

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Additional Actions Could Improve the Quality and Productivity of Employment Tax Examinations of Federal, State, and Local Governments

March 17, 2023

Report Number: 2023-10-015

HIGHLIGHTS: Additional Actions Could Improve the Quality and Productivity of Employment Tax Examinations of Federal, State, and Local Governments

Final Audit Report issued on March 17, 2023

Report Number 2023-10-015

Why TIGTA Did This Audit

Federal, State, and local government (FSLG) entities are established and recognized by the U.S. and State constitutions and are generally exempt from paying Federal income taxes. However, FSLG entities are required to withhold, report, and pay employment taxes for both the employer and their employees. This audit was initiated to determine whether the IRS ensures that FSLG entities comply with their employment tax responsibilities.

Impact on Tax Administration

Tax Year 2021 filing data showed that there were approximately 77,000 FSLG entities that employed 20 percent of the American workforce. These employees earned approximately \$1.36 trillion and paid more than \$200 billion in employment taxes. Oversight of this sector is a critical component of tax administration.

Tax Year 2021 filing data showed that approximately:



77,000 FSLG entities
employed 20 percent of
the American workforce



\$1.36 trillion
Was earned by these
employees



\$200 billion
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paid by these employees

What TIGTA Found

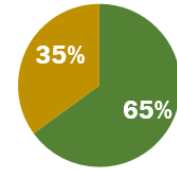
As a result of low Fiscal Year 2021 quality review scores, the IRS implemented corrective actions to improve FSLG examination case quality. Quality review scores subsequently improved for 13 (65 percent) of the 20 quality elements.

In February 2022, quality reviewers began providing Feedback Memorandums to group managers for five specific quality review elements. These memorandums were intended to help group managers make improvements, and the five elements improved by an average of 18 percent.

However, Federal, State, and Local Governments/Employment Tax (FSL/ET) management has not established quantifiable goals for quality review results. Management stated that they have not established goals because they are always working to improve their quality review results. Various statutory and regulatory provisions require the IRS to set performance goals for organizational units and to measure the results achieved by those units. Goals help measure how organizations perform relative to past performance and also help facilitate accountability. Without goals, quality measures do not provide a full perspective about direction and progress in the FSL/ET function.

The IRS may be able to identify additional noncompliant behavior within the FSLG entity population of taxpayers by continuing to refine its data-driven approaches. TIGTA's analysis of Forms W-2, *Wage and Tax Statement*, identified 528 FSLG entities that issued 50 or more Forms W-2 with potential Social Security noncompliance, including 32 entities that issued more than 1,000 such forms in Tax Year 2021. Additionally, 464 of these entities issued Forms W-2 to employees in Tax Year 2021, but they had not issued Forms W-2 to the same employees in any of the previous five years, reducing the likelihood that they were long-term employees exempt from paying Social Security taxes. Most FSLG employees hired or rehired as of July 2, 1991, are subject to Social Security taxes.

Quality review scores improved for 13 of the 20 quality elements.



What TIGTA Recommended

TIGTA recommended that the Commissioner, Tax Exempt and Government Entities Division, should 1) ensure that the quality elements addressed in the Feedback Memorandums are periodically reviewed and updated as needed; 2) ensure that annual baseline goals for the FSL/ET function's Tax Exempt Quality Management System scores are developed and adjusted periodically as needed; and 3) continually analyze and periodically update the data-driven approaches to improve the productivity of case selection. In their response, IRS management agreed with all the recommendations.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

March 17, 2023

MEMORANDUM FOR: ACTING COMMISSIONER OF INTERNAL REVENUE

Heather Hill

FROM: Heather M. Hill
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Actions Could Improve the Quality and Productivity of Employment Tax Examinations of Federal, State, and Local Governments (Audit # 202210030)

This report presents the results of our review to determine whether the Internal Revenue Service ensures that Federal, State, and local government entities comply with their employment tax responsibilities. This review is part of our Fiscal Year 2023 Annual Audit Plan and addresses the major management and performance challenge of *Increasing Domestic and International Tax Compliance and Enforcement*.

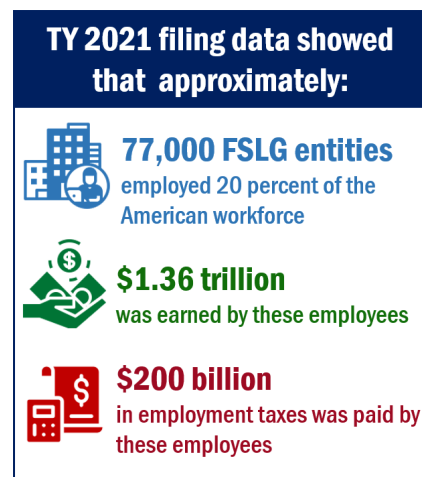
Management's complete response to the draft report is included as Appendix III. If you have any questions, please contact me or Bryce Kisler, Assistant Inspector General for Audit (Management Services and Exempt Organizations).

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Background

Federal, State, and local government (FSLG) entities are established and recognized by the U.S. and State constitutions and are generally exempt from paying Federal income taxes. However, FSLG entities are required to withhold, report, and pay employment taxes for both the employer and their employees. Employment taxes consist of Federal income tax, Social Security tax, and Medicare tax.¹ Tax Year (TY) 2021 filing data showed that there were more than 77,000 FSLG entities that employed 20 percent of the American workforce. These employees earned approximately \$1.36 trillion and paid employment taxes in excess of \$200 billion.



FSLG entities report compensation and taxes paid for employees yearly on Form W-2, *Wage and Tax Statement*, and file Form 941, *Employer's Quarterly Federal Tax Return*, quarterly to report the aggregate wage and withholding amounts, including employment taxes paid.² Form W-3, *Transmittal of Wage and Tax Statements*, is used to total all parts of Forms W-2 for a given tax year. The Internal Revenue Service (IRS) performs a match of Forms W-3 and Forms 941 to ensure that no discrepancies are identified in the employees' reported wages and taxes.

The Tax Exempt and Government Entities (TE/GE) Division's Federal, State, and Local Governments/Employment Tax (FSL/ET) function is responsible for ensuring Federal tax compliance by Federal, quasi-governmental, State, and local entities. Internal Revenue Code § 3402 generally requires employers to withhold the proper amount of taxes from their employees' compensation to ensure that withheld taxes can be paid to the IRS throughout the year.³ Internal Revenue Code § 3403 states that employers are liable for the payment of Federal income taxes that are required to be withheld from their employees' wages.

The withholding of employment taxes is a critical component of tax administration. FSL/ET examiners should analyze information, perform tests, and maintain a working relationship with FSLG officials. The examination may include a review of common compliance issues, which include taxable fringe benefits, reclassification of worker classes, and other issues such as backup withholding. Examiners are required to use the Reporting Compliance Case Management System while working cases, which is the inventory control system for FSL/ET cases. The examiner should continue the examination until they are reasonably certain that the FSLG entity complies with its employment tax withholding requirements.

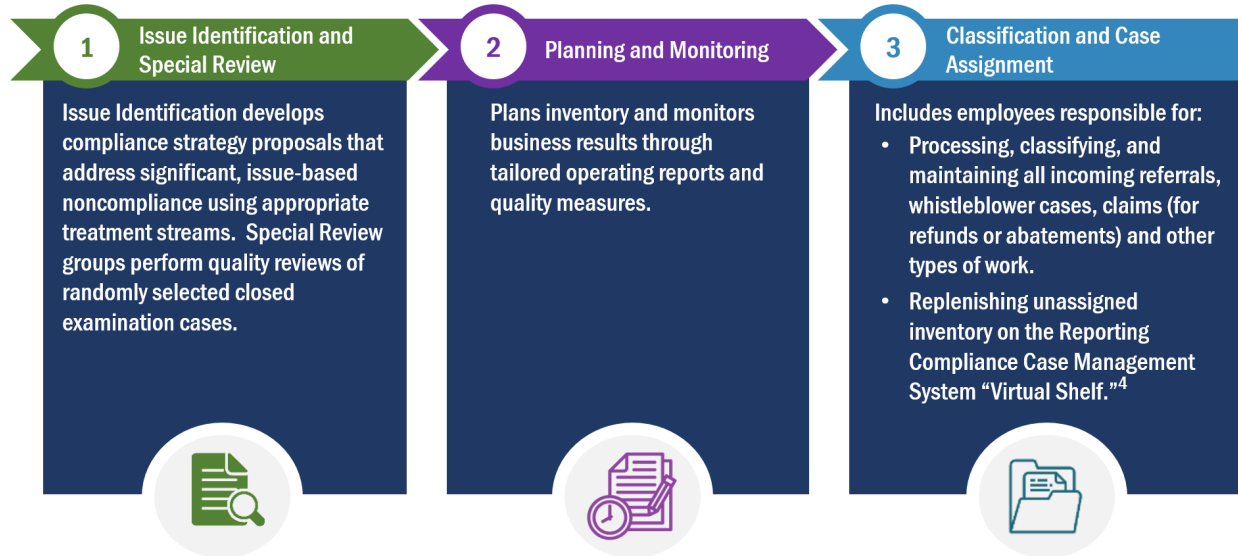
¹ FSLG entities are also responsible for other employment taxes such as the Additional Medicare Tax.

² Instead of reporting quarterly, the IRS allows the smallest employers (those whose annual liability for Social Security, Medicare, and withheld Federal income taxes is \$1,000 or less) to file annually using Form 944, *Employer's Annual Federal Tax Return*. During Calendar Year 2022, the IRS received approximately 28 million Forms 941 and 76,000 Forms 944.

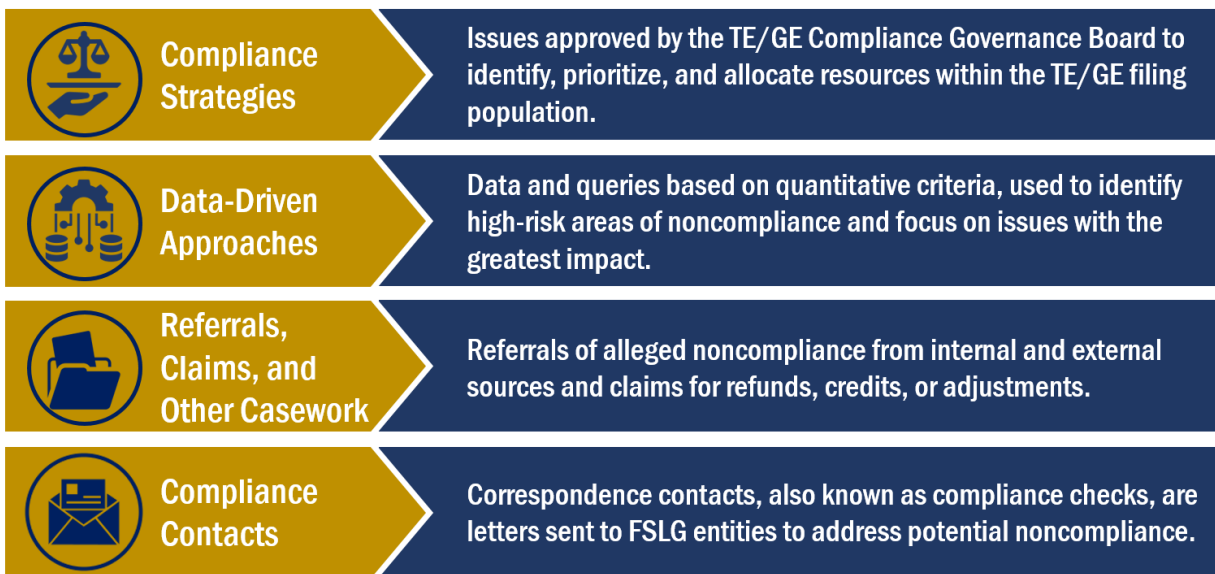
³ There are situations in which an employer is not required to withhold taxes. For example, employers are not required to withhold taxes on tips that are not reported to them.

Additional Actions Could Improve the Quality and Productivity of Employment Tax Examinations of Federal, State, and Local Governments

The TE/GE Division’s Compliance Planning and Classification (CP&C) function is responsible for developing compliance issues, monitoring organizational compliance activities, and contributing to the annual TE/GE Fiscal Year Program Letter. The CP&C function includes three subfunctions:



The CP&C function sorts FSL/ET examination inventory into different work streams based on how the work was identified.



Special Review conducts quality reviews of a sample of completed FSL/ET examinations, which they manage and maintain using the Tax Exempt Quality Measurement System (TEQMS). Special Review determines the number of closed FSL/ET cases selected for review by considering historical examination rates, expected case closures, and staffing conditions. In addition, Special Review uses 20 evaluative criteria to measure case quality, referred to as quality elements. If a case fails an element, the reviewer must provide a comment explaining why the case failed. The 20 quality elements fall under one of the three quality measures listed in Figure 1.

⁴ The Virtual Shelf is the unassigned case inventory ready for assignment to an examiner.

Figure 1: TEQMS Quality Measures and Elements

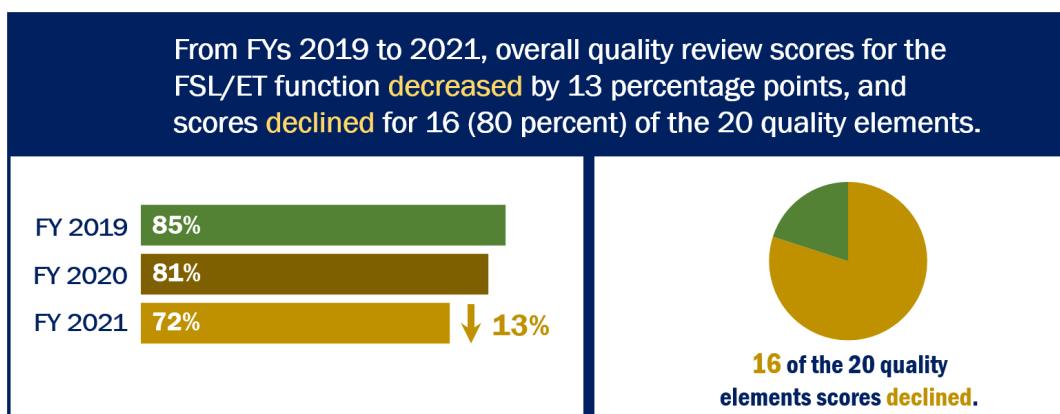
	Proper Identification, Development, and Resolution of Issues (10 elements):
Element #1	Was the compliance activity adequately planned?
Element #2	Were material issues (beyond CP&C) identified and properly considered during the compliance activity?
Element #3	Were adequate filing checks completed?
Element #4	Were adequate interviews conducted and recorded in the file?
Element #5	Were material issues properly developed?
Element #6	Did the workpapers and file adequately document the steps taken, techniques, and conclusions?
Element #7	Did the Case Chronology Record adequately document the activity?
Element #8	Were material issues properly resolved?
Element #9	Were penalties considered, applied, waived, or removed as warranted?
Element #10	Was fraud adequately considered?
	Communications (six elements):
Element #11	Were information document requests and/or other information requests clear, concise, and appropriate?
Element #12	Were the letters to the taxpayer properly prepared?
Element #13	Were the reports to the taxpayer properly prepared?
Element #14	Were proper closing procedures followed?
Element #15	Was the taxpayer/representative regularly kept informed throughout the compliance activity?
Element #16	Were taxpayer/representative rights observed and protected?
	Timeliness (four elements):
Element #17	Was the timespan on the compliance activity reasonable?
Element #18	Was the total time spent on the compliance activity commensurate with the nature and complexity of the issues?
Element #19	Were actions taken timely to monitor and protect the statute of limitations?
Element #20	Was there timely and adequate level of managerial oversight and involvement?

Source: TEQMS User Guide, FSL/ET Examinations.

Figure 2 shows that, from Fiscal Years (FY) 2019 to 2021, the overall quality review scores for the FSL/ET function decreased by 13 percentage points, and scores declined for 16 (80 percent) of the 20 quality elements.⁵

⁵ Since quality elements may not be applicable to all cases, there could be significant increases and decreases in quality scores.

Figure 2: FSL/ET Quality Review Results (FYs 2019 to 2021)⁶



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Special Review's TEQMS quality review results.

Results of Review

Management Actions Have Improved Quality Review Scores

As a result of low FY 2021 quality review scores, FSL/ET management and Special Review implemented corrective actions intended to improve case quality. The corrective actions included:

- **Semiannual presentations.** Twice each year, Special Review provides training, also known as "Audit Hours," designed to refresh examiners on the quality review elements and how to improve the quality of examinations.
- **Consistency reviews.** FSL/ET managers complete independent reviews of cases previously scored by Special Review. The results are compared with Special Review's rating of the elements, and any differences are used to identify potential improvements.
- **Feedback Memorandums.** Special Review sends Feedback Memorandums to group managers when reviewed cases do not meet certain quality review elements. Feedback Memorandums include information about the issues identified so that managers can focus on areas needing improvements.

According to the Government Accountability Office's *Standards for Internal Control in the Federal Government*, management should establish and operate activities to monitor the internal control system and evaluate the results.⁷ Special Review conducts quality reviews of completed FSL/ET examinations in order to measure the quality of FSL/ET function work that is being done so that improvements can be made.

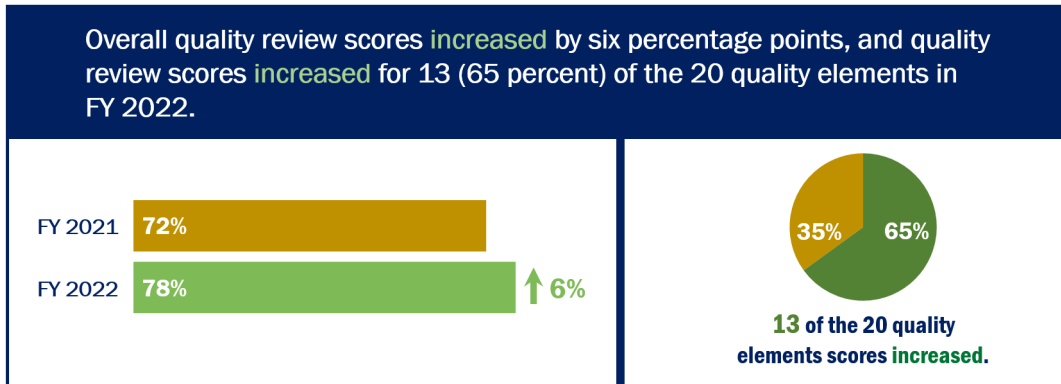
⁶ Appendix II shows all the quality review scores for each element from FYs 2019 to 2021. Special Review evaluated 49 cases in FY 2019, 34 cases in FY 2020, and 37 cases in FY 2021.

⁷ Government Accountability Office, GAO-14-704G, *Standards for Internal Control in the Federal Government* (Sept. 2014).

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Figure 3 shows that, for FY 2022, overall quality review scores increased by 6 percentage points and increased for 13 (65 percent) of the 20 quality elements.

Figure 3: FSL/ET Quality Review Results (FYs 2021 and 2022)⁸

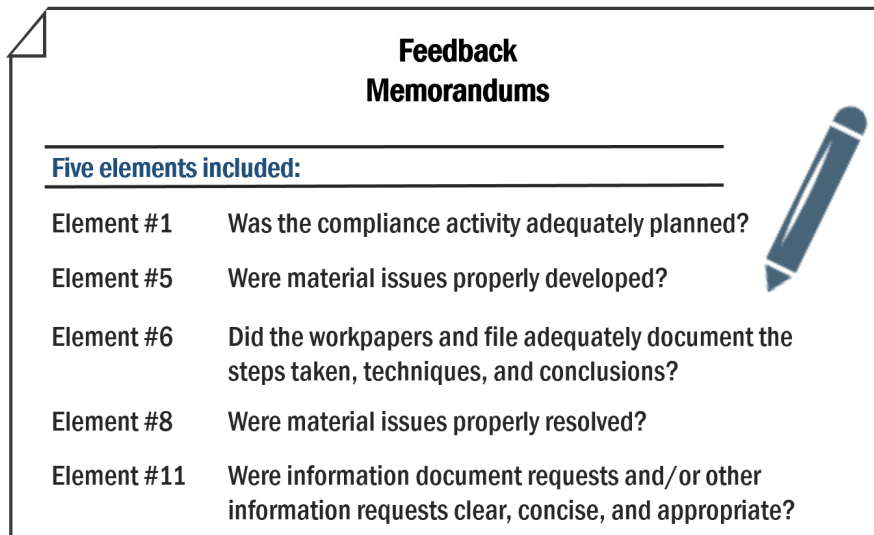


Source: TIGTA analysis of Special Review's TEQMS quality review results.

Periodic Updates to Feedback Memorandum Elements Could Improve Examination Quality

FSL/ET examination quality scores could potentially improve for additional quality elements if Special Review and FSL/ET management periodically reviewed and updated which elements to include in the Feedback Memorandums. In February 2022, Special Review began providing Feedback Memorandums to group managers when one or more of the five specific quality review elements shown in Figure 4 did not meet requirements.

Figure 4: Five Elements Included in the Feedback Memorandums



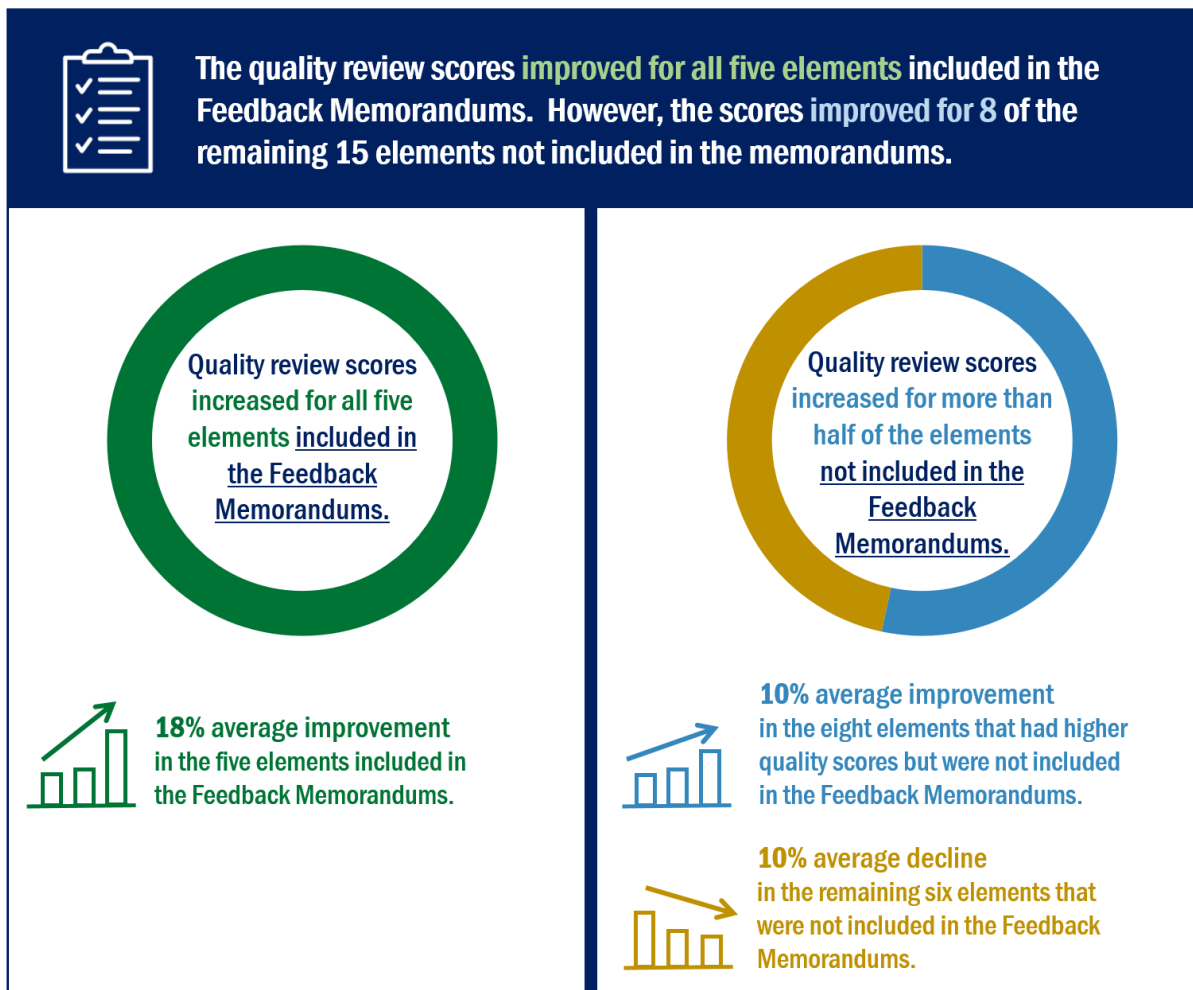
Source: FY 2022 Feedback Memorandums.

⁸ Appendix II shows all the quality review scores for each element from FYs 2021 and 2022. Special Review evaluated 37 cases in FY 2021 and 50 cases in FY 2022.

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Although all 20 quality elements are important, these five elements were selected because management believed that they have a broad and critical connection to overall effectiveness of casework and that improvements in these elements could lead to improvements in other elements. Figure 5 shows that the quality review scores improved for all five elements included in the Feedback Memorandums by an average of 18 percent and that, for the 15 elements not included in the Feedback Memorandums, quality review scores improved for eight elements by an average of 10 percent and declined for six by an average of 10 percent. There was one element for which cases could not be rated in FYs 2021 and 2022.

**Figure 5: Comparison of Quality Review Scores for Elements
Included in/Excluded From the Feedback Memorandums⁹**



Source: TIGTA analysis of Special Review's TEQMS quality review results.

CP&C management stated that the Feedback Memorandums are a work in progress, but the results so far show that they are an effective tool. As more data and results are collected, management should consider periodically updating the Feedback Memorandums to include the other elements to help improve overall examination quality scores. Low quality review scores could be an indication that FSL/ET examiners may not always perform high-quality

⁹ Appendix II shows the increase in scores for each of the five elements included in the Feedback Memorandums and any increases/decreases in the scores for the remaining 15 elements not included in the Feedback Memorandums.

examinations, which could increase the risk that FSLG entities are noncompliant with their employment tax obligations.

Recommendation 1: The Commissioner, TE/GE Division, should ensure that the quality elements addressed in the Feedback Memorandums are periodically reviewed and updated as needed.

Management's Response: The IRS agreed with this recommendation. The CP&C function will ensure that the quality elements addressed in the Feedback Memorandums are periodically reviewed and updated as needed.

The Federal, State, and Local Governments/Employment Tax Function Does Not Have Specific Quality Review Goals

FSL/ET management has not established quantifiable goals for quality review results. Various statutory and regulatory provisions require the IRS to set performance goals for organizational units and to measure the results achieved by those units. For example, the *Standards for Internal Control in the Federal Government* states that Government entities should use actual results against qualitative and numeric targets to report on agency progress in delivering its administrative responsibilities.

FSL/ET management stated that they have not established quantifiable goals for quality review results because they are always working to improve their quality review results. However, quality review goals are essential to performance measures because they:

- Provide direction to program management and employees about where and how the IRS desires to improve in an area.
- Allow meaningful evaluation of progress because it is immediately clear whether the targets have been met or little progress has been made.
- Facilitate accountability for the level of results achieved.

Goals also help measure how organizations perform relative to past performance. Without goals, the quality measures do not provide a full perspective about progress and improvements in the FSL/ET function.

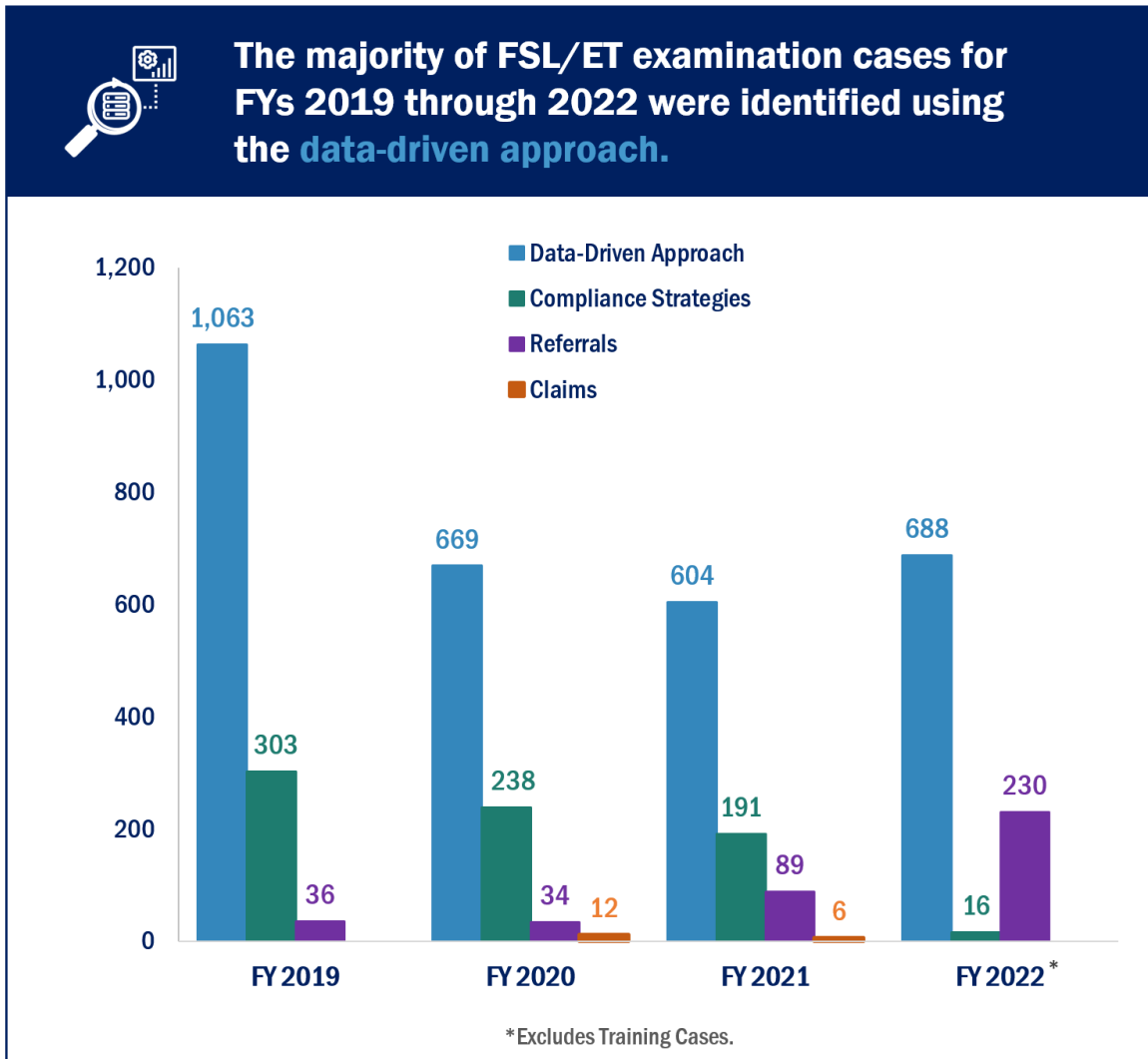
Recommendation 2: The Commissioner, TE/GE Division, should ensure that annual baseline goals for the FSL/ET function's TEQMS scores are developed and adjusted periodically as needed.

Management's Response: The IRS agreed with this recommendation. The FSL/ET function will develop baseline FSL/ET TEQMS goals and adjust periodically as needed.

Case Selection Could Be Enhanced

The CP&C function may be able to identify additional noncompliant behavior within the FSLG entity population of taxpayers by continuing to refine its data-driven approaches. Figure 6 shows that most FSL/ET examination cases were identified using the data-driven approach in FYs 2019 through 2021.

Figure 6: FSL/ET Closed Examinations by Work Stream
(FYs 2019 Through 2021)



Source: TIGTA analysis of FYs 2019 through 2021 FSL/ET closed examination cases.

In FY 2021, 68 percent of all FSL/ET examination cases came from the data-driven work stream. For example, the CP&C function identifies employment tax related issues by comparing the total in Forms W-2, Box 1, *Wages, tips, other compensation*, with the total in Box 5, *Medicare wages and tips*.¹⁰ This comparison identifies FSLG entities that reported more wages, tips, and other compensation than total Medicare wages, which could be an indication that FSLG entities are not paying the appropriate amount of Medicare taxes. When there is a significant difference, the case may be selected for examination by the FSL/ET function.¹¹ CP&C management stated that they use this approach instead of analyzing Social Security taxes because there are fewer exceptions for paying Medicare taxes than Social Security taxes.¹² We

¹⁰ The CP&C function uses other data-driven approaches to identify potential issues relating to backup withholding and worker classification.

¹¹ The CP&C function performs additional steps during its data analysis to ensure that it only captures FSLG entities.

¹² For example, Medicare and Social Security taxes do not apply to services performed by students employed by a school, college, or university for which the student is pursuing a course of study or for compensation paid to a duly ordained, commissioned, or licensed minister of a church in the exercise of their ministry.

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analyzed TY 2021 return information using the IRS’s methodology and identified 238 FSLG entities that issued nearly 2 million Forms W-2, with a total of \$66.4 billion reported in Box 1 and a total of \$60.6 billion reported in Box 5. This \$5.8 billion in potentially underpaid Medicare taxes is an average of \$24 million per FSLG entity. However, this figure is potentially overstated because some FSLG entities have exemptions from paying Medicare taxes.

In addition to the Medicare taxes, most employees not covered under a qualified retirement plan must pay Social Security taxes.¹³ Therefore, with few exceptions, we should expect to see wages reported on an employee’s Form W-2, Box 3, *Social Security wages*, and a check in Box 13, *Retirement Plan*. We analyzed TY 2021 Forms W-2 to identify employees that had:¹⁴

- Nothing reported in Box 3, *Social Security wages*.
- Nothing checked in Box 13, *Retirement Plan*, which is used when employees pay into a separate retirement plan.

We identified 528 FSLG entities that issued 50 or more Forms W-2 with nothing reported in Box 3 and Box 13, including 32 entities that issued more than 1,000 forms in TY 2021.¹⁵ Figure 7 shows that these 32 entities reported income of approximately \$6.9 billion with no Social Security taxes paid, which is an average of approximately \$216 million per entity.

**Figure 7: FSLG Entities That Issued at Least 1,000 Forms W-2
With No Social Security Wages and No Reported Qualifying Retirement Plan**

Issued Forms W-2	Number of Entities	Total Box 1	Average per Entity
10,000+	3	\$2.3 billion	\$765 million
5,000 to 9,999	6	\$2.2 billion	\$375 million
1,000 to 4,999	23	\$2.4 billion	\$103 million
Total	32	\$6.9 billion	\$216 million

Source: TIGTA analysis of TY 2021 Forms W-2.

Similar to the IRS data-driven approach to identify Forms W-2 with more compensation paid than Medicare wages reported, our analysis identified a high number of Forms W-2 with no Social Security wages, which could be an indication of inaccurate reporting or noncompliant activity.

¹³ Beginning July 2, 1991, § 11332 of Pub. L. No. 101-508 mandates Social Security coverage for State and local government employees who are neither members of a qualified retirement system nor covered by a § 218 Agreement. Certain government employees are exempt because they were hired on or before July 1, 1991. Additionally, other exemptions exist such as students, workers on certain visas, and certain military payments.

¹⁴ Our analysis used information from multiple sources, which included: 1) the Business Master File – an IRS database that consists of Federal tax-related transactions and accounts for businesses (these include employment taxes, income taxes on businesses, and excise taxes) and 2) the Information Returns Master File – an IRS database that contains third-party information return documents for taxpayers, such as Form W-2 and Form SSA-1099, *Social Security Benefit Statement*.

¹⁵ We filtered the data to identify only FSLG entities. Additionally, we considered Forms W-2 only for which wages, tips, and other compensation (Box 1) were greater than \$20,000. Of the 528 FSLG entities that we identified, 40 (8 percent) were previously selected for examinations.

We further analyzed the 528 FSLG entities and identified 464 that issued Forms W-2 to employees in TY 2021 but did not issue any Forms W-2 to the same employees from TYs 2016 through 2020 (the previous five tax years). The absence of Forms W-2 within the previous five years reduces the likelihood that these were long-term employees exempt from paying Social Security taxes. Most employees hired or rehired as of July 2, 1991, are subject to Social Security taxes.¹⁶ Figure 8 shows that 22 of these FSLG entities issued 100 or more such Forms W-2 in TY 2021, including four that issued 500 or more.

**Figure 8: FSLG Entities That Issued at Least 100 Forms W-2 With
No Social Security Income in FY 2021 (but Did Not Issue Any
Forms W-2 to the Same Employees From TYs 2016 Through 2020)**

Issued Forms W-2	Number of Entities	Total Box 1	Average per Entity
500+	4	\$182 million	\$45 million
250 to 500	5	\$53 million	\$11 million
100 to 249	13	\$61 million	\$5 million
Total	22	\$296 million	\$13 million

Source: TIGTA analysis of TYs 2016 through 2021 Forms W-2.

These 22 entities reported compensation of approximately \$296 million, which is an average of approximately \$13 million per entity. The CP&C Issue Identification and Special Review function is responsible for conducting research and analysis to identify compliance gaps, underlying problems, and patterns in data that reveal potential opportunities for improvements or further development. It helps make data-driven decisions using various research models.

Although the data-driven approaches identify cases with potential noncompliance, without an examination, it is difficult to substantiate noncompliance because of exceptions for paying employment taxes as some employees of FSLG entities who are also students may not be required to pay Social Security taxes. The CP&C function should consider continually analyzing and making periodic updates to the data-driven approaches to improve the productivity of its case selection. For example, the CP&C function could take a sample of the cases we identified in Figures 7 and 8 to determine if this data-driven approach provides more productive cases.

Recommendation 3: The Commissioner, TE/GE Division, should continually analyze and periodically update the data-driven approaches to improve the productivity of case selection.

Management's Response: The IRS agreed with this recommendation. The CP&C function will analyze and periodically update the data-driven approaches to improve the productivity of case selection.

¹⁶ Most FSLG employees hired or rehired as of July 2, 1991, are subject to Social Security taxes. However, if employees were laid off and subsequently rehired and enrolled in the same retirement plan, in general, they do not have to pay Social Security taxes.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the IRS ensures that FSLG entities comply with their employment tax responsibilities. To accomplish our objective, we:

- Determined whether IRS processes and procedures ensure that FSLG entities comply with their employment tax obligations.
- Determined if additional improvements can be made to the examination process as a result of Special Review's quality reviews of FSL/ET examinations.
 - Obtained the TEQMS U.S. Summary Year End reports for FYs 2019 through 2022.
 - Analyzed Special Review's quality review comments to identify common issues that were identified for examination quality standards and the standard's sub-elements.
 - Determined what corrective actions FSL/ET management has taken as a result of the quality reviews performed by Special Review.
- Determined if improvements can be made to the FSL/ET examination case selection process.
 - Analyzed TY 2021 Forms W-2 and Business Master File data to identify a potential alternative data-driven approach to identify individuals who should be paying employment taxes but are not.
 - Discussed our data analysis and results with CP&C management to determine if these types of cases have examination potential.
 - Obtained and reviewed the data-driven approach methodologies used in the CP&C function to identify potential improvements or supplements to the case identification process.

Performance of This Review

This review was performed with information obtained from the TE/GE Division's CP&C and FSL/ET functions during the period January through December 2022. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Bryce Kisler, Assistant Inspector General for Audit (Management Services and Exempt Organizations); Carl Aley, Director; David Bueter, Audit Manager; Jeremy Berry, Lead Auditor; and Richard Kemble, Senior Auditor.

Validity and Reliability of Data From Computer-Based Systems

We performed tests to assess the reliability of data from TEQMS data for FYs 2019 through 2022 by matching them to the case data contained in the Reporting Compliance Case Management System database. Additionally, we performed tests to assess the reliability of data from the Information Returns Master File and the Business Master File. We evaluated the data by 1) performing electronic testing of required data elements, 2) reviewing existing information about the data and the system that produced them, and 3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for purposes of this report.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the controls over the quality review of closed examination case files and the feedback provided on the results of reviewing closed examinations. We evaluated these controls by obtaining the policies, procedures, and training documents for the quality review process and interviewing IRS employees who developed the quality review process. Additionally, we reviewed quality scores to identify significant issues for each group.

Appendix II

Federal, State, and Local Governments/ Employment Tax Function Quality Review Scores

FSL/ET Quality Review Results (FYs 2019 to 2021)¹

#	Element	Percentage "Yes"			Percent Point Change FY 2019 to FY 2021
		FY 2019 49 Cases Reviewed	FY 2020 34 Cases Reviewed	FY 2021 37 Cases Reviewed	
1.	Was the compliance activity adequately planned?	80%	85%	57%	-23%
2.	Were material issues (beyond CP&C) identified and properly considered during the compliance activity?	98%	91%	87%	-11%
3.	Were adequate filing checks completed?	67%	88%	68%	1%
4.	Were adequate interviews conducted and recorded in the file?	80%	62%	54%	-26%
5.	Were material issues properly developed?	73%	79%	49%	-24%
6.	Did the workpapers and file adequately document the steps taken, techniques, and conclusions?	71%	59%	54%	-17%
7.	Did the Case Chronology Record adequately document the activity?	94%	88%	84%	-10%
8.	Were material issues properly resolved?	73%	70%	79%	6%
9.	Were penalties considered, applied, waived, or removed as warranted?	93%	81%	80%	-13%
10.	Was fraud adequately considered?	100%	100%	-	-
11.	Were information document requests and/or other information requests clear, concise, and appropriate?	86%	91%	81%	-5%
12.	Were the letters to the taxpayer properly prepared?	82%	82%	62%	-20%
13.	Were the reports to the taxpayer properly prepared?	82%	91%	95%	13%
14.	Were proper closing procedures followed?	84%	74%	73%	-11%
15.	Was the taxpayer/representative regularly kept informed throughout the compliance activity?	94%	85%	84%	-10%
16.	Were taxpayer/representative rights observed and protected?	80%	62%	54%	-26%
17.	Was the timespan of the compliance activity reasonable?	94%	76%	76%	-18%
18.	Was the total time spent on the compliance activity commensurate with the nature and complexity of the issues?	94%	91%	70%	-24%
19.	Were actions taken timely to monitor and protect the statute of limitations?	100%	100%	95%	-5%
20.	Was there timely and adequate level of managerial oversight and involvement?	82%	74%	70%	-12%
Measure 1 - Proper Identification, Development, and Resolution of Issues		81%	78%	66%	-15%
Measure 2 - Communications		84%	81%	75%	-9%
Measure 3 - Timeliness		92%	85%	78%	-14%
Overall:		85%	81%	72%	-13%

Source: TIGTA analysis of Special Review's TEQMS quality review results.

¹ In FY 2021, all quality reviewed cases were not applicable for Element #10.

**Additional Actions Could Improve the Quality and Productivity
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FSL/ET Quality Review Results Post Corrective Actions (FYs 2021 and 2022)²

#	Element	Percentage "Yes"		Percent Point Change
		FY 2021 37 Cases Reviewed	FY 2022 50 Cases Reviewed	
1.	Was the compliance activity adequately planned?	57%	94%	37%
2.	Were material issues (beyond CP&C) identified and properly considered during the compliance activity?	87%	95%	8%
3.	Were adequate filing checks completed?	68%	82%	14%
4.	Were adequate interviews conducted and recorded in the file?	54%	52%	-2%
5.	Were material issues properly developed?	49%	78%	29%
6.	Did the workpapers and file adequately document the steps taken, techniques, and conclusions?	54%	64%	10%
7.	Did the Case Chronology Record adequately document the activity?	84%	94%	10%
8.	Were material issues properly resolved?	79%	91%	12%
9.	Were penalties considered, applied, waived, or removed as warranted?	80%	60%	-20%
10.	Was fraud adequately considered?	-	-	-
11.	Were information document requests and/or other information requests clear, concise, and appropriate?	81%	82%	1%
12.	Were the letters to the taxpayer properly prepared?	62%	52%	-10%
13.	Were the reports to the taxpayer properly prepared?	95%	90%	-5%
14.	Were proper closing procedures followed?	73%	90%	17%
15.	Was the taxpayer/representative regularly kept informed throughout the compliance activity?	84%	64%	-20%
16.	Were taxpayer/representative rights observed and protected?	54%	60%	6%
17.	Was the timespan of the compliance activity reasonable?	76%	86%	10%
18.	Was the total time spent on the compliance activity commensurate with the nature and complexity of the issues?	70%	78%	8%
19.	Were actions taken timely to monitor and protect the statute of limitations?	95%	100%	5%
20.	Was there timely and adequate level of managerial oversight and involvement?	70%	68%	-2%
Measure 1 - Proper Identification, Development, and Resolution of Issues		66%	78%	12%
Measure 2 - Communications		75%	73%	-2%
Measure 3 - Timeliness		78%	83%	5%
Overall		72%	78%	6%

Source: TIGTA analysis of Special Review's TEQMS quality review results.

**FSL/ET Quality Review Scores for the Five Elements
Included in the Feedback Memorandums (FYs 2021 and 2022)**

#	Element	Percentage "Yes"		Percent Point Change
		FY 2021	FY 2022	
1.	Was the compliance activity adequately planned?	57%	94%	37%
5.	Were material issues properly developed?	49%	78%	29%
6.	Did the workpapers and file adequately document the steps taken, techniques, and conclusions?	54%	64%	10%
8.	Were material issues properly resolved?	79%	91%	12%
11.	Were information document requests and/or other information requests clear, concise, and appropriate?	81%	82%	1%

Source: TIGTA analysis of Special Review's TEQMS quality review results.

² In FY 2022, all quality reviewed cases were not applicable for Element #10.

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**FSL/ET Quality Review Scores for the 15 Elements
Excluded From the Feedback Memorandums**

#	Element	Percentage "Yes"		Percent Point Change
		FY 2021	FY 2022	
2.	Were material issues (beyond CP&C) identified and properly considered during the compliance activity?	87%	95%	8%
3.	Were adequate filing checks completed?	68%	82%	14%
4.	Were adequate interviews conducted and recorded in the file?	54%	52%	-2%
7.	Did the Case Chronology Record adequately document the activity?	84%	94%	10%
9.	Were penalties considered, applied, waived, or removed as warranted?	80%	60%	-20%
10.	Was fraud adequately considered?	-	-	-
12.	Were the letters to the taxpayer properly prepared?	62%	52%	-10%
13.	Were the reports to the taxpayer properly prepared?	95%	90%	-5%
14.	Were proper closing procedures followed?	73%	90%	17%
15.	Was the taxpayer/representative regularly kept informed throughout the compliance activity?	84%	64%	-20%
16.	Were taxpayer/representative rights observed and protected?	54%	60%	6%
17.	Was the timespan of the compliance activity reasonable?	76%	86%	10%
18.	Was the total time spent on the compliance activity commensurate with the nature and complexity of the issues?	70%	78%	8%
19.	Were actions taken timely to monitor and protect the statute of limitations?	95%	100%	5%
20.	Was there timely and adequate level of managerial oversight and involvement?	70%	68%	-3%

Source: TIGTA analysis of Special Review's TEQMS quality review results.

Appendix III

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

February 27, 2023

MEMORANDUM FOR HEATHER HILL
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Edward T. Killen Edward T. Killen
Commissioner, Killen
Tax-Exempt and Government Entities Division (TE/GE)

Digitally signed by Edward T. Killen
Date: 2023.02.27 14:55:17 -05'00'

SUBJECT: Draft Audit Report– Additional Actions Could Improve the Quality and Productivity of Employment Tax Examinations of Federal, State, and Local Governments (Audit # 202210030)

Thank you for the opportunity to review and comment on the subject draft audit report: "Additional Actions Could Improve the Quality and Productivity of Employment Tax Examinations of Federal, State, and Local Governments."

We appreciate your recognition that because of IRS corrective actions already taken to improve Federal, State, and Local/Employment Tax (FSL/ET) examination case quality, review scores have subsequently improved for 13 (65 percent) of the 20 quality elements.

We also appreciate your evaluation of the program and recommendation to improve our FSL/ET examination quality further by 1) ensuring that the quality elements addressed in the Feedback Memorandums are periodically reviewed and updated as needed; 2) ensuring that annual baseline goals for the FSL/ET function's Tax Exempt Quality Management System (TEQMS) scores are developed and adjusted periodically as needed; and 3) continually analyzing and periodically updating the data-driven approaches to improve the productivity of selection.

One of our efforts to improve examination quality is the introduction of Feedback Memorandums. As stated in your report, the Feedback Memorandums were initiated in February 2022 and focus on 5 specific quality review elements at a time. These five elements were selected because management believed they have a broad and critical connection to overall effectiveness of casework and improvements in these elements could lead to improvements in other elements. As we continue to evaluate quality

**Additional Actions Could Improve the Quality and Productivity
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review results, we will periodically assess and update the elements accordingly to continue to improve quality.

FSL/ET will ensure that baseline goals for the function's TEQMS scores are developed and adjusted periodically to provide direction to employees and where and how the program would like to improve in certain areas. This will provide meaningful evaluation of progress and facilitate accountability.

We continually seek to improve the productivity of workstream selections, and to this end Compliance, Planning and Classification (CP&C) is implementing a process where the results from data-driven workstreams are documented and analyzed annually to evaluate their effectiveness and consider improvements. The analysis and potential improvements are presented to TE/GE's Governance Board for input regarding any possible changes to the project and the continuance of the workstream.

We agree with your recommendations and appreciate your acknowledgement of the efforts we have already taken to improve FSL/ET examination quality.

Attached is our detailed response to your recommendations. If you have any questions, please contact me or Robert Malone, Director, Exempt Organizations/Government Entities, TE/GE at Robert.Malone@irs.gov.

Attachment

**Additional Actions Could Improve the Quality and Productivity
of Employment Tax Examinations of Federal, State, and Local Governments**

Attachment

Corrective Actions for TIGTA Audit Draft Report –

Additional Actions Could Improve the Quality and Productivity of Employment Tax
Examinations of Federal, State, and Local Governments (Audit #202210030)

Recommendation 1:

The Commissioner, TE/GE Division, should ensure that the quality elements addressed in the Feedback Memorandums are periodically reviewed and updated as needed.

Planned Corrective Action:

CP&C will ensure that the quality elements addressed in the Feedback Memorandums are periodically reviewed and updated as needed.

Implementation Date:

September 15, 2023

Responsible Official(s):

Director, CP&C

Corrective Action Monitoring Plan:

IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 2:

The Commissioner, TE/GE, should ensure that annual baseline goals for the FSL/ET function's TEQMS scores are developed and adjusted periodically as needed,

Planned Corrective Action:

FSL will develop baseline FSL/ET TEQMS goals and adjust periodically as needed.

Implementation Date:

September 15, 2023

Responsible Official(s):

Director, EO/GE

Corrective Action Monitoring Plan:

IRS will monitor this corrective action as part of our internal management system of controls.

**Additional Actions Could Improve the Quality and Productivity
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Recommendation 3:

The Commissioner, TE/GE Division, should continually analyze and periodically update the data-driven approaches to improve the productivity of case selection.

Planned Corrective Action:

CP&C will analyze and periodically update the data-driven approaches to improve the productivity of case selection.

Implementation Date:

September 15, 2023

Responsible Official(s):

Director, CP&C

Corrective Action Monitoring Plan:

IRS will monitor this corrective action as part of our internal management system of controls.

Appendix IV

Abbreviations

CP&C	Compliance Planning and Classification
FSL/ET	Federal, State, and Local Governments/Employment Tax
FSLG	Federal, State, and Local Government
FY	Fiscal Year
IRS	Internal Revenue Service
TE/GE	Tax Exempt and Government Entities
TEQMS	Tax Exempt Quality Measurement System
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year



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Treasury Inspector General for Tax Administration

P.O. Box 23291

Washington, D.C. 20026

Information you provide is confidential, and you may remain anonymous.