TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The Human Capital Office Made Improvements to the Employee Tax Compliance Program but Has Not Yet Improved the Detection of Noncompliance

August 31, 2007

Reference Number: 2007-10-128

Phone Number | 202-927-7037
Email Address | Bonnie.Heald@tigta.treas.gov
Web Site | http://www.tigta.gov

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

August 31, 2007

MEMORANDUM FOR CHIEF HUMAN CAPITAL OFFICER

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Human Capital Office Made Improvements to the Employee Tax Compliance Program but Has Not Yet Improved the Detection of Noncompliance (Audit # 200610039)

This report presents the results of our review of the Employee Tax Compliance Program (hereafter referred to as the ETC Program or the Program). The overall objective of this review was to determine whether the Internal Revenue Service (IRS) effectively implemented the ETC Program Task Force recommendations and whether the Program is able to proactively identify instances in which employees may have understated their tax liabilities. This audit was conducted as part of the Treasury Inspector General for Tax Administration's Fiscal Year 2007 audit plan.

Impact on the Taxpayer

The ETC Program Office has taken several steps to improve the Program, but efforts to better detect potential employee noncompliance are still in the development stage. Until these efforts are fully implemented, certain kinds of employee tax noncompliance may not be detected. Employee noncompliance with the tax laws could cause embarrassment to the IRS and erode the public's confidence in the tax system.

Synopsis

The IRS Human Capital Office (HCO) is responsible for administering the ETC Program. The goal of the Program is to encourage employees to fulfill their tax obligations and to identify employees who are noncompliant with Federal tax laws. After the discovery of certain kinds of employee noncompliance that had not been detected by the Program, the IRS formed the ETC Program Task Force (the Task Force) to assess the Program. The Task Force concluded the IRS could not timely determine employee tax compliance, and it lacked the tools needed to analyze tax return data and provide a data-driven synopsis of the ETC Program's performance. In November 2004, the Task Force made six recommendations for improving the Program.

In response to the Task Force recommendations, the HCO established the ETC Program Office to provide leadership for the Program and to coordinate with the IRS operating divisions. The Program Office took actions to improve how the IRS oversees employee tax compliance, including steps to:

- Improve outreach to employees so they understand the importance of timely filing and paying their Federal income taxes.
- Centralize examination results to expedite the processing of noncompliance cases.
- Revise case closing guidelines to more expeditiously close certain types of cases.

However, the HCO has not fully implemented all of the Task Force recommendations. Actions to better track and share data are not yet completed, and efforts to better detect potential employee noncompliance are still in the development stage. As a result, the ETC Program still cannot identify certain types of employee tax noncompliance. In addition, the Program Office has not developed performance measures to assist in evaluating its efforts to improve employee tax compliance.

Recommendations

We recommended the Chief Human Capital Officer (1) determine how best to timely and effectively improve employee tax compliance detection procedures and weigh the risk of not implementing them and achieving the goals associated with them against other priorities of the HCO, (2) ensure the ETC Program Manager creates a new schedule for implementing the remaining Task Force recommendations, and (3) develop performance measures so the ETC Program can be fully assessed.

Response

The Chief Human Capital Officer agreed with our recommendations. HCO management plans to assess the staffing needs of the ETC Program Office to determine if staffing is adequate to meet the objectives of the Program within the priorities of the HCO. Management also plans to review and revise the schedule of Task Force recommendations, develop a risk-assessment methodology, prioritize the noncompliance projects, and review current HCO data systems for integration strategies. The ETC Program Manager has begun the process of developing performance measures. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

Table of Contents

Abbreviations

AIMS	Audit Information Management System
ETC	Employee Tax Compliance
HCO	Human Capital Office
IRS	Internal Revenue Service

Background

The Code of Federal Regulations[1] states that all Federal Government employees are expected to satisfy their obligations as citizens of the United States, ". . . including all just financial obligations, especially those such as Federal, State, or local taxes that are imposed by law." As the agency of the Federal Government primarily responsible for administering the Federal tax law, the Internal Revenue Service (IRS) must ensure its employees comply with the same tax laws to which all taxpayers are subject.

The IRS Human Capital Office (HCO) is responsible for administering the Employee Tax Compliance Program (hereafter referred to as the ETC Program or the Program). The ETC Program Manager has the responsibility to coordinate and interact with all IRS divisions and business units to address employee tax compliance issues; identify trends and issues to proactively address noncompliance; and orient, educate, and assist employees in complying with the tax laws.

In July 1995, ETC Program operations were centralized into a single branch office in Cincinnati, Ohio, to improve the IRS' ability to identify noncompliant employees. The role of the ETC Branch is to ensure consistency in the treatment of employee tax noncompliance, protect employee privacy by further restricting access to employee tax information, and ensure employees fulfill their tax obligations by identifying those who are noncompliant with Federal tax laws.

Each year, the IRS employee database[2] is matched with tax data[3] to identify potential employee noncompliance. The computer match will identify (but is not limited to) instances when an employee did not file a Federal tax return, did not file timely, or did not pay the tax owed when due. Noncompliance cases are routed through the HCO Labor and Employee Relations function to the individual employees' managers for initial action and can be eventually referred to the 1203 Review Board and the IRS Commissioner for final settlement. A detailed explanation of the ETC Program process and the number of cases identified for the past 2 years is included in Appendix IV.

There have been indications that some instances of employee noncompliance have not been detected by the ETC Program. In May 2001, the Treasury Inspector General for Tax Administration received allegations that some IRS employees were understating their tax liability by filing a fraudulent U.S. Individual Income Tax Return (Form 1040) Profit or Loss

---

[1] Code of Federal Regulations Title 5, Volume 3, Section 2635.809 (Revised as of January 1, 2004).
[2] The Treasury Integrated Management Information System contains employment information for all IRS employees.
[3] The Individual Master File is the IRS database that maintains transactions or records of individual tax accounts.

From Business (Schedule C) with their Federal tax returns. The Treasury Inspector General for Tax Administration Office of Investigations worked with the IRS Small Business/Self-Employed Division to select for review and audit 822 employee (or former employee) tax returns. As of October 2005,[4] 405 completed examinations had resulted in adjustments (both increases and decreases) to taxable income averaging $1,071 (median adjustment of $136) and adjustments to other taxes and tax credits claimed averaging $2,650 (median credit adjustment of $307).[5] The Schedule C Project demonstrated that the ETC Program–as it was designed at that time–could not identify cases of employee noncompliance when the employee had timely filed a tax return with no balance due but had taken erroneous deductions as a part of that tax return.

Because the ETC Branch's case identification process was not designed to detect cases like those identified in the Schedule C Project, and because the recommendations from two earlier studies had not been fully implemented, in March 2004 the IRS established a task force to reassess the ETC Program. The conclusion of the ETC Program Task Force (the Task Force) study was that no single individual or office had effective control of the process. As a consequence, the IRS could not timely determine employee tax compliance, and it lacked the tools needed to analyze tax return data and provide a data-driven synopsis of the ETC Program's performance. In November 2004, the Task Force issued a report that made the following six recommendations to improve the Program:

1. Create a comprehensive program office.
2. Enhance communications and educational outreach.
3. Include an IRS employee indicator on all data systems.
4. Enhance employee noncompliance detection procedures.
5. Enhance data support within the ETC Program process.
6. Improve ETC Program administrative adjudication procedures.

This review was performed in the HCO, Workforce Relations, Employee Conduct and Compliance function in Washington, D.C., and the ETC Branch in Cincinnati, Ohio, during the period July 2006 through March 2007. The audit was conducted in accordance with *Government Auditing Standards.* Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[4] These were the most current data available at the time of our review.
[5] Adjustments are per line item; there can be more than one adjustment per tax return.

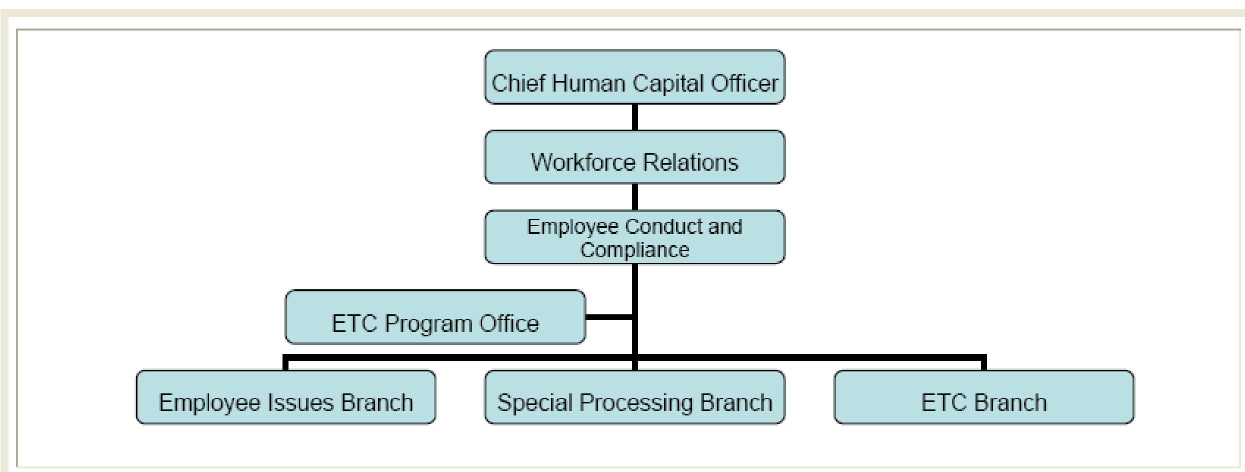
Results of Review

The HCO has implemented three of the six recommendations made by the Task Force, but additional work is needed to address the three remaining recommendations. The HCO created an ETC Program Office, which took action to enhance the Program's educational outreach and improve the adjudication procedures associated with the Program. Although the Program Office took actions to address the Task Force recommendations to (1) add an employee indicator on IRS data systems, (2) enhance data support for the Program, and (3) enhance the employee noncompliance detection procedures, the recommendations are not yet fully implemented. As a result, the ETC Program still cannot identify certain types of employee tax noncompliance, such as those that were identified during the Schedule C Project. In addition, the Program Office has not developed any performance measures to assist in evaluating its success and identifying areas needing improvement.

The Human Capital Office Created a Program Office, Enhanced Communication and Outreach, and Improved the Adjudication Procedures

As recommended by the Task Force, the HCO created the Program Office in August 2005 with the selection of the ETC Program Manager. The Program Office is positioned above the ETC Branch organizationally but does not have line authority over the Branch. Figure 1 shows how the Program Office is aligned within the HCO.

Figure 1: Alignment of the ETC Program Office Within the HCO



Source: IRS Human Capital Office.

The Program Manager cannot unilaterally implement reviews of employee returns and is dependent on the Small Business/Self-Employed Division to provide the resources needed to conduct actual audits of employee returns. The decision to commit these resources is made by the 1203 Review Board, based on the recommendation of the Program Manager, availability of resources, and consideration of other IRS priorities. The Program Manager's duties closely match the Program Office responsibilities recommended by the Task Force, including:

- Overseeing implementation of the Task Force recommendations.
- Advising the 1203 Review Board on major policy initiatives, employee issues, and mitigation strategies.
- Actively participating in formulation of ETC Program policy.
- Providing leadership over the activities designed to identify noncompliant employees, including providing data to support specific enforcement actions.
- Evaluating the program measures, including ensuring programmatic issues are addressed timely.
- Coordinating employee communication, education, and assistance efforts with the operating divisions.

The Program Office is comprised of one permanent employee, the Program Manager, and occasional temporary assistance from another HCO employee. Since the creation of the Program Office in August 2005, the Program Manager has worked extensively on communication with and outreach to IRS employees, with a goal to reduce the number of employees that are not compliant with their tax responsibilities by educating them about tax compliance. The outreach efforts involve presentations and other communications given at employee training sessions, particularly at the IRS campus[6] locations. Because most tax compliance problems have originated with lower grade employees in the campuses (90 percent of cases relate to employees at Grade 8 and below[7]), many Employee Tax Compliance Alerts are addressed to those employees. In addition, the IRS Intranet includes a link to the Employee Tax Compliance webpage, which provides employees with news and information on tax compliance including different sets of "Questions and Answers" for both employees and managers. Furthermore, in his 2007 annual tax compliance message to all employees, the IRS Commissioner recommended both managers and employees review the information contained on the Employee Tax Compliance webpage.

The Program Manager has also addressed the recommendation to enhance the process by centralizing the examination results and adjusting the ETC Program case closing guidelines. As

[6] The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[7] Calendar Year 2005.

recommended, employee returns identified during the audit process are controlled by a support manager. When the examinations are completed, they are subject to mandatory reviews, and the results of the examinations are submitted to a central location within the IRS to ensure cases are quickly referred through the ETC Branch to the proper Labor and Employee Relations office.

The Program Office obtained approval for changes to the Program case closing guidelines that will allow the ETC Branch to more expeditiously close certain types of cases. These changes dealt with adjusting the Branch criteria so a first-time offense involving an issue(s) below a specific tolerance(s) is handled as a minor compliance infraction, with an advisory letter being sent to the employee instead of the case being referred to management. The guideline changes relate only to those cases in which the employee has no prior history of noncompliance.

The establishment of the Program Office and its actions to improve outreach to employees, centralize examination results, and revise closing guidelines improved how the IRS oversees employee tax compliance. However, we determined additional actions are needed to better detect employee noncompliance and address the remaining Task Force recommendations.

Some Types of Employee Noncompliance May Still Be Undetected

The Program Office focused on improving communication and outreach because it believed those activities would have the greatest impact on improving tax compliance. However, it is important that the remaining Task Force recommendations be fully implemented to improve the detection procedures for any noncompliance. Although the Program Office has made some progress, additional efforts are needed to fully address the Task Force recommendations to:

- Include an employee indicator on IRS data systems.
- Enhance data support.
- Enhance employee noncompliance detection procedures.

Until these recommendations are fully implemented, the Program Office may not detect certain kinds of employee tax noncompliance, such as erroneous deductions that were identified during the Schedule C Project. Further, the Program Office needs to develop performance measures to help evaluate the success of the Program and identify areas needing improvement.

When the Program Office was created, the Program Manager suggested three full-time employees would be needed to implement the Task Force recommendations and improve noncompliance detection procedures. However, the Program Office currently consists of only one person; the Program Manager believes additional resources would allow the IRS to improve its noncompliance detection procedures. The Chief Human Capital Officer should consider how best to timely and effectively implement the remaining Task Force recommendations and weigh the risk of not implementing them or achieving the goals associated with them against other priorities of the HCO.

In our opinion, the success of the ETC Program depends, in part, on IRS senior executives' commitment to devoting sufficient examination resources to audit employee returns selected for review. This requires a balance between ensuring employees are fully compliant with their tax obligations and pursuing higher dollar cases that may have a greater impact on closing the existing tax gap.[8] Although the ETC Program may not produce a high-dollar impact, noncompliant employees may cause embarrassment to and erode the public's confidence in the IRS. We further believe a balanced approach of employee education together with examination projects is needed to enforce the IRS' position that employee tax noncompliance is inappropriate, will be detected, and will be properly addressed.

Employee indicators are not present on older compliance tracking system records

The Task Force reported, "One of the main obstacles to performing analysis and identifying employees entering the noncompliance stream is that employee indicators are not present on all of the primary Compliance [function] tracking systems." This principally applied to the Audit Information Management System (AIMS)[9] and three other systems based on the AIMS. Within the AIMS database, Source Code 46 is specifically designated for employee audits that are initiated as part of a referral or as part of a new employee's background process. However, audits of employee returns may also originate from several other sources. The Task Force found that, by relying only on Source Code 46 to identify employee cases, as much as 52 percent of the true volume of employee cases in the audit process was excluded. To address this problem, the Task Force recommended that an employee indicator be added to the AIMS.

In January 2006, the IRS added to the AIMS an employee indicator that will allow it to more easily identify and evaluate the noncompliance identified through audits of employee tax returns regardless of the audits' origins. However, the indicator field is used only when an audit is started, which means the employee indicator will be blank or zero for any employee audits started prior to January 2006. Therefore, until the older cases are closed off the AIMS, any analysis of the System will still not be accurate because some older cases did not have this indicator field. Our tests of the AIMS revealed that 13 percent of the employee audits conducted did not have the source code that would identify them as employee audits, which is a considerable improvement from the 52 percent reported by the Task Force. Over time, this problem will diminish as older audits are closed from the System and new audits are entered on the System. Eventually, because of this systemic change, all employee accounts should contain an employee indicator when audits are conducted.

---

[8] The tax gap is the difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law.

[9] The AIMS is a computer system used by the IRS during the audit process to control returns, input assessments/adjustments to IRS data records, and provide management reports.

ETC Branch and Labor and Employee Relations function management information systems have not been integrated

The Task Force reported that conducting just one data extract each year and having two different systems that did not share data were hindering efforts to detect and analyze employee noncompliance. The HCO partially addressed the Task Force recommendation to enhance data support by working with the Modernization and Information Technology Services organization to increase the number of computer extracts run each year. However, the HCO has not taken any action to integrate the ETC Program's principal management information systems.

Beginning in Calendar Year 2006, the Program Office increased the number of computer matches from one to three each year. The former annual computer match was timed each year to identify when an employee did not file a tax return. It also identified other types of noncompliance that were not dependent on the timing of the filing date of the annual tax return, such as when audit results post to an employee's account. The Program Office added two new computer matches that more timely identify these other types of noncompliance. Although these two matches do not identify new types of noncompliance, they do reduce the time between the occurrence and the detection of the noncompliance.

The ETC Program's two principal management information systems (for the ETC Branch and the Labor and Employee Relations function) still have not been integrated, even though the ETC Implementation Plan reported an expected completion date of July 2006. The Task Force noted that modification and integration of these two systems was fundamental to understanding and evaluating the processing of employee cases. In addition, the Task Force noted that determining the status of employee cases and analyzing the results of cases was difficult, in part, because of various data system limitations. The addition of certain fields, such as dollar amounts, and the integration of the two systems should allow for tracking of cases from inception to final closure and for greater analysis by case type and dollar impact. The Task Force also noted this type of data would be useful in evaluating program performance.

Employee noncompliance detection procedures have not been improved

The Task Force observed that the IRS could not determine if its process of using common examination filtering criteria effectively identifies employee tax noncompliance. However, the Schedule C Project demonstrated that the process could not detect more complicated types of employee noncompliance. That Project originated from a complaint made to the Treasury Inspector General for Tax Administration Office of Investigations, not through the routine audit processes. To address this gap in the detection process, the Task Force recommended several issues be considered, including:

- Consistent analysis of employee tax return filings to identify patterns of potential noncompliance.
- Screening of employee returns against known abusive tax avoidance scheme participants' lists and promoter lists.
- Development of standardized employee return filters to identify indicators of potential noncompliance.

The Program Office has worked with the Small Business/Self-Employed Division to develop potential projects to identify previously undetected employee tax noncompliance.[10] However, since its inception in August 2005, the Program Office has requested 1203 Review Board approval for only one project to identify different types of employee noncompliance. The Project Office submitted the project request in January 2007, and the request was still pending as of the end of our audit fieldwork. In addition, the Program Office has not created standardized filters to identify employee noncompliance, although this was projected to be completed by February 2006.

Furthermore, the IRS *Management Controls Accountability Program Handbook for Managers* requires managers to establish policies and procedures to ensure reliable information is obtained and used for decision making. However, the Program Manager does not have a documented process for identifying which potential employee noncompliance projects should be prioritized and submitted to the 1203 Review Board, so there is little assurance that the projects with the greatest possibility for identifying noncompliance will be implemented for examinations.

As more work is done in this area, the Program Manager will need a formal process to assess the benefits of any potential projects. For example, while the Schedule C Project audits were being conducted, adjustments had to be made to several other forms and schedules attached to employee returns. The adjustments most often involved itemized deductions, capital gains and losses, and supplemental income and losses. Any of these areas might yield several additional projects, and the Program Office will need to prioritize the projects based on risk and expected results.

The Program Office has not established performance measures

While creation of performance measures was not a specific, standalone recommendation of the Task Force, sound internal management controls and the Budget and Performance Integration portion of the President's Management Initiatives require that:

[10] The Program Office has received Tax Year 2003 filing pattern data and expects to receive data for Tax Years 2004 and 2005 in the near future.

- Managers use performance information to make budget, regulatory, and management decisions.
- Agencies estimate the full and marginal cost of achieving performance goals.
- All programs include efficiency measures.

However, the Program Office has not developed effective performance measures. This occurred, in part, because of data limitations previously described and because the Program Office decided to dedicate its resources to other priorities. The HCO Strategic Implementation Plan reports that improved ETC Program communication/education, employee noncompliance detection, and higher employee compliance levels are desired outcomes of the Program. However, the Plan does not list the performance measures that will be used to assess progress or the specific target levels to be obtained. Until better measures are developed, the Program Office plans to assess the success of its efforts by evaluating the number of ETC Program cases that go before the 1203 Review Board and the workload statistics of the ETC Branch; however, these measures do not address all of the desired outcomes.

Recommendations

Recommendation 1: The Chief Human Capital Officer should determine how best to timely and effectively improve employee tax compliance detection procedures and weigh the risk of not implementing them and achieving the goals associated with them against other priorities of the HCO. Consideration should be given to the availability of HCO resources when delegating the work needed to make improvements.

> ***Management's Response:*** HCO management agreed with this recommendation and plans to assess the staffing needs of the ETC Program Office to determine if the staffing is adequate to meet the objectives of the Program within the priorities of the HCO. Management also plans to work with the Small Business/Self-Employed Division Research function and the 1203 Review Board to analyze and communicate the filing patterns of IRS employees.

Recommendation 2: The Chief Human Capital Officer should ensure the ETC Program Manager creates a new schedule for completing the open Task Force recommendations, paying particular attention to (1) developing a risk-assessment methodology to justify which projects are selected for work and developing an appropriate set of filters based on the projects' results and (2) integrating data systems with which to analyze identified employee noncompliance and report Program accomplishments.

Management's Response: HCO management agreed with this recommendation and plans to review and revise the schedule of Task Force recommendations, develop a risk-assessment methodology, and prioritize the noncompliance projects. Management also plans to consult with the Modernization and Information Technology Services organization to review current HCO data systems and suggest integration strategies.

Recommendation 3: The Chief Human Capital Officer should develop performance measures so the ETC Program can be fully assessed.

Management's Response: HCO management agreed with this recommendation and stated the ETC Program Manager has begun the process of developing performance measures.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS effectively implemented the ETC Program (the Program) Task Force recommendations and whether the Program is able to proactively identify instances in which employees may have understated their tax liabilities. To accomplish this objective, we:

I. Evaluated the strategic direction and current results of the ETC Program.

   A. Determined if the HCO had identified performance measures to evaluate the success of the Program.

   B. Contacted Small Business/Self-Employed Division senior management to determine if the Division can devote additional resources necessary to conducting the audits if the Program increases its number of cases.

   C. Determined if there were any Memoranda of Understanding between the ETC Branch and the operating divisions identifying the specific level of support that should be provided and if the Memoranda needed to be amended based on an increase in the volume of cases.

   D. Evaluated the results of the Program by reviewing the case closures for Calendar Years 1999 – 2005 to identify any trends in case source, types of issues pursued, and demographics of the employees involved.

II. Determined if the IRS had taken actions necessary to implement the recommendations of the ETC Program Task Force.

   A. Determined if the IRS had created a comprehensive program office to serve as a liaison across organizational lines to bring noncompliance detection, Program adjudication, and communications under one individual.

   B. Evaluated the communications and educational outreach efforts the IRS has taken to communicate tax compliance requirements to its employees.

   C. Determined if the IRS had installed employee indicators on its Compliance function systems, so data on noncompliant employees can be captured and analyzed timely.

D. Determined if the Program had enhanced its data support by increasing the number of Individual Master File[1] extracts done each year and by making changes to its management information systems to track cases through the Program.

E. Evaluated the adjudication process to determine if the Program had improved its adjudication procedures by centralizing the examination of employee returns and reviewed its case closing guidelines.

F. Determined if the Program is taking the necessary steps to enhance its ability to detect employees not complying with their tax responsibilities.

[1] The Individual Master File is the IRS database that maintains transactions or records of individual tax accounts.

Appendix II

Major Contributors to This Report

Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)
Carl L. Aley, Director
Kevin Riley, Audit Manager
David Robben, Lead Auditor
Stephanie Foster, Senior Auditor
William Thompson, Auditor

Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Attn: Acting Chief of Staff C
Deputy Commissioner for Operations Support OS
Deputy Commissioner for Services and Enforcement SE
Commissioner, Small Business/Self-Employed Division SE:S
Chief Information Officer OS:CIO
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Chief Human Capital Officer OS:HC

Appendix IV

Employee Tax Compliance Program Process and Historical Data

The ETC Branch works cases on a calendar year basis based on the annual computer match. The cases can represent more than one tax period, depending on the type of noncompliance. Figure 1 shows the types of cases in the ETC Branch beginning inventory for Calendar Years 2005 and 2006.

Figure 1: Employee Noncompliance Cases for Calendar Years 2005 and 2006

Type of Noncompliance	Calendar Year 2005		Calendar Year 2006	
	Number of Issues	Percentage to Total	Number of Issues	Percentage to Total
Failed to file tax return	999	10%	882	11%
Open balance due	2,063	22%	1,641	20%
Filed return late or paid tax due late	6,316	66%	5,359	67%
Employee audit or adjustment	179	2%	144	2%
Other	13	0%	11	0%
Totals	**9,570**	**100%**	**8,037**	**100%**

Source: IRS ETC Branch.

The ETC Branch researches each issue to determine whether a potential problem exists. The Branch closes those cases in which noncompliance is not indicated or that have previously been addressed by management administratively. In the remaining cases, employees are contacted by letter and provided a chance to explain the potential noncompliance issue. If information is provided that resolves an issue or if it can be determined the issue involves a minor or technical error, the issue is closed without any further action. Issues that cannot be resolved or closed are referred to the employee's manager through the HCO Labor and Employee Relations function for further investigation and administrative action. Figure 2 shows the manner in which Calendar Year 2005 ETC Program cases were processed.

Figure 2: Disposition of Calendar Year 2005 ETC Program Cases

Description of Closure	Number	Percentage
Closed based on ETC Branch research	6,169	64%
Closed after receiving information from the employee	225	2%
Closed with an advisory letter to the employee	721	8%
Referred to manager through the Labor and Employee Relations function	2,455	26%
Totals	**9,570**	**100%**

Source: ETC Branch.

Once the cases are referred to a manager through the Labor and Employee Relations function, administrative disciplinary actions could range from oral counseling to suspension or even removal, depending on the severity of the noncompliance issue and whether there have been repeated or multiple offenses.

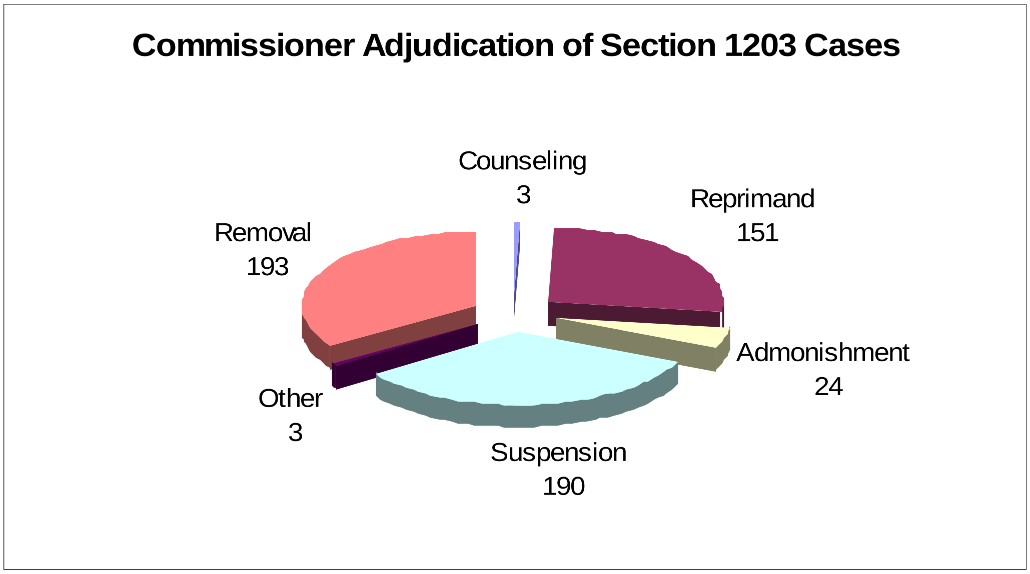
In Section 1203, the IRS Restructuring and Reform Act of 1998[1] specified that any IRS employee determined to have willfully failed to file any required Federal tax return or willfully understated a tax liability must be terminated from employment with the IRS. The Deciding Official from the employee's operating division makes the determination if the employee's noncompliance was willful. Cases involving willful intent are referred to the IRS 1203 Review Board[2] for the Board's determination and recommendation to the IRS Commissioner. The 1203 Review Board forwards to the Commissioner only those cases for which the Board recommends some type of punishment other than removal. The Commissioner can then either agree with the Board's recommendation to mitigate the penalty or remove the employee. The IRS Commissioner has sole discretion to determine what action to take. This authority cannot be delegated, and the Commissioner's determination may not be appealed. For the period October 2003 through August 2006, 564 cases were presented to the 1203 Review Board and forwarded to the Commissioner for adjudication. This total includes cases identified from sources other than the annual ETC Program computer match. A total of 193 employees were fired (removed) for not complying with their Federal tax obligations. Figure 3 shows a complete breakdown of the adjudications.

---

[1] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

[2] The Board Members are the Deputy Commissioner for Operations Support; the Deputy Commissioner for Services and Enforcement; the Deputy Chief Appeals; and the Chief, Equal Employment Opportunity and Diversity.

Figure 3: Breakdown of the 564 Cases Referred to the 1203 Review Board From October 2003 Through August 2006



Source: ETC Program Office.

Appendix V

Management's Response to the Draft Report

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

CHIEF
HUMAN CAPITAL OFFICER

JUL 17 2007

RECEIVED
JUL 17 2007

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Robert Buggs

SUBJECT: Draft Audit Report - The Human Capital Office Made Improvements to the Employee Tax Compliance Program but Has Not Yet Improved the Detection of Noncompliance (Audit # 200610039)

Thank you for allowing us to review and comment on the draft audit report titled: *The Human Capital Office Made Improvements to the Employee Tax Compliance Program but Has Not Yet Improved the Detection of Noncompliance.*

During FYs 2004 and 2005, the Employee Tax Compliance (ETC) Task Force studied the ETC process and developed six recommendations to improve the IRS's employee tax compliance efforts:

1. Create a comprehensive ETC program office
2. Enhance communications and outreach
3. Install IRS indicators on all data systems
4. Improve employee noncompliance detection procedures
5. Enhance the data support for the ETC process
6. Improve ETC administrative adjudication procedures

I am pleased with the progress we have made so far. We have created the ETC program office, enhanced communication and outreach efforts, installed IRS indicators on key data systems and improved ETC administrative adjudication procedures. I recognize there is still much work to be done. We are committed to the successful and ongoing implementation of all of the task force recommendations, as well as the recommendations described in your report.

Our ETC outreach efforts and products are designed to communicate common, avoidable misconceptions and mistakes that IRS employees have made since the inception of the Restructuring and Reform Act of 1998, Section 1203. Our analysis showed that mistakes range from simple misunderstandings, such as missing filing deadlines, to more complex issues, such as ignorance of the tax ramifications of early withdrawals from individual retirement or Thrift Savings Plan accounts.

2

We developed an ETC website that provides key tax and conduct resources for employees to review. Our website also contains a popular presentation for managers to use when discussing tax compliance in their workgroups. During the Tax Year 2006 filing season, employees and managers made more than 6,000 downloads of this presentation. We anticipate using this data as a baseline for future measures of outreach effectiveness.

The Director, Workforce Relations Division, has shifted dedicated resources to ensure that outreach presentations are given to as many managers and employees as possible. Our efforts to leverage these valuable resources have resulted in discussions with several hundred campus and field managers. We plan to continue this partnership as a way of reaching more and more employees regarding their tax obligations.

Our efforts to gather and analyze IRS employee tax filing profile data are ongoing as we work with subsequent tax years. We are working with Small Business/Self-Employed Division Research, and expect to receive their data report within the next 30 days. These efforts will give us three years of filing patterns, which will enable us to identify areas of noncompliance risk, and to develop standard filters for future examination projects.

We agree that we still have work to do and concur with your recommendations. Our comments are attached.

If you have any questions, please contact me at (202) 622-7676 or Christine M. Adams, Associate Director, Employee Conduct and Compliance Office at (202) 622-9363.

Attachment

Attachment

RECOMMENDATION 1
The IRS Human Capital Officer should determine how best to timely and effectively improve employee tax compliance detection procedures and weigh the risk of not implementing them and achieving the goals associated with them against other priorities of the HCO. Consideration should be given to the availability of HCO resources when delegating the work needed to make improvements.

CORRECTIVE ACTION
a) We agree with this recommendation, and we will assess the staffing needs of the Employee Tax Compliance (ETC) Program Office to determine if staffing is adequate to effectively meet the objectives of the program within the priorities of the HCO.
b) We will continue to work with our income tax data provider, SB/SE Research, and the Commissioner's Section 1203 Review Board to analyze and communicate the filing patterns of IRS employees for Tax Years 2004 and 2005.

IMPLEMENTATION DATE
a) December 31, 2007
b) September 30, 2007

RESPONSIBLE OFFICIAL
a) IRS Human Capital Officer
b) Associate Director, Employee Conduct and Compliance Office

CORRECTIVE ACTION MONITORING PLAN
We will monitor these corrective actions as part of the monthly meetings with the Workforce Relations Division (WRD) Director. The ETC Program Manager will report progress to the Associate Director, Employee Conduct and Compliance Office.

RECOMMENDATION 2
The IRS Human Capital Officer should ensure the ETC Program Manager creates a new schedule for completing the open Task Force recommendations, paying particular attention to 1) developing a risk-assessment methodology to justify which projects are selected for work and developing an appropriate set of filters based on the projects' results and
2) integrating data systems with which to analyze identified employee noncompliance and report Program accomplishments.

CORRECTIVE ACTION
1) We agree with this recommendation; we will review and revise the schedule of ETC Task Force recommendations, and will consult with SB/SE Research and SB/SE Examination to develop a risk-assessment methodology and to prioritize noncompliance

projects that are suggested by the analysis and comparison of total positive income data for these tax years against known data from Tax Year 2003.
2) We will consult with Modernization & Information Technology Services to review current HCO data systems and to suggest system integration strategies.

IMPLEMENTATION DATE
1) September 30, 2007
2) October 31, 2007

RESPONSIBLE OFFICIAL
Associate Director, Employee Conduct and Compliance Office

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of the monthly meetings with the WRD Director. The ETC Program Manager will report monthly progress to the Associate Director, Employee Conduct and Compliance Office.

RECOMMENDATION 3
The IRS Human Capital Officer should develop performance measures so the ETC Program can be fully assessed.

CORRECTIVE ACTION
We agree that regular performance measures are needed to fully assess the ETC Program.

The ETC Program Manager has begun the measures development process by soliciting and receiving ideas for specific measures from the ETC project implementation team. He has also contacted the Human Capital Planning and Measures organization for guidance and next steps in measures development.

IMPLEMENTATION DATE
Target implementation date: December 31, 2007

RESPONSIBLE OFFICIAL
Associate Director, Employee Conduct and Compliance Office

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of the monthly meetings with the WRD Director. The ETC Program Manager will report monthly progress to the Associate Director, Employee Conduct and Compliance Office.