TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The Internal Revenue Service Can More Effectively Address Noncompliance by Better Using and Controlling the Fed/State Program

August 29, 2018

Reference Number: 2018-30-060

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THE INTERNAL REVENUE SERVICE CAN MORE EFFECTIVELY ADDRESS NONCOMPLIANCE BY BETTER USING AND CONTROLLING THE FED/STATE PROGRAM

Highlights

Final Report issued on August 29, 2018

Highlights of Reference Number: 2018-30-060 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

The IRS collaborates with Federal, State, and local governmental agencies to increase tax compliance, enforcement, and services to taxpayers. One way that the IRS accomplishes this is through the Fed/State Program. In the Fed/State Program, the IRS Governmental Liaison function (part of the IRS's Office of Privacy, Governmental Liaison, and Disclosure) facilitates and expands joint tax administration relationships between the IRS and State taxation authorities, such as Departments of Revenue and State workforce agencies.

WHY TIGTA DID THE AUDIT

TIGTA initiated this audit to determine the effectiveness of the IRS's use of data and information received from State agencies to increase tax compliance by identifying nonfilers and underreporters.

WHAT TIGTA FOUND

The IRS can more effectively address filing noncompliance and underreporting by better using the State Audit Report Program. TIGTA analyzed Fiscal Years 2013 through 2016 State Audit Report Program nonfiler inventories and found that the IRS had dropped 39,142 records for taxpayers who were either repeat nonfilers, high-income nonfilers, or both with estimated tax liabilities not collected totaling approximately $285 million.

Additionally, only 12 States participate in the State Audit Report Program. TIGTA also found that there is a lack of coordination and knowledge regarding the agreements with State agencies. More coordination is needed between the Office of Privacy, Governmental Liaison, and Disclosure and the Small Business/Self-Employed Division for the development and tracking of these agreements.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS expand the State Audit Report Program to other State agencies, evaluate high-income and repeat nonfilers prior to dropping them from the State Audit Report Program nonfiler inventory, and document the analysis. Additionally, the Office of Privacy, Governmental Liaison, and Disclosure should coordinate with the Small Business/Self-Employed Division to ensure that all Fed/State agreements are accounted for in the Internal Revenue Service Agreement Database, and routinely review and validate the database for all Fed/State agreements.

The IRS agreed with two of the recommendations and partially agreed to one. The IRS plans to make appropriate outreach to State agencies regarding data transfer to expand the State Audit Report Program, and evaluate and make improvements, if necessary, to the ranking process of the State Audit Report Program nonfiler inventory and formalize a process to document all non-selected nonfiler cases. Also, the Office of Privacy, Governmental Liaison, and Disclosure will ensure that all Small Business/Self-Employed Division Fed/State agreements are accurately recorded in the Internal Revenue Service Agreement Database and will annually validate that the Internal Revenue Service Agreement Database is current for all active Small Business/Self-Employed Division Fed/State agreements. The Office of Privacy, Governmental Liaison, and Disclosure will also develop written procedures for conducting this annual review.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

August 29, 2018

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

Michael E. McKenney

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Can More Effectively Address Noncompliance by Better Using and Controlling the Fed/State Program (Audit # 201730021)

This report presents the results of our review to determine the effectiveness of the Internal Revenue Service's use of data and information received from State agencies to increase tax compliance by identifying nonfilers and underreporters. This review is included in our Fiscal Year 2018 Annual Audit Plan and addresses the major management challenge of Improving Tax Compliance.

Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

Table of Contents

Appendices

Abbreviations

CY	Calendar Year
FY	Fiscal Year
IA	Implementing Agreement
IAD	Internal Revenue Service Agreement Database
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LOU	Letter of Understanding
MOU	Memorandum of Understanding
PGLD	Privacy, Governmental Liaison, and Disclosure
SARP	State Audit Report Program
SB/SE	Small Business/Self-Employed
SRFMI	State Reverse File Match Initiative
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year

Background

The Internal Revenue Service (IRS) collaborates with Federal, State, and local government agencies to increase tax compliance, enforcement, and services to taxpayers by facilitating, developing, and maintaining relationships between Federal, State, and local government agencies and IRS operating and functional divisions on strategic IRS programs. If the IRS effectively leverages tax information from the States, such as audit results and other information, it can more effectively identify noncompliance with the Federal tax laws, which may help to reduce the Tax Gap.[1] The Fed/State Program is an important example of how the IRS can use information provided by the States to enhance tax compliance. In the Fed/State Program, the IRS Governmental Liaison function, part of the IRS's Office of Privacy, Governmental Liaison, and Disclosure (PGLD), facilitates and expands joint tax administration relationships between the IRS and State taxation authorities, such as Departments of Revenue and State workforce agencies. The IRS and State taxation agencies share data, including audit results, Federal tax return information, and employment tax information with each other through a variety of ongoing initiatives.[2]

Pursuant to Internal Revenue Code Section 6103(d)(1), the IRS is generally permitted to disclose tax return information to State authorities that have the responsibility for the administration of any State tax law. However, the disclosure may be made only to the extent necessary in the administration of such tax laws and is restricted to the State agency's justified need for and use of such information for State tax administration. Unlawful disclosure of tax return information is considered a felony punishable by a fine in an amount not exceeding $5,000 or imprisonment of not more than five years, or both, together with the costs of prosecution.

During Calendar Years (CY) 2014 through 2017, the IRS made on average 8.8 billion disclosures of tax return information to State taxation agencies each year.[3] As outlined by the IRS in Internal Revenue Manual (IRM) 11.4.1, *Communications and Liaison, Office of Governmental Liaison, Governmental Liaison Operations*, before any data can be shared between the IRS and State taxation authorities, there must be a written agreement in place signed by both the IRS and State representatives.[4] The IRS uses two formal documents that establish the exchange of tax return information between the IRS and State taxation agencies. These documents are known as the Basic Agreement and Implementing Agreement (IA), and they

[1] The gross Tax Gap is the estimated difference between the amount of tax that taxpayers should pay and the amount paid voluntarily and on time and is estimated to be $458 billion. In the IRS's analysis, nonfilers accounted for $32 billion of the Tax Gap during Tax Years 2008 through 2010.
[2] The term initiative denotes a specific program that uses the same "type" of information. There may be one State or multiple States that participate in one initiative.
[3] A calendar year is defined as a tax year that begins January 1 and ends on December 31.
[4] IRM 11.4.1.7 (Sep. 22, 2015).

govern the type of tax return information that is shared and how it is exchanged. The Basic Agreement contains the required procedures for exchanging and safeguarding return information for all State taxation agencies and is signed by the Commissioner. The IA supplements the Basic Agreement by specifying the detailed working arrangements and items to be exchanged, such as instructions as to who may request the information and a description of the information being exchanged along with any criteria or tolerances used. If modifications need to be made to an IA, such as to modify an exchange of data under a specific program that is not listed in the IA, a Memorandum of Understanding (MOU) may be used in lieu of amending the IA. An MOU is a separate agreement that is referenced in the IA and provides more specific details about the data being exchanged and the State agency receiving the data. The IRS may have several MOUs related to different initiatives with each State. All of the MOUs associated with a particular State should be referenced in the IA for that State.

With initiatives for which the exchange of information is recurring and long term, an MOU would not be necessary as long as the details of the exchange are included in the IA. Two initiatives for which this type of data exchange generally occurs are the State Audit Report Program (SARP) and the State Reverse File Match Initiative (SRFMI).[5]

SARP

In February 2005, the IRS implemented the SARP initiative, which is designed to identify underreporters and nonfilers from State audit information. The SARP includes standard criteria for State audit report requests and creating a centralized process for classifying, working, and tracking cases. According to the IRS, there are 55 State agencies that have language in their IAs and eight State agencies with language in their MOUs with the IRS that allows the IRS and State agencies to participate in the SARP together.[6] As of May 2018, there were only 12 State agencies actively participating in the SARP.

SRFMI

The SRFMI began as a test program between the IRS and the State of New York in CY 2004. Under the SRFMI, State taxation agencies match Federal tax data against State tax returns to identify potential Federal underreporters and nonfilers. The IRS uses the results of the match in compliance programs such as audits, collections, and the Automated Substitute for Return Program. In November 2008, the Government Accountability Office issued a report with concerns about the SRFMI program.[7] Those concerns included the absence of:

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[5] There are eight State agencies that have SARP language included in an MOU rather than included in an IA.

[6] Some States have more than one State agency that participates in the SARP, and not all States participate in the SARP. Also included in the 63 State agencies are four U.S. territories: American Samoa, Guam, Puerto Rico, and the U.S. Virgin Islands.

[7] Government Accountability Office, GAO-09-45, *IRS Needs to Strengthen Its Approach for Evaluating the SRFMI Data-Sharing Pilot Program* (Nov. 2008).

- An overall sound evaluation plan that accurately and reliably assesses all components of the SRFMI pilot program's results.
- Criteria or standards for determining whether the SRFMI performs adequately enough to be incorporated into the normal compliance processes.
- An analysis plan for cost-effectiveness to help ensure that the program produces sufficient benefits relative to cost.

In CYs 2009 and 2010, the IRS worked with an outside contractor to develop an evaluation plan. Subsequently, the contractor was tasked with evaluating the SRFMI program and summarized the results in a report dated June 30, 2011. The results indicated that the use of SRFMI information to identify potential nonfilers might be beneficial; however, the use of the SRFMI in the creation of underreporter workload was not recommended. The variety and differences in State and Federal tax laws complicate identifying underreporters using SRFMI data.

Since CY 2009, all SRFMI information received, *i.e.*, individual, corporate, withholding, and sales, is configured into documents that are available to examiners during audits and are used as case-building tools. SRFMI documents from the State agencies are due to the IRS more than a year after the Federal tax return is due. Additionally, the IRS created an inventory for Tax Year (TY) 2012 as a test to determine the types of nonfilers contained in the SRFMI data and subsequently identified a SRFMI nonfiler inventory for TYs 2013 and 2014.[8] However, audits were not conducted on these inventories due to the lack of resources. The IRS identified 664,328 SRFMI nonfiler records for TYs 2013 and 2014. We analyzed the 664,328 records and identified 538,416 unique taxpayer records. Of those 538,416 records, 141,886 were identified as potential identity theft cases. We further analyzed the 141,886 potential identity theft cases and confirmed that actions were taken by the IRS to contact the taxpayers. During discussions with IRS management, they expressed concerns with the SRFMI data, including delays in receiving the data, the high number of potential identity theft cases, and inconsistency in the data. We confirmed these issues during our review of the SRFMI data. The IRS plans to identify the nonfiler inventory for TY 2015 but currently does not have plans to work any of the SRFMI inventories due to limited resources in the nonfiler programs and its concerns with the data.[9]

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[8] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[9] The TY 2015 SRFMI inventory is scheduled to be identified during Fiscal Year 2018, which begins on October 1, 2017, and ends on September 30, 2018. There is a delay in identifying this inventory because the matching of Federal tax return data against State tax returns cannot be performed until after the tax return due date. For example, for TY 2015, the Federal tax return was due for most individual taxpayers by April 18, 2016. The State taxation agencies' results of the matching of TY 2015 State tax return data to the Federal tax return data was due to the IRS by July 1, 2017. Upon receipt of the results, the IRS plans to identify the TY 2015 SRFMI inventory in Fiscal Year 2018.

This review was performed with information obtained from the Small Business/Self-Employed (SB/SE) Division Campus Workload Identification function in Kansas City, Missouri; the SB/SE Division Headquarters in New Carrollton, Maryland; and the PGLD Office at the IRS National Headquarters in Washington, D.C., during the period May 2017 through March 2018. 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.

Results of Review

The Internal Revenue Service Can More Effectively Address Nonfiling and Underreporting by Better Using the State Audit Report Program

The IRS has been exchanging tax return information with State taxation agencies for many years. However, the IRS did not use State audit report information effectively due to differences in the State laws, report formats, inconsistencies in the use of referrals among divisions, and changing priorities.

When SARP records are received by the IRS, they are sorted based on whether the SARP record identifies a potential underreporter versus a potential nonfiler. SARP records that identify potential underreporters go through an initial review process to remove any cases that are easily identified as unworkable based on a set of criteria. The remaining cases are sent to either:

- The SB/SE Division Planning and Special Programs function.
- The SB/SE Division Specialty Examination function.
- One of the IRS's other divisions such as Criminal Investigation or the Large Business and International Division.
- The IRS function performing the audit if the taxpayer associated with the case is being audited.

During Fiscal Years (FY) 2013 through 2016, 92 percent of these cases were forwarded to the SB/SE Division Planning and Special Programs function for further evaluation to determine whether the cases were workable. If the case is deemed workable, it is classified to determine whether it should be selected to be worked, and if so, it will be reviewed and accepted as filed or forwarded for audit.[10] SARP records that identify potential nonfilers are sent directly to the SB/SE Division Campus Case Selection function, where four tax years of the nonfiler's records are evaluated based on another set of criteria to determine whether the case is workable.[11] Therefore, the records identified as workable could increase fourfold if issues are also identified in all of the related four tax years. Figure 1 shows that during FYs 2013 through 2016, the IRS

[10] Approximately 92 percent of the potential underreporter records were forwarded to the SB/SE Division Planning and Special Programs function for further review, 6 percent were forwarded to the IRS function performing an audit on the taxpayer associated with the SARP records, and the remaining 2 percent were forwarded to other IRS functions for further review.

[11] Nonfiler criteria that identifies a case as unworkable is based on several factors. Some examples of these factors are: an estimated tax adjustment that is considered de minimis after withholding, a taxpayer who is under audit, or a taxpayer who came into compliance with the filing requirement.

received a total of 837,581 SARP records from State agencies. After the initial review process, approximately 96 percent of the SARP records received were identified as potential nonfilers, 2 percent were identified as potential underreporters, and 2 percent were considered unworkable cases.

Figure 1: Summary of SARP Records Received by the IRS During FYs 2013 Through 2016

FY	Total SARP Records Received	Potential Nonfiler Records Forwarded for Review		Potential Underreporter Records Forwarded for Further Review		SARP Records Determined Unworkable During Initial Review	
		Number	Percentage	Number	Percentage	Number	Percentage
2016	226,510	212,752	94%	3,576	2%	10,182	4%
2015	204,992	197,155	96%	5,705	3%	2,132	1%
2014	218,025	209,381	96%	3,718	2%	4,926	2%
2013	188,054	184,006	98%	1,131	1%	2,917	2%
TOTAL	837,581	803,294	96%	14,130	2%	20,157	2%

Source: FYs 2013 through 2016 SARP records received by the SB/SE Division Campus Case Selection function.

The IRS should continue to explore options to expand upon the SARP

During FYs 2013 through 2016, the IRS assessed more than $1.7 billion on underreporters and nonfilers as a result of the SARP. We analyzed the IRS's Audit Information Management System database to determine the number of potential underreporters identified by SARP records that resulted in a taxpayer being audited or surveyed.[12] We found that 6,969 potential underreporter SARP cases resulted in taxpayers that were either audited or surveyed during FYs 2013 through 2016. The SB/SE Division Planning and Special Programs function determined that the remaining cases were unworkable for reasons such as statute expirations or only having State tax issues.[13] Of the 6,969 potential underreporter SARP cases, 5,979 resulted in an audit with additional assessments of $365.6 million and 990 were surveyed.

To determine the number of potential nonfilers identified by the SARP, we compared the SARP nonfiler inventory to the IRS's Audit Information Management System database to determine the number of records that resulted in a taxpayer being audited or surveyed. Although, the IRS

[12] The Audit Information Management System is a computer system used by the Small Business/Self-Employed Division Examination Operations function and others to control returns, input assessments/adjustments to the Master File, and provide management reports.
[13] A majority of these cases came from a single State agency.

received approximately 803,294 SARP nonfiler records during FYs 2013 through 2016, only 545,123 SARP records were received by the SB/SE Division Campus Case Selection function.[14] These records were filtered, and four related tax years were analyzed.[15] After this process, the IRS identified 460,331 workable cases as SARP nonfiler inventory. We analyzed the 460,331 workable cases and identified 421,542 unique records related to 239,924 taxpayers.[16] Based on the results in the Audit Information Management System database, 91,867 of the potential nonfiler SARP inventory cases resulted in audits with additional assessments of approximately $1.4 billion, and 7,353 cases were surveyed. Figure 2 summarizes the number of SARP underreporter and nonfiler records that resulted in taxpayers being audited or their cases surveyed during FYs 2013 through 2016.

Figure 2: Number of SARP Underreporter and Nonfiler Records That Resulted in a Taxpayer Being Audited or Surveyed During FYs 2013 Through 2016

FY	Potential Underreporters			Potential Nonfilers			Combined Potential Underreporters and Nonfilers		
	Audited	Assessed	Surveyed	Audited	Assessed	Surveyed	Audited	Assessed	Surveyed
2016	1,648	$62,417,495	319	17,766	$385,492,122	1,695	19,414	$447,909,617	2,014
2015	1,099	$53,327,056	274	53,683	$634,765,122	2,810	54,782	$688,092,178	3,084
2014	1,135	$85,881,380	172	20,378	$351,753,233	2,397	21,513	$437,634,613	2,569
2013	2,097	$163,941,901	225	40	$584,973	451	2,137	$164,526,874	676
Total	5,979	$365,567,832	990	91,867	$1,372,595,450	7,353	97,846	$1,738,163,282	8,343

Source: *TIGTA's analysis of SARP records identified in the Audit Information Management System database.*

The 421,542 SARP nonfiler records identified during FYs 2013 through 2016 had $6.8 billion of overall estimated tax liabilities due associated with them.[17] However, $1.8 billion of payments or withholdings have been collected for these taxpayers, resulting in estimated tax liabilities of

[14] In CY 2012, the Wage and Investment Division was the owner of the SARP; however, in CY 2015, the IRS reorganized and the SB/SE Division became the owner of the SARP. Due to this reorganization, the remaining SARP records should have been received by the Wage and Investment Division. The SB/SE Division will now receive all current and future records.
[15] The four related tax years include the most current tax year identified in SARP nonfiler inventory and three prior tax years. The most current tax year identified in the FY 2016 SARP nonfiler inventory is TY 2014. There is a delay in the tax years identified in this inventory to allow for late-filed returns. For example, for FY 2016 SARP nonfiler inventory, the records were compared against TYs 2011 through 2014.
[16] One taxpayer may have been identified in multiple tax years, resulting in more than one record.
[17] The total overall estimated tax liability due amount is calculated based on the total income, such as wages, unemployment, capital gains, rents, and royalties, filing status, standard deduction, and exemptions.

$5 billion.[18] We compared FYs 2013 through 2016 SARP nonfiler inventory records to the IRS's other nonfiler programs and found that 99,629 (24 percent) records were unique to the SARP.[19] These taxpayers had estimated tax liabilities totaling $1.5 billion (approximately 30 percent), which is nearly one-third of the total estimated tax liabilities of SARP nonfiler inventory.

The IRS has not been proactive in soliciting State agencies for their participation in expanding the SARP until recently. In September 2017, after our audit had commenced, the IRS drafted an e-mail to send to State agencies requesting information on the types and characteristics of audits performed by each State agency and their willingness and ability to share audit reports. Five months later, the e-mail was sent to the State agencies (in February 2018). The IRS also provided various reasons that not all State agencies actively participate in the SARP, including: 1) States with technology limitations in this area conduct only paper audits and 2) the program is voluntary. Given the effectiveness of the SARP in identifying nonfilers, we believe that the IRS should work to expand the program to more States.

The IRS should ensure that high-priority cases are not dropped from SARP inventory and that high-priority cases remaining in the inventory are worked

We analyzed the IRS's SARP nonfiler inventories for FYs 2013 through 2016 and found that 228,278 of the 421,542 SARP nonfiler inventory records showed that the taxpayer met the filing requirement (meaning that a tax return was filed or it was determined that a return was no longer required to be filed). The remaining 193,264 records did not indicate that the taxpayer met the filing requirement. Of those records, 53,383 were dropped from the inventory and 139,881 remained in the inventory as of September 30, 2017.[20]

The taxpayers associated with the 53,383 records dropped from inventory had potential estimated tax liabilities of $350 million.[21] We analyzed the dropped records and found that 39,142 (73 percent) nonfilers are either repeat nonfilers, high-income nonfilers, or both with estimated tax liabilities totaling approximately $285 million, which represents 81 percent of the total estimated tax liabilities of the dropped records.[22] Of the 39,142 repeat and high-income nonfilers, 34,956 are repeat nonfilers only, with estimated tax liabilities not collected totaling

[18] The estimated tax liability amount is calculated based on the estimated tax liability due minus any payments and withholdings received by the IRS.
[19] We specifically compared SARP nonfiler inventory to the Case Creation Nonfiler Identification Process and SRFMI Nonfiler program inventories.
[20] The records dropped from inventory were removed from SARP inventory and, therefore, may never be worked. The records that remain in the inventory are the records that are still part of the inventory and have the potential to be worked.
[21] The potential estimated tax liabilities of $350 million is estimated taking into account any payments and withholdings received by the IRS. This amount does not take into consideration any basis for sold assets, business deductions, or itemized deductions that the taxpayer may be entitled to claim.
[22] A high-income nonfiler is identified in IRM 5.19.2.8, *Liability Collection, Return Delinquency* (Nov. 6, 2015), as any nonfiler with total income of $100,000 or more.

$148 million; 1,788 are high-income nonfilers only, with estimated tax liabilities not collected totaling $58.1 million; and 2,398 are both repeat and high-income nonfilers with estimated tax liabilities totaling $78.8 million. Figure 3 summarizes the number of repeat and high-income nonfilers associated with the dropped records.

Figure 3: Summary of Nonfilers Dropped From SARP Nonfiler Inventory

Types of Nonfilers Dropped From Inventory	Number of Nonfilers Dropped	Percentage of Nonfilers Dropped[23]	Estimated Tax Liability Due	Estimated Payments and Withholdings Received	Estimated Tax Liability
Repeat Nonfiler Only	34,956	65%	$244,544,546	$96,526,476	$148,018,070
High-Income Nonfiler Only	1,788	3%	$79,567,827	$21,479,143	$58,088,683
Repeat Nonfiler and High-Income Nonfiler	2,398	4%	$108,028,126	$29,181,345	$78,846,781
Total Repeat and High-Income Nonfilers Dropped	**39,142**	**73%**	**$432,140,499**	**$147,186,964**	**$284,953,534**
Other Nonfilers, *i.e.*, Not a Repeat or High-Income Nonfiler	14,241	27%	$108,982,743	$43,912,781	$65,069,963
Total Nonfilers Dropped	**53,383**	**100%**	**$541,123,242**	**$191,099,745**	**$350,023,497**

Source: *TIGTA's analysis of FYs 2013 through 2016 SARP nonfiler inventory records.*

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********************2***************** Specifically, of the 23,765 dropped records, 11,294 records were for TY 2011 (with estimated tax liabilities of approximately $79.3 million),

[23] Percentages may not add up due to rounding.

and 12,471 were for TY 2012 (with estimated tax liabilities of approximately $106.4 million). IRS management explained that these records were not earmarked for audit, but due to the overall volume of cases, they cannot track the reason for each case that was dropped.

The remaining SARP nonfiler inventory contains 139,881 nonfilers with estimated tax liabilities of $955.2 million. We further analyzed the remaining records and found that 94,271 (67 percent) are either repeat nonfilers, high-income nonfilers, or both with estimated tax liabilities totaling $645 million (68 percent of the current inventory's total estimated tax liability). Of the 94,271 repeat and high-income nonfilers, 81,698 are repeat nonfilers only (with estimated tax liabilities totaling $290 million), 5,642 are high-income nonfilers only (with estimated tax liabilities totaling $158.6 million), and 6,931 are both repeat and high-income nonfilers (with estimated tax liabilities totaling $196.6 million). Figure 4 summarizes the number of repeat and high-income nonfilers that remain in SARP nonfiler inventory.

Figure 4: Summary of Nonfilers Remaining in SARP Nonfiler Inventory

Type of Nonfilers Remaining in Inventory	Number of Nonfilers Remaining in Inventory	Percentage of Nonfilers Remaining in Inventory	Estimated Tax Liability Due	Estimated Payments and Withholdings Received	Estimated Tax Liability
Repeat Nonfilers Only	81,698	58%	$524,482,430	$234,687,669	$289,794,761
High-Income Nonfilers Only	5,642	4%	$362,857,525	$204,255,627	$158,601,898
Repeat and High-Income Nonfilers	6,931	5%	$289,619,005	$93,017,174	$196,601,831
Total Repeat and High-Income Nonfilers Remaining in Inventory	**94,271**	**67%**	$1,176,958,960	$531,960,470	**$644,998,490**
Other Nonfilers, *i.e.*, Not a Repeat or High-Income Nonfiler,	45,610	33%	$348,610,486	$38,432,097	$310,178,389
Total Nonfilers Remaining in Inventory	**139,881**	**100%**	$1,525,569,446	$570,392,567	**$955,176,879**

Source: *TIGTA's analysis of FYs 2013 through 2016 SARP nonfiler inventory records.*

We analyzed the 94,271 records and identified 42,531 records for TYs 2011 and 2012 with estimated tax liabilities of approximately $244 million. Of these 42,531 records, 16,510 records are for TY 2011 (with estimated tax liabilities of approximately $81 million) and 26,021 records are for TY 2012 (with estimated tax liabilities of approximately $163 million). ****2****
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*********************2*********************. We believe that repeat and high-income nonfilers are high-priority cases, and if these cases are dropped from the inventory, the IRS would miss the opportunity to bring these taxpayers into compliance and collect outstanding taxes.

Among other efforts, the IRS Nonfiler Strategy, dated February 2014, includes improving nonfiler enforcement efforts by reviewing the identification process and treatment of repeat nonfilers. In May 2018, the IRS revised its nonfiler strategy to test the nonfiler data to identify and prioritize nonfiler work that maximizes dollars collected while promoting continued filing compliance and increasing operational efficiencies across existing nonfiler programs. Additionally, the IRM states that high-income nonfiler cases will receive priority.[24] The IRS should renew its focus on repeat and high-income nonfilers.[25] By focusing on repeat and high-income nonfilers, the IRS would help ensure that examination activities are addressing the highest risks to tax compliance and are working productive cases with the IRS's limited resources.

Recommendations

Recommendation 1: The Commissioner, SB/SE Division, should expand the SARP to other State agencies by requesting that the PGLD Office contact each of the agencies. The SB/SE Division should evaluate the responses and determine whether further actions are warranted to obtain State participation and coordinate those responses with the PGLD Office.

> ***Management's Response:*** IRS management agreed with this recommendation. The SB/SE Division engaged the PGLD Office in September 2017 and the PGLD Office contacted all non-participating State agencies in February 2018. The SB/SE Division will evaluate all responses and partner with the PGLD Office to make appropriate outreach to State agencies regarding data transfer.

Recommendation 2: The Commissioner, SB/SE Division, should evaluate high-income and repeat nonfilers prior to dropping them from SARP inventory and document the analysis if not selected for examination.

> ***Management's Response:*** IRS management partially agreed with this recommendation. IRS management responded that the SB/SE Division will review the current ranking process for all SARP nonfiler inventory, including high-income and repeat nonfilers, to determine whether improvements to the ranking process are necessary. The IRS will also formalize a process to document the non-selected nonfiler SARP cases.
>
> The IRS disagreed with the measurable impact (outcome measure) that our recommended corrective actions will have on tax administration. IRS management stated that the related outcome measure is overstated and the measure 1) assumes that staffing is available to initiate compliance activities on all 39,142 repeat and high-income nonfilers

[24] IRM 5.19.2.8.1 (Nov. 6, 2015).
[25] IRS strategic plans in the past recognized that higher income taxpayers have more financial complexity and more opportunity to engage in noncompliance, and accordingly, they received special focus. For example, see IRS Strategic Plan 2005 – 2009, p. 18 – 20.

without considering the impact to other compliance activities and 2) fails to consider any basis for assets sold, business deductions, or itemized deductions that taxpayers may be entitled to claim that could offset their taxable income.

Office of Audit Comment: Although the IRS stated it only partially agreed to this recommendation, we believe the IRS's planned corrective action sufficiently addresses our concerns related to dropping repeat and high-income nonfilers from inventory.

We maintain our position that the outcome measure is valid and reasonable as presented. It is not possible to account for basis for assets sold, business deductions, or itemized deductions that taxpayers may be entitled to claim until the taxpayers file a Federal tax return. However, our estimate does take into consideration all payments and withholdings received by the IRS. We continue to emphasize that focusing on high-priority cases such as repeat and high-income nonfilers will help the IRS address the higher risk cases for tax compliance and ensure that more productive cases are worked with the IRS's limited resources.

More Coordination Is Needed Between the Office of Privacy, Governmental Liaison, and Disclosure and the Small Business/ Self-Employed Division for the Development and Tracking of Agreements

At the start of this audit, the PGLD Office explained that the SB/SE Division owned and managed 25 initiatives with 262 MOUs with State taxation agencies.[26] During further discussions with the IRS, we later learned that the SB/SE Division, in fact, owns and manages 27 initiatives with 266 MOUs (which include the 25 initiatives with 262 MOUs that the PGLD Office originally informed us of). We identified two additional initiatives with one MOU each and two original initiatives that resulted in three additional MOUs. Additionally, one original initiative overstated the number of related MOUs by one.[27] Figure 5 summarizes of the number of initiatives and the MOUs worked by each SB/SE Division function. See Appendix V for a detailed summary of SB/SE Division initiatives and MOUs.

[26] One of the 25 initiatives has a Letter of Understanding (LOU) associated with it rather than an MOU. An LOU is similar to an MOU in that it is a separate agreement to share or coordinate information and is signed by the IRS and the State agency. For the purpose of this report, we included the LOU in the same population of the MOUs.
[27] See Appendix V for more details about the additional initiatives and the MOUs identified.

Figure 5: Summary of the MOUs by SB/SE Division Function

SB/SE Division Function	Number of Initiatives	Number of MOUs
Specialty Tax	10	194
Campus Compliance	3	8
Collection	14	64
Grand Total of SB/SE Division Initiatives With MOUs	**27**	**266**

Source: IRS PGLD Office and SB/SE Division records of initiatives and the MOUs.

The PGLD Office has the primary responsibility for the development, coordination, and tracking of all data exchange agreements made through the use of Basic Agreements, the IAs, and the MOUs with State agencies. This responsibility includes checking the need and use of the return information requested by State officials under the agreements and ensuring that safeguards are in place to protect Federal tax information in their possession. According to IRM 11.4.1.14.4(13), Federal, State, and local document files are to be reviewed annually, and any agreements required to be terminated will be deleted in accordance with records control schedule guidelines.[28] However, based on current practices, the PGLD Office is involved only in the development, coordination, and tracking of the MOUs for which the IRS is sharing Federal tax information with a State taxation agency or if the SB/SE Division requests the PGLD Office's assistance. Therefore, if the SB/SE Division is not sharing Federal tax information with a State agency under an agreement or does not request the PGLD Office's assistance, SB/SE Division management uses their discretion as to how the agreement is developed, managed, and tracked and may never notify the PGLD Office of any such agreement.

Beginning in March 2015, the PGLD Office developed a Service-wide IRS Agreement Database (IAD) to track all data exchange agreements made through the use of Basic Agreements, the IAs, and the MOUs with Federal, State, and local agencies, which has since expanded to include all U.S. Governmental agencies and external partners, and allows users to conduct searches and generate reports on such agreements.[29] IRS officials explained that the IAD houses critical information that is important to manage and leverage IRS relationships with external stakeholders for strategic partnering.[30] Although a validation of the database was performed in

[28] IRM 11.4.1.14.4(13), *Communications and Liaison, Office of Governmental Liaison, Governmental Liaison Operations* (Sep. 22, 2015).
[29] External partners are entities with the MOUs executed through the PGLD Office for tax administration purposes.
[30] In addition to the 266 MOUs, the SB/SE Division owns 88 other agreements that are not supported by the use of an MOU with State agencies, such as procurement agreements for which there is a cost for the IRS to obtain the data. Procurement agreements are not tracked in the IAD but are tracked in separate IRS databases and are the responsibility of the IRS business owner.

April 2016, the PGLD Office still was unaware of all agreements owned by the SB/SE Division. We verified the list provided by the PGLD Office with the SB/SE Division and identified an additional two initiatives and four MOUs that were not included in the database or provided to us by the PGLD Office. IRS management indicated that they plan to perform periodic reviews of the IAD; however, they are unsure how often the periodic reviews will occur.

As previously mentioned, we verified the list of initiatives and the MOUs originally provided by the PGLD Office to the list provided by the SB/SE Division and identified initiatives and MOUs that were unknown to the PGLD Office. In addition to these unknown initiatives and MOUs in place, we also identified a lack of coordination and knowledge regarding the initiatives and the MOUs that the PGLD Office was tracking in the IAD. We selected a judgmental sample of 15 initiatives with 235 MOUs from the original list of 25 initiatives with 262 MOUs that the PGLD Office provided.[31] We developed a questionnaire regarding each initiative and sent it to the IRS for response. Based on our analysis of the responses, we identified a lack of coordination for 106 of the 235 MOUs, which relate to 11 initiatives. We identified 63 MOUs with no evidence that the PGLD Office reviewed the MOUs in more than two years and 43 MOUs with no evidence that the PGLD Office ever reviewed the MOUs. Figure 6 summarizes the number of MOUs reviewed by the PGLD Office under each of the 15 initiatives.

[31] Initially we selected a judgmental sample of 15 initiatives with 232 MOUs, but we later identified that there are, in fact, 235 MOUs associated with these 15 initiatives. See Appendix V, which shows the discrepancies between the number of the MOUs for these 15 initiatives. A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

Figure 6: Summary of the Number of MOUs Reviewed by the PGLD Office for Each of the 15 Initiatives

Initiative Name	Total Number of MOUs	Number of MOUs Reviewed During CY							No Evidence of Review Conducted
		2011	2012	2013	2014	2015	2016	2017	
Alaska Permanent Fund Dividend Levy Program MOU	1						1		
California Department of Industrial Relations Licensing MOU*	1		1						
Data Processing Agreement*	1								1
Employment Commission Data Exchange MOU*	4	4							
Employer Wage Data Match MOU*	3					2			1
Excise Summary Terminal Activity Reporting System MOU*	36						1	31	4
Fuel Sampling MOU*	31					12	8		11
Gaming Tips Initiative LOU*	1								1
Highway Use Tax Form 2290 MOU	29							29	
Liquor Licensing MOU*	1			1					
Money Services Business MOU*	44					9	16		19
Municipal Tax Levy Program MOU	2							2	
New Generation Tax System Online Access MOU*	1								1
Questionable Employment Tax Practices*	40					34		1	5
State Income Tax Levy Program MOU	40							40	
Total	**235**	**4**	**1**	**1**	**0**	**57**	26	103	**43**
Total number of MOUs reviewed more than two years ago (CYs 2011 through 2015)		**63**					0		0
Total number of MOUs reviewed within the last two years (CYs 2016 and 2017)		0					129		0
Total number of MOUs with no evidence of a review		0					0		**43**

* = 11 initiatives in which we identified a lack of coordination with at least one MOU/LOU that has not been reviewed by the PGLD Office in more than two years.

Source: TIGTA's analysis of PGLD Office records and IRS responses to questionnaires.

In addition to the lack of reviews performed by the PGLD Office for these 11 initiatives, we also identified two initiatives with one MOU/LOU each that have not been used in more than 10 years (one for which the SB/SE Division was not even aware of the agreement).[32]

Without proper controls and adequate coordination of the MOUs, there is an increased risk of unnecessary/improper disclosures and a duplication of efforts. It is important for the IRS to know whether the MOUs that are in place are actually being used and that there is a need for the data being exchanged by both the IRS and the State agencies.

Recommendation

Recommendation 3***:*** The Chief Privacy Officer, PGLD, should coordinate with the SB/SE Division to ensure that all Fed/State agreements are accounted for in the IAD. In addition, the PGLD Office should routinely review and validate all agreements in the database to ensure that the database is current.

> ***Management's Response:*** IRS management agreed with this recommendation and stated that the PGLD Office will coordinate with the SB/SE Division to ensure that they have copies of all SB/SE Division Fed/State agreements and that these agreements are accurately recorded in the IAD. Additionally, the PGLD Office will annually contact each business unit that owns initiatives covered by the agreements maintained in the IAD to validate that the IAD is current for all active agreements. The PGLD Office will also develop written procedures for conducting this annual review.

[32] The first two initiatives with one MOU/LOU each that have not been used in more than 10 years include the Data Processing Agreement and Gaming Tips Initiative LOU. See Appendix V for more details about this initiative.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine the effectiveness of the IRS's use of data and information received from State agencies to increase tax compliance by identifying nonfilers and underreporters. To accomplish this objective, we:

I. Determined the applicable policies, procedures, and controls in place for receiving and administering information obtained by the SB/SE Division from external State agencies.

II. Reviewed SB/SE Division initiatives supported by State information obtained through the MOUs and evaluated the efficient and effective use of the State information to bring taxpayers into compliance.

   A. Evaluated internal documents and interviewed IRS officials to obtain an understanding of the policies, procedures, and business practices used for establishing, administering, and managing information obtained from State agencies.

   B. Selected a judgmental sample of 15 initiatives with 235 MOUs and analyzed the program results for each of the initiatives.

III. Reviewed the SB/SE Division's use of SRFMI data to determine whether the IRS is using the data to identify and work nonfiler cases.

   A. Evaluated internal documents and interviewed IRS officials to obtain an understanding of the policies, procedures, and business practices used for establishing, administering, and managing SRFMI information obtained from State agencies.

   B. Obtained an extract of SRFMI nonfiler inventory and evaluated the data to determine the IRS's ability to use the information to improve taxpayer compliance.

IV. Reviewed the SB/SE Division's use of SARP data and evaluated the effective use of SARP data to bring taxpayers into compliance.

   A. Evaluated internal documents and interviewed IRS officials to obtain an understanding of the policies, procedures, and business practices used for establishing, administering, and managing SARP information obtained from State agencies.

   B. Obtained the FYs 2013 through 2016 SARP nonfiler and underreporter inventories and evaluated the data to determine the IRS's ability to use the information to improve taxpayer 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 that the following internal controls were relevant to our audit objective: IRS policies and procedures for receiving and administering information obtained by the SB/SE Division from external State agencies. We evaluated the controls by reviewing written policies, procedures, and overall Fed/State Program documentation and holding discussions with IRS officials.

Appendix II

Major Contributors to This Report

Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Glen Rhoades, Director
Michele Jahn, Audit Manager
Curtis Kirschner, Audit Manager
Tina Fitzsimmons, Lead Auditor
Kim McMenamin, Senior Auditor

Appendix III

Report Distribution List

Deputy Commissioner for Operations Support
Deputy Commissioner for Services and Enforcement
Commissioner, Small Business/Self-Employed Division
Chief Privacy Officer
Director, Examination, Small Business/Self-Employed Division
Director, Exam Case Selection, Small Business/Self-Employed Division
Director, Governmental Liaison, Disclosure, and Safeguards
Director, Headquarters Exam, Small Business/Self-Employed Division
Director, Office of Audit Coordination

Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; approximately $284,953,534 in additional tax revenue by addressing the 39,142 repeat and high-income nonfilers that were dropped from SARP nonfiler inventory (see page 5).[1]

Methodology Used to Measure the Reported Benefit:

We analyzed the IRS's FYs 2013 through 2016 SARP nonfiler inventories. The IRS had identified 460,331 workable cases. We analyzed these records and identified 421,542 unique records.

We matched the unique SARP nonfiler inventory records against the IRS Individual Master File as of May 25, 2017, to determine whether the taxpayer met the filing requirement (meaning that a tax return was filed or it was determined that a return was no longer required to be filed) and identified 228,278 records that showed that the taxpayer met this requirement.[2] The remaining 193,264 records did not indicate that the taxpayer met the filing requirement; therefore, they are considered nonfilers. Of those, 53,383 records were dropped from the inventory, and 139,881 records remained in the inventory as of September 30, 2017.

We analyzed the 53,383 dropped records and found that 39,142 of those records are repeat and high-income nonfilers, with estimated tax liabilities due totaling $432 million. We reduced this amount by $147 million to account for estimated payments and withholdings received by the IRS, resulting in a total estimated tax of approximately $285 million. Figure 1 summarizes the 39,142 dropped records.

[1] The potential amount of additional tax revenue is estimated taking into account any payments and withholdings received by the IRS. It does not take into consideration any basis for sold assets, business deductions, or itemized deductions that the taxpayer may be entitled to claim.
[2] The IRS Individual Master File is an IRS database that maintains transactions or records of individual tax accounts.

Figure 1: Summary of the Repeat and High-Income Nonfilers Dropped From SARP Nonfiler Inventory

Types of Nonfilers Dropped From Inventory	Number of Repeat and High-Income Nonfilers Dropped	Percentage of Repeat and High-Income Nonfilers Dropped	Estimated Tax Due	Estimated Payments and Withholdings Received	Estimated Tax
Repeat Nonfiler Only	34,956	89%	$244,544,546	$96,526,476	$148,018,070
High-Income Nonfiler Only	1,788	5%	$79,567,827	$21,479,143	$58,088,683
Repeat Nonfiler and High-Income Nonfiler	2,398	6%	$108,028,126	$29,181,345	$78,846,781
Total Repeat and High-Income Nonfilers Dropped	**39,142**	**100%**	$432,140,499	$147,186,964	$284,953,534

Source: *TIGTA's analysis of FYs 2013 through 2016 SARP nonfiler inventory records.*

Appendix V

Summary of Small Business/Self-Employed Division Initiatives That Are Supported by a Memorandum of Understanding or a Letter of Understanding

This appendix summarizes the MOUs and the LOU that the SB/SE Division has in place with State agencies under the Fed/State Program.

* = Additional initiative or MOU identified during our review.
** = Initiative was selected and included in the judgmental sample of 15 initiatives as mentioned in the report.

Initiatives Identified by the PGLD Office and the SB/SE Division			
Initiative Name	**Initiative Description**	**Number of MOUs Per the PGLD Office**	**Number of MOUs Per the SB/SE Division**
Alaska Permanent Fund Dividend Levy Program MOU**	This MOU is an annual program that conducts an automated database match of Alaska residents who applied for the Permanent Fund Dividend against the IRS Master File database of taxpayers who have a balance due account eligible for levy action. Using the levy authority, the Permanent Fund Dividend Division compares entities on the IRS levy file with entities on the Permanent Fund Dividend Division database. When a match is identified, the Permanent Fund Dividend Division will deduct up to the levied amount, if the levy is honored, from the Permanent Fund Dividend. The resulting revenue as well as entity information will be forwarded to the IRS to be posted as appropriate to satisfy a Federal tax liability. For the administrative benefit of both the Permanent Fund Dividend Division and the IRS, this program is being used in lieu of sending individual levies for each taxpayer who is subject to levy and to whom the Permanent Fund Dividend Division owes money.	1	1
California Department of Industrial Relations, Division of Labor Standards Enforcement Licensing MOU**	License applicants in garment manufacturer, farm labor contractor, and car wash industries are required to submit Form 8821, *Tax Information Authorization*, to the IRS to authorize Federal tax compliance checks as part of the State license application and renewal process. The IRS provides weekly summaries of compliance check results to the California State Department of Industrial Relations, Division of Labor Standards Enforcement.	1	1
Collection MOU	The purpose of this initiative is to provide for open discussion and cooperative collection efforts between the IRS and the State regarding collection cases of mutual interest to both parties. This MOU is intended to be of benefit to the taxpayer, the IRS, and the State.	2	2

Initiatives Identified by the PGLD Office and the SB/SE Division			
Initiative Name	**Initiative Description**	**Number of MOUs Per the PGLD Office**	**Number of MOUs Per the SB/SE Division**
Data Processing Agreement**	This agreement allows the IRS to acquire, on a quarterly basis, wage data from the Texas Employment Commission.	1	1
Electronic Access MOU	This MOU defines the general administrative, procedural, and technical framework that permits the IRS to receive access to the West Virginia Secretary of State corporate records.	1	1
Employment Commission Data Exchange MOU**	The purpose of this initiative is to allow the IRS to receive employment information on a particular population of taxpayers, *i.e.*, The Employment Commission Data Exchange Program uses State workforce agencies' data to produce levy sources for delinquent accounts.	4	4
Employer Wage Data Match MOU**	The Employer Wage Data Match is a program designed to work with State workforce agencies for the exchange of data on inactive and active businesses. State workforce agencies send business information to the IRS on a quarterly basis.	3	3
Excise Summary Terminal Activity Reporting System MOU**	The purpose of the Excise Summary Terminal Activity Reporting System MOU is to collect and share fuel industry transaction information.	36	36
Fuel Sampling MOU**	This MOU provides the framework under which the parties will conduct mutually beneficial taxable fuel sampling and share information resulting from such sampling.	31	31
Gaming Tips Initiative LOU**	The voluntary compliance process allows gaming industry employers and employees and the IRS to work together to objectively determine tip rates for tipped employees in specified occupational categories.	1	1
Highway Use Tax Form 2290 MOU**	This MOU acknowledges that an agency in the State may accept a Form 2290, *Heavy Vehicle Use Tax Return*, with related remittances, submitted to it by taxpayers as proof of payment of the tax imposed by Internal Revenue Code Section 4481, which is required under Treasury Regulation Section 41.6001-2 as a condition of issuing a registration for a highway motor vehicle. This MOU provides the procedures and guidelines regarding the agency's acceptance of Forms 2290 and related remittances and the agency's transmission of the same to the IRS. This MOU also affirms that the agency is acting voluntarily on behalf of taxpayers, that neither the State nor the agency is acting as an agent or contractor of the IRS, and that no return or return information will be provided to the State or the agency regarding this matter.	29	29
Joint Installment Agreement MOU	The IRS and the State agree to cooperate in attempting to reduce taxpayer burden, increase agency efficiency, and improve revenue collection by providing a single point of contact to establish installment agreements for taxpayers owing both State and Federal taxes.	1	1

Initiatives Identified by the PGLD Office and the SB/SE Division			
Initiative Name	**Initiative Description**	**Number of MOUs Per the PGLD Office**	**Number of MOUs Per the SB/SE Division**
Joint Operations Center MOU	This MOU sets forth the agreement of the parties to work joint compliance activities and to initiate information sharing for tax administration purposes in conjunction with the Joint Operations Center.	10	10
Liquor Licensing MOU**	This MOU with the State of New Jersey is an agreement as to how proceeds from the sale of a seized liquor license will be divided between the IRS and the State of New Jersey when both have a lien interest in the license.	1	1
Montana Integrated System to Improve Customer Service and Status, Tax Accounting, Audit, and Rating System Access Agreement	The purpose of this agreement is for the Montana Department of Labor and Industry, Unemployment Insurance Division, to transfer certain data elements or information described in Section 4 of the agreement to the IRS for the IRS's specific intended use.	1	1
Money Services Business MOU**	This MOU is between the IRS and the State Regulator for money services businesses and certain other nonbank financial institutions. It sets forth an agreement of the parties to facilitate the sharing of information in order to assist each party in the examination of money services businesses and certain other nonbank financial institutions within their respective regulatory jurisdictions.	44	44
Motor Vehicle Data Access MOU	This MOU provides the user access to the motor vehicle driver and vehicle databases which provides information to complement the identification of individuals or vehicles pertaining to official case investigations.	7	7
Municipal Tax Levy Program MOU**	This MOU sets forth the agreement of the parties with respect to an initiative for the collection of Federal tax liabilities owed by individuals through the Municipal Tax Levy Program.	1	**2***
New Generation Tax System Online Access MOU**	This MOU between the IRS and State agency sets forth the agreement whereby the State agency will provide the IRS certain employer/employee information for the purposes of Federal tax administration.	1	1
Online Access MOU	This MOU, between the IRS and State agencies, sets forth the agreement whereby the State agencies will provide the IRS certain employer/employee information for the purposes of Federal tax administration.	3	3

Initiatives Identified by the PGLD Office and the SB/SE Division			
Initiative Name	**Initiative Description**	**Number of MOUs Per the PGLD Office**	**Number of MOUs Per the SB/SE Division**
Questionable Employment Tax Practices MOU**	This MOU, between the SB/SE Division Specialty Tax function, the U.S. Department of Labor, Employment and Training Administration, the National Association of State Workforce Agencies, the Federation of Tax Administrators, and the State workforce agency sets forth the agreement of the parties with respect to an initiative to facilitate information sharing and other collaboration for tax administration purposes in conjunction with questionable employment tax practices.	40	40
State Income Tax Levy Program MOU**	The State Income Tax Levy Program is an automated levy program that uses State income tax refunds as the levy source. This program is for the administrative benefit of both the IRS and the State and is used in lieu of sending individual levies to the State of each taxpayer who is subject to levy and to whom the State owes money.	38	**40***
Tax Lien Priority MOU	The purpose of this MOU is to establish guidelines for the resolution of lien priority disputes for instances in which the IRS and Departments of Revenue are the only competing creditors.	3	**2***
Technical Advisor Training MOU	This MOU is intended to provide guidelines for sharing training material between the IRS and the New Mexico Taxation and Revenue Department.	1	1
Unemployment Insurance Database Access MOU	The purpose of this MOU is to establish terms and conditions for user access to the New Mexico Department of Workforce Solutions information system between the Unemployment Insurance Bureau of New Mexico Department of Workforce Solutions and the IRS.	1	1
*Arizona Department of Economic Security	The purpose of this MOU is to receive online computer access to Arizona Department of Economic Security Unemployment Insurance wage and employer data through computer applications. The IRS will use this information to determine the current status of the employer's business, employment tax liability, and levy sources for collection enforcement.	0	**1***
*Ohio Bureau of Motor Vehicles	The purpose of this MOU is for online access to driver's license, vehicle registration, and title records. Currently, the online access is unavailable due to information technology issues. However, a new MOU is being pursued to document an alternative fax method.	0	**1***

Source: IRS PGLD Office and SB/SE Division records of initiatives and MOUs.

Appendix VI

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

August 9, 2018

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mary Beth Murphy for Lisa J. Beara-Numann
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Internal Revenue Service Can More Effectively Address Noncompliance by Better Using and Controlling the Fed/State Program (TIGTA #201730021)

Thank you for the opportunity to review the above subject draft audit report. Our Fed/State program is a collaborative effort among federal, state, and local government agencies to share information. It is an important and effective tax administration tool that allows us to leverage the data shared by these agencies in our pursuit to increase tax compliance and reduce the tax gap.

Within the Fed/State program, the State Audit Report Program (SARP) initiative identifies potential underreporters and nonfilers based on state audit information. Earlier this year, we contacted all non-participating state agencies to request information about their willingness and ability to share information. State participation is voluntary and cannot be mandated by us. Collaboration among our agencies can also present challenges such as the format, quality, and compatibility of the data to be exchanged. We are currently analyzing the information gathered and identifying those agencies with which it may be appropriate to begin data sharing.

We must have signed, written agreements with the state agency representatives in place before any data can be exchanged. We created the Service-wide IRS Agreement Database (IAD) in March 2015 as a centralized system to track all of our data exchange agreements. This database houses critical information important to managing and leveraging our relationships with external parties. It also enhances our privacy, internal controls, and partnering initiatives with state agencies. We conducted an initial validation of the information contained in the database a year after it was created. We plan to conduct annual reviews to ensure accurate recordation and maintenance of these agreements on IAD going forward.

We do not agree with the outcome measure of $284,953,534. This measure assumes that staffing is available to initiate compliance activities on all 39,142 repeat and high-income non-filers without considering the impact to other compliance activities. Additionally, it fails to consider any basis for assets sold, business deductions, or itemized deductions that the taxpayer may be entitled to claim that could offset their taxable income.

Attached is a detailed response outlining our corrective actions to address your recommendations. If you have any questions, please contact me or Brenda Dial, Director, Examination Operations.

Attachment

Attachment

RECOMMENDATION 1:
The Commissioner, SB/SE Division, should expand the SARP to other State agencies by requesting that the Privacy, Governmental Liaison and Disclosure (PGLD) Office contact each of the agencies. The SB/SE Division should evaluate the responses and determine whether further actions are warranted to obtain State participation and coordinate those responses with the PGLD Office.

CORRECTIVE ACTION:
We agree with the recommendation. SB/SE engaged the PGLD office in September 2017 and contacted all non-participating state agencies in February 2018. SB/SE will evaluate all responses and partner with PGLD to make appropriate outreach to state agencies regarding data transfer.

IMPLEMENTATION DATE:
May 15, 2019

RESPONSIBLE OFFICIAL:
Director, Examination Case Selection, Small Business/Self Employed Division

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:
The Commissioner, SB/SE Division, should evaluate high-income and repeat nonfilers prior to dropping them from the SARP inventory and document the analysis if not selected for examination.

CORRECTIVE ACTION:
We agree with the recommendation in part. SB/SE will review our current ranking process for all SARP non-filer inventory, including high income and repeat non-filers, to determine whether improvements to the ranking process are necessary. Additionally, we will formalize a process to document all non-selected non-filer SARP cases.

IMPLEMENTATION DATE:
August 15, 2019

RESPONSIBLE OFFICIAL:
Director, Examination Case Selection, Small Business/Self Employed Division

2

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 3:
The Chief Privacy Officer, PGLD, should coordinate with the SB/SE Division to ensure that all Fed/State agreements are accounted for in the IAD database. In addition, the PGLD Office should routinely review and validate all agreements in the database to ensure that the database is current.

CORRECTIVE ACTION:
We agree with the recommendation. PGLD will work with SB/SE to ensure it has copies of all SB/SE Fed/State agreements and that they are accurately recorded in the IAD database. Annually, PGLD will contact each of the business units that own initiatives covered by agreements maintained in the IAD to obtain updated information to validate that the database is current for all active agreements. PGLD will develop written procedures for conducting this annual review.

IMPLEMENTATION DATE:
July 15, 2019

RESPONSIBLE OFFICIAL:
Chief Privacy Officer (Director, Governmental Liaison, Disclosure and Safeguards)

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.