



*Improvements Are Needed in the
Voluntary Closing Agreement Process for
Public Employers*

May 27, 2011

Reference Number: 2011-10-042

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

7 = Predecisional Staff recommendations or Suggestions to Agency Decision Makers

Phone Number | 202-622-6500

Email Address | TIGTACommunications@tigta.treas.gov

Web Site | <http://www.tigta.gov>



HIGHLIGHTS

IMPROVEMENTS ARE NEEDED IN THE VOLUNTARY CLOSING AGREEMENT PROCESS FOR PUBLIC EMPLOYERS

Highlights

Final Report issued on May 27, 2011

Highlights of Reference Number: 2011-10-042 to the Internal Revenue Service Acting Commissioner for the Tax Exempt and Government Entities Division.

IMPACT ON TAXPAYERS

The Federal, State, and Local Governments (FSLG) office enters into Voluntary Closing Agreements (Agreements) to resolve tax issues with government entities that voluntarily come forward and report noncompliance. TIGTA's review of the limited number of FSLG office Agreements signed to date revealed inconsistencies in controlling, processing, and monitoring Agreements, as well as in the terms and conditions of the Agreements. As a result, refunds were issued to public employers that were not due refunds, and taxpayer rights were potentially violated by inaccurately assessing interest.

WHY TIGTA DID THE AUDIT

This review was requested by the Internal Revenue Service (IRS) and addresses the major management challenge of Tax Compliance. The overall objective of this review was to assess the FSLG office's efforts to oversee and promote public employers' requests for Agreements related to self-identified filing and payment errors.

WHAT TIGTA FOUND

The FSLG office's Agreement process allows public employers that determine they are not in compliance with various employment and income tax laws to step forward and be accountable by entering into an agreement with the IRS to become compliant. While this assists the IRS in improving compliance in the government sector without using scarce resources to uncover noncompliance, the FSLG office has generally not promoted or

completely implemented adequate internal controls for its Agreement process. **7**. As a result, TIGTA found inconsistencies, inaccuracies, potential taxpayer rights violations, and weak internal controls that increase the risk of error, fraud, or abuse. For example, TIGTA identified approximately \$371,000 that was refunded to public employers that were not due refunds.

1. In addition, approximately \$1,850 in interest was assessed against public entities when interest should not have been assessed.

TIGTA also determined that Agreement terms and conditions differed in cases with similar fact patterns. For example, some public employers were required to file corrected information returns, while others were not required to file the corrected returns. In addition, TIGTA identified changes that may lead to an increase in the number of Agreements being requested. As a result of these changes, the FSLG office needs to begin building a more defined Agreement program.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Acting Commissioner, Tax Exempt and Government Entities Division, develop guidance on how to process, review, and monitor Agreements; follow up on taxpayers whose rights were potentially violated; research claims and take action to ensure future claims are worked properly; improve inventory and case management controls; and develop guidance on how to negotiate the terms and conditions of Agreements.

IRS officials agreed with our recommendations and concurred with the estimate of the measurable benefits on tax administration.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 27, 2011

MEMORANDUM FOR ACTING COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Improvements Are Needed in the Voluntary
Closing Agreement Process for Public Employers (Audit # 201010010)

This report presents the results of our review to assess the Federal, State, and Local Governments office's efforts to oversee and promote public employers' requests for Voluntary Closing Agreements (Agreements) related to self-identified filing and payment errors. This review was requested by the Internal Revenue Service and was included in the Treasury Inspector General for Tax Administration's Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance.

Management's complete response to the draft report is included in Appendix V.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

Table of Contents

Background	Page 1
Results of Review	Page 3
Agreements Could Be Better Controlled, Processed, and Monitored	Page 3
<u>Recommendations 1 and 2:</u>	Page 8
<u>Recommendations 3 and 4:</u>	Page 9
Agreements' Terms and Conditions Were Not Always Consistent.....	Page 10
<u>Recommendation 5:</u>	Page 12
Ongoing Initiatives May Lead to an Increase in the Number of Agreements	Page 12
Appendices	
Appendix I – Detailed Objective, Scope, and Methodology	Page 14
Appendix II – Major Contributors to This Report	Page 16
Appendix III – Report Distribution List	Page 17
Appendix IV – Outcome Measures.....	Page 18
Appendix V – Management's Response to the Draft Report	Page 20



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

Abbreviations

FSLG Federal, State, and Local Governments
IRS Internal Revenue Service



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

Background

The Federal, State, and Local Governments (FSLG) office is responsible for Federal tax administration issues relating to more than 105,000 Federal, State, and local government entities (public employers) across the country. As of Calendar Year 2008, public employers employed approximately 24 million employees, representing 18.3 percent of the American workforce,¹ and paid wages in excess of \$760 billion annually and employment taxes in excess of \$200 billion.² The FSLG office addresses its tax administration responsibilities through a combination of targeted outreach, development of new educational products, and various compliance activities.³ These efforts support the Internal Revenue Service (IRS) and the Tax Exempt and Government Entities Division's strategic goals of: 1) improving service to make voluntary compliance easier and 2) enforcing the tax law to ensure everyone meets their obligation to pay taxes.

In support of these goals, the FSLG office has used different approaches in past fiscal years to encourage voluntary compliance by public employers. One such approach is the use of Voluntary Closing Agreements (hereafter referred to as Agreements). This approach allows public employers that determine they are not in compliance with various employment and income tax laws to enter into an agreement with the IRS to become compliant. In other words, governments can step forward and be accountable. Agreements assist the IRS in improving compliance in the government sector without using scarce resources to uncover noncompliance.

Voluntary Closing Agreements allow public employers to voluntarily step forward and report noncompliance with tax laws and resolve the situation.

Agreements are specific arrangements the FSLG office uses to resolve various compliance issues, including fringe benefit taxability, employment tax, and income tax. For example, a government entity (Federal or State agency, county or city government, local school, etc.) discovers that it made errors on its payroll taxes in prior years and contacts the IRS, generally through representatives, to provide details of the problem. The government entity is asked to provide a written statement of the issues of noncompliance and the proposed resolutions. If the

¹ Based upon United States Bureau of Labor Statistics: Table B-1. Employees on nonfarm payrolls by industry sector and selected industry detail (in thousands) plus active duty military personnel as published by the Office of the Secretary of Defense. We did not verify the accuracy of the information because its accuracy did not affect the accomplishment of our audit objective.

² Based on data from the Bureau of Economic Analysis. We did not verify the accuracy of the information because its accuracy did not affect the accomplishment of our audit objective.

³ Compliance activities refer to examinations and compliance checks. An **examination** is an inspection of the books and records of a taxpayer for the purpose of making a determination of the correct tax liability. A **compliance check** is a contact with a government entity that involves a review of the filed information and tax returns of the entity. It is a verification of recordkeeping and tax return and information return filing.



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

IRS agrees with the proposed resolutions of the errors, the government entity enters into an Agreement with the IRS to pay the taxes owed. Interest and penalties are waived since the entity came forward voluntarily.

The IRS has received requests for Agreements from all segments of the FSLG office’s customer base (e.g., Federal, State, and local entities). As shown in Figure 1, the FSLG office received 40 requests⁴ for Agreements from October 1, 2006, through March 31, 2010. During the same period, 31 Agreements were reached⁵ with government entities that voluntarily identified issues of noncompliance. These Agreements resulted in more than \$17.7 million in additional back taxes that might otherwise have not been collected.⁶

Figure 1: Types of Public Employers Requesting Agreements (October 2006 – March 2010)⁷

*****1*****

Source: Treasury Inspector General for Tax Administration analysis of Agreement requests received in the FSLG office.

This review was performed at the Tax Exempt and Government Entities Division Headquarters in Washington, D.C., and the FSLG Compliance and Program Management office in Austin, Texas, during the period April through October 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. 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 The FSLG office received 40 requests during the scope of our review; however, *****1*****

⁵ Of the 40 Agreements, *****1***** 7 requests were still pending at the close of our scope period.

⁶ The IRS does not know the extent of noncompliance because these Agreements are the result of public employers self reporting that they are not compliant. The IRS may not know about noncompliance that is not reported by public employers.

⁷ Quasi-governmental entities have authority delegated from a Federal, State, or local government.



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

Results of Review

The FSLG Agreement process has evolved over the last several years. In Calendar Year 2005, the FSLG office identified a need for an Agreement process as public employers began coming forward with self-identified areas of prior years' noncompliance. The FSLG office developed interim guidelines for working with public employers to resolve noncompliance issues. The interim guidelines were turned into formal written procedures in Calendar Year 2008.

Although written procedures were developed, the FSLG office has generally not promoted or completely implemented adequate internal controls for its Agreement process. This is due to the lack of a formal Agreement program, which has been on hold awaiting the results of an *****7*****. As a result, we found inconsistencies, inaccuracies, potential taxpayer rights violations, and weak internal controls that increase the risk of errors, fraud, or abuse.

We also identified changes that may lead to an increase in the number of Agreements being requested. For example, the IRS is considering *****7*****, and the FSLG office recently posted a checklist on the Internet to help Federal, State, and local governments determine whether they are in compliance with tax laws. As a result of these changes, the FSLG office needs to begin building a more defined Agreement program.

Agreements Could Be Better Controlled, Processed, and Monitored

In its experience to date, the FSLG office has not always properly controlled, processed, and monitored all requests for Agreements received from its customers. Specifically, the FSLG office has not always:

- Accurately processed, reviewed, and monitored adjustments made to public employer tax accounts after an Agreement is signed to ensure that the terms of the Agreement are followed.
- Segregated key duties and responsibilities related to authorizing Agreements and processing related payments.
- Tracked its entire inventory of Agreement requests and maintained all case documentation on a centralized database.

If FSLG office management does not improve internal controls and management oversight of its Agreement process, the FSLG office increases the risks of: 1) losing revenue; 2) potentially violating taxpayer rights; 3) allowing errors, fraud, and abuse to occur without detection; and 4) not easily locating information on which to base decisions.



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

public employers' accounts. Without proper management oversight and better guidelines to ensure assessments on taxpayer accounts are properly processed and monitored, taxpayers' rights may be violated if interest is assessed improperly. In addition, the Government may lose revenue if public employers receive refunds to which they are not entitled.

Subsequent claims submitted by public employers were not always forwarded to the Compliance and Program Management office. FSLG office customers generally file claims for adjustments at a specific campus. IRS guidelines require that these claims be forwarded to the FSLG Compliance and Program Management office. This is important because campus employees working claims have no access to the Reporting Compliance Case Management System¹¹ that tracks Agreements. Therefore, they would not be aware that the entity had entered into an Agreement nor would they be familiar with the terms of the Agreement. For example, Agreements generally include a provision that no part of the Agreement assessment amount is refundable.

While guidelines were in place to forward claims to the FSLG office, they were not always followed. We identified five cases where public employers filed claims for adjustments with a campus after an Agreement had been finalized; however, the campus employees did not forward the claims to the FSLG office. These taxpayers subsequently received refunds and/or abatement of tax and/or interest totaling more than \$431,014.¹² Per FSLG office management, campus employees have no way of knowing if the adjustments on these taxpayers' accounts are associated with the closed Agreements unless they contact the Compliance and Program Management office. If the IRS does not ensure that claims submitted by public employers with signed Agreements are forwarded to the FSLG office, potentially erroneous refunds and/or abatements of tax could be provided to public employers improperly, resulting in loss of revenue to the Federal Government.

Management Actions: After our fieldwork was complete, FSLG office personnel stated they were aware of issues with the claims process and had begun working with another functional area in the IRS to correct the situation. FSLG office personnel also stated that in three out of the five cases cited, the Compliance and Program Management Office would not have received the cases because of the low dollar amounts involved. *****1*****
*****1*****
*****.

Key duties and responsibilities were not always segregated

The Government Accountability Office's guidelines state internal controls should ensure the separation of key duties and responsibilities for authorizing transactions, processing and

¹¹ The Reporting Compliance Case Management System is the Tax Exempt and Government Entities Division's inventory and case management system.

¹² See Appendix IV for details.



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

always emphasized the need to segregate key duties and responsibilities among different people in its Agreement process. Without adequate internal controls to ensure key duties and responsibilities are divided among different people, the FSLG office increases the risk of error and potential fraud. For example, if one person receives a check and there are no other individuals ensuring the correct amount of funds was transmitted and received by the campus, the individual receiving the check could be in a position to convert the check to his or her personal use without detection.

Agreements were not always properly controlled, and case records were not centralized

Requests for Agreements by public employers are centrally processed in the FSLG office's Compliance and Program Management office and are required to be established on the FSLG office's case inventory system, the Reporting Compliance Case Management System. In addition, these requests require the creation of a case file. However, the FSLG office does not always accurately track all the requests and maintain all case file documentation on a centralized database for Agreements submitted by public employers. Although the FSLG office has worked a small number of Agreements to date, if the Agreement process expands as intended, the FSLG office would need to improve its inventory and case management process to effectively control requests for Agreements from its customers.

Requests for Agreements were not always controlled on a centralized database. The FSLG office uses two databases to control its Agreement inventory: 1) an in-house Microsoft Access database developed prior to the implementation of a formal IRS case management system and 2) the Reporting Compliance Case Management System. The FSLG office continued to maintain its Access database after the deployment of the Reporting Compliance Case Management System in Fiscal Year 2007 because the new System experienced many technical problems, the staff was not consistently using it, and the System did not include the Agreements finalized prior to its deployment. While the new System has improved since its initial deployment, the Agreement Coordinator does not have access to case files once they are closed. In addition, there is no code on the Reporting Compliance Case Management System that allows for easy identification of Agreement cases. Until improvements can be made to the new System, we understand why two databases are being used to track Agreements. However, neither database is complete. Specifically, three Agreement requests¹³ identified on the Reporting Compliance Case Management System were not tracked on the Microsoft Access database, and
*****1*****
*****.

13

*****1*****
*****.



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

Due to multiple, incomplete systems being used to track Agreements, FSLG office management cannot readily determine how many of its customers requested Agreements or if an Agreement could not be reached. For example, in its Fiscal Year 2009 Work Plan, the FSLG office incorrectly reported the number of Agreements entered into during Fiscal Years 2007 and 2008. Inconsistent and inaccurate tracking of Agreement requests occurred because the FSLG office does not have sufficient written guidelines specifying how all requests for Agreements should be tracked.

The FSLG office is not maintaining all records associated with Agreements on a centralized database. The FSLG office is not controlling all the case management records associated with Agreements on a centralized IRS computer system that would be accessible to employees on a need-to-know basis. Specifically, the Reporting Compliance Case Management System did not contain all of the Agreement case documentation (e.g., the signed Agreements and documentation obtained after case closure). Instead, case information was maintained in three locations (some in paper format and others in electronic format). Without one complete and centralized database that allows employees access to data on the system after the Agreement cases are closed, the FSLG office will be unable to easily review closed cases (e.g., for subsequent claims made by a public employer or for determining if public employers have remained in compliance after signing an Agreement). All records were not maintained on a centralized database because the FSLG office does not have specific written guidelines identifying which records should be maintained. In addition, once a case is closed, the Coordinator cannot add documentation to the Reporting Compliance Case Management System.

Recommendations

To build a strong foundation for working Agreement cases in the future, the Acting Commissioner, Tax Exempt and Government Entities Division, should:

Recommendation 1: Develop additional written guidance on how to process, review, and monitor Agreements. Specifically, the guidance should include, but not be limited to:

- Stating which specific transaction codes to use to input the tax assessment that would also waive the interest in accordance with the Agreement.
- Ensuring Agreement adjustments are monitored for proper processing of the tax assessments.
- Segregating key duties and responsibilities in processing Agreements.

Management's Response: Management agreed with this recommendation and has developed and issued the recommended guidance, and implemented procedural changes that address the concerns raised in this recommendation.



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

Recommendation 2:

*****1*****
*****.

Management's Response: *****1*****
*****.

Recommendation 3: *****1*****
*****1*****

*****.

Management's Response: *****1*****
*****1*****

*****.

Recommendation 4: Improve inventory and case management controls of all Agreement requests by:

- Tracking all requests for Agreements, including denied, declined, and approved requests on a centralized database.
- Providing additional written guidelines to ensure all pertinent data and results (including the signed Agreement) are maintained on a centralized database that allows employees access to data on the system after the cases are closed.
- Adding specific project codes on the centralized database to identify Agreement cases.

Management's Response: Management agreed with our recommendation and has issued guidance improving inventory and case controls in the existing Tax Exempt and Government Entities Division's Reporting Compliance Case Management System. All future requests and agreements will be recorded and maintained in this System.



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

because of changes made in wage totals for prior years. If these corrections are not reported, affected employees may not receive the full amount of Social Security benefits they are entitled to under the law when they retire.

FSLG office management stated that the requirement to file corrected information returns was a management decision at the time each Agreement was negotiated. The draft Agreement would usually include the requirement to file corrected information returns. However, when the public employer indicated that making the correction would be too burdensome, the requirement was not incorporated into the final Agreement. FSLG office management informed us that they subsequently revised their procedures to require public employers to issue corrected Forms W-2 to enter into an Agreement. Exceptions to this policy could only be made with the approval of the Office of the Chief Counsel.

Guidelines are not available to help specialists determine whether all tax should be collected or cases should be settled for less than the total amount owed to the Government.

Assessments of additional tax were inconsistent

Additional tax due was not recorded consistently on tax accounts for public employers. In six cases, the amount of tax due was separately assessed for each tax year on IRS computer systems. However, in another eight cases, the amount of tax due for multiple tax years was assessed in the aggregate on one tax year. FSLG office management stated that the assessments were sometimes calculated in the aggregate because some of the statutes on the earlier tax years were about to expire. Government Accountability Office internal control standards require the accurate recording of transactions. IRS procedures also state that the adjustment document should include specific information as to the tax years involved.

We also identified inconsistencies in how the amounts of additional tax due were determined. In most instances, FSLG office personnel assessed the correct amount of tax due for all open tax periods. *****1*****
*****1***** , we identified nine cases where the assessments of tax were negotiated for less than the total amount of tax due as part of an Agreement. For example, *****1*****
*****1*****
***** . In other cases, the FSLG office and public employers agreed to settle for less than the total amount due because the public employer could not pay the entire amount of tax owed.

We believe these inconsistencies are partially due to a lack of specific written guidelines on how to consistently settle the additional tax due when negotiating Agreements with public employers to ensure taxpayers are treated fairly. While guidelines cannot be written to address every situation, we believe some of these inconsistencies could be eliminated and decisions could be



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

more transparent with written guidelines. Based on our review of case histories and discussions with FSLG office management, the differences in the amount of tax assessed are based on management decisions at the time the Agreements were settled. Without clearly defined guidelines when addressing Agreements and resolving compliance issues, the FSLG office cannot protect and promote fair tax administration and ensure fair and equitable taxpayer treatment.

Recommendation

To continue to build a strong foundation for working Agreement cases in the future, the Acting Commissioner, Tax Exempt and Government Entities Division, should:

Recommendation 5: Develop clearly defined written guidelines on negotiating the terms and conditions in the Agreement to ensure fair and equitable taxpayer treatment, to include:

- Defining when information returns associated with Agreements should be corrected or could be waived. This may include scenarios to assist those working Agreement cases.
- Ensuring assessments are posted to the applicable tax periods instead of grouping assessments into one tax period.
- Establishing guidelines for entering into Agreements for amounts less than the total amount due.

Management's Response: Management agreed with our recommendation and has developed and issued the recommended guidance, and implemented procedural changes that address the concerns raised in the recommendation.

Ongoing Initiatives May Lead to an Increase in the Number of Agreements

During the past several fiscal years, the FSLG office has worked a relatively small number of Agreement requests. Accordingly, it has not established a formal program and, instead, has relied on an ad hoc process to work these cases. As a result, we identified errors and inconsistencies in how Agreement cases are currently being handled.

The FSLG office is participating in various compliance initiatives underway that could lead to an increase in Agreement requests. These initiatives include consideration of a *****7*****
*****7***** and posting of a self-assessment checklist on the Internet for FSLG office customers to use in identifying compliance issues. This may heighten the need for a better-defined process detailed earlier in this report. In addition, the FSLG office may need to consider additional changes in the future.



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

*****7*****
*****7*****

In addition, the FSLG office and the Tax Exempt and Government Entities Division Advisory Committee on Taxation expanded an FSLG office internal checklist used in compliance checks. In Fiscal Year 2011, the FSLG office made the checklist available on the Internet for public employers to use as a self-assessment tool to help identify areas that indicate potential compliance issues. The checklist advises public employers that they can contact FSLG office specialists to “help interpret the results of the checklist and ensure that you know what, if any steps you need to take.” It also informs public employers about the Agreement process and invites them to contact a specialist or “submit a detailed letter disclosing the specific nature of the tax error, the employees affected, and their proposed resolution.”

A better defined process for working Agreement requests may be needed if the volume of requests increases.

With an increase in demand for Agreements likely as a result of *****7***** and posting of the self-assessment checklist on the Internet, the FSLG office will need to correct the issues identified in this report and implement a better defined Agreement process, including consideration of a formal program that protects and promotes fair tax administration and ensures fair and equitable taxpayer treatment.

The FSLG office may also need to consider additional improvements as the volume of Agreement requests grows. For example, we did not identify any 1) timeliness standards for working Agreement requests, 2) measures showing the impact of the Agreement process on voluntary compliance, or 3) standardized forms for requesting an Agreement. These controls, as well as active promotion of the Agreement process, are seen in some of the larger voluntary compliance efforts we have reviewed in the past¹⁵ and will be needed for the FSLG office Agreement process to more fully develop should volumes increase substantially.

¹⁵ *Additional Process Improvements Are Needed Due to Continued Growth in the Voluntary Correction Program for Retirement Plans* (Reference Number 2010-10-012, dated December 11, 2009).



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the FSLG office's efforts to oversee and promote public employers' requests for Voluntary Closing Agreements (hereafter referred to as Agreements) related to self-identified filing and payment errors. To accomplish this objective, we:

- I. Obtained background information on FSLG office Agreements and how they related to other employment tax voluntary compliance efforts in the IRS.
 - A. Obtained receipt/closure/assessment information on the FSLG office's processing of requests for Agreements for Fiscal Years 2007 to 2010 (through March 31, 2010) and validated the number of Agreements. We validated the number of Agreement cases by comparing the number of Reporting Compliance Case Management System cases to the number tracked on the database maintained by the Compliance and Program Management Office.
 - B. Determined whether interest and penalties were waived as part of Agreements.
 - C. Interviewed FSLG office management to determine the purpose of Agreements and how they fit into the FSLG office's overall program.
 - D. Determined the status of the IRS's efforts to adopt *****7*****.
*****7*****.
- II. Evaluated whether existing processes and procedures were sufficient for timely, consistent, and efficient processing of requests for Agreements.
 - A. Interviewed FSLG office personnel to determine how the FSLG office processes, controls, and monitors its voluntary compliance inventory.
 - B. Determined whether existing Internal Revenue Manual procedures for controlling, screening, assigning, reviewing, and closing FSLG office Agreements clearly delineate roles and responsibilities.
 - C. Assessed whether there was adequate managerial control and supervision for processing requests for Agreements.
 - D. Obtained and reviewed all Agreements and associated case files closed from Fiscal Years 2007 to 2010 (through March 31, 2010) to determine whether cases were closed timely, resolutions were consistent, and sufficient oversight was provided to promote voluntary compliance.



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

- III. Determined whether FSLG office management's education and outreach efforts provide guidance for public employers and encourage these entities to submit requests for Agreements.
 - A. Interviewed FSLG office management and reviewed available documentation to identify the education and outreach efforts undertaken from Fiscal Years 2007 to 2010 (through March 31, 2010) to inform customers on how to request Agreements.
 - B. Interviewed responsible FSLG office employees to determine the status of the Advisory Committee on Taxation's project to develop a self-check electronic form for public employers use in self-identifying noncompliance.
 - C. Determined whether the FSLG office plans to inform public employers what to do if they identify noncompliance as a result of using the self-check electronic form.
- IV. Determined whether the FSLG office measures the results of efforts related to Agreements and how those results affect efforts to increase voluntary compliance.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: FSLG office policies, procedures, and practices for controlling, processing, authorizing, reviewing, monitoring, and resolving requests for Agreements. We evaluated these controls by interviewing management, conducting case reviews, and researching IRS computer records and other applicable information.



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

Appendix II

Major Contributors to This Report

Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations)
Troy D. Paterson, Director
Cheryl J. Medina, Acting Audit Manager
Thomas F. Seidell, Audit Manager
Theresa M. Berube, Lead Auditor
Donald J. Martineau, Auditor
Carol A. Rowland, Auditor



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Small Business/Self-Employed Division SE:S
Director, Government Entities, Tax Exempt and Government Entities Division SE:T:GE
Director, Federal, State, and Local Governments, Tax Exempt and Government Entities Division
SE:T:GE:FSLG
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 Liaisons:
 Commissioner, Small Business/Self-Employed Division SE:S
 Director, Communications and Liaison, Tax Exempt and Government Entities Division
 SE:T:CL



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- *****7*****

Methodology Used to Measure the Reported Benefit:

As part of our review of all Voluntary Closing Agreements (hereafter referred to as Agreements) from Fiscal Year 2007 to March 31, 2010, *****1*****

Type and Value of Outcome Measure:

- *****1*****

Methodology Used to Measure the Reported Benefit:

As part of our review of all Agreements from Fiscal Year 2007 to March 31, 2010, ***7*****

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$431,014 erroneous refunds and/or abatements of tax and/or interest (see page 4).

As part of our review of all Agreements from Fiscal Year 2007 to March 31, 2010, we identified five cases where public employers submitted claims for adjustments that were worked in a campus¹ after an Agreement had been finalized. Agreements generally include a provision that no part of the Agreement assessment amount is refundable. However, campus employees

¹ The campus is the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

working adjustment cases had no access to the Reporting Compliance Case Management System.² Therefore, they would not be aware that the entity had entered into an Agreement nor would they be familiar with the terms of the Agreement. These taxpayers subsequently received refunds and/or abatements of tax and/or interest totaling \$431,014. Per FSLG office management, there is no way of knowing if the adjustments on these taxpayers' accounts are associated with the closed Agreements unless the employee from the campus contacted the Compliance and Program Management office.

After our fieldwork was complete, FSLG office personnel stated that in three out of the five cases cited, the Compliance and Program Management Office would not have received the cases because of the low dollar amounts involved. In addition, FSLG management commented that they believe in *****1*****
*****1*****

² The Reporting Compliance Case Management System is the Tax Exempt and Government Entities Division's inventory and case management system.



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

May 5, 2011

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Joseph H. Grant /s/ Joseph H. Grant
Acting Commissioner
Tax Exempt and Government Entities Division

SUBJECT: Response to Draft Audit Report - Improvements Are Needed in the Voluntary
Closing Agreement Process for Public Employers (Audit # 201010010)

I very much appreciate your work in reviewing our Federal, State and Local Government (FSLG) unit's Voluntary Closing Agreement (VCA) program. Several years ago we began offering public employers the opportunity to approach us to resolve discrepancies involving their payment of employment taxes. As you note in your report, the VCA process was not a formal IRS program. It was initiated to provide a customer service to taxpayers who wanted assistance in addressing self-identified compliance issues.

Over the past four years, the FSLG process has attracted the interest of 39 public employers, and we have successfully entered into some 31 voluntary closing agreements with them. As you point out, we have collected more than \$17.7 million in back taxes, and helped improve the climate of compliance for public employers.

The program began as an innovative, informal process, but as we and public employers gained experience with voluntary closing agreements, and as it became apparent that the demand for such agreements would grow in the future, we thought it would be wise to make the program more formal and to give it a permanent structure. With that in mind, we felt the program would benefit going forward from a careful review of past cases, and so we asked the TIGTA to conduct this review.

We are grateful that you accepted our request, and thank you for the careful review you conducted, and the insight and recommendations you offered for ways to improve the program for the future. Your



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

recommendations, each of which we accept in full, will enhance our effort to continuously improve the consistency, controls, and transparency of FSLG's VCA process.

We concur with the estimate of the measurable benefits on tax administration that you present in your report.

We attached a detailed response outlining our corrective actions. If you have questions, you may call me at (202) 283-2500 or Paul Marmolejo, Director of Federal, States and Local Governments, at (559) 443-7601.

Attachment

Attachment

Recommendation 1:

Develop additional written guidance on how to process, review and monitor Agreements. Specifically, the guidance should include, but not be limited to:

- Stating which specific transaction codes to use to input the tax assessment that would also waive the interest in accordance with the Agreement.
- Ensuring Agreement adjustments are monitored for proper processing of the tax assessments.
- Segregating key duties and responsibilities in processing Agreements.

Corrective Actions:

Completed. FSLG has developed and issued the recommended guidance, and implemented procedural changes that address the concerns addressed in this recommendation.

Implementation Date:

Completed April 21, 2011

Responsible Official:

Director, Government Entities, TE/GE

Recommendation 2:

*****1*****

Corrective Actions:

*****1*****

Implementation Date:

*****1*****

Responsible Official:



Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers

*****1*****

Recommendation 3:

*****1*****

Corrective Actions:

*****1*****

FSLG will conduct a test over the next 24 months to evaluate a way to monitor taxpayer accounts of taxpayers who enter into voluntary closing agreements with FSLG in the future. Among other things, we will evaluate the current claim criteria and claim screening system to improve the efficiency of claim monitoring. At the end of the 24 month test period, FSLG will determine what additional steps, if any, it should take with respect to this issue.

Implementation Dates:

- *****1*****
- Evaluation of monitoring of taxpayer accounts: June 30, 2013.

Responsible Official:

Director, Government Entities, TE/GE

Recommendation 4:

Improve inventory and case management controls of all Agreement requests by:

- Tracking all requests for Agreements, including denied, declined, and approved requests on a centralized database.
- Providing additional written guidelines to ensure all pertinent data requests (including signed Agreements) are maintained on a centralized database that allows employees access to data on the system after cases are closed.
- Adding specific project codes on the centralized database to identify Agreement cases.

Corrective Actions: Completed. FSLG has issued guidance improving inventory and case controls, as recommended, in the existing TEGE Reporting Compliance Case Management System. All future requests and agreements will be recorded and maintained in this system.

Implementation Date: Completed April 21, 2011

Responsible Official: Director, Government Entities, TE/GE

Recommendation 5:



*Improvements Are Needed in the Voluntary Closing Agreement
Process for Public Employers*

Develop clearly defined written guidelines on negotiating the terms and conditions in the Agreement to ensure fair and equitable taxpayer treatment, to include:

- Defining when information returns associated with Agreements should be corrected or could be waived. This may include scenarios to assist those working Agreement cases.
- Ensuring assessments are posted to the applicable tax periods instead of grouping assessments in one tax period.
- Establishing guidelines for entering into Agreements for amounts less than the total amount due.

Corrective Actions:

Completed. FSLG has developed and issued the recommended guidance and, implemented procedural changes that address the concerns addressed in this recommendation.

Implementation Date:

Completed April 21, 2011

Responsible Official:

Director, Government Entities, TE/GE