary for Management and Chief Financial Officer, that the previously identified internal and management control issues had been fully addressed and the Modernization Program no longer warranted being identified as a material weakness. While we support the IRS's decision, we believe the Program remains a risk for the IRS, and we suggest that it continue to stress improvements in its overall processes and performance.

IMPLEMENTING MAJOR 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 the annual January through April period and, if needed, it is usually during this same time period that they contact the IRS with questions about specific tax laws or filing procedures. Correctly implementing late tax law changes remains a significant challenge because

[10] The Customer Account Data Engine is the foundation for managing taxpayer accounts in the IRS Modernization plan. When completed, its databases and related applications will replace existing IRS Master File processing systems and will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer tax account and return data.
[11] The Modernized e-File system is a replacement of the current IRS tax return filing technology with a modernized, Internet-based electronic filing platform.
[12] The Account Management Services system provides IRS employees with the ability to view, access, update, and manage taxpayer data.
[13] The Customer Account Data Engine 2 system creates a modernized processing and data-centric infrastructure that will enable the IRS to improve the accuracy and speed of individual taxpayer account processing, enhance the customer experience through improved access to account information, and increase the effectiveness and efficiency of agency operations.

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. Pertinent examples of major tax law changes that contribute to this management and performance challenge are provided below.

Health Care

The recently enacted health care reform statute known as the Affordable Care Act contains an extensive array of tax law changes that will present a continuing source of challenges for the IRS in the coming years. While the Department of Health and Human Services will have the lead role in the policy provisions of the Affordable Care Act, the IRS will administer the law's numerous tax provisions. The IRS estimates that at least 42 provisions will either add to or amend the tax code and at least eight 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.

For Fiscal Years 2011 and 2012, TIGTA identified a critical need to initiate 16 audits related to the Affordable Care Act to oversee the implementation of such significant provisions as:

- Small Business Health Care Tax Credit;
- Qualified Therapeutic Discovery Project Credit;
- Annual Fees Assessed on Branded Prescription Pharmaceutical Manufacturers and Importers;
- Expansion of the Adoption Credit;
- Indoor Tanning Excise Tax;
- Tax-Exempt Hospital Provisions; and
- Reporting Requirements Included in the Affordable Care Act.

TIGTA's audit results to date illustrate the significant need for continued oversight of the IRS's administration of many of these tax-related provisions. For example, taxpayers erroneously received millions in Adoption Credits; the IRS did not require sufficient information to determine if taxpayers claiming Small Business Health Care Tax Credits filed required employment taxes when these taxpayers entered into a contractual relationship with professional employment organizations to manage human resources; and the IRS did not take adequate steps to ensure taxpayers potentially liable for the indoor tanning excise tax were aware of the new law, particularly after the number of taxpayers filing tax returns reporting the excise tax for tanning services was much lower than expected.

A provision in this law increased the Adoption Credit from $12,150 to $13,170 and made the tax credit refundable.[14] Although the IRS requires taxpayers to attach documentation to their tax returns supporting Adoption Credit claims, it does not have math error authority to deny the credits if documentation is not provided. As a result, tax returns without required documentation must be sent to the Examination function, increasing costs for the IRS and burden for the taxpayer. As of April 30, 2011, of the 72,330 Adoption Credit claims received, 41,591 (58 percent) either had no required documentation or the documentation was invalid or insufficient. Furthermore, as of April 30, 2011, 736 taxpayers had erroneously received more than $4 million in Adoption Credits.

American Recovery and Reinvestment Act

The *American Recovery and Reinvestment Act of 2009* (Recovery Act)[15] was enacted on February 17, 2009. The Recovery Act presented significant challenges to all Federal agencies 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. TIGTA has issued numerous reports related to the IRS's efforts to implement Recovery Act tax provisions. Some examples include:

- A review of the Plug-in Electric and Alternative Motor Vehicle Credit identified 12,920 individuals who erroneously claimed $33 million in plug-in electric and alternative motor vehicle credits on electronically filed (e-filed) tax returns. Furthermore, 1,719 of the 12,920 individuals erroneously reduced the amount of the Alternative Minimum Tax owed by almost $5.3 million.[16]
- A review of the Residential Energy Credit identified that the IRS cannot verify whether individuals claiming Residential Energy Credits were entitled to them at the time their tax returns are processed. The IRS does not require individuals to provide any third-party documentation to verify eligibility.[17]
- A review of the IRS's compliance with requirements over procurements funded by the Recovery Act determined that the IRS did not always comply

[14] A refundable tax credit is a tax credit that is treated as a payment and can be refunded to the taxpayer. Refundable credits can create a Federal tax refund that is larger than the amount a person actually paid in taxes during the year.
[15] Pub. L. No. 111-5, 123 Stat. 115.
[16] TIGTA, Ref. No. 2011-41-011, *Individuals Received Millions of Dollars in Erroneous Plug-in Electric and Alternative Motor Vehicle Credits* (2011).
[17] TIGTA, Ref. No. 2011-41-038, *Processes Were Not Established to Verify Eligibility for Residential Energy Credits* (2011).

with the Recovery Act and its implementing guidance in planning and awarding those procurements.[18]

- A review of the IRS's use of compliance check questionnaires regarding Build America Bonds found that the questionnaires issued by the Tax Exempt Bonds office were appropriate for identifying indications of a high risk of potential noncompliance for Build America Bonds. However, the office did not have formal written procedures for developing and conducting compliance checks that would aid in the development of compliance check programs and provide added assurance the IRS does not exceed its authority when executing such programs.[19]

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

Along with the usual required updates[20] for the 2011 Filing Season, the late passage of the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (enacted December 17, 2010)[21] resulted in a need for the IRS to reprogram its computer systems to accommodate provisions extended by this law. As a result, taxpayers who claimed one or more of the three affected deductions or who itemized deductions were unable to file their tax returns until February 14, 2011. The IRS reported it had Electronic Return Originators hold approximately 6.5 million e-filed tax returns for transmission until February 14, 2011, and as of February 11, 2011, the IRS itself had received and held for processing approximately 100,000 paper tax returns.

In addition, more than 1.5 million taxpayers who purchased a home between April 9 and December 31, 2008, and claimed the First-Time Homebuyer Credit (Homebuyer Credit) were required to begin repaying the credit on their Tax Year 2010 tax return. The credit is intended to be repaid over 15 years, in equal annual installments. However, the IRS experienced difficulties in implementing the repayment process. As of April 30, 2011, we identified 26,649 taxpayers for whom the Homebuyer Credit was inaccurately processed, which resulted in the IRS not assessing more than $5.8 million in repayment amounts owed but not paid and erroneously assessing $675,063 as a repayment amount in excess of what was owed by the taxpayer.

---

[18] TIGTA, Ref. No. 2011-11-132, *Procurements Were Not Processed in Compliance With the American Recovery and Reinvestment Act of 2009* (2011).
[19] TIGTA, Ref. No. 2011-11-053, *The Direct Pay Build America Bond Compliance Check Program Has Yet to Result in Wide-Scale Examinations* (2011).
[20] Each year, tax products must be updated to reflect current tax rates, exemption amounts, and cost of living adjustments as shown in Revenue Procedures.
[21] Pub. L. No. 111-312, 124 Stat. 3296.

These difficulties resulted in inaccurate processing of repayments and significant delays in providing refunds to taxpayers with repayment requirements.

FRAUDULENT CLAIMS AND IMPROPER PAYMENTS

The *Improper Payments Information Act of 2002*[22] defines an improper payment as any payment that should not have been made or that was made in an incorrect amount (both overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. Improper payments include any payment to an ineligible recipient or for an ineligible service, any duplicate payment, any payment 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, and on November 20, 2009, the President signed Executive Order 13520,[23] which included a strategy to reduce improper payments by increasing transparency, holding agencies accountable, and creating strong incentives for compliance. In addition, the *Improper Payments Elimination and Recovery Act of 2010*[24] placed additional requirements on Federal agencies to reduce improper payments. Erroneous and improper payments issued by the IRS generally involve improperly paid refunds, tax return filing fraud, or improper payments to vendors or contractors.

Refundable Credits

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

Our reviews have shown the need for appropriate controls to be established before refundable credits are issued. This includes requiring documentation to substantiate claims, implementing filters timely to identify erroneous claims, and entering key information into IRS computers so that it can be used to verify eligibility.[25]

The EITC remains the largest refundable credit, based on the total claims paid, and it continues to be vulnerable to a high rate of noncompliance, including incorrect or erroneous claims caused by taxpayer error or resulting from fraud. We recently assessed the IRS's efforts to implement Executive Order 13520, which requires the IRS to intensify its efforts and set targets to reduce EITC improper payments. It also requires the IRS to provide TIGTA with its plans and supporting analysis for meeting those targets. The IRS's report to TIGTA did not include any quantifiable targets to reduce EITC improper payments. Without targets to reduce EITC improper

---

[22] Pub. L. No. 107-300, 116 Stat. 2350.
[23] Executive Order No. 13,520, 74 Fed. Reg. 62201 (Nov. 25, 2009), *Reducing Improper Payments and Eliminating Waste in Federal Programs.*
[24] Pub. L. No. 111-204, 124 Stat. 2224.
[25] TIGTA, Ref. No.2011-41-035, *Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits* (2011).

payments as required by the Executive Order, there is a lack of accountability for eliminating payment error, waste, fraud, and abuse.[26] As such, the risk remains high that the IRS will continue to pay billions of dollars in EITC improper payments annually. The IRS continues to report that 23 to 28 percent of EITC payments are issued improperly each year. In Fiscal Year 2009, this equated to $11 to $13 billion in EITC improper payments.

The Additional Child Tax Credit is the second largest refundable credit available to individuals. Refunds for the credit processed in Fiscal Year 2010 totaled $28.3 billion, and we have reported that the IRS paid $4.2 billion for this credit in Processing Year 2010 to individuals who were not authorized to work in the United States. Furthermore, the Examination function does not effectively and efficiently work Additional Child Tax Credit cases of those individuals filing with an Individual Taxpayer Identification Number. We have recommended that the IRS work with the Department of the Treasury to seek clarification in the law as to whether this and other refundable credits may be paid to individuals who are not authorized to work in the United States.

The Recovery Act amended the Hope Scholarship Credit to provide for a refundable tax credit called the American Opportunity Tax Credit to help taxpayers offset the costs of higher education. TIGTA identified 2.1 million taxpayers who appear to have received $3.2 billion in erroneous education credits. This includes 1.7 million taxpayers who received $2.6 billion in education credits for students for whom there was no supporting documentation in IRS files establishing that they attended an educational institution. This is further indication that the IRS needs to have processes in place to verify eligibility for refundable credits at the time a tax return is processed.

Contract and Other Payments

Federal contract spending has nearly doubled since 2002. In Fiscal Year 2010, the Federal Government spent approximately $538 billion to acquire goods and services. Similarly, contract spending by the IRS represents a significant outlay of funds. As of May 2011, the IRS administered more than 1,000 procurements, including 807 contracts of varying types and 201 Blanket Purchase Agreements and Interagency Contracts and Agreements. These 1,008 active contracts have a reported systems life value of approximately $39.2 billion. Numerous past TIGTA investigations and audits have identified millions of dollars in questioned costs and several instances of contractor fraud.

During Fiscal Years 2010 and 2011, court-ordered civil settlements directed $156 million and $113 million, respectively, to be paid back to the U.S. Treasury as a result of TIGTA criminal investigative efforts. During these investigations, two recurring trends emerged. Contracting Officer's Technical Representatives were frequently overwhelmed by their workloads, and current business practices have not enhanced the IRS's ability to identify anomalies warranting additional review.

---

[26] TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* (2011).

Further, in a recent review of the IRS Purchase Card Program, TIGTA determined that, while some purchase card controls were working as intended, overall management controls were inadequate to ensure the appropriate use of IRS purchase cards. TIGTA found violations of applicable laws and regulations that included purchases made without necessary approvals and verification of funding, purchases that were potentially split into two or more transactions to circumvent micro-purchase limits, and purchases made from improper sources.[27]

PROVIDING QUALITY TAXPAYER SERVICE OPERATIONS

The Department of the Treasury and the IRS recognize that the delivery of effective taxpayer service has a significant impact on voluntary tax compliance. Answering taxpayers' questions to assist them in correctly preparing their returns reduces the need to send notices and correspondence when taxpayers make errors. Taxpayer service also reduces unintentional noncompliance and shrinks the need for future collection activity. The IRS continues to focus on the importance of improving service by emphasizing it as a main goal in its strategic plan, including seeking innovative ways to simplify or eliminate processes that unnecessarily burden taxpayers or Federal Government resources.

In a review of the taxpayer experience during the 2011 Filing Season,[28] the overall experiences of TIGTA auditors who posed as taxpayers to obtain answers to tax law questions from the toll-free telephone assistance lines, IRS.gov, and Taxpayer Assistance Centers were generally positive. However, taxpayers were experiencing long wait times at Taxpayer Assistance Centers and on telephones. At Taxpayer Assistance Centers, our auditors waited an average of one hour to receive assistance and, in some cases, were turned away and told to return another day to obtain services. In addition, Taxpayer Assistance Centers do not always allow qualified taxpayers to schedule appointments and do not consistently apply new taxpayer screening guidelines and procedures.

Our recent review of the Taxpayer Advocate Service's process for selecting systems advocacy projects[29] determined it can improve the process used for identifying these projects. Specifically, we found that Taxpayer Advocate Service management primarily relies on IRS employees and external stakeholders to submit issues for consideration as potential projects. However, we found that Taxpayer Advocate Service could improve the research it performed during the screening process to better identify systemic problems affecting multiple taxpayers. Such improvements will assist management in identifying and resolving broad-based taxpayer problems, thereby preventing or reducing similar problems in the future.

[27] TIGTA, Ref. No. 2011-10-075, *Controls Over the Purchase Card Program Were Not Effective in Ensuring Appropriate Use* (2011).
[28] TIGTA, Ref. No. 2011-40-070, *The Internal Revenue Service Provides Helpful and Accurate Tax Law Assistance, but Taxpayers Experience Lengthy Wait Times to Speak With Assistors* (2011).
[29] TIGTA, Ref. No. 2011-10-062, *The Identification and Evaluation of Systemic Advocacy Projects Designed to Resolve Broad-Based Taxpayer Problems Can Be Improved* (2011).

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 new challenges as the implementation of health care reform, the recruitment of new employees and retention of existing employees is critical to 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. This challenge is especially evident in the IRS's leadership ranks, where about one-third of all executives and almost 20 percent of managers are already retirement eligible. Within five years, nearly 70 percent of all IRS executives and almost 50 percent of managers are projected to be eligible for retirement.

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 Federal, State, and local governmental agencies and the private sector for the same human resources, an effort that 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.

The IRS is improving in its human capital management practices and has developed a comprehensive agency-wide recruitment strategy. However, there is still much work left to be done. For example, we recently determined that the IRS, like other Government agencies, was struggling to accomplish the basic tasks in acquisition workforce planning, including identifying its acquisition workforce, determining the number of acquisition workforce personnel it needs to accomplish its mission, and determining the skills its employees have compared to the skills it requires. If the IRS does not take action to improve its acquisition workforce planning, it: (1) may not be able to easily determine whether its acquisition workforce has enough people with the right skills to perform acquisition duties, (2) may be understaffed to handle the anticipated acquisition workload, and (3) may not have all the prerequisite skills to oversee procurements.[30]

The IRS also faces challenges to maintain the number of Revenue Officers needed, due to attrition and an increasing inventory. The IRS's Revenue Officer hiring initiative added 1,515 new Revenue Officers throughout the country between June 2009 and February 2010. The methodology to assign these new employees was effective in placing them in the Collection areas with the greatest need. However, even though 1,515 Revenue Officers were hired over a nine-month period, the net increase was only 580 Revenue Officers. The IRS has also projected that planned hiring for Fiscal

[30] TIGTA, Ref. No. 2011-10-072, *Additional Actions and Data Are Needed to Further Analyze the Size and Skills of the Acquisition Workforce* (2011).

Years 2011 and 2012 will barely cover attrition losses. Meanwhile, the percentage of delinquent accounts closed has steadily decreased because of increasing inventory.

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 that conduct international business transactions, including individuals, businesses, and tax-exempt organizations, continues to grow. The IRS is still 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 continues to realign and expand its international efforts under its Large Business and International Division. The IRS expects that these efforts will improve international tax compliance by allowing it to focus on high-risk issues and cases with greater consistency and efficiency.

The IRS continues to work with the U.S. Department of Justice on tax evasion cases involving foreign countries with bank secrecy laws that prevent the United States from obtaining information on taxpayer transactions. In addition, the 2009 and 2011 Offshore Voluntary Disclosure Initiatives have encouraged taxpayers with hidden offshore assets and income to come back into the tax system using the IRS's Voluntary Disclosure Program. The Initiatives offer a uniform penalty structure for taxpayers who voluntarily disclose their hidden offshore assets and income to the IRS and, in return, ensure that the taxpayers receive consistent tax and penalty treatment. They also provide the opportunity to calculate, with a reasonable degree of certainty, the total cost of resolving all outstanding offshore tax issues related to the undisclosed foreign bank and financial accounts and assets. Taxpayers with undisclosed foreign accounts and assets who do not submit a voluntary disclosure run the risk of detection by the IRS. If caught, these taxpayers face the imposition of substantial penalties, including the fraud and foreign information return penalties, as well as an increased risk of criminal prosecution.

In addition, one of the biggest challenges currently facing the IRS is the implementation of the *Foreign Account Tax Compliance Act* (FATCA).[31] As capital markets become

---

[31] Pub. L. No. 111-147, 124 Stat. 71 (2010) (codified in scattered sections of 26 U.S.C.).

increasingly globalized, U.S. investors may be able to benefit from a corresponding increase in international investment opportunities. The FATCA was enacted to combat tax evasion by U.S. persons holding investments in offshore accounts. Under this Act, a U.S. taxpayer with financial assets outside the United States will be required to report those assets to the IRS. In addition, foreign financial institutions will be required to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest.

Foreign financial institutions that do not enter into an agreement to report this information to the IRS will be subject to withholding on certain types of payments, including U.S. source interest and dividends, gross proceeds from the disposition of U.S. securities, and pass-through payments. To avoid being withheld upon, foreign financial institutions will have to enter into an agreement with the IRS to:

- Identify U.S. accounts;
- Report certain information to the IRS regarding U.S. accounts; and
- Withhold a 30-percent tax on certain payments to nonparticipating foreign financial institutions and account holders who are unwilling to provide the required information.

According to the IRS Commissioner, "FATCA is an important development in U.S. efforts to combat offshore noncompliance. At the same time, the IRS recognizes that implementing FATCA is a major undertaking for financial institutions."[32] Based on the initial feedback from foreign financial institutions as well as foreign governments, the IRS will continue to face significant opposition from abroad in implementation of this Act.

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).[33] 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*[34] Violations;
- Notice of Lien;
- Seizures;
- Illegal Protestor Designations;

[32] IRS News Release IR-2011-76, *Treasury and IRS Issue Guidance Outlining Phased Implementation of FATCA Beginning in 2013* (July 14, 2011).
[33] 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.).
[34] 15 U.S.C. §§ 1601 note, 1692-1692o (2006).

- Assessment Statute of Limitations;
- Collection Due Process Appeals;
- Denial of Requests for Information;
- Restrictions on Directly Contacting Taxpayers Instead of Authorized Representatives; and
- Separated or Divorced Joint Filer Requests.

In general, the IRS has improved its compliance with these statutory taxpayer rights provisions. 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[35] and did not always follow procedures for mailing notices to taxpayers or their representatives in Federal tax lien cases.[36] IRS management information systems do not track all cases that require mandatory annual audit coverage.[37] Thus, neither TIGTA nor the IRS could evaluate the IRS's compliance with certain RRA 98 provisions.

In addition, identity theft remains the single largest type of complaint submitted to the Federal Trade Commission's Consumer Sentinel Network. The Federal Trade Commission estimates that as many as 9 million Americans have their identities stolen each year. Identity theft affects the IRS and tax administration in two ways – fraudulent tax returns and misreporting of income. Both can potentially harm taxpayers who are the victims of the identity theft. The IRS is seeing a significant growth in identity theft cases. At a recent hearing[38] of the House Oversight and Government Reform Subcommittee on Government Organization, Efficiency, and Financial Management, identity theft victims testified that other individuals had filed fraudulent tax returns using their identities. The victims stated that the IRS withheld their tax refunds, sometimes more than once, and further stated that they had been treated unprofessionally by numerous IRS employees while they tried to resolve their problems.

ACHIEVING PROGRAM EFFICIENCIES AND COST SAVINGS

Given the current economic environment and the increased focus by the Administration, Congress, and the American people on Federal Government accountability and efficient use of resources, the American people must be able to trust that their Government is taking action to stop wasteful practices and ensure that every tax dollar is spent wisely. On June 13, 2011, President Obama signed an Executive Order[39] to cut waste,

---

[35] TIGTA, 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).
[36] TIGTA, Ref. No. 2010-30-072, *Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (2010).
[37] TIGTA, Ref. No. 2010-30-026, *Fiscal Year 2010 Statutory Review of Disclosure of Collection Activity With Respect to Joint Returns* (2010) and TIGTA, Ref. No. 2010-30-060, *Fiscal Year 2010 Statutory Review of Restrictions on Directly Contacting Taxpayers* (2010).
[38] *IRS E-File and Identity Theft*, *Hearing Before the House Oversight and Government Reform Subcommittee on Government Organization, Efficiency, and Financial Management*, 112th Cong. (2011).
[39] Executive Order No. 13,576, 76 Fed. Reg. 35297 (June 16, 2011), *Delivering an Efficient, Effective, and Accountable Government.*

streamline Government operations, and reinforce the performance and management reform gains achieved by his Administration. In addition, the Government Accountability Office is now statutorily required to identify and report to the Congress those Federal programs, agencies, offices, and initiatives, either within departments or Government-wide, that have duplicative goals or activities.

While the IRS has made progress in using its data to improve program effectiveness and reduce costs, this area continues to be a major challenge. In a recent audit,[40] we reviewed the IRS's $88 million contract with a private vendor to provide support-service functions, including storage and management, throughout IRS facilities. We determined that the IRS should take additional steps to ensure support services are managed in a more cost-effective manner. Specifically, the IRS should evaluate whether it is cost effective to continue to move into storage rather than dispose of furniture and equipment that has not been clearly determined to be of future usefulness. As a result, the IRS may be paying more for its support services than is necessary.

The IRS is reducing publishing and mail costs, but recent reductions have resulted from budget cuts and were not part of a long-term strategy. In response to the cost savings proposed in the Fiscal Year 2011 budget request, the IRS formed task forces to identify ways to achieve cost savings.[41] A task force proposed 25 actions to reduce publishing and mail costs and lay the foundation for long-term implementation of cost reductions for Fiscal Year 2011 and beyond. However, the task force proposal did not include documentation to show the methodology used to make the proposals, the method used to calculate or validate its estimates, or the manner in which the IRS will measure the results or the cost savings of the proposals. As the IRS moves forward with the proposed cost savings or pursues other methods of saving publishing and mail costs, it needs to implement sufficient controls and procedures to ensure the methodology for the decisions are documented and that the data used are accurate and complete.

In a prior audit,[42] we reviewed the IRS's methodology to reasonably and accurately calculate the cost of Unemployment Trust Fund administrative expenses. This fund was established to provide a portion of extended unemployment benefits during periods of high unemployment. The IRS is reimbursed the costs of collecting and processing the taxes that are deposited to the fund. However, we determined that there were insufficient controls to ensure that expenses associated with the administration of the Unemployment Trust Fund are accurately calculated. Specifically, we found that the IRS overestimated the related expenses by $63 million during Fiscal Years 2005 through 2009. As a result, these funds were not available during this period to fund the Federal Government's share of unemployment benefit payments to eligible taxpayers.

---

[40] TIGTA, Ref. No. 2011-10-086, *Controls Over Costs and Building Security Related to Outsourced Office Support Services Need to Be Improved* (2011).
[41] TIGTA, Ref. No. 2011-40-025, *Publishing and Mail Costs Need to Be More Effectively Managed to Reduce Future Cost* (2011).
[42] TIGTA, Ref. No. 2010-10-039, *Internal Accounting Errors Reduced the Federal Funding Available for Unemployment Benefits by $63 Million During Fiscal Years 2005 Through 2009* (2010).

CONCLUSION

This correspondence is provided as our annual summary of the most serious major management and performance challenges confronting the IRS in Fiscal Year 2012. TIGTA's *Fiscal Year 2012 Annual Audit Plan* contains our proposed reviews, which are organized by these challenges. If you have questions or wish to discuss our 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