United States House Ways & Means Committee
Hearing on "Minding the Tax Gap: Improving Tax Administration for the 21st Century."
June 10, 2021
Questions for the Record for Doug O'Donnell, Deputy Commissioner for Services & Enforcement, IRS

Ms. Walorski – Q2: Mr. O'Donnell, as you are aware, Commissioner Rettig recently told the Senate Finance Committee in April 2021 that IRS funding and resource increases would enhance ongoing agency modernization and help put a dent in the tax gap. To improve tax administration for the 21st century, the IRS will continue to rely on vendors for program management, technology, and contracted personnel. In agencies, procurement offices often consolidate contract awards to solicit large single-award IDIQs in order to reduce administrative requirements, which can limit the government's reach across industry. With the emerging and evolving cybersecurity threats to the IRS and the financial sector, how does the IRS anticipate keeping pace with the speed of technology to protect against these threats and ensure they have access to a broad number of industry partners and vendors? And what is the IRS doing to ensure the agency is not committing itself to a limited pool of vendors?

The IRS aspires to be one step ahead of the threat actors and their tactics, techniques, and procedures. When we define a requirement, we then carefully consider the value in building solutions from commercial off the shelf (COTS) products and hosting and supporting those solutions in-house, to as-a-service security solutions delivered by Federal Risk and Authorization Management Program (FedRAMP) approved vendors. We obtain services using many available contracting strategies allowed by the Federal Acquisition Regulation (FAR), including, but not limited to: Best-In-Class vehicles, small businesses, Blanket Purchase Agreements, and Indefinite Delivery, Indefinite Quantity (IDIQ) contracts acquired by the IRS, Department of the Treasury (Treasury), General Services Agency (GSA), and other agencies using Inter-Agency Agreements.

Governance activities within the IRS also help mitigate the risk of overcommitting to a limited pool of vendors. This includes executive-level review and approval of acquisition plans for critical acquisitions to ensure consideration of trusted and qualified vendors. Additionally, we make frequent use of Industry Days. These events present the plans for current or future procurements to industry representatives and provide information they can use to better respond to contract opportunities and provide more innovative technology solutions. We also conduct Reverse Industry Days, providing opportunities for industry communication to the agency and facilitating improvements in IRS procurement strategies. Further, we lead or participate in a dozen or more small business outreach sessions each year. These Industry Days, Reverse Industry Days, and outreach sessions help expand the pool of industry partners who have a more thorough understanding of the IRS mission and can respond to our procurement needs.

Mr. Arrington - Q1: The spread of cyber technology and the diffusion of power allows not only adversarial Nation States but also non-state actors to orchestrate attacks on the security of financial systems. What is the IRS currently doing to rapidly procure cybersecurity solutions?

The IRS works to proactively accelerate the procurement of services when needed. As noted above, we obtain services using many available contracting strategies allowed by the FAR, including, but not limited to: Best-In-Class vehicles, small businesses, Blanket Purchase Agreements, and IDIQ contracts acquired by the IRS, Treasury, GSA, and other agencies using Inter-Agency Agreements.

Mr. Arrington - Q2: The spread of cyber technology and the diffusion of power allows not only adversarial Nation States but also non-state actors to orchestrate attacks on the security of financial systems. Single-award contracts by their very design necessitate single source solutions. Are changes needed to existing contract vehicles or parameters to ensure that we are competing with the pace of evolving cyber threats?

Where appropriate, we currently make use of hybrid-type contracts that include firm-fixed prices for services unlikely to evolve over the course of the contract along with a structure that allows for the provision of unanticipated additional services falling within the scope of the contract.

Two recommendations for change are:

- Creation and maintenance of government-wide vehicles to provide rapid access to a range of vetted and qualified vendors for common challenges to reduce market research time at agencies and ensure better results. This recommendation would allow the IRS to focus on its own specific challenges.
- Improvements to the clearance process for individual contractors working for vendors on IRS contracts would indirectly facilitate the acquisition process by reducing transition times between contract periods of performance.

Mr. Arrington – Q3: The IRS has not developed specific or long-term plans to address updating, replacing, or retiring most of its legacy systems. As stated in the August 2020 Treasury Inspector General for Tax Administration, the IRS identified 45 systems for modernization or as candidates for modernization and 34 systems for retirement. Furthermore, the IRS does not have an enterprise-wide definition of or a complete and accurate inventory of legacy systems. How will the

IRS balance the recapitalization of legacy platforms with the requirement to migrate to the cloud and the necessity of cybersecurity protection?

We are committed to modernizing our technology foundation while maintaining a strong cybersecurity posture, which includes migrating targeted legacy applications to the cloud. To account for evolving technology opportunities and needs, we annually refresh the IRS Information Technology Strategic Plan and supporting documents, including the Enterprise Technology Blueprint and the Target Enterprise Architecture. The scope of this work includes migrating some legacy systems to the cloud, with a continuous emphasis on cybersecurity and the protection of taxpayer data.

The IRS legacy computing ecosystem is comprised of hundreds of systems that enable us to deliver on a complex set of technical requirements. We are focused on modernizing some of our most complex legacy systems first, including the Individual Master File and legacy management systems used to process the billions of information returns we receive and process each year. We have planned the modernization of these highly complex initiatives in meaningful increments that will result in a quicker, more consistent pace of completion. This strategy of working incrementally allows for continual improvement of taxpayer services while also ensuring we take a risk-based approach to introducing change without compromising security.

For each modernization initiative, one of our guiding principles is Cloud Smart, which directs us to carefully consider the cost and advantages of migrating to the cloud. When the modernization of a certain legacy application aligns with our priorities and available resources, we consider the benefits of migrating that application to the cloud, including whether it could result in more efficient and secure operations. We have established a robust IRS Enterprise Cloud Program that includes cloud technology planning, governance, cybersecurity architecture considerations and compliance with National Institute of Standards and Technology and FedRAMP requirements.

As of July 2021, the IRS has over 45 applications in the cloud. Notably, we are also in the third year of a multi-year effort to modernize enterprise case management at the IRS using a FedRAMP cloud facility deployed on a COTS platform. Our cloud security architecture and strict adherence to FedRAMP and Federal Information Security Management Act of 2002 program requirements ensures that IRS cloud deployments go through rigorous security reviews in accordance with the applicable Federal laws, regulations, mandates and standards for data security and protection.

Specific to the August 2020 Treasury Inspector General for Tax Administration report, we have established an enterprise-wide definition of legacy systems, launched a program specifically focused on modernizing our legacy technology, and accounted for the full inventory of legacy applications in operation at the

IRS. Given our large and complex technology infrastructure, as well as the importance of benefitting from proven technology advancements, we plan to continue moving incrementally while keeping a focus on security and sustaining a well-trained Information Technology (IT) workforce.

Mr. Arrington – Q4: The IRS IT ecosystem is extremely complex with many of the systems requiring a high level of interoperability and scalability. Security and resiliency are of paramount importance. All of these challenges are addressable using next generation IT solutions, such as Cloud computing. What is the IRS doing to leverage Cloud and other emerging technologies to modernize its IT infrastructure, which will enable modernization of the systems to maximize interoperability, security, scalability and resiliency?

As noted above, one of our guiding principles in modernization is Cloud Smart, which directs us to carefully consider the cost and advantages of migrating to the cloud. When the modernization of a certain legacy application aligns with our priorities and available resources, we consider the benefits of migrating that application to the cloud, including whether it could result in more efficient and secure operations. The IRS Enterprise Cloud Program focuses specifically on driving innovation and accelerating cloud adoption at the IRS.

In fiscal year (FY) 2018, we developed the IRS Cloud Target State Plan, which calls for a hybrid multi-cloud ecosystem with multiple service providers and service models, core services, connectivity components and on-premises capabilities. Since then, we have made significant progress. We now have over 45 systems, projects and applications leveraging cloud services. These systems include the IRS.gov infrastructure and applications on the IRS.gov website, such as the search function, lookup tools and certain calculators.

In FY 2020, we successfully established the Enterprise Container Platform (ECP), which has the primary advantage of enabling more seamless migrations to cloud environments. Containers are widely used by modernized organizations to increase the speed and reliability of deploying programming changes. In FY 2021, we successfully migrated an additional five applications to the cloud through the ECP. Looking ahead to FY 2022, we will continue migrating and building applications directly in the cloud to increase the efficiency and currency of the agency's technology environment.

Successful adoption of cloud solutions requires a workforce that can manage the complexities of a migration, as well as support a cloud environment once fully developed. We are working now to equip our IT workforce with the necessary skills to operate in a cloud environment, including the development of role-based training plans for IRS cloud migration and infrastructure capabilities.

Additional Questions from Ms. Walorski:

1. **How many auditors does the R&D Group for the IRS's Small Business/Self-Employed (SB/SE) Division currently employ?**

   As of June 30, 2021, we have 33 total revenue agents within 3 groups.

   a. **How many audits does the R&D Group for the IRS's SB/SE Division currently have in its inventory?**

      As of June 30, 2021, we have 231 key cases (taxpayers).

   b. **Of those cases, how many of the taxpayers are architects or engineers vs. how many are manufacturers?**

      Architects are the taxpayers in 18 key cases, engineers in 15 key cases, and manufacturers in 35 key cases.

   c. **Of those cases, what is the average audit timeline for these audits?**

      The average examination completion time is 623 days for architects, 781 days for engineers, and 731 days for manufacturers.

   d. **Of those cases, how many have been worked on by an IRS engineer? How long does it take from the time an IRS engineer is requested to the time the IRS engineer can actually work on the case?**

      We do not track how many cases have been worked on by an IRS engineer. Timelines vary, but a request for an engineer is generally assigned within 60 days and started within four to six months of assignment.

   e. **Of those cases during the last three years, how many of the audits result in tax credits that have been allowed after being audited by this group?**

      For these industry categories, 21 examinations resulted in the credit being allowed.

   f. **Of those cases, for those disallowed, what are the top three legal theories for disallowing the credits?**
      The top three legal theories for disallowing the credits are:

      1. Failure to determine the qualified research expenditures at the

business component level under Internal Revenue Code (IRC) Section 41(d)(2)(A).
2. Failure to identify a new or improved business component as defined in IRC Section 41(d)(2)(B).
3. Failure to prove substantially all research activities constitute a process of experimentation for a permitted purpose under IRC Sections 41(d)(1)(C) and (d)(3).

Could the IRS not issue guidance for one or more of these issues to make it easier to comply with the rules and less burdensome to audit?

The statutes are clear as written; however, the IRS is working with stakeholders to identify and potentially clarify any areas where guidance could be helpful.

2. **Does the R&D Group for the IRS's SB/SE Division use technical guidance employees or other decision makers for R&D credit cases?**

Revenue agents working on research and development (R&D) cases utilize Subject Matter Experts (SMEs) and advice from attorneys in the Office of Chief Counsel (Counsel) as tools for consideration.

a. **If so, are those employees available to taxpayers to work with directly or do they review cases without interacting with taxpayers?**

Neither the SMEs nor Counsel is available to anyone outside the IRS for guidance or advice; however, both SMEs and Counsel interact with taxpayers as appropriate during taxpayer interviews or litigation.

b. **If so, are these employees working off of standard guidance or written policies about what is and is not allowable? If so, please provide the Committee with a copy of the guidance.**

Technical guidance that governs the application of the Section 41 credit is comprised of regulations and other published guidance in the Internal Revenue Bulletin. Employees can also consult Counsel on questions relating to the application of technical guidance to a specific set of facts.

c. **If so, do the auditors who actually see the case have the ability to reach a different conclusion than that recommended by the technical guidance employees or other decision makers or are they required to proceed with the decision by the technical employee?**

All cases have a quality review to ensure issues are properly developed; however, the assigned agent and their manager have the final decision on the proposed audit results.

d. **If so, are the auditors ever instructed by any other party (be it an IRS manager, IRS attorney, or IRS technical guidance employee) to disallow research tax credits?**

Cases can be closed with or without proposed adjustments for a myriad of reasons. Guidance may be offered by any one of the persons listed.

e. **Has the R&D Group of the SB/SE Division been provided instruction that businesses that provide services, such as the services provided by architect and engineering firms, cannot meet the Qualified Purpose portion of the four-part test under I.RC. § 41 for qualifying research activities because there is no identifiable "business component''?"**

Our agents are advised to consider each case and the facts therein individually and review them on their merits, regardless of the industry. Any categorical guidance for architects and engineers was recalled in November 2019 and is not in use.

f. **Understanding the Code clearly defines the term "business component" as a product, process, computer software, technique, formula, or invention and that the IRS exam function has longstanding precedent confirming that a "design drawing" or "blueprint" (synonymous with "technique" or "formula") qualifies as the business component of the Qualified Purpose portion of the four-part test- has the R&D Group been provided guidance clarifying this distinction to its examiners when reviewing I.RC. § 41 qualifying research activities performed by architecture and engineering firms?"**

There is not a single precedent for making determinations in these cases. Section 41(d)(2)(B) defines a "business component" as any product, process, computer software, technique, formula, or invention which is to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer. We do not agree the IRS exam function has a longstanding precedent that a "design drawing" or "blueprint" qualifies as a business component. Regardless of the trade or business of the taxpayer, examiners gather facts in each case and evaluate whatever business component the taxpayer identified as meeting the statutory definition of a business component.

3. **Has the IRS's SB/SE Division prepared any training materials for its auditors in its R&D group? If so, please provide the Committee with a copy of the materials.**

   Yes, the SB/SE Division delivers formal training to revenue agents at the time they join the R&D group. Attached are copies of the formal training materials, as well as relevant job aids that are available to employees examining the research credit issue. There are also published documents that are publicly available on-line, such as the following:

   <u>Audit Technique Guides:</u>
   - May 2008 - Research Credit Claims Audit Techniques Guide: Credit for Increasing Research Activities § 41*[1]
   - January 2005 - Research Credit Audit Techniques Guide for Aerospace Industry[2]
   - April 2004 - Research Credit Audit Techniques Guide for Pharmaceutical Industry[3]

   <u>Guidelines and Guidance:</u>
   - Audit Guidelines on the Application of the Process of Experimentation Requirement for all Software[4]
   - Qualified Small Business Payroll Tax Credit for Increasing Research Activities[5]
   - Office of Chief Counsel Memorandum on Qualified Research Expenses (20171601F)[6]

4. **Is it a prerequisite for auditors within R&D Group of the IRS SB/SE Division to have experience auditing qualifying research activities under I.R.C. § 41?**

   Experience with R&D issues is one of the selection criteria when soliciting for revenue agents for the R&D groups in SB/SE.

5. **How does the current SB/SE's R&D group differ from the previous LB&I**

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[1] Available at https://www.irs.gov/businesses/research-credit-claims-audit-techniques-guide-rccatg-credit-for-increasing-research-activities-ss-41.
[2] Available at https://www.irs.gov/businesses/corporations/aerospace-industry-audit-techniques-guide-january-2005.
[3] Available at https://www.irs.gov/businesses/pharmaceutical-industry-research-credit-audit-guidelines-revised-4-30-04.
[4] Available at https://www.irs.gov/businesses/audit-guidelines-on-the-application-of-the-process-of-experimentation-for-all-software.
[5] Available at https://www.irs.gov/businesses/small-businesses-self-employed/qualified-small-business-payroll-tax-credit-for-increasing-research-activities.
[6] Available at https://www.irs.gov/pub/irs-lafa/20171601f.pdf.

team that audited research tax credits when they were previously designated as a Tier 1 Issue?

There were no designated LB&I teams auditing research tax credit issues. The scope and depth of each audit was set by the individual examiner or examination team that was assigned a case with potential research credit issues. They could seek the assistance of an engineer, SMEs and Counsel, as necessary.

Under Tier I, there was an Issue Management Team that provided guidance in the identification, development, and resolution of the research tax credit issue. Among other things, the team provided training on research credit claims, as well as job aids such as a mandatory Information Document Request (IDR) and research credit Audit Technique Guide. Currently, LB&I utilizes a centralized risking process for research credit issues, as set forth in a March 2020 Directive.[7]

6. **How long did the LB&I team, which audited research tax credits when they were previously designated as a Tier 1 Issue, exist?**

   As stated in our response to question 5, there were no designated LB&I teams auditing research tax credit issues. The research tax credit issue was designated as a Tier 1 issue on April 4, 2007 and remained a Tier 1 issue until August 27, 2012.

   When and why was the determination made to remove LB&I's Tier 1 designation for research credits?

   In August 2012, the Issue Management Teams and Tiered Issue Process was rescinded. While the Tiered Issue Process may have been well-suited for the audit of tax shelter-type issues, LB&I needed a different approach to manage compliance priorities and provide guidance to examiners. The new approach needed to balance the need for consistency with the recognition that there is no "one size fits all" approach to examining and resolving issues.

   LB&I developed a knowledge management network through the use of Issue Practice Groups (IPGs) for domestic issues and International Practice Networks (IPNs) for international issues. Today, IPGs and IPNs are known as Practice Networks. They are designed to:

   - Provide examination teams clear and timely guidance to manage their cases efficiently, consistently and with a high degree of technical proficiency;
   - Foster effective collaboration and the sharing of knowledge and expertise across LB&I and Counsel;

[7] See https://www.irs.gov/businesses/lbi-directive-on-the-centralized-risking-of-research-issues-under-irc-sections-41-and-174.

- Increase accountability and transparency in the resolution of issues; and
- Enable robust lines of communication with taxpayers.

Did the SB/SE team receive any lessons learned from the prior LB&I effort? If so, what were they?

Because LB&I had no designated audit teams auditing research tax credit issues, we do not believe there were any lessons learned to be received by SB/SE.

7. Does the IRS provide its examiners within LB&I and the SB/SE the same guidance for examining qualifying research activities under I.R.C. § 41?

All technical issue guidance is stored on the Knowledge Management Virtual Library and accessible by both LB&I and SB/SE examiners; however, administrative guidance may be different. For example, LB&I issued a directive that provides an administrative solution for LB&I examiners to accept as sufficient evidence of qualified research expenditures adjusted research and development costs currently expensed under Financial Accounting Standards Board Accounting Standards Topic 730 as shown on a taxpayer's audited financial statements. SB/SE taxpayers typically do not have audited financial statements. LB&I also has an LB&I Examination Process and IDR enforcement process, whereas SB/SE has their own administrative guidance, including a mandatory quality review of all research credit cases. Regardless of which division the taxpayer falls into, however, the code and requirements to meet the four-part test remains the same.