JENNY L. JOHNSON WARE, Partner, McDermott Will & Emery LLP.

Practice

The IRS and Its Auditor: Using TIGTA Reports to Understand and Predict IRS Enforcement Priorities

By Jenny L. Johnson Ware*

The Treasury Inspector General for Tax Administration (TIGTA) provides independent oversight of the Internal Revenue Service (IRS). One of its key functions involves auditing IRS programs, operations, and activities, ostensibly to ensure that resources are allocated to the "areas of highest vulnerability to the nation's tax system."[1] TIGTA's audit process and the interplay between TIGTA and the IRS give tax practitioners valuable insights into current IRS procedures, potential shifts in enforcement priorities, and the difficulties facing a resource-strapped agency.

TIGTA's Audit Process

In October of each year, TIGTA submits to the Secretary of the Treasury a letter summarizing the most serious management and performance challenges confronting the IRS. TIGTA also prepares an Annual Audit Plan describing the audits TIGTA intends to start during the upcoming fiscal year. Each year, TIGTA conducts a number of audits focused on various aspects of the IRS's compliance and enforcement programs.

TIGTA initiates its audits through an engagement letter and opening conference with IRS managers coordinated by the Legislative Affairs Division of the IRS. TIGTA's audit staff interview IRS personnel, review files and documents, and conduct auditing tests of systems and processes. At the conclusion of that fieldwork, the auditors prepare a draft report summarizing the audit findings, conclusions, and recommendations. The audit staff then hold an exit conference with IRS management to discuss the results and recommendations, verify the information is accurate, and obtain management's perspective on the issues. A formal draft report is issued from the Deputy Inspector General for Audit to the IRS Commissioner for formal response, typically requested within 30 days. The formal response is included in the final report, which is issued to the IRS Commissioner and typically made available to the public.

IRS Response to TIGTA's Recommendations

TIGTA's final audit reports generally incorporate or attach a detailed response from IRS management that describes plans for implementing at least some of TIGTA's recommendations. In a more unusual move, the IRS issued an agency statement in September 2020, expressing frustration with TIGTA's failure to consider the limited resources available to the IRS. On the heels of separate TIGTA reports recommending allocation of more resources to collecting unpaid taxes from high-income nonfilers, tax return preparers, and individual taxpayers with large business losses and no income, the IRS stressed that it does not have "sufficient resources to implement a series of competing TIGTA recommendations."[2]

> While many recommendations may appear to have merit when viewed in isolation, the IRS must develop compliance plans to balance coverage across all return and taxpayer types and then allocate resources holistically .... Without acknowledging in each report the difficult task of allocating limited resources, the recommendations present an unrealistic picture of the issue and oversimplify its possible solution. This misleads both the public and policy makers into possibly believing that such compliance and enforcement issues can be easily resolved.[3]

This response from the IRS highlights that: (1) it would be naïve to anticipate wholesale implementation of TIGTA's recommendations, and (2) complex resource allocation issues play a critical role in the determining which taxpayers and tax return types are prioritized for enforcement.

Recent Reports

During 2020, TIGTA completed a number of audits that provide interesting information regarding weaknesses in current enforcement procedures and the strategies IRS management may or may not adopt to improve compliance.

The Growth of the Marijuana Industry Warrants Increased Tax Compliance Efforts and Additional Guidance, March 30, 2020

TIGTA identified compliance risks when cash-intensive marijuana businesses fail to report all income and deduct expenses not allowed under Section 280E, which prohibits the deduction of expenses incurred in trafficking controlled substances. The audit report and the IRS response describe existing compliance projects, training and staffing, including the designation of a "National Champion" and eight "Area-level Champions" who provide oversight for examinations in the marijuana industry.

TIGTA made six recommendations and reported IRS agreement with five of the six. Review of the IRS response, however, reveals a lack of any meaningful commitment to change its approach. For example, in response to a recommendation that the IRS develop a comprehensive compliance program for the marijuana industry and leverage State marijuana business lists to identify noncompliant taxpayers, IRS wrote "[w]hether we pursue taxpayers in the marijuana industry, or any other industry, depends upon IRS priorities and availability of resources." In response to a recommendation that the IRS develop guidance specific to the marijuana industry, IRS responded that it already has an audit technique guide for cash intensive businesses. TIGTA also noted that its audit work was impaired because IRS refused to use existing information sharing agreements with State agencies to assist in identifying cash-based businesses that underreport or fail to file returns. IRS responded that requesting such information solely for use by TIGTA was outside the scope of the memorandums of understanding with the States, which govern requests for which the IRS has a compliance need. IRS did, however, pledge to review the publicly available State tax information and agreements "to determine whether and how they could be legally, systematically, effectively, and efficiently used in compliance activities."

High-Income Nonfilers Owing Billions of Dollars Are Not Being Worked by the Internal Revenue Service, May 29, 2020

TIGTA found that there were nearly 880,000 high-income nonfilers with an estimated tax due of $45.7 billion for tax years 2014–2016. TIGTA previously focused significant attention on lapses in IRS nonfiler enforcement in reports issued in 2016 and 2017, resulting in revisions to the IRS nonfiler strategy in 2018. In this latest review, TIGTA acknowledged the existence of an improved strategic framework but emphasized that hundreds of thousands of high-income nonfilers from 2014 through 2016 have still gone unaddressed. The report illustrates the ongoing dialogue between TIGTA and the IRS, with TIGTA making recommendations, IRS responding, and TIGTA replying in further support of its recommendations. The IRS response, unsurprisingly, focuses on its resource challenges, including the fact that IRS lost a third of its enforcement personnel, including half of its revenue officers, due to budget constraints since 2010. Advocating for additional funding, the response argued that the "audit findings made a good case for a program integrity cap adjustment allowing Congress to appropriate funding for IRS enforcement initiatives on the basis that the initiatives are projected to generate a positive return on investment." The response also highlighted some of the innovative strategies the IRS has implemented in an effort to do more with less, including Revenue Officer Compliance Sweeps that are publicized to enhance their impact.

The Large Case Examination Selection Method Consistently Results in High No-Change Rates, June 20, 2020

TIGTA found that the IRS Large Business & International Division's Discriminant Analysis System (DAS) used to select returns for audit resulted in no-change audits 47% of the time, resulting in ineffective use of IRS resources and burdening compliant taxpayers. The report described recent efforts by the IRS to use data analytics, combined with input from IRS compliance employees and feedback from the tax community, to select better work. The report categorized examinations into fast (less than 150 examiner hours), average (150 to 200 hours), and slow (more than 250 hours), and found that 44% of the no-change audits involved more than 200 hours of examiner time. LB&I management conducted a division-wide employee survey asking why the no-change rates are so high and how they can be reduced. The top three causes cited by employees were case assignment and quality, a flawed risk assessment process, and insufficient time to work cases properly. TIGTA and IRS management clashed on some of the specifics related to the data selection and modeling, but IRS released a new DAS model in April 2020 and implemented a plan to minimize the hours spent on no-change audits. The IRS response also noted that it is shifting its compliance resources away from DAS-source work to other compliance programs, such as Large Corporate Compliance and Campaigns.

Individual Returns with Large Business Losses and No Income Pose Significant Compliance Risk, September 28, 2020

TIGTA initiated this audit to evaluate whether the IRS effectively identifies noncompliance among Schedule C filers. Noting that less than 1 percent of returns filed during calendar year 2017 were examined in fiscal year 2018, TIGTA emphasized the need for a workload selection process that effectively identifies tax returns that present the largest risks to tax compliance. The report identified ten strategies used by the IRS Small Business / Self Employed (SB/SE) Division's Examination function to select inventory, with 45% of closed examinations in fiscal years 2014 through 2018 selected through the Discriminant Function (DIF) scoring methodology. Although LB&I and the Tax Exempt and Government Entities (TEGE) divisions have moved in the direction of becoming more issue-based in their audit selection techniques, SB/SE management indicated to TIGTA that SB/SE is not configured to transition to an issue-based approach. TIGTA recommended that IRS conduct a national Compliance Initiative Project on tax returns with at least one Schedule C, no gross receipts, and more than $100,000 on losses. IRS disagreed, disputing TIGTA's methodology, defending its current coverage of Schedule C filers, and calling attention to its limited resources. IRS did note that "[b]eginning in FY 2020, we have a renewed focus on the compliance of high-income taxpayers and on combating fraud."

More Enforcement and a Centralized Compliance Effort Are Required for Expatriation Provisions, September 28, 2020

U.S. citizens relinquishing their citizenship and long-term residents terminating their U.S. residency are required to file Form 8854, Initial and Annual Expatriation Statement, by which they certify that they have been in compliance with Federal tax laws during the five years preceding the year of expatriation and determine if they are a "covered expatriate" for purposes of the exit tax in Section 877A. With the number of expatriating taxpayers increasing significantly since 2008, TIGTA initiated an audit to determine the effectiveness of the IRS's efforts in ensuring compliance with the exit tax. TIGTA found that the IRS did not have a centralized compliance effort aimed at enforcing the expatriate rules. The IRS has an expatriate database, but did not use it to identify or address expatriates who failed to comply with the exit tax. TIGTA determined that IRS assigned responsibilities related to expatriates to the Philadelphia campus, but that those duties were limited to collecting and publishing the data required by Section 6039G and did not include any enforcement activity. Over the 10-year period from 2008 through 2018, 41% of individuals required to send a copy of Form 8854 to the Philadelphia campus did not do so, but the IRS had no procedures in place for securing the missing forms.

TIGTA made five specific recommendations to which IRS agreed. The report also described an Expatriation Campaign announced by IRS LB&I on July 19, 2019, involving soft letters, outreach and education, and examinations. The IRS response to TIGTA's findings described the compliance campaign and committed to assessing initial campaign results, compliance risks, available resources, and organizational priorities to determine what modifications should be made to the campaign, to the expatriation database, to Form 8854 and to the procedure for requesting information missing from incomplete Forms 8854.

Conclusions

TIGTA's audits and IRS's responses frequently highlight the difficulties the IRS is facing as a result of its limited resources and aging workforce. Comparing and contrasting the IRS responses to different audit reports, however, can provide meaningful insights into current enforcement priorities. The response to the report on expatriation, in which the IRS described its recent compliance campaign and agreed to all of the recommendations from TIGTA, differs markedly from the responses where budget constraints play a prominent role in defending existing processes. The ongoing dialogue between IRS management and TIGTA in these audit reports shows that priorities of IRS management drive the allocation of enforcement resources and that those priorities are more complex than predicted return on investment in the form of revenue collection.

ENDNOTES

* The author can be reached at *jjohnsonware@mwe.com*.

[1] *www.treasury.gov/tigta/about_what.shtml*.

[2] TIGTA Report: Individual Returns with Large Business Losses and No Income Pose Significant Compluace Risk, September 28, 2020, Reference Number 2020-30-056, IRS Statement in Response to the Report.

[3] *Id.*