DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20005

INSPECTOR GENERAL
FOR TAX
ADMINISTRATION

October 15, 2014

MEMORANDUM FOR SECRETARY LEW

FROM: J. Russell George J. Russell George
Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2015

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

Each year, TIGTA evaluates IRS programs, operations, and management functions to identify the areas of highest vulnerabilities to the Nation's tax system. For Fiscal Year (FY) 2015, the top management and performance challenges, in order of priority, are:

1. Security for Taxpayer Data and IRS Employees;
2. Implementing the Affordable Care Act and Other Tax Law Changes;
3. Tax Compliance Initiatives;
4. Fraudulent Claims and Improper Payments;
5. Achieving Program Efficiencies and Cost Savings;
6. Modernization;
7. Providing Quality Taxpayer Service Operations;
8. Globalization;
9. Taxpayer Protection and Rights; and
10. Human Capital.

Despite operating with a significantly reduced budget in FY 2013, the IRS collected nearly $2.9 trillion in tax revenue, processed more than 240 million tax returns and supplemental documents, and issued approximately $364 billion in tax refunds. The IRS continued to face budgetary pressure and address ongoing congressional inquiries and investigations related to the IRS's prior criteria and processes to select and review applications for tax-exempt status. In FY 2015, the IRS will continue to face budgetary constraints that will present a substantial challenge in effectively carrying out its

[1] 31 U.S.C. § 3516(d) (2006).

mission. In FY 2014, the IRS budget was approximately $11.3 billion, $850 million less than its FY 2010 level. During the same period, the IRS lost almost 10,000 full-time permanent employees. As the IRS faces new or growing challenges with a reduced budget and smaller staff, it must identify and implement innovative and cost-saving strategies to accomplish its mission of providing America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness.

Further, the IRS has increased responsibilities as it implements and administers certain provisions of the Patient Protection and Affordable Care Act (Affordable Care Act).[2] Until FY 2012, the IRS received some funding from the Department of Health and Human Services to support implementation of the Affordable Care Act. Since FY 2013, all Affordable Care Act spending has been funded from the IRS's operating budget. The IRS estimated its FY 2014 Affordable Care Act budget needs at approximately $400 million and requested approximately $450 million in its FY 2015 budget. If the IRS does not receive sufficient funding, it expects that Affordable Care Act implementation costs will adversely affect both taxpayer service and enforcement activities. This includes a projected further decline in the IRS Level of Service[3] due to increased demand to address Affordable Care Act questions. In addition, the IRS may reduce hours and services at its walk-in centers throughout the country.

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

SECURITY FOR TAXPAYER DATA AND IRS EMPLOYEES

The IRS relies extensively on its computer systems to support both its financial and mission–related operations. Effective information systems security is essential to ensure that data are protected against inadvertent or deliberate misuse, improper disclosure or destruction, and that computer operations supporting tax administration are secured against disruption or compromise. Protecting the confidentiality of this sensitive information is paramount. Otherwise, taxpayers could be exposed to the loss of privacy and to financial loss and damages resulting from identity theft or other financial crimes.

According to an Office of Management and Budget report to Congress, threats to Federal information—whether from insider threat (*e.g.*, mistakes, as well as fraudulent or malevolent acts by employees or contractors), criminal elements, or nation states—

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[2] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. code), as amended by the Heath Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

[3] Level of Service is the primary measure of service to taxpayers. It is the relative success rate of taxpayers who call for live assistance on the IRS toll-free telephone lines.

continue to grow in number and sophistication, creating risks to the reliable functioning of our Government.[4] The IRS faces the daunting task of securing its massive computer systems against this growing threat. According to the Department of Homeland Security's U.S. Computer Emergency Readiness Team, Federal agencies reported 60,753 cyberattacks in FY 2013, an increase of about 24 percent from FY 2012.[5]

Computer security has been problematic for the IRS since 1997. In April 2014, the Government Accountability Office (GAO) reported that the IRS is making progress in addressing information security control weaknesses; however, the GAO noted that weaknesses remain that could affect the confidentiality, integrity, and availability of financial and sensitive taxpayer data.[6]

TIGTA also continues to identify significant security weaknesses in this area. During a review to determine whether closed corrective actions to security weaknesses and findings reported by TIGTA have been fully implemented, we found that 8 of the 19 planned corrective actions had not been fully implemented and should not have been closed. These planned corrective actions involved systems containing taxpayer data.[7] When the right degree of security diligence is not applied to systems, disgruntled insiders or malicious outsiders can exploit security weaknesses and may gain unauthorized access.

TIGTA also reported that taxpayer and other sensitive information may be at risk due to a lack of background investigation requirements in five contracts for courier, printing, document recovery, and sign language interpreter services. For example, in one printing services contract, the IRS provided the contractor a computer disk containing 1.4 million taxpayer names, addresses, and Social Security Numbers; however, none of the contractor personnel who worked on this contract were subject to a background investigation.[8] By allowing contractor personnel access to taxpayer data and other sensitive information without the appropriate background investigation, the IRS exposes taxpayers to increased risk of fraud and identity theft.

Beyond safeguarding a vast amount of sensitive financial and personal data, the IRS must also protect more than 92,000 people working in more than 650 facilities nationwide. Physical violence, harassment, and intimidation of these employees pose

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[4] Office of Mgmt. & Budget, Exec. Office of the President, *Fiscal Year 2012 Report to Congress on the Implementation of The Federal Information Security Management Act of 2002,* at 1 (Mar. 2013).
[5] Office of Mgmt. & Budget, Exec. Office of the President, *Annual Report to Congress: Federal Information Security Management Act, at* 31 (May 2014).
[6] U.S. Gov't Accountability Office, GAO-14-405, *IRS Needs to Address Control Weaknesses That Place Financial and Taxpayer Data at Risk* (Apr. 2014).
[7] TIGTA, Ref. No. 2013-20-117, *Improved Controls Are Needed to Ensure That All Planned Corrective Actions for Security Weaknesses Are Fully Implemented to Protect Taxpayer Data* (Sep. 2013).
[8] TIGTA, Ref. No. 2014-10-037, *Some Contractor Personnel Without Background Investigations Had Access to Taxpayer Data and Other Sensitive Information* (July 2014).

significant challenges to the implementation of a fair and effective system of tax administration.

The IRS has approximately 25,000 frontline employees who have direct contact with taxpayers and their representatives. While the IRS has programs that focus on employee protection, including the Potentially Dangerous Taxpayer and Caution Upon Contact programs, the IRS has not developed sufficient procedures to enable frontline employees to readily identify whether a taxpayer representative has been designated as a Potentially Dangerous Taxpayer or Caution Upon Contact.[9] The safety of frontline employees, others working in the same facilities, and taxpayers is at risk when these employees unknowingly meet with potentially dangerous taxpayer representatives.

In the last four years, threats directed at the IRS have become the second largest component of the workload of TIGTA's Office of Investigations. Between FYs 2011 and 2013, TIGTA processed more than 8,200 threat-related complaints. This resulted in nearly 4,000 threat investigations that required the prompt response of TIGTA special agents to mitigate those threats and determine whether criminal prosecutions of the perpetrators making the threats were warranted.

The continuing public debate surrounding the Affordable Care Act and increased scrutiny over Federal Government spending and management could fuel threats against the Federal Government, including IRS employees and facilities.

IMPLEMENTING THE AFFORDABLE CARE ACT AND OTHER TAX LAW CHANGES

One of the challenges the IRS confronts each year in processing tax returns is the implementation of new tax law changes as well as changes resulting from expired tax provisions. Correctly implementing tax law changes remains a significant challenge because the legislative actions generating the changes often occur late in the year, shortly before the filing season begins. As a result, the IRS must often act quickly to assess the changes and determine the necessary actions to ensure that all legislative requirements are satisfied. Errors in the IRS's tax return processing systems may delay tax refunds, affect the accuracy of taxpayer accounts, and/or result in incorrect taxpayer notices.

The Affordable Care Act represents the largest set of tax law changes in more than 20 years and presents a continuing challenge for the IRS as provisions take effect. Changes in the implementation of Affordable Care Act tax provisions could result in increased demand for customer service assistance resulting in more contacts with the IRS. Depending on the nature of any changes, the IRS's strategy and plans to provide adequate customer service could be affected. This is particularly important because

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[9] TIGTA, Ref. No. 2014-40-020, *Improvement Is Needed to Better Enable Frontline Employee Identification of Potentially Dangerous and Caution Upon Contact Designations* (Mar. 2014).

beginning in January 2015, the IRS will take the lead in providing Affordable Care Act-related customer service to taxpayers.[10]

The Affordable Care Act provision which imposed an excise tax on medical devices became effective in Calendar Year 2013. Manufacturers, producers, and importers are responsible for collecting the excise tax and filing Form 720, *Quarterly Federal Excise Tax Return*. The IRS is attempting to develop a compliance strategy to ensure that businesses are compliant with medical device excise tax filing and payment requirements. However, the IRS still cannot identify the population of medical device manufacturers registered with the Food and Drug Administration that are required to file a Form 720 and pay the medical device excise tax.[11]

TIGTA remains concerned about the protection of confidential taxpayer data that will be provided to the Federal and State Exchanges. We determined that the steps the IRS took to provide assistance to the Exchanges were helpful; however, additional procedures are needed to provide greater assurance that Federal tax information is protected prior to its release. IRS procedures do not require the Exchanges to submit an initial independent Security Assessment Report that could help evaluate risk levels at the individual agencies and be used to prioritize on-site reviews. Without sufficient and complete information regarding the status of required security controls, the IRS might approve the release of Federal tax information to an environment that puts the information at risk of unauthorized disclosure or misuse.[12]

The Affordable Care Act provides for a refundable tax credit, the Premium Tax Credit, to offset an individual's health insurance expenses. Like other refundable credits, the Premium Tax Credit carries a risk for improper payments. The IRS informed us that two new systems are under development that will address Affordable Care Act tax refund fraud risk. However, until these new systems are successfully developed and tested, TIGTA remains concerned that the IRS's existing fraud detection system may not be capable of identifying Affordable Care Act refund fraud or schemes prior to the issuance of tax refunds.

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[10] TIGTA, Ref. No. 2014-43-006, *Affordable Care Act: The Customer Service Strategy Sufficiently Addresses Tax Provisions; However, Changes in Implementation Will Create Challenges* (Dec. 2013).
[11] TIGTA, Ref. No. 2014-43-043, *The Affordable Care Act: An Improved Strategy Is Needed to Ensure Accurate Reporting and Payment of the Medical Device Excise Tax* (July 2014).
[12] TIGTA, Ref. No. 2014-23-070, *Affordable Care Act: Expanded Guidance Provided Assistance to the Exchanges, but Greater Assurance of the Protection of Federal Tax Information Is Needed* (Sep. 2014).

TAX COMPLIANCE INITIATIVES

Increasing budgetary pressure has led to a reduction of IRS resources in the enforcement area, which has impacted tax compliance. Since FY 2010, the number of enforcement personnel has decreased by 20 percent, from 17,206 in FY 2010 to 13,696 at the end of FY 2013. The decline in IRS personnel has contributed to a decrease in the number of examinations and an increase in the number of delinquent tax accounts that are assigned to an inactive status. Although we identified some positive indicators in compliance activities, the negative trends are cause for concern, especially given that diminished enforcement could also affect voluntary compliance over time.[13]

Businesses and Individuals

The underreporting of individual and corporate income, employment, and estate taxes, at $376 billion a year, accounts for the largest portion of the $450 billion Tax Gap, which is defined as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. The IRS addresses this gap by attempting to identify questionable tax returns when they are received and processed and by conducting examinations of tax returns filed to determine if any adjustments to the information reported on the tax returns are needed. In addition, the IRS issues notices and contacts taxpayers to collect the delinquent taxes. If necessary, the IRS takes enforcement action, such as filing liens and seizing assets, to collect the taxes.

The IRS Commissioner testified in May 2014 that the IRS expects the Federal Government will lose almost $3 billion in revenue in FY 2014 as a result of key enforcement programs operating well below historical levels. This includes the IRS performing 100,000 fewer individual audits and significant declines in audits of high-wealth individuals, businesses, and partnerships.

TIGTA recently reviewed the IRS's Delinquent Return[14] Refund Hold Program (Program) that addresses taxpayer filing compliance by delaying issuance of a taxpayer's income tax refund for up to six months while the IRS investigates a return delinquency on another tax year. The refund can be used to offset any balance due on a taxpayer's delinquent return. The Program helps to reduce the Tax Gap by increasing revenue at a lower cost and in a shorter time period than assigning a return delinquency to a revenue officer who attempts to obtain the delinquent return. As part of the Program, the IRS holds refunds that meet certain criteria, including a specific dollar threshold.

Program results show that taxpayers whose refunds are held are significantly more likely to resolve return delinquencies on previous tax years than taxpayers whose

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[13] TIGTA, Ref. No. 2014-30-062, *Trends in Compliance Activities Through Fiscal Year 2013* (Sep. 2014).

[14] A tax return is delinquent if a taxpayer does not file the return with the IRS by the due date (including extensions) for any year in which a filing requirement exists.

refunds are not held. In Calendar Year 2012, the Program collected nearly $242 million which was applied to balances due on delinquent returns.

Because of limited resources, the IRS has been unable to expand the Program's use, even though there could be tangible benefits in doing so. In the current budget environment, lowering the threshold and expanding the Program represents an opportunity to increase both taxpayer filing compliance and revenue dollars at a lower cost than traditional collection programs, such as assigning cases to revenue officers in the field.[15]

Tax-Exempt Entities

In its most recent Strategic Plan, the IRS noted the complexity of tax laws related to the administration of tax-exempt and government entities. While these entities are not subject to Federal income tax, they represent a significant aspect of tax administration with approximately 2.5 million entities holding $18 trillion in assets.

The IRS's prior use of inappropriate criteria for selecting and reviewing applications for tax-exempt status has been a significant concern to Congress and to organizations seeking tax-exempt status. There have been a number of congressional hearings and investigations into this matter. It is likely that the IRS will continue to receive scrutiny in the exempt organizations area in FY 2015, and its actions will be reviewed by TIGTA.

Similar to for-profit employers, tax-exempt organizations with compensated employees are required to pay payroll taxes that are withheld from employees' wages "in trust" for the Federal Government as well as other applicable Federal taxes. Payroll taxes required to be withheld from employees and matched by the tax-exempt organization generally consist of income taxes and Old Age, Survivors, and Disability Insurance, commonly referred to as Social Security and Medicare taxes. TIGTA found that more than 64,200 tax-exempt organizations accumulated nearly $875 million in Federal tax debt as of June 16, 2012. While some organizations owed minor amounts, approximately 1,200 tax-exempt organizations owed more than $100,000 each.[16] We reviewed a judgmental sample of 25 Internal Revenue Code Section 501(c)(3) tax-exempt organizations that appeared to have significant Federal tax noncompliance.[17] The IRS tried to resolve the tax

[15] TIGTA, Ref. No. 2014-30-023, *Expansion of the Delinquent Return Refund Hold Program Could Improve Filing Compliance and Help Reduce the Tax Gap* (May 2014).
[16] TIGTA, Ref. No. 2014-10-012, *Some Tax-Exempt Organizations Have Substantial Delinquent Payroll Taxes* (Jul. 2014).
[17] These 25 organizations had Federal tax debt totaling more than $25 million, incurred delinquencies in five or more tax periods, and accepted funding from Medicare, Medicaid, and government grants. These organizations are not representative of all delinquent organizations but appear to be among the worst examples of the more than 64,200 tax-exempt organizations with delinquent Federal taxes. Thus, the results from these 25 cases cannot be projected to the more than 64,200 tax-exempt organizations with delinquent Federal taxes.

liabilities and collection action has been taken on all 25 tax-exempt organizations and most officers of the organizations that we reviewed. We recommended the IRS periodically complete analyses to identify and evaluate tax-exempt organizations with significant unpaid payroll and other Federal taxes and that receive funding from government grants and pay large salaries to executives and officers to determine if there are any tax-exempt issues that may warrant examinations.

FRAUDULENT CLAIMS AND IMPROPER PAYMENTS

Improper payments by Federal Government agencies have been an issue for many years, and numerous efforts have been made to identify, measure, and reduce them. These include laws specifically addressing improper payments, an Executive Order,[18] and guidance by certain oversight agencies, such as the Office of Management and Budget. The Improper Payments Information Act of 2002[19] requires Federal agencies, including the IRS, to estimate the amount of improper payments made each year and report to Congress on the causes of and the steps taken to reduce improper payments, as well as to address whether they have the information systems and other infrastructure needed to reduce improper payments. TIGTA reported that the IRS continued to not provide all required improper payments information to the Department of the Treasury for inclusion in the *Department of the Treasury Agency Financial Report* for FY 2013 as required by the Act.[20]

The Earned Income Tax Credit remains the largest refundable credit[21] based on the total claims paid, and it continues to be vulnerable to a high rate of noncompliance, including incorrect or erroneous claims caused by taxpayer error or resulting from fraud. The IRS estimates that 24 percent of all Earned Income Tax Credit payments made in FY 2013, or $14.5 billion, were paid in error.[22] TIGTA continues to report that the IRS does not have effective processes to ensure that claimants qualify for these credits at the time tax returns are processed and prior to issuance of fraudulent tax refunds. In addition, the IRS estimates that it has paid between $124 billion and $148 billion in improper Earned Income Tax Credit payments in FYs 2003 through 2013.[23]

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[18] Exec. Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*, 74 Fed. Reg. 62201 (2009).
[19] Pub. L. No. 107-300, 116 Stat. 2350.
[20] TIGTA, Ref, No. 2014-40-027, *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act* (Mar. 2014).
[21] A refundable credit allows taxpayers to reduce their tax liability to below zero and thus receive a tax refund even if no income tax was withheld or paid.
[22] The estimated Earned Income Tax Credit improper payment range for Fiscal Year 2013 was from 22 to 26 percent and from $13.3 billion to $15.6 billion.
[23] Department of the Treasury Performance and Accountability Reports for Fiscal Years 2003 through 2010 and Department of Treasury Agency Financial Reports for Fiscal Years 2011 through 2013.

The IRS's compliance resources are limited and additional alternatives to traditional compliance methods have not been developed. Consequently, the IRS does not address the majority of potentially erroneous Earned Income Tax Credit claims. This is despite the IRS having processes that successfully identify billions of dollars in potentially erroneous Earned Income Tax Credit payments. Statutory requirements further limit the IRS's ability to ensure that Earned Income Tax Credit claims are valid before they are paid. The Internal Revenue Code requires the IRS to process tax returns and pay any related tax refunds within 45 days of receipt of the tax return or the tax return due date, whichever is later. Because of this requirement, the IRS cannot conduct extensive eligibility checks similar to those that occur with other Federal programs that typically certify eligibility prior to the issuance of payments or benefits.[24]

Another significant and growing problem with an increasingly significant impact on tax administration is identity theft. Identity theft for the purpose of committing tax fraud occurs when an individual uses another person's name and Taxpayer Identification Number (generally a Social Security Number) to file a fraudulent tax return to obtain a fraudulent tax refund. The IRS has described identity theft as the number one tax scam for 2014.[25] The IRS has made this issue one of its top priorities and has made some progress; however, significant improvements are still needed.

The IRS continues to expand identity theft filters to identify fraudulent tax returns at the time the returns are processed. As of April 30, 2014, the IRS reported that it identified and confirmed 236,313 fraudulent tax returns and prevented the issuance of nearly $1.2 billion in fraudulent tax refunds as a result of identity theft filters. Tax returns identified by these filters are held during processing until the IRS can verify the taxpayer's identity. However, verifying whether the returns are fraudulent will require additional resources. Without the necessary resources, it is unlikely that the IRS will be able to work the entire inventory of potentially fraudulent tax returns it identifies. The net cost of failing to provide the necessary resources is substantial, given that the potential revenue loss to the Federal Government of these tax fraud-related identity theft cases is in the billions of dollars annually. Less easy to quantify is the erosion in taxpayer confidence concerning the security of the system of tax administration when they do not receive the assistance that they seek to regain the integrity of their identities.

To provide relief to victims of identity theft, the IRS began issuing Identity Protection Personal Identification Numbers (IP PIN) to eligible taxpayers in FY 2011. Use of an IP PIN provides relief to taxpayers because it allows the IRS to process tax returns without delay and helps prevent the misuse of taxpayers' Social Security Numbers on fraudulent tax returns. However, TIGTA determined that the IRS did not provide an

[24] TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sep. 2014).
[25] IRS Press Release, IR-2014-16 (February 19, 2014).

IP PIN to 532,637 taxpayers who had an identity theft indicator on their tax account indicating that the IRS resolved their case. The IRS also did not provide an IP PIN to 24,628 taxpayers who were potential victims since their Personally Identifiable Information had been lost by the IRS or breached/stolen from the IRS. IRS officials stated they did not provide an IP PIN because these individuals have not been a victim of tax-related identity theft. However, it should be noted that this position is not consistent with actions the IRS takes to proactively provide an IP PIN to taxpayers who have an increased exposure to the possibility of identity theft. Finally, IRS programming errors resulted in 32,274 taxpayers not timely receiving an IP PIN.[26]

TIGTA's Office of Investigations focuses its limited resources on investigating identity theft characterized by any type of IRS employee involvement, the misuse of client information by tax preparers, or the impersonation of the IRS through phishing[27] schemes and other means. In the late summer of 2013, TIGTA became aware of numerous complaints from around the country about suspicious callers claiming to be IRS employees collecting taxes from recent IRS audits. The callers demanded that the tax payments be made to pre-paid debit cards and threatened arrest, suspension of business or driver's licenses, and even deportation if the callers' demands were not met. In many cases, the callers became hostile and insulting. As of August 2014, the TIGTA Hotline received more than 120,000 reports related to this scam, and it is estimated that the scheme has resulted in more than $7 million in payments made by the victims. TIGTA special agents are actively investigating this criminal activity.

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

ACHIEVING PROGRAM EFFICIENCIES AND COST SAVINGS

Given the current economic environment and the increased focus by the Administration, Congress, and the American people on Federal Government accountability and efficient use of resources, the American people must be able to trust that their Government is taking action to stop wasteful practices and is spending every tax dollar wisely. This challenge has become even more pressing in recent years as the IRS has struggled to maintain key taxpayer service and enforcement operations while operating with a reduced budget and smaller staff.

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[26] TIGTA, Ref. No. 2014-40-086, *Identity Protection Personal Identification Numbers Are Not Provided to All Eligible Taxpayers* (Sep. 2014).
[27] Phishing is an attempt by an individual or group to solicit personal and financial information from unsuspecting users in an electronic communication by masquerading as trustworthy entities such as government agencies, popular social websites, auction sites, online payment processors, or information technology administrators.

While the IRS has taken steps to improve program effectiveness and reduce costs, progress in this area will continue to be a major challenge in FY 2015. Recently, TIGTA reported that the IRS incurred unnecessary costs as a result of storing records past due for disposal. As of June 2013, the IRS had 238,523 cubic feet of records past due for disposal on which it was obligated to pay ongoing monthly storage costs. We calculated the excess cost paid from the start of FY 2011 through March 2014, and determined that the IRS had to pay more than $700,000 in excess storage costs related to these records. While these unnecessary expenditures are not a significant portion of the approximately $15 million the IRS spends annually on storage costs for tax records, the current IRS budget environment makes it a priority to find any cost savings.

In the same audit, we found that the IRS did not perform a sufficient review of National Archives Records Administration invoices for $30.8 million in tax record storage services before certifying them for payment. Specifically, we did not identify any evidence that the IRS performed a review of available supporting information or compared the charges to any internal IRS records prior to certifying the invoices for payment.[28]

We also found that the IRS does not effectively manage server software licenses and is not adhering to Federal requirements and industry best practices. Until the IRS addresses these issues, it will continue to incur increased risks in managing software licenses. TIGTA estimates that the amount wasted because of the inadequate management of server software licenses is in the range of $81 million to $114 million based on amounts spent for licenses and annual license maintenance that were not being used at the time of a compliance review.[29]

TIGTA also reported that the IRS could reduce its paper return processing costs by more than $17 million annually if the same electronic filing requirement that currently applies to paid preparers who file individual tax returns was also applied to paid preparers filing business tax returns. Paid preparers who file 11 or more individual returns are required to file the returns electronically. Federal law currently prohibits the IRS from creating requirements for businesses to electronically file. Legislation would be needed in order for an electronic filing requirement to be implemented.[30]

MODERNIZATION

The Business Systems Modernization Program (Modernization Program) is a complex effort to modernize IRS technology and related business processes. The IRS's modernization efforts continue to focus on core tax administration systems designed to

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[28] TIGTA, Ref. No. 2014-10-074, *Controls Over Records Storage Costs Could Be Improved* (Sep. 2014).
[29] TIGTA, Ref. No. 2014-20-042, *The Internal Revenue Service Should Improve Server Software Asset Management and Reduce Costs* (Sep. 2014).
[30] TIGTA, Ref. No. 2014-40-084, *A Service-Wide Strategy Is Needed to Increase Business Tax Return Electronic Filing* (Sep. 2014).

provide taxpayers and IRS employees with more sophisticated tools. These efforts will provide the foundation for implementing a real-time tax system and reducing improper payments and fraudulent refunds. They will also provide the technology infrastructure and architecture that will enable taxpayers and other stakeholders the capability to securely access tax account information. The complexity of these efforts continues to pose significant technological and business challenges for the IRS. For FY 2015, the IRS requested $330 million to modernize its business systems.

In February 2013, the GAO reported that it removed the Modernization Program from its High Risk List because of the IRS's progress in addressing the significant weaknesses in information technology and financial management capabilities and commitment to sustaining progress in the future.[31] Although the GAO removed the Modernization Program from its High Risk List, we believe the program remains a high risk and major management challenge for the IRS because of the need for improvements in information technology practices and performance.

The IRS considers the Customer Account Data Engine 2 (CADE 2) program critical to the IRS mission. It is the IRS's most important information technology investment. The CADE 2 system provides for a centralized database of individual taxpayer accounts. Once implemented, it will allow IRS employees to view tax data online and provide timely responses to taxpayers.

Over the past several years, TIGTA has reported on the progress of CADE 2 implementation. In September 2012, we reported that the IRS had data integrity checks in place at several levels of the CADE 2 database. Despite these controls and their data integrity testing efforts, the IRS could not ensure that the data on the CADE 2 database were consistently accurate and complete at the data field level. This is due to the complexity of many of the data transformation rules and embedded business logic contained within certain data fields.[32] In September 2013, we reported that the CADE 2 database could not be used as a trusted source for downstream systems. The IRS applied a total of 2.4 million data corrections to the CADE 2 database as a result of data validation tests. At that time, the IRS was unable to evaluate 431 CADE 2 database columns of data for data accuracy.[33] However, we reported in September 2014 that the IRS's data validation efforts were efficiently performed due to adequate planning and resource coordination. Still, while a large percentage of the data fields are validated

[31] GAO-13-283, *High Risk Series – An Update* (Feb. 2013).
[32] TIGTA, Ref. No. 2012-20-109, *The Customer Account Data Engine 2 Database Was Initialized; However, Database and Security Risks Remain, and Initial Timeframes to Provide Data to Three Downstream Systems May Not Be Met* (Sep. 2012).
[33] TIGTA, Ref. No. 2013-20-125, *Customer Account Data Engine 2 Database Deployment Is Experiencing Delays and Increased Costs* (Sep. 2013).

periodically with automated tools, the IRS has no documented plan to ensure that data fields validated using other means are validated periodically.[34]

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

PROVIDING QUALITY TAXPAYER SERVICE OPERATIONS

Providing quality customer service to taxpayers is the IRS's first step to achieving compliance with tax laws. An important component of this involves answering taxpayers' questions to assist them in correctly preparing their tax returns, because providing them with accurate information reduces the incidence of taxpayer errors and the subsequent need to send notices and correspondence when taxpayers make errors. Further, quality taxpayer service can also reduce unintentional noncompliance and shrinks the need for future collection activity.

In the past, TIGTA has evaluated the IRS's efforts to provide quality customer service and made recommendations for areas of improvement. Although the IRS has implemented certain procedures to better assist taxpayers, budget reductions pose a significant challenge and continue to force the IRS to cut service to taxpayers. As demand for taxpayer services continues to increase, resources devoted to customer service have decreased, thereby affecting the quality of customer service that the IRS is able to provide.

TIGTA has seen a decline in the IRS's ability to provide a sufficient level of customer service in each of the channels that taxpayers use, including telephone, face-to-face assistance at Taxpayer Assistance Centers (TAC) and Volunteer Program sites, and correspondence. Despite the various options, most taxpayers continue to use the telephone as the primary method to make contact with the IRS. The IRS continues to struggle in providing high-quality customer service over the telephone. There are long customer wait times, customers abandoning calls, and customers redialing the IRS toll-free telephone lines for service. For the 2014 Filing Season, as of May 3, 2014, approximately 65 million taxpayers contacted the IRS by calling the various toll-free telephone assistance lines seeking help to understand the tax laws and meet their tax obligations. As of May 3, 2014, IRS assistors answered approximately 11 million calls compared to more than 15 million calls answered at the same time last year. IRS numbers continue to show a decline in the total number of taxpayers who contact the IRS who are actually assisted. As of March 8, 2014, the number of taxpayers actually assisted had dropped from 56.1 percent to 51.6 percent as of the same time last year.[35]

[34] TIGTA, Ref. No. 2014-20-063, *Customer Account Data Engine 2 Database Validation Is Progressing; However, Data Coverage, Data Defect Reporting, and Documentation Need Improvement* (Sep. 2014).
[35] TIGTA, Ref. No. 2014-40-029, *Interim Results of the 2014 Filing Season* (Mar. 2014).

Additionally, each year, many taxpayers seek assistance from one of the IRS's 388 TACs. However, the IRS estimates that the number of taxpayers it will assist at its TACs will decline this fiscal year. The IRS assisted more than 6.5 million taxpayers in FY 2013 and plans to assist 5.6 million taxpayers in FY 2014, which is 14 percent fewer than in FY 2013. The IRS indicated that budget cuts and its strategy of not offering services at TACs that can be obtained through other service channels (such as the IRS's website) resulted in the reduction of the number of taxpayers the IRS plans to assist at the TACs. As part of these service reductions in FY 2014, the TACs no longer prepared tax returns, did not answer any tax law questions after the filing season ended, and no longer answered taxpayers' tax refund inquiries unless the taxpayer had waited more than 21 days for a refund.[36]

The IRS's ability to process taxpayer correspondence in a timely manner has also declined. The backlog of paper correspondence inventories has substantially increased. The over-age inventory rose from 181,000 at the end of 2010 to almost 1.2 million at the end of 2013.

GLOBALIZATION

The scope, complexity, and magnitude of the international financial system present significant enforcement challenges for the IRS. The number of taxpayers conducting international business transactions continues to grow as technological advances provide opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

As this global economic activity increases, so do concerns regarding the International Tax Gap.[37] While the IRS has not developed an accurate and reliable estimate of the International Tax Gap, non-IRS sources estimate it to be between $40 billion and $133 billion annually. To address the International Tax Gap, the IRS developed an international tax strategy plan with two major goals: (1) enforce the law to ensure that all taxpayers meet their obligations and (2) improve service to make voluntary compliance less burdensome.

International tax noncompliance remains a significant area of concern for the IRS. However, the IRS's collection efforts need to be enhanced to ensure that delinquent international taxpayers become compliant with their U.S. tax obligations. TIGTA found that the IRS has not provided effective oversight to International Collection (part of the Small Business/Self-Employed Division), which contributed to several control weaknesses in the program. For example, International Collection does not have adequate policies and procedures, position descriptions, or the training needed to

[36] TIGTA, Ref. No. 2014-40-077, *Key Tax Provisions Were Implemented Correctly for the 2014 Filing Season* (Sep. 2014).
[37] The International Tax Gap consists of taxes owed but not collected on time from a U.S. person or foreign person whose cross-border transactions are subject to U.S. taxation.

ensure that international revenue officers can properly work International Collection cases. Additionally, the IRS does not have a specific inventory selection process that ensures that the International Collection cases with the highest risk and most collection potential are worked by the revenue officers.[38]

The Foreign Account Tax Compliance Act (FATCA)[39] is an important development in the IRS's efforts to improve U.S. tax compliance involving foreign financial assets and offshore accounts. The FATCA was enacted to combat tax evasion by U.S. persons holding investments in offshore accounts. Under FATCA, a U.S. taxpayer with financial assets outside the United States will be required to report those assets to the IRS. In addition, foreign financial institutions will be required to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest.

TIGTA reported that there are some barriers for the IRS in ensuring the tax compliance of real estate sales transactions subject to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[40] The intent of the FIRPTA is to ensure that foreign sellers of U.S. real estate pay income taxes on any gains resulting from the sale of the property. However, under existing law, it is difficult for the IRS to ensure that many of the real estate transactions involving foreign sellers are in compliance with the FIRPTA. TIGTA's review of Form 1099-S, *Proceeds From Real Estate Transactions*, revealed that approximately 53 percent of the real estate sales reported may not have properly complied with the FIRPTA. In addition, TIGTA identified various internal control weaknesses in the IRS's processing of FIRPTA withholding payments and withholding credits claimed by foreign sellers on their income tax returns. These internal control weaknesses resulted in the issuance of erroneous refunds and balance due notices.[41]

TAXPAYER PROTECTION AND RIGHTS

The IRS must ensure that tax compliance activities are balanced against the rights of the taxpayers to receive fair and equitable treatment. In June 2014, the IRS updated Publication 1, *Your Rights as a Taxpayer*. In this publication, the IRS outlines the rights of the taxpayer and the processes for examination, appeals, collection, and refunds. The IRS continues to dedicate significant resources and attention to implementing the taxpayer rights provisions of the IRS Restructuring and Reform Act of 1998.[42] The

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[38] TIGTA, Ref. No. 2014-30-054, *The Internal Revenue Service Needs to Enhance Its International Collection Efforts* (Sep. 2014).
[39] Pub. L. No. 111-147, §§ 501-41, 124 Stat 71, 97-117 (2010)(codified in scattered sections of 26 U.S.C.).
[40] Enacted as Subtitle C of Title XI (the Revenue Adjustments Act of 1980) of the Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599, 2682 (Dec. 5, 1980).
[41] TIGTA, Ref. No. 2014-30-051, *Additional Actions Are Needed to Help Ensure Taxpayer Compliance With the Foreign Investment in Real Property Tax Act* (Sep. 2014).
[42] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered section of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

following audits related to taxpayer rights provisions are mandated to be completed annually by TIGTA: Notices of Levies; Restrictions on the Use of Enforcement Statistics to Evaluate Employees; Fair Debt Collection Practices Act[43] Violations; Notices of Liens; Seizures; Illegal Tax Protestor Designations; Statute of Limitations for the Assessment of Additional Taxes and Penalties; Collection Due Process Appeals; Denial of Requests for Information; Restrictions on Directly Contacting Taxpayers Instead of Authorized Representatives; and Separated or Divorced Joint Filer Requests.

In general, the IRS has improved its compliance with these statutory taxpayer rights provisions and is documenting its protection of taxpayer rights. However, during the review of the IRS's use of enforcement statistics to evaluate employees, TIGTA found instances of noncompliance with the IRS Restructuring and Reform Act of 1998 Section 1204 requirements.[44] Specifically, TIGTA identified instances of noncompliance with each subsection of the law: Section 1204(a), which prohibits the IRS from using any record of tax enforcement results to evaluate employees or to impose or suggest production quotas or goals; Section 1204(b), which requires that employees be evaluated using the fair and equitable treatment of taxpayers as a performance standard; and Section 1204(c), which requires each appropriate supervisor to self-certify quarterly whether records of tax enforcement results were used in a prohibited manner. Use of records of tax enforcement results may create the misperception that safeguarding taxpayer rights is secondary to IRS enforcement results.

In addition, TIGTA reported that complaints against tax return preparers are not always timely processed.[45] TIGTA's review of 8,354 complaints received in Calendar Years 2012 and 2013 identified that work on 47 percent of the complaints had yet to be initiated as of September 11, 2013. Nearly one-half of these complaints had been in the IRS's inventory for at least 60 business days. Additionally, processes do not ensure that complaints are accurately and consistently worked. TIGTA's review of a statistically valid sample of 73 complaints found that, for 25 complaints worked, the risk-ranking process used by case processors to rank, score, and prioritize the complaints was insufficient because each case processor applied the risk-ranking elements differently. Tax return preparers serve a critical role in tax administration. Because of this critical role, identifying problem preparers through the complaint process is an essential component of the IRS's oversight responsibilities. Unqualified or unethical tax return preparers can negatively impact taxpayers as well as tax revenue if the tax returns they prepare are incorrect and/or fraudulent.

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[43] 15 U.S.C. §§1601 note, 1692-1692o (2006).
[44] TIGTA, Ref No. 2014-30-055, *Fiscal Year 2014 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results* (Sep. 2014).
[45] TIGTA, Ref. No. 2014-40-056, *Processes Do Not Ensure That Complaints Against Tax Return Preparers Are Timely, Accurately, and Consistently Processed* (Aug. 2014).

HUMAN CAPITAL

Human capital is the Federal Government's most critical asset, making the strategic management of human capital a key ongoing challenge facing the IRS. Budget reductions in recent years have caused the IRS to reduce staffing, which may have unforeseen implications on the IRS's ability to carry out its mission in future years. Specifically, the IRS's workforce shrank by approximately 9.3 percent between FYs 2011 and 2014. Additionally, by the end of FY 2017, nearly 70 percent of all IRS executives and nearly one-half of the IRS's non-executive managers are projected to be eligible for retirement. The anticipated retirements and reduction in employees possessing unique skills and institutional knowledge is particularly challenging as the number of tax returns the IRS processes continues to rise, the number of identity theft-fraud cases continues to increase, and the IRS needs to implement Affordable Care Act-related tax provisions.

TIGTA reported on how declining resources were impacting the Automated Collection System (ACS).[46] We found that since FY 2010, the number of ACS employees has decreased by 39 percent due to attrition or reassignment. The combination of fewer resources and the business need to continue answering telephone calls has contributed to unfavorable trends in several ACS business results over the past four years. Specifically, we determined that inventory is growing because new inventory is outpacing case closures, cases in inventory are aging because inventory is taking longer to close, revenue declined while more cases were closed as uncollectible, and fewer enforcement actions (liens and levies) were taken.

TIGTA also reported that implementation of the mandated sequestration, coupled with a trend of lower budgets, reduced staffing, and the loss of supplementary funding for the implementation of the Affordable Care Act, affected the IRS's ability to effectively deliver its priority program areas, including customer service and enforcement activities.[47] Our analysis of select customer service and enforcement statistics indicates that the downward trend in these areas may continue. The IRS's Level of Service decreased from 68 percent in FY 2012 to 61 percent in FY 2013. Key examination and collection statistics also declined. Examinations of individual tax returns declined approximately 5 percent from FY 2012 to FY 2013; and collection activities initiated by the IRS, such as liens, levies, and property seizures, declined approximately 33 percent during the same period.

With a shrinking workforce and budget, it will be a challenge for the IRS to successfully achieve its mission of providing America's taxpayers with top-quality service by helping

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[46] TIGTA, Ref. No. 2014-30-080, *Declining Resources Have Contributed to Unfavorable Trends in Several Key Automated Collection System Business Results* (Sep. 2014).
[47] TIGTA, Ref. No. 2014-10-025, *Implementation of Fiscal Year 2013 Sequestration Budget Reductions* (June 2014).

them understand and meet their tax responsibilities and enforcing the law with integrity and fairness.

CONCLUSION

This memorandum is provided as our annual summary of the most serious major management and performance challenges confronting the IRS in FY 2015. TIGTA's *Fiscal Year 2015 Annual Audit Plan* contains our proposed reviews, which are organized by these challenges, in order of priority. If you have any questions or wish to discuss our views on the challenges in greater detail, please contact me at (202) 622-6500.

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