DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

October 14, 2004

MEMORANDUM FOR SECRETARY SNOW

FROM: Pamela J. Gardiner
Acting Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2005

The Reports Consolidation Act of 2000[1] requires that we summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2004,* our perspective on the most serious management and performance challenges currently facing the Internal Revenue Service (IRS).

Our assessment of the major IRS management challenge areas for Fiscal Year (FY) 2005 has not changed substantially from the prior year. While the IRS has acted to address each challenge area, we were unable to remove any challenge area from our list at this time. We have, however, removed the subtitles previously included for two areas – Security of the Internal Revenue Service and Integrating Performance and Financial Management. The narrative for each primary category describes the issue as a whole; therefore the subtitles are no longer needed. The ten current challenges are:

Systems Modernization of the Internal Revenue Service

The latest effort to modernize IRS' computer systems, mandated by the IRS Restructuring and Reform Act of 1998 (RRA 98)[2] and started in FY 1999, is expected to take 10 to 15 years at a cost of $7 to $10 billion. The IRS has developed an enterprise architecture to guide the Business Systems Modernization (BSM) program. In addition, the IRS and the PRIME[3] contractor have deployed projects that provide value to taxpayers and have built the infrastructure needed to support these projects. Even so, the IRS and its contractors have drawn increased criticism due to continuing schedule delays and cost increases. To address the results of recent studies, the IRS and the PRIME contractor have developed and are implementing a 48-point action plan that should help improve the BSM program.

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[1] Pub. L. No. 106-531.
[2] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 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.).
[3] The Prime Systems Integration Services Contractor (PRIME) is the Computer Sciences Corporation, which is responsible for designing new systems to meet IRS business needs, developing these systems, integrating them into the IRS, and ultimately transferring operation of these systems to the IRS.

Tax Compliance Initiatives

The IRS continues to face challenges in administering programs that deal with tax gap issues, especially those resulting from corporate and high-income individual taxpayer corrosive activities as well as domestic and off-shore tax and financial criminal activity. The IRS is revising its compliance program by reengineering the collection and examination practices, and we have noted some improvements. However, without the proposed FY 2005 budget relief for additional Collection function staffing and legislation to allow some cases to be worked by contract staff, a significant number of cases will remain unworked. The Examination function staffing decreased during FY 2003; however, the percent of tax returns examined increased. Still, the number of corporate tax return examinations continued the decline that started in FY 1997, decreasing a total of 67 percent since that time. We also noted that the Tax Exempt and Government Entities (TE/GE) Division must develop better research tools, improve training to trace funds through complex transactions, and enhance and leverage available electronic data to address heightened concerns that charities are being used to fund terrorists and other illegal activities. The President's FY 2005 budget includes funding to address some of these issues.

Security of the Internal Revenue Service

For the last 3 years, TIGTA assessments have concluded that the security infrastructure and the applications that guard sensitive data are weak because of inadequate accountability and security awareness as well as insufficient training for key security employees. The end result is that the IRS still does not have an organizational culture that places strong emphasis on the security and privacy of taxpayer data. For example, additional work remains in certifying its many computer systems; sensitive technology information was posted on the Internet; some equipment, when synchronized to a network computer, provided a backdoor into the network and could bypass existing security detection controls; and centralizing security issues under the Mission Assurance organization could encourage complacency in other IRS offices. In addition, some disaster recovery plans require additional development, testing, or personnel training to assure that the IRS can quickly recover in the event of a disaster.

Integrating Performance and Financial Management

The IRS recently issued its 5-year strategic plan for FYs 2005-2009, building on its first plan issued in January 2001. In addition, during the FY 2005 budget formulation process, the IRS took the important step of aligning performance and resources requested, and modified its budget and performance plans to include more customer-focused and "end results" measures. Still, the IRS has had mixed success in establishing its long-term goals. We believe the IRS must continue to integrate performance into its decision-making and resource allocation processes to completely achieve an integrated performance budget. The IRS' financial statements and related activities also continue to be of concern to IRS stakeholders. In its audit of the financial statements, the Government Accountability Office identified some continuing serious deficiencies in the IRS financial systems, including control weaknesses and system deficiencies affecting financial reporting, unpaid tax assessments, tax revenue and refunds, and computer security.

Complexity of the Tax Law

Tax administration comprises approximately 80 percent of the overall paperwork burden imposed by the Federal Government. Simplifying the tax process could include a range of actions from developing legislative recommendations to clarifying tax instructions or forms. Computer modernization, too, has a role in simplifying the tax process. For example, the current *e-file* system can be modernized to provide a single standard for filing electronic tax returns with the IRS, allowing transmittal of multiple return types in the same transmission. Complexity has also given rise to the latest generation of abusive tax avoidance transactions, with taxpayers attempting to take advantage of the tax code's length and complexity by combining a myriad of technical rules to claim tax benefits not intended by the Congress.

Providing Quality Customer Service Operations

Every year, the IRS helps millions of taxpayers understand their tax obligations by answering questions over toll-free telephone lines or in person at local offices, making information available on its Web site, and responding to correspondence. The IRS' success rate in implementing these efforts has been mixed. For example, during the 2004 Filing Season, the IRS provided taxpayers with effective and improved access to its toll-free telephone system, providing over 872,000 more toll-free telephone services to taxpayers than in the prior year. While Customer Service Representatives exceeded goals in professionalism and timeliness, they provided taxpayers with accurate answers in only 62 percent of the calls monitored. In addition, the success of IRS' Kiosk Program, an effort initiated in 1998 to broaden taxpayer use of a convenient electronic channel for obtaining information, cannot be measured since there are no guidelines or processes in place to efficiently and effectively monitor the Program. If some of the traditional prefiling work of assisting taxpayers at the Taxpayer Assistance Centers (TAC) could largely be accomplished through an effective Kiosk Program, IRS could refocus TAC resources to providing face-to-face assistance to taxpayers with compliance issues.

Erroneous and Improper Payments

For the IRS, improper and erroneous payments are generally associated with refund and filing fraud issues as well as vendor or contractor overpayments. The availability of certain tax credits, such as the Earned Income Tax Credit (EITC), the Disabled Access Credit, and the Education Credit, increases the possibility for abuse. Improper use of the EITC, a refundable credit available to taxpayers with certain limited earned income and a qualifying child, has resulted in a significant loss of tax revenue. An IRS compliance study of TY 1999 returns estimated between $8.5 and $9.9 billion (27 to 32 percent) of the $31 billion in EITC claimed for TY 1999 should not have been paid. Recent audits revealed that not all data available to the IRS is used to validate EITC claims. We identified instances in which IRS processed returns with taxpayers claiming as dependent children persons who were older than the primary taxpayer and returns improperly using a deceased individual's social security number. In addition to tax refund issues, recent TIGTA audits revealed instances where contract expenditures, representing a significant outlay of IRS funds, were unreasonable or unallowable. In our opinion, the IRS needs to strengthen its invoice review process by routinely requesting and reviewing a sample of supporting documents.

Processing Returns and Implementing Tax Law Changes During the Tax Filing Season

Overall, the 2004 Filing Season was successful and most of the 123.1 million individual income tax returns received through May 2004 (including over 60 million received electronically, an increase of nearly 16 percent over 2003) were timely and accurately processed. However, we are continuing to identify tax law changes from prior years that have not been correctly implemented and could result in loss of taxpayer entitlements and erroneous tax reductions.

Taxpayer Protection and Rights

The IRS has dedicated significant attention and resources toward implementing the 12 provisions of the RRA 98 that increase or further protect taxpayers' rights. The IRS was in full compliance with the following taxpayer rights provisions:

- *Restrictions on the Use of Enforcement Statistics to Evaluate Employees.*
- *Fair Debt Collection Practices Act Violations.*

The IRS did not remove all *Illegal Tax Protestor Designations* from its records, did not always address all *Collection Due Process* issues, and sometimes improperly *Denied Taxpayer Requests for Information.* In addition, the IRS did not always properly notify taxpayers in situations involving:

- *Notice of Levy.*
- *Notice of Lien.*
- *Notice of Seizure.*
- *Assessment Statute of Limitations.*

Neither the TIGTA nor the IRS could evaluate the IRS' compliance with three RRA 98 provisions since IRS management information systems do not track the specific cases:

- *Restrictions on directly contacting taxpayers instead of authorized representatives.*
- *Taxpayer complaints.*
- *Separated or divorced joint filer requests.*

Human Capital

The IRS' ability to meet program requirements and the expectations of both external and internal customers is in jeopardy because of substantial loss of experience in some occupations. For example, the Small Business/Self-Employed and the Large and Mid-Size Business Divisions reported in the FY 2006 strategic assessments that the human capital crisis continues to intensify as employees in key occupational series increasingly become retirement eligible, are lost through attrition, or migrate to other areas. Stagnant funding allocations have impacted the ability to attract new hires and retain existing employees. The TE/GE Division is already understaffed for its current volume of customer calls, and without additional staffing or system enhancements, the level of service will deteriorate. In contrast, the Wage and Investment Division and the Criminal Investigation function have reported significant progress in the human capital area.

The Office of Audit's FY 2005 Annual Audit Plan categorizes the planned audits by these issues. If you have questions or wish to discuss our views on these management and performance challenges in greater detail, please contact me at (202) 622-6510.

cc: Assistant Secretary for Management (Acting)

http://www.tigta.gov/
Treasury Inspector General for Tax Administration

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Annual Audit Plans

TIGTA's Annual Audit Plans contain an overview of TIGTA's audit resources and brief descriptions of the audits TIGTA plans to start during the current fiscal year.

TIGTA's Annual Audit Plans are provided in PDF and HTML format. Documents noted as PDF require a special plugin. To obtain a free reader for this format, please visit the Adobe® web site at: http://www.adobe.com/prodindex/acrobat/readstep.html

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