

**Further Improvements Are Needed to the
Internal Revenue Service's Process for
Admitting Preparers and Transmitters Into Its
Electronic Filing Program**

September 1999

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 30, 1999

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in cursive script that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Further Improvements Are Needed to the Internal Revenue Service's Process for Admitting Preparers and Transmitters Into Its Electronic Filing Program

This report presents the results of our review of the Internal Revenue Service's (IRS) Electronic Return Originator (ERO) suitability screening process for processing year 1998. We conducted our review as part of our overall review of the Revenue Protection Strategy to evaluate the effectiveness of the consolidation of suitability screening to one site.

Overall, the Office of Electronic Tax Administration (ETA) implemented significant improvements to the suitability screening process, particularly the implementation of the consolidated site for processing new and revised applications. To further enhance this improvement, ETA management should consider more stringent enforcement of existing criteria and improved automated suitability screening.

We recommended that management ensure procedures are consistently followed in application processing and suitability decisions. We also recommended some computer programming enhancements that would strengthen the suitability process. Finally, we recommended that management ensure that prior suitability-related recommendations are implemented.

Management agreed with our recommendations, with one exception. They disagreed with our recommendation that the IRS should compare the ERO automated database to the Criminal Investigation Information System (CIMIS) database in order to identify

accepted EROs who have criminal histories. The IRS did state that it would research the CIMIS database further to determine if it could be beneficial to the Electronic Filing Program. The response of the Assistant Commissioner (Electronic Tax Administration) has been summarized in the body of the report and is included in its entirety as an appendix to the report.

Copies of this report are also being sent to IRS managers who are affected by the report recommendations. Please call me at (202) 622-6510 if you have any questions, or your staff may call Walter Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 455-2475.

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Executive Summary

The General Accounting Office (GAO) and the Internal Revenue Service (IRS) Inspection Service (now the Treasury Inspector General for Tax Administration (TIGTA)) have repeatedly reported on the high number of fraudulent refunds claimed on electronically filed returns. In October 1994, the Department of the Treasury's Under Secretary (Enforcement) testified before the Congress that up to "\$5 billion in problematic refunds [was being] paid out annually." One way the IRS acts to deter the filing of fraudulent tax returns is by controlling access to the Electronic Filing (*e-file*) program. Under this control procedure, Electronic Return Originators (EROs, also referred to as electronic return preparers and/or transmitters) are screened against established criteria prior to being accepted for the next year's Electronic Filing Program. This screening process is commonly referred to as determining the "suitability" of EROs to participate in *e-file*.

In response to a material weakness initially identified during a 1992 Federal Managers' Financial Integrity Act (FMFIA) review, the IRS centralized the national screening of the ERO suitability from 33 sites into a consolidated site. During the first centralization phase, effective for processing 1997 tax returns, the consolidated site undertook the screening of new applications for becoming EROs. The suitability screening for the remaining EROs continued to be decentralized, with the decisions on suitability being made by personnel in the 33 IRS districts.

For the 1998 filing season, the IRS determined the suitability of 19,285 new¹ applicants to participate in *e-file* as EROs. The IRS concluded that 18,780 (97 percent) of the new applicants were suitable to participate.

Our audit objective was to determine if the IRS' suitability screening process was effective in assuring that only appropriate EROs participated in the *e-file* program.

Results

For the 1998 filing season, the IRS implemented significant improvements to the suitability screening process, particularly the implementation of the consolidated site for processing new applications. To further enhance this improvement, the IRS should consider more stringent enforcement of existing criteria and improved automated suitability screening. This would help ensure that only EROs meeting minimum tax

¹ This includes both new applications and revised applications (adding additional officials to an existing ERO entity).

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compliance and background qualification requirements participate in the Electronic Filing Program in the future. This should further help limit the IRS' susceptibility to filing fraud. The results of our three primary test areas showed that:

Suitability Decisions Made on New Electronic Filing Program Applicants Were Reasonably Accurate and Consistent

The Office of Electronic Tax Administration (ETA) actions to consolidate the processing of new applications into one location resulted in reasonably accurate and consistent initial suitability decisions. Our analysis showed that consolidated site tax examiners made an accurate suitability decision on 92 of the 96 cases tested.

Annual Suitability Screening Conditions Allowed Inappropriate Electronic Return Originators to Participate in Electronic Filing

The 1998 suitability screening process could have been more effective in preventing inappropriate EROs from participating in the Electronic Filing Program. An analysis of the overall universe of EROs (new applicants and current participants) accepted to participate in *e-file* showed that 1,733 EROs had one or more inappropriate characteristics, yet were allowed to participate in the 1998 *e-file* program. A detailed analysis of 90 of these EROs showed that they transmitted 13,392 *e-file* returns, an average of 149 per ERO.

Appeal Procedures for Applicants That Failed Suitability Should Be Strengthened

During the first phase of the appeals process, 85 percent (401 of 470) of the EROs that failed suitability had the decision reversed and were admitted into the *e-file* program.

Prior Suitability-Related Recommendations Had Not Been Implemented

ETA management had not fully implemented 16 of 62 suitability-related recommendations made in relation to FMFIA, GAO, TIGTA, and *e-file* Task Force activities. For example, after repeated recommendations, management has been unable to update computer programming so that tax examiners making ERO admission decisions could be made aware *immediately* of ERO tax compliance information that could affect continued participation.

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Summary of Recommendations

The risk of allowing inappropriate preparers/transmitters to participate in the IRS' *e-file* program as EROs could be reduced by ensuring that application processing procedures are followed and that more aggressive and consistent procedures are developed to check and remove questionable preparers/transmitters from the program. IRS management should also develop procedures to ensure a separation of duties between employees responsible for the initial failed suitability decision and the employees responsible for the initial appeal decision.

ETA management also should improve suitability computer programming so participants that were identified during annual suitability as having incomplete filing data are automatically rechecked prior to the start of the filing season. Improvements should also be made to the IRS' computer systems to identify EROs and generate a report when specific transactions appear on an ERO's tax account that would affect suitability. In addition, the IRS should utilize the Criminal Investigation Management Information System (CIMIS) to more efficiently and effectively identify EROs who have a criminal history.

ETA management should review prior FMFIA, GAO, *e-file* Task Force, and TIGTA suitability-related recommendations and ensure that they are implemented.

Management's Response: ETA stated that they have taken or will take actions as a result of our recommendations. To improve the *e-file* program, ETA agreed to: (1) update procedures and/or hold meetings to ensure that consistent suitability procedures and instructions are used to check and remove questionable preparers; (2) update applicable suitability procedures to separate the appeal process from the original determination process; (3) start preliminary coordination to correct suitability programming; and (4) review prior suitability-related recommendations and determine if they should be implemented.

In addition, ETA management agreed that implementing the recommendation to develop a code on an IRS computer system, when specific transactions appear on an ERO's tax account, would provide early notification of instances that potentially impact suitability. However, ETA stated that the implications to a computer system, and the extensive programming needed, prevented their ensuring its implementation.

ETA management disagreed with our recommendation that the IRS should compare the ERO automated database to the CIMIS database to identify accepted EROs who have a criminal investigation history. However, ETA officials stated that they would research the CIMIS computer database further to determine if it could be beneficial to the Electronic Filing Program.

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Office of Audit Comments: We encourage ETA management to reconsider its decision not to use available computer based tools to help identify accepted EROs who have a criminal investigation history. We strongly believe that the use of CIMIS would provide important background information with minimal expense and fewer delays than the primary source currently used. Our limited test of CIMIS matching identified three accepted EROs who had criminal histories or criminal investigation case information.

Regarding the lack of IRS programming capability, we suggest the IRS begin to look to external alternatives if internal IRS resources remain in short supply. In addition, we also suggest ETA management closely supervise and control the review and implementation of prior FMFIA, GAO, *e-file* Task Force, and TIGTA recommendations to ensure thorough completion.

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Objective and Scope

We initiated this review as part of our overall strategy to provide coverage of the Internal Revenue Service's (IRS) revenue protection activities. For the 1998 filing season, the IRS centralized the processing of new applications for preparers and transmitters of electronic returns from 33 district offices to a consolidated site at the Andover Service Center (ANSC).

Since 1988, over \$250 million in possible fraudulent refunds from e-file returns have been detected.

These changes were made in response to a Federal Managers' Financial Integrity Act (FMFIA) revenue protection-related material weakness that found applicants "shopping" for undemanding IRS districts in which to pass suitability. Improvements were necessary in order to help attack the continual problem of fraudulent and erroneous refund claims associated with electronically filed (*e-file*) returns. Since 1988, Criminal Investigation has detected 113,642 questionable *e-file* returns, involving possible fraudulent refunds totaling over \$250 million.

Audit work was performed at the ANSC and the National Office. The audit was conducted between January and August 1998, in accordance with *Government Auditing Standards*.

Our overall objective was to determine if the IRS' suitability screening process was effective in assuring that only appropriate Electronic Return Originators (EROs) participated in *e-file*. Specifically, we determined if:

- The consolidated site was effective in screening new *e-file* applicants.
- The IRS' overall suitability screening process was effective in assuring only appropriate preparers and transmitters participated in *e-file*.
- Prior suitability-related recommendations were implemented.

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We analyzed applications processed at the consolidated site to determine the accuracy of suitability decisions made.

To accomplish our objectives we:

- Identified 12,487 applications processed at the consolidated site, as of December 18, 1997, and analyzed 96 randomly selected cases to verify the accuracy of the suitability determinations.
- Conducted a computer analysis of ERO tax accounts to identify any tax compliance conditions that could affect suitability. To verify the results of this analysis, we randomly selected cases to sample from the various categories identified.
- Conducted an in-depth analysis of 34 randomly selected appeal cases to determine the appropriateness of the appeal decisions.
- Analyzed the status of 62 prior Treasury Inspector General for Tax Administration (TIGTA), General Accounting Office (GAO), FMFIA, and *e-file* Task Force recommendations related to the suitability process.

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

Background

The GAO and the IRS Inspection Service (now the Treasury Inspector General for Tax Administration (TIGTA)) have repeatedly reported on the high number of fraudulent refunds claimed on *e-file* returns. In October 1994, the Department of the Treasury's Under Secretary (Enforcement) testified before the Congress that up to "\$5 billion in problematic refunds [was being] paid out annually." One way the IRS acts to deter the filing of fraudulent tax returns is by controlling access to the *e-file* program. Under this control procedure, EROs (also referred to as electronic return preparers and/or transmitters) are screened against established criteria prior to being accepted for the next year's Electronic Filing Program. This screening process is commonly

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Participants in the e-file program are required to have a high degree of integrity and to adhere to all tax filing requirements.

The Automated Suitability Analysis Program analyzes an IRS computer system to identify e-file applicants and participants who are not current with their tax obligations and other suitability conditions.

ETA made significant improvements to the process for reviewing new applications.

referred to as determining the “suitability” of EROs to participate in *e-file*.

One IRS revenue protection control is to screen for the suitability of all organizations and individuals that want to participate in the *e-file* program. This process verifies, among other things, that all required tax returns have been filed and tax liabilities have been satisfied. Suitability screening helps to ensure that *e-file* applicants and participants have and maintain a high degree of integrity and adhere to the highest professional and ethical standards, thus reducing the potential for fraudulent activities.

The computer-based Automated Suitability Analysis Program (ASAP) analyzes an IRS computer system for each applicant and participant for various suitability exception criteria. Cases that meet suitability exception criteria, or for which no tax records are found, are researched further to determine their suitability status. New applicants are accepted or rejected based on the results of the ASAP analysis, plus any research that may be needed. All accepted participants are rechecked annually to ensure continued adherence to the suitability standards.

As of September 2, 1997, the ANSC became the consolidated site for receiving and processing *new* electronic filing applications. In processing year 1998, annual suitability determinations continued to be made in the district offices. Since July 1998, all suitability determinations have been made at the ANSC.

Results

For 1998, the Office of Electronic Tax Administration (ETA) implemented improvements to the suitability screening process, particularly the implementation of the consolidated site for processing new applications. To enhance this improvement further, the IRS should consider more stringent enforcement of existing criteria and improved automated suitability screening. This

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would help to ensure that only electronic preparers and transmitters meeting minimum tax compliance and background qualification requirements participate in the Electronic Filing Program in the future. Also, this should help to limit the IRS' susceptibility to filing fraud. The results of our three primary test areas showed:

1. ETA's actions to consolidate the processing of *new* applications into one location resulted in reasonably accurate and consistent initial suitability decisions. Our in-depth analysis of selected suitability criteria showed that consolidated site tax examiners made an accurate suitability decision on 92 of the 96 cases tested.
2. The 1998 suitability screening and appeal processes could have been more effective in preventing EROs who did not meet minimum tax compliance or background clearance criteria from participating in the *e-file* program. We identified 1,733 EROs which had been approved to continue to participate in *e-file* even though conditions existed on their tax accounts prior to the 1998 filing season that may have warranted rejection or suspension. Also, we determined that, during the first phase of the appeal process, 12 failed suitability determinations were inappropriately reversed, and one applicant was inappropriately denied acceptance into *e-file*.
3. ETA had not fully implemented 16 of 62 suitability-related recommendations made in relation to FMFIA, GAO, TIGTA, and *e-file* Task Force activities.

Suitability Decisions Made on New Electronic Filing Program Applicants Were Reasonably Accurate and Consistent

Effective September 2, 1997, the IRS consolidated the processing of *new* applications to the centralized location at the ANSC. Handling of existing, *annual*

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Consolidated site tax examiners made reasonably accurate and consistent suitability determinations.

suitability determinations was left with IRS district offices.

As of April 30, 1998, ANSC's tax examiners had determined the suitability of 19,285 new applications. The centralized staff concluded that 18,780 (97 percent) of the new applicants were suitable to participate in the *e-file* program.

Our in-depth analysis of selected suitability criteria, on 96 randomly selected applications processed by the centralized staff, showed that 92 (96 percent) of the suitability decisions were accurate and consistent based on the ASAP information available to the staff. Of the 96 cases reviewed, the consolidated site tax examiners had approved 92 for participation and failed 4.

Application processing procedures were not always followed

In 4 of the 92 approved cases, examiners did not follow established administrative procedures. This increased the risk of unsuitable applicants being allowed to participate in the IRS' *e-file* program.

On one of the applications, there was information that the applicant had been convicted of a criminal offense for willfully aiding and assisting in the preparation of a materially false federal income tax return. The information was apparently not forwarded to Criminal Investigation (CI) as required, or noted by the tax examiner when conducting the suitability determination.

Background checks could be more effective

IRS procedures require that research of an applicant's criminal history be part of the suitability check. However, the examiners did not consider this because their suitability guidelines did not require the tax examiner to consider any data on the application, even when the applicant admitted to a criminal conviction. We reviewed 19 applications with indications of a criminal history on the application. We found that two applicants with convictions of filing false tax returns had been accepted into the program, even though they

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enclosed court documentation of the conviction of filing false tax returns. One of the applicants was accepted into the program less than a year after conviction and was on probation for five years.

With the help of CI, we checked a sample of 276 Social Security Numbers (SSNs) from active EROs against the computerized Criminal Investigation Management Information System (CIMIS), to see if there were any formal Criminal Investigation cases shown. CIMIS data files showed that 3 of the 276 (1 percent) had a criminal case investigation (including the two applicants noted above).

Prior to the implementation of a consolidated site, the IRS districts compared applicant data to the CIMIS. However, with the new centralized location, the districts are no longer involved in the *new* application process and the CIMIS was not routinely checked at the consolidated site.

Fingerprint cards were not processed timely

The processing of fingerprint cards for new applicants was not effective in assuring that only appropriate participants are in the *e-file* program. When the fingerprint cards are received back from the Federal Bureau of Investigation and contain criminal history information, they should be sent to CI for further review. However, this did not occur until February 3, 1998, giving potential problem filers at least two weeks of filing before CI reviewed the data.

IRS procedures state that applicants should not be admitted into the program until the fingerprint results are received and analyzed. These procedures were not followed by the staff conducting the suitability screenings at the consolidated site.

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Effective July 1998, staff at the consolidated site (ANSC) assumed responsibility for all suitability determinations.

For the 1999 e-file program, responsibility for the annual suitability review of ongoing participants was transferred to the staff at the centralized site (ANSC)

Each participant is rechecked annually to ensure continued adherence to the suitability standards. For the 1998 filing season, the IRS districts performed this task.

As of July 1, 1998, the staff at the centralized site assumed responsibility for the *annual* suitability process. National Office officials believed this change will free-up time for the districts to work on other aspects of their job, such as marketing and monitoring. But more importantly, it should result in consistent suitability determinations and stop the perception that participants will “shop” around at various IRS districts for acceptance into the program.

Recommendations

We recommended that the Office of Electronic Tax Administration:

1. Compare the ERO automated database to the CIMIS in order to identify accepted EROs who have a criminal history.

Management's Response: The Office of Electronic Tax Administration disagreed with this recommendation. They stated that they would need to do more extensive research to determine if routinely checking the CIMIS would be beneficial to the Electronic Filing Program.

Office of Audit Comment: We encourage the Office of Electronic Tax Administration to reconsider its decision not to use available computer-based tools, such as CIMIS, to help identify accepted EROs who have a criminal investigation history. We strongly believe that the use of CIMIS would provide important background information with minimal expense, and fewer delays, than the primary source currently used.

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2. Ensure that application processing procedures, especially those relating to background investigations, are followed.

Management's Response: The Office of Electronic Tax Administration stated that meetings were held to ensure instructions are consistent and that applicable suitability procedures were updated.

Annual Suitability Screening Conditions Allowed Inappropriate Electronic Return Originators to Participate in Electronic Filing

Conditions in the suitability screening process allowed inappropriate EROs to participate in e-file.

Although improvements were made to the 1998 suitability screening process, the overall process was not completely successful in preventing inappropriate EROs from participating in the *e-file* program. Some of the weaknesses identified included:

- Suitability computer programming that did not identify some cases with incomplete filing data.
- An inability to identify conditions *immediately* that would adversely impact the ERO's continued participation.
- Inconsistent enforcement of existing criteria.

Over 1,700 EROs may have warranted rejection or suspension from e-file primarily because of unfiled tax returns or outstanding tax liabilities.

An analysis of the overall universe of EROs (new applicants and current participants), accepted to participate in *e-file*, showed that 1,733 EROs had one or more of the following inappropriate characteristics, yet were allowed to participate in the 1998 program:

- 1,359 participants with untimely filed tax returns (many of these cases also had a history of filing late).
- 334 participants with unpaid tax liabilities as high as \$143,801.
- 55 participants with cumulative miscellaneous penalties as high as \$84,676.

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- 6 participants with fraud penalties as high as \$4,179.
- 2 participants convicted of filing false federal tax returns (as mentioned previously).

Many of the participants identified above had previously been subject to the annual suitability process conducted by the IRS district offices.

Suitability computer programming allowed the acceptance of 1,359 late filers

The ASAP suitability computer program did not identify all untimely filing conditions.

Suitability criteria state that one of the reasons an ERO may be suspended or rejected from the *e-file* program is the failure to file timely and accurate business and/or personal tax returns. Although improvements were made to suitability programming in 1998, a programming oversight prevented the ASAP from identifying all cases that had incomplete filing data.

The IRS was unable to identify conditions immediately that would adversely affect an ERO's continued participation

The IRS could not timely identify federal tax account transactions (federal tax compliance problems) that would adversely impact e-file participation suitability.

E-file participants were not identified as EROs on the IRS' computer systems, which house taxpayer account information. As a result, the IRS could not immediately "flag" participants who, after acceptance into the program, have problems that might adversely affect their suitability.

An analysis of 33 *e-file* participants, with unpaid federal tax liabilities, showed the liability condition occurred *after* the suitability determination, but *prior* to the start of the 1998 filing season for 19 (58 percent) of the 33 participants.

Prior reviews have recommended that the IRS take action to identify EROs on IRS computer systems.

Since 1991, an IRS Task Force, GAO, and TIGTA have recommended that action be taken so *e-file* participants can be identified on the IRS' computer systems. This would allow tax examiners to be made aware of information that could affect continued participation. Although initially agreed to, action on this recommendation has not been implemented.

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More thorough tax account reviews would identify unsuitable EROs

More thorough tax account reviews would identify unsuitable EROs.

Conditions that should have led to suspension or rejection from *e-file* participation were readily identifiable on participants’ tax accounts at the time of the suitability decision. For example, five of the six EROs cited in the table below had been assessed penalties for tax fraud prior to the suitability determination. IRS procedures require that individuals assessed penalties for fraud should be denied participation in the *e-file* program. However, these EROs were allowed to participate in *e-file*.

As a group, EROs with fraud penalties had a higher reject rate for electronic returns submitted. We analyzed *e-file* data for 90 participating EROs, selected from the 1,733 EROs with inappropriate characteristics. The analysis showed that the 6 participants with a fraud penalty assessment in their record had an overall reject rate of 23 percent, which is about 9 percent higher than the national average for all EROs. The reject rate for the other conditions we sampled was similar to the national reject rate of 14 percent. Specifically, the analysis showed the following:

<i>Condition</i>	<i>EROs Sampled</i>	<i>Returns Sent</i>	<i>Returns Rejected</i>	<i>Reject Rate</i>
<i>Fraud Penalty</i>	6	2,099	481	23%
<i>Misc. Penalty</i>	10	2,802	368	13%
<i>Tax Liability</i>	33	4,376	587	13%
<i>Untimely Filed</i>	41	4,115	554	13%
<i>Totals</i>	90	13,392	1,990	15%

Source: The IRS Inspection Service (now TIGTA) analysis of IRS statistics

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Suspension of inappropriate EROs would not materially affect e-file program goals.

Within each of these categories there was at least one ERO with a very high reject rate. For example, an ERO with a fraud penalty assessment had a reject rate of 34 percent (664 returns transmitted and 229 rejections).

Program goals would not be materially affected by the suspension of inappropriate EROs

In filing season 1998, the IRS received 17.5 million *e-file* tax returns. The IRS estimates that 24.2 million *e-file* returns will be received in the year 2001. As shown above, we made a detailed analysis of 90 EROs with inappropriate characteristics that were allowed to participate. These EROs had transmitted an average of 149 returns each. This indicates that if the 1,733 inappropriate EROs identified were suspended from *e-file*, the impact to the overall volume of *e-file* returns would not be significant.

Recommendations

We recommended that the Office of Electronic Tax Administration:

3. Develop more aggressive and consistent procedures for checking and removing questionable preparers from the *e-file* program.

Management's Response: The Office of Electronic Tax Administration stated that meetings were held to ensure instructions are consistent and that applicable suitability procedures were updated.

4. Develop suitability computer programming and procedures to recheck participants, prior to the start of a processing year, that had incomplete data at the time of the annual suitability process.

Management's Response: The Office of Electronic Tax Administration stated that they started preliminary coordination to correct suitability programming.

5. Develop an identification code on an IRS computer system that will identify EROs and generate a report

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when specific transactions appear on the ERO's tax account that would impact suitability.

Management's Response: The Office of Electronic Tax Administration stated they agreed that implementing the recommendation to develop an entity code on an IRS computer system, when specific transactions appear on a tax account, would provide early notification of instances that potentially impact suitability. However, they stated that they believe that the implications to the IRS computer system prevent their ensuring its implementation.

Office of Audit Comment: Regarding the lack of IRS programming capability, we suggest the IRS consider external alternatives if internal IRS resources remain unavailable.

Appeal Procedures for Applicants That Failed Suitability Should Be Strengthened

Applicants can appeal failed suitability determinations.

An applicant who has been denied participation in the IRS' *e-file* program has the right to appeal the failed suitability determination. The appeal letter, which is sent to the Director, ANSC, must contain a detailed explanation, with supporting documentation, of why the denial should be reversed. If the Director, ANSC, issues a final letter of denial, the applicant can submit another appeal, this time to the Director of Practice.

When failed suitability determinations were appealed, local management reversed a high percentage of their decisions

When appealed, local management reversed a high percentage of their suitability decisions.

During the first phase of the appeal process, under the consolidated staff review, 85 percent (401 of 470) of appealed suitability determinations were reversed.

The accuracy of the appeal process could be improved. We found that 12 (35 percent) of the 34 appeal cases we tested had the appealed determination inappropriately reversed. In addition, one appellant, whose

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disqualification should have been reversed, was not admitted.

Comparable appeal statistics for prior years were not available because the data was not specifically reported for *new* applications.

Four of the inappropriate reversals involved the assessment of civil/miscellaneous penalties. One of these cases had a prior suspension from the *e-file* program that was subsequently reversed. In another case, the taxpayer resigned and stated that he would not work on electronic tax returns but would remain at the business as a consultant.

A policy change to waive certain admission criteria regarding penalties was never put in writing.

ETA and ANSC officials decided to waive certain admission criteria. However, this decision was never put in writing and applied only to certain applicants. They believed that large volume filers would be more susceptible for failing suitability because of this type of penalty. We did not agree with this decision because: (1) the policy change was not put in writing, and (2) the same policy was not made available to EROs subject to the annual suitability process.

Separation of duties is needed

In some cases, the same officials made the initial suitability decision and the appeal decision.

A factor that may have contributed to the high percentage of reversed determinations was that the centralized suitability process did not have an independent group reviewing the appeal information provided by the taxpayer. Instead, at least one centralized site official, who was involved in the initial suitability determination, was also involved in the appeal decision. We believe that an independent group should be established within the ANSC to review the appeal information and determine if the taxpayer provided reasonable cause for the specific condition that caused the failed determination.

Recommendations

We recommended that the Office of Electronic Tax Administration:

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6. Develop procedures to ensure that officials involved in the first phase of the appeal process are independent from the officials that made the failed suitability determination.

Management's Response: The Office of Electronic Tax Administration stated that changes have been made to separate the appeal process from the original determination process and that program procedures have been updated to include these changes.

7. Ensure consistent suitability determinations are made on cases with civil/miscellaneous penalties.

Management's Response: The Office of Electronic Tax Administration stated that instructions have been clarified and that updated procedures would be published.

Prior Suitability-Related Recommendations Had Not Been Implemented

Sixteen pertinent past e-file suitability-related recommendations were still open.

We reviewed selected TIGTA, GAO, FMFIA, and *e-file* Task Force reports, issued from 1990 to 1997, for recommendations designed to ensure only appropriate applicants participated in the *e-file* program. We identified 62 applicable recommendations. At the time of our follow-up, 16 pertinent recommendations were open or only partially implemented, including some from a report issued in November 1990. Two had been canceled.

Examples of open recommendations included:

- One recommendation that stated *e-file* participants should be identified on the IRS' computer systems. These two sources of account information would allow tax examiners to be made aware of information that could affect continued participation. Since 1991, an IRS *e-file* Task Force, GAO, and the IRS Inspection Service (now TIGTA) have raised this concern. Although initially agreed to, this recommendation has not been implemented due to

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A recommendation made in 1990 was still under discussion in 1997.

the IRS' reluctance to add additional identification codes to its computer systems.

- One of the open recommendations, made in an IRS Inspection Service (now TIGTA) report titled, “*Review of the Electronic Filing System*” (Reference Number 01115, Dated November 29, 1990), dealt with the acceptance of applicants that owed taxes which the IRS determined to be uncollectable. The recommendation was still under discussion during a suitability meeting in December 1997.
- A recommendation was made to create and make available a list of participants who have been rejected, expelled, or suspended from the *e-file* program.
- A recommendation was made to establish a target percentage for monitoring visits.
- A recommendation was made to establish error rate standards.
- A recommendation was made to clarify the conditions for issuing warning and suspension letters.

Most of the 16 open recommendations are valid and would help assure that only appropriate applicants are accepted to participate in the *e-file* program. Please see Appendix V for a complete list of recommendations that need follow-up review.

Recommendation

We recommended that the Office of Electronic Tax Administration:

8. Review prior FMFIA, GAO, *e-file* Task Force, and TIGTA suitability-related recommendations and ensure that they are implemented.

Management's Response: The Office of Electronic Tax Administration stated that they would review prior

Further Improvements Are Needed to the Internal Revenue Service's Process for Admitting Preparers and Transmitters Into Its Electronic Filing Program

recommendations and determine if they should be implemented.

Office of Audit Comment: We suggest the Office of Electronic Tax Administration closely supervise and control the review and implementation of prior FMFIA, GAO, *e-file* Task Force, and TIGTA recommendations to ensure thorough completion.

Conclusion

The ETA implemented significant improvements to the suitability screening process, particularly the implementation of the consolidated site for processing new applications. To enhance this improvement further, the ETA should consider more stringent enforcement of existing criteria and improved automated suitability screening. This would help to ensure that only electronic preparers and transmitters, meeting minimum tax compliance and background qualification requirements, participate in the Electronic Filing Program in the future. Also, this should help to limit the IRS' susceptibility to filing fraud.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective was to determine if the Internal Revenue Service's (IRS) suitability screening process was effective in assuring that only appropriate Electronic Return Originators (EROs) participated in the IRS Electronic Filing (*e-file*) program. To accomplish this objective, we:

- I. Determined if the IRS effectively developed and implemented suitability goals, objectives, and procedures that assure only appropriate EROs participate in the IRS' *e-file* program. To accomplish this, we:
 - A. Obtained pertinent Internal Revenue Manuals, job aids, local procedures, and other documents relating to ERO suitability.
 - B. Analyzed the Automated Suitability Analysis Program, job aids, and procedures, and determined if deficiencies existed that would allow inappropriate applicants to participate in *e-file*.
 - C. Conducted a database extract on all *accepted* EROs, by selecting a random sample of 90 cases from the 1,756 problem cases identified, in order to verify the extent of any identified problem.
 - D. *[Due to high costs and limited anticipated pay-back results, this audit step (I-D) was surveyed out with approval of the Deputy Regional Inspector General for Audit.]* Determine if the IRS correctly and consistently processed appeals relating to suspensions based on missing signature documents (Form 8453).
 1. Nationally, determine:
 - a. The number of EROs suspended due to missing taxpayer signature documents Forms 8453).
 - b. The number of these cases appealed.
 - c. The number of cases that were reinstated.
 - d. The reasons for the reinstatement.
 2. Sample cases to determine the consistency and correctness of the appeal process.
- II. Determined if the IRS' new centralized site initiative for processing *new* ERO applications was effective in assuring that only appropriate EROs participate in *e-file*. To accomplish this, we:

Further Improvements Are Need to the Internal Revenue Service's Process for Admitting Preparers and Transmitters Into Its Electronic Filing Program

- A. Closely monitored the new process and provided on-site feedback to management.
- B. Analyzed *new* ERO applications processed at the consolidated site in order to determine if only appropriate applicants were allowed to participate in *e-file*. Specifically, we:
 1. Selected a random sample of 96 *new* ERO applications and determined if the applications were correctly and consistently processed, thus preventing unscrupulous or high-risk preparers from participating in *e-file*. (*The methodology used included analyzing ERO databases and identifying only new applicants processed at the consolidated site. Based on an identified universe of 12,487 cases, we used accepted formulas for attribute sampling and selected 96 cases for detailed review. No projections were made from this sampling.*)
 2. Determined if applicant information from the sample cases selected was correctly recorded on the Applicants Database.
- C. Determined if the receipt and processing of fingerprint cards for new applications were effective in assuring that only appropriate EROs participate in *e-file*. Specifically, we determined:
 1. How the receipt of fingerprint cards was controlled.
 2. How many applicants were rejected from participation based on a fingerprint card analysis.
- D. Determined if the IRS correctly and consistently processed appeals on *new* applications that were initially rejected due to compliance problems. (*Sample drawn from the universe of 352 suitability decisions in inventory, as of April 3, 1998. We used accepted techniques for random sampling and selected 34 cases for detailed review. No projections were made from this sampling.*) Specifically, we determined:
 1. How many *new* applications were rejected.
 2. How many cases were appealed.
 3. How many were reinstated.
 4. If appeals (for sampled cases) were reversed and why.
 5. If the appeal process is consistent and correct by sampling 34 cases.

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- E. *[Time did not permit the completion of audit step II-E.]* Review correspondence from EROs, including memos of telephone calls, to determine the level of program satisfaction or dissatisfaction.
 - F. *[Time did not permit the completion of audit step II-F.]* Obtain comments from district office and National Office staff on the effectiveness (advantages and disadvantages) of the new centralized suitability site.
- III. Determined if the prior Treasury Inspector General for Tax Administration, General Accounting Office, Federal Managers' Financial Integrity Act, and *e-file* Task Force recommendations that were made to ensure that only appropriate applicants participated in *e-file* were enacted. To accomplish this, we:
- A. Identified viable prior ERO-related recommendations from the above sources.
 - B. Determined if the above recommendations were implemented through interviews and limited testing. If not implemented, we determined why.

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Appendix II

Major Contributors to This Report

Walter Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs)

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Donald Butler, Audit Manager

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Thomas Seidell, Senior Auditor

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Appendix III

Report Distribution List

Deputy Commissioner Operations C:DO
Chief Information Officer IS
Chief Operations Officer OP
Assistant Commissioner (Electronic Tax Administration) OP:ETA
Assistant Commissioner (Program Evaluation and Risk Analysis) M:OP
Executive Officer for Service Center Operations OP:SC
Director, Andover Service Center
National Director, Electronic Program Operations OP:ETA:O
National Director for Legislative Affairs CL:LA
Office of Management Controls M:CFO:A:M

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Appendix IV

Prior Recommendations Not Fully Implemented

Source	Recommendation
<p>IRS Inspection Service (now TIGTA) report titled, “Review of the Electronic Filing System” (Reference Number 01115, Dated November 29, 1990)</p>	<p>Reevaluate the specific guidelines concerning outstanding balances greater than \$1,000. No consideration is given to the size of the business. Currently, large corporations with billion dollar assets have the same criteria as individual taxpayers. Consideration should also be given for liabilities to other federal agencies (TC130). These liabilities represent long term delinquencies.</p>
<p>IRS Inspection Service (now TIGTA) report titled, “Review of the Electronic Filing System” (Reference Number 01115, Dated November 29, 1990)</p>	<p>Reconsider the criteria for Currently Not Collectible Accounts. The current criteria states that if an account is in Currently Not Collectible status the applicant should not be rejected. There are conditions that require further analysis. For example if the reason for the uncollectible status is unable to locate, the applicant should be contacted by Collection.</p>
<p>IRS Inspection Service (now TIGTA) titled, “Review of the Electronic Filing System” (Reference Number 01115, Dated November 29, 1990)</p>	<p>The research methods to obtain criminal information could be enhanced in two areas. The criteria states that an applicant will be rejected for “other conduct of a disreputable nature that would reflect adversely on the EFS program.” First, a method to obtain this information is the National Crime Information Center (NCIC) system maintained by the FBI. However, provisions have not been made to research NCIC. We recognize that there are currently administrative provisions to limit on-line NCIC usage to criminal research; however, the IRS should pursue efforts to access this information for Electronic Filing preparers. Second, the Alpha Index for Criminal Investigation information items is available to each district for information items within that district. If an applicant relocates to another district, the information is not available in the new district. A comparison of applicants to Service-wide information items would be more informative</p>
<p>IRS Inspection Service (now TIGTA) report titled, “Review of the Electronic Filing System” (Reference Number 01115, Dated November 29, 1990)</p>	<p>Consideration should be given to require the following information during the application process: date of birth for the principal owners; business street address and telephone number; notarized signature to ensure the principal owner’s signature is on the application; and, questions concerning where and when tax returns have been filed.</p>

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<p>GAO/GGD-93-27 IRS Can Improve Controls Over Electronic Filing Fraud</p>	<p>Seek approval to allow Criminal Investigation staff access to National Crime Information Center (NCIC) data for the purpose of checking the background of electronic filing applicants. Until that approval is obtained, district offices should use the National Law Enforcement Telecommunications System to check criminal records maintained by state and local law enforcement authorities.</p>
<p>FMFIA-Control # IRS-92-01</p>	<p>Implement a requirement that the electronic return originator (ERO) transmitter must see two pieces of identification prior to transmitting the return to deter the filing of fraudulent returns.</p>
<p>FMFIA-Control # IRS-92-01</p>	<p>Accept Return Preparer/Transmitter team recommendations; implement through IRM changes, revenue procedure changes and requests for legislative changes.</p>
<p>Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>Obtain congressional action to provide criminal investigation with the ability to access TECS to determine if the applicants have any type of criminal background. This access would identify applicants who have withheld information on the application regarding their criminal history.</p>
<p>Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>Procedures should be established to run all applicants against the Criminal Investigation Management Information System to determine any activity. This would assist in providing information on a nationwide basis as opposed to individual districts. It would also provide information where accounts are not controlled on the Master File.</p>
<p>Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>The Electronic Filing System Project Office should develop an automated transcript request program similar to the Andover project. The program should reflect changes to facilitate district office screening procedures and should incorporate the specific changes to the Andover program, with specific transaction codes incorporated. The program should take into account Master File reversals of penalties and assessments. The program should only review Master File activity within the past three years. The program should only print those transcripts containing a match. This program should be run at the service center from the Applicants Database. The National Office should develop a method of automating the delivery of this data to the district offices. A member of this task force should be involved with the National Office to develop an automated transcript request program.</p>
<p>Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>Develop an entity code to identify electronic filers on both the Master File and Integrated Data Retrieval System (IDRS). This information could be obtained from the ADB and uploaded to the Master File.</p>

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<p align="center">Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>Create a list of participants who have been rejected, expelled, or suspended from the EFS program. The system now in place makes it impossible for taxpayers and organizations to know that a participant has been removed from the program. As a result, participants who have been rejected, expelled, or suspended can continue to sell services to innocent taxpayers. A list of those identified entities should be made available on the electronic filing bulletin board and be available to the public on request.</p>
<p align="center">Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>Develop a system in which the various offices can trade information. Participants can exhibit various symptoms that indicate unsuitable behavior. An inordinately high reject rate or a high number of refund inquiries that related to a specific participant could be an indication of stockpiling. A system should be established so such information can be captured and shared with all IRS offices.</p>
<p align="center">Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>Transcribe the signature date on Form 8453. Capturing the signature date on the Form 8453 and comparing that to the received date of the return could help in detecting problem participants. A difference of more than a week could be an indication that a participant is having problems with the electronic return or with the Form 8453.</p>
<p align="center">Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>Establish a target percentage of district office electronic filing coordinators' visitations. Establishing a Service presence through personal visitations is essential to monitoring. These visits should be conciliatory in nature.</p>
<p align="center">Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>Establish error rate standards. An error rate of 5 percent and a reject rate of 15 percent are the suggested maximums for continued participation in EFS. Remedial action should be left to the discretion of the Service Center Directors, giving consideration to receipt volumes, corrective actions, performance history, etc.</p>
<p align="center">Electronic Filing System Suitability/Security/QRDT Final Report 5/91</p>	<p>Clarify the conditions for issuing warning and suspension letters. If, in the monitoring process, a situation is found that is correctable and the participant shows a willingness to correct it, a warning letter should be issued giving specific corrective actions to be taken and appropriate timeframes. If the situation is not correctable, or if the participant is either unable or unwilling to correct the problem, a suspension letter should be issued suspending the participant from the program until the situation is rectified.</p>

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Appendix V

Management's Response to the Draft Report



ASSISTANT COMMISSIONER
ELECTRONIC TAX
ADMINISTRATION

EO 14176

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

MEMORANDUM FOR ASSISTANT CHIEF INSPECTOR (INTERNAL AUDIT) AND
REGIONAL INSPECTORS

FROM:

Robert E. Barr

Assistant Commissioner (Electronic Tax Administration) OP.ETA

SUBJECT:

Responding to Internal Audit Products - Review of the Service's
ERO Suitability Screening Process for Processing Year 1998
(MIS#980022)

Recommendation 1: Compare the ERO automated data base to the Criminal Investigation Management Information System (CIMIS) in order to identify accepted EROs who have a criminal history.

Assessment of Cause: A memo was issued to ANSC indicating that every suitability case did not have to be cleared through each compliance area. This memo was coordinated and cleared through Office of Refund Fraud (ORF).

Corrective Actions: We disagree. We are doing more extensive research on CIMIS to determine if this process is beneficial to the IRS e-file program

Implementation Dates: N/A

Recommendation 2: Ensure that application processing procedures, especially those relating to background investigations, are followed.

Assessment of Cause: The Andover Service Center, in partnership with district office electronic filing coordinators, created a Suitability Job Aid using as a basis, the existing procedures in Law Enforcement Manual (LEM) covering Suitability and Monitoring. This was created for the purposes of the implementation of the One Site Application and Suitability (OSAS). Due to the limited time for implementation, the procedures were delayed being incorporated into the IRM.

Corrective Actions: We agree. Meetings, conference calls and site visits have taken place to ensure that instructions are consistent. The IRM 3.42 .3, Individual Income Tax Returns in the IRS e-file Program, includes the updated application and suitability instructions and procedures.

Further Improvements Are Need to the Internal Revenue Service's Process for Admitting Preparers and Transmitters Into Its Electronic Filing Program

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Implementation Dates: December 1, 1996, for IRM distribution.

Recommendation 3: Develop more aggressive and consistent procedures for checking and removing questionable preparers from the ELF program.

Assessment of Cause: Procedures were administered inconsistently.

Corrective Actions: We agree. Consistent procedures should be used to screen applicants. This was the reason the suitability process was consolidated to one location. Understanding that OSAS was implemented in a very short timeframe, we began to review and revise our procedures once the process was consolidated. As discussed in the recommendation 2 response, discussions were held and revised IRM instructions have been disseminated.

Implementation Dates: 9/97 - 9/98

Recommendation 4: Develop suitability computer programming and procedures to recheck participants, prior to the start of processing year, that have submitted extensions of time to file to ensure the tax return was filed timely, and ensure that those who do not timely file or pay tax liabilities are suspended.

Assessment of Cause: Currently, the program looks for current year return status and if a valid extension is in place, the filer will be passed. If the filer defaults on the extension once the annual suitability check process has passed, it won't be known until the following annual suitability process.

Corrective Actions: We agree. Preliminary coordination has begun with IS and ANSC. We will ask IS to extract out the extension portion of the program from the ASAP and reprogram it to run later in the year, but prior to the processing year.

Implementation Dates: June 22, 2000

Recommendation 5: Develop an entity code on the Master File that identifies EROs, produces an indicator, and generates a report when specific transactions appear on a tax account that would impact suitability.

Assessment of Cause: During the course of the year after the annual suitability check process takes place, some participants become non compliant, but the timing of the annual suitability process allows them to remain in the program until the process takes place again the following year.

Further Improvements Are Need to the Internal Revenue Service's Process for Admitting Preparers and Transmitters Into Its Electronic Filing Program

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Corrective Actions: We agree. This would provide early notification of instances that may potentially impact suitability; however, our position remains consistent as originally stated after the recommendation was first made. This has major master file implications and would require extensive programming. We will begin the coordination process, but competing programming priorities will likely cause major delay or a decision not to program this enhancement.

Implementation Dates: Tentative for 2001

Recommendation 6: Develop procedures to ensure that officials involved in the first phase of the appeal process are independent from the officials that made the failed suitability determination.

Assessment of Cause: Currently, the tax examiners who participate in the suitability determinations are also involved in the first level of appeals when received from the rejected or suspended applicant or participant. This is clearly a conflict of interest and could result in a nonobjective decision.

Corrective Actions: We agree. We have already coordinated with ANSC and internal changes have been made to separate the appeal process from the original determination process. The IRM has been updated to include this change.

Implementation Dates: June 1998

Recommendation 7: Develop a policy statement that clearly states which suitability determination should be made on cases with civil penalties resulting from accuracy related errors.

Assessment of Cause: The various publications related to suitability were inconsistent.

Corrective Actions: We agree. Instructions were clarified early this year and the IRM 3.42.4 will be published December 1998. The LEM will be published in January of 1999 and the IRS e-file Application Package was published in June 1998.

Implementation Dates: September 1998

Recommendation 8: Review prior FMFIA, GAO, ELF Task Force, and Internal Audit suitability-related recommendations and ensure that they are implemented.

Assessment of Cause: Prior recommendations were agreed to, but some were not implemented.

Further Improvements Are Need to the Internal Revenue Service's Process for Admitting Preparers and Transmitters Into Its Electronic Filing Program

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Corrective Actions: We agree. We will review prior recommendations and determine if they should be implemented. We are requesting from Internal Audit a copy of their analysis of prior recommendations that relate to suitability and monitoring to expedite the rework process.

Implementation Dates: To be determined