

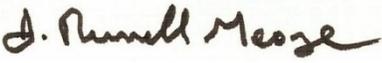


INSPECTOR GENERAL
FOR TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20005

October 14, 2020

MEMORANDUM FOR SECRETARY MNUCHIN

FROM: J. Russell George 
Inspector General

SUBJECT: Management and Performance Challenges Facing the
Internal Revenue Service for Fiscal Year 2021

The Reports Consolidation Act of 2000¹ 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 most vulnerable areas in the Nation's tax system. For Fiscal Year (FY) 2021, the IRS's top management and performance challenges, in order of priority, are:

1. Responding to the COVID-19 Pandemic;
2. Enhancing Security of Taxpayer Data and Protection of IRS Resources;
3. Implementing Tax Law Changes;
4. Addressing Emerging Threats to Tax Administration;
5. Supporting an Enhanced Taxpayer Experience;
6. Modernizing IRS Operations;
7. Improving Tax Reporting and Payment Compliance;
8. Reducing Fraudulent Claims and Improper Payments;
9. Increasing International Tax Compliance; and
10. Protecting Taxpayer Rights.

The most significant change since the prior year is the onset of the Coronavirus Disease 2019 (COVID-19) pandemic, which has dramatically impacted the IRS and the taxpayers that it serves. As such, we have identified "Responding to the COVID-19 Pandemic" as the top challenge facing the IRS. To address this challenge, the IRS has implemented laws and taken action to provide relief to taxpayers experiencing financial hardship and to protect the health of its employees. Although no longer listed, achieving operational efficiencies should remain an area of continued focus for the IRS.

¹ 31 U.S.C. § 3516(d) (2006).

The IRS faces significant resource challenges. Its budget has been reduced significantly in real terms since FY 2011, which has affected its ability to provide sufficient levels of service and enforcement. Further, human capital remains a serious underlying issue that impacts all 10 of the Major Management Challenges. Between FY 2010 and FY 2019, the IRS lost more than 29,000 full-time positions, which included more than 14,600 key enforcement personnel.²

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

RESPONDING TO THE COVID-19 PANDEMIC

The Coronavirus Aid, Relief, and Economic Security (CARES) Act, the largest economic rescue package in U.S. history, had a significant impact on the IRS and Federal tax administration. The CARES Act contained numerous tax-related provisions impacting individuals and businesses and appropriated approximately \$750 million in additional funding to the IRS to administer and oversee these provisions.

TIGTA has implemented a multi-audit strategy to provide oversight of IRS's relief and recovery efforts. TIGTA is currently reviewing the IRS's pandemic plan, designed to protect the health and safety of IRS employees, as well as its response to health and safety incidents that occur during the pandemic.

In addition, TIGTA is assessing the IRS's processes designed to ensure that only eligible taxpayers received financial relief through the tax provisions of the CARES Act. TIGTA reported that significant coordination and efforts were taken by the IRS to expedite its analysis and reprogramming of systems and to educate individuals on the Economic Impact Payment (EIP).³ During our initial review in May 2020, TIGTA found that the IRS issued more than 157 million payments totaling more than \$264 billion and had correctly computed the payment amount for approximately 98 percent of the payments processed. However, at the time of our review, we found that the IRS had issued 1.2 million payments to prisoners and deceased individuals. TIGTA is continuing to assess the accuracy of the EIPs, the assistance provided to individuals who did not receive a payment, and the recovery efforts for any erroneous payments. TIGTA is also reviewing the impact of the CARES Act provisions related to business taxpayers.

The IRS also announced the "People First Initiative" in March 2020 as part of an effort to assist taxpayers facing the challenges of COVID-19. The initiative temporarily adjusted or suspended key IRS compliance programs. The changes generally included postponing certain payments related to installment agreements and offers in compromise; suspending liens and levies; suspending passport certifications of seriously delinquent taxpayers; not referring new delinquent accounts to private debt

² IRS, *Management's Discussion and Analysis, Fiscal Year 2019*.

³ TIGTA, Ref. No. 2020-46-041, *Interim Results of the 2020 Filing Season: Effect of COVID-19 Shutdown on Tax Processing and Customer Service Operations and Assessment of Efforts to Implement Legislative Provisions* (June 2020).

collection; and delaying new field, office, or correspondence examinations. This initiative was implemented for the period March through July 15, 2020.

TIGTA works closely with the IRS to identify, investigate, and combat threats to tax administration. After passage of the CARES Act, TIGTA observed an increase in related illicit scams and schemes with various objectives, such as manipulation of IRS online applications, theft of the EIPs, and efforts to steal sensitive taxpayer information.

ENHANCING SECURITY OF TAXPAYER DATA AND PROTECTION OF IRS RESOURCES

Advances in technology have provided the IRS an opportunity to be more responsive to taxpayers' needs for its services. The IRS continues to work toward improving its public-facing applications to ensure that taxpayers who want access to IRS's online services have verified their identities and can securely access IRS resources. TIGTA reported that the IRS is making progress to comply with the National Institute of Standards and Technology guidelines on identity proofing⁴ by developing and using a five-step process to determine the required assurance level for each of its applications.⁵ However, the IRS may not complete its processes on all applications as scheduled. The IRS is using compensating controls that include identity proofing and authentication level of assurances based on superseded guidelines.

While identity verification and secure access are imperative to the function of IRS public-facing applications, the IRS has to ensure that it does not surrender access to the data necessary to investigate abuses of these portals. The IRS is currently exploring the possibility of outsourcing identity proofing under a project that relies heavily on third-party verification, which creates the possibility that neither the IRS nor TIGTA would be able to access authentication and validation logs.

TIGTA also evaluated the effectiveness of security controls and procedures over wireless networks in use at IRS facilities and identified areas of improvement.⁶ We determined that security weaknesses related to the wireless networks are not timely resolved and the IRS's inventory of wireless access points could be improved. An inaccurate inventory hinders the IRS's ability to timely detect the loss or potential theft of the access points. Further, we determined that wireless access points are broadcasting a wireless network signal beyond IRS-controlled space, which creates the potential risk of external entities detecting and attempting to access or hack the IRS through the wireless networks. TIGTA detected the wireless signal outside of the IRS-controlled space in 21 (75 percent) of the 28 locations visited.

In addition to external threats, the IRS must ensure that its systems and data are protected against internal threats. An audit trail can help protect against insider threats

⁴ Identity proofing is ensuring that users who interact with an entity over open networks, *i.e.*, the Internet, are who they claim to be.

⁵ TIGTA, Ref. No. 2020-20-012, *While Progress Is Being Made on Digital Identity Requirements, Completion Dates to Achieve Compliance With Identity Proofing Standards Have Not Been Established* (Mar. 2020).

⁶ TIGTA, Ref. No. 2020-20-063, *Improvements Are Needed to Ensure Wireless Networks Are Secure* (Sept. 2020).

as it is a record of events⁷ occurring on a computer system. TIGTA reported that the IRS continues to struggle with ensuring that all applications are providing complete and accurate audit trails for monitoring and identifying unauthorized access.⁸ TIGTA also found that the IRS could not provide an accurate inventory of all applications that store or process taxpayer data and Personally Identifiable Information. This inventory is critical to identify applications that need to be monitored for potential unauthorized access by employees. We also noted that not all applications with audit trail deficiencies were being monitored as required, which could allow unresolved deficiencies to persist.

IMPLEMENTING TAX LAW CHANGES

Legislative developments related to tax reform and tax policy continue to present challenges for the IRS. During the year, the IRS implemented many tax provisions in the Families First Coronavirus Response Act⁹ and the CARES Act which were intended to provide relief to those experiencing financial hardship. The IRS developed online assistance tools and a dedicated web page and has expedited analysis and reprogramming of systems needed to provide EIPs to taxpayers. In addition, the IRS identified other tax law and administrative changes affecting the filing season. These changes affected tax forms, instructions, and publications.

In addition, the Taxpayer First Act,¹⁰ enacted on July 1, 2019, aims to expand and strengthen taxpayer rights and to reform the IRS into a more taxpayer-friendly agency by requiring it to develop a comprehensive customer service strategy, modernize its technology, and enhance its cybersecurity. It also requires the IRS to propose an organizational redesign, with the goals of improving efficiency, modernizing systems and business processes, and finding ways to better serve taxpayers. In its FY 2021 budget justification, the IRS is requesting approximately \$106 million for 262 full-time equivalents to implement this legislation.

Further, according to the IRS's Strategic Plan,¹¹ implementing the Tax Cuts and Jobs Act of 2017¹² is a high priority for the IRS. The provisions that affect individual taxpayers include the repeal of the personal exemption, increase in the standard deduction, modification of itemized deductions, increase in the Child Tax Credit, and creation of a new Other Dependent Credit. While the majority of the changes enacted in the Tax Cuts and Jobs Act of 2017 were effective beginning in Tax Year 2018, some are effective beginning in later tax years.

⁷ An event is any action that happens on a computer system. Examples include logging into a system, executing a program, and opening a file.

⁸ TIGTA, Ref. No. 2020-20-033, *Most Internal Revenue Service Applications Do Not Have Sufficient Audit Trails to Detect Unauthorized Access to Sensitive Information* (July 2020).

⁹ Pub. L. No. 116-127.

¹⁰ Pub. L. No. 116-25.

¹¹ *Internal Revenue Service Strategic Plan – FY 2018 – 2022*, IRS Pub. 3744 (Rev. Apr. 2018).

¹² Pub. L. No. 115-97.

ADDRESSING EMERGING THREATS TO TAX ADMINISTRATION

Identity theft tax refund fraud involves the use of another person's name and Taxpayer Identification Number¹³ to file a fraudulent tax return reporting false income and withholding in an effort to receive a fraudulent tax refund. TIGTA has continually reported that new fraud patterns are constantly evolving and, as such, the IRS needs to adapt its detection and prevention processes. We reported that the IRS continues to evaluate and expand on successful fraud detection initiatives, while also piloting new fraud detection initiatives.¹⁴ The actions taken on the part of the IRS have been extremely effective in addressing the identity theft epidemic and reducing its negative impact on tax administration. Specifically, the IRS's multifaceted approach has significantly reduced losses to the Government from the \$5.2 billion reported for Processing Year 2010 that TIGTA first estimated in July 2012¹⁵ to the IRS's most recent estimated losses for Processing Year 2018 of between \$90 million and \$380 million. However, the IRS has not yet developed metrics to quantitatively measure its success in detecting and preventing identity theft tax refund fraud, *i.e.*, reporting the number of tax returns stopped and refunds protected, as required by the Taxpayer First Act.

In addition to identity theft, telephone calls from criminals impersonating IRS agents also are near the top of the IRS's "Dirty Dozen"¹⁶ tax scams and remain an ongoing threat to taxpayers as con artists threaten taxpayers with arrest, deportation, and license revocation if the victim does not pay a bogus tax bill. Since the fall of 2013, a significant amount of TIGTA's Office of Investigations' workload has consisted of investigating impersonation scams in which more than 2.5 million intended victims have received unsolicited telephone calls from individuals falsely claiming to be IRS or Department of the Treasury employees. The callers demand money from the taxpayer under the pretense that they owe unpaid taxes. To date, more than 16,000 victims reported that they have paid approximately \$81 million to these criminals.

As of July 31, 2020, TIGTA's commitment to protecting taxpayers has resulted in 198 individuals being charged in Federal court for their roles in IRS impersonation scams. Ninety-seven of those individuals have been sentenced and collectively received a total of more than 402 years' imprisonment.

Threats and assaults directed at IRS employees, facilities, and infrastructure impede the effective and safe administration of the Federal tax system and the IRS's ability to collect tax revenue. Recent incidents involving taxpayers who threatened or assaulted IRS employees underscore the dangers that these employees face each day. In August 2020, a taxpayer was indicted for making an online bomb threat directed at an

¹³ A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, it can be an Employer Identification Number, a Social Security Number, or an Individual Taxpayer Identification Number.

¹⁴ TIGTA, Ref. No. 2020-40-040, *Constantly Evolving Refund Fraud Patterns Require Continued Refinement and Development of Detection Initiatives* (July 2020).

¹⁵ TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (July 2012).

¹⁶ Compiled annually, the "Dirty Dozen" lists a variety of common scams that taxpayers may encounter.

IRS facility in New York. If convicted, the taxpayer could face 10 years' imprisonment, followed by a period of supervised release.

SUPPORTING AN ENHANCED TAXPAYER EXPERIENCE

Providing taxpayers with quality customer service is a key component in the IRS's mission. The IRS continues to take action to assist victims of identity theft. The IRS established a single point of contact to assist identity theft victims and resolve their cases efficiently. The IRS also sent notifications to victims that provided instructions about the actions they can take to reduce the burden of identity theft. While these are positive steps, TIGTA identified other areas that need improvement to better assist identity theft victims.¹⁷ For instance, taxpayers eligible to obtain an Identity Protection Personal Identification Number may not be aware of their eligibility due to a lack of IRS advertising for its Identity Protection Personal Identification Number Opt-In Program. In addition, the IRS did not issue notices to the parents or legal guardians of 133,864 dependents that it identified as employment identity theft victims in Processing Year 2019.

Another area for improvement is the Free File Program. The Free File Program is a private-public partnership between the IRS and Free File Inc. to provide online Federal tax preparation and electronic filing to economically disadvantaged and underserved populations at no cost to the individual or the Government. TIGTA recently reported that the complexity, confusion, and lack of taxpayer awareness about the operation and requirements of the Free File Program are contributing reasons why many eligible taxpayers do not participate in the Program.¹⁸ During Processing Year 2019, only 2.5 million (2.4 percent) of the 104 million eligible taxpayers obtained a free return filing through the Program. In contrast, more than 34.5 million taxpayers, who met Free File Inc. members' Free File Program criteria, used the members' commercial software to file their tax return. TIGTA estimates that more than 14 million taxpayers met the Free File Program criteria and may have paid a fee to electronically file their Federal tax return in the 2019 Filing Season.

Additionally, the IRS's actions in response to the pandemic will continue to affect its ability to provide timely customer service and tax return processing. The closure of the processing sites resulted in significant backlogs of work. As of August 21, 2020, the IRS estimates it still has more than 7.3 million pieces of unopened mail, as well as 4.3 million paper individual tax returns and 3.3 million paper business tax returns that need to be processed. In addition, the IRS has more than 737,000 tax returns in its Error Resolution inventory. The IRS has reopened 211 (59 percent) of its 358 Taxpayer Assistance Centers with limited services, and 83 (78 percent) of its 107 toll-free lines.

¹⁷ TIGTA, Ref. No. 2020-45-070, *Taxpayer First Act: Implementation of Identity Theft Victim Assistance Provisions* (Sept. 2020).

¹⁸ TIGTA, Ref. No. 2020-40-009, *Complexity and Insufficient Oversight of the Free File Program Result in Low Taxpayer Participation* (Feb. 2020).

MODERNIZING IRS OPERATIONS

Modernization is vital to the IRS's core functions: serving taxpayers, processing tax returns and payments, and enforcing the tax laws. To ensure that the IRS fulfills its mission over the long term, the IRS will need to update legacy computing infrastructure and business operations. The IRS budgeted \$300 million for the modernization effort in FY 2019 and an equal amount in FY 2020. In April 2019, the IRS issued its Integrated Modernization Business Plan, which is a six-year road map to improve the taxpayer experience by modernizing core tax administration systems, IRS operations, and cybersecurity. However, Modernization efforts will not be complete at the end of the six years, but the IRS believes it will be better positioned for future successes. According to the IRS, the Plan's success is dependent on a number of legislative proposals and regulatory authorities, which include the Direct Hire Authority for Information Technology modernization positions (granted to Federal agencies in April 2019), Streamlined Critical Pay (granted by the Taxpayer First Act), and funding for multiple fiscal years at somewhat predictable intervals.

While legacy systems are critical for many organizations because they support key mission functionalities, the systems carry significant risks, including increased cybersecurity threats and maintenance costs. TIGTA reported that the IRS's management of its legacy systems can be improved.¹⁹ Specifically, the IRS does not have an enterprise-wide definition or a complete and accurate inventory of legacy systems, nor has it developed specific or long-term plans to address updating, replacing or retiring most of its legacy systems. TIGTA also reported that the IRS generally does not capture operations and maintenance costs at the system or subsystem levels, only at the investment level. As a result, the IRS does not have sufficient and detailed cost data that can be used in its decision-making processes to prioritize its legacy system modernization efforts.

To help modernize operations, the IRS is planning to invest in cloud services. While the IRS created an enterprise-wide cloud strategy that was approved and authorized in December 2017, the strategy has not been updated to reflect current Federal and Department of the Treasury guidance and requirements.²⁰ Without an updated cloud strategy, the IRS may miss the opportunity to deliver public value by increasing operational efficiency and responding faster to taxpayer needs.

IMPROVING TAX REPORTING AND PAYMENT COMPLIANCE

One of the IRS's key responsibilities is to ensure that taxpayers comply with the tax law. The gross Tax Gap is the estimated difference between the amount of tax that taxpayers should pay and the amount paid voluntarily and on time. The average annual gross Tax Gap is estimated to be \$441 billion for Tax Years 2011 through 2013, and approximately \$39 billion (9 percent) is due to nonfilers.²¹ According to the IRS,

¹⁹ TIGTA, Ref. No. 2020-20-044, *Legacy Systems Management Needs Improvement* (Aug. 2020).

²⁰ TIGTA, Ref. No. 2020-20-010, *The Enterprise Cloud Program Developed a Strategy, but Work Remains to Achieve Cloud-Based Modernization Goals* (Mar. 2020).

²¹ Nonfilers are taxpayers who do not timely file a required tax return and timely pay the tax due for such delinquent returns.

high-income nonfilers, although fewer in number, contribute to the majority of the nonfiler Tax Gap.

In May 2020, TIGTA reported that the IRS was not working high-income nonfiler cases owing billions of dollars.²² TIGTA's analysis of Tax Years 2014 through 2016 data identified 879,415 high-income nonfilers who did not have a satisfied filing requirement with an estimated tax due of \$45.7 billion. The top 100 high-income nonfilers for Tax Years 2014 through 2016 have estimated tax due of approximately \$9.9 billion, making up 22 percent of the \$45.7 billion associated with the 879,415 high-income nonfilers.

TIGTA also reported that the IRS could better use Currency Transaction Reports (CTR)²³ to improve its compliance activities.²⁴ The IRS considers CTR information useful to identify cash activity that may not be reported accurately on the income tax return. It may lead the examiner to discover sources of unreported income. However, some subjects of the CTRs with significant dollar amounts of cash transactions may not be filing income tax returns. TIGTA found that 5,266 subjects of the CTRs totaling more than \$1.9 billion did not file income tax returns for Tax Year 2017; however, the IRS is not using the data to identify these nonfilers.

Large corporation (those with assets of \$10 million or more) tax noncompliance contributes an estimated \$26 billion to the average annual underreporting Tax Gap. The IRS uses a computer model, the Discriminant Analysis System (DAS), to systemically score the examination potential for Form 1120, *U.S. Corporation Income Tax Return*, tax returns with total assets of \$10 million or more. Generally, the higher the score, the greater the audit potential. However, TIGTA reported that the IRS could improve the DAS model to better identify returns with a higher likelihood of potential tax adjustment.²⁵ We analyzed 10,755 returns closed in the DAS workstream during FYs 2015 through 2018 and found that 47 percent were closed with no change to the tax return. Although the IRS is updating the DAS model to improve the no-change rates, TIGTA found that it is not leveraging all available examination information, such as the examination scope and knowledge on productive issues, when developing new formulas, and it plans to test new formulas only on returns that are nearly a decade old.

REDUCING FRAUDULENT CLAIMS AND IMPROPER PAYMENTS

The Office of Management and Budget describes an improper payment as any payment that should not have been made, was made in an incorrect amount, or was made to an

²² TIGTA, Ref. No. 2020-30-015, *High-Income Nonfilers Owing Billions of Dollars Are Not Being Worked by the Internal Revenue Service* (May 2020).

²³ Federal law requires financial institutions to report currency (cash or coin) transactions of more than \$10,000 conducted by, or on behalf of, one person, as well as multiple currency transactions that aggregate to more than \$10,000 in a single day. The Financial Crimes Enforcement Network Form 112, *Currency Transaction Report*, is used to report these transactions.

²⁴ TIGTA, Ref. No. 2020-30-055, *The Accuracy of Currency Transaction Report Data in IRS Systems Should Be Improved to Enhance Its Usefulness for Compliance Purposes* (Sept. 2020).

²⁵ TIGTA, Ref. No. 2020-30-031, *The Large Case Examination Selection Method Consistently Results in High No-Change Rates* (June 2020).

ineligible recipient. The Improper Payments Information Act of 2002²⁶ requires Federal agencies, including the IRS, to estimate the amount of improper payments and report to Congress annually on the causes of and the steps taken to reduce improper payments. The Earned Income Tax Credit (EITC) has been identified as a high-risk program, and as such, the IRS must include the rate and amount of improper payments in the Department of the Treasury's annual Agency Financial Report.

For FY 2019, in response to TIGTA recommendations, the IRS correctly rated the Additional Child Tax Credit (ACTC), the American Opportunity Tax Credit (AOTC), and the Net Premium Tax Credit (PTC) as also being susceptible to significant improper payments, *i.e.*, high risk, similar to the EITC.²⁷ The IRS estimates it issued approximately \$27.2 billion in potentially improper EITC, ACTC, AOTC and Net PTC payments in FY 2019. This represents a significant loss to both the Federal Government and taxpayers. TIGTA remains concerned about the IRS's inability to significantly reduce these payments.

Congress provided the IRS with tools to address taxpayers identified as submitting fraudulent or reckless refundable credit claims. These tools include the authority to assess the erroneous refund penalty, to require taxpayers to recertify that they meet refundable credit eligibility requirements for credits claimed on a return filed subsequent to disallowance of a credit, and to apply two-year or 10-year bans on taxpayers who disregard credit eligibility rules.

However, TIGTA reported that the IRS does not use the tools provided by Congress to the fullest extent possible to address erroneous credit payments.²⁸ While the IRS assessed the erroneous refund penalty on 3,190 returns, TIGTA identified 494,555 taxpayers with more than \$2.6 billion in withholding and refundable credits that were disallowed for Tax Years 2015, 2016, and 2017 for which almost \$534.7 million in potential penalties was not assessed. In addition, TIGTA identified 289,059 returns processed during Calendar Year 2018 for which the IRS did not verify the taxpayers' eligibility before recertifying them to receive a refundable credit. These taxpayers received more than \$532 million in refundable credits.

Since Calendar Year 2012, TIGTA has issued several reports addressing weaknesses in the IRS's Individual Taxpayer Identification Number (ITIN) program that increase the risk that individuals filing questionable applications will be assigned an ITIN.²⁹ While the IRS has made some improvements, there are indications that there is a reduced emphasis on identifying questionable ITIN applications.³⁰ For example, the IRS does not require individuals to show they have a tax filing need, *i.e.*, provide a tax return prior

²⁶ Pub. L. No. 107-300, 116 Stat. 2350.

²⁷ TIGTA, Ref. No. 2020-40-025, *Improper Payment Reporting Has Improved; However, There Have Been No Significant Reductions to the Billions of Dollars of Improper Payments* (Apr. 2020).

²⁸ TIGTA, Ref. No. 2020-40-008, *Authorities Provided by the Internal Revenue Code Are Not Effectively Used to Address Erroneous Refundable Credit and Withholding Credit Claims* (Feb. 2020).

²⁹ An ITIN is issued by the IRS to individuals who are required to have a Taxpayer Identification Number for Federal tax purposes but do not have and are not eligible to obtain a Social Security Number.

³⁰ TIGTA, Ref. No. 2020-40-064, *Processes Do Not Ensure That Individual Taxpayer Identification Numbers Are Issued Only to Qualifying Individuals With a Tax Administration Need* (Sept. 2020).

to renewing their ITIN. The IRS renewed 38,597 ITINs between January 2017 and April 2019 for the purpose of filing a tax return that have not been used on a tax return since being renewed.

INCREASING INTERNATIONAL TAX COMPLIANCE

Complexity and change in the international tax environment require that the IRS collaborate with tax administrations of foreign countries to enforce compliance. The IRS must continue to focus significant efforts on global tax cooperation and tax administration practices that can prevent and resolve disputes among countries to increase certainty for taxpayers. In most cases, foreign persons³¹ are subject to U.S. tax of 30 percent³² on their U.S. source income. The U.S. tax owed is generally withheld from payments made to foreign persons by a withholding agent.³³ Withholding agents are required to file Forms 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, to report on an individual taxpayer basis the income and withholding for each foreign person. For Tax Year 2017, the IRS received 6.3 million Forms 1042-S from 49,618 withholding agents. These agents reported U.S. tax withholdings totaling more than \$528 billion.

In response to our prior recommendations, the IRS has implemented processes to improve its identification of reporting discrepancies for Federal tax withheld on U.S. source income paid to foreign individuals. However, these processes did not identify some withholding tax discrepancies. TIGTA reported that IRS processes did not identify 1,919 withholding agents with reporting discrepancies totaling more than \$182.7 million.³⁴ Our review also identified 366 withholding agents that claimed \$506 million more in credits for tax withheld than was reported on the Forms 1042-S.

In addition, partnerships conducting business in the United States are required to withhold taxes on certain income paid to foreign partners.³⁵ The withholding serves as an incentive for foreign partners to file the appropriate U.S. tax return. However, TIGTA reported that the IRS's compliance efforts in this area can be improved.³⁶ TIGTA identified significant errors in the database that the IRS uses to track withholding reported by partnerships, which limits the IRS's ability to verify withholding credits and accurately identify potential nonfilers.

³¹ A foreign individual is any person that is not a U.S. person, including a nonresident alien, a foreign corporation, a foreign partnership, a foreign trust, or a foreign estate.

³² A reduced rate, including exemption, may apply when there is a tax treaty between the United States and the country of residence for the foreign individual.

³³ A withholding agent is any U.S. or foreign entity (individual, corporation, partnership, *etc.*) that takes receipt of, has control or custody of, or disposes of or makes a payment of any income to a foreign individual that is subject to withholding.

³⁴ TIGTA, Ref. No. 2020-40-021, *Continued Efforts Are Needed to Address Billions of Dollars in Reporting and Payment Discrepancies Relating to Tax Withheld From Foreign Persons* (June 2020).

³⁵ A foreign partner can be a foreign corporation, foreign partnership, and any other person who is not a U.S. citizen.

³⁶ TIGTA, Ref. No. 2020-30-026, *Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved* (June 2020).

Foreign individuals are also required to pay tax related to the sale of U.S. real estate. Specifically, the Foreign Investment in Real Property Tax Act (FIRPTA) of 1980³⁷ imposes an income tax on foreign persons selling U.S. real property interests. Buyers are required to withhold a percentage of the anticipated taxes due on the amount realized from the sale. A foreign seller of U.S. property can claim a credit for the tax withheld by the buyer. If the seller's tax liability is less than the amount of tax withheld, the seller gets a refund of the difference. TIGTA reported that the IRS's reconciliation processes do not effectively identify and address FIRPTA reporting and payment noncompliance.³⁸ TIGTA identified 2,988 buyers with discrepancies of more than \$688 million between the withholding reported on Forms 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*, filed during Processing Year 2017 and the withholding assessed to the buyer's tax account. Extensive data inaccuracies in the FIRPTA database, incorrect and unclear guidelines, and employee errors contributed to these discrepancies.

The IRS also has not established processes to use Form 1099-S, *Proceeds from Real Estate Transactions*, to identify buyers that do not report and pay FIRPTA withholdings. TIGTA's analysis of Forms 1099-S for Tax Year 2017 identified approximately \$22 million in FIRPTA withholding that was not reported and paid to the IRS. Finally, employee errors resulted in 1,835 foreign individuals potentially receiving more than \$60 million in FIRPTA withholding credits than they were entitled.

PROTECTING TAXPAYER RIGHTS

The IRS must balance tax compliance activities to enforce the tax code while at the same time upholding taxpayer rights. The IRS continues to dedicate significant resources and attention to complying with the taxpayer rights provisions of the IRS Restructuring and Reform Act of 1998.³⁹

The IRS Restructuring and Reform Act of 1998 requires TIGTA to audit certain taxpayer rights provisions and report whether the IRS complied with those provisions. While overall compliance has improved, TIGTA continues to identify areas in which the IRS can improve. For example, during the review of the IRS's compliance with the prohibition against referring to taxpayers as Illegal Tax Protesters or similar designations, TIGTA found that IRS employees used these designations in some case narratives or case review comments.⁴⁰ Also, during the audit to determine whether the IRS improperly withheld information requested by taxpayers, we found that for 15 (17 percent) of the 87 cases reviewed, the IRS did not follow Freedom of Information

³⁷ 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).

³⁸ TIGTA, Ref. No. 2020-40-014, *Millions of Dollars in Discrepancies in Tax Withholding Required by the Foreign Investment in Real Property Tax Act Are Not Being Identified or Addressed* (Mar. 2020).

³⁹ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 19 U.S.C., 22 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C. and 49 U.S.C.).

⁴⁰ TIGTA, Ref. No. 2020-30-057, *Fiscal Year 2020 Statutory Audit of Compliance With Legal Guidelines Prohibiting the Use of Illegal Tax Protester and Similar Designations* (Sept. 2020).

Act⁴¹ requirements when redacting information, even though managers had reviewed these cases for accuracy.⁴²

TIGTA also evaluated the IRS's compliance with asset seizure legal provisions.⁴³ TIGTA reviewed 205 (60 percent) of the 342 seizures the IRS conducted from July 1, 2018, through June 30, 2019. TIGTA identified instances in which the IRS did not comply with a particular Internal Revenue Code section or internal procedure and identified IRS procedures that are problematic and result in potentially unfair outcomes.

Additionally, Collection Due Process hearing provisions are designed to give taxpayers an opportunity for an independent review to ensure that the levy action that has been proposed or the Notice of Federal Tax Lien that has been filed is warranted and appropriate. During the review of the IRS Office of Appeals Collection Due Process Program, TIGTA identified some hearing processing errors that were similar to errors identified in prior reports.⁴⁴ We determined that the IRS did not always classify taxpayer requests properly and, as a result, some taxpayers received the wrong type of hearing. In addition, the Collection function did not timely forward misdirected cases to the correct location, and taxpayer accounts had Collection Statute Expiration Date⁴⁵ errors due to incorrectly input suspension start and stop dates. In some cases, TIGTA determined that the incorrect Collection Statute Expiration Date allowed the IRS additional time to collect delinquent taxes.

CONCLUSION

This memorandum is provided as our annual summary of the major management and performance challenges confronting the IRS in FY 2021. TIGTA's *Fiscal Year 2021 Annual Audit Plan* and *Fiscal Year 2021 Inspections and Evaluations Program Plan* contain our proposed reviews. 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: Assistant Secretary for Management
Deputy Chief Financial Officer
Commissioner of Internal Revenue

⁴¹ 5 U.S.C. § 552.

⁴² TIGTA, Ref. No. 2020-10-038, *Fiscal Year 2020 Mandatory Review of Compliance With the Freedom of Information Act* (July 2020).

⁴³ TIGTA, Ref. No. 2020-30-058, *Fiscal Year 2020 Review of Compliance With Legal Guidelines When Conducting Seizures of Taxpayers' Property* (Sept. 2020).

⁴⁴ TIGTA, Ref. No. 2020-10-054, *Review of the Independent Office of Appeals Collection Due Process Program* (Aug 2020).

⁴⁵ The Collection Statute Expiration Date is the expiration of the time period established by law to collect taxes.