



*Fiscal Year 2005 Statutory Audit of
Compliance With Legal Guidelines
Restricting the Use of Records
of Tax Enforcement Results*

September 2005

Reference Number: 2005-40-157

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 21, 2005

MEMORANDUM FOR DEPUTY COMMISSIONER FOR OPERATIONS SUPPORT

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Fiscal Year 2005 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results (Audit # 200540023)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) complied with legal guidelines set forth in IRS Restructuring and Reform Act of 1998 (RRA 98) Section 1204.¹

Synopsis

RRA 98 Section 1204 (a) prohibits the IRS from using any records of tax enforcement results (ROTTER) to evaluate employees or to impose or suggest production quotas or goals. Section 1204 (b) requires employees to be evaluated using the fair and equitable treatment of taxpayers as a performance standard. Section 1204 (c) requires each appropriate supervisor to certify quarterly whether tax enforcement results were used in a prohibited manner. The Treasury Inspector General for Tax Administration is required under Internal Revenue Code Section 7803(d)(1) (2000) to annually evaluate the IRS' compliance with the provisions of RRA 98 Section 1204.

Managers in the IRS Small Business/Self-Employed (SB/SE) and Wage and Investment (W&I) Divisions had not used ROTERs or production quotas or goals to evaluate manager performance for the Section 1204 first-line managers we statistically sampled. These managers had been

¹ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).



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evaluated using the updated evaluation form² that included an assessment of the employees' performance on the fair and equitable treatment of taxpayers.

In addition, the SB/SE and W&I Division first-line managers identified as Section 1204 managers were appropriately certifying to their immediate supervisors that they did not use ROTERs to evaluate Section 1204 employees.

In October 2004, the IRS discontinued the requirement for executives to obtain waivers for activities that do not involve Section 1204 work and for individual managers that were not required to participate in the Section 1204 self-certification process. This eliminated the control the IRS had established to ensure Section 1204 managers were accurately identified and monitored. The scope of the Independent Review of Section 1204 managers' performance documentation should be expanded to include an assessment as to whether the managers designated as non-Section 1204 managers were accurately classified.

Recommendation

The Chief Financial Officer (CFO) should establish a control to ensure managers are accurately designated as Section 1204 managers or non-Section 1204 managers. For example, the CFO could expand the scope of the Independent Review to include an assessment of the accuracy of managers designated as non-Section 1204 managers.

Response

The IRS agreed with our recommendation and the CFO will expand the scope of the annual Independent Review process to include a review of a random sample of non-Section 1204 managers in an effort to validate the accuracy of that designation. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

² IRS Performance Management System Manager Performance Agreement (Form 12450-A (Rev. 10-2000)).



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Background

On July 22, 1998, the President signed the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98) into law.¹ Among many other requirements contained in the law, Section 1204 restricts the use of enforcement statistics. Specifically, RRA 98 Section 1204 (a) prohibits the IRS from using any record of tax enforcement results (ROTTER) to evaluate employees or to impose or suggest production quotas or goals.

The IRS defines ROTERs as data, statistics, compilations of information, or other numerical or quantitative recordation of the tax enforcement results reached in one or more cases. A ROTER does not include the tax enforcement results of an individual case when used to determine if an employee exercised appropriate judgment in pursuing enforcement of the tax laws based upon a review of the employee's work on that individual case. Examples of ROTERs include the amount of dollars collected or assessed, the number of fraud referrals, and the number of seizures conducted.

ROTTERs are data, statistics, compilations of information, or other numerical or quantitative recordation of the tax enforcement results reached in one or more cases.

RRA 98 Section 1204 (b) requires employees to be evaluated using the fair and equitable treatment of taxpayers as a performance standard. The IRS requires employees to administer the tax laws fairly and equitably; protect all taxpayers' rights; and treat each taxpayer ethically with honesty, integrity, and respect. This provision of the law was enacted to provide assurance that employee performance is focused on providing quality service to taxpayers instead of achieving enforcement results.

RRA 98 Section 1204 (c) requires each appropriate supervisor to perform a self-certification on a quarterly basis. In the self-certifications, they attest as to whether they used ROTERs in a prohibited manner. The IRS defines an appropriate supervisor as the highest-ranking executive in a distinct organizational unit that supervises directly or indirectly one or more Section 1204 employees.² IRS procedures require that, beginning with first-line managers of Section 1204 employees, each level of management self-certify that they have not used ROTERs in a manner prohibited by RRA 98 Section 1204 (a). The appropriate supervisor is to prepare a consolidated office certification covering the entire organizational unit.

¹ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

² An enforcement employee (Section 1204 employee) is one who exercises judgment in recommending or determining whether or how the IRS should pursue enforcement of tax law.



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The Assistance and Review Unit of the office of the Chief Financial Officer (CFO) coordinates the process the IRS uses to ensure compliance with Section 1204 requirements. Specifically, it provides overall program direction, coordination, and guidance to the business units and functions responsible for identifying managers of Section 1204 employees.

The IRS divisions, including the Small Business/Self-Employed (SB/SE) Division and the Wage and Investment (W&I) Division, are responsible for Section 1204 program implementation in their respective areas. We selected these two divisions for review because we believed they had the largest number of employees with Section 1204 duties. The Section 1204 Program Managers and Section 1204 Coordinators in each division provide guidance to managers regarding Section 1204 issues, support the Independent Review process, and manage the certification process.

To implement the certification process, IRS procedures require appropriate supervisors to annually identify and list all managers who supervise a Section 1204 employee or provide guidance or direction for Section 1204 activities. These lists of Section 1204 managers must be updated quarterly to ensure all managers of Section 1204 employees self-certify.

To compile these lists, the SB/SE and W&I Division Section 1204 Program Managers obtain quarterly personnel listings of all managers and cascade them to their respective Section 1204 Coordinators or staff assistants. The Section 1204 Coordinators are responsible for updating the list of all managers and ensuring the managers are properly designated as Section 1204 managers. These Section 1204 Coordinators use information from the last quarterly list and their knowledge of the work activity to identify managers who supervise a Section 1204 employee or provide guidance or direction for Section 1204 activities. The IRS did not provide specific guidelines on how this process should be completed.

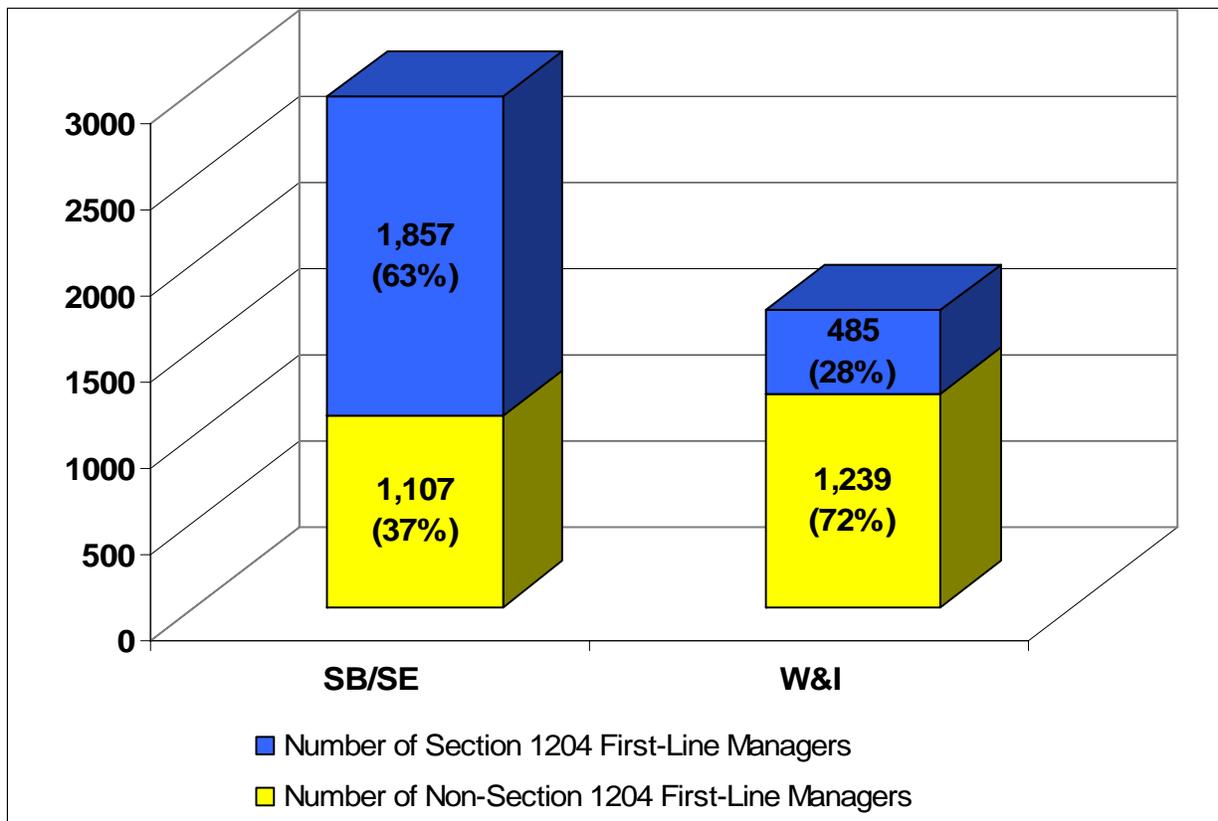
On an annual basis, the Assistance and Review Unit conducts an Independent Review to monitor the accuracy of the IRS' quarterly certification process for the previous fiscal year. An Independent Review team selects samples of Section 1204 managers at all organizational levels to review their documentation of employees' reviews.

As shown in Figure 1, as of October 1, 2004, approximately 63 percent (1,857 of 2,964) of the first-line managers in the SB/SE Division were designated as Section 1204 managers who supervise a Section 1204 employee or provide guidance or direction for Section 1204 activities. In contrast, approximately 28 percent (485 of 1,724) of the W&I Division first-line managers were designated as Section 1204 managers.



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Figure 1: Percentage of Section 1204 Managers, as of October 1, 2004



Source: IRS HR Connect³ and Division Quarterly Listings of Section 1204 Managers, as of October 1, 2004.

Internal Revenue Code Section 7803(d)(1) (2000) requires the Treasury Inspector General for Tax Administration to determine annually whether the IRS is in compliance with restrictions on the use of enforcement statistics. We have previously performed six mandatory reviews of the IRS' use of enforcement statistics in employee evaluations.

This review was performed at the IRS National Headquarters in Washington, D.C., in the offices of the CFO, the Chief Human Capital Officer, and the SB/SE Division Headquarters, and in the W&I Division Headquarters in Atlanta, Georgia, during the period February through July 2005.

³ HR Connect is the Department of the Treasury's primary human resources system.



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The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

Small Business/Self-Employed Division and Wage and Investment Division Managers Had Appropriately Not Used Records of Tax Enforcement Results

SB/SE Division and W&I Division managers effectively implemented the provisions of RRA 98 Section 1204 in evaluating Section 1204 first-line managers. Managers had not used ROTERs or production quotas or goals to evaluate manager performance for the 82 SB/SE Division and 72 W&I Division Section 1204 first-line managers we statistically sampled. These managers had been evaluated using the updated evaluation form⁴ that included an assessment of the employees' performance on the fair and equitable treatment of taxpayers. Based on our statistically valid sample, we are 95 percent confident there were no inappropriate uses of ROTERs in the populations.

Managers designated as Section 1204 managers are required to self-certify on a quarterly basis that they have not used ROTERs to evaluate their employees. This serves as a frequent reminder that ROTERs should not be used when evaluating enforcement employees. In addition, the Assistance and Review Unit conducts its annual Independent Review of Section 1204 managers' evaluations in randomly selected locations. This review team randomly samples managers at these locations to determine if Section 1204 managers are in compliance with Section 1204 regarding the use of ROTERs.

By not inappropriately using ROTERs or production goals and quotas, the IRS protects the rights of taxpayers by ensuring employees are working toward collecting the correct amount of tax as opposed to fulfilling enforcement statistic quotas. This also provides the IRS both a work environment that protects taxpayer rights and a fair employee evaluation system.

A Control Is Needed to Ensure Section 1204 Managers Are Properly Identified

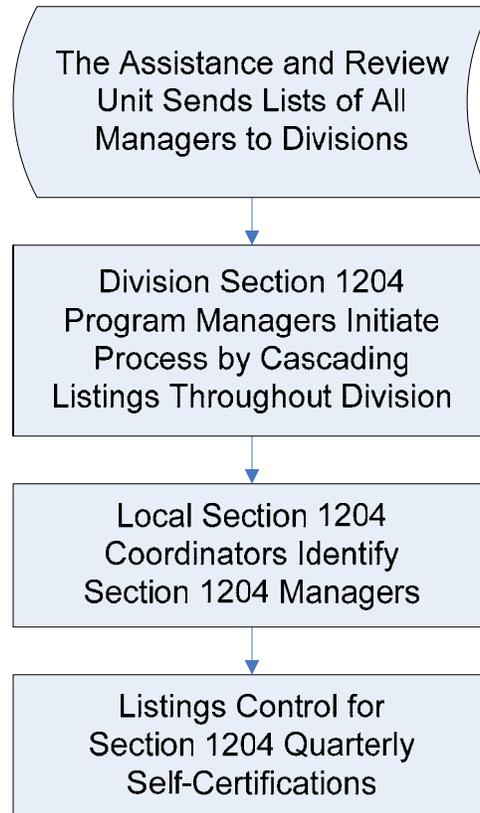
The SB/SE and W&I Divisions are required to evaluate personnel listings annually to identify managers designated as Section 1204 managers, to ensure they participate in the self-certification process. Figure 2 presents a flowchart of this process.

⁴ IRS Performance Management System Manager Performance Agreement (Form 12450-A (Rev. 10-2000)).



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**Figure 2: Process for Identifying Section 1204 Managers
(Repeats Each Fiscal Year)**



Source: Discussions with SB/SE Division and W&I Division management and personnel.

The listings should then be updated on a quarterly basis to ensure all managers are properly designated as Section 1204 managers or non-Section 1204 managers.

Prior to October 2004, the IRS used waivers as a control to ensure Section 1204 managers were appropriately identified. The IRS required waivers to be prepared annually for organizations with no Section 1204 work and for managers that were identified as non-Section 1204 managers. This process required executives who determined there was no Section 1204 work performed in their areas to request a waiver from Section 1204 certification from the appropriate supervisor. In addition, executives could also request waivers from the appropriate supervisor for individual managers in their organizations who were non-Section 1204 managers.



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However, the IRS no longer requires executives to obtain waivers.⁵ According to an October 27, 2004, memorandum from the CFO:

The waiver process was initially implemented to ensure all Section 1204 managers required to conduct quarterly self-certifications were identified and monitored. Subsequently, the Service [IRS] has made considerable progress in identifying those managers governed by Section 1204. Because [the IRS maintains] a current and accurate list of all Section 1204 managers that is updated and validated quarterly, the Office of the Chief Financial Officer determined that the waiver process is redundant, and therefore, unnecessary.

Removing the waiver process eliminated the control that had been established to ensure all Section 1204 managers required to conduct quarterly self-certifications were accurately identified and monitored. If Section 1204 managers are not properly identified, the IRS may not be accurately self-certifying to the Commissioner that they have not used ROTERs improperly.

Although we believe the waiver process was a very resource-intensive and time-consuming control, we believe there should be some control established to ensure 1) managers are accurately designated as Section 1204 managers or non-Section 1204 managers, 2) the IRS is maintaining a current and accurate list of all Section 1204 managers, and 3) the list is updated and validated quarterly. This would ensure the IRS identifies changes in managers and work area activities that involve Section 1204 work.

The Assistance and Review Unit conducts an annual Independent Review of performance documentation for managers designated as Section 1204 managers. We believe the current scope of the Independent Review could be expanded to include an assessment as to whether managers designated as non-Section 1204 managers were accurately classified.

The designation as a non-Section 1204 manager was accurate for 29 of the 47 SB/SE Division and 46 of the 47 W&I Division first-line managers we statistically sampled. In the remaining 19 instances (18 in the SB/SE Division and 1 in the W&I Division), managers that had not been designated as Section 1204 managers had actually prepared a self-certification and/or their managers confirmed that they were performing Section 1204 duties. The 18 SB/SE Division managers were transferred from the SB/SE Division to the W&I Division as of October 1, 2004, and were inadvertently omitted from the SB/SE Division Section 1204 manager listing.

⁵ Memorandum from the CFO, *Interim Guidance for Section 1204 Waiver Process*, dated October 27, 2004.



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Recommendation

Recommendation 1: The CFO should establish a control to ensure managers are accurately designated as Section 1204 managers or non-Section 1204 managers. For example, the CFO could expand the scope of the Independent Review to include an assessment of the accuracy of managers designated as non-Section 1204 managers.

Management's Response: The IRS agreed with our recommendation and the CFO will expand the scope of the annual Independent Review process to include a review of a random sample of non-Section 1204 managers in an effort to validate the accuracy of that designation.

The Small Business/Self-Employed Division and the Wage and Investment Division First-Line Managers Appropriately Completed Their Self-Certifications

The SB/SE and W&I Division first-line managers identified as Section 1204 managers were certifying to their immediate supervisors that they did not use ROTERs to evaluate Section 1204 employees. The 82 SB/SE Division and 72 W&I Division first-line managers we statistically sampled each appropriately completed and forwarded their self-certifications to the next level of management. Based on our statistically valid sample, we are 95 percent confident first-line managers in the populations appropriately completed and forwarded their self-certifications.

RRA 98 Section 1204 requires specific managers to certify quarterly in writing to the IRS Commissioner as to whether ROTERs are used in a prohibited manner (i.e., to evaluate their employees or to impose or suggest production quotas or goals). To do this, the IRS requires all managers who evaluate Section 1204 employees to certify to their immediate supervisors that they have not used ROTERs to evaluate their employees.

The SB/SE and W&I Division Section 1204 Program Managers and Section 1204 Coordinators monitor the quarterly certification process throughout their respective organizations. The Program Managers' and Section 1204 Coordinators' duties include providing guidance to managers regarding Section 1204 issues, supporting the Independent Review process, and managing the certification process.

The IRS has effectively implemented Section 1204 requirements. As a result of ensuring ROTERs or production goals and quotas are not used to evaluate first-line managers, the IRS is protecting the rights of taxpayers by ensuring employees are working toward collecting the correct amount of tax as opposed to fulfilling enforcement statistic quotas.



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Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to determine whether the Internal Revenue Service (IRS) complied with legal guidelines set forth in IRS Restructuring and Reform Act of 1998 (RRA 98)¹ Section 1204, which prohibit the IRS from using any record of tax enforcement results (ROTTER) to evaluate employees or to impose or suggest production quotas or goals. To accomplish this objective, we:

- I. Determined if the Small Business/Self-Employed (SB/SE) Division and the Wage and Investment (W&I) Division complied with provisions of RRA 98 Sections 1204 (a) and (b) when evaluating first-line Section 1204 managers' performance.
 - A. Identified procedures used to ensure compliance with provisions of RRA 98 Sections 1204 (a) and (b) by interviewing IRS management and reviewing the Internal Revenue Manual, IRS memoranda, and the IRS Section 1204 Intranet web site.
 - B. Obtained a list of 2,469 SB/SE Division and 725 W&I Division Section 1204 managers compiled by the SB/SE and W&I Division Section 1204 Program Managers for the fourth quarter of Fiscal Year 2004.
 - C. Identified 1,857 SB/SE Division and 485 W&I Division Section 1204 first-line managers using IRS data and the listings obtained in Step I.B.
 - D. Determined our sample sizes and selected a 1-sided random sample of 82 SB/SE Division and 72 W&I Division first-line Section 1204 managers from the populations of Section 1204 first-line managers using a desired confidence level of 95 percent, an expected error rate of 2 percent, and a precision level of ± 2.50 percent. A statistical sample was taken because we wanted to estimate the numbers of managers in the populations for which ROTERS were documented when evaluating the managers' performance (if we identified any ROTERS).
 - E. Requested copies of the managers' Fiscal Year 2004 evaluations, mid-year reviews, commitments, and award documents from the SB/SE Division Liaison and the W&I Division Section 1204 Program Manager.
 - F. Reviewed the documents in Step I.E. to determine if ROTERS were documented when evaluating the managers. We also determined if managers were using the IRS

¹ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).



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- Performance Management System Manager Performance Agreement (Form 12450-A (Rev. 10-2000)) for their annual evaluations of first-line Section 1204 managers.
- II. Determined if controls were adequate in the SB/SE Division and the W&I Division to appropriately identify first-line Section 1204 managers subject to RRA 98 Section 1204.
- A. Obtained the SB/SE Division and W&I Division listings of all managers as of October 1, 2004, from the Agency-Wide Shared Services organization.
 - B. Compared the listing in Step II.A. to the listings of SB/SE Division and W&I Division first-line Section 1204 managers from Step I.C. and identified 1,107 SB/SE Division and 1,239 W&I Division first-line managers not classified as Section 1204 managers.
 - C. Determined our sample sizes and selected a random sample of 47 SB/SE Division and 47 W&I Division managers identified in Step I.B. from the populations of first-line managers not classified as Section 1204 managers using a desired confidence level of 95 percent, an expected error rate of 2 percent, and a precision level of ± 3.30 percent. A statistical sample was taken because we wanted to estimate the numbers of managers from the populations of managers not classified as Section 1204 that should have been classified as Section 1204 managers (if there were significant numbers of misclassifications).
 - D. Researched HR Connect² to identify the position and location of each manager in our samples (Step II.C.) and obtained position descriptions, critical job elements, evaluations, and job commitments for each to determine if the managers are involved in enforcement activities.
 - E. For those in our sample for which we were unable to determine the nature of the manager's assignments, contacted the appropriate Liaison/Section 1204 Program Manager/Section 1204 Coordinator for an explanation.
- III. Determined if the SB/SE and W&I Division first-line managers complied with RRA 98 Section 1204 by completing their required self-certification documents assessing whether ROTERs were being used in a prohibited manner.
- A. Identified the procedures used to ensure compliance with the provisions of RRA 98 Section 1204 (c) by interviewing IRS management, obtaining and reviewing any written documentation and guidance for achieving compliance, and reviewing other sources (such as the Section 1204 web site and previous audit work).

² HR Connect is the Department of the Treasury's primary human resources system.



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- B. Used the statistical sample of first-line managers in Step I.D. and requested copies of the self-certifications.
- C. Determined if first-line managers completed the quarterly self-certifications per the IRS guidelines and procedures.



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Appendix II

Major Contributors to This Report

Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Mary V. Baker, Director
James O'Hara, Audit Manager
Kenneth L. Carlson, Jr., Lead Auditor
Tanya Boone, Senior Auditor
Cindy J. Harris, Senior Auditor
Sharon Summers, Senior Auditor
David Lowe, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Chief Financial Officer OS:CFO
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
Director, Assistance and Review OS:CFO:AR
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Acting Director, Strategy and Finance, Wage and Investment Division SE:W:S
Acting Chief, Performance Improvement, Wage and Investment Division SE:W:S:PI
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
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 Acting Senior Operations Advisor, Wage and Investment Division SE:W:S



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Appendix IV

Management's Response to the Draft Report



CHIEF FINANCIAL OFFICER

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

RECEIVED
SEP 07 2005

September 7, 2005

MEMORANDUM FOR PAMELA J. GARDINER
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Janice Lambert *Janice Lambert*
Chief Financial Officer

SUBJECT: Fiscal Year 2005 Statutory Audit of Compliance With
Legal Guidelines Restricting the Use of Records of
Tax Enforcement Results (Audit No. 200540023)

Thank you for the opportunity to review and comment on your draft report. I am pleased your review found the Internal Revenue Service (IRS) is in compliance with Section 1204 of the IRS Restructuring and Reform Act of 1998.

I appreciate and agree with your recommendation for improving the IRS' self-certification process to ensure that managers are accurately designated as Section 1204 managers or non-Section 1204 managers. In response to your recommendation, we will expand the scope of our annual Independent Review to include an assessment to identify whether IRS employees designated as non-Section 1204 managers were accurately classified.

Our corrective action that responds to your recommendation is attached. If you have any questions, please contact Elaine T. Munroe, Director, Assistance and Review, at (202) 435-5373.

Attachment



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Attachment

Recommendation

The Chief Financial Officer (CFO) should establish a control to ensure managers are accurately designated as Section 1204 managers or non-Section 1204 managers. For example, the CFO could expand the scope of the Independent Review to include an assessment of the accuracy of managers designated as non-Section 1204 managers.

Corrective Action

The CFO will expand the scope of the annual Independent Review Process to include a review of a random sample of non-Section 1204 managers in an effort to validate the accuracy of their designation as non-Section 1204 managers and achieve a confidence level of 95 percent, an expected error rate of 2 percent, and a precision level of ± 3.30 percent.

Implementation Date

July 15, 2006

Responsible Official

Director, Assistance and Review

Corrective Action Monitoring Plan

The CFO will monitor this corrective action as a part of its internal management control system. The national Section 1204 Program Manager will provide monthly updates on the implementation of this corrective action to the Director, Assistance and Review.