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ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20005

November 8, 2013

MEMORANDUM FOR SECRETARY LEW

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SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2014

The *Reports Consolidation Act of 2000*[1] requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize, for inclusion in the annual *Department of the Treasury Agency Financial Report*, its perspective on the most serious management and performance challenges confronting the Internal Revenue Service (IRS).

Each year, TIGTA evaluates IRS programs, operations, and management functions to identify the areas of highest vulnerabilities to the Nation's tax system. For Fiscal Year 2014, the top management and performance challenges, in order of priority, are:

1. Security for Taxpayer Data and IRS Employees;
2. Implementing the Affordable Care Act and Other Tax Law Changes;
3. Tax Compliance Initiatives;
4. Modernization;
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.

The IRS was faced with numerous challenges during FY 2013, including several that resulted in Congressional hearings on IRS management practices. The IRS will continue to face other pressing priorities and challenges during FY 2014. Several key provisions of the Patient Protection and Affordable Care Act (Affordable Care Act)[2] will

[1] 31 U.S.C. § 3516(d) (2006).
[2] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

become effective in FY 2014, and the IRS must ensure that the tax system is able to fully implement these provisions. Of utmost importance is ensuring the adequate protection of Federal tax data when it is sent to the Federal and State exchanges.

Furthermore, the continuing budget constraints present a substantial challenge to the IRS in effectively carrying out its mission. In FY 2013, the IRS budget was reduced by $618 million at mid-year, which required management to make a number of difficult decisions: among them, implementation of a hiring freeze, a reduction in customer service and enforcement, and declaration of three furlough days for IRS employees. As the IRS faces new or growing challenges with a smaller staff, it must identify and implement innovative and cost saving strategies to accomplish its mission of providing America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness for all.

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

SECURITY FOR TAXPAYER DATA AND IRS EMPLOYEES

As our Nation's tax collector and administrator of the Internal Revenue Code, the IRS collected over $2.5 trillion in tax revenue in FY 2012, processed over 237 million tax returns, and issued approximately $373 billion in tax refunds. In today's environment, the IRS faces the daunting task of securing its massive computer systems against the growing threat of cyberattacks. Effective information systems security is essential to ensure that data are protected against inadvertent or deliberate misuse, improper disclosure or destruction, and that computer operations supporting tax administration are secured against disruption or compromise. According to the Department of Homeland Security's U.S. Computer Emergency Readiness Team, Federal agencies reported 48,842 cyberattacks in FY 2012, an increase of about 11 percent from FY 2011.[3]

Computer security has been problematic for the IRS since 1997, when the IRS initially reported computer security as a material weakness during its annual evaluation of internal accounting and administrative controls under the *Federal Managers' Financial Integrity Act of 1982.*[4] In March 2013, the Government Accountability Office reported that the IRS is making progress in addressing information security control weaknesses.[5]

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[3] Office of Management and Budget, Fiscal Year 2012 Report to Congress on the Implementation of The Federal Information Security Management Act of 2002 (Mar. 2013).

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

[5] GAO-13-350, *IRS Has Improved Controls but Needs to Resolve Weaknesses* (March 2013).

However, TIGTA continues to identify significant security weaknesses in this area that could affect the confidentiality, integrity, and availability of financial and sensitive taxpayer data.

Meanwhile, beyond safeguarding a vast amount of sensitive financial and personal data, the IRS must also protect approximately 100,000 employees and contractors working at more than 600 facilities throughout the country. To proactively mitigate threats made against IRS facilities and employees, the IRS is required to conduct comprehensive and timely risk assessments to identify and address vulnerabilities in physical security. TIGTA identified deficiencies in the IRS's risk assessment program and found that not all IRS facilities had a risk assessment conducted.[6] Additionally, the IRS did not implement some of the additional countermeasures that were identified by the completed risk assessments.

Physical violence, harassment, and intimidation of IRS employees pose significant challenges to the implementation of a fair and effective system of tax administration. Between FYs 2009 and 2012, TIGTA has processed over 8,600 threat-related complaints. This resulted in over 4,000 threat investigations that required the prompt response of TIGTA Special Agents to mitigate those threats and determine whether criminal prosecutions of the perpetrators making the threats were warranted.

Additionally, the ongoing public debate regarding the health care law and increased scrutiny over IRS spending and treatment of certain exempt organizations could fuel threats against the Federal Government, including IRS employees and facilities. These challenging operating conditions for the IRS underscore the need for continued vigilance in the area of physical and personnel security.

IMPLEMENTING THE AFFORDABLE CARE ACT AND OTHER TAX LAW CHANGES

Each filing season tests the IRS's ability to implement tax law changes made by Congress. Correctly implementing late tax law changes remains a significant challenge because the IRS must often act quickly to assess the changes and determine the necessary actions to ensure that all legislative requirements are satisfied. In addition, the IRS must often create new or revise existing tax forms, publications and instructions; revise internal operating procedures; provide outreach and education to taxpayers and tax professionals; train employees; and reprogram computer systems to accurately and timely process tax returns affected by the new tax law changes. For the 2014 filing season, the IRS announced a delay of approximately one to two weeks to the start of the filing season to allow adequate time to program and test tax processing systems following the 16-day Federal Government closure.

[6] TIGTA, Ref. No. 2013-10-101, *The Physical Security Risk Assessment Program Needs Improvement* (Sept. 2013).

Affordable Care Act

The Affordable Care Act (ACA) contains an extensive array of tax law changes that will present a continuing source of challenge for the IRS in coming years. The Affordable Care Act provides incentives and tax breaks to individuals and small businesses to offset health care expenses. It also imposes penalties, administered through the tax code, for individuals and businesses that do not obtain health care coverage for themselves or their employees. The Affordable Care Act represents the largest set of tax law changes in more than 20 years.

Starting in Calendar Year 2014, the IRS will be responsible for implementing the Advanced Premium Tax Credit,[7] as well as implementing the penalty on applicable individuals for each month they fail to have minimum essential health care coverage. These two issues have a far-reaching impact on the IRS and will require significant resources, particularly customer service resources, as taxpayers turn to the IRS with questions and issues about the Affordable Care Act. Customer service has been declining in recent years, with fewer taxpayers being served at local IRS offices and the IRS answering fewer telephone calls.[8]

The IRS's implementation plan for the ACA includes providing information on eligibility and enrollment, developing calculations for the Advanced Premium Tax Credit, reconciling Premium Tax Credits[9] with reported taxable income, and developing new ACA information collection and processing systems. These provisions require development of new computer systems, modification of existing systems, revision and/or creation of new fraud detection systems, and deployment and testing of new interagency communication portals to support ACA operations.

From FY 2010 to 2012, the IRS reported that it received $488 million from the Health Insurance Implementation Fund to implement the ACA. Although the IRS stopped receiving funds from the Health Insurance Implementation Fund at the end of FY 2012, implementation of the ACA remains an ongoing effort, and all implementation efforts in FY 2013 and beyond will be funded solely from the IRS's operating budget.

TAX COMPLIANCE INITIATIVES

With an estimated voluntary compliance rate of approximately 83 percent,[10] a significant amount of income remains unreported and unpaid. Tax compliance initiatives include

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[7] An Advanced Premium Tax Credit is paid in advance to a taxpayer's insurance company to help cover the cost of premiums.

[8] TIGTA, Ref. No. 2012-40-119, *The Majority of Individual Tax Returns Were Processed Timely, but Not All Tax Credits Were Processed Correctly During the 2012 Filing Season* (Sept. 2012).

[9] A refundable tax credit to assist individuals and families in purchasing health insurance coverage through an Affordable Insurance Exchange.

[10] The voluntary compliance rate is an estimate of the amount of tax for a given year that is paid voluntarily and timely. The IRS reported in the *Tax Gap for Tax Year 2006 Overview (Jan. 2012)* that the voluntary compliance rate for 2006 was 83.1 percent.

the administration of tax regulations, collection of the correct amount of tax from businesses and individuals, and oversight of tax-exempt and governmental entities.

Increasing voluntary taxpayer compliance and reducing the Tax Gap[11] are the focus of many IRS initiatives. Although the IRS reported that the Tax Gap is caused by both unintentional taxpayer errors (whether due to tax law complexity, confusion, or carelessness) and willful tax evasion or cheating, the IRS does not have sufficient data to distinguish the amounts attributable to each. The IRS also reported that a meaningful improvement in the voluntary compliance rate requires a long-term, focused effort on taxpayer service, modernization, and enforcement.

However, the budget reductions over the past three years have led to a reduction in the IRS's resources in the enforcement area, which has impacted tax compliance. Since Fiscal Year 2010, approximately 8,000 full-time IRS positions have been lost—about 5,000 from front-line enforcement.

The amount of enforcement revenue collected declined by nine percent in Fiscal Year 2012, from $55.2 billion to $50.2 billion. This has decreased for two straight years and is 13 percent less than the $57.6 billion collected in Fiscal Year 2010. The 13 percent reduction in enforcement revenue correlates to the 14 percent reduction in the number of IRS enforcement personnel.

In the Examination function, the combination of a decrease in the number of revenue agents and tax compliance officers and an increase in the number of corporate, partnership, and S corporation examinations has contributed, in part, to a reduction in the number of individual tax returns examined. Two factors contributing to the increase in partnership and S corporation examinations are the growth in the number of these filings and the compliance risk these tax returns pose.

IRS filing statistics show that partnerships and S corporations are the fastest growing segments of all tax returns filed. For example, the IRS estimates that S corporations will file nearly 5.7 million returns in Processing Year (PY) 2015, which is a 26 percent increase over S corporation returns filed in PY 2011.

In terms of compliance risk and potential fraud or abuse, both partnerships and S corporations provide shareholders and partners with opportunities to structure transactions improperly to reduce the income taxes they would otherwise owe. In Calendar Year 2000, the IRS published guidance on 10 transactions that would likely trigger an audit because they purportedly abuse the tax law, represent a significant loss of tax revenue, and undermine the public's confidence in the tax system. As of January 2012, the list of such abusive transactions had expanded to 34, several of which involve partnerships and/or S corporations.

TIGTA reported in 2012 that examiners are recommending a considerable amount of adjustments to items reported on the returns. For example, in FY 2011, examiners

[11] 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.

closed 5,310 audits of partnership returns and recommended approximately $728 million in adjustments to items reported on the returns. This indicates that examiners recommended an average of $137,000 in adjustments for each return audited. TIGTA also reported that the number of partnership and S corporation examinations that result in no adjustments (no-change) is high. According to the IRS, a high number of no-change examinations means it is spending significant resources on unproductive examinations and unnecessarily burdening compliant taxpayers.

The following three sections will examine tax compliance challenges the IRS faces affecting businesses and individuals, tax-exempt entities, and tax return preparers.

Businesses and Individuals

The IRS estimated the gross Tax Gap for Tax Year 2006 to be approximately $450 billion. This estimate is the best approximation of noncompliance the IRS can provide. However, TIGTA found that the IRS could improve its Tax Gap estimates.[12] Specifically, there are no estimates for nonfiling of tax returns related to corporate, employment, or excise taxes. In addition, the reliability and accuracy of the tax information that is reported on corporate tax returns could be improved.

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

- **Information Reporting.** The availability of third-party income and withholding information at the time tax returns are processed would encourage voluntary compliance and would prevent the issuance of billions of dollars in fraudulent tax refunds.
- **Taxpayer Service.** Ensuring high-quality service to taxpayers can help encourage those taxpayers who wish to comply with tax laws but do not understand their tax obligations. However, tax law changes and funding priorities have recently affected the IRS's ability to provide quality taxpayer service.
- **Enforcement.** Devoting additional resources to enforcement would enable the IRS to contact the millions of potentially noncompliant taxpayers it identifies but cannot currently contact due to resource limitations.
- **Compliance Checks.** Expanding compliance checks before the IRS issues refunds would involve matching information returns to tax returns during, rather than after, the tax filing season. TIGTA reported that the IRS designed

[12] TIGTA, Ref. No. 2013-IE-R008, *the Internal Revenue Service Needs to Improve the Comprehensiveness, Accuracy, Reliability, and Timeliness of the Tax Gap Estimate* (Aug. 2013).

new identity theft screening filters for the 2012 filing season that improved the IRS's ability to identify false tax returns before the tax return was processed; however, more needs to be done in this area.[13]

- **External Parties.** Leveraging external resources, such as paid tax return preparers and whistleblowers, can help improve tax compliance because paid preparers' actions have an enormous impact on the IRS's ability to effectively administer tax laws, and whistleblowers provide the IRS with information on suspected noncompliance.
- **Modernization.** Modernizing information systems could potentially allow the IRS to post more comprehensive tax return information to its computer systems, which could facilitate the examination process and expedite taxpayer contacts for faster resolution.

Tax-Exempt Entities

The IRS's use of inappropriate methods for selecting and reviewing applications for tax-exempt status became a top concern for both Congress and the public in 2013 and has resulted in congressional hearings and investigations. The IRS will continue to face unprecedented levels of scrutiny from a variety of stakeholders in the exempt organizations area in FY 2014.

Most organizations requesting tax-exempt status must submit an application to the IRS. The type of application submitted depends upon the type of tax-exempt organization the organization desires to be. For example, a charitable organization would request exemption under I.R.C. Section 501(c)(3),[14] whereas a social welfare organization would request exemption under I.R.C. Section 501(c)(4).[15] TIGTA found that the IRS developed and used criteria to identify potential political cases for review that inappropriately identified specific groups applying for tax-exempt status based on their names or policy positions instead of developing criteria based on tax-exempt laws and Treasury Regulations.[16] TIGTA also found that ineffective management allowed the inappropriate criteria to be developed and stay in place for more than 18 months, resulting in substantial delays in processing certain applications, and allowed unnecessary information requests to be issued.

Tax Return Preparers

Every year, more than half of all taxpayers pay someone else to prepare their Federal income tax returns. During the 2013 Filing Season,[17] the IRS processed

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[13] TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (July 2012).

[14] I.R.C. § 501(c)(3) (2012).

[15] I.R.C. § 501(c)(4) (2012).

[16] TIGTA, Ref. No. 2013-10-053, *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review* (May 2013).

[17] The period of January 1 through April 15 when most individual income tax returns are filed.

over 70 million individual Federal income tax returns prepared by paid tax return preparers.

TIGTA has reported on the IRS's efforts to improve oversight of the return preparer community.[18] While the IRS began implementing the new preparer requirements in FY 2011, TIGTA reported that it will take years for the IRS to implement the Return Preparer Program, including establishing all the program requirements and developing the system(s) and processes necessary to administer and oversee the program. However, this program is on hold based on a recent court ruling.[19] On January 18, 2013, the U. S. District Court for the District of Columbia ruled that the IRS did not have the authority to regulate tax preparers who had not been regulated before: namely, preparers who were not certified public accountants, attorneys, enrolled agents, or enrolled actuaries. The IRS filed a notice of appeal on February 20, 2013. After the initial ruling, the Court clarified that all paid tax return preparers are still required to obtain a preparer tax identification number from the IRS.[20] TIGTA also reported that the IRS's requirement for return preparers to electronically file tax returns helped the IRS meet its goal to receive and process 80 percent of individual returns electronically, but better controls were needed to ensure preparer compliance with the new preparer regulations.[21]

MODERNIZATION

The Business Systems Modernization Program (Modernization Program) is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system. The IRS originally estimated that completion of the Modernization Program would take up to 15 years and incur contractor costs of approximately $8 billion. The Modernization Program was funded for $313 million in Fiscal Year 2013; the President's Budget request for Fiscal Year 2014 was $300.8 million.

The IRS's modernization efforts continue to focus on core tax administration systems designed to provide taxpayers and IRS employees with more sophisticated tools. These efforts will provide the foundation for implementing a real-time tax system and reducing improper payments and fraudulent refunds. They will also provide the technology infrastructure and architecture that will enable taxpayers and other stakeholders the capability to securely access tax account information. The complexity of these efforts continues to pose significant technological and business challenges for the IRS.

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[18] TIGTA, Ref. No. 2010-40-127, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (Sept. 2010).
[19] Loving v. IRS, 2013 U.S. Dist. LEXIS 7980 (D.D.C. Jan. 18, 2013).
[20] Loving v. IRS, 2013 U.S. Dist. LEXIS 13818 (D.D.C. Feb. 1, 2013).
[21] TIGTA, Ref. No. 2012-40-010, *More Tax Return Preparers Are Filing Electronically, but Better Controls Are Needed to Ensure All Are Complying With the New Preparer Regulations* (Dec. 2011).

The IRS considers the Customer Account Data Engine 2 (CADE 2) program critical to the IRS's mission. It is the IRS's most important information technology investment. The CADE 2 system also provides for a centralized database of individual taxpayer accounts. Once implemented, it will allow IRS employees to view tax data online and provide timely responses to taxpayers. TIGTA found that the implementation of CADE 2 daily processing allowed the IRS to process tax returns for individual taxpayers more quickly by replacing existing weekly processing.[22] However, the IRS has experienced delays in the implementation of the CADE 2 database interfaces to downstream systems.[23] This has resulted in increased costs and delayed taxpayer service improvements that were to be provided by the new transactional database.

Modernization efforts also include the development of computer programs to conduct predictive analytics to reduce refund fraud.[24] The IRS is developing a new Return Review Program system to implement the IRS's new business model for a coordinated criminal and civil tax noncompliance system. TIGTA found that roles for program-level governance were not yet established for the Return Review Program and the key role of system integrator was not documented or clearly communicated.[25] As a result, it is not clear how the IRS will govern the systems development process for this mission-critical system, resolve enterprise-wide issues for fraud projects and programs, and resolve disputes and issues concerning fraud projects and programs.

Modernizing legacy tax administration systems to receive and process CADE 2 data and to process new legislative changes, such as the Affordable Care Act, will continue to be a major challenge for the IRS.

<u>FRAUDULENT CLAIMS AND IMPROPER PAYMENTS</u>

Improper payments by Federal Government agencies have been an issue for many years, and various efforts have been made to identify, measure, and reduce them. These include laws specifically addressing improper payments, an Executive Order,[26] and guidance by certain oversight agencies, such as the Office of Management and Budget. The *Improper Payments Information Act of 2002* 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.[27] The Act requires Federal agencies, including the IRS, to estimate the amount of improper payments made each

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[22] TIGTA, Ref. No. 2012-20-122, *Customer Account Data Engine 2 Systems Requirements and Testing Processing Need Improvement* (Sept. 2012).
[23] TIGTA, Ref. No. 2013-20-125, *Customer Account Data Engine 2 Database Deployment Is Experiencing Delays and Increased Costs* (Sept. 2013).
[24] Computer models that analyze extremely large quantities of data to seek out data patterns and relationships that could indicate potential tax fraud schemes.
[25] TIGTA, Ref. No. 2013-20-063, *Improvements Are Needed to Ensure Successful Development and System Integration of the Return Review Program* (July 2013).
[26] Executive Order No. 13,520, 74 Fed. Reg. 62201 (Nov. 25, 2009), *Reducing Improper Payments and Eliminating Waste in Federal Programs.*
[27] Pub. L. No. 1007-300, 116 Stat. 2350.

year and report to Congress on the causes of and the steps taken to reduce improper payments, as well as to address whether they have the information systems and other infrastructure needed 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 and the Additional Child Tax Credit.

The Earned Income Tax Credit 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. TIGTA continues to report that the IRS does not have effective processes to ensure that claimants qualify for these credits at the time tax returns are processed and prior to issuance of fraudulent tax refunds. The IRS estimates that it has paid between $111 billion and $133 billion in improper Earned Income Tax Credit payments from FY 2003 through FY 2012.[28]

The Additional Child Tax Credit is also susceptible to improper claims. TIGTA found that taxpayers repeatedly claimed erroneous Additional Child Tax Credits after their claims were disallowed the previous year.[29] The IRS could have saved more than $108 million by reviewing claims made by taxpayers who were previously disallowed the credit.

Fraudulent Payments

Identity theft continues to be a serious and growing problem which has a significant impact on tax administration. Identity theft for the purpose of committing tax fraud occurs when an individual uses another person's name and Taxpayer Identification Number (generally a Social Security Number) to file a fraudulent tax return to obtain a fraudulent tax refund. Incidents of identity theft affecting tax administration have continued to rise since Calendar Year 2011, when the IRS identified more than one million incidents of identity theft. During the first half of Calendar Year 2013, the IRS had identified almost 1.9 million incidents of identity theft.

TIGTA reported that undetected tax refund fraud resulting from identity theft results in significant unintended Federal outlays.[30] Specifically, TIGTA analyzed Tax Year

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[28] The Department of the Treasury Performance and Accountability Reports for Fiscal Years 2003 through 2010 and the Agency Financial Report for Fiscal Years 2011 and 2012, as outlined in Office of Management and Budget Circular A-136.
[29] TIGTA, Ref. No. 2012-40-105, *Expansion of Controls Over Refundable Credits Could Help Reduce the Billions of Dollars of Improperly Paid Claims* (Sept. 2012).
[30] TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From identity Theft* (July 2012).

2011 tax returns that were processed during the 2012 Filing Season and identified approximately 1.1 million undetected tax returns where the primary Taxpayer Identification Number on the tax return was a Social Security Number. These tax returns had potentially fraudulent tax refunds issued totaling approximately $3.6 billion, a decrease of $1.6 billion compared to the $5.2 billion we reported for Tax Year 2010.

In addition, we expanded our Tax Year 2011 analysis to include tax returns for which the primary Taxpayer Identification Number on the return is an Individual Taxpayer Identification Number (ITIN). We identified more than 141,000 Tax Year 2011 tax returns filed with an ITIN that have the same characteristics as IRS confirmed identity theft tax returns involving an ITIN. Potentially fraudulent tax refunds issued for these undetected tax returns totaled approximately $385 million.

Although the IRS is continuing to make changes to its processes to increase its ability to detect, prevent, and track fraudulent tax returns and improve assistance to victims of identity theft, there is still work to be done.

Contract and Other Payments

In the first half of Fiscal Year 2013, the IRS expended approximately $1.3 billion in contract spending, an area which continues to experience several risks for fraud and abuse. Previous TIGTA investigations and audits have identified millions of dollars in questioned costs and several instances of contractor fraud. During the last three fiscal years, TIGTA's criminal investigative efforts contributed to court-ordered civil settlements which required Government contractors to pay $156 million in FY 2010, $113 million in FY 2011, and $4.6 million in FY 2012 to the U.S. Treasury. These payments were the result of Federal procurement law violations that occurred with work contracted with multiple Federal agencies, including the IRS.

Additionally, TIGTA continues to identify issues with the awarding and administering of IRS contracts. TIGTA recently performed a review of the IRS's cost reimbursement contracts and found that the IRS did not comply with the majority of the new Federal Acquisition Regulations requirements for 46 of the 49 cost reimbursement contracts entered into between March 17, 2011 and June 20, 2012, totaling nearly $47 million.[31] Specifically, the IRS did not always document required information to justify the selection of cost reimbursement contracts and did not always assign acquisition workforce resources prior to award to manage these contracts. Additionally, TIGTA reported that two contracts totaling $3.6 million failed to comply with Federal Acquisition Regulations requirements regarding contractor accounting systems. In order to adequately protect government resources, the Federal Acquisition Regulations states that cost reimbursement

[31] TIGTA Ref. No. 2013-10-046, *Cost-Reimbursement Contracts Did Not Fully Comply With Federal Acquisition Regulation Revisions* (April 2013).

contracts should only be awarded to contractors with an adequate accounting system.

Another TIGTA review found that while some controls are working as intended, the IRS purchase card program lacks consistent oversight to identity and address inappropriate use.[32] TIGTA identified approximately $7,000 in improper purchases, including purchases for giveaway items, purchases made for personal use, and items purchased from the restricted-purchase list.

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.

Taxpayers have several options to choose from when they need assistance from the IRS, including telephone assistance through the toll-free telephone lines, face-to-face assistance at the Taxpayer Assistance Centers and or Volunteer Program sites, and self-assistance through IRS.gov and social media channels. The use of self-assistance options has seen the most significant growth as more taxpayers seek information and assistance through these channels.[33]

As of May 4, 2013, the IRS reported an increase of 24.7 percent in the number of visits to IRS.gov over the same period in the prior filing season. The IRS also reported an increase of 55.6 percent in the number of taxpayers obtaining their refund information online via the "Where's My Refund" feature found on IRS.gov. However, TIGTA identified that the "Where's My Refund" tool did not consistently provide accurate refund status information to some taxpayers that filed early in the 2013 Filing Season. The IRS reported that this issue was resolved on March 14, 2013.

The budget reductions and declining IRS resources reduced the number of taxpayers whom the IRS estimated could be assisted at Taxpayer Assistance Centers. The IRS assisted approximately 6.8 million taxpayers at its walk-in Taxpayer Assistance Centers during FY 2012 and planned to assist 6 million in FY 2013. This represents 11.8 percent fewer taxpayers than were assisted in FY 2012. The FY 2013 plan was based on the assumption of limited seasonal staff support and the continuing reduction of permanent staff as a result of the hiring freeze and buyout authority.

In addition, TIGTA reported in May 2012 that the IRS is not providing effective assistance to taxpayers who report that they have been victims of identity theft, resulting

[32] TIGTA, Ref. No. 2013-10-056, *The Purchase Card Program Lacks Consistent Oversight to Identify and Address Inappropriate Use* (June 2013).
[33] TIGTA, Ref. No. 2013-40-124, *Late Legislation Delayed the Filing of Tax Returns and Issuance of Refunds for the 2013 Filing Season* (Sept. 2013).

in increased burden for those victims.[34] In September 2013, TIGTA reported that taxpayers continued to face delays with some cases having significant inactivity during case processing. In addition, the IRS did not always correctly resolve tax accounts before the cases were closed.[35]

HUMAN CAPITAL

Human capital is the Federal Government's most critical asset, making strategic management of human capital a top priority of the IRS. Continued focus by IRS management on human capital will remain important because the IRS is facing several key challenges.

First, a wave of anticipated retirements presents a critical challenge in the human capital area. More than one-third of all executives and almost 20 percent of non-executive managers are currently eligible for retirement, according to IRS data. By the end of FY 2017, nearly 70 percent of all IRS executives and nearly one-half of the IRS's non-executive managers are projected to be eligible for retirement. Overall, about 40 percent of the IRS's employees will be eligible to retire within five years. In FY 2013, the IRS experienced significant changes in its most senior executive leadership.

Further, 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. Budget constraints have resulted in fewer personnel to accomplish the IRS's mission. Specifically, the IRS's workforce shrank by approximately 10,000 employees between the end of FY 2010 and the end of FY 2012. This reduction in employees possessing unique skills and institutional knowledge is particularly challenging as the number of tax returns the IRS processes continues to rise and the number of identity theft fraud cases the IRS works is also increasing. The IRS will also be required to implement provisions related to the Affordable Care Act using their own operating budget in the future, further stretching its limited resources.

TIGTA reported that outstanding corrective actions in response to human capital audits require a continued focus by IRS management.[36] For example, TIGTA has found that the IRS needs to develop an agency-wide strategy for integrating new employees into the workforce because some best practices that would help new employees become more productive were not fully implemented.

With a shrinking workforce and budget, the IRS will be challenged to successfully achieve its mission of providing America's taxpayers with top-quality service by helping them understand and meet their tax responsibilities and enforcing the law with integrity and fairness.

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[34] TIGTA, Ref. No. 2012-40-050, *Most Taxpayers Whose identities Have Been Stolen to Commit Refund Fraud, Do Not Receive Quality Customer Service* (May 2012).

[35] TIGTA, Ref. No. 2013-40-062, *The Taxpayer Protection Program Improves Identity Theft Detection; However, Case Processing Controls Need to Be Improved* (June 2013).

[36] TIGTA, Ref. No. 2013-10-017, *Improvements Have Been Made to Address Human Capital Issues, but Continued Focus Is Needed* (Jan. 2013).

GLOBALIZATION

The scope, complexity, and magnitude of the international financial system present significant enforcement challenges for the IRS. At the end of Calendar Year 2012, foreign business holdings and investments in the United States were $25.5 trillion, an increase of nearly $135 billion over Calendar Year 2011, while U.S. business and investments abroad grew to over $21.6 trillion, an increase of nearly $1.5 billion during the same period.[37] The numbers of taxpayers conducting international business transactions continues to grow as technological advances provide opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

As advancing technology continues to allow more cross-border transactions, the IRS is increasingly challenged by a lack of information reporting on many of them. In addition, the varying legal requirements imposed by different jurisdictions lead to the creation of complex business structures that are not easy to understand, making determination of the full scope and effect of cross-border transactions extremely difficult.

As this global economic activity increases, so do concerns regarding the International Tax Gap.[38] While the IRS has not developed an accurate and reliable estimate of the International Tax Gap, non-IRS sources estimate it to be between $40 billion and $133 billion annually. To address the International Tax Gap, the IRS developed an international tax strategy plan with two major goals: (1) enforce the law to ensure that all taxpayers meet their obligations and (2) improve service to make voluntary compliance less burdensome.

The IRS currently faces the challenge of implementing the *Foreign Account Tax Compliance Act* (FATCA).[39] FATCA was enacted to combat tax evasion by U.S. persons holding investments in offshore accounts. Under this Act, a U.S. taxpayer with financial assets outside the United States will be required to report those assets to the IRS. In addition, foreign financial institutions will be required to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. The IRS is developing a new international system, the Foreign Financial Institution Registration System, to support the requirements of FATCA. This system is intended to register foreign financial institutions to assist in achieving the primary objective of FATCA which is the disclosure of U.S. taxpayer foreign accounts. TIGTA reviewed the development of this

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[37] Bureau of Economic Analysis, Department of Commerce.

[38] Taxes owed but not collected on time from a U.S. person or foreign person whose cross-border transactions are subject to U.S. taxation.

[39] Pub. L. No. 111-147, Subtitle A, 124 Stat 71, *96-116 (2010)(codified in scattered sections of 26 U.S.C.).

system and reported that the program management control processes did not timely identify or communicate system design changes to ensure its successful deployment.[40]

Concerns about the International Tax Gap have also led to increased enforcement efforts on international information reporting requirements and increased assessments of related penalties. For example, the IRS has automated the penalty-setting process for the Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, which has resulted in a total of $215.4 million in late-filed Form 5471 penalty assessments during Fiscal Years 2009 through 2012.[41]

In addition, the IRS established the International Campus Compliance Unit to expand audit coverage of tax returns with international aspects and to increase compliance among international individual taxpayers. For FY 2011 through March 13, 2013, the Campus Compliance Unit conducted almost 18,000 audits and assessed approximately $36 million in additional tax. Despite its accomplishments, TIGTA found that the Campus Compliance Unit has no specific performance measures for its operations.[42]

TAXPAYER PROTECTION AND RIGHTS

The IRS must ensure that tax compliance activities are balanced against the rights of the 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).[43] The following audits related to taxpayer rights provisions are mandated annually: Notices of Levies; Restrictions on the Use of Enforcement Statistics to Evaluate Employees; *Fair Debt Collection Practices Act*[44] Violations; Notices of Liens; Seizures; Illegal Protestor Designations; Assessment Statute of Limitations; Collection Due Process Appeals; Denial of Requests for Information; Restrictions on Directly Contacting Taxpayers Instead of Authorized Representatives; and Separated or Divorced Joint Filer Requests.

In general, the IRS has improved its compliance with these statutory taxpayer rights provisions and is documenting its protection of taxpayer rights. However, TIGTA continues to identify the same deficiencies in the IRS's processing of collection due-process cases.[45] Specifically, TIGTA continues to identify errors relating to the

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[40] TIGTA Ref. No. 2013-20-118, *Foreign Account Tax Compliance Act: Improvements Are Needed to Strengthen Systems Development for the Foreign Financial Institution Registration System* (Sept. 2013).
[41] TIGTA, Ref. No. 2013-30-111, *Systemic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement* (Sept. 2013).
[42] TIGTA, Ref. No. 2013-30-113, *The International Campus Compliance Unit Is Improving Individual Tax Compliance* (Sept. 2013).
[43] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered section of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[44] 15 U.S.C. §§1601 note, 1692-1692o (2006).
[45] TIGTA Ref. No. 2013-10-103, *The Office of Appeals Continues to Experience Difficulties in the Handling of Collection Due Process Cases* (Sept. 2013).

determination of the Collection Statute Expiration Date[46] on taxpayer accounts. In addition, the Office of Appeals did not always classify taxpayer requests properly and Office of Appeals personnel do not always document their impartiality statement in hearing notification letters issued to taxpayers. These deficiencies may result in taxpayers not receiving their full rights during an appeal hearing.

In addition, TIGTA reported that the IRS used inappropriate criteria to identify and review organizations applying for tax-exempt status. This activity caused delays in the resolution of the organizations' applications, as well as their being subject to unnecessary and burdensome requests for information from the IRS.

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 spending every tax dollar wisely. This management challenge became even more compelling in Fiscal Year 2013, when the IRS's budget fell $618 million below its Fiscal Year 2012 enacted level after application of the enacted rescission and sequestration reductions. As a result, the IRS had to reduce administrative costs, furlough employees for three days, and make difficult decisions to reduce both taxpayer service and enforcement operations.

While the IRS has taken steps to improve program effectiveness and reduce costs, progress in this area continues to be a major challenge. In January 2013, TIGTA reported that the IRS paid over $1 million during FY 2011 for aircards and BlackBerry® smartphones that were not used for periods of three months to one year.[47] Overall, process improvements could result in a cost savings totaling approximately $5.9 million over five years.

TIGTA also reported on several areas of concern associated with an August 2010 IRS conference in Anaheim, California and made recommendations to ensure that taxpayer funds are expended more efficiently in the future.[48] The Acting IRS Commissioner stated that new spending restrictions have been put in place at the IRS. The IRS has taken steps to ensure travel and conference spending is appropriate, limited, and undergoes a thorough review and approval process.

In another audit, TIGTA reported that the IRS has not identified the optimal footprint for its data centers.[49] TIGTA observed significant empty space at the IRS's Enterprise

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[46] The IRS generally has 10 years from the date of assessment to collect a liability owed by a taxpayer. The final date to collect is referred to as the Collection Statute Expiration Date.

[47] TIGTA Ref. No. 2013-10-010, *Inadequate Aircard and Blackberry Assignment and Monitoring Processes Result in Millions of Dollars in Unnecessary Access Fees* (Jan. 2013).

[48] TIGTA, Ref. No. 2013-10-037, *Review of the August 2010 Small Business/Self-Employed Division's Conference in Anaheim, California* (May 2013).

[49] TIGTA Ref. No. 2013-20-013, *The Data Center Consolidation Initiative Has Made Significant Progress, but Program Management Should Be Improved to Ensure That Goals Are Achieved* (June 2013).

Computing Center in Detroit, Michigan. After our audit was initiated, the IRS announced plans to close this facility, which will save the IRS approximately $15 million annually.

CONCLUSION

This memorandum is provided as our annual summary of the most serious major management and performance challenges confronting the IRS in FY 2014. TIGTA's *Fiscal Year 2014 Annual Audit Plan* contains our proposed reviews, which are organized by these challenges. If you have any questions or wish to discuss our views on the challenges in greater detail, please contact me at (202) 622-6500.

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