Additional Efforts Are Needed for Improving Revenue Protection

January 2001

Reference Number: 2001-40-021

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

January 9, 2001

MEMORANDUM FOR CHIEF, CRIMINAL INVESTIGATION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Additional Efforts Are Needed for Improving Revenue Protection

This report presents the results of our review of the Internal Revenue Service's (IRS) process to assess the impact of the Revenue Protection Strategy (RPS) on taxpayer compliance. We focused on determining the impact of the RPS program on ensuring and promoting taxpayer compliance. In addition, we evaluated IRS' methodology in evaluating and reporting the results of the RPS. In summary, we found the IRS has implemented additional checks in its tax return processing procedures to improve taxpayer compliance. However, we believe the IRS needs to develop a long-term RPS with measurable goals and objectives for effectively addressing taxpayer noncompliance and establish a process to measure the effectiveness of the initiatives on reducing taxpayer noncompliance.

As a result of this review, we recommend that the Chief, Criminal Investigation, should develop a comprehensive RPS with established measurable goals and objectives to evaluate the effectiveness of the Strategy. Until the RPS is developed and implemented, the IRS should develop a process to measure the effectiveness of individual initiatives on reducing noncompliance. The RPS should also contain provisions for measuring the effect of its components on reducing noncompliance.

Management agreed with these recommendations. The IRS' newly implemented Strategic Planning and Budgeting process will produce a comprehensive compliance strategy. In addition, a multi-functional Compliance Council will oversee the execution of the Strategic Planning and Budgeting process. The new process places responsibility for the compliance strategy with the corresponding operating division commissioner. Further, the IRS will look into measuring the effectiveness of the Earned Income Credit outreach efforts. IRS Management's complete response has been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

Table of Contents

Executive Summary

Following the release of an independent vulnerability assessment in September 1993, the Congress and the Internal Revenue Service (IRS) became interested in identifying the nature of tax filing fraud and abuse problems. In 1993, the IRS acknowledged the problem of filing fraud and estimated tax fraud and abuse to be in the millions of dollars. Since February 1995, the General Accounting Office (GAO) has identified filing fraud as a high-risk area for the IRS.[1]

To combat the return filing fraud and abuse, the IRS implemented the Revenue Protection Strategy (RPS). The RPS was comprised of individual initiatives to improve taxpayer compliance. These initiatives were developed and implemented by various IRS functional areas such as the Examination and the Criminal Investigation (CI) Divisions. Examples of these initiatives include prevention efforts focused on validating Social Security Numbers (SSN) and Taxpayer Identification Numbers (TIN), identifying fraudulent refund schemes for referral to CI field offices, and conducting suitability requirements for practitioners' entry into the electronic filing system.

The overall objective of this review was to determine whether the IRS has an effective process to assess the impact of the RPS on improving taxpayer compliance.

Results

In April 1994, the IRS established the Office of Refund Fraud (ORF), headed by the Director of Investigations within the CI Division, to set broad service-wide policy and respond to the challenges the IRS faced in the detection and prevention of tax filing refund fraud and abuse. The ORF established an RPS that focused efforts primarily on the Earned Income Credit (EIC) and electronic filing fraud and abuse. The ORF worked with various IRS functions as well as other governmental agencies, such as the Social Security Administration, to develop new ways for addressing filing fraud and abuse. There was a big emphasis on the RPS, and the ORF received executive support.

In 1997, the Congress appropriated over $700 million over a 5-year year period, beginning with Fiscal Year (FY) 1998, to fund initiatives to improve EIC compliance. In 1998, the IRS established the EIC Program Office to oversee and coordinate the IRS' EIC program. The establishment of this appropriation and office caused a major shift in focus from the ORF to the new EIC Program Office. Despite the shift in focus, the ORF continued to address filing fraud and abuse issues, including the EIC.

[1]General Accounting Office. January 1, 1999. " Major Management Challenges and Program Risks: Department of the Treasury." (GAO/OCG-99-14)

As a result of the RPS, the IRS implemented additional checks in its return processing procedures to improve taxpayer compliance. For example, it: (1) expanded the number of up-front filters[2] in the electronic filing system that are designed to screen electronically filed returns for problems, (2) employed math error procedures[3] for missing or incorrect TINs, and (3) employed due diligence requirements[4] for EIC preparers. These processing checks resulted in increased revenue protection by detecting tax filing schemes and abuse and by preventing the IRS from issuing many erroneous refunds.

However, the management of these initiatives has been fragmented. Each functional area has its own results measure, and there is no overall goal and performance measure to gauge the impact of these initiatives on reducing noncompliance. The individual initiatives alone are not enough to ensure the IRS is effectively addressing filing fraud and abuse. Additional efforts are needed to ensure goals and objectives are established and that actual performance can be compared against these goals and objectives to enable management to make decisions about the effectiveness of these initiatives, future outcomes, and how they can be best accomplished.

The Internal Revenue Service Needs a Long-Term Revenue Protection Strategy for Effectively Addressing Taxpayer Noncompliance

While the IRS has implemented individual revenue protection initiatives, it does not have a documented multi-year strategy with clearly defined goals and objectives. As increased emphasis has been placed on customer service and taxpayer education, compliance resources have been reallocated to support these activities. Since inception of the RPS, a significant number of RPS initiatives have focused on the EIC, and the IRS has concentrated its efforts on maintaining and refining the prior years' initiatives. These factors have contributed to a complacence in the development of long-term goals and the design of a long-term strategy to achieve those goals.

Sound management practices require that program activities be planned over the long term and documented to improve program performance. Without a long-term strategy, the IRS risks not being able to direct well-organized and effective responses in areas of actual fraud and abuse.

[2] Up-front filters are designed to screen electronically filed returns for problems, such as incorrect or missing SSNs.

[3] Math error procedures allow the IRS to change returns that are incorrect or incomplete before notifying the taxpayer.

[4] Due diligence requirements for EIC preparers include: (1) complete an Earned Income Credit eligibility checklist; (2) complete an Earned Income Credit worksheet; (3) have no reason to believe any information used to determine eligibility is incorrect; and (4) retain for 3 years a copy of the completed checklist, worksheet, and record of how and when information was obtained and who provided the information.

The Internal Revenue Service Needs a Process to Measure the Effectiveness of the Revenue Protection Initiatives on Reducing Taxpayer Noncompliance

From FYs 1996 to 1999, an RPS communication package was published to educate internal and external parties about each current year's revenue protection initiatives and report the results of the past year in terms of the numbers of returns selected or adjustments to refunds. Although the IRS reported the results of each initiative in the communication packages, no evaluation of the impact of these initiatives on reducing noncompliance was performed. In the past, the IRS measured noncompliance through its Taxpayer Compliance Measurement Program (TCMP). The last TCMP involved Tax Year (TY) 1988 returns.

In an attempt to measure compliance within one segment of the taxpaying population, the IRS conducted compliance studies on taxpayers claiming the EIC. A TY 1994 study showed a 25.8 percent overclaim rate. A subsequent study was commissioned by the IRS on TY 1997 returns. This study, released August 2000, indicated that of the estimated $30.3 billion in EIC claims, approximately $7.8 billion should not have been paid.

In addition, the Congress included a provision in the IRS Restructuring and Reform Act of 1998 (RRA 98)[5] requiring a joint study on noncompliance. The provision required the Secretary of the Treasury and the IRS Commissioner to complete the study within 1 year after enactment of the law (July 22, 1998). This study is in draft and will soon be released.

With the elimination of the TCMP, the IRS has not been able to measure noncompliance and, therefore, is unable to measure the impact of the individual initiatives on improving taxpayer compliance. IRS management informed us that changes every year with respect to laws, budget, resources, and abuse patterns make it difficult to measure the success of these initiatives. Furthermore, in its report *Major Challenges and Program Risks: Department of the Treasury* (GAO/OCG-99-14), the GAO identified system weaknesses, and the lack of adequate data as affecting the IRS' ability to identify delinquencies for targeting compliance and enforcement initiatives.

To support results-oriented management, the Government Performance and Results Act of 1993 (GPRA)[6] requires agencies to develop strategic plans, set performance goals, and report annually on actual performance as compared to those goals. The GAO stated during testimony before the Congress,[7] "Regularly measuring progress in voluntary compliance is important to gauge whether the IRS is accomplishing a key aspect of its

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[5] IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685.

[6] Government Performance and Results Act of 1993 (GPRA), Pub. L. No. 103-62, 107 Stat. 285.

[7] Government Accounting Office. April 10, 2000. "IRS Modernization, Business Practice, Performance Management, and Information Technology Challenges." (GAO/T-GGD/AIMD-00-144)

mission. Also, information about taxpayers to be generated as part of measuring voluntary compliance should help the IRS identify the characteristics of taxpayers who have difficulty understanding and meeting their tax responsibilities. The IRS must better understand the problems of noncompliant taxpayers and the sources of their problems so that it can develop better products and services to meet the needs of those taxpayers." Without an effective process for assessing the impact of the initiatives on compliance, the IRS will be unable to evaluate program accomplishments and analyze resource and budgetary allocation to reduce taxpayer noncompliance.

Summary of Recommendations

The Chief, CI, should develop a comprehensive RPS with established measurable goals and objectives to evaluate the effectiveness of the Strategy. Until the RPS is developed and implemented, the Chief, CI, should develop a process to measure the effectiveness of individual initiatives on reducing noncompliance. The RPS should also contain provisions for measuring the effect of its components on reducing noncompliance.

Management's Response: The IRS recently implemented a Strategic Planning and Budgeting process that will produce a comprehensive compliance strategy. Strategic Program plans will provide direction, goals and objectives, and balanced performance measures. In addition, the IRS has established a multi-functional Compliance Council to oversee the Strategic Planning and Budgeting process. The new process places responsibility for the compliance strategy for each taxpayer segment with the corresponding operating division commissioner. Further, the IRS will look into measuring the effectiveness of their EIC outreach efforts. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as Appendix IV.

Objective and Scope

The overall objective of this review was to determine whether the IRS has an effective process to assess the impact of the RPS on improving taxpayer compliance.

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) has an effective process to assess the impact of the Revenue Protection Strategy (RPS) on taxpayer compliance. We focused on the development and planning of the RPS, along with the evaluation process for assessing its impact on taxpayer compliance.

Audit work was performed at the IRS National Headquarters during October 1999 through March 2000. This audit was performed in accordance with *Government Auditing Standards.*

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

Following the release of an independent vulnerability assessment in September 1993, the Congress and the IRS became interested in identifying the nature of tax filing refund fraud and abuse problems. The IRS recognized the need to increase its efforts to address this problem. In April 1994, the Office of Refund Fraud (ORF) was established to set broad service-wide policy and respond to the challenges the IRS faced in the detection and prevention of tax filing refund fraud and abuse. The Director of Investigations within the Criminal Investigation (CI) Division was designated as the lead executive of the IRS' efforts. Chief Officers, Regional Commissioners, and Regional Chief Compliance Officers were directed to seek guidance from the Director of Investigations and ensure his continued involvement in their initiatives to address tax filing refund fraud.

The ORF worked with various IRS functions as well as other governmental agencies, such as the Social Security Administration, to develop new ways for addressing filing fraud and abuse. There was a big emphasis on the RPS, and the ORF received executive support.

In 1994, the ORF had a narrow focus on refund fraud in Electronic Filing (ELF). After a limited study of early Tax Year (TY) 1993 returns, preliminary results showed the problem was more than ELF returns; it extended to paper returns. The study also showed that Earned Income Credit (EIC) problems were bigger than originally thought—both in fraudulent and unintentionally erroneous claims. A Revenue Protection Strategy (RPS) was developed to deal with the broader issues identified. Since the creation of the strategy, the main focus has been EIC noncompliance, but other areas included the Questionable Refund Program, established in 1997, and the Return Preparer Program, implemented in 1996.

The RPS was comprised of individual initiatives to improve taxpayer compliance. These initiatives were developed and implemented by various IRS functional areas such as the Examination and the CI Divisions. Examples of these initiatives include prevention efforts focused on validating Social Security Numbers (SSN) and Taxpayer Identification Numbers (TIN), identifying fraudulent refund schemes for referral to CI field offices, and conducting suitability requirements for practitioners' entry into the electronic filing system.

In 1993, the IRS acknowledged the problem of filing fraud and estimated tax fraud and abuse to be in the millions of dollars. However, a subsequent study of TY 1994 returns conducted by the IRS revealed the problem to involve billions of dollars. Since February 1995, the General Accounting Office (GAO) has identified filing fraud as a high-risk area for the IRS.[1] In 1997, the Congress appropriated over $700 million over a 5-year year period, beginning with FY 1998, to fund initiatives to improve EIC compliance. In 1998, the IRS established the EIC Program Office to oversee and coordinate the IRS' EIC program.

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[1] General Accounting Office. January 1, 1999. "Major Management Challenges and Program Risks: Department of the Treasury." (GAO/OCG-99-14)

The establishment of this appropriation and office caused a major shift in EIC focus from the ORF to the new EIC Program Office. The ORF continued to address filing fraud and abuse issues, including the EIC.

From FYs 1996 to 1999, an RPS communication package was published to educate internal and external parties about each current year's revenue protection initiatives and report the results of the past year in terms of the numbers of returns selected or adjustments to refunds. The RPS was built on the following four-pronged approach to address the problems associated with fraudulent and questionable returns:

<u>Understanding</u> - Research and analyze data in an ongoing effort to understand fraud and the various methods of abuse, with a special emphasis on emerging trends.

<u>Prevention</u> - Validate return information up front to prevent fraudulent or questionable claims from entering the filing system.

<u>Detection</u> - Develop improved detection systems to identify multiple-return fraud schemes and patterns of abuse among groups of taxpayers.

<u>Enforcement</u> - Pursue criminal investigation and prosecution of fraudulent refund claims. In addition, conduct pre-refund audits to determine eligibility for certain tax benefits.

Results

The IRS implemented additional checks in its return processing procedures to improve compliance.

As a result of the RPS, the IRS implemented additional checks in its return processing procedures to improve taxpayer compliance. For example, the IRS implemented the following checks:

- Expanded the number of up-front filters[2] in the electronic filing system that are designed to screen electronically filed returns for problems causing tax returns to be rejected back to the transmitter.
- Employed math error procedures[3] for missing or incorrect TINs that could delay or disallow refunds.
- Employed due diligence requirements[4] for EIC preparers that could result in a penalty for failure to comply with requirements.

These processing checks resulted in revenue protection by detecting tax filing schemes and abuse and by preventing the IRS from issuing many erroneous refunds.

However, the management of these initiatives has been fragmented. Each functional area has its own results measure, and there is no overall goal and performance measure to gauge the impact of these initiatives on reducing noncompliance. For example, there exists some confusion about these and other revenue protection initiatives being part of an IRS revenue protection strategy.

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[2] Up-front filters are designed to screen electronically filed returns for problems, such as incorrect or missing SSNs.

[3] Math error procedures allow the IRS to change returns that are incorrect or incomplete before notifying the taxpayer.

[4] Due diligence requirements for EIC preparers include: (1) complete an Earned Income Credit eligibility checklist; (2) complete an Earned Income Credit worksheet; (3) have no reason to believe any information used to determine eligibility is incorrect; and (4) retain for 3 years a copy of the completed checklist, worksheet, and record of how and when information was obtained and who provided the information.

The ORF informed us that it does not have a document that frames a comprehensive RPS.

The individual initiatives alone are not enough to ensure the IRS is effectively addressing filing fraud and abuse. Additional efforts are needed to ensure goals and objectives are established and that actual performance can be compared against these goals and objectives to enable management to make decisions about the effectiveness of these initiatives, future outcomes, and how they can be best accomplished.

The Internal Revenue Service Needs a Long-Term Revenue Protection Strategy for Effectively Addressing Taxpayer Noncompliance

While the IRS has implemented individual revenue protection initiatives, it does not have a documented long-term plan.

While the IRS has implemented individual revenue protection initiatives, it does not have a documented multi-year compliance strategy with clearly defined goals and objectives.

The voluntary compliance of taxpayers is essential to the efficient operation of the tax system. Therefore, specific attention should be given by IRS officials to the isolation and definition of problems in tax administration that might adversely affect voluntary compliance. Sound management practices require that program activities be planned over the long term and documented to improve program performance. Strategic planning includes:

- Setting the mission, objectives, and measures.
- Assessing internal and external needs.
- Comparing actual results to expected results.
- Identifying causes of significant variances and implementing changes.
- Reassessing objectives after the identification of significant variances or results.

A continuous evaluation and adjustment process is important because it allows an organization to adapt to changes in the environment, such as reduction in budget and changes in law and personnel.

With the enactment of the IRS Restructuring and Reform Act of 1998 (RRA 98),[5] customer service and satisfaction have become the fundamental principles of the IRS mission. In response to this shift in program emphasis, some IRS resources have been reallocated from compliance to customer service. More efficient processing of returns and a quicker issuance of refunds is central to the service centers'[6] goal of customer satisfaction. The function of the RPS is to identify and stop fraudulent refunds, which may delay the issuance of valid refunds. Due to these differing goals, conflict arises among functions.

Since inception of the RPS, a significant number of RPS initiatives have focused on the EIC, and the IRS has concentrated its efforts on maintaining and refining the prior years' initiatives. These factors have contributed to a complacence in the development of long-term goals and the design of a long-term strategy to achieve those goals. Top management support is critical to the development and maintenance of a successful long-term RPS.

Currently, the IRS is going through a total redesign and the ORF has been renamed the Office of Refund Crimes. In support of the overall IRS mission, the Office of Refund Crimes will detect fraudulent returns, prevent issuance of related false refunds, and support the mission of CI field operations relative to tax administration.

Without a long-term strategy, the IRS risks not only being unable to direct well-organized and effective responses in areas of actual fraud and abuse, but may miss opportunities to prevent and deter potential fraud. Lack of a coordinated multi-functional strategy makes the IRS vulnerable in its ability to recognize, adapt, and respond quickly and effectively to emerging trends, schemes, and methods. It

[5] IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685.

[6] Service centers are the data processing arm of the IRS. The service centers process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

also contributes to a system geared toward maintenance of previously successful initiatives and reactive responses versus continued development of new initiatives and proactive approaches. In a system geared toward maintenance and reaction, the IRS is forced to respond after new fraudulent activities have been discovered and revenue already lost. If the area of fraud involves a sophisticated scheme not quickly identified, the IRS stands to lose significant revenue before the fraud has been stopped. Once the money has been refunded, it becomes very difficult to recover.

Recommendations

1. The Chief, CI, should ensure that the RPS is a long-term strategic plan that is coordinated among functional areas. The RPS should recognize and take steps to defeat known fraud and abuse, as well as outline proactive measures for attempting to eliminate potential areas of fraud and abuse.
2. The Chief, CI, should establish measurable goals and objectives to evaluate the effectiveness of the RPS. The goals and objectives should ensure that revenue is protected and taxpayer burden is reduced.

Management's Response: The IRS' recently implemented Strategic Planning and Budgeting process will produce a comprehensive compliance strategy. Strategic Program plans will provide direction, goals and objectives, and balanced performance measures. In addition, the IRS has established a multi-functional Compliance Council to oversee the execution of the Strategic Planning and Budgeting process.

The Internal Revenue Service Needs a Process to Measure the Effectiveness of the Revenue Protection Initiatives on Reducing Taxpayer Noncompliance

Although the IRS has developed and reported the results of each initiative, no evaluation of the impact of these initiatives on reducing noncompliance was performed.

Although the IRS has developed and reported the results of each initiative in the communication packages released to the public, no evaluation of the impact of these initiatives on reducing noncompliance was performed. In the past, the IRS measured noncompliance through its Taxpayer Compliance Measurement Program (TCMP). The last TCMP involved TY 1988 returns.

In an attempt to measure compliance among one segment of the taxpaying population, the IRS conducted compliance studies on taxpayers claiming the EIC. A TY 1994 study showed a 25.8 percent overclaim rate. A subsequent study was commissioned by the IRS on TY 1997 returns to provide a baseline measure for EIC overclaims. This study, released August 2000, indicated that of the estimated $30.3 billion in EIC claims, $7.8 billion should not have been paid.

Additionally, the Congress included a provision in the RRA 98 requiring a joint study on noncompliance. The provision required the Secretary of the Treasury and the IRS Commissioner to complete the study within 1 year after July 22, 1998, the date of the law's enactment. This study is in draft and will soon be released. The study will address some of the same interests as the TCMP.

Without the TCMP, the IRS has not been able to measure noncompliance and, therefore, is unable to measure the impact of the individual initiatives on improving taxpayer compliance. IRS management informed us that changes every year with respect to laws, budget, resources, and abuse patterns make it difficult to measure the success of these initiatives. Furthermore, in its report *Major Challenges and Program Risks: Department of the Treasury* (GAO/OCG-99-14), the GAO identified system weaknesses and the lack of adequate data as affecting the

IRS' ability to identify delinquencies for targeting compliance and enforcement initiatives.

To support results-oriented management, the Government Performance and Results Act of 1993 (GPRA)[7] requires agencies to develop strategic plans, set performance goals, and report annually on actual performance as compared to those goals. As the federal government implements this legislation, these plans and goals should be integrated into (1) the budget process, (2) the operational management of agencies and programs, and (3) accountability reporting to the public on performance results and on the integrity, efficiency, and effectiveness with which they are achieved. The GAO stated during testimony before the Congress,[8] "Regularly measuring progress in voluntary compliance is important to gauge whether the IRS is accomplishing a key aspect of its mission. Also, information about taxpayers to be generated as part of measuring voluntary compliance should help the IRS identify the characteristics of taxpayers who have difficulty understanding and meeting their tax responsibilities. The IRS must better understand the problems of noncompliant taxpayers and the sources of their problems so that it can develop better products and services to meet the needs of those taxpayers."

Without an effective process for assessing the impact of the initiatives on compliance, the IRS will be unable to evaluate program accomplishments and analyze resource and budgetary allocation to reduce taxpayer noncompliance.

Recommendation

3. Until the RPS is developed and implemented, the Chief, CI, should develop a process to measure the effectiveness of individual initiatives on reducing noncompliance. Once developed, the RPS should also

[7] Government Performance and Results Act of 1993 (GPRA), Pub. L. No. 103-62, 107 Stat. 285.

[8] Government Accounting Office. April 10, 2000. "IRS Modernization, Business Practice, Performance Management, and Information Technology Challenges." (GAO/T-GGD/AIMD-00-144)

contain provisions for measuring the effect of its components on reducing noncompliance.

Management's Response: Until specific measures of noncompliance are developed, the impact of individual initiatives cannot be determined. Where possible, the results of Office of Program Evaluation and Risk Analysis's findings in measuring the effectiveness of the EIC Program Office's outreach efforts will be tracked and the results acted upon to achieve increased compliance. The Strategic Planning and Budgeting process in conjunction with the Business Performance Review system requires each operating division to continuously evaluate its performance and adjust its program goals and objectives to maximize the impact on compliance within their taxpayer segment.

Conclusion

We found the IRS has implemented initiatives to reduce taxpayer filing fraud and abuse. However, we believe the IRS should develop a coordinated RPS with an effective process for assessing its impact. This would allow for the evaluation of program accomplishments and resource and budgetary allocation to reduce taxpayer noncompliance.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) has an effective process to assess the impact of the Revenue Protection Strategy (RPS) on improving taxpayer compliance.

To accomplish our objective, we determined if the RPS program provides adequate oversight and guidance for revenue protection initiatives. Specifically, we:

A. Identified and reviewed IRS memoranda and policies to identify the executive owner of the RPS and determined the official's involvement in coordinating and setting direction for the RPS.

B. Reviewed available documentation and determined the functional areas involved in implementing the RPS and their respective roles and responsibilities.

C. Reviewed procedures and other documentation relating to the return preparer strategy and determined how the RPS is communicated to the appropriate IRS personnel.

D. Interviewed IRS personnel to identify specific roles and responsibilities and determined how and when the RPS is communicated to functions outside the Office of Refund Fraud.

Appendix II

Major Contributors to This Report

Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs)
Michael Phillips, Director
Debra Gregory, Audit Manager
Patricia Lee, Audit Manager
James Traynor, Senior Auditor
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Kathy Henderson, Auditor

Appendix III

Report Distribution List

Commissioner, Wage and Investment Division W
Chief, Criminal Investigation CI
Director, Refund Crimes CI:RC
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National Taxpayer Advocate TA
Audit Liaison:
  Refund Crimes CI:RC

Appendix IV

Management's Response to the Draft Report

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

COMMISSIONER

November 27, 2000

RECEIVED
NOV 27 2000

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: for Charles O. Rossotti
Commissioner of Internal Revenue

SUBJECT: Draft Treasury Inspector General for Tax Administration (TIGTA) Audit Report–Additional Efforts Are Needed for Improving Revenue Protection (Ref. #200040001)

Thank you for the opportunity to respond to your subject draft report dated October 20, 2000. Your report recognizes the Service's desire to detect and deter return filing fraud through Servicewide policy. This began with enhanced vigor through the establishment of Criminal Investigation's (CI) Office of Refund Fraud (currently named Refund Crimes) in 1994. The IRS's focused efforts on revenue protection have been an integral component toward reducing taxpayer burden and encouraging taxpayer compliance. Criminal Investigation has worked diligently in establishing multifunctional cooperation to identify areas for improvement in fraud detection and prevention, revenue protection, and taxpayer education. From 1994 until 1999, the Office of Refund Fraud was responsible for identifying and supporting multifunctional efforts in these areas, and for coordinating a Revenue Protection Strategy (RPS) communication package.

There have been numerous initiatives put in place through the multifunctional efforts of CI, Service Center Correspondence Examination, Information Systems, Returns Processing, the Earned Income Tax Credit (EITC) Program Office, and Examination. These initiatives included such programs as Taxpayer Identification Number (TIN) validation, tracking and abuse issues, Math Error Notices, Earned Income Credit Ineligibles, Fuel Tax credits, and more. The Questionable Refund Program (QRP) has been effective, since 1977, in stopping in excess of $1.9 billion in fraudulent refunds. All of these multi-functional efforts have protected hundreds of millions of dollars annually, since 1994. The EITC program has long been identified as a major area in need of protection from fraudulent activity. Its supplemental funding has seen a majority of the revenue protection efforts directed toward EITC with significant results. Notwithstanding, the EITC initiative has produced excellent results.

The IRS reorganization plan establishes operating divisions with responsibility for specific customers covering clearly identified taxpayer segments. Each operating division has ultimate responsibility for developing strategic program plans to address all compliance issues within their customer base. The recently implemented Strategic Planning and Budgeting process establishes the priorities for each operating division and the compliance linkages among the divisions and functions such as CI and Chief Counsel. In addition, IRS has established a multi-functional Compliance Council to ensure a strategic, coordinated, and balanced execution of the compliance priorities established in the Strategic Planning and Budgeting process. The Compliance Council began meeting last month.

The new process places responsibility for the compliance strategy for each taxpayer segment with the corresponding operating division commissioner. However, CI will continue enforcement efforts in support of the operating divisions' compliance strategy. Part of CI's efforts will be working toward detection and deterrence of return filing fraud and providing recommendations to the operating divisions. This will improve compliance, protect revenue, educate taxpayers, and help reduce non-compliance, wherever possible. The operating divisions and functions of the Service will continue to improve their programs and develop initiatives in an effort to meet these objectives.

I have attached our response to the recommendations in the Draft Report. The merit of these recommendations is apparent, and corrective actions will be implemented as presented in the attachment.

Questions regarding this response should be directed to Mark E. Matthews, Chief, CI at 202-622-3200 or Gary Bell, Director, Refund Crimes (CI:RC), of his staff at 202-622-7140.

Attachment

cc: Director, Planning & Strategy Section CI:S:PS

Attachment

Response to Draft Internal Audit Report
Additional Efforts Are Needed for Improving Revenue Protection
(Ref. #200040001)
October 20, 2000

Recommendation #1

The Chief, CI, should ensure that the RPS is a long-term strategic plan that is coordinated among functional areas. The RPS should recognize and take steps to defeat known fraud and abuse, as well as outline proactive measures for attempting to eliminate potential areas of fraud and abuse.

Assessment of Cause(s):

Since 1994, Criminal Investigation's Office of Refund Fraud and the IRS in general have implemented individual revenue protection initiatives. IRS has not, however, documented a multi-year strategy with clearly defined goals and objectives. As increased emphasis has been placed on customer service and taxpayer education, some compliance resources have been reallocated to support these activities. IRS did not have an integrated RPS from 1994–1999, but began many specific initiatives with available resources that were deemed to be the most effective in addressing areas of abuse or potentially abusive. Some of these programs included Math Error on missing, invalid, or ineligible TINs; EITC ineligibles; Fuel tax credits; and the continuation of the QRP. Since the introduction of RPS, a significant number of RPS initiatives have focused on EITC. Additionally, the IRS has concentrated its efforts on maintaining and refining these initiatives. The Service did institute an integrated EITC Compliance Improvement Strategy.

Corrective Action(s):

The IRS reorganization plan establishes operating divisions with responsibility for specific customers covering clearly identified taxpayer groups. Each operating division has ultimate responsibility for developing strategic program plans to address all compliance issues within their customer base. The recently implemented Strategic Planning and Budgeting process will produce a comprehensive compliance strategy by establishing the compliance priorities and linkages for each operating division and function such as Criminal Investigation. In addition, the IRS has established a multi-functional Compliance Council to ensure a strategic, coordinated, and balanced execution of the compliance priorities established in the Strategic Planning and Budgeting process.
The Strategic Program Plan for each operating division and function provides direction, goals and objectives, and balanced performance measures.

Since the compliance issues raised focus on individual taxpayers, primary responsibility will rest with the Commissioners of the Wage and Investment and Small Business/Self-Employed Divisions with support from Criminal Investigation.

Attachment

Implementation Date:

Completed: **Proposed: 10/1/2002**

Responsible Official(s):
Commissioner, Wage and Investment Division; Commissioner, Small Business/Self-Employed Division

Corrective Action(s) Monitoring Plan:
It will be the responsibility of the operating divisions to direct high level performance reviews and determine Servicewide staffing and budget allocation based on the strategic compliance plan.

Recommendation #2
The Chief, CI, should establish measurable goals and objectives to evaluate the effectiveness of the RPS. The goals and objectives should ensure that revenue is protected and taxpayer burden is reduced.

Assessment of Cause(s):
The previous IRS Revenue Protection Strategy communication packages addressed broad areas of strategy to help taxpayers and practitioners avoid unnecessary problems in meeting their filing obligations. The specific program checks that were implemented were intentionally not disclosed so that people could not try to circumvent them. There have been projections such as the number of CI referrals to Exam or the number of audits started that can be analyzed. Some of the fiscal year 1998 results of these initiatives are: a) 1.7 million math errors dealing with missing, invalid, or ineligible TINs resulting in revenue protected of $1.3 billion; b) 1,600 compliance reviews of electronic filers resulting in the suspension of 51 for serious breaches of requirements; and c) Examination closed approximately 295,000 cases with assessments of $454 million. The IRS has not developed a long-term strategy with clearly defined goals and has not documented results to ensure improvement of program performance.

Corrective Action(s):
The IRS reorganization plan establishes operating divisions with responsibility for specific customers covering clearly identified taxpayer groups. Each operating division has ultimate responsibility for developing strategic program plans to address all compliance issues within their customer base. The recently implemented Strategic Planning and Budgeting process will produce a comprehensive compliance strategy by establishing the compliance priorities and linkages for each operating division and function such as Criminal Investigation. In addition, the IRS has established a multi-functional Compliance Council to ensure a strategic, coordinated, and balanced execution of the compliance priorities established in the Strategic Planning and Budgeting process.

Attachment

The Strategic Program Plan for each operating division and function provides direction, goals and objectives, and balanced performance measures.

Since the compliance issues raised focus on individual taxpayers, primary responsibility will rest with the Commissioners of the Wage and Investment and Small Business/Self-Employed Divisions with support from Criminal Investigation.

Implementation Date:

Completed: **Proposed: 10/1/2002**

Responsible Official(s):
Commissioner, Wage and Investment Division; Commissioner, Small Business/Self-Employed Division

Corrective Action(s) Monitoring Plan:
The IRS operating divisions will direct high-level performance reviews, monitor data collection and analysis, and direct initiatives within the appropriate business-unit areas. The monitoring and coordination processes will provide input to decision-making, program measurement, and future direction for the operating divisions.

Recommendation #3
Until the RPS is developed and implemented, the Chief, CI, should develop a process to measure the effectiveness of individual initiatives on reducing noncompliance. Once developed, the RPS should also contain provisions for measuring the effect of its components on reducing noncompliance.

Assessment of Cause(s):
There are no measures of effectiveness for previous initiatives on reducing noncompliance because the IRS does not have an integrated comprehensive process for measuring noncompliance. The only measure available is the results of the current audits, i.e., the dollars assessed, no change rate, etc. These results can only be marginally compared from one year to the next because of the change in the volume of audits conducted. Other programs such as education and outreach, validation checks, return preparer initiatives, etc., which have no dollar equivalents are even more difficult to measure. Currently, the inability to measure noncompliance compounds the inability to measure initiative effectiveness. The EITC Program Office has asked the Office of Program Evaluation and Risk Analysis (OPERA) to look into measuring the effectiveness of EITC outreach efforts.

Attachment

Corrective Action(s):
The only current tool to comprehensively measure noncompliance, the EITC Compliance Study initiative, does not produce results until up to eighteen months after the close of the processing year. The results only reflect whether there was a change in the abuse rate between different periods of time. Until specific measures of noncompliance are developed, the impact of individual initiatives cannot be determined. Where possible, the results of OPERA's findings in measuring the effectiveness of the EITC Program Office's outreach efforts will be tracked and the results acted upon to achieve increased compliance.

Since the compliance issues raised focus on individual taxpayers, primary responsibility will rest with the Commissioners of the Wage and Investment and Small Business/Self-Employed Divisions with support from Criminal Investigation. The Strategic Planning and Budgeting process in conjunction with the Business Performance Review system requires each operating division to continuously evaluate their performance and adjust their program goals and objectives to maximize the impact on compliance within their taxpayer segment.

Implementation Date:
Completed: **Proposed: 10/1/2002**

Responsible Official(s):
Commissioner, Wage and Investment Division; Commissioner, Small Business/Self-Employed Division

Corrective Action(s) Monitoring Plan:
The IRS operating divisions and functions will direct high-level performance reviews, monitor data collection and analysis, and direct initiatives within the appropriate business-unit areas.