2006 TAX RETURN FILING SEASON AND THE IRS BUDGET FOR FISCAL YEAR 2007

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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2006 TAX RETURN FILING SEASON AND THE IRS BUDGET FOR FISCAL YEAR 2007

THURSDAY, APRIL 6, 2006

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:02 a.m., in room 1100, Longworth House Office Building, Hon. Jim Ramstad (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
March 30, 2006
OV–6

CONTACT: (202) 225–7601

Ramstad Announces Hearing on 2006 Tax Return Filing Season and the IRS Budget for Fiscal Year 2007

Congressman Jim Ramstad (R–MN), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the 2006 tax return filing season, the Internal Revenue Service (IRS) budget for fiscal year 2007, and other issues in tax administration. **The hearing will take place on Thursday, April 6, 2006, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include IRS Commissioner Mark Everson and representatives of the U.S. Government Accountability Office, the Treasury Inspector General for Tax Administration, the IRS Oversight Board, and several tax practitioner groups.

BACKGROUND:

This year's tax return filing season runs from January 1st to April 17th, and during this time, the IRS expects to receive over 130 million tax returns, over half of which will be filed electronically. The IRS anticipates issuing more than $200 billion in refunds to approximately 105 million taxpayers during this period. Seeking assistance from the IRS in preparing their returns, Americans will contact the Service via telephone more than 25 million times and will make almost 120 million visits to the IRS website, which is one of the busiest in the world during the filing season.

To carry out these and other tax administration duties next year, the Administration has requested $10.6 billion to fund IRS operations for fiscal year 2007, a 0.2-percent increase over the amount enacted last year. This amount will be supplemented by $135 million in new user fees that the IRS expects to collect by providing individualized services to taxpayers. This level of funding will support nearly 100,000 employees who will collect nearly $2 trillion in revenue.

In addition to examining IRS performance during the filing season and the proposed budget for next year, the hearing will also provide the opportunity to review a number of significant tax administration issues that have recently arisen. For example, last year the IRS renegotiated the agreement with the Free File Alliance, a consortium of tax preparation software companies that provide free software to some taxpayers through the IRS website. The hearing will review the effects of the new agreement. Another issue that has recently arisen is proposed IRS regulations governing the use of taxpayer information by tax return preparers. The hearing will allow Members of the Subcommittee the opportunity to inquire about these proposed regulations and their potential effects on taxpayer privacy.

In announcing the hearing, Chairman Ramstad stated, "By collecting $2 trillion in revenue, the IRS fulfills a vital mission for the Federal Government, and the IRS must pursue its enforcement obligations aggressively. However, the IRS impacts the lives of all Americans, and it is important that the IRS respects taxpayers' rights and provides top-rate service in a time of budgetary constraints. I look forward to

hearing from Commissioner Everson and the other witnesses as they discuss how the IRS is carrying out these responsibilities this year."

FOCUS OF THE HEARING:

The hearing will focus on the 2006 tax return filing season, the IRS budget for fiscal year 2007, and current tax administration issues facing the IRS.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, April 20, 2006. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman RAMSTAD. The hearing will come to order. Welcome to our three distinguished panels. Welcome to all our guests. Commissioner, good to see you again. In a little more than a week we will reach the culmination of the annual tax return filing season,

as we all know. This is a time of the year when Americans are reminded of the tax burden they face, and the mind-numbing complexity of the Tax Code. This is also the time of the year that brings millions of Americans into contact with the Internal Revenue Service (IRS). I know everyone there around the country is working overtime these days. 105 million taxpayers will receive refunds from the IRS. Taxpayers will place 25 million calls to the IRS, and they will make 120 million visits to the IRS website, truly mind-numbing numbers.

With all of this interaction, it is important that the IRS provide high-quality service to taxpayers even in the face of budgetary constraints. It is just as important that the Service vigorously enforce the law to ensure that all taxpayers pay their fair share. We know this is a delicate balancing act, but it is essential to maintaining high levels of voluntary compliance with our tax laws.

I have been following the filing season closely, and I have some concerns that I will explore in detail at this hearing, that indeed, all of us on this Subcommittee will explore at this hearing.

First I want to ask about the Free File Alliance. Four years ago, the IRS entered into an agreement with a group of tax preparation software companies. The purpose of the agreement was to encourage more taxpayers to file their tax returns electronically. Under the agreement, the Government promised not to develop its own preparation software as the quid pro quo. In return, the companies, known as the Free File Alliance, would provide free preparation software to the American public for the taxpayers.

For the first 3 years under the agreement, this program was successful, and it grew in popularity with taxpayers. Its use, in fact, increased by 26 percent 2 years ago, and 46 percent last year. The popularity of Free File was due in large part to the fact that last year many of the participating companies decided to offer free Federal preparation to all taxpayers, regardless of their income level.

However, several months ago, the IRS renegotiated this agreement, and included for the first time a cap on the number of taxpayers who can be served by the Free File Alliance. This is the first filing season in which the new agreement has been in place, and as you can see from the graph, use of the Free File Alliance is down over 21 percent, like I said, in just one year.

We will explore today more about this agreement that seems to prevent many taxpayers from receiving free return preparation services, and apparently discourages taxpayers from electronic filing. We will also, today, talk more about the agreement that keeps companies from offering free tax preparation services to taxpayers through the IRS website. We are going to explore this with the various panels here today, and they know the Commissioner has some concerns he wants to express as well, because this 21-percent decline in the use of the program in this year alone is certainly concerning to all of us on the Subcommittee.

In fact, as I expressed on the record, I had some concerns about this agreement at the time it was signed, but I wanted to see if it would work, but now that the numbers are in and we see a dramatic drop-off in the public's use of Free File, I think we need to seriously look at whether this agreement should be renegotiated.

We are going to also look at a number of issues facing the IRS, as we routinely do at these yearly oversight hearings, the one during the filing season. For example, a number of Members have expressed concerns about how tax preparers handle their clients' taxpayer information. Last December the IRS proposed a new rule that expanded some of the ways that return preparers can use taxpayer information. This rule has been criticized by a number of people, including me, but what really concerns me is current law. Current law allows return preparers to share taxpayers' private information with any third party as long as they have taxpayers' consent.

I fear that many taxpayers may not give meaningful consent, and that many taxpayers will find their private information is being sold to third parties. This is a real privacy issue that I know concerns a number of Members.

I am interested in hearing the views of the witnesses as to whether Congress should consider changes to current law to provide greater protection to taxpayer information.

I certainly look forward to the Commissioner's testimony as well as the other two distinguished panels here today on these important matters.

I am now pleased to recognize my good friend, the distinguished ranking Member, Mr. Lewis.

Mr. LEWIS OF GEORGIA. Thank you very much, Mr. Chairman.

Again, this year the Subcommittee is holding an oversight review to examine how the current tax return filing season is progressing and the adequacy of the administration's proposed IRS budget for the coming year. Mr. Chairman, I want to thank you for conducting this annual hearing on the IRS.

More than 130 million tax returns will be filed during the 2006 tax return filing season. This year, the filing season ends a little later than usual, on April 17th, since April 15th is a Saturday. Reports indicate that the tax return filing season is progressing smoothly.

The administration has proposed, for fiscal year 2007, an IRS budget of about $10.6 billion. It is important that the IRS be adequately funded and have a balanced approach to administering our tax laws.

I welcome today's hearing witnesses, and look forward to each of your testimonies. Importantly, I want to commend you, Mr. Commissioner, I want to commend you for all of your good work, and all of the IRS employees nationwide for their good work, and their hard work to see that our tax laws are enforced, and that we get the revenue that is due the government.

Thank you, Mr. Chairman.

Chairman RAMSTAD. I thank the ranking Member, and I certainly concur in his sentiments. Nobody has a tougher job in Washington, except maybe the President, than you do, Commissioner, and you are doing a tough job very well, and all of the people that work for you are to be commended as well.

We look forward to your testimony, and, please, proceed.

STATEMENT OF THE HONORABLE MARK W. EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. EVERSON. Thank you for those kind words. Mr. Chairman, Mr. Lewis, Mr. Shaw, I am pleased to be here today to testify on the 2007 budget request for the IRS. I will also provide you with an update on the tax filing season currently under way.

Let me comment first on the tax gap. As you know, the tax gap is the difference between the amount that taxpayers should pay for a given year and the amount that they actually pay on a timely basis. The tax gap represents in dollar terms the annual amount of noncompliance with our tax laws. We have refined our research, and now estimate that for the year 2001, the overall growth tax gap for all types of tax was approximately $345 billion, or a noncompliance rate of 16.3 percent. Our estimate of the net tax gap, or what remains after enforcement and other late payments, is $290 billion. Our 2007 budget will help us reduce the tax gap.

Before discussing this budget though, I want to thank you for your support for last year's budget. We are using the moneys that Congress provided to continue our progress in building a balanced program of service and enforcement. The 2007 budget would sustain this progress. Our request is for $10.6 billion in direct appropriations, supplemented by $135 million in incremental user fee revenue, to represent a total operational level of $10.7 billion, or 1.4 percent more than this year's 2006 budget.

Let me touch briefly on IRS efforts in our three areas of strategic focus: service, enforcement and modernization, and then make brief comments on certain legislative proposals accompanying the 2007 budget which we believe will help close the tax gap.

We seek to improve service to taxpayers. We also enforce the law against those who do not comply. As you know, our working equation at the IRS is "service plus enforcement equals compliance." We strive to pursue a balanced and fair approach for all taxpayers.

First, services. We are enjoying a successful filing season. Electronic filing is up by almost 3 percent from last year, reflecting a strong increase in the use of tax software on home computers, partially offset by the effect of the elimination of our telephone filing program, and as you have pointed out, Mr. Chairman, somewhat lower returns received via the Free File Alliance. Our phone level of service is better than last year, as is the accuracy of our answers to tax law questions.

We are also seeing continued strong growth in our community based volunteer tax preparation program. The VITA sites are an increasingly important part of our efforts, and in fact, last year, the IRS was recognized by the Points of Light Foundation for its successful efforts. This was the first time any government agency has ever been so recognized. Previous recipients were March of Dimes, Mothers Against Drunk Driving, organizations like that, no other government agency.

As to enforcement, the fiscal year 2005 results demonstrate that we have restored the credibility of our enforcement programs. Individual audits were up 20 percent from 2004 to 1.2 million. That is 97 percent up since 2000. High-income audits were also up, and have now increased 120 percent since 2000. Corporate audits, which had bottomed out in 2003, have recovered now by over 50

percent. Collections are more robust. Last year we had 2.7 million levies against 200,000 in 2000. All told, enforcement revenues increased from $43.1 billion in 2004 to $47.3 billion last year. Concerning 2006, we expect continued progress in enforcement, although I would say, not as dramatic as some of the double-digit increases I have just indicated. We are bringing on new personnel with the moneys you provided, but it will take some time before they get fully up to speed.

As for the modernization of our computer systems, we have realized a number of achievements. In particular, I would note the progress of our taxpayer master file update, the CADE system. Last year CADE posted 1.4 million returns. Thus far this year we have already processed 5 million returns through CADE.

Before taking your questions, let me make one additional point. As I indicated, we refined our estimates of the tax gap. We will be using this information to update our audit models and selection procedures and to calibrate our resource allocation within our business units. The research also clearly indicates that where there is third-party reporting, there is better compliance. In this regard I would draw to your attention a number of proposals that accompany the President's 2007 budget request. These proposals aim to address administrative and reporting issues. The most important of these is a proposal to mandate reporting to the IRS of gross receipts by credit card issuers for their business customers.

I believe the five legislative proposals that accompany the funding request can make a significant contribution to reducing the tax gap. I hope they will enjoy your support.

Finally, I would indicate that I remain a strong advocate of tax reform and simplification.

Thank you.

[The prepared statement of Commissioner Everson follows:]

Statement of The Honorable Mark W. Everson, Commissioner, Internal Revenue Service

Introduction

Chairman Ramstad, Ranking Member Lewis and members of the Subcommittee, I thank you for the opportunity to testify today on the 2006 Income Tax Filing Season. I would also like to update you on both the FY 2007 budget request for the Internal Revenue Service as well our latest numbers of the tax gap.

2006 Filing Season

We expect to process almost 135 million individual tax returns in 2006, and we anticipate a continued growth in the number of those that are e-filed. In the 2005 filing season, over 50 percent of all income tax returns were e-filed.

We fully expect to exceed that number this year. As of April 1st, we have received nearly 54 million tax returns filed through e-file, an increase of over 3 percent compared to the same period last year.

This increase in e-filing is being driven by people using their home computers. The total number of self-prepared returns that are e-filed are up by 16.9 percent compared to this time a year ago. Almost 15 million returns have been e-filed by people from the comfort of their own home, up from just over 12 million for the same period a year ago. Fully, 28 percent of all electronically filed returns have been done on home computers. This is up 3 percentage points over this time frame last year.

Overall, 67 percent of the nearly 80 million returns filed thru April 1, have been e-filed, over a 3 percent increase compared to the same period in the 2005 filing season.

Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank ac-

count in two weeks or less. That is about half the time it takes us to process a paper return. For the IRS, the error rate for returns e-filed is less than for paper returns.

Most people are choosing to have their tax refunds directly deposited into their bank than ever before. So far this year, we have directly deposited more than 44 million refunds, or 69 percent of all refunds issued this tax filing season. This is up from 65 percent for the same period in 2005.

People are also visiting our web site, IRS.gov in record numbers. The IRS has recorded almost 90 million visits to our web site, up from 84 million for the same period a year ago. This is a 6.43 percent increase.

The millions of taxpayers that have visited IRS.gov have benefited from many of the updates that we have made for this filing season. We have made it easier for taxpayers to get answers to many of their tax questions. The web site:

- Allows a taxpayer to determine whether he or she qualifies for the Earned Income Tax Credit (EITC);
- Assists the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);
- Allows more than 70 percent of taxpayers the option to actually file their tax returns at no cost through the FreeFile program;
- Assists hurricane victims with information on many of the changes in the tax laws that are designed to help them along with a toll free number for victims to get their questions answered; and
- Allows a taxpayers who are expecting refunds to track its progress via the "Where's My Refund?" feature on the site.

As of April 1, we have received almost 80 million returns, a very slight decline over the same period as last year. We have issued 66.7 million refunds this year for a total of $154.3 billion. The average refund this year is $2,314, $104 more than last year. In addition, more than 17 million taxpayers have tracked their refund on IRS.gov, up almost 18 percent over last year.

At the present time we have been able to mitigate much of the impact of retaining 15 hours of service on our toll free lines. Our planning assumptions called for reducing toll-free operating hours from 15 hours to 12 hours while still maintaining the same service level for our customers. When this change was not implemented, the expected savings were restored and used to increase overtime. In addition, resources from answering paper correspondence were diverted to telephones. To date, these strategies have produced positive results.

In addition to these personnel actions, we have not yet experienced some of the workload increases that were anticipated as a result of the hurricane disasters. Overall, this filing season through March 25th, we have actually received about one million fewer telephone calls that last year (24.6 million in 2006 vs. 25.6 million in 2005). As a result, our Customer Service Representative (CSR) Level of Service (percent of calls answered) is slightly above last year (84.19% in 2006 vs. 82.60% in 2005). Additionally, we have received over 204,000 fewer pieces of correspondence than last year. However, because we deployed Adjustments staff to the telephones, paper inventories are 110.6.9% of last year (870,987 in 2006 vs. 787,491 in 2005). The number of cases that are overage has also increased significantly (44,915 in 2006 vs. 32,578 in 2005).

While it is still too early to tell if the expected hurricane disaster calls will materialize, if they do not we are guardedly optimistic that we will be able to maintain these service levels for the remainder of the filing season.

As of March 18th, our Taxpayer Assistance Centers (TACs) are reporting a 12.6 percent decline in face to face contacts this filing season as compared to last year. We believe that the decline in visits to our TACs as well as the reduction in the number of calls is largely attributable to taxpayers increasing their use of IRS.gov and other electronic means to get their questions answered and obtain tax forms.

The use of other alternatives, such as volunteer return assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased while the numbers of TAC contacts have decreased. In FY 2005 over 2.1 million returns were prepared by volunteers. As of March 25th, volunteer return preparation is up 6.5 percent above last year's level. Volunteer e-filing is also up, by 4.5 percent over the same period in the last tax filing season. This is reflective of continuing growth in existing community coalitions and partnerships.

Free File

I recognize there have been some questions raised as to the renewal of our Free File agreement. Allow me to update you on the both the background of Free File and the new agreement.

Free File's roots can be found in the President's FY 2002 Management Agenda. It contained five Government-wide initiatives, one of which was to expand electronic government. The overarching goal was to "champion citizen-centered electronic government that will result in major improvements in the federal government's value to the citizen."

Subsequently, in November 2001, OMB's Quicksilver Task Force established 24 e-government initiatives as part of the President's Management Agenda. These initiatives were designed to improve government-to-government, government-to-business, and government-to-citizen electronic capabilities.

One initiative instructed the IRS to provide free online tax return preparation and filing services to taxpayers. In accordance with this OMB directive, the IRS began working in partnership with the tax software industry to develop a solution. Two principles guided its development: no one should be forced to pay extra to file his or her return and the IRS should not get into the software business.

The IRS believes that private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available. Rather than entering the tax software business, IRS' partnership with private industry: (1) provides taxpayers with high quality services by using the existing private sector expertise; (2) maximizes consumer choice; (3) promotes competition within the marketplace; and (4) meets these objectives at the least cost to taxpayers.

On October 30, 2002, the IRS and the Free File Alliance, LLC, signed an agreement that created a public-private partnership to provide free services to the majority of taxpayers.

The Free File Alliance, LLC, is a private-sector consortium of tax preparation software companies. The original agreement was for three years with a series of two year renewal options. The primary candidates for Free File were those taxpayers who prepare their own taxes and still file paper returns.

While membership in the Alliance may change from time to time, all members must meet certain IRS standards. Specifically, we must approve each member's proprietary tax preparation software. In addition, each member must obtain third party privacy and security certification. Finally, all Alliance members must adhere to all Federal laws regarding taxpayer privacy.

Each Free File Alliance member was allowed to set taxpayer eligibility requirements for its program. Generally, eligibility was based on such factors as age, adjusted gross income, state residency, eligibility to file a Form 1040EZ or for the Earned Income Tax Credit. But, as a whole, under the original agreement, the Alliance was required to provide free services to at least 60 percent or 78 million of the nation's individual taxpayers. In addition, all active armed forces, federal reservist and National Guard personnel were eligible to free file through a separate program operated by the military.

While the IRS did not support or endorse any Free File Alliance company or product offered, it did provide a listing of the Alliance members via the Free File web page, which is hosted on IRS.gov. Companies were allowed to offer ancillary services to taxpayers for a fee, but the taxpayer was under no obligation to purchase any of those services as a condition of getting their Federal tax return prepared free of charge.

The intent of the Free File program was to reduce the burden on individual taxpayers, make tax preparation easier and expand the benefits of electronic filing to a majority of Americans. In the 2003 filing season, 2.8 million taxpayers took advantage of Free File. This number rose to 3.4 million in 2004. In 2005, the number increased to over 5 million.

The 2005 number may be a bit of an aberration in that many of the companies in the Alliance opted to lift qualification restrictions on taxpayers thus allowing any taxpayer, regardless of income, to utilize Free File. This started as some companies sought a competitive advantage by expanding their base and ended with many of the companies' offering free return preparation services to anyone.

While this was good for taxpayers in general, it posed a serious threat to the survival of the Alliance and was a prime topic of discussion when the contract was up for renewal at the end of last year. Many of the companies could not continue in the Free File Alliance unless it returned to offering the free service to low and moderate income individuals. The loss of these companies would have jeopardized the continued existence of the Alliance.

As we prepared for negotiations to extend the Free File agreement in 2005, the IRS took the position that Free File should be available to as many taxpayers as possible. The Alliance's position was that Free File should only be available to low and moderate income taxpayers.

As is the case in most negotiations, we compromised and agreed that Free File would be offered to 70 percent of taxpayers, or anyone with an AGI of $50,000 or less in 2005. This covers approximately 93 million of the 133 million taxpayers expected to file. This is an improvement over our earlier agreement which only guaranteed coverage of 60 percent or availability to 78 million taxpayers. The active armed forces, federal reservist and National Guard personnel continue to be eligible to free file under their own program.

In 2006, three Free File Alliance members are offering state filing for free. Seven members are offering to file F4868, Extension of Time to File Individual return. As of the end of February, 653 extension forms had been filed. In addition, there are two companies offering free packages in Spanish.

While the number of taxpayers taking advantage of Free File in 2006 will likely be less than in 2005, we are unable at this time to fully explain the decline. Certainly the fact that it is not available to everyone is one factor, but there likely are other factors as well.

A year ago, the Free File program was benefited greatly by a major article on the front page of *USA Today*. Immediately following that article, there was a tremendous surge of positive publicity as well as a surge in Free File usage by taxpayers. We have not been the beneficiary of similar publicity this year and to the extent we have received coverage much of it has focused on the taxpayers that Free File does not cover.

One of the major concerns that many critics of the Free File program have had has been the ability of the Alliance members to use Free File to market other services to taxpayers. These include the filing of state tax refunds and the offering of refund anticipation loans (RALs). We make it clear to taxpayers that the IRS does not endorse any of these products or services nor is the completion of their tax return at no cost conditioned on the purchase of any product or service.

We generally do not know what, if any, fee services taxpayers actually use from the Free File vendors. The one service that we do have data on is refund anticipation loans (RALs). RALs are designed to provide the taxpayer an immediate refund in the form of a consumer loan. Often the costs incurred with the RAL are disproportionate to the amount of the refund, especially considering that a taxpayer that files electronically will get the refund from the IRS in about two weeks. Unfortunately, it is often low income taxpayers, the ones that can least afford it, which choose RALs.

What we are seeing from our Free File data thus far in this regard is encouraging. Only 0.6 percent of the taxpayers utilizing Free File have utilized a RAL. In fact, half of the Free File vendors do not even offer refund anticipation loans.

This 0.6 percent RAL participation for Free File is the lowest of any of our electronic filing groups. Other online filers have a 0.8 percent participation rate. The rate for online returns done by paid tax preparers is the highest. Approximately 20 percent of the preparer returns submitted electronically include a RAL.

Now, I would like to talk about the President's FY 2007 proposed budget for the IRS.

President's FY 2007 Budget Maintains the Balance between Taxpayer Service and Enforcement

Our total budget request for FY 2007 is $10.6 billion in direct appropriations supplemented by $135 million in new user fee revenue, for a total operating level of $10.7 billion. This request represents a total increase of 1.4 percent from the FY 2006 enacted level. The FY 2007 Budget sustains the enforcement funding increase provided in FY 2006 to improve tax compliance. More importantly, the budget maintains the balance between service and enforcement.

The IRS' taxpayer service and enforcement activities are funded from the three appropriations: Processing, Assistance and Management (PAM); Tax Law Enforcement (TLE); and Information Systems (IS). The total FY 2007 Budget request for these three operating accounts is $10.4 billion supplemented by the $135 million in new user fee revenue, for a total operating level of $10.5 billion, or 1.8 percent increase over the FY 2006 enacted level.

The $135 million in new user fees revenue will be generated from several increased and new user fees earned from special or non-routine services provided to taxpayers by the IRS. These would include such services as providing private letter rulings for interpretations of tax law and applications for exempt status. The largest portion of the anticipated increase in fees will come from new and restructured installment agreements ($66.7 million). Another $47.1 million is expected from letter rulings and determinations. The remainder will come from technical training and enrolled agent fee increases.

These increased fees were designed to more fully reflect the cost of providing these services as required by OMB Circular A–25. Every two years the fees are reexamined to see whether they reflect the full cost.

The budget includes an additional $137 million, a 2 percent increase for enforcement to fund the pay raise and other cost adjustments needed to maintain the FY 2006 enforcement initiative increase. Similar to last year, the President's Budget proposes to fund this enforcement increase through an adjustment to the discretionary cap, which in effect would increase the amount of funding dedicated to tax enforcement from $6.82 billion in FY 2006 to $6.96 billion in FY 2007. The IRS will continue to focus its enforcement resources on efforts designed to increase compliance and reduce the tax gap. We will continue our examination of tax-exempt entities used to violate federal income tax law and tax strategies involving international elements for both corporations and high income individuals.

I would remind the Subcommittee that in FY 2005 we brought in a record of $47.3 billion in enforcement revenue, an increase of $4.2 billion from the previous year. In FY 2006, we expect that total to increase to $48.1 billion, a 42 percent increase from FY 2001.

We have done a lot of work at the IRS regarding our return on investment (ROI) for the enforcement dollars we are spending. Based on that work, we estimate that when we receive the full productive benefits of the FY 2006 increase, the ROI for additional enforcement resources will be 4:1. Stated another way, we estimate that each dollar invested in enforcement will return four dollars in additional enforcement revenue, although this should not be interpreted as a fixed ratio.

This estimated "return" is based on the amount of additional tax collected and attributes the revenue to the enforcement occupations that originated each case. For each type of IRS enforcement employee, the associated amount of additional tax collections is estimated based on an extensive data base, covering the most recent 11 years of collection experience.

This analysis does not include the indirect effect of increased enforcement activities in deterring taxpayers considering engaging in non-compliant behavior. Econometric estimates of the indirect effects indicate that they may be 10 times the size of the direct effects, or larger.

The $3.58 billion for taxpayer service, including the $135 million from new user fee revenue, will maintain our commitment to provide high-quality taxpayer services through improvements to information technology and other targeted efficiencies such as those resulting from increased electronic filing.

The Business Systems Modernization appropriations account funds the IRS' costs to develop and deploy our critical, major information systems. The requested level for BSM is $167.3 million, a 15.1 percent reduction from the FY 2006 level. This is discussed later in the testimony.

Lastly, the Health Insurance Tax Credit appropriation (HITCA) remains a separate account that funds the administration of a refundable tax credit. The FY 2007 request for HITCA is $14.9 million, a 25.8 percent reduction from the FY 2006 enacted level.

FY 2007 Detailed Budget Summary

Our FY 2007 Budget request of $10.7 billion, which is offset by the $135 million in new user fee revenue, primarily funds costs to maintain the IRS' current levels of service and enforcement ($272.2 million) and an initiative to consolidate the Philadelphia Campus ($20.9 million). This request also includes several program savings and efficiencies that reflect the IRS' aggressive efforts to identify and deploy technology improvements that will benefit both taxpayer service and enforcement programs. Collectively, these cost savings total $116.1 million:

- *E–File Savings −$6,760,000/−174 FTE:* This savings results from increased electronic filing (e-file) and a reduction in Individual Master File paper returns. Estimated e-file savings are based on the projected reduction in the number of paper returns processed each year, offset by the cost of processing e-filed returns.
- *Improvement Project Savings −$8,215,000/−135 FTE:* This savings results from operational improvements generated by the Contact Recording, Queuing Management (Q–Matic), Correspondence Imaging Systems, and End-to-End Publishing improvement projects already in progress.
- *Competitive Sourcing Savings −$17,000,000/−242 FTE (The −242-FTE is a revised figure which corrects an error included in the FY 2007 President's budget request for the IRS).* These savings reflect efficiencies and savings that will be achieved through the IRS' competitive sourcing efforts resulting from six different projects in various phases of implementation.

- *Program Efficiencies −$84,121,000/−873 FTE: (−873 FTE is a revised figure, which corrects an error included in the FY 2007 President's Budget request for the IRS)* These savings reflect Service-wide efficiencies resulting from the elimination of duplicative overhead in internal support functions, increased productivity through improved workload selection, and distribution techniques, automation of certain taxpayer assistance functions, and deployment of the FY 2006 enforcement hires to full time examiner positions. These efficiency savings can be realized with no adverse impact on taxpayer service and enforcement operations.

Of the $84 million in efficiency savings, approximately $24 million of this reduction reflects savings from renegotiated information systems and telecommunication contracts. Another $38 million of these savings are based on enhanced productivity and efficiency of the IRS' enforcement programs achieved by consolidating, reducing, and redirecting some of the overhead resources, as well as reengineering of processes and improved workload selection techniques in examination and collection. Some examples of these improvements include:

- Increased efficiency of LMSB examination process to improve identification of risks and issues to enable earlier issue resolution, reduce audit cycle time, and increase inventory turnover;
- Conversion of enforcement trainees hired in 2006 to examiner positions, allowing veteran examiners (working as trainers) to resume exam work;
- Re-engineering of workload selection techniques to resolve simple cases quickly, and concentrate resources on the most egregious cases;
- Maintenance of audit coverage for large organizations through improved data collection techniques. Reduction of time required to complete compliance checks to place returns with agents more quickly; and
- Improved investigative efficiencies, enhanced managerial oversight, streamlined business processes, and improved technological capability to process electronic data and evidence.

The remaining $22 million of these savings results from efficiencies to taxpayer services, including the judicious distribution of workload and the automation of certain taxpayer assistance functions, such as the centralized monitoring of case inventories. For example, approximately $12 million of these efficiencies in taxpayer service are based on improvements such as:

- Deployment of the use of the Individual Taxpayer Identification Number Real Time System (ITIN RTS). The ITIN RTS will save time and resources for both the Service and taxpayers, through automation of the process of providing an Individual Taxpayer Identification Number (ITIN) to taxpayers ineligible for a Social Security Number but required to provide identifying information on tax returns.
- Reductions in printing and postage costs due to efficiencies to the current processes for notices, and
- Expanding the use of automated reference tools, such as operator scripts, to improve telephone operations.

In addition to the program savings and increases for taxpayer service and enforcement, the FY 2007 Budget includes a $5.5 million reduction to the Health Insurance Tax Credit Administration (HICTA) Program. This funding adjustment for HITCA reflects the program's effort to align fiscal year costs with contract year expenditures.

IRS Modernization

The requested level for BSM of $167.3 million, a decrease of $29.7 million, will continue the support for Customer Account Data Engine (CADE), Filing and Payment Compliance (F&PC) and the Modernized e-File (MeF) project along with some of the needed investments to upgrade our modernized infrastructure.

After several years of cost, schedule, and performance problems, the BSM program has demonstrated a markedly improved performance in the past two years in delivering projects and releases on time, on budget, and meeting or exceeding expectations. Taxpayers are now realizing the benefits of our enhanced BSM program management capabilities. In FY 2006 and continuing in FY 2007, we are revising our modernization strategy to emphasize the release of projects to deliver business value sooner at a lower risk. We will concentrate on delivering releases of the major tax administration projects, along with infrastructure initiatives that support all modernization projects, and continuing our improvements to program management operations. These projects and initiatives address core IRS strategic priorities: taxpayer service, enforcement, and modernization.

As part of our continuing effort to improve taxpayer service, we plan to expand services provided and the number of taxpayers served by Modernized E–File (MeF). MeF uses the latest secure Internet technology and speeds turnaround time for tax return submissions, equating to significant reductions in burden and time for corporate and tax-exempt taxpayers.

As of March 25th, MeF had processed nearly 240,000 Form 1120 and 1120S corporate returns. This compares to 95,000 at this point a year ago. In addition, there have been another 335,000 requests for extensions as opposed to 46,000 at this point in 2005. In recent regulations, the IRS has mandated the nation's largest corporations and tax exempt organizations file electronically in 2006 through the use of MeF.

Finally, we will continue to expand the use of the Customer Account Data Engine (CADE). CADE will ultimately replace our antiquated Master File system, which is the repository of taxpayer information. CADE allows faster refunds, improved taxpayer service, faster issue detection, more timely account settlement, and a robust foundation for integrated and flexible modernized systems. CADE posted more than 1.4 million returns and generated more than $427 million in refunds in 2005. In 2006, CADE has already posted 5.2 million returns and generated over $2.5 billion in refunds from electronic filers alone. We anticipate to processing an additional 1.5 to 2 million returns during this filing season. In the 2007 filing season, we expect that number to rise 33 million. CADE serves as the single authoritative repository for account and return data for those returns.

Private Collection Agencies (PCA)

The American Jobs Creation Act of 2004 created section 6306 of the Internal Revenue Code, which allows the IRS to use private contractors to collect delinquent taxes in instances where the amount owed is not in dispute. It is important to understand that these PCAs will be assigned cases where the tax balance is not in dispute and will not be performing audits or assessing penalties, or taking enforced collection actions of any kind. They will only be used in instances where what is owed has been determined but the taxpayer has not paid.

On March 9th, we announced the award of contracts to 3 PCAs. It is our expectation that these firms will begin work as soon as issues are resolved regarding the two protests to these awards. If cases are placed in FY 2006, as allowed by statute, the IRS will retain 25 percent of any posted revenue receipts from this program which we will use to supplement our existing budget (for collection related activities). We anticipate an even greater return for FY 2007 since case placements are expected to increase.

The Tax Group

To understand the need for full funding of IRS's proposed FY 2007 budget, one also needs to understand the nature of the tax gap. The tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws.

It is the need to reduce that gap that drives much of what we do. This is true not only from a revenue standpoint, but also from a taxpayer fairness perspective. Our tax system is largely based on voluntary compliance and that compliance is enhanced if taxpayers believe that everyone is paying their fair share.

A year ago, we released preliminary estimates of the tax gap based on data derived from a National Research Program (NRP) study done on individual income tax returns from Tax Year 2001. This was the first comprehensive update of our tax gap estimate since 1988. We have now revised those estimates and I would like to summarize them for you.

Our latest numbers show that there is an overall gross tax gap of approximately $345 billion, leading to a noncompliance rate of 16.3 percent. Both of these numbers are in the upper end of the range of estimates provided last spring. Our estimate of the corresponding net tax gap, or what is remaining after enforcement and other late payments, is $290 billion, also in the upper end of the earlier range.

Noncompliance takes three forms: not filing required returns on time; not reporting one's full tax liability even when the return is filed on time; and not paying by the due date the full amount of tax reported on a timely return. We have separate tax gap estimates for each of these three types of noncompliance.

Underreporting constitutes nearly 82 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes 8.6 percent and underpayment 9.6 percent of the gross tax gap.

Individual income tax accounts for 46 percent of all tax receipts. However, individual income tax underreporting is approximately $197 billion. This constitutes about 56 percent of the overall tax gap.

As in previous compliance studies, the NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent ($56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated reductions of income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits.

The corresponding estimate of the self-employment tax underreporting gap is $39 billion, which accounts for about 11 percent of the overall tax gap. Self employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self employment tax together, then, we see that individual underreporting constitutes about two-thirds of the overall tax gap.

Increasing Compliance through Service *and* Enforcement

It is important to understand that the complexity of our current tax system is a significant reason for the tax gap. It is easy for even sophisticated taxpayers to make honest mistakes. We must achieve fundamental reform and simplification of the tax law in order to achieve significant reductions in the tax gap.

Until we have fundamental tax reform, there are some changes in the law that will improve compliance and provide us with additional tools that we can use to go after those taxpayers unwilling to pay their fair share. Later in my testimony, I will discuss five specific legislative proposals that are offered as part of the FY 2007 budget and designed to reduce the tax gap.

IRS is committed to assisting taxpayers in both understanding the tax law and remitting the proper amount of tax. We are continuing to do this by maintaining the balance between service and enforcement that is so critical to tax administration.

Service

I have already talked about IRS.gov and how it can answer many taxpayer questions on issues ranging from the Earned Income Tax Credit (EITC) to the Alternative Minimum Tax (AMT) to refund tracking. On a recent day, our site ranked third in overall hits according to Yahoo's Buzz Index. The American Customer Satisfaction Index has ranked our site well ahead of the government benchmark in the areas of content, functionality, navigation, privacy, satisfaction and in many other areas. Thus far this year, visits to our site are up 6.43 percent over the same period a year ago.

This success has been recognized by others. In 2004, IRS.gov won the Keynote Performance Award as the most reliable Federal web site for performance and availability. It won the 2005 Government Computer News agency award for innovation and is a finalist for the 2005 Excellence.gov Award in recognition of being an outstanding Federal interactive web site.

We believe the internet has become our primary vehicle for delivering service information to taxpayers. Please note that I said primary and not exclusive. We recognize that we will likely always have a percentage of taxpayers that we need to serve through either direct personal service or over the telephone, but we hope to continually drive that number down, while at the same time improving the levels of service and taxpayer satisfaction. This will not only save us time and resources, but also will provide a valuable service to taxpayers. They can get answers to their questions at their home, at their convenience, rather than visiting a walk-in site.

We continue to get good marks on various customer service surveys. Our toll free telephone service customer satisfaction rating is 94 percent. In FY 2005, the IRS' customer assistance call centers answered 59.1 million calls. We achieved an 82.6 percent toll-free-telephone CSR level of service, exceeding our FY 2005 target of 82 percent. We also improved our toll free tax law accuracy rate to 89 percent, an increase from 80 percent in FY 2004. While this is the highest yearly rate ever, we continue to strive to improve. This filing season through February, the tax law accuracy rate is 90.2 percent.

We provided and staffed toll-free FEMA phone assistance lines for hurricane victims and answered approximately 950,000 calls. The IRS also implemented numerous tax law changes to help the victims of hurricanes Katrina, Rita and Wilma, businesses located in the disaster areas, and individuals donating to charities to support the victims.

We continue to leverage community partnerships to provide free tax return preparation assistance through successful programs such as Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). In 2005, 62,000 trained volunteers at 14,000 locations across the country prepared more than 2.1 million tax returns, an 80 percent increase since 2001. We expect the number of customers served this year to exceed 2.2 million.

I personally have had the opportunity to visit several VITA sites and I remain impressed by the diligence, the competence, and the commitment of the thousands of volunteers that make this program work.

For small businesses, we simplified the employment tax filing process for more than 950,000 small companies by allowing them to file their employment tax return annually, rather than quarterly. Our office of Taxpayer Burden Reduction led a collaborative effort to redesign the Form 1041 Schedule K–1, which among other things, is used to report income, deductions, and credits from trusts and estates to beneficiaries.

We are also making progress on our Taxpayer Assistance Blueprint (TAB). This is an ambitious, agency-wide, five-year taxpayer services plan aimed at improving IRS services.

Over the past five years we have taken significant steps to understand the needs and preferences of individual taxpayers, our primary customers, and their representatives. Many studies, such as the Multilingual Initiative, the EITC outreach, and partnerships with organizations such as AARP and the National Community Tax Coalition have focused on understanding key demographic and behavioral differences in our customers. Before now, those initiatives have not been integrated to form a complete picture of customer needs.

The TAB project will pull the pieces of the puzzle together and develop a complete picture of our customer base. Through a systematic data collection and analysis process, a dynamic plan (or Blueprint) will be developed to meet our short and long term business needs as it relates to taxpayer assistance and address concerns expressed by Congress and other oversight bodies.

In short, TAB will help us better understand our customers—their characteristics, how they access our services, what services they use and prefer, and if our services truly meet their needs.

We are nearing completion of the first phase of the TAB project. In Phase 1, we are conducting research and surveying taxpayers, stakeholders, and IRS employees to form a preliminary assessment of taxpayer needs, preferences, and demands. We will complete that phase by mid-April. In Phase 2, we will perform extensive primary research with taxpayers to refine our assessment and conclude by creating an IRS blueprint for taxpayer service delivery. We will complete this phase in October 2006.

Enforcement

The IRS made significant progress towards achieving its enforcement related goals in FY 2005. We achieved increases in every major area of enforcement. We have:

- Audited nearly 220,000 high income taxpayers in 2005, more than double the number audited in 2000.
- Increased audits for individuals to 1.2 million, 20 percent more than 2004 and almost double the level five years earlier.
- Audited nearly 5,000 businesses with assets over $250 million, an increase of 11 percent. In addition, we audited one out of every five companies with assets of $10 million. Finally, audits of businesses with less than $10 million in assets rose 145 percent from 2004.
- Increased enforcement revenue from audits of corporations and individuals to $17.7 billion in 2005, compared to $10.7 billion in 2003.
- Increased overall collections from heightened enforcement efforts by 10 percent, from $43.1 billion in 2004 to $47.3 billion in 2005.
- Generated more than $4.7 billion in revenue through two prominent settlement initiatives aimed at reducing examination and litigation expenses while deterring the use of abusive tax shelters.
- Increased collection closure cases by 12 percent and dollars collected by 14 percent over 2004.
- Increased convictions to 2,151 (from 1,926 in 2002) through increased productivity.

Combating abusive tax shelters remains a high priority in FY 2006. Last October we announced a global settlement initiative that covered 21 listed and non-listed transactions. They include a wide range of transactions involving funds used for em-

ployee benefits, charitable remainder trusts, offsetting foreign currency contracts, debt straddles, lease strips, and certain abusive conservation easements.

Taxpayers had until January 23,2006 to file an election to take part in the global settlement program. Under the terms of the settlement, taxpayers will generally be required to pay 100 percent of taxes owed, interest and, depending on the transaction, either a quarter or half the accuracy-related penalty the IRS will otherwise seek.

We have been pleased by the response to this initiative, and we believe the response was buoyed by provisions in the Gulf Opportunity Zone Act of 2005 that modified the rules for calculating interest on tax deficiencies of individual taxpayers who participated in certain abusive tax shelters, increasing the incentives for individuals to come forward as part of this program.

In addition, our Large and Mid-Sized Business Division (LMSB) has issued more than 500 administrative summonses as part of our attack on shelter promoters, and we have approximately 200 active promoter examinations under way. Entities being looked at include banks, accounting firms, law firms and brokerage houses. We want to make it clear that taxpayers who take aggressive return positions relying on the "audit lottery" and the chance they will not be examined have made a really bad decision.

In addition, we are continuing to focus on improper uses of certain tax exempt bonds and trusts, questionable transfer-pricing practices, offshore accounts, and charitable donations of intangible assets.

Another enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures.

We have done quite a bit to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. New Treasury Department regulations took effect last June that revise Circular 230 governing tax practitioner behavior. The new regulations establish standards for written tax advice prepared by practitioners.

Further, additional revisions to Circular 230 were recently proposed to make disciplinary proceedings more transparent so that practitioners may learn the types of behavior IRS is likely to challenge under the Circular.

The IRS has made noncompliance by tax exempt and governmental entities and misuse of the tax exempt status of such entities by third parties for tax avoidance purposes another major enforcement priority. For example, earlier this year, we concluded that more than 30 credit counseling firms, accounting for more than 40 percent of the industry's revenues, are not entitled to tax exempt status. The proposed revocations of the tax exempt status of these entities are the culmination of more than two years of work covering more than 60 credit counseling organizations.

These organizations were granted tax exempt status originally because they were supposed to be educating and assisting people who have credit or cash flow problems. Unfortunately, too many of these organizations instead operate for the benefit of insiders or are improperly in league with profit making companies. We want to make sure that money donated to charities goes for the purpose intended and not into the pockets of individuals associated with the charitable organization.

In 2006, our Tax Exempt/Government Entities (TE/GE) division will continue to focus on key areas where organizations are abusing their exempt status or where others are using them for unintended purposes. Three of the areas in which we anticipate renewed enforcement include political intervention, compensation and abusive transactions.

Regarding political intervention by entities claiming tax exempt status, in 2006 we will be finishing up contacts with 130 organizations suspected of political intervention in the 2004 election. Almost half of these are churches. Thus far we have completed 82 examinations and have concluded that nearly three-quarters of the non-profits examined, including churches, engaged in some level of prohibited activity. Most of these exams concerned one-time, isolated occurrences of prohibited campaign activity, which the IRS addressed through written advisories to the organizations. In three cases involving non-churches, the prohibited activity was egregious enough to warrant the IRS proposing the revocation of the organization's tax-exempt status.

We have also issued a fact sheet designed to offer guidance to non-profits on what is and is not permissible activity for tax-exempt organizations. In addition, we have taken steps to ensure that all referrals regarding campaign activity that the IRS

receives from the public, as well as activity the IRS itself uncovers, are reviewed expeditiously, and treated consistently and fairly.

Excessive compensation of executives also will be a main focus of our enforcement efforts. There are indications that tax-exempt organizations have allowed key executives too great a voice in determining their own compensation or otherwise have not used due diligence in setting compensation levels. We have contacted almost 2000 Section 501(c)(3) organizations, including about 400 private foundations regarding this issue. In addition, we are exploring compensation to tax-exempt hospital executives.

In the FY 2006 budget, our enforcement resources increased by $442 million (post-rescission). I know it is important to you, and it is equally important to us, to show a return on that investment.

Of the total $442 million in increased funding, $180 million funds the pay and non-pay inflationary costs to maintain the $6.4 billion devoted to enforcement. The remaining $262 million funds direct costs for enhanced enforcement hiring, including staff for the Counsel and Appeals organizations, and associated indirect costs for these hires. We will focus these resources on:

- Increased coverage of high-risk compliance problems to address the largest portion of the tax gap—the underreporting of tax—across all major compliance programs;
- Complex high-risk issues in abusive tax avoidance transactions, promoter activities, corporate fraud and aggressive transactions, resulting in increased corporate and high income audit coverage;
- Efforts aimed at reversing the erosion of individual tax compliance and support of the strategy to implement a balanced compliance program;
- Return preparer fraud identified through enhanced operations of the Fraud Detection Centers located on IRS campuses;
- Improved ability to identify compliance risks and significantly expanded coverage of tax-exempt communities;
- Safeguarding compliant customers from unscrupulous promoters through earlier detection of abusive schemes and heightened efforts to prevent their proliferation; and
- Increased vigilance to ensure the assets of tax-exempt organizations are put to their intended tax-preferred purpose and not misdirected to fund terrorism or for private gain, including enhanced processing of questionable exemption applications and increased technical support to the examination process.

Legislative Proposals

IRS understands that the complexity of the current tax system is a significant reason for the tax gap. It is easy for even sophisticated taxpayers to make honest mistakes. We must achieve fundamental reform and simplification of the tax law in order to achieve significant reductions in the tax gap.

Until we have fundamental tax reform, however, there are some changes in the law that will improve compliance, without imposing a significant burden on taxpayers, and provide us with additional tools that we can use to go after those taxpayers unwilling to pay their fair share.

The President's FY 2007 proposed budget includes five legislative recommendations, the enactment of which is critical to closing the tax gap. Collectively, these five changes should generate $3.6 billion over the next ten years. Allow me to address each proposal individually.

The first and perhaps most important proposal would increase reporting on payment card transactions. Our tax gap study shows clearly that increased information reporting and backup withholding are highly effective means of improving compliance with tax laws. More than 150 million wage earners already have their information reported directly by their employer to the IRS and the non-compliance rate for this group is less than 1 percent. All of these wage earners are also subject to mandatory withholding of taxes.

Payment cards (including credit cards and debit cards) are a growing form of payment in retail business transactions. The failure of some merchants to accurately report their gross income, including income derived from payment card transactions, accounts for a significant portion of the tax gap and creates a significant competitive advantage for those businesses that underreport.

Specifically, the Administration proposes that the Treasury Secretary be given the authority to promulgate regulations requiring annual reporting of the aggregate reimbursement payments made to merchants in a calendar year, and to require backup withholding by payment card companies in the event that a merchant payee fails to provide a valid taxpayer identification number.

Because reimbursement information is already provided to merchants, requiring this information to be reported to the IRS on an aggregate annual basis will impose minimal burden on payment card companies and no burden on the affected merchants. In addition, implementing a backup withholding system for payment card reimbursements to businesses would lead to material improvements in the compliance rates of these taxpayers without imposing a significant burden on the card companies. Finally, the IRS will be able to use payment card reporting information to better focus its resources and relieve the burden that existing audits place on businesses that accurately report their gross income.

The second legislative proposal would clarify when employee leasing companies can be held liable for their clients' Federal employment taxes. Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Typically, these firms prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of the clients' workers.

Non-compliance with the Federal employment tax reporting and withholding requirements is a significant part of the tax gap. Under present law, there is uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to the wages paid by a company that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes are assessed and collected.

The Administration's proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also allow employee leasing companies to qualify to be solely liable if they met certain specified standards.

Our third proposal would amend collection due process procedures for employment tax liabilities. Currently, we are authorized to take various collection actions including issuing Federal tax levies to collect past-due taxes. Before a tax levy can be issued, however, the IRS generally must provide the taxpayer with notice and an opportunity for an administrative collection due process (CDP) hearing, and for judicial review.

Frequently, an employer who fails to satisfy its Federal tax liabilities for one period will also fail to satisfy them for later periods, resulting in a "pyramiding" of unpaid taxes. Some employers who request a CDP hearing or judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities during the CDP proceedings. Liabilities for the subsequent periods cannot be collected by levy until the employer has been given notice and opportunity for a hearing and judicial review for each period. The existing CDP framework compounds the pyramiding problem by depriving the government of enforced collection as a tool to encourage employers to satisfy their current Federal employment tax obligations.

Our proposal would allow the levy to be imposed prior to a CDP hearing in a fashion similar to current law provisions for levies issued to collect a federal tax liability from a state tax refund. Taxpayers would have the right to a CDP hearing with respect to employment tax liabilities within a reasonable time after the levy. Taxpayers would also continue to have access to existing pre-collection administrative appeal rights other than CDP.

The fourth proposal would require increased information reporting and backup withholding for certain government payments for property and services. It should be noted that present law requires information reporting for the provision of services and direct sales, but does not for provisions of goods. This proposal will extend information reporting, with some exceptions, to the purchase of goods by federal, state, and local governments.

Our proposal would authorize the Treasury Secretary to promulgate regulations requiring information reporting and backup withholding on non-wage payments by Federal, state and local governments to procure property and services. Certain payments would, of course, be exempt. These include payments of interest, payments for real property, payments to tax exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract.

The final legislative proposal would expand the signature requirement and penalty provisions applicable to paid tax return preparers. Under current law a paid tax return preparer is required to sign and include his/her taxpayer identification number (TIN) on an income tax return and related documents that he/she prepares

for compensation. Paid return preparers, however, are not required to sign and include their TINs on non-income tax returns, such as employment tax returns, excise tax returns, and estate and gift tax returns, and tax return related documents filed with the IRS. The Administration's proposal would expand preparer identification and penalty provisions to non-income tax returns and tax return-related documents prepared for compensation. Further, it would impose penalties for preparing tax return related documents that contain false, incomplete, or misleading information or certain frivolous positions that delay collection.

These five legislative changes strategically target areas where (1) research reveals the existence of significant compliance problems, (2) improvements will burden taxpayers as little as possible, and (3) the changes support the Administration's broader focus on identifying legislative and administrative changes to reduce the tax gap.

In addition to these specific legislative proposals, we will study the distinction between independent contractors and employees under current law. The improper classification of employees as independent contractors is a significant problem and substantial contributor to the tax gap.

Conclusions

Mr. Chairman, Members of the Subcommittee, I would like to emphasize the following points:

- E–Filing continues to grow. Over 50 million people have already e-filed their return, 67 percent of all returns filed.
- Taxpayers who are e-filing from their home computers show the greatest increase in e-filing, up almost 17 percent from a year ago.
- Hits to IRS' web site, IRS.gov are almost 90 million, up 6.43 percent over last year.
- Returns filed by VITA and TCE sites are up 6.5 percent over a year ago.

In addition, the best way to reduce the tax gap and continue the progress made last year in both service and enforcement is the adoption of the President's proposed budget for FY 2007, particularly the $137 million for enforcement that is part of a program integrity cap adjustment, and enactment of the five legislative proposals.

Thank you, Mr. Chairman and I will be happy to respond to any questions.

Chairman RAMSTAD. Thank you very much, Commissioner. I certainly appreciate your testimony. I have a couple questions, and I can applaud the significant progress that you have made in a number of important areas that you highlighted today.

I want to, as I said in my opening statement, ask a couple questions about the Free File agreement. I know in your written testimony you stated that the new Free File agreement is an improvement over the original agreement because the original agreement guaranteed coverage of only 60 percent of taxpayers. That is a direct quote. However, I am somewhat puzzled because with this new agreement we have the cap on the number of taxpayers that can be covered under Free File, and it seems to me, based on the statistics we have seen, that the effect of the cap is that more than 40 million Americans who could use Free File last year cannot do so this year. Isn't that a major concern?

Mr. EVERSON. If you will indulge me, let me try to talk about this through the passage of time here, because as you indicate, we think this is a very important and good program. We had the initial three-year term, and that lapsed after last filing season, so then we have renegotiated with this new deal, as you indicated.

I think that the overall tradeoff that was always in the spirit of the first negotiation was that the government would not get into the preparation of tax returns or providing software that is actually being provided by industry. That was sort of the quid pro quo, if you will, of the agreement.

What happened here was that, I think as the volumes grew—and as you indicated, Mr. Chairman, they grew rapidly, and last year they exceeded 5 million, and there were no caps. Some of the players—I guess it was about 17 or 18 firms—they let it go all the way up. We were interested in a couple of things, and we wanted to make sure, as we renegotiated this, that we got as high a cap as possible on the income, because they indicated to us they wanted to put in a cap to keep it to middle-income and lower-income people. We were also interested in getting protection on Refund Anticipation Loans (RALs). The RALs—as you know, we do not favor RALs. We think that they are predatory and that they are bad for taxpayers. They are not a real big deal in connection with the Free File Alliance, but what we did do was we were anxious to get more protections in terms of clear, up-front indication, "do you want to be given information or not on these kinds of products?" So, that was a goal that we had.

We were working in what I would call a difficult negotiation because the parties on the other side, they wanted to limit this as much as they could. Then you should know that both sides of this issue are present in Congress, and in a voice vote in the Senate appropriations process last fall, in October, an amendment was agreed to that said—and this was right in the last hours of negotiation—"The Internal Revenue Service shall provide taxpayers with free individual tax electronic preparation and filing services only through the Free File program, and the Internal Revenue Service's Taxpayer Assistance Center's tax counseling for the elderly, and VITA sites." The effect of that was to say all of our leverage, which was that the government 1 day might provide these services for free to taxpayers, was effectively removed. Now, thankfully, the House didn't follow that. It dropped out in the Conference Report.

So, I think that we did our best to negotiate the best deal we could, but corporate interests intruded at a delicate moment in a negotiation, and limited what we got. We had a proposal on the table which would have increased that. Our threshold is about $50,000. That is a 70 percent level. We would have gotten a higher level we think had this maybe not have happened, but we got the protection on the RAL, so overall, I am disappointed that the volumes have gone down. There has been a lot less publicity on it. Last year, USA Today really trumped it up. I am hopeful that it will recover over the life of the program.

Going to your point, should we renegotiate it? I want to get out of this year's filing season, see where we stand, also understand where the Congress is, because Senators Grassley and Baucus, in a hearing earlier this week, were talking about more like the government ought to get into this. On the other hand, I got a question last week from Members that were saying the Government should never get into this, so I am not quite sure where the Congress is on this issue, sir.

Chairman RAMSTAD. I appreciate that explanation. I think there are some flaws or problems that you obviously have agreed to look at, some results that are hard to understand, quite frankly. I just don't understand why the IRS should prohibit companies willing to offer free services to all taxpayers from doing so on the IRS website. I know that one member of the Alliance, to be more

specific, offers free Federal preparation software to all taxpayers on its own website and through advertisements on the Internet. The same company can offer free preparation software on the IRS website, as you know, only to taxpayers making less than $50,000. It just seems to me that the IRS shouldn't prohibit companies willing to offer free services to all taxpayers from doing so on the IRS website. I just don't understand that distinction.

Mr. EVERSON. I haven't thought of that particular point, but I guess that I would express some concern about trumpeting any commercial product on our website, even if an element of it is being offered for free, because obviously, the private entity is doing that for ultimately some commercial benefit. It is part of their program to——

Chairman RAMSTAD. Only to taxpayers with income under $50,000.

Mr. EVERSON. Right.

Chairman RAMSTAD. It seems to people what is good for the goose is good for the gander.

Mr. EVERSON. Yes, I understand what you are saying, but I haven't thought——

Chairman RAMSTAD. There is inconsistency, and I trust you will certainly look at that in terms of renegotiating.

Mr. EVERSON. Yes.

Chairman RAMSTAD. Of course, the bottom line here, if you look at the aggregate, as we talked about, use of Free File again, as the graph depicted, is down over 21 percent this year.

Mr. EVERSON. Yes.

Chairman RAMSTAD. Obviously, having a negative impact on electronic filing overall. It seems to me that can only be construed as a negative result of the agreement. Is it your plan or your desire to renegotiate the agreement?

Mr. EVERSON. I haven't reached a conclusion on that at this stage. There are two factors. One, I want to see how we do through the whole filing season, and one of the things we were able to do here also is get a little more data. I think we will have better data on who participated in the Free File exercise through some of the stuff that was renegotiated. That is a good thing. We will know more. We will have to assess it, and then again, I do want to work with the Congress and understand, because I think there are two different views on this.

Many people say the government shouldn't get into this. Others seem to be saying the government ought to provide the software. That gets to this issue too, sir.

Chairman RAMSTAD. At the very least you are——

Mr. EVERSON. We will sit back and——

Chairman RAMSTAD. You will consider renegotiating.

Mr. EVERSON. Of course. At the end of this filing season we will take a good hard look at what happened and why and talk with all the involved parties, yes, sir.

Chairman RAMSTAD. I want to now defer to the ranking Member, to recognize the ranking Member. I assume that either the ranking Member or other colleagues will broach the new regulations relating to the handling of taxpayer information by tax return preparers.

Mr. EVERSON. I hope not.

Chairman RAMSTAD. There are some serious privacy concerns I know my friend from my Arizona has, and so I am going to now yield to the distinguished ranking Member, Mr. Lewis.

Mr. LEWIS OF GEORGIA. Thank you very much, Mr. Chairman.

Again, Mr. Commissioner, I thank you for being here this morning. I just want to ask one question. Have the tax laws become more complex or simpler during the past 10 years?

Mr. EVERSON. Is this a trick question?

[Laughter.]

Mr. LEWIS OF GEORGIA. No, Mr. Commissioner. I would never attempt to trick you, Mr. Commissioner.

Mr. EVERSON. No, of course, they get more complex all the time. I got this question yesterday at Small Business, and it is nothing new under this Congress or this administration, it is a steady march toward complexity that exists in our system. You look at something like the American Jobs Creation Act (JOBS Act) (P.L. 108–357), numerous provisions that we had to respond to extremely rapidly. One that is—like just the manufacturing, the benefit for manufacturing activities entails a lot of complexity in terms of regulation writing and everything else. So, absolutely, we are not doing tax compliance any favor here, sir, as we write more and more laws. I would say there are two reasons for that, one, the inherent complexity, and two, stability. Obviously, to the degree to which there is stability in a system, people or businesses can better understand over time what their obligations are.

Mr. LEWIS OF GEORGIA. Thank you, sir.

Thank you, Mr. Chairman.

Chairman RAMSTAD. Thank you, Mr. Lewis.

The distinguished gentleman from Florida, Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

I would like to follow up on Congressman Lewis's question because I think it was at the tail end of your remarks where you talked about simplification. Would simplification promote compliance?

Mr. EVERSON. I don't think there is any question to that, sir. I believe that complexity obscures understanding, and the people who want to be compliant have a harder time. Look at something as important as the Earned Income Tax Credit (EITC), where there is a lot of complexity about whether a child qualifies. There are something like seven different educational credits. It is a morass for people to try and understand that system, let alone when you get into the corporate area. So, the compliant taxpayer has difficulty. I would say the unscrupulous taxpayer takes advantage of the complexity, trying to tier transactions or make it harder for us to detect what the reality is. So, the good guys suffer and the government suffers as well, from a compliance point of view.

I am not suggesting, again, that there aren't valid public policy reasons for what you do up here.

Mr. SHAW. I think maybe we need some help there too, as to your last point. Where are some areas that you would look to for simplification? I know now that most of your tax preparers couldn't

possibly file many of the returns that they have today without computers.

Mr. EVERSON. Yes.

Mr. SHAW. It used to be I would sit down at probably the dining room table or somewhere in the house, and go through it, usually on the morning of April 15, and pencil out my tax return, and then run to the post office by midnight. That is impossible now with the Alternative Minimum Tax (AMT) and all of these things, because if you try to do it by hand, you are probably going to end up with some errors in the return itself. Where are some areas that you would look to for simplification? Where should this Committee go to search out areas of simplification? I would like for you to include in your answer your thoughts with regard to the AMT.

Mr. EVERSON. That was where I was going to start, because this whole concept of going through a return, and then getting to the end, and then we sort of pull the rug out from underneath the taxpayer, "Aha, that's not your real tax. It's over here on a separate schedule." That is hard to understand. It undoubtedly makes people mad, and in the end, they may throw up their hands and say, "Geez, why bother with all this?"

So, I think the AMT, whatever you think about it from a policy point of view, it hurts compliance because of that dynamic that I just talked about.

Mr. SHAW. I wish we could score it that way.

Mr. EVERSON. Yes, I don't know if you can. I would get rid of that, obviously, and then I would focus on these credits that I have mentioned, the multitude of credits is one area that is problematical. I think that the incredible complexity on the corporate side of the ledger is also an area that is damaging or corrosive to the system, if you will.

Mr. SHAW. Mr. Chairman, I would say here there is a fertile ground for you to spend the next couple of years in going through the tax code and looking over where we might do better and where we might be able to solve some of these problems to report back to the full Committee.

Thank you, sir, Commissioner, appreciate your being here.

Thank you, Mr. Chairman. I yield back.

Chairman RAMSTAD. Thank you, Mr. Shaw.

The distinguished gentleman from North Dakota, Mr. Pomeroy.

Mr. POMEROY. So, much to ask, so little time. Mr. Chairman, we may need another panel round, if that would be all right.

Mr. Chairman, you were following a particularly interesting line of discussion relative to the $50,000 limit. I think we will start right there.

Commissioner, I like you. I think that from a management perspective you have done a terrific job, and yet there are some things about the IRS that just make me shake my head. You are telling me that because one appropriations Members of Congress wrote a letter to you during negotiations with this Free File Alliance, you felt—of course, the appropriations Member writing basically the talking points of a couple of stakeholders that very much wanted to have the Free File limit, not for all taxpayers but limited to the $50,000 level, that based on that single letter from one Member of the Appropriations Committee——

Mr. EVERSON. No, sir.

Mr. POMEROY. You felt like——

Mr. EVERSON. No, no. Perhaps I wasn't clear. What happened was, when we were in the final days of negotiation, in a voice vote on an appropriations bill, the Senate passed the language that I read. The Senate passed it, and it was part of the massive—it didn't go through the authorizing Committees. This is a fundamental change to our tax administration system that bypassed any discussion with either Finance or Ways and Means.

Mr. POMEROY. It wasn't adopted by the House.

Mr. EVERSON. In the end it was not adopted by the House. It came out in the conference. It was not a letter, a single letter, no, sir.

Mr. POMEROY. A voice vote in the Senate Approps that in the end didn't——

Mr. EVERSON. A voice vote when the Appropriations bill was on the floor, yes, sir.

Mr. POMEROY. So, the Senate has their version, the House has their version. They are reconciled in Conference Committee. This was not one of those items that was specifically in the legislation coming out of——

Mr. EVERSON. In the end, we were in the latter days of the negotiation last fall, and there was the Senate language that came out of the Appropriations Committee, and then when that came to the floor, that amendment that I read to you was added to that. So, it was in the pending legislation on the Senate side.

Now, I learned, to my peril, last year, that things that I was told would come out of conference, in conference, and then didn't, particularly on the Senate side and some of the language that we are living with now, that I had better take pretty seriously anything that is in a bill on either side of the appropriations process.

Mr. POMEROY. I will tell you something, I think that your principal responsibility is to the taxpayers of this Nation, and if you come into your job wondering what kind of mood is Congress in today, you are going to have a miserable, miserable job. I think you need to administer the tax laws of this country in a way that benefits the taxpayers, and if Congress legislates something, you follow it, but you don't have old Floyd watching legislative debate with Senator Hucklestuffel said this and such. Forget that. So to suggest to us that this kind of intramural discussion ought to force the Agency to knuckle under to this collusive, rotten limit advanced by the Alliance, is ridiculous.

Mr. EVERSON. I am talking about at the margin, sir. We are talking about a couple percentage points in terms of eligibility. We got to 70 percent, so we protected the middle income and the lower income people, and we had——

Mr. POMEROY. Wait a minute. The $50,000 cap protects middle income people? We have just now defined middle income as $50,000 as below?

Mr. EVERSON. I think it covers 70 percent of the taxpayers, so——

Mr. POMEROY. I represent a lot of folks, North Dakota is not a high income State.

Mr. EVERSON. I understand.

Mr. POMEROY. There are a lot of people who are making $55,000 in joint income today who would be really thrilled to know they have just been promoted to the upper class. That is, in my opinion, completely insufficient. It shows to me—and I am going to pursue this in future panels—that there is way too much influence by this—basically, the Alliance, they are supposed to be helping this effort. We are not supposed to be running this effort for the benefit of the Alliance, and I kind of think things got a little askew here, and I think the $50,000 cap—as long as you are so attentive to legislative intent, let me tell you, this legislator thinks a $50,000 cap is absurd.

Mr. EVERSON. Okay. I understand your view. I wanted to see higher. There is only so much we can do to impose an agreement between two parties that is being freely negotiated, but I appreciate your interest and the espousal of that side, because that side was silent at that point in time in the Congressional debate.

Mr. POMEROY. Sorry to hear that.

Chairman RAMSTAD. Thank you, Mr. Pomeroy.

The distinguished gentleman from Georgia, Mr. Linder.

Mr. LINDER. Thank you, Mr. Chairman.

Good morning.

Mr. EVERSON. Morning.

Mr. LINDER. Nice to have you here.

How much do you charge e-filers for filing electronically?

Mr. EVERSON. We don't make a charge.

Mr. LINDER. Who does make the charge? Because people have been telling me that it cost them $30 to file electronically. Would that be the tax preparer?

Mr. EVERSON. That would be the entity that is processing them.

Mr. LINDER. Why do you want to have the gross receipts from credit cards information?

Mr. EVERSON. If you will indulge me, I have a couple of charts that I will show you on this. If you look at the tax gap—let's go to the overall tax gap map. It is kind of hard to see here, but the total tax gap of $345 billion, over 80 percent of that comes from under reporting. That is this center area. The biggest piece of the under reporting is off that blue column down on the left, which is individual under reporting, which is about $200 billion.

If you go to the next chart, this chart shows you, sir, that the noncompliance rate on wages where there is third-party reporting and withholding is only 1 percent. 150 million Americans are used to getting 235 million W–2s each year. We get that information. People report accurately.

If you go all the way to the right here, so there is only about $10 or $11 billion in that tax gap is in that area, where you get third-party reporting withholding.

Mr. LINDER. I am sure you are going to come to the credit card issue pretty soon.

Mr. EVERSON. Yes. When you come all the way to the right here where you get no reporting at all, the noncompliance rate is more like 50 percent. This is particularly relating to Schedule C income—and this is important because over the years, since 1978, the percentage of people filing Schedule C returns, saying they

have a business, has increased by 175 percent, instead of the normal—that is the red line there. The normal filer, that has just gone up by 50 percent. That is where we have no income verification.

So, what we wanted to craft—and I got some tough questions from Chairman Manzullo yesterday on this because it affects the small businesses—we wanted to craft the least burdensome way to making sure we got the information on the revenues. We feel by having the credit card issuers report to us once a year the gross receipts, we will get that information, but without the small businesses themselves having to do more reporting.

Mr. LINDER. Is your under reporting including what you think is in the underground economy that doesn't report at all?

Mr. EVERSON. In this proposal it wouldn't get to that because we are talking only about the credit cards, and when you are talking about strictly the cash, obviously, that would fall outside of that. That is an even more difficult element.

Mr. LINDER. That is 2 to 3 trillion dollars a year.

Mr. EVERSON. 2 or 3 trillion, you are saying?

Mr. LINDER. Yes.

Mr. EVERSON. I don't have an exact number on that.

Mr. LINDER. Your under reporting doesn't even consider an estimate of the underground economy?

Mr. EVERSON. We don't have—we have not captured in this $345 billion all of the underground economy, no, sir.

Mr. LINDER. How much do you think is in the offshore financial centers in dollar denominated deposits?

Mr. EVERSON. I don't have an exact answer. You are saying how much cash is sitting offshore? I don't have an answer for that. We have been pretty clear that we are very concerned about, in the corporate domain in particular, about the increasing difficulty of understanding the international transactions and the complexity entailing from globalization.

Mr. LINDER. Would you believe $10 trillion?

Mr. EVERSON. That is entirely possible. We have, as you know, the big trade deficits that are generating hundreds of billions of dollars each year, so, yes.

Mr. LINDER. What percentage of the revenues you receive from income comes from corporations?

Mr. EVERSON. From corporations, it is down—I don't have the exact number with me—but I think it is about 15, 16 percent or something like that.

Mr. LINDER. About 11.

Mr. EVERSON. 11 percent.

Mr. LINDER. 11. What do you think it was in 1950?

Mr. EVERSON. It was much higher. I know it was 20 or 30 percent, something like that.

Mr. LINDER. 23. Is that because they are getting better at it or because it is too complex?

Mr. EVERSON. I think that those are a variety of policy choices that the Congress has taken in terms of what it has done, and it also changes the economic activity. If you go back to that map that I showed you a minute ago, we have estimated the corporate tax gap for the larger corporations at $25 billion. I believe that is probably understated. We did not update the research on that. It may

be understated by half, but it doesn't change the way I would propose allocating our resources.

If you look at the coverage rates we do, sir, we are already auditing each year the biggest companies, 44 percent of those businesses each year. So, the hard thing here, I would say, if I could be clear, the hard thing here goes back to this question of simplification. It is the structure of international transactions, the complexity of the Code. It would be a lot easier for us to get after more of the corporate money if we had some help on simplification.

Mr. LINDER. Do you actually believe corporations pay taxes?

Mr. EVERSON. Well, they pay——

Mr. LINDER. They collect them.

Mr. EVERSON. If you are asking me to defend corporate practices, I have spoken to this, and I have said that there are two different incentives. There is an incentive to increase book earnings that is taking place for the public companies, and to decrease taxable earnings and maximize cash. I am very concerned about that, and that dynamic. They have extremely good help in the sense of very talented attorneys and accountants.

Mr. LINDER. They all used to work here.

Mr. EVERSON. Yes, and who operate on a global basis. We do not operate on a global basis. We have worked to sort of increase our relationships with Inland Revenue, and everybody else, and we have projects where we now have an entity—be happy to have you come down and visit it—the Joint International Tax Shelter Information Center, with the United Kingdom, Canada, Australia, where we are sharing case information with each of those countries so that we can do better, because one thing I am very concerned about is tax arbitrage, not strictly illegal, but you need to look at this because increasingly a business will structure a transaction so it comports with one set of laws on one side, and got no tax on our side, and then you got no tax on the United Kingdom side either, because it is debt here or equity there. It is an area we need to look at.

Mr. LINDER. Thank you, Mr. Chairman.

Chairman RAMSTAD. Thank you, Mr. Linder.

The distinguished gentleman from Arizona, Mr. Hayworth.

Mr. HAYWORTH. Let me thank the distinguished Chairman for the recognition, and we thank our very distinguished guest. Commissioner, thank you for coming back by, and we appreciate the time you spend in front of these Committees.

As you might expect, given the nature of our constitutional office, we spend a lot of time talking to constituents. So it was when all of us were home recently, we read with great interest of proposed new regulations from the IRS relating to the handling of taxpayer information by tax return preparers. Commissioner, I must tell you, at the various townhalls that I conducted across the width and breadth of the Fifth Congressional District of Arizona, there was genuine concern about privacy protection.

One of the proposed regulations would allow preparers to use taxpayer information to solicit taxpayers for financial services offered by unrelated third parties. I will tell you that I am hearing from my constituents, and they are not vague on this at all. They are very concerned at what seems to be an unnecessary and unwise

expansion for current rules and regulations. Can you tell me why you think this change is important?

Mr. EVERSON. Absolutely. It comes back to some of the remarks that the Chairman made in the opening statement. This area, the regulations in this area have been in effect since 1974. Under the law, a taxpayer could always have that information shared with others if there was consent by the taxpayer. We felt that—what had happened was there had been a change over the years, these standards were too general. They didn't recognize what had evolved with the Internet, outsourcing the preparation of hundreds of thousands of returns in India and places like that. There was a lot of concern that came from this body, in part, the outsourcing of the returns.

As we look at this, we said, "Geez, we need to tighten up in this area." We think we have tightened up in this area. What our proposal seeks to do is to make some pretty clear standards and improve the consent process, if you will. It even goes so far as to have a type size that has to be there so that it is not in some little paragraph at the end of something you are signing when you are under pressure to get a return finished.

As I look at this—and there have been a lot of comments on both sides of this—I think that we are tightening this up. I think this is a classic kind of Washington story, where the purest in the consumer protection group who would have no information shared, they have been vocal and they have caused the concerns—given light to the concerns that you are hearing about, but the folks who really oppose this regulation the most, which are the corporate interests, they have been silent, relatively silent. They are writing to us and commenting officially, but they have been silent in the public space because they would like the proposal to die.

The comments I have gotten from corporations, I will read you one from a letter from a lawyer. "It requires a nearly impenetrable morass of language to see anything."

If we stand down on this, this would basically be the H&R Block Relief Act, because right now, the big players, they can sit down with you when you are getting your return prepared and they say, "Geez, you ought to be in an Individual Retirement Account (IRA). We can put you in an IRA." Yet your fellow back in Arizona, who has a little three-man operation, who understands your situation, he cannot say, "Geez, First Bank and Trust down the street has got a product that would save you money here." What we are trying to do is level the playingfield so that you, as the taxpayer, knowingly consent if you want to use your information for anything other than just filing your return. That is what we are trying to do here.

Let me make one final point if I could. I know I have gone on. There is talk, as the Chairman said, about changing the statute. What I would point out here is, the basic question is, whose information is this? I do think that the civil libertarians, some of whom are talking about this, I think they would jump down my throat if I said that you as a citizen couldn't make a decision to share something with Jim Ramstad as a citizen. All we are trying to do here is make sure that if that happens, that there are clear rules

of the road and that it is done knowingly. That is what we are trying to do, sir.

Mr. HAYWORTH. Mr. Chairman, I would ask your indulgence. I see the time has expired, but I just feel it is important to pursue this line of questioning.

Chairman RAMSTAD. Proceed.

Mr. HAYWORTH. You offered the hypothetical of the small operations and the financial services offered down the block. It has been my experience, and I think the experience of virtually every taxpaying American, that there is already a deluge of investment and financial opportunities marketed to consumers, and I just wonder how you really believe this helps consumers. Now, you have talked about some of the dynamics within the tax preparation field, but how does it benefit consumers to set up this pipeline, because even in your answer you acknowledge that for so many people who go to different preparers, let's say, on the morning of the 15th, trying to get things postmarked by midnight, "Yes, sure, let me sign, let me sign, let me sign." Caveat emptor, of course, is a doctrine that has served us well. I suppose it is caveat taxpayer, but even with the type change, what is the benefit to consumers to see this information shared for yet more financial information showing up at their doorstep?

Mr. EVERSON. I think there is a benefit in some instances. Obviously, you do have to weigh—and the Congress can weigh, as the Chairman indicated, a change in the statute to say that you want to draw a hard wall on this. You can weigh those two competing interests, because, obviously, privacy—we are very concerned about privacy of information. I have been doing some TV work on phishing. We are getting increasing phishing exercised. You know what that is, when somebody does a scam to try and get information. It is a big issue.

What we were trying to do here is work with the current law in the context of all the changes that have taken place. We just had a hearing on this this week, where we get people to come in. We are going to digest all the comments, and we may make some refinements in this, but we welcome a dialog with the Congress, because you are right, there is a case to be made to say, "No, you can't do this if you are a tax preparer." That case can be made, I agree with you. However, there are other benefits that can occur, because some people do, sir, turn to their tax advisor as their real trusted financial advisor. They may not have a broker or something like that.

Mr. HAYWORTH. I will just finish up. I thank you for being indulgent with the time.

Commissioner, it also seems that advice is one area, but solicitation is something all together different.

Mr. EVERSON. I agree with that.

Mr. HAYWORTH. Given our constitutional charge, Mr. Chairman, I have prepared information. Let me be fair about this. I think, for example, one of the proposed regulations that says that a taxpayer would be provided with information if his or her return was outsourced overseas, I welcome that. However, Mr. Chairman, it is incumbent upon us in the Congress to make sure that this wall of privacy exists, and I have prepared legislation to that effect

for us to fulfill our constitutional obligations, mindful and thankful, as we always are, for our friends in the IRS handling things from the administrative angle. It is important for constitutional officers to weigh in on behalf of the people to make sure that the wall of privacy exists, as the Commissioner pointed out, for phishing, "ph" phishing, if you will, on the Internet with e-mail and a variety of other concerns. So I welcome the Commissioner's response and look forward to working with the Chairman on legislation.

Mr. EVERSON. If I could, Mr. Chairman, I think that is a very fair characterization. This is worthy of a public debate, I would suggest, sir.

Chairman RAMSTAD. The Chair thanks the gentleman from Arizona for his questioning.

Commissioner, each of the five Members presently on the dais, has at least one more question that they would like to ask. Does your schedule so permit?

Mr. EVERSON. I am okay until I think about 11:30 or so.

Chairman RAMSTAD. We will try to be as concise as possible, and we will certainly have you out of here at 11:30, at which time we are also expecting a round of votes, so that will coincide with the vote schedule.

Let me just ask you one question. I want to broach a subject that has not been talked about today, and that is the authorization that Congress gave Treasury to enter into private debt collection of delinquent taxes owed the Federal government, with the obvious purpose being to shrink an incredible inventory of potentially uncollectible Federal tax debt.

A number of us were strong supporters of my predecessor's bill, former Chairman Amo Houghton, who authored the bill to provide for private debt collection, because we believe that this authority given the Treasury Department, the IRS, has a potential to raise literally hundreds of millions of dollars for the Federal government. These are for delinquent taxes that aren't being paid and aren't going to be paid for the most part.

You recently said it would cost more to hire private debt collectors than to hire additional IRS employees to do the same work. I am not sure I understand that because we went through that, if you look at the legislative history, and given the various percentages charged by the debt collectors, it seems to me not entirely accurate to make that claim. Maybe you could explain. Maybe it is taken out of context.

Mr. EVERSON. I think what I have said is I do believe that if we had infinite resources at the IRS, we could do this work as cheaply or more cheaply than the private sector. As you know, we do the President's Competitive Sourcing Initiative and we look at different things all the time, different projects, and more often than not, the government wins because it doesn't have to make a profit. So, I believe you could do this more cheaply internally.

The reason I support this is because we have limited resources, as we have all indicated, in terms of appropriated funds. This extends our reach on a segment of the debt that we want to get after. We are working to provide all the appropriate privacy protections on this. We have just awarded contracts in the first tranche to three. There has been a protest that has been lodged. That runs

for 100 days, so that will run till the end of June with GAO, and we are hopeful that will be resolved, and then we will get after this, and that it will prove successful.

I didn't mean to imply that this is a bad deal for the Government. It is not a bad deal. Mr. Rothman, in Appropriations, was trying to get me to say I was wasteful. I don't believe this is wasteful. I think this is an intelligent thing that we have done, and we will do a good job of it.

Chairman RAMSTAD. I certainly appreciate that clarification, and that is what I assumed you would say, and that has been your position certainly, because given the limited resources with which you are operating, it seems to me that without private debt collection, this debt is sure to go uncollected. So, I appreciate it.

So, when then, given the 100-day period you mentioned pursuant to the protest, when can we expect that private debt collection firms will begin collecting taxes owed the Federal government?

Mr. EVERSON. Later this fiscal year is our hope that we will finally get after it. We are ready to go. We are taking some steps that we can do now in terms of some background checks and some of the potential individuals who will be doing the work. We have worked very carefully to develop models for the training, and again, I want to reassure the Committee that—it goes back to this privacy issue—we are very sensitive to that and the private debt collectors, and they are already being used in the vast majority of States, and they are being used by the Federal Government for education loans and things like that. We are going to make sure that the standards are pretty rigorously enforced.

Chairman RAMSTAD. As you alluded, a number of critics of this authority are still raising concerns about the private debt collection program, and maybe you could just outline very briefly the safeguards that the IRS has instituted, the safeguards which you alluded to to protect taxpayer privacy and taxpayer rights.

Mr. EVERSON. I think it really comes down to two areas. It comes down to within a parameter that they have to have the same standards that we do in terms of they can't share information. It comes down to training, and we have been working on developing good training models on this, and then it will have very rigorous contract performance monitoring where our people are in and able to monitor what is happening.

Obviously, particularly, as we ramp this up, I am acutely aware, sir, that as we ramp this up, we are only going to get one swing at bat on this and we have to do it right. I meet monthly with our team that includes training people, technical people on the use of the systems because one of the issues here is we have to make sure that the people who are making the calls have the same data. If we are talking to Mr. Pomeroy and he has sent a payment in 3 weeks ago, but the private contractor doesn't have that reflected, that is not going to be good. So, there is a system element here too.

Chairman RAMSTAD. I don't think you will get any disagreement from this panel that it has to be done right, that there is only one, as you put it, crack at the bat. I think those parameters you spelled out will result in getting it right, in administering this in a fair manner, one that protects taxpayer rights, taxpayer privacy,

and one, at the same time, an effort that at the same time will yield good results for the Federal Treasury.

Mr. EVERSON. Yes. If I can make one final point on this. I know that Mr. George, who is the Inspector General—you will be hearing from him later—he has made this one of his personal areas of concern, so we are going to get—as has the Taxpayer Advocate—we are going to get a lot of help, sort of if anybody sees anything going awry here, very quickly we will see it and respond.

Chairman RAMSTAD. Thank you again, Commissioner.

The Chair now recognizes the distinguished gentleman from North Dakota, Mr. Pomeroy, for a second question.

Mr. POMEROY. Thank you.

I have three quick items. First one, you and I have talked about the tax treatment of conservation reserve payment for retired farmers.

Mr. EVERSON. Yes.

Mr. POMEROY. The self-employment applied, the question that exists on that.

Mr. EVERSON. Yes.

Mr. POMEROY. We had worked to get this as a work item to get resolution from the Service. Where is that?

Mr. EVERSON. It has been in the guidance plan, I guess, this year. It was in last year. I think it got squeezed out because of that JOBS Act and all the things that happened there, but I checked on this, having been reliably informed you might ask about it. Our guidance here ends June 30th. I am confident we are going to get this resolved. Now, I am not sure you are going to get the answer that necessarily some of your folks would be interested in, but I think we will get this done by June 30th with the guidance plan.

Mr. POMEROY. Well, you are going to have favorable resolution.

Mr. EVERSON. I know, I know.

Mr. POMEROY. The next issue. You never see the day where you have in the U.S. Post Office, a little private vendor in the corner, "Get your payday loan here." You just never have that. The Federal Government is not going to sponsor what I believe is private enterprise engaged in such shoddy, predatory lending with usurious rates charged by those that might participate.

Yet the Consumer Law Center and the Consumer Federation of America tell us that the effective annualized rate of an RAL, based on a 10-day loan period, and then annualized—or an average refund size of $2,150. An annualized rate for that loan is 178 percent, and that loan gets even worse if the refund—if someone's taking out an anticipation loan on a smaller refund.

Mr. EVERSON. Right.

Mr. POMEROY. I am anxious about minimum standards that these Free File partners of ours need to have. In my opinion, when we refer taxpayers to them from the IRS website for Free File, and then they are just free to market this stuff that does not involve sufficient minimum quality standards, I believe, I think it is very much like the payday loan guy sitting in the corner of a post office. So, I have encouraged you in the past to look at minimum quality, minimum standards for the products that our Free File Alliance partners might be selling, so that it is appropriate. Has that gone forward?

Mr. EVERSON. Let me make a general comment. First of all, I don't like these RALs. I particularly don't like the fact that some of the preparers keep an interest in the paper. I think the banks want that because they feel that they get a more reliable indication that the loan will be repaid. Yet I am concerned about the inherent conflict there. It gets back to sort of this privacy issue, and what are we allowing preparers to do.

Mr. POMEROY. Right.

Mr. EVERSON. Your concern is one that we had that we addressed in this negotiation that the Chairman was talking about earlier and that you were mentioning. In actual fact, my understanding, sir, is that the percentage of Free File participants who actually get the RALs is de minimis. It is less than 1 percent, in contrast to a much higher number for folks who walk into a preparer and someone says, "By the way, do you want your money this afternoon?"

Mr. POMEROY. Yes, but we don't sponsor those.

Mr. EVERSON. So, what we did though was we put in some additional standards, and I think to be very clear, up front, when you come on, do you want to be solicited or not for this kind of a product? That's the change we put in to be absolutely clear that you do, if you want to go down that road. Then if you say no, I believe you cannot then—there is no other pop-up that takes place.

Mr. POMEROY. Right. I do encourage—I think the Service has a continuing obligation to make sure our private partners are only offering acceptable quality products to the taxpayers.

The final issue really relates to something that Congressman Hayworth was asking about, privacy, and privacy in the context of this taxpayer information. Congress is embroiled in an immigration debate, and I am wondering if the Service is involved in discussions with any segment of Congress or the Treasury Department regarding use of taxpayer data for immigration enforcement? I would be terribly alarmed if there were discussions along that line proceeding.

Mr. EVERSON. Mr. Pomeroy, I think this did come up, and there was a hearing in this room some 4 or 6 weeks ago that involved the U.S. Department Homeland Security (DHS) and Social Security, and myself. It was part of the Subcommittee on Social Security, and some of the Members here, Mr. Hayworth in particular, were present.

What I have said on this issue is that I do not oppose the sharing of that information. I understand the great stakes that our Nation has in having a strong immigration, an effective immigration system.

What I have said, however, is that against that public good—and there is no doubt if DHS had the information, they would be better able to enforce workplace rules. We must understand, though, that a price will be paid in our tax administration system if we go down that path, because right now my job is to make sure we get our share of the money whether you are working——

Mr. POMEROY. Not to recount. I think your view is very interesting. I am cognizant of my time being up. I just want to know, so we know the state of play here, are discussions proceeding regarding the use of taxpayer data?

Mr. EVERSON. That is in the administration proposal. That is in the administrative proposal that is being discussed on the Senate side, is my understanding. One of the principal areas is that, yes, you are strengthening the—stopping employers from hiring people, and if there is a no-match here, yes, they want that information, they do, sir.

Mr. POMEROY. So, we are going to use taxpayer data for immigration enforcement, under discussion.

Mr. EVERSON. That is under discussion, and I have given the caveat that from my point of view, this would hurt tax administration, but I am saying if we do effective immigration reform. I am a former Immigration and Naturalization Services (INS) deputy, as you may recall. That is a big problem. We have to fix that.

Mr. POMEROY. Thank you.

Chairman RAMSTAD. The Chair recognizes Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman. I would like to proceed with the sharing of data problem, but going off in a different direction. You could, in my opinion—and correct me if my opinion is all wrong—if we were to simply provide that the EITC is paid on Social Security wages, and then you were to get information from Social Security as to whose account has gotten credit for Social Security and how much that is, wouldn't that almost eliminate any need to audit the EITC? I noticed on the figures that you had up a while ago it is like 2.39 percent of your effort is toward that.

Mr. EVERSON. Right.

Mr. SHAW. I would think that when you start auditing that, you are really talking to a lot of people who have no records or anything else, which probably makes it very difficult and probably you are spinning your wheels a lot.

Mr. EVERSON. I think part of this may be income issues, but it is also who qualifies or not, and there is a lot of complexity as indicated before on the qualifying child and other issues like that. Let me try and frame this issue for you, sir. The EITC, we dispense about $40 billion a year to 22 million claimants. The cost that we have to run that program, which is a back end program—it is the largest means tested benefit program—is about $165 million. It has a very high error rate, which has been a concern. In contrast, if you look at food stamps, which has, instead of a 25 or 30 percent error rate, a 6 percent error rate, they dispense $30 billion a year, but they have a $3 billion administrative budget that is paid for or used by the States.

So, what we have here is an honors system. You claim the credit, and at the back end the IRS looks at it, which is totally different than any other benefits program where there is an up-front verification process. That is why the audit rate is a little bit higher than for some other areas.

Mr. SHAW. I think up to a certain level, the more income you produce or show, the better deal you get on the EITC. As I view the IRS, you are not really geared up to catching people for over reporting income, you are geared to catching them for under reporting income. So, it would appear to me that if we were to simply say that the EITC is to be based upon Social Security—we can talk about dependents and all of that stuff too—but Social Security wages, and then you had a direct link to what has been paid in,

so that if somebody is trying to claim the EITC on wages that they didn't pay that Social Security was not paid on, but that wouldn't qualify. It would seem that that would simplify your system and make it very easy to back away from even having to do any audits in that regard.

Mr. EVERSON. It is an interesting idea on the revenue side. As you indicate, you are absolutely right, there is a sweet spot at something like $14,000 or $15,000 dollars where the credit maxes out and then starts to come down until—I think it drops off entirely in the mid 30s.

Mr. SHAW. This would also I think—and of course, another hot-button subject, which Mr. Pomeroy was talking about, is what about the wages paid of Social Security wages or wages that are paid where there is withholding on illegal immigrants. That is a whole different subject to get into, and I am not going to prolong the hearing to get involved in that, but that would also be an area that you could probably stop payment on a lot of those things and being able to save the American taxpayer some money.

Thank you, and I yield back.

Chairman RAMSTAD. The gentleman from Arizona, Mr. Hayworth.

Mr. HAYWORTH. Mr. Chairman, mindful of the time and the indulgence of the Commissioner, I will yield to my friend from California if that is okay.

Mr. NUNES. Thank you, Mr. Hayworth, appreciate that.

Welcome Commissioner. I just want to talk briefly about the 501(c)(3)s, and recently the IRS conducted a study where out of the 82 examinations that you did, 59 had engaged in prohibited political activity. I assume you are familiar with that report.

Mr. EVERSON. Yes, sir.

Mr. NUNES. Which I commend you for conducting that report. I think it is important. I have two letters here that are dated March 1st from the IRS to Greenpeace, to their 501(c)(4) and the Greenpeace Fund, which is a 501(c)(3), in which in the letter you say that they continue to qualify for exemption from Federal income tax despite the fact that it clearly outlines the political activity that was a violation of Federal law. It looks to me like from what they were doing, it is Enron-type accounting, where they were moving money from one account to another, and then never repaying the loan.

With all the political activity that is going around this place now, I guess I wonder when are you actually going to enforce the law on some of these 501(c)(3)s, and stop them from engaging in this political activity?

Mr. EVERSON. Let me make several points here. First of all, I will not comment on a particular matter. As this Committee is well aware, I can't do that.

Mr. NUNES. I understand.

Mr. EVERSON. As a general comment, we were very concerned in the 2004 cycle about increasing indications of political intervention in 501(c)(3)s. We very much ramped up our effort on that. We established a small group of experts, all career people, and they went through a very detailed process of deciding which matters to look at. That was reviewed independently by the Inspector General.

There is no politics in any of this. As you indicate, our conclusions were that it did substantiate political intervention. At the extreme end, we have proposed the revocation of the tax exempt status for three of those organizations, and in fact, one of the revocations has been finalized.

Most of the problems we have seen were one-time problems, where we issue an advisory, and the organization agrees to stand down on that practice. A lot of this involves education of the organization and making sure they understand the rules of the road.

So, we are doing two things for this 2006 cycle. We have issued a lot of increased guidance, a lot of sort of scenarios, what is okay, what is not okay, and we are going to have that same group—we are going to augment it as we need to—to work very quickly to address problems that we see.

More broadly speaking, if I could comment upon the regulatory scheme here. Congress does need to look—and I have indicated this in my testimony on tax exempts generally—at the sanctions, because all too often in this area, or in the area of noncompliance generally by exempt organizations, we are really faced with two choices, the imposition of a de minimis tax—in this case, 10 percent of the cost of the activity, which can be quite de minimis—or lifting the tax exemption, which may not, on the other hand, be in the public good because of the many good things the organization is doing. Something in the middle that has got a little more pain to it, I think would make our jobs easier, sir.

Mr. NUNES. I think that is a very good point, because you can understand. My concern is that if you look at this activity, clearly these groups are sophisticated at what they are doing, especially in the case—I know you don't want to comment on it—but these are sophisticated groups that are very good at what they do, and perhaps you are right, that this Committee, Mr. Chairman, should look more into these 501(c)(3)s, into not only the political activities they are doing, but the possible penalties that the IRS is able to enforce. I think that is a very good point. Thank you for being here once again, Commissioner.

I yield back the balance of my time.

Chairman RAMSTAD. Thank you, Mr. Nunes.

Thank you very much, Commissioner, for your testimony today. I think some very important issues have been covered, and I appreciate the ongoing dialog, and look forward to working with you. Thank you again.

Mr. EVERSON. Thank you, sir.

Chairman RAMSTAD. The Chair now would ask the second panel to take seats so we can begin. The second panel, while they are coming forward, comprises the Hon. Russell George, Treasury Inspector General for Tax Administration (TIGTA); the Hon. Raymond T. Wagner, Chairman of the IRS Oversight Board; the Hon. Timothy Hugo, Executive Director of the Free File Alliance; and Director James R. White, Director of Tax Issues at the Government Accountability Office (GAO).

We will begin as soon as we get the dais rearranged. We will begin with you, Inspector General George, please. Take your time. I don't mean to rush you at all, Inspector General.

STATEMENT OF THE HONORABLE J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, U.S. DEPARTMENT OF THE TREASURY

Mr. GEORGE. Thank you, Mr. Chairman. Chairman Ramstad, Members of the Subcommittee, thank you for the opportunity to testify.

The IRS' planning for the 2006 season was unusually difficult due to the tax law changes enacted in response to Hurricanes Katrina and Rita. However, to date, my office has not identified any significant processing problems resulting from that. In fact, our review of the IRS' preparation for the 2006 filing season has determined that the IRS accurately updated its tax products and computer programming to incorporate tax law and other changes.

As of March 24, 2006, the IRS has received more than 73 million returns. Of those, the IRS has seen an increase in electronically filed returns of 2.6 percent, and a decrease in paper returns of 6.5 percent compared to the same period in 2005. Over the past several years the IRS has seen a steady growth in electronic filing of income tax returns. In 2005 the number of electronically filed returns increased to 51 percent of the total individual income tax returns received. While the IRS will not meet its Congressionally mandated goal of having 80 percent of all tax returns electronically filed by 2007, it does expect to see continued growth in electronic filing, albeit at a diminished rate.

Although electronic filing continues to increase overall, there are indications that taxpayers are shifting between the various types of electronically filed returns, and in some segments the numbers of electronically filed returns is actually decreasing. Returns filed electronically are generated from three basic sources: paid preparers who submit their clients' tax returns, taxpayers who purchase tax preparation software, and filed their own return via the Internet from their personal computers, and taxpayers who take advantage of free electronic filing programs, such as the Free File program, or in past years, the TeleFile program.

The IRS Restructuring and Reform Act 1998 (P.L. 105–206) required the IRS to work with the private sector to increase electronic filing. In 2003, the Free File program was launched featuring private sector partners that allowed qualifying taxpayers to prepare and file their taxes online at no cost. This was made possible through a public-private partnership consisting of a consortium of tax software companies, known collectively as the Free File Alliance.

According to statistics provided by the Alliance, almost 2.8 million taxpayers used the program in its first year. In subsequent years, use of the program increased significantly to just over 5 million taxpayers in 2005. Following the 2005 filing season, the IRS and the Alliance amended their agreement which resulted in a significant change in the focus of the program. While the new agreement comported with the original goal of increasing the number of taxpayers who electronically filed their returns, it effectively changed the intent of the program to focus on assisting lover income and underserved taxpayers.

The agreement limits the program's availability to 70 percent, approximately 93 million taxpayers for the 2005 tax year this limit

equates to an adjusted gross incomes, as was discussed by the Commissioner, of $50,000 or less. The net impact of that during the 2006 filing season, approximately 40 million taxpayers are not being offered free filing services through the program. This change, as was discussed, has support from Congress. With the 2005 budget, the House Committee on Appropriations restated the proposition that the Alliance is foremost intended to provide electronic tax return preparation and electronic filing services at no cost to the working poor and underserved taxpayers. This stems in part from the different objectives of the IRS and Alliance members.

One of the IRS' principal purposes for establishing the program was to increase electronic filing. Alliance members, however, incur a cost to provide these services. According to the Alliance members my office interviewed, their primary goal is to keep the Federal Government from entering the tax preparation business. Furthermore, Alliance members we spoke to acknowledge that participants in the program are afforded the opportunity to market additional services to taxpayers.

Overall, my office has found that the increase in electronic filing this season appears to be the result of a greater number of taxpayers paying for online filing services. As of March 18, 2006, paid online filing was up 25 percent. Free online filing, however, fell 21 percent. There are two possible explanations for this disparity. Taxpayers who filed electronically through a practitioner last year may have decided to purchase software and file online this year, or taxpayers who filed through the Free File program last year and who were disqualified from participating this year, purchased software to file online.

Another factor that may have contributed to the decline of free online filing is the elimination of the IRS' TeleFile program. The IRS and the Alliance had hoped that many of the 3.3 million taxpayers who TeleFiled in 2005, would migrate to the Free File program. However, we have found that many former TeleFilers have instead opted to file paper returns.

In addition, I am concerned that the Free File program may not be accessible to all who were eligible for it. Many low-income families do not have Internet access. Although the IRS Free File Internet site allows taxpayers to determine whether they qualify, finding the best software package to meet their needs may be difficult for less savvy computer users.

I must point out that in preparation for today's hearing, I called the IRS' 800 number yesterday, which is, as you know, designed to assist taxpayers in preparing their tax returns. The many automated options provided did not contain information on how to access Free File materials. When I reached an IRS assistor, she did not mention the program to me at all. Instead, I had to suggest to her that there was an opportunity to file my taxes online free of charge. Once I made that statement to her, I was directed to the IRS website for information regarding the program.

Overall, I am concerned that changes in the Free File program agreement, along with the elimination of the Tele-File program, have contributed to a significant slowing of the growth in electronic filing, which will defer the efficiency gains the IRS hoped to achieve this year.

Before proceeding with any reduction in customer services, whether related to tax preparation and filing options, or walk-in and toll free telephone assistance, the IRS needs to better understand the impact of such changes on taxpayers.

Mr. Chairman, Members of the Committee, thank you for allowing me to share my views. I would be pleased to answer any questions you may have at the appropriate time.

[The prepared statement of Mr. George follows:]

Statement of The Honorable J. Russell George, Treasury Inspector General for Tax Administration, U.S. Department of the Treasury

Chairman Ramstad, Ranking Member Lewis, and Members of the Subcommittee, I thank you for the opportunity to testify today on the Internal Revenue Service's (IRS) 2006 Filing Season and the 2007 budget proposal. I will discuss the challenges facing the IRS during the 2006 Filing Season, its longer term goal of increasing the number of taxpayers who file electronically, and its ability to provide quality taxpayer service.

The 2006 Filing Season

During the 2006 Filing Season, the IRS expects to process an estimated 135 million individual returns. One of the major challenges for the IRS each filing season is the implementation of tax law changes. Changes to tax law have a major impact on how the IRS conducts its activities, the resources it requires, and how quickly it can meet its strategic goals. Congress generally makes changes to tax law each year, and before each filing season begins, the IRS must identify tax law changes, revise various tax forms, instructions, and publications, and reprogram its computer system to ensure returns are accurately processed.

So far, TIGTA has not identified any significant problems with the IRS' processing of individual tax returns during the 2006 Filing Season. As of March 24, 2006, the IRS has received over 73.4 million returns. Of those, 50.3 million were filed electronically (an increase of 2.6 percent from this time last year), and 23.1 million were filed on paper (a decrease of 6.5 percent from 2005). Additionally, $144.5 billion in refunds have been timely issued. Of this amount, $113.4 billion were directly deposited to taxpayer bank accounts, an increase of 4 percent compared to last year.

Planning for the 2006 Filing Season was unusually difficult for the IRS because of many tax law changes enacted late last year in response to unprecedented natural disasters. Disaster relief provisions were enacted into law for taxpayers affected by Hurricanes Katrina, Rita, and Wilma, and were intended to provide relief to over11 million taxpayers who lived in the affected areas of the Gulf Coast, as well as to others who may have been adversely impacted by these storms.

This year, TIGTA is reviewing 28 new tax law provisions and also closely monitoring the implementation of changes intended to assist taxpayers adversely affected by the 2005 hurricanes. New tax law provisions were included in the Katrina Emergency Tax Relief Act of 2005,[1] the Gulf Opportunity Zone Act of 2005,[2] and in provisions in the Working Families Tax Relief Act of 2004[3] and the American Jobs Creation Act of 2004,[4] all of which became effective in 2005. The latest legislation, the Gulf Opportunity Zone Act of 2005, was signed into law on December 21, 2005.

TIGTA reviewed the IRS' preparation for the 2006 Filing Season and determined that the IRS accurately updated its tax products and computer programming to incorporate the tax law changes effective in 2005. TIGTA reviewed 42 tax forms, publications, and instructions that required updating, and determined that they were accurately updated. The IRS also accurately updated its computer programming and returns processing programs for the new tax law provisions and other adjustments or changes.[5] TIGTA will continue to monitor the IRS' processing of income tax returns during the 2006 Filing Season and will report its results later this year.

Electronic Filing

The IRS has seen a steady growth in electronic filing (e-file) of income tax returns over the past several years. In Calendar Year 2002, 35.9 percent of the 130.3 million

[1] Pub. L. No. 109–73, 119 Stat. 2016 (to be codified in scattered sections of 26 U.S.C.).
[2] Pub. L. No. 109–135, 199 Stat. 2577 (2005).
[3] Pub. L. No. 108–311, 118 Stat. 1166 (2004).
[4] Pub. L. No. 108–357, 118 Stat. 1418 (2004).
[5] Discussion Draft Report Tax Products and Computer Programs for Individual Income Tax Returns Were Accurately Updated for the 2006 Filing Season (Audit #200640015)

individual income tax returns received by the IRS were e-filed. Last year, the percentage of e-filed returns increased to 51.7 percent of the total individual income tax returns received. The number of e-filed returns increased 46.2 percent over the three-year span. While the IRS will not meet its goal of having 80 percent of all tax returns e-filed by 2007, it does expect to see continued growth in electronic filing, although at a somewhat diminished growth rate from year to year. For example, the IRS expects the e-file percentage to reach 54.1 percent this year, 57.7 percent in 2007, and 60.6 percent in 2008.

Although e-filing continues to increase overall, TIGTA notes some indications that taxpayers are shifting between the various types of e-filed returns, and some segments of e-filed returns are starting to show a decrease in the numbers filed. E-filed returns are generated from three basic sources—paid preparers who transmit their clients' tax returns, taxpayers who purchase tax-preparation software and file their own returns via the Internet from their personal computers, and taxpayers who take advantage of free e-filing options, such as the Free File Program, or in years past, via the TeleFile Program.

Overall, as of mid-March of this year, e-filing has increased 2.6 percent compared to the same period in 2005, although this is significantly less than the 6 percent increase the IRS expected. While the number of taxpayers e-filing from their home computers is up 16.6 percent this Filing Season, the number of taxpayers taking advantage of free online filing is down 21 percent below last year. I am concerned that more taxpayers are not using the free e-filing services offered by the IRS, and I will discuss some issues related to the Free File and TeleFile Programs in the following sections of this testimony.

Free File Program

Background

In February 2002, President Bush established an agenda to improve management of the Federal Government. One of his agenda items is E-Government. E-Government is an integral part of the President's Management Agenda to make it easier for citizens and businesses to interact with the government, save taxpayer dollars and streamline citizen-to-government transactions. In response to the President's E-Government initiative, the Office of Management and Budget (OMB) developed the EZ Tax Filing Initiative. EZ Tax Filing was intended to make it easier for citizens to file taxes in a Web-enabled environment. Citizens would no longer have to pay for basic, automated tax preparation. The goal of this initiative was to increase the number of citizens who filed their tax returns electronically.

The IRS Restructuring and Reform Act of 1998 (RRA 98)[6] established a goal for the IRS of having 80 percent of Federal tax and information returns filed electronically by 2007. It also required the IRS to work with private industry to increase electronic filing. In response to this requirement, in 2003 the Department of the Treasury (Treasury), OMB and the IRS launched the Free File Program featuring private-sector partners that allow qualifying taxpayers to prepare and file their taxes online for free. The Treasury, OMB and IRS made this possible through a public-private partnership with a consortium of tax software companies, the Free File Alliance, LLC (Alliance).

The Free File Program provides taxpayers with access to free online tax preparation and e-filing services made possible through a partnership agreement between the IRS and the tax software industry. Eligible taxpayers may prepare and e-file their Federal income tax returns using commercial online software provided by Alliance members. After the IRS and Alliance entered into a Free File Agreement, the Free File Program debuted in January 2003. According to statistics provided by the Alliance, more than 2.79 million taxpayers used the program in its first year. In subsequent years, use of the Free File Program increased significantly, to about 3.51 million taxpayers in 2004, and 5.12 million taxpayers in 2005.

The Amended Free File Alliance Agreement and Its Potential Impact on Electronic Filing

After the 2005 Filing Season, the IRS and the Alliance amended their agreement to continue the Free File Program through October 2009. With the amended agreement, the overall focus of the Free File Program changed significantly. While the amended agreement still contributes to the original goal of increasing the number of citizens who electronically file their tax returns, new limits effectively changed the intent of the Free File Program. The original intent of the program was to pro-

[6] 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.).

vide free tax preparation and electronic filing services to all taxpayers. The revised intent is to assist lower income and underserved taxpayers.

The original 2002 agreement between the IRS and the Alliance established a minimum number of taxpayers who should be served by the Free File Program and was more in line with the intent of the EZ Tax Filing Initiative. There is, however, some support in Congress for the shift in the program's focus to lower income and underserved taxpayers. For example, according to the House Appropriations Committee Report accompanying the IRS' FY 2005 Budget Appropriations, the Committee reaffirmed its position that the Alliance is first and foremost intended to provide electronic Federal tax return preparation and e-filing services at no cost to the working poor and other disadvantaged and underserved taxpayers.

As part of the amended agreement, new limits were set for participation in the Free File Program. The new limits stem, in part, from the differing objectives of the IRS and the Alliance members. One of the IRS' principal purposes for establishing the program was to add another avenue for electronic filing with the intent of increasing electronic filing overall. However, Alliance members are businesses that incur a cost to provide free services. According to representatives of Alliance member companies that TIGTA interviewed,[7] their primary goal is to keep the Federal Government from entering the tax preparation business. A secondary benefit of their participation in the program is the opportunity to market their other products for free. Taxpayers opting to use these services provide additional revenues to Alliance members.

Per the initial agreement, a minimum of 60 percent of all taxpayers (approximately 78 million) were eligible for the Free File Program. Last year, the Alliance opened the program up to almost 130 million taxpayers. However, only 5.12 million taxpayers took advantage of it. The amended agreement now limits the program's availability to 70 percent of taxpayers (approximately 93 million). For Tax Year 2005, this limitation equates to an Adjusted Gross Income (AGI) of $50,000 or less. The maximum AGI to achieve the 70 percent limit, however, may vary from year to year. The net impact of this new limit is that during the 2006 Filing Season approximately 40 million taxpayers will no longer be offered free filing services through the program.

As mentioned earlier, online filing on home computers is up 16.6 percent this Filing Season. This increase, however, appears to be the result of additional taxpayers paying for online filing services. As of March 18, 2006, paid online filing is up 33.8 percent while free online filing is down 21 percent. Two possible explanations for the growth in online filing from home computers and the decline in free online filing are: 1) taxpayers who filed electronically through a practitioner last year may have decided to purchase software and file online this year; and 2) taxpayers who filed through the program last year do not qualify this year, and they purchased software to file online.

Another factor that appears to have contributed to the decline in free online filing is elimination of the IRS' TeleFile Program. The IRS and the Alliance had hoped that many of the 3.3 million taxpayers who used TeleFile in 2005 would migrate to the Free File Program. However, current Filing Season statistics indicate that many former TeleFilers are no longer electronically filing and instead are filing their returns on paper.

Positive Provisions of the New Free File Alliance Agreement

Although the changes in the amended Free File Agreement limit the number of taxpayers offered free tax preparation and filing services, several other changes enhance the quality of the program. Under the amended agreement, Alliance members must adhere to more stringent disclosure on the nature, costs, and alternative methods of receiving refunds faster. In addition, not all taxpayers will be offered a Refund Anticipation Loan (RAL). There is some controversy over RALs because of the high fees and rates sometimes associated with those loans. Starting in 2006, the agreement guarantees that some taxpayers using the Free File Program will have the option to prepare and file their tax return without being offered a RAL. The decision of whether or not to accept an RAL lies with the taxpayer; however, these new provisions make the choice more clear. If taxpayers choose to apply for an RAL, all terms of the loans must be fully disclosed.

The amended agreement also increased security requirements and added performance measures for the individual Alliance members. Alliance members must have third party security assessments to ensure that taxpayer information is adequately

[7] TIGTA interviewed a sample of 6 of the 20 Alliance member companies.

protected. Also, performance standards require a 60 percent acceptance rate[8] for providers who e-file returns through the program. This acceptance rate will be gradually increased in future years.

Under the amended agreement, Alliance members also agreed for the first time to provide the IRS with an indicator that identifies those taxpayers who use the Free File Program. Prior to the amendment, the IRS had no way to independently determine how many taxpayers participated in the program, or which taxpayers were using it. Previously, individual Alliance members reported data on participation in the program, and the IRS lacked a method to monitor participation. This significantly hampered the IRS' ability to evaluate the program's success or the effects of changes to the program.

Difficulties Using the Free File Program

Although the Free File Program offers some taxpayers the option to prepare and file their tax return for free, the program may not be accessible to all who are eligible for it and it is not necessarily easy to use. The Free File Internet site easily allows taxpayers to determine whether they qualify for the program, but finding the best software provider for their needs is time consuming and may be difficult for less savvy computer users.

Taxpayers must access the Free File Program through the IRS' Internet site at IRS.gov. The Internet site clearly identifies the basic requirements for participation in the program and provides a tool that guides taxpayers to free filing providers. This tool presents taxpayers with a number of providers from which to choose based on some basic information that taxpayers provide. Although this tool guides taxpayers to the providers they qualify to use, the tool does not assist taxpayers with determining which of those providers best meets their needs.

Taxpayers must access each provider's Internet site to determine the services offered and must then compare the services offered and select the provider that is the best for them. Additionally, each Alliance member company sets taxpayer eligibility requirements for its own program. These requirements may differ from company to company. Generally, eligibility is based on such factors such as age, adjusted gross income, State residency, military status or eligibility for the Earned Income Tax Credit.

Although the Free File Program is currently focused on low-income taxpayers, many of these taxpayers do not have access to the tools to use it. For example, taxpayers who speak limited English have not been provided access to all the filing options offered. Only two providers offer services in Spanish and neither of them offer free electronic filing of Form 4868, Automatic Extension of Time to File.

The Free File Program also requires taxpayers to have access to a computer and the Internet. Taxpayers who have access to the necessary technology must also be savvy enough to navigate the IRS' and the Alliance members' Internet sites. The focus of the program on lower income taxpayers may be at odds with their ability to participate in it. In her 2004 Report to the Congress, the National Taxpayer Advocate wrote that in 2001 approximately 50 percent of low income families[9] used a computer and only 38 percent had access to the Internet. Furthermore, access to a computer or the Internet does not necessarily indicate that a person has the ability to navigate the Internet or use tax preparation software.[10]

The IRS offers free assistance to taxpayers with tax preparation and filing through its Taxpayer Assistance Centers, Voluntary Income Tax Assistance, and Tax-Aide Programs as well as through the Free File Program. Similar to the Free File Program, taxpayers must meet certain requirements in order to receive assistance from those other programs. The Free File Program, however, is the only free filing option that taxpayers may use from their homes. Taxpayers must bring their tax documentation to an assistance site to take advantage of the other free tax preparation and filing services.

The addition of the RAL provisions, increased security, and added performance measures to the agreement are important means to further promote public confidence in the Free File Program. Adding the electronic indicator to returns filed through the program will provide the IRS with information to measure the program's success. However, limiting the scope of the program to 70 percent of taxpayers has impacted the use of the program. Based on the statistics Alliance members provided in previous years, the new limits in the amendment to the agreement appear to be substantially reducing participation in the program. Furthermore, the AGI limit also keeps the program from achieving the full intent of the EZ Tax Filing

[8] The percentage of returns an individual provider must transmit to the IRS error free.
[9] Income of less than $25,000.
[10] *National Taxpayer Advocate 2004 Annual Report to the Congress, Volume 1* December 2004.

Initiative, which never specified any such limits for access to free, basic, automated tax preparation and electronic filing. Not yet known, however, is whether the IRS' ability to better understand who is using and who is not using the program will help the IRS better market the program and expand its usage despite the new limits. The answer to that question may ultimately have a significant effect on the overall growth rate of electronic filing.

Elimination of the TeleFile Program

As mentioned earlier in my statement, one factor that appears to have negatively impacted the Free File Programgrowth of e-filing this year is the elimination of the TeleFile Program. The IRS discontinued this program for individual taxpayers in August 2005. The TeleFile Program allowed taxpayers with the simplest tax returns [11] to file their returns by telephone. The pilot TeleFile Program was launched on a limited basis in 1992, and the program became available nationally in 1997. The RRA 98 included the expectation that the IRS would continue to offer and improve TeleFile, and make a similar program available on the Internet.

Despite its initial success, use of the TeleFile Program began to decrease in 1999. According to IRS electronic filing statistics as of April 17, 2005, approximately 3.3 million filers used TeleFile in 2005, a 12.7 percent decline from the previous year. Until the IRS eliminated the TeleFile Program last year, participation in the program had declined every year since 1999 when 5.2 million filers used it.

Declining use was one factor the IRS considered when deciding whether or not to end the TeleFile Program. Other contributing factors included the increasing cost of maintaining an aging TeleFile system, declining and discontinued State TeleFile programs, and the growing use of other electronic filing alternatives, such as the Free File Program.

According to the IRS, taxpayers who previously used TeleFile may continue to file electronically using one of the following five methods:

1. Tax preparers;
2. Personal computers with Internet access and tax preparation software;
3. IRS' Free File Program;
4. Free tax assistance sites, such as the Voluntary Income Tax Assistance and Tax-Aide Programs; and
5. IRS Taxpayer Assistance Centers.

However, two of the five alternatives require the taxpayer to pay for tax preparation and filing services that were previously free, and two other options require taxpayers to have access to computers and the Internet. Consequently, in many cases, the most cost-effective avenue for the taxpayer is to file a paper tax return. According to initial IRS statistics, a significant number of former TeleFile users are reverting to filing paper returns this year. As of March 17, 2006, the number of paper Form 1040EZ returns filed has increased 22 percent compared to this time last year (4.5 million in 2006 compared to 3.7 million in 2005), and there has been a corresponding decrease in electronically filed Forms 1040EZ (5.8 million in 2006 vs. 7.3 million in 2005).

TIGTA will further evaluate the impact of the elimination of the TeleFile Program on taxpayers and the IRS' efforts to increase electronic filing, and will report the results later this year.

Providing Quality Taxpayer Service Operations for the 2006 Filing Season

Providing quality customer service to the taxpayer is not only a primary goal of the IRS, but it is also one of its major management challenges. The Commissioner has frequently stated that service combined with enforcement will result in compliance. Quality taxpayer service includes helping the taxpaying public understand their tax obligations while making it easier to participate in the tax system.

Since the passage of the RRA 98, the IRS' focus on customer service has led to many improvements. One of the goals of the IRS is to improve taxpayer service by improving service options, facilitating participation in the tax system by all sectors of the public, and simplifying the tax process. Every year, the IRS helps millions of taxpayers understand their tax obligations by answering questions on its toll-free telephone lines or in person at local offices, making information available on its web site, and responding to correspondence.

Over the past seven years, the IRS has made commendable strides in customer service. However, I am concerned that the IRS does not sufficiently ensure that it uses adequate and reliable data for making decisions that impact customer service operations. Recent decisions to close Taxpayer Assistance Centers (TAC) and reduce

[11] Forms 1040EZ.

the hours of operation for toll-free telephone service were based primarily on input from IRS functional areas and considered other factors that included internal priorities, resource demands, and shifts in the IRS' customer service perspective. However, data were not obtained from taxpayers who use these services to determine the impact of removing or reducing them.

After the IRS' closure announcement, Congress enacted legislation to delay the closure of any TACs.[12] The IRS is prohibited from using funds provided in the Fiscal Year 2006 budget appropriation to reduce any taxpayer service function or program until TIGTA completes a study detailing the effect of the IRS' plans to reduce services relating to taxpayer compliance and taxpayer assistance.

IRS.gov

IRS.gov continues to be one of the most visited Web sites in the world, especially during filing seasons. As of the week ending March 18, 2006, the IRS is reporting a 5.7 percent increase in the number of visits to IRS.gov over the same period last filing season. The IRS now provides practitioners with online tools to provide better service to their customers, such as electronic account resolution, transcript delivery, and disclosure authorization. As of the week ending March 18, 2006, the IRS is also reporting a 17.9 percent increase in taxpayers obtaining their refund information online via "Where's My Refund."

Toll-Free Operations

The 2006 Filing Season has presented unique challenges for the IRS toll-free operations. The IRS had also planned to reduce the hours of its toll-free telephone operation in Fiscal Year 2006. The IRS has about 400 fewer full-time equivalents for toll-free telephone operations than it had in Fiscal Year 2005 because of plans to reduce operating hours from 15 to 12 hours per day. Congress, the Taxpayer Advocate and the National Treasury Employees Union have expressed concerns about the IRS reducing operating hours for the toll-free telephone lines. A new law enacted in November 2005 requires the IRS to consult with stakeholder organizations, including TIGTA, regarding any proposed or planned efforts to terminate or significantly reduce any taxpayer service activity.[13] Congress recently further defined a reduction of taxpayer service to include limiting available hours of telephone taxpayer assistance on a daily, weekly, and monthly basis below the levels in existence during the month of October 2005. TIGTA is currently assessing the IRS' plans to reduce operating hours and will report its results later this year.

As of March 18, 2006, assistor level of service has not been negatively impacted, with an IRS reported level of service rate of 84.3 percent. In addition, about 8 percent fewer assistor calls are being answered but the number of taxpayers who hang-up prior to reaching an IRS assistor is up 8.5 percent. The average speed of answer is about 60 percent of the time planned so those taxpayers who are calling and talking with an assistor are not experiencing longer wait times.

In planning for Fiscal Year 2006, IRS management expected fewer calls programwide, even after taking into consideration taxpayers affected by Hurricanes Katrina and Rita. IRS management believed that most taxpayers needing disaster relief assistance obtained it during the latter part of 2005. Prior to the start of the filing season, TIGTA brought to IRS management's attention our concern that more taxpayers than expected could call the help line with questions due to the effects of Hurricanes Katrina and Rita.

After we shared our concern, IRS management raised the estimated volume of services to these telephone lines by about 78,000 services, from approximately 27,000 to about 105,000 from January through June 2006, a 365.1 percent increase over the total Fiscal Year 2005 services provided on those telephone lines. For the 2006 Filing Season it appears that the calls to these telephone lines are higher than anticipated. For example, the IRS had planned 59,081 services for one of its applications devoted to assisting disaster victims; however, through March 16, 2006, the IRS has already provided 106,141 services.

Taxpayer Assistance Centers

The TACs are walk-in sites where taxpayers can receive answers to both account and tax law questions, as well as receive assistance preparing their returns. The IRS has acknowledged that staffing would be a challenge during the 2006 Filing

[12] Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006, Pub. L. No. 109–115, 119 Stat. 2396 (2005).

[13] The Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, Pub. L. No. 109–115, 119 Stat. 2396 (2006).

Season since not all TACs would be fully staffed and not all TACs will provide standard services or standard hours of operation (from 8:30 a.m. to 4:30 p.m., Monday through Friday). As of December 1, 2005, the IRS identified 47 TACs with critical staffing shortages (a critical vacancy is one that must be filled to ensure that a TAC remains open).

The IRS took actions to minimize the impact of the staffing shortages. As of January 31, 2006, the IRS had hired additional frontline technical employees, recalled intermittent employees back to work, detailed former TAC employees from their current positions in other IRS functions back to the TACs, and made plans to have some employees travel between TACs to ensure that all TACs remain open daily. The IRS' decision to focus more resources on compliance activities, however, has further limited resources available for the TAC Program. As a result, the IRS has limited some assistance services and not all TACs are open during standard operating hours. As of the week ending March 11, 2006, the IRS is reporting a 12.8 percent reduction in TAC contacts with taxpayers.

Although the IRS publicized when TAC operating hours are limited, it did not publicize when TACs limit their services. When notified by TIGTA, the IRS implemented changes and standardized the list of services offered at each TAC. Furthermore, the IRS modified its Internet site, IRS.gov, to indicate when TACs would provide limited services.

While planning for the 2006 Filing Season, the IRS considered the impact of Hurricanes Katrina and Rita. Specifically, the IRS accounted for all employees affected by the hurricanes and located alternate office space in affected areas. All TACs in impacted areas are open and operational for the 2006 Filing Season. The IRS also added services to help lessen taxpayer burden, including tax return preparation for taxpayers affected by the hurricanes regardless of the income guidelines. Additionally, the scope of tax law topics in which assistors are trained was expanded to provide assistance to taxpayers with questions about casualty losses. Furthermore, the IRS will treat taxpayers affected by Hurricanes Katrina and Rita as meeting extreme hardship criteria. That designation allows affected taxpayers to request and immediately receive transcripts of prior year tax returns instead of having to order them and wait for delivery.

TIGTA is currently in the process of making anonymous visits to TACs to determine if taxpayers are receiving quality service, including correct answers to their questions. TIGTA will also visit additional TACs to ask tax law questions specifically related to the Katrina Emergency Tax Relief Act of 2005. IRS assistors should have been trained to answer these questions. TIGTA's preliminary observations are that assistors sometimes inappropriately refer taxpayers to publications to conduct their own research, or respond to tax law questions without following required procedures such as using the publication method guide that requires them to ask probing questions.

Volunteer Income Tax Assistance (VITA) Program

The VITA Program plays an increasingly important role in IRS' efforts to improve taxpayer service and facilitate participation in the tax system. The VITA Program provides no-cost Federal tax return preparation and electronic filing to underserved taxpayer segments, including low income, elderly, disabled, and limited-English-proficient taxpayers. These taxpayers are frequently involved in complex family situations that make it difficult to correctly understand and apply tax law.

TIGTA is currently in the process of visiting VITA sites to determine if taxpayers are receiving quality service, including the accurate preparation of their individual income tax returns. TIGTA developed scenarios that are designed to present volunteers with a wide range of tax law topics that taxpayers may need assistance with when preparing their tax returns. These scenarios include the characteristics (e.g., income level, credits claimed, etc.) of tax returns typically prepared by the VITA Program volunteers based on an analysis of the Tax Year 2004 VITA-prepared tax returns. TIGTA's preliminary observations are that volunteer sites do not always use the tools and information available when preparing returns.

Conclusions

To date, TIGTA has not identified any significant processing problems during the 2006 Filing Season. Furthermore, the IRS has taken a number of actions to ensure that taxpayers impacted by Hurricanes Katrina and Rita are able to obtain disaster relief assistance. TIGTA will continue monitoring the IRS' administration of the disaster relief provisions to ensure that impacted taxpayers are receiving the relief to which they are entitled.

While the 2006 Filing Season appears to be progressing without major problems, I am concerned that changes in the Free File Agreement as well as the elimination

of Telefile Program may have contributed to a significant slowing of the growth in electronic filing this year. This slowed growth comes at a time when the IRS is still far from reaching Congress' goal of 80 percent electronic filing by 2007. Slower growth in electronic filing will defer the efficiency gains for the IRS that result from electronic filing.

Reducing customer services, such as TAC closures, the elimination of the TeleFile Program, and a reduction in toll-free hours of operation, to gain resource efficiencies must be carefully considered before any further decisions are made. TIGTA continues to be concerned that the IRS does not ensure that it has adequate and reliable data prior to making decisions that impact customer service operations. Before proceeding with these efforts, the IRS needs to better understand the impact of such changes on taxpayers as well as taxpayers' abilities to obtain these services through alternative means.

I hope my discussion of some of these 2006 Filing Season issues will assist you with your oversight of the IRS' filing season operations. Mr. Chairman and Members of the Subcommittee, thank you for allowing me to share my views. I would be pleased to answer any questions you may have at this time.

Chairman RAMSTAD. Thank you, Mr. George. The Chair would now recognize the Honorable Raymond T. Wagner. Chairman Wagner?

STATEMENT OF THE HONORABLE RAYMOND T. WAGNER, JR., CHAIRMAN, INTERNAL REVENUE SERVICE OVERSIGHT BOARD

Mr. WAGNER. Thank you, Mr. Chairman, Members of the Committee. Thank you for this opportunity to present the Oversight Board's recommendations for the IRS fiscal year 2007 budget. I have submitted a written statement with more details, and I respectfully ask this Committee to make that statement a part of this hearing record.

Chairman RAMSTAD. So ordered.

Mr. WAGNER. The Oversight Board recommends an fiscal year 2007 IRS budget of $11.31 billion, an increase of $732 million over the enacted fiscal year 2006 budget. This compares to the President's budget request of $10.59 billion in direct appropriations. The two budgets share some essential elements. Both reflect the same adjustments for inflation of $272 million. Both show a savings in reinvestment of $122 million, and both are supplemented by $135 million in increased user fees to achieve a higher operating level.

The Board recognizes the theme of the fiscal austerity in all components of the President's budget, and we highly respect what the administration is doing. That said, the Board's statutory responsibility is to speak to a budget which will ensure that the IRS can carry out its mission and its annual and long-term strategic plans.

Mr. Chairman, we believe that effective tax administration and reducing the tax cap requires a comprehensive multi-faceted long-term plan with organizational commitment and action on many fronts, from a simpler tax code and more complete income reporting, to more effective enforcement and service that improve taxpayer compliance.

We recommend program increases of $705 million in four program areas. The Board recommends $44 million for more taxpayers services, $368 million for more enforcement, $105 million for management and infrastructure, $189 million for business systems modernization (BSM).

Let me summarize the Board's recommendations. In the area of customer service, the Oversight Board seeks to restore levels to the fiscal year 2003—2004 levels of performance. During that period the telephone level of service on the main toll free line was 87 percent. Since then there has been a modest erosion in that measure with a 2007 level of service target of 82 percent. The Board also recommends an additional $368 million for enforcement. Of that, $308 million would provide for additional resources to combat egregious noncompliance, especially among small business and self-employed taxpayers. We would also add resources to curtail noncompliance and abusive schemes, nonfilers in corporate employment taxes and EITC payment fraud.

The Board also calls for $60 million to provide up-to-date research on taxpayer compliance and the sources of noncompliance, which could then therefore be used to influence strategic planning in their resource allocation decisions.

To this end, the Board recommends that the IRS make the National Research Program permanent, perform compliance research annually, and produce solid up-to-date tax gap estimates for all taxpayer segments. We also need solid research on customer service needs and how customer service affects compliance.

I want to emphasize that taxpayers want more service and enforcement from the IRS. The Board surveys of taxpayer attitudes in 2004 and in 2005 indicate that approximately two-thirds of taxpayers support additional IRS funding for both service and enforcement. Time does not permit me to describe our recommendation for infrastructure and management fully, but I would like to highlight one specific recommendation, the need to restore leadership, development training to fiscal year 2003 levels. The lack of leadership training capacity at the IRS is especially critical during a period in which approximately 50 percent of the IRS managers are eligible for retirement.

It is also critical to discuss BSM. Despite productivity improvements in recent years, the IRS is still forced to rely upon a 40-year-old information system. No modern financial institution in the private sector could survive under these conditions, and eliminating these limitations are key to making the IRS as efficient and as effective as a modern financial institution. The Board recommends that BSM move forward at an accelerated pace.

Another very important topic to taxpayers is the ability to electronically file their tax returns, as we have heard much discussion about so far today. Electronic filing of individual tax returns so far this filing season is growing at a mere 2.6 percent compared to the previous year. Although the filing season is far from over, this growth rate is below the historic growth rate. The Board has recommended in its 2005 electronic filing report to Congress to extend the Congressionally mandated goal of 80 percent of all returns file electronically from 2007 until 2011. The 2007 goal has become unrealistic, as we have heard, and will not be met. Extending the goal to 2011 will not only clarify Congressional intent that the goal is important, but by setting a realistic date, it will restore the goal's ability to influence key policy decisions and affect electronic filing.

Mr. Chairman, this concludes my oral statement, and I would be pleased to answer your questions. Thank you, sir.

[The prepared statement of Mr. Wagner follows:]

Statement of The Honorable Raymond T. Wagner, Chairman, Internal Revenue Service Oversight Board

INTRODUCTION AND OVERVIEW

Mr. Chairman, thank you for this opportunity to present the Oversight Board's views on the Administration's FY2007 IRS budget request. I will explain in my testimony why the Board believes its proposed budget is needed to meet the needs of the country and of taxpayers. In developing these recommendations, the Board has applied its own judgment but has also drawn on the collective wisdom of others in the tax administration community, including the IRS, Government Accountability Office (GAO), the Treasury Inspector General for Tax Administration (TIGTA), National Taxpayer Advocate, and Congress.

In fulfilling its responsibilities, the Board must ensure that the IRS' budget and the related performance expectations contained in the performance budget support the annual and long-ranges plans of the IRS, support the IRS mission, are consistent with the IRS goals, objectives and strategies and ensure the proper alignment of IRS strategies and plans. In addition to my statement today, the Board is developing a formal report in which it will explain why it has recommended this budget for the IRS.

Now is a fiscally challenging time for our nation. Defense and homeland security needs coupled with rebuilding efforts along the hurricane-ravaged Gulf Coast have placed an enormous strain on the federal budget.

In addition to our fiscal challenges, taxpayers are expected to comply with an increasingly complex tax code which places heavy burdens on honest taxpayers who wish to comply and offers untold opportunities for mischief by those who do not.

Against this backdrop, it is imperative that government work better and smarter and get the most out of every taxpayer dollar. But there is also a drain on the Treasury that undermines our country's tax revenues and threatens the integrity of our tax administration system—the tax gap.

The IRS recently disclosed that the nation's annual tax gap—the difference between what is owed and what is collected annually—stands at $345 billion, and some experts believe it could be even more. The Board considers the existence of such a large tax gap to be an affront to honest taxpayers, and is pleased with the attention that Congress has focused on the tax gap in the last year, especially with the release of the IRS' latest tax gap estimates. The Board, along with many other members of the tax administration community, believe that reducing the tax gap requires a comprehensive, multi-faceted plan with action on many fronts—from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

Such an approach needs to be more thoughtful and comprehensive that merely increasing IRS resources and expecting that the gap will shrink. However, increased IRS resources are certainly a part of the solution. A successful strategy will encompass several separate but interrelated approaches that will reinforce each other to produce the desired result. In the Board's opinion, a number of actions that can be taken will require additional IRS resources.

The Oversight Board recommends an integrated set of strategies to close the tax gap: (1) tax code simplification; (2) improved information reporting and enforcement tools related to the cash economy; (3) improved customer service to make taxpayers aware of their obligations and modern technology to ease their burdens; (4) greater focus on research; (5) more productive partnerships between the IRS and tax professionals; and (6) and more emphasis on personal integrity.

There can be no doubt that in the last five years the agency has achieved significant progress in all dimensions of its mission. Customer service has rebounded from the lows of the 1990s and through targeted investments and greater management focus, IRS enforcement has also turned the corner.

This across-the-board improved performance has not gone unnoticed—especially among taxpayers. According to the 2005 American Customer Service Index, overall satisfaction among individual tax filers with the Internal Revenue Service remains stable at 64 percent; it is even higher among e-filers. The IRS Oversight Board 2005 Annual Survey also found that American taxpayer support for overall compliance reached an all-time high. However, the IRS's job is far from complete and it must close the tax gap while achieving balance in other parts of its critical mission.

The Board recommends budget increases in four IRS program areas in FY2007: customer service, enforcement, Business Systems Modernization, and infrastructure and management tools.

To achieve balance and ultimately compliance, the Board recommends two modest investments in customer service to ensure that there is no slippage in hard won gains. For example, the toll-fee telephone level of service is slightly down and wait times have increased compared to FY2004. The Board proposes restoring customer service to FY2003/4 levels and investing in telephone infrastructure. It is far less expensive to prevent or solve a problem early on than let it grow.

The Board proposes a modest increase in resources for virtually all IRS enforcement activities. This is money well-spent and there is a growing recognition of the positive return on money invested in the IRS. The Board strongly believes that the enforcement increase includes a significant investment in research to better understand enforcement and customer service needs and the impact of customer service on voluntary compliance. The Board's recommended budget puts the IRS on track to make the National Research Program (NRP) permanent and produce annual tax gap estimates. The Board further recommends that the IRS consider developing a long-term strategic plan for research.

Business Systems Modernization is also a priority and the Board advocates a larger investment in information technology to improve IRS productivity and reduce taxpayer burden. Despite productivity improvements in recent years, the IRS is still hampered in its efforts to modernize because of its reliance on a forty-year-old information system for its central recording-keeping functions, which limit the IRS to weekly updates of its central taxpayer records. No modern financial institution in the private sector could survive under these conditions and eliminating these limitations is key to making the IRS an efficient and effective modern financial institution.

Last, the Board recommends a number of management increases that will help the IRS cope with unfunded mandates, implement BSM projects, and restore leadership training to FY2003 levels, which has become especially critical during a period in which over 50 percent of IRS managers are eligible to retire.

Overall, the Oversight Board proposes a budget that is good for the country, good for taxpayers, and allows the IRS to achieve its strategic goals and objectives in an efficient and effective manner. It calls for $11.3 billion funding for FY2007, a 6.9 percent increase over last year's appropriation.

The Board has also voiced concern that two items in the Administration's proposed FY2007 budget for the IRS pose significant risks. First, the budget proposes $84 million in savings from program efficiencies. The Oversight Board believes there is a risk that these reductions will decrease performance. Second, last December the IRS announced that it would dramatically raise fees for certain services and the President's budget assumes that the IRS will receive an additional $135 million in fee revenue. Although the IRS has expressed confidence it would receive this amount in additional fees based on its estimates, there is still some risk whether the estimated fee revenue can be achieved. In addition, external stakeholders have expressed concern that the additional fees could have an unintended negative impact on taxpayer compliance.

In conclusion, the Board believes that it has constructed a fiscally responsible and realistic budget for the IRS that meets national needs and priorities. It would help shrink the tax gap while providing taxpayers with a level of service they rightly deserve and need. It would speed the modernization of the IRS' antiquated technology and give it the research tools to better understand current and developing trends. Most importantly, it would maintain that delicate but critical balance between enforcement and customer service that America's taxpayers have said time and again they want, and which has been validated through the Board's Taxpayer Attitude Survey. The IRS is now solidly on the right track and is making progress, but we must give it the resources to do its job. It is the right investment for this and future generations of taxpayers.

Recommended IRS Oversight Budget in Brief

The IRS Oversight Board recommends an FY2007 IRS budget of $11.31 billion, an increase of $732 million over the enacted FY2006 budget.[1] This recommendation compares to the President's budget request for the IRS of $10.59 billion in direct appropriations. The two budgets share the following characteristics:

- Both reflect the same adjustments for inflation, $272 million
- Both show a savings and reinvestment of $121.6 million
- Both are supplemented by $135 million in increased user fees to achieve a higher operating level

The Board's budget, however, proposes program increases of $705 million compared to a proposed program decrease of nearly $9 million in the President's budget, as shown in the table below.

Comprison of Board and President's Program Increases

(all dollars in thousands)

Function	Oversight Board Recommendation	President's Request
Taxpayer Service	$ 43,637	$ 0
Enforcement	$367,768	$ 0
Infrastructure and Mgt Modernization	$104,715	$20,900
Business Systems Modernization	$188,600	($29,700)
Total Program Increases (Decreases)	$704,720	($ 8,800)

Recommended initiatives for enforcement, customer service, infrastructure and management and Business Systems Modernization can be found in the individual sections of this statement and Appendices 2 through 5.

IRS Performance from FY2001 to FT2005

The agency, which had become synonymous with poor customer service in the late 1990s, has demonstrated a remarkable performance improvement in the last five years. Toll-free telephone level of service has steadily increased from 56 percent in FY2001 to a high of 87 percent in FY2004. (In FY2005, there was a slight three percent drop which the IRS attributes to reduced funding for taxpayer services.) Toll-free tax law accuracy also rose from 82 percent in FY2003 to an impressive 88 percent in FY2005.

Perhaps the most important and notable gain recorded over the past five years is the percent of individuals filing electronically—31 percent in FY2001 to 51 percent in FY2005.[2] And although it will miss the 2007 deadline, the IRS is making steady progress in closing in on the 80 percent e-file goal established by the IRS Restructuring and Reform Act of 1998.

Through targeted investments and greater management focus, IRS enforcement has also turned the corner. Enforcement revenue rebounded from $33.8 billion in FY2001 to $44.1 billion in FY2005. Audit rates also steadily increased. For high-income individuals they rose from 0.79 percent in FY2001 to 1.61 percent in FY2005. Over the same time period, corporate and small business audits increased respectively from 13.5 percent to 16.9 percent and 0.88 percent to 1.32 percent.

Taxpayers Respond to Better Performance but Problems Remain

This across-the-board improved performance has not gone unnoticed—especially among taxpayers. According to the 2005 American Customer Service Index, overall satisfaction among individual tax filers with the IRS remains stable at 64 percent. However, the number is much higher among e-filers who had an ACSI score of 77 percent.[3] By way of comparison, the IRS received a 51 percent score in 1998. Taxpayer attitudes have also improved. Since 2002, the IRS Oversight Board has conducted an annual survey to gain a deeper understanding of taxpayers' attitudes. Of great concern was the growing number of individuals who thought it acceptable to cheat on their taxes.

In 2003, twelve percent of respondents thought it acceptable to cheat a "little here and there" on their taxes, and five percent would cheat as much as possible. However, two years later those numbers have dropped to seven and three percent respectively and public support for tax compliance is at an all-time high. Moreover, the 2005 survey found that 82 percent of respondents say that their own personal integrity has the greatest influence on whether or not they report and pay their taxes honestly—double the number who cite any other factor. Significantly, the survey also found two out of three surveyed expressed continued support for additional funding for both IRS assistance and enforcement.[4] America's taxpayers want a balanced tax administration system.

However, as welcome as the news may be, it cannot disguise the hard fact that the tax gap has remained unacceptably high. In testimony before the Senate Budget Committee, Comptroller General David Walker stated that the $345 billion tax gap estimated by the IRS could indeed be greater: "IRS has concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data and IRS has no estimates for other areas of the tax gap. For example, IRS used data from the 1970s and 1980s to estimate underreporting of corporate income taxes and employer-withheld employment taxes."[5]

The tax gap is more that an abstract number. According to National Taxpayer Advocate Nina Olson, it hurts taxpayers in a very concrete way:

The collective failure by certain taxpayers to pay their taxes imposes greater burdens on other taxpayers. The IRS receives approximately 130 million individual income tax returns each year. Given the size of the net tax gap, the average tax return includes a "surtax" of about $2,000 to make up for tax revenues lost to noncompliance. The tax gap may also impose significant costs on businesses in the form of unfair competition by noncompliant competitors who can pass along a portion of their tax "savings" to customers by charging lower prices.

Most importantly, the tax gap can erode the level of confidence that taxpayers have in the government, thereby reducing federal revenue and increasing the need for more examination and collection actions. The tax gap, then, can produce a vicious cycle of increased noncompliance and increased enforcement.[6]

The IRS Oversight Board believes that its FY2007 IRS budget recommendations are part of the solution to reversing this corrosive trend.

Budget Environment Should Not Discourage Investment

The IRS does not operate in a vacuum and the Oversight Board recognizes that the current budget environment stresses fiscal restraint and austerity. However, at the same time, we should not throw up our hands in defeat and say we can do no more to improve tax administration. We should look at the larger picture.

Unlike other government agencies, there is a positive return on money invested in the IRS. Senate Budget Committee Chairman Judd Gregg agrees. He observed at a recent hearing on the tax gap, "We've got to talk to the CBO about scoring on that [investing in IRS enforcement], clearly there's a return on that money."[7]

The Board would welcome such a change but also recognizes that this is a problem that has plagued the IRS for decades. Former IRS Commissioner Charles O. Rossotti wrote:

When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of job, by far, was dealing with the IRS budget. The reaction was usually, "Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn't you be able to get it?[8]

Indeed, this lack of recognition of a direct return on investment has left many puzzled. In his April 14, 2004 column, *Washington Post* financial writer Al Crenshaw wondered why the Administration and Congress "aren't falling over themselves to give the IRS more money. Tax Enforcement pays for itself many times over, and it would be a good way to cut the deficit."[9]

In its FY2007 budget recommendation, the Board calls for increases in enforcement that would result in a real return on investment, ranging from three to six dollars on every dollar spent, resulting in $730 million revenue by FY2009 on a $242 million investment.

The Oversight Board urges Congress to adopt the Board's budget recommendations and invest in more effective tax administration.

SIX STRATEGIES TO REDUCE THE TAX GAP

The Board considers the existence of such a large tax gap to be an affront to honest taxpayers, and is pleased with the attention that Congress has focused on the tax gap in the last year, especially with the release of IRS latest tax gap estimates. The Board, along with many other members of the tax administration community, believe that reducing the tax gap requires a comprehensive, multi-faceted plan with action on many fronts—from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

Such an approach needs to be more thoughtful and comprehensive than merely increasing IRS resources and expecting that the gap will shrink. That being said, however, increased IRS resources are a part of the solution. A successful strategy will encompass several separate but interrelated approaches that will reinforce each other to produce the desired result. In the Board's opinion, a number of actions that can be taken will require additional IRS resources.

The Board supports six strategies that it believes would constitute an over-arching plan to reduce the tax gap. This information is presented here only to provide some additional background to understand the Board's FY2007 budget recommendations, so that these recommendations can be understood in the context of an overall approach where the individual elements reinforce each other.

The first is a simplified tax code. Our complex and ever changing tax code not only confounds honest taxpayers who want to comply with their obligations under the law, but provides ample opportunity for those who exploit its complexity to cheat. The President's Advisory Panel on Federal Tax Reform observed:

Since the last major reform effort in 1986, there have been more than 14,000 changes to the tax code, many adding special provisions and targeted tax benefits, some of which expire after only a few years. These myriad changes decrease the stability, consistency, and transparency of our current tax system while making it drastically more complicated, unfair, and economically wasteful. Today, our tax system falls well short of the expectations of Americans that revenues needed for government should be raised in a manner that is simple, efficient, and fair.[10]

Second, the Oversight Board recommends improved information reporting and enforcement tools to address large areas of the tax gap related to what has been called the cash economy. Although the Board is prohibited by statute from endorsing any specific proposal, we note that in its FY2007 budget submission for the IRS, the Administration makes five legislative recommendations to close the tax gap that include: (1) increasing information reporting on payment card transactions; and (2) expanding information reporting to certain payments made by federal, state and local governments to procure property and services. They certainly merit congressional discussion and consideration.

The National Taxpayer Advocate also recommended in her 2005 Annual Report to Congress that the IRS create a cash economy program office, similar to the Earned Income Tax Credit program office. The Board is pleased that the IRS Small Business/Self-Employed Operating Division Commissioner has agreed to establish a task force on the cash economy that will seek to determine the feasibility of this and other recommendations.

In testimony before the Senate Budget Committee, the National Taxpayer Advocate further recommended that to address the tax gap "we should begin by identifying various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose."[11] The Board supports such analysis.

Third, the Board believes that the IRS must improve customer service to make taxpayers aware of their legal obligations and ease taxpayer burden through modernization. Indeed, not all non-compliance is willful; a significant amount of is due to the complexity of the tax laws that results in errors. IRS Commissioner Mark Everson recently testified:

[T]he tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, though, at this point, we do not have sufficiently good data to help us know how much arises from willfulness as opposed to innocent mistakes. This is an area where we expect future research to improve our understanding.[12]

Fourth, there should be a much greater emphasis and focus on research so the IRS can more effectively target areas of major non-compliance. It bears mentioning that a lack of research in the 1990s contributed in part to the IRS' failure to detect the emergence and subsequent epidemic of illegal tax avoidance schemes. The Board recommends an additional $60 million in funding for research. The IRS needs to know much more about non-compliance than it currently does to mount a successful campaign against the tax gap.

Fifth, the Board urges a more productive partnership between IRS and the tax administration community. At the Board's 2006 open meeting, the AICPA supported the IRS' efforts to partner with professional organizations in the area of *pro bono* tax assistance, noting that such a synergy provides the IRS with the opportunity to leverage precious resources and increase customer service at the same time. The Board would add that such a partnership also contributes directly to compliance.

Sixth, there must be more emphasis on personal integrity in making tax decisions. The Board has found that the vast majority of taxpayers state that their personal integrity is a very import factor in influencing their tax compliance. In the Board's most recent Taxpayer Attitude Survey, 82 percent of taxpayers cite personal integrity as the principal factor for reporting and paying their taxes honestly. Commissioner Everson also testified at the Senate Budget Committee tax gap hearing:

[A]nother enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures.[13]

Our tax administration system should challenge taxpayers to be conscious of the need for integrity when making tax decisions.

The Oversight Board recognizes that no single initiative or program will solve the tax gap—a multi-faceted effort must be taken to shrink it. The plan must be more

comprehensive than just applying additional resources to do more of what is being done today. Indeed as Commissioner Everson told the Senate Budget Committee, a combination of appropriate funding, legislative changes, new enforcement tools, tax simplification and auditing and taxpayer service improvements, will allow the IRS to collect an additional $50–100 billion.[14] The $705 million in additional funding recommended by Board to help in this effort is dwarfed in comparison to this estimate of new revenues collected.

COMPARING THE PRESIDENT'S AND BOARD'S FY2007 BUDGET RECOMMENDATIONS

The size of the tax gap should be a clarion call for our nation to examine the tax administration system and invest time, energy, and resources to making it better.

This is not the time to stand still but to move forward in a comprehensive and unified way to build on what has already been accomplished and give America's taxpayers a better, more efficient and fair system in return—what the President's tax reform panel suggested. The Oversight Board's FY2007 budget recommendations focus on the IRS resources needed to move forward in FY2007, but much more needs to be done.

To this end, the Board recommends additional investments in better service, enforcement, infrastructure and management, and BSM in the following amounts:

Taxpayer Service	$ 43,637
Enforcement	$367,768
Infrastructure and Management	$104,715
BSM	$188,600

Additionally, the Oversight Board has identified two areas of significant risk in the IRS' FY2007 budget request. First, the IRS budget justification includes $84.1 million in savings coming from program efficiencies. The Board is concerned that the IRS may not be able to achieve these efficiencies without decreasing performance.

Second, the proposed IRS budget for FY2007 in direct appropriations is supplemented by $135 million in increased user fees. The IRS announced last December that it would charge taxpayers for receiving advance assurance from the IRS about the tax consequences of certain transactions. For example, the fee for IRS Chief Counsel private letter rulings will increase from $7,000 to $10,000.[15]

The Oversight Board believes that there is risk in assuming that this revenue stream will be available without a proven record of collecting fees at this level, especially since the IRS could not present the Board with FY2006 data to confirm the realism of the proposed FY2007 revenue stream. The Board recommends that Congress evaluate actual FY2006 fee collection data to evaluate the validity of the proposed FY2007 revenue expected from increased fees.

The Board is also concerned about the negative impact these fees might have on taxpayer compliance. Testifying at the Board's annual public meeting, the AICPA was also apprehensive that these increases will result in a substantial reduction in general taxpayer use of critical IRS programs:

These programs for the most part encourage taxpayers to seek advance assurance from the IRS that the tax consequences of their proposed actions will be treated consistently by both the taxpayer and the IRS. Actions by the IRS that discourage use of programs, such as private letter ruling requests, could result in greater compliance costs for taxpayers and enforcement costs for the IRS.[16]

Customer Service: What Is "Good Enough?"

Good customer service leads to fully informed and satisfied taxpayers who understand their tax obligations and experience few problems in interacting with the IRS. Clearly, there is a linkage between customer service and compliance. Speaking at the Board's 2006 open meeting, Diana Leyden, Associate Clinical Professor of Law, University of Connecticut School of Law Tax Clinic said:

Customer service at the Internal Revenue Service has a direct impact on voluntary compliance and ultimately on the tax gap. For example: (1) making it easier for taxpayers to get their returns prepared free of charge and quickly encourages taxpayers to become compliant; (2) providing face-to-face interaction with IRS employees helps taxpayers get advice in 'real time' and usually reduces the time for resolution of problems.[17]

At the April 14, 2005 Senate Finance Committee hearing on closing the tax gap, Ranking Member Max Baucus similarly observed:

The IRS cannot close the tax gap simply by increasing enforcement. Issuing more liens. Conducting more seizures. Levying more bank accounts. We do need targeted,

appropriate enforcement. If, however, the IRS lets taxpayer service slide—if the IRS diminishes the access and accuracy of taxpayer service—including the essential need for face-to-face taxpayer service—then we fail to help taxpayers comply with the law on the front end. Ensuring up front quality is more efficient than back end enforcement.[18]

However, efforts to provide quality customer service are hindered by the fact that there is no consensus among the tax administration community on desired customer service standards of performance, which makes informed decision-making about desired levels of service very difficult. Achieving such a consensus among the executive and legislative branches and external stakeholder organizations would allow customer service requirements to influence budget decisions rather than having budget decisions set service levels.

The drive for improved customer service is further aggravated by the lack of data on the impact that service levels have on taxpayer compliance. Such data could be used to make a stronger case to policy makers about the importance of customer services. We should not retreat from the high customer service levels previously achieved during FY2003/2004. Two initiatives contained in the Board's budget are designed to prevent such a reduction.

First, although significant progress has been made during the past five years, toll-free telephone level of service is slightly down from FY2004 and call wait-time on hold has increased. To restore the level of service, the Oversight Board proposes an initiative to restore the toll-free telephone service to FY2003/2004 levels. Although the cost is $35 million, the Board believes that this level of service should be provided to taxpayers. The potential impact of lower service is that taxpayers will not get the assistance they need, hurting compliance, and creating a need for additional enforcement. As Senator Baucus rightly observed, preventing problems is more cost-effective than the price of future corrections, such as collection.

Second, the Board also recommends an $8.7 million investment in telephone infrastructure to expand services to callers and provide telephone representatives with a more state-of-the-art call center environment. The IRS predicts this investment would result in lower queue times across the enterprise for all applications and would counter a negative trend in telephone service. (Wait time on hold for taxpayers has been increasing in the last three years. It has gone from 158 seconds in FY2004 to 258 seconds in FY2005, and the FY2006 target is 300 seconds.)

Enforcement Must Continue to Improve; More Research Needed

As noted earlier in this report, the IRS has boosted its enforcement activity, and enforcement revenue has increased during the last two years. The IRS is working smarter and it needs to continue to improve and build on this important trend.

However, it should be noted that despite these positive results, it is difficult to evaluate the impact that increased enforcement activity has had on overall taxpayer compliance.

Absent this information, the Oversight Board still believes that one important element of the campaign to reduce the tax gap should be increasing IRS enforcement resources, especially since the application of additional resources has a positive return on investment. The Board recommends a modest increase in enforcement resources in virtually all IRS enforcement activities, including:

1. **Combat Egregious Non-Compliance and Prevent Tax Gap Growth** (+$136 million) *Add 748 FTEs to enhance coverage of high-risk compliance areas and address the tax gap associated with small business and self-employed taxpayers.*
2. **Intensify Tax Enforcement** (+$28 million) *Add 86 FTEs to curtail non-compliance in abusive schemes, corporate fraud, non-filers, employment tax and Bank Secrecy Act*
3. **Attack Fraudulent Payments** (+$27 million) *Add 62 FTEs to address fraudulent payments made through the EITC program.*

The IRS must also do a better job of identifying where non-compliance is occurring. For example, IRS data indicates impressive results on abusive, high-profile tax shelters, such as Son-of-BOSS. However, the most recent research indicates that a majority of the tax gap is the result of underreporting of income in areas where there is little third-party reporting.

According to the IRS' National Research Program, half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent ($56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated subtractions from in-

come (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits.

Given this situation, the Oversight Board believes that special attention should be placed on the National Research Program and additional research be conducted on customer service and its relation to compliance. Indeed, the National Taxpayer Advocate "recommends that the IRS undertake a research-driven needs-assessment, from the taxpayers' perspective, to help identify what services taxpayers need and want and how best to deliver them."[19] These efforts are necessary to improve tax administration to the point where the effects of IRS activities on taxpayer compliance can be better understood. To this end, the Board proposes two research initiatives: (1) Improve Tax Gap Estimates (+$46 million); and (2) Additional Customer Service Research (+$15 million).

The first of these two initiatives, Improve Tax Gap Estimates, will establish permanent staffing for the NRP program and put the IRS on a path to conducting research annually. The Oversight Board recommends that the NRP be made a permanent program. The NRP is now reporting estimates of the tax gap based on 2001 tax returns. Prior estimates were based on extrapolations of 1988 data. It is time to progress from "catching up" to making current research the normal and preferred way of doing business.

The Board also proposes that the IRS consider developing a long-range strategic plan for research that goes beyond the current 2009 end date for the IRS Strategic Plan, and covers approximately a decade. In such a plan, the IRS should describe how it will bring its research on all taxpayer segments up to date, and perform a limited sample every year so that its research on all segments will be as current as possible.

The Board believes the availability of up-to-date research data will allow the IRS to more effectively focus its service and enforcement programs on areas that have the greatest impact on taxpayer compliance, and use the changes in taxpayer compliance rates as feedback to evaluate the effectiveness of IRS' service and enforcement program on actual taxpayer compliance. Achieving such a capability will be a vast improvement over the current situation in which the lack of data makes it virtually impossible to evaluate the effectiveness of IRS activity on taxpayer compliance and make informed decisions.

The second research initiative recommended by the Board is to add $15 million to begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers. The need for such research is also consistent with recommendations made by Treasury Inspector General for Tax Administration and the National Taxpayer Advocate in testimony last year to the Senate Appropriations Committee on the closing of a number of Taxpayer Assistance Centers. (The committee has also requested TIGTA to evaluate the connection between service and compliance in its study of TAC closings, but TIGTA was unable to find much existing research.)

However, the IRS has told the Oversight Board that it could extend and update research efforts in two major areas: evaluating the service needs of taxpayers and estimating the effect of customer service on taxpayer compliance. Additional resources in FY2007 would be used to further evaluate the service needs of taxpayers and to scope and design the data gathering and analysis capability to estimate the effect of customer service on taxpayer compliance.

A modest initial effort should include identifying promising areas of research and determining data needs. If the initial efforts are promising, this could be expanded in future years. Due to the long-term nature of these studies, resources should be provided on a multi-year basis.

Modernizing Infrastructure and Management

The Oversight Board is pleased that the IRS is developing an IRS Infrastructure Roadmap. It is a detailed plan for replacing the agency's aging IT equipment in an orderly and cost-effective manner. Rather than replacing outdated equipment on a one-for-one basis, the roadmap will identify and prioritize opportunities to consolidate equipment, retire redundant and low-demand infrastructure components, and replace old equipment with new technology that is cheaper to maintain and use. Because the IRS fully anticipates that the Infrastructure Roadmap will identify new strategies for IT infrastructure delivery that will mitigate the cost of replacing old IT equipment while assuring a sound IRS IT infrastructure, the Board is deferring any recommendations on modernizing IT infrastructure until FY2008.

The Oversight Board does recommend funding infrastructure and management initiatives that will assist the IRS to cope with unfunded mandates, implement BSM projects, and restore its capacity for leadership development training to FY2003 levels:

1. Fund Business Unit IT Solutions (Non-Major Investments)
2. Implement e-Travel
3. Fund HR Connect
4. Consolidate Philadelphia Campus (included in the President's budget)
5. Restoration of Leadership Development Training to FY2003 levels (Board-initiated)

The Board notes that a lack of leadership training capacity at the IRS is especially critical during a period in which approximately 50 percent of IRS managers are eligible for retirement. The Board recommends a consistent budget base to allow planning for these anticipated leadership development training needs.

The requested funds would enable the IRS to: (1) eliminate the backlog of untrained leaders at all levels by the end of FY2007; (2) ensure enough capacity to train new managers upon selection in all Business Units; (3) improve and expand readiness programs to provide a cadre of manager candidates to step up to management positions; (4) revise the management curriculum to incorporate more e-learning and promote continuous learning; and (5) evaluate the effectiveness and impact of the leadership development training program.

Funding Leadership Development Training at FY2003 levels will also assist in meeting the objectives of the President's Management Agenda, which in turn will improve performance and the IRS' objectives of enhanced employee engagement, employee satisfaction and customer satisfaction.

Business Systems Modernization

The Board is pleased that the IRS' once-troubled BSM program experienced better performance in FY2005. In a recent report submitted to Congress on the BSM FY 2006 expenditure plan, the Government Accountability Office offered these positive comments:

IRS has made further progress in implementing BSM—Future BSM project deliveries face significant risks and issues which IRS is addressing—.IRS has made additional progress in addressing high-priority BSM program improvement initiatives. [They] appear to be an effective means of assessing, prioritizing, and addressing BSM issues and challenges—In response to our prior recommendations, IRS reports having efforts under way to develop a new Modernization Vision and Strategy to address a new modernization roadmap.[20]

GAO also had some criticism of the IRS and BSM, but improved management focus over the past few years has helped the BSM program deliver within cost and budget targets important technology projects that will generate greater efficiencies throughout the agency and real world benefits for taxpayers.

The first taxpayers have already been moved to a modernized data base known as the Customer Account Data Engine (CADE) and corporate taxpayers are now able to file their income tax returns with the IRS electronically using the Modernized e-File system. Indeed, CADE will process more than 30 million returns in 2007 and will process 70 million by 2009. Daily updates by CADE will allow taxpayers to receive their refund in just a few days.

Future BSM deliverables are also critical to improved customer service and enforcement. The IRS does not yet offer products and services familiar to customers of many financial institutions, such as daily updating of accounts, electronic access by customers to account records, and a full range of electronic transactions. However, with the help of modern technology, the IRS can close this gap.

If the IRS can continue to demonstrate improvement, it would seem desirable and logical to increase BSM's pace and program funding in FY2007, especially as BSM funding levels were severely reduced in the last several years: from $388 million in FY2004 to $203 million in FY2005, and a requested $199 million in FY2006. In addition to the base, the Board would fund:

1. Web-based Self-service (+$24 million)
2. Filing and Payment Compliance (+$30 million)
3. Modernized e-Filing (+$70 million)
4. Customer Account Date Engine (+$25 million)
5. Core Infrastructure (+$18 million)
6. Architecture, Integration, and Management (+$13 million)
7. Management Reserve (+$9 million)

Therefore, the Board recommends that the BSM program move forward at an accelerated pace. Not only will this allow the IRS to operate more efficiently and effectively, it will strengthen the agency's efforts to enforce the tax law and improve customer service. Despite productivity improvements in recent years, the IRS is still hampered in its efforts to modernize because of its reliance on a forty-year-old information system for its central recording-keeping functions, which limit the IRS to

weekly updates of its central taxpayer records. No modern financial institution in the private sector could survive under these conditions, and eliminating these limitations is key to making the IRS an efficient and effective modern financial institution.

We would like to make one last point on modernization. Both GAO and TIGTA have reported on the cost overruns and delays the BSM program has experienced. However, one cost you will not hear about is the significant cost to the taxpayers of delaying the benefits of a modernized IRS.

Professor Joel Slemrod of the University of Michigan testified to the President's Advisory Panel on Federal Tax Reform that individual taxpayers spend approximately $85 billion a year complying with the tax code.[21] If a modernized IRS makes taxpayers only five percent more efficient, that would still save taxpayers over $4 billion a year.

Electronic Filing

Another topic that is important to millions of taxpayers is the ability to electronically file their tax returns. Electronic filing of individual tax returns so far this filing season is growing at a 2.6 percent rate compared to the previous year. Although the filing season is far from over, this growth rate is below the historical growth rate and seems to be influenced by the following two factors:

- The loss of approximately 2.6 million TeleFile returns
- Fewer returns received through the Free File Alliance, which is not offering free tax preparation and electronic filing for taxpayers with income in excess of $50,000 this year. Last year this capability was offered to all taxpayers.

The Board had reported in its 2005 Electronic Filing report to Congress that although the e-filing goal had had very positive impacts on the IRS and taxpayers, the IRS will not meet its congressionally-mandated goal of 80 percent of all returns filed electronically by 2007, and that other groups, such as the Electronic Tax Administration Advisory Council (ETAAC) have made similar observations. In this report, the Board recommended that Congress extend the goal to 2011, and performed an analysis to demonstrate the revised goal was realistic.

The Board is concerned that the 2007 goal is becoming so widely perceived as unrealistic that it is losing its potency. Extending the goal to 2011, as recommended by the Board, will not only clarify congressional intent that the goal is important, but by setting a realistic date it will restore the goal's ability to influence key policy decisions that affect electronic filing.

CONCLUSION

The IRS Oversight Board believes that it has constructed a fiscally responsible and realistic budget for the IRS that meets national needs and priorities. It would help shrink the tax gap while providing taxpayers with a level of service they rightly deserve and need. It would speed the modernization of the IRS' antiquated technology and give it the research tools to better understand current and developing trends. Most importantly, it would maintain that delicate but critical balance between enforcement and customer service that America's taxpayers have said time and again they want. The IRS is now solidly on the right track and is making progress but we must give it the resources to do its job. It is an investment we must make for this and future generations of taxpayers.

Appendices:

1. Comparison of the Administration's IRS FY2007 Budget Request and IRS Oversight Board Recommendation
2. Recommended FY2007 Program Increases: Enforcement
3. Recommended FY2007 Program Increases: Taxpayer Service
4. Recommended FY2007 Program Increases: Infrastructure and Management Modernization
5. Recommended FY2007 Program Increases: Business Systems Modernization
6. Explanation for Difference in IRS Oversight Board Budget in the Administration's FY2007 Budget Request and this Recommendation

Appendix 1:

Comparison of the Administration's IRS FY2007 Budget Request and IRS Oversight Board Recommendations

(all dollars in thousands)

Final Board Budget	Board's budget	President's Budget	Difference
FY2006 Enacted budget (with 1% rescission)	$10,573,706	$10,573,706	$0
FY2007 Maintaining Current Levels (MCLs) Adjustments (includes HITCA)			
Labor Annualization	$61,994	$61,994	$0
Labor MCL (2.7 %)	$149,819	$149,819	$0
Non-Labor MCL (1.5 %)	$60,418	$60,418	$0
Total MCL Adjustments	$272,231	$272,231	$0
Base Reinvestment			
Increase Returns processing efficiencies	$12,237	$12,237	$0
Program Cost Savings			
E-file savings	($6,760)	($6,760)	$0
Improvement project savings	($8,215)	($8,215)	$0
Competitive sourcing savings	($17,000)	($17,000)	$0
Program efficiencies	($84,121)	($84,121)	$0
HITCA program efficiency	($5,500)	($5,500)	$0
Total Savings and Reinvestments	($121,596)	($121,596)	$0
Transfer Out to TIGTA	($941)	($941)	$0
Total, FY2007 Current Service Level	$10,735,637	$10,735,637	$0
Program Increases			
Tax Administration Operations			
Taxpayer Service	$43,637	$0	$43,637
Enforcement	$367,768	$0	$367,768
Infrastructure and Mgt Modernization	$104,715	$20,900	$83,815
Business Systems Modernization	$188,600	($29,700)	$218,300
Total, Program Increases Above FY2006 Current Service Level	$704,720	($8,800)	$713,520
Total, FY2007 Operating Level	$11,440,357	$10,726,837	$713,520
Fee Adjustment	($135,000)	($135,000)	
FY2007 Budget Appropriation Request	$11,305,357	$10,591,837	$713,520
Growth Over FY2006 Enacted Budget	$731,651	$18,131	$713,520
Percent Growth	6.9%	0.2%	

Appendix 2:

Recommended FY2007 Program Increases: Enforcement

(In $/thousands)

Enforcement Program Increases	Total	Enforcement-Related	Service-Related
Combat Egregious Non-Compliance and Prevent Tax Gap Growth This initiative provides an increase of 748 FTE and $135.5 million to enhance coverage of high-risk compliance areas as well as address the tax gap associated with small business and self-employed taxpayers.	$135,518	$132,696	$2,822
Increase Individual Taxpayer Filing and Payment Compliance The initiative provides 84 FTE (87 positions) and $8 million to support the IRS' enforcement presence through contracts with Private Collection Agencies (PCAs) for Qualified Tax Collection Contracts.	$7,773	$6,968	$805
Detect and Deter Non-Compliant Enterprise Structures This initiative provides an increase of 200 FTE (400 positions) and $37 million to increase the coverage of the flow-through population, including examination of controlling enterprise entities, that are posing significant compliance risks.	$37,008	$37,008	
Increase Individual Taxpayer Reporting Compliance This initiative provides an increase of 100 FTE (125 positions) and $10.8 million to enable the Automated Underreporter (AUR) program to address reporting compliance in a program that is effective, efficient, less labor intensive and less costly.	$10,821	$8,808	$2,013
Enhance Enforcement in the Tax-Exempt and Governmental Sectors This initiative requests an additional 69 FTE (138 positions) and $12,940,668 to improve detection of compliance risks, accelerate enforcement actions, and balance the pursuit of critical enforcement initiatives while maintaining adequate coverage of the exempt community.	$12,941	$12,941	
Intensify Tax Enforcement This initiative requests an increase of 86 FTE (172 positions) and $27.6 million to curtail non-compliance in the following areas: abusive schemes, corporate fraud, non-filers, employment tax and Bank Secrecy Act (BSA).	$27,570	$27,570	

Recommended FY2007 Program Increases: Enforcement—Continued

(In $/thousands)

Enforcement Program Increases	Total	Enforcement-Related	Service-Related
Attack Fraudulent Payments This initiative, which provides an increase of 62 FTE (123 positions) and $27 million, relates directly to the President's Management Agenda Program Initiative "Eliminating Improper Payments," and also supports the IRS' strategies for addressing erroneous payments and non-compliance involving Earned Income Tax Credits (EITC).	$26,998	$26,837	$161
Improve Compliance With the Bank Secrecy and PATRIOT Acts This initiative provides an increase of 124 FTE (248 positions) and $25.9 million to improve the Bank Secrecy Act (BSA) compliance program.	$25,858	$25,858	
Strengthen Regulatory Compliance This initiative provides an increase of 38 FTE (76 positions) and $6.6 million to strengthen regulatory compliance activities to deter fraud, abuse, and terrorist financing in the tax exempt and governmental entities community.	$6,616	$6,376	$241
Improve Enforcement of Circular 230 This initiative provides an increase of 8 FTE (16 positions) and $4.1 million to detect and address tax practitioner misconduct. The IRS, Treasury, and Congress are placing increased emphasis on practitioner misconduct by providing new statutory and regulatory tools to address abusive behavior.	$4,104	$4,104	
Improve Tax Gap Estimates, Measurement and Detection of Non-Compliance Supports 268 FTE (536 positions) and $45.9 million to fund and support ongoing Reporting Compliance Studies through the National Research Program.	$45,942	$45,942	
Study EITC Compliance This initiative provides an increase of 49 FTE (65 positions) and $6.8 million to develop estimates of Earned Income Tax Credit compliance.	$6,822	$6,822	

Recommended FY2007 Program Increases: Enforcement—Continued

(In $/thousands)

Enforcement Program Increases	Total	Enforcement-Related	Service-Related
Improve Compliance Through Data-Driven Workload Identification This initiative provides an increase of 67.5 FTE (90 positions) and $4.8 million to develop and test decision analytical tools and models for improved identification of high-risk filers.	$4,796		$4,796
Customer Service Research Begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers.	$15,000	$15,000	
Subtotal Enforcement	$367,768	$356,931	$10,837

Appendix 3:

Recommended FY2007 Program Increases: Taxpayer Service

(In $/thousands)

Taxpayer Service Program Increases	Total	Enforcement-Related	Service-Related
Increase Accounts Management Efficiencies Provides funding to improve the telephone infrastructure, e.g., Compliance Services and Accounts Management call centers, by expanding services to customers and providing telephone representatives with a more state-of-the-art center environment and providing taxpayers with improved service through multiple access channels. Enterprise queuing will eliminate the queuing of calls at the local level and be queued at the enterprise level, reducing taxpayer wait times.	$8,657		$8,657
Restore Customer Service to FY2004 levels Supports 450 FTE from W&I to restore telephone level of service back to 87.3 percent achieved in FY2004 rather than the current 82 percent target. Improves TE/GE service measures for EP and EO determination timeliness, CAS toll-free level of service, correspondence timeliness measures to FY2004 levels.	$34,980		$34,980
Subtotal: Taxpayer Service	$43,647		$43,647

Appendix 4:

Recommended FY2007 Program Increases: Infrastructure and Management Modernization

(In $/thousands)

Infrastructure and Mgt Modernization Program Increases	Total	Enforcement-Related	Service-Related
Expand IT Security—Personal Identity Verification This initiative requests an increase of $20 million to ensure IRS' compliance with Homeland Security Policy Directive—12 (HSPD–12) and Federal Information Processing Standards–201 (FIPS–201).	$20,000	$12,576	$7,424
Close Financial Management Material Weaknesses—Custodial Detail Data Base This initiative provides $4.7 million to develop the CFO Custodial Detail Data Base (CDDB) which will establish the foundation for building an IRS-modernized custodial financial management system.	$4,743	$2,982	$1,761
Fund Modernization Information Systems (Major Investments) O&M This initiative will result in modernized information systems to improve enforcement activities.	$15,000	$9,432	$5,568
Fund Business Unit IT Solutions (Non-Major Investments) O&M This initiative provides an increase of $15 million for the successful transition of Business Systems Modernization (BSM) projects to the Current Production Environment (CPE), funding their operations and maintenance as they move to full production.	$9,972	$7,121	$2,851
Implement e-Travel Treasury has mandated that IRS must implement eTravel by October 1, 2006.	$10,000	$6,288	$3,712
Fund HR Connect The initiative requests $11.9 million in FY 2007 to fully fund the additional Operations and Maintenance cost associated with the HR Connect system that the IRS has implemented and is billed through the Treasury's Working Capital Fund.	$11,900	$7,482	$4,418
Consolidate Philadelphia Campus	$20,900	$14,215	$6,685
Restoration of Leadership Training to FY2003 levels The requested funds would enable the IRS to: (1) eliminate the backlog of untrained leaders at all levels by the end of FY2007; (2) ensure enough capacity to train new managers upon selection in all Business Units; (3) improve and expand readiness programs to provide a cadre of manager candidates to step in to management positions; (4) revise the management curriculum to incorporate more e-learning and promote continuous learning; and (5) evaluate the effectiveness and impact of the leadership training program.	$12,200	$7,564	$4,636

Recommended FY2007 Program Increases: Infrastructure and Management Modernization—Continued

(In $/thousands)

Infrastructure and Mgt Modernization Program Increases	Total	Enforcement-Related	Service-Related
Subtotal Modernization	$104,715	$67,660	$37,055

Appendix 5:

Recommended FY2007 Program Increases: Business Systems Modernization

(In $/thousands)

Business Systems Modernization Program Increases	Total
Web-based Self Service Identify and design initial set of internet self-service applications.	$24,200
Filing & Payment Compliance (F&PC) Completes delivery of full capability needed to support Private Collection Agencies.	$30,000
Modernized e-file (MeF) Funds development, testing and deployment of modernized electronic filing for Form 1040.	$70,200
Customer Account Data Engine (CADE) **Process 33 million returns for the FY2007 filing season.**	$25,000
Core Infrastructure Projects Improve the facilities which allow pre-deployment testing and integration of modernized systems, which help ensure modernized systems will operate as needed when they are deployed.	$17,900
Architecture, Integration & Management Ongoing support and improvements to BSM's program with planning, engineering, and management activities.	$12,800
Management Reserve	$8,500
Subtotal BSM	**$188,600**

Explanation for Difference in IRS Oversight Board Budget in the Administration's FY2007 Budget Request and this Recommendation

After the Board-approved budget is submitted to the Department of Treasury, it is reviewed and modified by both the Treasury Department and the Office of Management and Budget (OMB) before being incorporated into the President's budget. During the first several years of IRS Oversight Board operation, the Treasury Department would inform the Oversight Board of changes as the IRS budget progressed through the formulation process. However, for the past two years, the Treasury Department has taken the position that although RRA98 provides the Oversight Board with the responsibility of reviewing and approving the budget request prepared by the Commissioner and submitted to the Department of the Treasury, this authority does not include participating in subsequent budget decision adjustments and formulation of the President's Budget.

Consequently, changes in IRS requirements that occur after the Board approves the IRS budget are not provided to the Board, and can only be considered by the Board when the President's budget is made available to the public. The Board adjusted its previously approved budget to account for the following circumstances:

- The Board's initial FY2007 budget was based on the FY2006 President's request, not the enacted appropriation, and is adjusted to use the FY2005 enacted level as the base.

- The inflation factors for labor and non-pay inflation were not known to the Board when it first approved the IRS budget, and are adjusted to reflect the lower base as well as changes in rates.
- The IRS budget submitted to the Board identified approximately $15 million in savings, which the Board approved. During subsequent reviews with the Treasury Department and OMB, the IRS identified an additional $106 million in savings, for a total savings of $121 million. The Board's budget is adjusted to reflect these additional savings, despite the Board's assessment that they may represent some risk.
- The IRS budget submitted to the Board did not identify any fee offsets, which were not yet authorized by Congress. The Board's budget is adjusted to reflect these offsets.
- The budget is adjusted to reflect the development of an IRS Infrastructure Blueprint to define a cost-effective approach to meeting IRS infrastructure needs and the elimination of the need to fund Kansas City growth in FY2007.

Endnotes

[1] The President's budget includes on pages IRS–127 to IRS–129 of the Congressional Justification, as required by law, a copy of the FY2007 IRS budget the Oversight Board approved and submitted to the Department of the Treasury. The Board's recommended budget, as show on these pages, is higher than the request shown above; Appendix 6 provides an explanation of the differences.

[2] Statistics provided to the Oversight Board by the IRS.

[3] Professor Claes Fornell, "ACSI Commentary: Federal Government Scores", December 15, 2005.

[4] IRS Oversight Board, 2005 Taxpayer Attitude Survey.

[5] Comptroller General David Walker, Testimony Before the Senate Budget Committee, "Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions," February 15, 2006, GAO–06–453T.

[6] Nina E. Olson, National Taxpayer Advocate, Testimony Before the Senate Subcommittee on Federal Financial Management, Government Information, and International Security Committee on Homeland Security and Governmental Affairs, October 26, 2005

[7] Tax Notes, February 16, 2006

[8] Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America,* Harvard University Press, 2005. p. 278.

[9] Al Crenshaw, "Letting Cheaters Prosper," *Washington Post,* April 14, 2004.

[10] Statement by the Members of the President's Advisory Panel on Federal Tax Reform, "America Needs a Better Tax System," April 13, 2005.

[11] National Taxpayer Advocate, "Testimony Before the Senate Budget Committee, Causes and Solutions to the Federal Tax Gap," February 15, 2006.

[12] IRS Commissioner Mark Everson, Testimony Before the Senate Budget Committee, February 15, 2006

[13] Everson, *op.cit*.

[14] Tax Notes, Everson Says IRS Could Collect Up To $100 Billion More Per Year, February 16, 2006

[15] IRS Press Release, "IRS to Raise Some User Fees in 2006," IR–2005–144, December 19, 2005.

[16] AICPA, "Statement Presented to the IRS Oversight Board, "Meeting the Customer Service Needs of Taxpayers and the Importance of Measures", February 8, 2006.

[17] Statement of Diana Leyden, Associate Clinical Professor of Law, University of Connecticut School of Law Tax Clinic Before the IRS Oversight Board, February 8, 2006.

[18] Senator Max Baucus, Opening Statement, Senate Finance Committee, Hearing, April 14, 2005.

[19] The National Taxpayer Advocate, 2005 Annual Report to Congress, Executive Summary, p. I–1.

[20] General Accountability Office, Report to Congress, "Business Systems Modernization: Internal Revenue Service's Fiscal Year 2006 Expenditure Plan," February 2006, GAO–06–360, pp. 2–3.

[21] Statement of Professor Joel Slemrod, University of Michigan Ross School of Business, before the President's Advisory Panel on Federal Tax Reform, March 3, 2005.

Chairman RAMSTAD. Thank you, Mr. Wagner. Mr. Hugo, please.

STATEMENT OF TIMOTHY HUGO, EXECUTIVE DIRECTOR, FREE FILE ALLIANCE

Mr. HUGO. Mr. Chairman, thank you for the opportunity to appear before you today. I am Tim Hugo, and I am the Executive Di-

rector of the Free File Alliance, and I have served in this position since July of 2005.

The Free File Alliance is a voluntary association of tax software companies that provides free tax preparation e-file service under a growing set of rules that govern the IRS Free File program. Currently, we have 20 members. Member companies come and go, and we are open to new members each year.

I am very proud of the public-private partnership that the Alliance and the IRS have created over the life of the program, now in its fourth year. The Alliance companies have donated over $14 million free tax returns to U.S. taxpayers. Estimates are that each return has saved the U.S. taxpayer approximately $30, and a case can be made that it is even more, but this would also indicate that the U.S. taxpayers have saved over $42 million, but the savings to the IRS are far greater and are summarized below.

First, the IRS has been able to avoid the cost the industry must accept to development software product which changes every year as Congress makes changes to the Code. Second, the IRS has avoided the necessity of building computer and telecom infrastructure to take individual returns from the Alliance. Alliance companies paid this cost. Third, the IRS saves $7 or more each time a paper return filer converts to submitting a return electronically. Fourth, and perhaps most importantly, it keeps the IRS from accepting the conflicting role of tax preparer and tax cop. Fifth, the IRS has avoided significant technological and political risk of a security breach or a failure of an IRS product. Sixth, the Free File Alliance makes the IRS and the Alliance member partners, not opponents. If the IRS were to become a competitor, it would create a very different and dynamic relationship with industry.

This 2005 renewal of the agreement between the IRS and the Alliance, after three pioneering years, was the work of the program's maturity and success, but it required a balance.

Again, this year, we refocused, as has been commented earlier, we have refocused on the low-income and low and middle income that serves $93 million—makes eligible $93 million, 70 percent of the taxpayers.

We have a full statement that I would ask be submitted for the record, and I thank you, sir, and look forward to answering questions.

[The prepared statement of Mr. Hugo follows:]

Statement of The Honorable Timothy D. Hugo, Executive Director, Free File Alliance

Good morning, Mr. Chairman, and other distinguished Members of the Subcommittee.

I am the Executive Director of the Free File Alliance, LLC ("Alliance"). I have served in that capacity since July of 2005. I am only part-time on this role. I also serve as an elected Member of the Virginia General Assembly where I am in my third term.

The Free File Alliance is a voluntary association of tax software companies that provide free tax preparation and efiling services under the growing set of rules that govern the IRS Free File Program. Currently, we have twenty member companies. Member companies can and do come and go. We are open to new members each year.

I am very proud of the public-private partnership the Alliance and IRS have created. Over the life of the program, now in its fourth year, the Alliance companies have donated over 14,000,000 free tax returns to the U.S. taxpayers. I estimate that

each return has saved U.S. taxpayers approximately $30 and a case can be made for an even greater number. That would indicate U.S. taxpayers have directly saved over $42,000,000. But the savings to the IRS are far greater, and can be summarized as follows.

First, the IRS has been able to avoid the costs industry must accept to develop a software product—which must be changed each year as Congress makes its changes in the Code.

Second, the IRS has avoided the necessity of building the computer and telecommunications infrastructure to take individual returns from taxpayers—Alliance companies pay these costs.

Third, the IRS saves $7 or more each time a paper return filer converts to submitting a return electronically.

Fourth, and perhaps most importantly, it keeps the IRS from accepting the conflicting role of tax preparer and tax cop.

Fifth, the IRS has also avoided significant technological and political risks of a security breach or failure of an IRS product.

Sixth, the Free File Program makes the IRS and Alliance members partners, not opponents. If the IRS becomes a competitor, it will create a very different and dynamic relationship with industry.

The 2005 renewal of the Agreement between the IRS and the Alliance after three pioneering years was a mark of the program's maturity and success, but required a balance between conflicting policy goals. The 2005 Agreement continues the same core agreement as was originally negotiated, but with some interesting changes. The IRS is still not permitted to take on the role of a tax preparation company.

The Alliance member companies do not always agree on what is good policy, or what is good for their companies. Within the government there is also disagreement as to what should be the requirements of this program, which revealed itself when the IRS and Treasury took slightly different negotiating positions with the Alliance in 2005, notwithstanding that they both work for the same President. Important Members of Congress have urged different policies for the Free File Program. The 2005 Agreement is a product of all these forces. Let me tick off what I think are the key elements of the 2005 Agreement.

First, the Alliance member companies have over time voluntarily agreed to impose standards of conduct on themselves which exceed all government regulation and requirements. These standards were often suggested or sought by the IRS. While accepting this challenge, the Alliance has an appropriate corresponding fear that over time the IRS or Congress will use the existence of the Free File Program to create a new regulatory regime that will burden the companies in the Free File Program, but not companies who do not participate. After years of experience, it became clear that both the IRS and the Alliance need to have authority to restrict any Alliance member company that does not meet the voluntary high standards. Correspondingly, a dispute resolution mechanism was created in the 2005 Agreement to utilize the General Services Board of Contract Appeals ("GSBCA") to arbitrate with companies who contest IRS determinations that their practices do not meet the high standards.

Second, and related to the first issue, Alliance members agreed to restrictions on sale of certain ancillary products, particularly Refund Anticipations Loans ("RALs"), that exceed those required by law and regulation.

Third, the IRS and the Alliance agreed to certain measures designed to refocus the Free File Program on its original intent to service lower income, disadvantaged and underserved taxpayer populations. How and why did we do so?

The Alliance companies are currently required to provide free services to 93 million taxpayers, which is 70% of the U.S. taxpayers. This is an increase from the 60% of taxpayers the Alliance agreed to cover in the original Agreement. This binding 70% coverage requirement will increase in numbers as the taxpayer population increases.

This focus on the poor, lower income, disadvantaged and underserved was an underpinning of the original Alliance-IRS agreement. It has been recognized throughout the Program's history. It is contained in many of the documents that collectively constitute our forming our agreement.

For example, this language is written in the first and only Supplemental Memorandum of Understanding Between the IRS and Free File Alliance. A copy of this one page document is appended to my statement.

It also appears as a portion of the Purpose in the Alliance Operating Agreement (a current version of paragraph 2.6 of that document is appended to my statement).

It is contained in the Preamble of the Memorandum of Understanding on Service Standards and Disputes Between the IRS and Free File Alliance executed in 2005

("offer online preparation and filing services to taxpayers least able to afford e-filing tax returns. . . .").

It also appears in a letter from Chairman Ernest Istook, then Chairman of the Transportation, Treasury and Independent Agencies Appropriations Subcommittee, to the current Treasury Secretary and IRS Commissioner, and states in part that the program should be focused upon the "under served and lower income citizens. . . . There should be no uncertainty that the Free File Alliance program is not intended to provide universal free service to all regardless of need. Such an objective could break the market-based model that enables the donation of the services at no cost to those who truly need them."

Some may assert the program should provide Bill Gates and Warren Buffett, or other wealthy folks, with free returns. But I do not think a compelling policy case can be made that such high wealth individuals need such free services. Last year $4 billion in eligible EITC payments were not paid to U.S. taxpayers who qualify. Those are the people to whom I want to provide free services to, and potentially transform their lives.

Fifty-five million people in this country have no bank account. Let's bring them into some aspect of the modern financial system, even if they have to do their Free File return at a VITA site or public library. A very few miles from this hearing room, in Anacostia, on the aptly named Good Hope Road, Operation HOPE, an African-American focused financial literacy group, provides 16 internet work stations where people in the community can and do take advantage of Free File services. Those are the people I believe we should focus upon.

Both the IRS and the Alliance made their own evaluations of how to ensure the long term success of the program. Both concluded the 2005 agreement meets a variety of needs. The 2005 Agreement has created a stable program with well understood rules. Free for everyone may sound great, but it has consequences, such as creating pressure for sales of ancillary products. We have tried to appropriately balance policy concerns, and now we need to see how that balance works out in practice. If any company wants to give away their product free to everyone, there is no restriction in their choosing to do so at the their own web page, or in Union Station, or anywhere else but the Free File site.

We do not yet know the final volumes of Free File returns in this tax season. The IRS and Alliance annually cooperate in evaluating each season, decide what went well, what needs to be fixed, and what research is needed to better evaluate this season. We need to do so again, and evaluate how the IRS can help the 93 million eligible taxpayers generate savings for themselves and the IRS.

The Alliance program remains dynamic. But it cannot be used to satisfy every policy. Let me give an example. All fifty states have little IRS-type organizations to collect taxes, and these agencies have a professional association called the Federation of Tax Administrators (FTA). Approximately 20 states, led by New York, Michigan and many others, are working to replicate the success of the Free File model. We appreciate those states' efforts. The Alliance does not administer these state Free File programs. But the FTA has in the past focused their efforts on the other 20 states that have chosen to compete and create tax software products. FTA took the position that the IRS should require that the Alliance provide free state tax returns to states that compete. We do not feel comfortable dealing in an indirect manner with groups like the FTA. If the FTA wants to talk to us about this program, we welcome them—but note that the FTA walked out of such talks when the Free File Program was starting and hence are not fully reaping the benefits of the program.

CONCLUSION

We appreciate the Subcommittee's interest in the Free File Program, and look forward to answering your questions.

Chairman RAMSTAD. Thank you, Mr. Hugo. The Chair now recognizes Mr. White, please.

STATEMENT OF JAMES R. WHITE, DIRECTOR, STRATEGIC ISSUES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. WHITE. Thank you, Mr. Chairman. Mr. Chairman and Members of the Committee, we are pleased to participate in today's

hearing. I want to cover three topics: the filing season, IRS' 2007 budget requests, and IRS's new long-term goals.

First, IRS' filing season performance so far has improved compared to last year, and this continues a trend of improvement going back several years. Return processing has gone smoothly with over 70 percent of refunds now directly deposited to taxpayers' bank accounts, which is faster, less costly and more convenient than issuing paper checks. Telephone assistance continues to improve with the accuracy rate for both tax law and taxpayer account questions now over 90 percent. Wait time to get through to the telephone assistor is down from almost 4 minutes to 3 minutes. IRS' website is heavily used and highly rated by external reviewers.

Taxpayers continued the recent pattern of using IRS' walk-in sites less, and volunteer sites run by community based organizations more.

Perhaps the biggest concern about the filing season is the slower growth rate of electronic filing that has been discussed. Electronic filing is up this year, but only by 2 percent compared to last year. E-filing is important because it reduces the staff needed for labor-intensive processing of paper returns. Since 1999 IRS reduced staff devoted to paper processing by about 1,600. According to IRS, the slower growth of e-filing is due to new income limits in the Free File program, which reduced the number of taxpayers eligible to file electronically for free via IRS website and the termination of the Tele-File program.

Turning to IRS' budget, the 2007 budget request is for $11 billion, a slight decrease after adjusting for inflation. The decrease is reflected in staffing. IRS is proposing to cut staffing for service by about 4 percent, and for enforcement by about 2 percent.

However, IRS is proposing to improve performance for both service and enforcement. The 2007 budget request sets performance goals that are higher than or equal to those for 2006. The proposed budget also reduces funding by 15 percent for BSM, the ongoing effort to replace IRS' aging information systems. This reduction could impede progress delivering improvements to taxpayers.

In a tight budget environment, savings and efficiencies can help agencies fund their programs. For 2007 IRS has identified $121 million in savings, expected to free up about 1,400 FTEs for other uses. While commendable, there are opportunities for additional savings. For example, we were told that IRS' 25 call sites have underutilized space. Because calls to IRS are routed through a central call processing center in Atlanta, the 25 call sites could be consolidated without affecting service to taxpayers.

Another option for gaining efficiencies is to increase electronic filing by additional mandates. The IRS currently mandates electronic filing for large corporations, and 12 States mandate electronic filing of individual tax returns by certain tax preparers.

Now I want to discuss IRS' new long-term goals. The IRS' budget request sets two long-term goals, increasing the voluntary compliance rate from 83 percent to 85 percent, and reducing the percentage of taxpayers who think it is acceptable to cheat on their taxes to under 9 percent by 2009. However, the effect of taxpayer service and enforcement on compliance has never been quantified. Consequently, IRS does not have a database plan demonstrating how

it will achieve the goals, nor does IRS have a plan to measure compliance by 2009. The compliance rate has been measured once since 1988. Reducing the net tax gap of $290 billion and increasing compliance will be a challenge.

For years, we have listed tax law enforcement as a high-risk area. Despite IRS' efforts, the tax gap has persisted at a relatively stable level for decades. Although IRS' enforcement efforts are vital, reducing the tax gap will require innovative solutions beyond funding for IRS. These solutions include increasing the types of income subject to withholding, more information reporting about income, and simplifying the Tax Code.

Mr. Chairman, this conclude my statement. I would be happy to answer any questions.

[The prepared statement of Mr. White follows:]

Statement of James R. White, Director, Tax Issues, U.S. Government Accountability Office

Mr. Chairman and Members of the Subcommittee:

Since the passage of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98),[1] IRS has made noticeable improvements to taxpayer services such as telephone assistance, and delivered some modernized information systems that, among other benefits, speed up refunds to taxpayers. Increased funding financed some of the improvements, but a significant portion has been financed internally through efficiencies from increased electronic filing of tax returns and other operational improvements.

IRS has also increased revenue collected through its enforcement programs; however, tax law enforcement continues to be included on our list of high-risk federal programs.[2] This is due, in part, to the persistence of a large tax gap.[3] IRS estimated the gross tax gap to be $345 billion for tax year 2001. After late payments by taxpayers and revenue brought in by IRS's enforcement efforts, the resulting net tax gap is estimated to be $290 billion.[4] Even modest progress in reducing the tax gap would yield significant revenue; each 1 percent reduction would likely yield nearly $3 billion annually.

If its 2007 budget request is a harbinger of longer term funding, IRS faces an era of tight budgets. Consequently, continued performance improvements will depend on the extent to which IRS can make more efficient use of limited resources to provide internal funding for the improvements. By indicating how resources are allocated to specific programs and activities within the agency, the budget request is a key planning tool showing where the agency intends to achieve additional efficiencies.

The 2007 budget request is also an indication of how IRS intends to achieve longer term goals. For the first time, IRS lists two agencywide long-term goals: to increase the compliance rate and reduce the proportion of taxpayers who think it is acceptable to cheat on their taxes.[5] This budget can be viewed as a first step in a series of annual steps that will determine whether IRS achieves these long-term goals.

Our statement discusses IRS's 2006 filing season performance to date and fiscal year 2007 budget request. To address your request, we assessed (1) the interim results of IRS's 2006 filing season performance compared to prior years; (2) IRS's budget request compared to prior years; and (3) how the budget helps IRS achieve its long-term goals aimed at reducing the tax gap.

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[1] Pub. L. No. 105–206 (1998).

[2] GAO, High Risk Series: An Update, GAO–05–207 (Washington, D.C.: January 2005).

[3] The tax gap is an estimate of the difference between the taxes that should have been timely and accurately paid and what was actually paid. Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

[4] GAO, Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions, GAO–06–453T (Washington, D.C.: Feb. 15, 2006).

[5] The Congress set one long-term goal for the IRS in RRA 98 for IRS to have 80 percent of all individual income tax returns filed electronically by 2007. We and IRS have previously reported that IRS likely will not meet this goal. Also, IRS's budget describes plans to establish other agencywide goals, targets for which have not yet been established and therefore are not listed in the budget request.

Our assessment of the interim results of IRS's filing season is based on comparing IRS's performance this year to prior filing seasons, monitoring various production meetings and production statistics, reviewing other IRS documents and reports, interviewing IRS and Treasury Inspector General for Tax Administration (TIGTA) officials and paid tax practitioners and other external stakeholders, reviewing TIGTA and other external reports, and reviewing IRS's Web site. Our assessment of the budget request is based on a comparative analysis of IRS's fiscal year 2002 (in most cases) through 2007 budget requests, funding, expenditures, and other documentation and interviews with IRS officials. We used historical budget and performance data from reports and budget requests used by the IRS, Department of the Treasury, and Office of Management and Budget. In past work, we assessed IRS's budget and performance data. Since the data sources and procedures for producing this year's budget and performance data have not significantly changed from prior years, we determined that the data were sufficiently reliable for the purposes of this statement. The budget and performance data for fiscal years 2006 and 2007 are subject to change as IRS revises its estimates. We did not verify IRS's estimates for enforcement revenue and the tax gap. IRS presents tax gap information as supplemental information in its financial statements; that information is not required to be audited. However, we have been involved in tax gap methodology briefings, and the TIGTA has an ongoing review of the accuracy of IRS's tax gap estimates. Additionally, our analysis of IRS's Business Systems Modernization (BSM) program was based primarily upon the results of our detailed review of IRS's fiscal year 2006 BSM expenditure plan in a recent report.[6] We performed our work in Washington, D.C., and Atlanta, Georgia, from January 2006 through April 2006, in accordance with generally accepted government auditing standards.

Our statement makes these key points: IRS has improved its 2006 filing season performance to date in important areas compared to last year, continuing a recent trend. IRS's returns processing has gone smoothly and over 70 percent of refunds are now directly deposited to taxpayers' bank accounts, which is faster, more convenient and less costly than issuing paper checks. Electronic filing continues to grow, but at a slower rate. So far this filing season, electronic filing has grown 2.4 percent compared to 4.3 percent annually for the previous two years. According to IRS officials, the slower rate of growth is due, in part, to new income limits in the Free File program, which reduced the number of taxpayers eligible to file electronically for free via IRS's Web site, and the termination of the TeleFile program, which eliminated electronic filing by phone. Telephone assistance has improved this year, in part, due to lower call volume. The percentage of taxpayers attempting to reach an IRS telephone assistor and who actually received service increased 1 percentage point to 84 percent this filing season and the length of time taxpayers waited to get their calls answered decreased from 235 seconds to 182 seconds. The accuracy of IRS's responses to tax law and account questions improved—both are now at 90 percent or more. IRS's Web site is being used more, is performing well based on third-party evaluations, and has been reconfigured with the goal of improving taxpayer service. Taxpayers continued the recent pattern of using IRS's walk-in sites less, and using sites run by community-based organizations and staffed by volunteers more.

- IRS's fiscal year 2007 proposed budget is $11 billion, which is a small decrease compared to the 2006 enacted level after adjusting for expected inflation.[7] For service, the budget proposes to cut staffing by 4 percent. For enforcing tax laws, the budget proposes to cut staffing by 2 percent. However, for service and enforcement, the budget sets performance goals for 2007 that are higher than or equal to those for 2006. For maintaining and operating IRS's existing information systems (IS), the 2007 budget request shows an increase in resources when compared to the 2006 enacted budget. However, when compared to the level currently assumed for 2006, the 2007 budget request leaves Full-time Equivalents (FTE)[8] for IS virtually constant. For the BSM program, which is the ongoing effort to replace the agency's aging information systems, the budget proposes to reduce spending by about 15 percent. This reduction could delay delivery of improved services for taxpayers. As it has in prior years, IRS's budget

[6] GAO, Business Systems Modernization: Internal Revenue Service's Fiscal Year 2006 Expenditure Plan, GAO–06–360 (Washington, D.C.: Feb. 21, 2006).

[7] The Congressional Budget Office is estimating inflation to be 1.8 percent in 2007. Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2007 to 2016. (Washington, D.C.: January 2006).

[8] According to IRS, a FTE is the equivalent of one person working full-time for one year with no overtime. A staff year includes overtime. Therefore, the cost of 1 staff year is equal to the cost of 1 FTE plus overtime.

request identifies savings—the 2007 budget proposes to save over $121 million and 1,424 FTEs. However, additional opportunities exist for savings. One is to increase electronic filing by additional use of mandates. IRS currently mandates electronic filing by large corporations and 12 states currently mandate electronic filing of individual income tax returns by certain tax preparers. Another opportunity is to consolidate IRS's 25 telephone call sites. IRS officials told us that the call sites have space that is not used for 850 staff. Call sites could be consolidated without affecting service to taxpayers. Finally, IRS has long been hampered by a lack of current and accurate cost information for making resource allocation decisions. IRS recently implemented components of a cost accounting system, but needs to continue gathering the cost data needed to make it an effective planning tool.

- IRS's budget request sets two long-term goals: increasing the rate of voluntary compliance from 83 percent to 85 percent by 2009 and reducing the percentage of taxpayers who think it is acceptable to cheat on their taxes from 10 percent to 9 percent in 2008. These goals will be challenging to meet because the tax gap has persisted at a relatively stable level of 81 to 84 percent for many years. However, because the effect of taxpayer service and enforcement on compliance has never been quantified, IRS does not have a data-based plan demonstrating how it will use its programs to achieve its goals and reduce the tax gap. Nor does IRS have a plan for measuring compliance by 2009. Reducing the tax gap will likely require new and innovative solutions such as simplifying the tax code, increasing income subject to withholding, and increasing information reporting about income. IRS's budget request includes several proposals for increasing compliance that would not require additional resources for IRS. For example, the Department of the Treasury plans to study, and we have long supported, clarifying the definition of independent contractors and requiring additional information reporting on their income, steps that could increase tax revenue by billions of dollars.

IRS's Filing Season Performance to Date Has Improved in Important Areas, Continuing a Recent Trend

IRS improved its 2006 filing season performance in important areas that affect large numbers of taxpayers. This continues a trend of improvement since at least 2002. Returns processing has gone smoothly and electronic filing continues to grow, although at a slower rate than in previous years. Taxpayer assistance has improved in the two most commonly used services—toll-free telephones and the Internet Web site. Fewer taxpayers visited IRS's walk-in sites, and more sought assistance at volunteer-staffed sites.

Return Processing Has Been Smooth and Electronic Filing Continues to Grow, Although At a Slower Rate Than Previous Years

From January 1 through March 17, 2006, IRS processed about 63 million individual income tax returns, about the same number as the same period last year. Of those returns, 47 million returns were filed electronically (up 2.2 percent) and 16 million returns were filed on paper (down 9.8 percent).

According to IRS data and officials, returns processing has gone smoothly so far this filing season. IRS issued 56 million refunds, 40 million, or 71 percent, of which were directly deposited, up 3 percentage points over the same period as last year. Direct deposit is faster, more convenient for taxpayers, and less expensive for IRS than mailing paper checks.

Because of the volume of tax returns, it is normal for IRS to experience some processing disruptions, although this year, disruptions have not been significant. For example, 13 different tax forms were unavailable for electronic filing until February 1 due to the late hurricane relief legislation, which caused a minor processing delay for some returns.

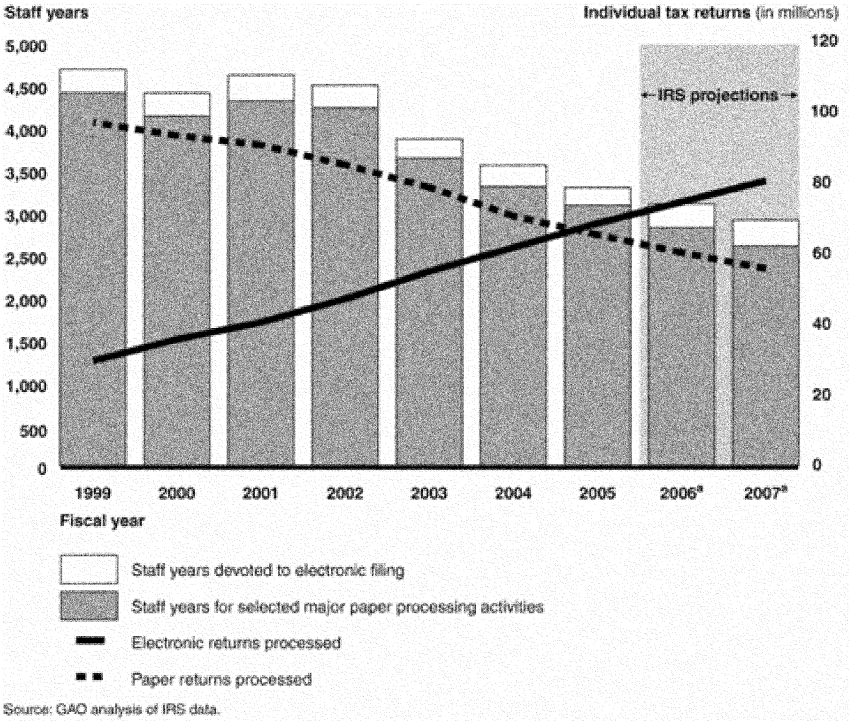
Furthermore, IRS officials said that the new Customer Account Data Engine (CADE), which is intended eventually to replace IRS's antiquated Master File system containing taxpayer records, processed 4.3 million returns and dispersed 3.8 million refunds, so far during the 2006 filing season without disruptions. IRS is reporting that direct deposit refunds and paper check refunds are being issued within 4 and 6 business days, respectively, after tax returns are posted to CADE, which is faster than for returns processed by the Master File system. CADE's growth in future years will directly benefit taxpayers. Not only can it speed up refunds, but it also updates taxpayer account information quicker than the Master File system.

Representatives of the taxpayer industry corroborated IRS's view that the filing season is going smoothly. Groups and organizations that we talked to included the National Association of Enrolled Agents, the American Institute of Certified Public

Accountants, and others. In addition, the TIGTA recently testified that thus far it has seen no significant problems during the filing season.[9]

The growth of electronic filing is important, because it generates savings by reducing staff years needed for labor intensive paper processing. Between fiscal years 1999 and 2006, IRS reduced the number of staff years devoted to paper and electronic processing by 1,586, or 34 percent as shown in figure 1.

Figure 1: Number of Individual Returns and IRS Staff Years for Individual Paper and Electronic Processing, Fiscal Years 1999–2007



Source: GAO analysis of IRS data.

[a] Fiscal years 2006 and 2007 are IRS projections.

Note: Staff years and FTE are units of measurement that are often used interchangeably. As noted in the figure, staff years for paper filing are for selected major activities only.

Electronic filing continues to grow but at a slower rate than previous years. This year's 2.4 percent rate of growth is less than the average annual rate of growth of 4.3 percent for each of the preceding 2 years. According to IRS officials, the slower growth in electronic filing this year is due, in part, to changes in the Free File program, which reduced the number of taxpayers eligible to file electronically for free this year and to reduced advertising by companies involved in that program, and the termination of the TeleFile program, which eliminated the way for taxpayers to file their returns electronically via telephone.

The Free File program enables taxpayers to file their returns electronically via IRS's Web site. Through IRS's Web site, taxpayers can access the Web sites of 20 companies comprising the Free File Alliance. The alliance is a consortium of tax preparation companies that agreed to offer free return preparation and electronic filing for taxpayers that meet certain criteria (see app. 1 for further detail). In an amended agreement with IRS that took effect this year, the Free File Alliance set a $50,000 income limitation on taxpayer participation. This limit was absent last

[9] Written statement of Treasury Inspector General for Tax Administration, J. Russell George, before the Committee on Appropriations, Subcommittee on Transportation, Treasury and Housing and Urban Development, the Judiciary, District of Columbia, and Independent Agencies, U.S. House of Representatives, Hearing on the Internal Revenue Service's Fiscal Year 2007 Budget, Washington, D.C., Mar. 29, 2006.

year and reduced the number of taxpayers eligible to participate in the program. As of March 19, 2006, IRS processed about 2.9 million free file returns, which is a decrease of 23 percent from the same period last year. This decline is inconsistent with IRS's projection that it would receive 6 million tax returns filed through the Free File program, almost a million more compared to last year.

For 2006, IRS terminated the TeleFile program. IRS expected that eliminating TeleFile would reduce electronic filing, but justified the decision because of declining usage and relatively high costs. The number of taxpayers using the program had been decreasing—from approximately 5.7 million in 1999 to 3.8 million in 2004. IRS estimated the cost per tax return submitted through TeleFile, typically Form 1040EZ, to have been $2.63 versus $1.51 for a return filed on paper, largely due to contractor, telecommunications, and other costs. Given the limitations of IRS's cost accounting system, the validity of these figures is unknown. IRS officials stated that the reason for this year's increase in the number of 1040EZ returns filed on paper is due, in part, to the elimination of TeleFile. Through March 17, 2006, the number of 1040EZ returns has increased 18 percent from last year.

Options for increasing electronic filing, in particular mandated electronic filing, will be discussed in the budget section of this statement.

Telephone Access and Accuracy Improved, in Part Due to Lower Call Volume

Taxpayers' ability to access IRS's telephone assistors and the accuracy of answers provided improved compared to previous years. From January 1 through March 11, 2006, IRS answered approximately 22 million phone calls, which is about a 7 percent decline from the same period as last year.[10] The call volume has been less than projected by IRS and less than was assumed when IRS set staffing levels for telephone assistors for the filing season. IRS officials offered several explanations for the unexpected decline in call volume. One explanation is that more taxpayers are using improved tax preparation software, which reduces their need to call IRS. Another explanation is that more taxpayers are getting through to a telephone assistor the first time they call, thus reducing the need for taxpayers to call again.

As shown in table 1, the percentage of taxpayers who attempted to reach an assistor and actually got through and received service—referred to as the level of service—was 84 percent so far this filing season compared to 83 percent over the same period last year—and greater than its 2006 fiscal year goal of 82 percent. According to IRS officials, one possible explanation for the improvement in access is the decline in overall call volume. When call volume decreases, taxpayers are likely to wait less time to speak with an IRS telephone assistor. As a result, fewer taxpayers would likely hang up, increasing the percentage of taxpayers who get through to an assistor.

IRS also reported that, so far this filing season, the average speed of answer (length of time taxpayers wait to get their calls answered) is down 53 seconds from the same time last year to 182 seconds, a decrease of about 23 percent, and significantly better than IRS's 2006 fiscal year goal of 300 seconds. IRS also reported that the rate at which taxpayers abandoned their calls[11] to IRS decreased from 11.5 percent to 8.9 percent compared to the same period last year.

Table 1: IRS Telephone Assistance Performance in the First Weeks of the Filing Seasons, 2002 through 2006

Telephone assistance	2002	2003	2004	2005	2006
Total calls [a]	34,489	27,905	29,058	23,340	21,616

[10] Despite less demand overall, call volume increased from affected taxpayers in federally-declared disaster areas. IRS maintains a special services hotline (1–866–562–5227) to provide assistance on questions related to hurricane relief and combat zone participation. Between January 1 and March 11, 2006, the hotline received 36,552 calls, an increase of 158 percent over the same period in 2005. According to IRS officials, the hotline received primarily combat zone calls in 2005 because there were so few federally-declared disaster areas. Therefore, IRS officials attribute the 2006 increase to the three major hurricanes in 2005.

[11] IRS divides abandoned calls into two subsets, primary abandons and secondary abandons. Primary abandons occur when callers hang up before being put into queue to wait for an available assistor. Secondary abandons are the number of callers who hang up after being put into the queue to wait for an assistor. In November 2004, IRS established a program to help determine where primary abandons occur within the IRS scripts. According to IRS officials, looking at the number and percentage of where callers hang up highlights opportunities where IRS can improve its menu prompt phrasings in a way that would be more beneficial for callers.

Table 1: IRS Telephone Assistance Performance in the First Weeks of the Filing Seasons, 2002 through 2006—Continued

Telephone assistance	2002	2003	2004	2005	2006
Answered by assistors	9,208	9,434	10,116	9,421	8,653
Answered by automation	25,281	18,471	18,942	13,919	12,963
Assistor level of service	62%	82%	84%	83%	84%
Average speed of answer [b]	227 seconds	183 seconds	199 seconds	235 seconds	182 seconds
Accounts customer accuracy rate estimates [c]	88.3% +/–.9%	87.9% +/–.7%	89.1% +/–.8%	91.7% +/–.7%	92.7% +/–.7%
Tax law customer accuracy rate estimates [c]	83.5% +/–.7%	81.2% +/–1.0%	75.8% +/–1.3%	87.5% +/–1.0%	90.2% +/–1.0%

Source: IRS.
[a] Total calls (i.e., calls answered by assistors and automation) and CSR level of service are based on actual counts from January 1 to March 16, 2002; March 15, 2003; March 13, 2004; March12, 2005; and March 11, 2006.
[b] From January 1 to March 16, 2002; March 15, 2003; March 13, 2004; March 12, 2005; and March 11, 2006.
[c] Based on a representative sample estimated at the 90 percent confidence interval from January through February 2002, 2003, 2004, 2005, and 2006.

Using a statistical sampling process, IRS estimates that the accuracy of telephone assistors' responses to taxpayers' tax law and account questions improved compared to last year. IRS estimates its tax law accuracy rate to be 90.2 percent, an increase of 2.7 percentage points over the same time period last year, continuing an improvement since 2004. Additionally, IRS estimates that the accuracy rate to taxpayers' inquiries about their accounts, to be 92.7 percent this year compared to 91.7 percent over same period last year, continuing an improvement since 2003. IRS officials attribute these improvements in performance to several factors, including better and more timely performance feedback for telephone assistors, increased assistor experience, better training, and increased use of the Probe and Response Guide, a script used by telephone assistors to understand and respond to tax law questions.

IRS's Web Site Is Being Used More, Is Performing Well, and Has Been Reconfigured withthe Goal of Improving Taxpayer Service

Use of IRS's Web site has increased so far this filing season compared to prior years based on the number of visits and downloads. From January 1 through February 28, IRS's Web site was visited 67 million times by visitors who downloaded 56 million forms and publications. The number of visits reflects a 7 percent increase over the same period last year while the number of forms and publications downloaded has increased by 25 percent.

Further, IRS's Web site is performing well. For example,

- we found IRS's Web site to be readily accessible, easy to navigate, and easy to search,
- an independent weekly study by Keynote, a company that evaluates Web sites, reported that IRS's Web site has repeatedly ranked second out of 40 government agencies evaluated in terms of average download time. The same study also reported that IRS has repeatedly ranked first out of the most commonly accessed government related Web sites for response time and success rate, and
- the American Consumer Satisfaction Index overall customer satisfaction with IRS's Web site increased from 68 to 72 percent after IRS reconfigured the site.

IRS reconfigured its Web site for the 2006 filing season. According to IRS officials, the goal for reconfiguring the Web site was to improve overall customer service through easier navigation and a more effective search function. As a result, the number of Web site searches has decreased by 53 percent, from 76 million during the same period last year to 36 million this year. Typically, search functions are used when users fail to find information through links. According to IRS officials, the decrease in the number of searches indicates that users are finding the information that they need faster.

IRS also added the following new features to its Web site this year:

- Electronic IRS: The Electronic IRS brand reconfigured the IRS's Web site and made it easier to locate items, as evidenced by the decline in searches;

- Alternative Minimum Tax (AMT) Assistant: Helps taxpayers determine if they do not owe AMT; and
- Help for Hurricane Victims: A special link that provides victims of the recent hurricanes information on special tax relief, assistance and how to get help with tax matters;
- IRS's Web site continues to include several important features in addition to the Free File program;
- Where's My Refund, which allows taxpayers to check on the status of their refunds. As of March 20, 2006, 19.8 million taxpayers accessed the Where's My Refund feature to check on the status of their tax refunds. This was a 21 percent increase from the same period last year; and
- Electronic Tax Law Assistance, where taxpayers can ask IRS general tax law questions via its Web site. From January 1 through March 20, 2006, IRS received 7,353 emails requesting tax law assistance (down over 32 percent compared to last year). As of February 28, 2006, IRS estimated the accuracy rate of IRS's responses to tax law questions submitted via the Web site, to be 85 percent down from 88 percent in 2005. However, the average number of days that it took IRS to respond to tax law questions submitted via the Web site improved to 2.4 days, compared to 4 days in 2005.

Taxpayers Continue Their Recent Pattern of Using IRS's Walk-In Sites Less and Using Volunteer Sites More, and Information About the Quality of Service Remains Limited

Fewer taxpayers have used IRS's 400 walk-in sites so far in the 2006 filing season compared to the same period in prior years. Staff at walk-in sites provide taxpayers with information about their tax accounts and answer taxpayers' questions within a limited scope of designated tax law topics, such as those related to income, filing status, exemptions, deductions, and related credits.[12] Walk-in site staffs also provide need-based tax return preparation assistance, limited to taxpayers meeting certain requirements.[13] As of March 11, 2006, the total number of contacts at IRS's walk-in sites declined by approximately 12 percent compared to last year. The decline thus far this year is consistent with the annual trends in walk-in use shown in figure 2, including IRS's projection for 2006. The declines in the number of taxpayers using IRS's walk-in sites, including for tax return preparation, are also consistent with IRS's strategy to reduce its costly face-to-face assistance by providing taxpayers with additional options, such as IRS's toll-free telephone service, Web site, and numerous volunteer sites. It is unclear, however, whether the declining volume is an indicator of how well IRS is meeting taxpayers' demand for face-to-face assistance. For example, IRS does keep track of the number of taxpayers entering a walk-in site, taking a number to queue for service, but then leaving the site without receiving service. If a taxpayer did not take a number, IRS would have no way of counting those taxpayers.

IRS officials said the types of services offered at walk-in sites remained constant for most sites from 2005 to 2006. For sites in areas with a high number of natural disaster victims, IRS expanded the types of assistance provided. For example, IRS eliminated income limits for taxpayers seeking return preparation assistance.

[12] IRS considers some tax law questions to be out of scope related to businesses and corporations, for example. If staff cannot answer taxpayer's questions, they are required to refer taxpayers to IRS's telephone service or Web site.

[13] Return preparation assistance is limited to taxpayers with income of $38,000 or less. According to IRS, this limitation approximates the amount set in the tax code for claiming the Earned Income Tax Credit. IRS has required appointments for most taxpayers seeking this assistance since 2003.

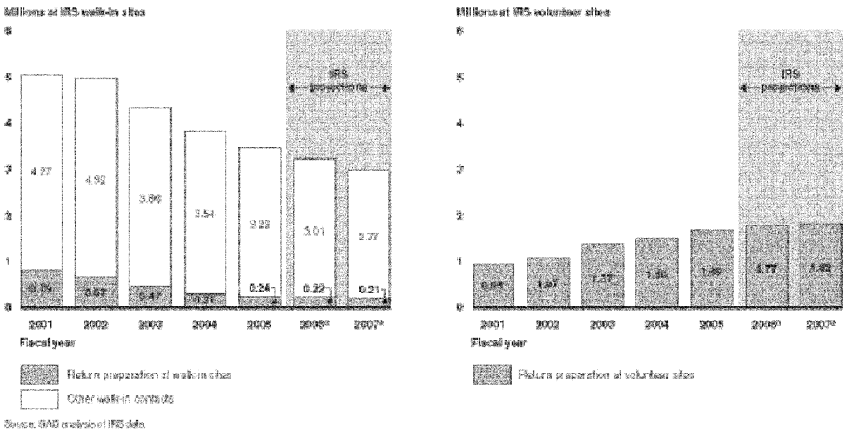


Figure 2: Assistance Provided at IRS Walk-in Sites and Volunteer Sites, 2001—2006 Filing Seasons (contacts in millions)

Note: "Other walk-in contacts" includes assistance for account notices, tax law inquiries, forms, and compliance work, but not return preparation. For the walk-in sites, the time periods covered are December 31, 2000, through April 28, 2001; December 30, 2001, through April 27, 2002; December 29, 2002, through April 26, 2003; December 28, 2003, through April 24, 2004; and December 26, 2004, through April 23, 2005. For volunteer sites, the time period covered for 2001 is January 1, 2001, through April 21, 2001; December 30, 2001, through April 27, 2002; December 29, 2002, through April 26, 2003; December 28, 2003, through April 24, 2004; and December 26, 2004, through April 23, 2005.

[a] Fiscal years 2006 and 2007 are IRS projections. For walk-in sites, projections cover the time periods of December 25, 2005 through April 22, 2006, and December 31, 2006 through April 28, 2007. For volunteer sites, projections cover the time periods from January 1 through April 30, 2006 and 2007.

In contrast to IRS walk-in sites, the number of taxpayers seeking return preparation assistance at approximately 14,000 volunteer sites has increased this year by 5.6 percent, continuing the trend since 2001 (see fig. 2). These sites, often run by community-based organizations and staffed by volunteers who are trained and certified by IRS, do not offer the range of services IRS provides at walk-in sites, but instead focus on preparing tax returns primarily for low-income and elderly taxpayers and operate chiefly during the filing season. As we have previously reported,[14] the shift of taxpayers from walk-in to volunteer sites is important because it has allowed IRS to transfer time-consuming services, such as return preparation, from IRS to other less costly alternatives that can be more convenient for taxpayers.

IRS has used both walk-in and volunteer sites to provide relief efforts for federally-designated disaster zones such as in hurricane-affected areas. IRS developed a Disaster Referral Services Guide and new training materials for employees to better equip them to address disaster-related issues. Also, IRS adjusted the type of tax law questions that it would answer at walk-in sites to include casualty loss and removed income limitations for disaster victims seeking return preparation assistance at walk-in sites. Volunteer sites performed outreach within their network of partners by creating training material for tax practitioners, and agreeing with two organizations to accept referrals from IRS of disaster victims needing tax return preparation assistance.

Concerning the quality of services provided at walk-in and volunteer sites, IRS continues to lack reliable and comprehensive data on the quality of the services provided. As in previous years, TIGTA is conducting an audit on the accuracy of some services provided at walk-in sites, although the results will not be available until after the filing season. However, TIGTA has noted problems with the quality of services provided at IRS walk-in sites in prior reports.[15] We have made rec-

[14] GAO, Tax Administration: IRS Improved Performance in the 2004 Filing Season, but Better Data on the Quality of Some Services Are Needed, GAO–05–67 (Washington, D.C.: Nov. 15, 2004).

[15] Treasury Inspector General for Tax Administration, Coordination and Monitoring Are Needed for Continued Improvement in the Tax Return Preparation Process at the Taxpayer Assistance Centers, Reference No. 2004–40–147, (Washington, D.C.: 2005), and Treasury Inspector General for Tax Administration, Customer Accuracy at Taxpayer Assistance Centers Showed

ommendations for IRS to improve its quality measurement at walk-in sites.[16] At volunteer sites, IRS is conducting different types of reviews to monitor tax return preparation assistance.[17] According to IRS officials, the results to date show that the quality of service has improved at volunteer sites compared to previous years, but they acknowledge that challenges remain in terms of volunteers' adherence to IRS's procedures and use of IRS materials. As in previous years, TIGTA will conduct limited quality reviews at volunteer sites. While the results of those reviews are based on a judgmental sample, TIGTA has concluded in the past that, while significant improvements have been made in the oversight of volunteer sites, continued effort is needed to ensure the accuracy of tax return assistance provided.[18]

IRS's Budget Proposes Decreases in Staffing and Identifies Savings, but Opportunities for Additional Savings Exist

IRS's fiscal year 2007 budget request is a small decrease compared to 2006 enacted levels after adjusting for expected inflation. It proposes to reduce overall staffing levels, as well as staffing levels for taxpayer service and enforcement activities, while maintaining or improving taxpayer service and enforcement. As it has in prior years, IRS has identified some savings, but additional opportunities exist for enhancing savings.

IRS's Budget Proposes Decreases in Funding After Adjusting for Expected Inflation and in Staffing

IRS's proposed fiscal year 2007 budget is $11 billion (a 1.6 percent increase), but after adjusting for expected inflation, it reflects a slight decrease over last year's enacted budget. The $11 billion includes $417 million from new and existing user fees and reimbursable agreements with other federal agencies.[19] The 2007 budget request for IRS's appropriation accounts is shown in table 2 (see app. II for more details).[20]

Table 2: IRS's Changes in Funding and FTEs for Fiscal Years 2006 through 2007

Dollars in thousands	Fiscal year 2007 requested including new user fee revenue		Fiscal year 2006 enacted		Percentage change fiscal year 2006–2007	
	Dollars	FTEs	Dollars	FTEs	Dollars	FTEs
Processing, Assistance, and Management (PAM)	$4,159,893	37,126	$4,095,212	38,796	1.58	–4.30
Tax Law Enforcement (TLE)	4,764,954	49,479	4,678,498	50,559	1.85	–2.14
IS	1,619,834	7,351	1,582,977	7,032	2.33	4.54

Little Improvements During the 2005 Filing Season, Reference No. 2005–40–146, (Washington, D.C.: 2003).

[16] See GAO–05–67 and GAO–06–51.

[17] The different types of reviews include site reviews to measure the administrative aspects of a volunteer site such as readiness. IRS plans on conducting 825 of these site reviews. IRS also plans on conducting 2,475 return reviews, approximately 3 during each site review, which will involve on-site review of the return for accuracy and discretionary reviews for problem sites not operating in accordance with the IRS's guidelines.

[18] Treasury Inspector General for Tax Administration, Significant Improvements Have Been Made in the Oversight of the Volunteer Income Tax Assistance Program, but Continued Effort Is Needed to Ensure the Accuracy of Services Provided, Reference No. 2006–40–004, (Washington, D.C.: 2005).

[19] According to IRS, the $417 million estimate is based on receiving $135 million from increasing existing user fees and establishing new ones. IRS has committed to distributing the $135 million over its PAM, TLE, and IS accounts, exclusively for taxpayer service. The remaining user fees will be used as needed by IRS.

[20] The PAM appropriation account primarily funds functions related to taxpayer service which includes funding for enforcement; TLE primarily funds enforcement activities but includes funding for taxpayer services; IS funds information technology support and improvements for legacy systems which support both taxpayer services and enforcement; BSM funds the new modernized business system; and HITCA administers a refundable tax credit for health insurance for qualified individuals. We did not review the HITCA account as part of our work.

Table 2: IRS's Changes in Funding and FTEs for Fiscal Years 2006 through 2007—Continued

Dollars in thousands	Fiscal year 2007 requested including new user fee revenue		Fiscal year 2006 enacted		Percentage change fiscal year 2006–2007	
	Dollars	FTEs	Dollars	FTEs	Dollars	FTEs
BSM	167,310	0	197,010	0	–15.08	0.00
Health Insurance Tax Credit Administration (HITCA)	14,846	17	20,008	17	–25.80	0.00
Total	**$10,726,837**	**93,973**	**$10,573,706**	**96,404**	**1.45**	**–2.52**
Existing user fees and reimbursablesa	$282,543	1,503	$258,820	1,350	9.17	11.33
Total program operating level	**$11,009,380**	**95,476**	**$10,832,526**	**97,754**	**1.63**	**–2.33**

Source: GAO analysis of IRS data.
Notes: For fiscal year 2007, the figures shown for requested FTEs reflect an IRS adjustment and differ slightly from what IRS reported in its budget request. The Congressional Budget Office projects the inflation rate to be 1.8 percent in 2007; therefore, IRS's proposed increases are less than the rate of inflation.
[a] Reimbursables are payments IRS receives for providing services to other federal agencies and states.

The real decrease in the proposed budget can be seen in staffing. IRS proposes to fund 95,476 FTEs in fiscal year 2007, down over 2 percent from 97,754 FTEs in enacted fiscal year 2006 (see table 5 in app. II for comparisons in enacted FTE levels for fiscal years 2002 through 2007). Actual FTEs tend to be lower than enacted FTEs, in part, because of how IRS absorbs unbudgeted costs (see table 6 in app. II for actual FTEs).

The decrease in FTEs may be greater than shown in IRS's fiscal year 2007 budget request. Every year agencies, including IRS, are expected to absorb some costs that are not included in their budget requests. For fiscal year 2007, IRS officials currently anticipate having to absorb over $117 million in costs, including about $41 million for homeland security-related controls over physical access to government facilities. Absorbing such costs reduces the actual number of FTEs that IRS can support. For example, for fiscal year 2005, the enacted level of FTEs was 96,435 but the actual level was 94,282.

IRS's Budget Request Proposed to Maintain or Improve Taxpayer Services with Fewer Resources

IRS is requesting $4.2 billion for PAM, including some user fees, which is funding primarily spent on providing service to taxpayers.[21] The amount requested is about a 1.6 percent increase over fiscal year 2006 enacted levels, but is a slight decrease after adjusting for expected inflation. This funding level translates into reduced staffing, down over 4 percent from an enacted level of 38,796 FTEs in fiscal year 2006 to 37,126 proposed FTEs in fiscal year 2007. Since fiscal year 2002, FTEs devoted to PAM have declined over 15 percent from an enacted level of 43,866 FTEs.

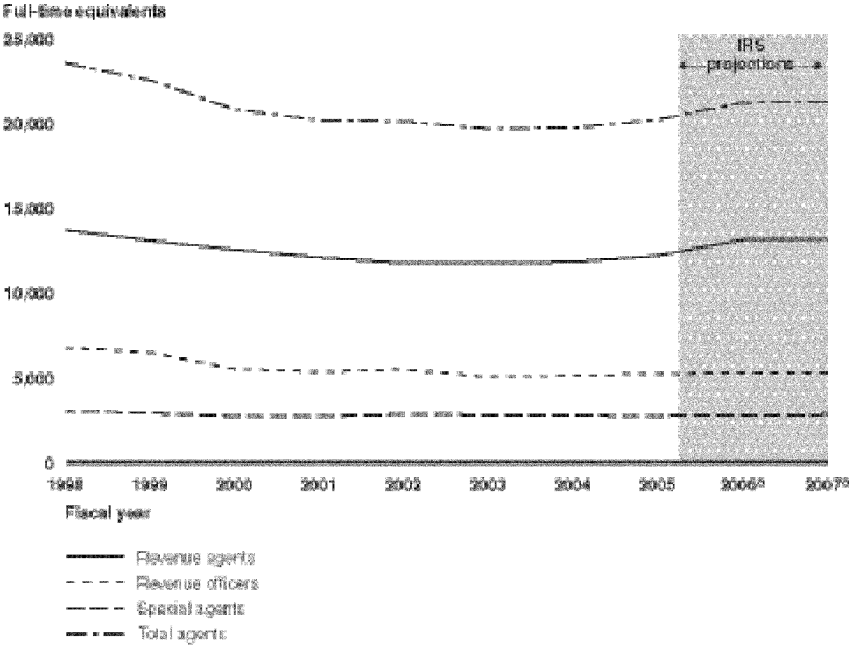
Despite the proposed inflation-adjusted decrease in funding in 2007, IRS is planning to maintain or improve taxpayer services. For every one of the major taxpayer services listed in the budget, 2007 planned performance goals are higher or equal to 2006 performance goals. These services include telephone assistance and refund issuance.

IRS's Budget Request Reduces Enforcement Staffing Slightly, While Increasing Major Enforcement Activities

IRS is requesting $4.8 billion for TLE.[22]] The 2007 budget request proposes an overall decrease in enforcement FTEs, down over 2 percent to a proposed 49,479 FTEs from last year's enacted level of 50,559 FTEs. For its three main categories

[21] IRS has funding in other appropriation accounts that support its taxpayer service programs.
[22] In his recent testimony, the IRS Commissioner said that if the Congress failed to provide funding outside the program integrity cap adjustment it could potentially jeopardize past gains. This year, IRS is seeking $137 million outside the cap.

of skilled enforcement staff, IRS is proposing a marginal increase in staffing of 0.2 percent (see fig. 3). For special agents (those who perform criminal investigations), the increase is 1.7 percent. For the other two categories—revenue agents (those who examine complex returns), revenue officers (those who perform field collection work)—IRS is proposing to keep the number of staff the same as in 2006.



Source: GAO analysis of IRS data.

Figure 3: Revenue Agents, Revenue Officers, and Special Agents, Fiscal Years 1998—2007

Notes: Numbers for 2006 and 2007 are IRS estimates. IRS recalculated the figures since GAO reported them last year. GAO is using the new figures because IRS has validated those figures using its new cost accounting system.

Despite keeping skilled enforcement staff virtually unchanged, IRS is proposing to maintain or increase its major enforcement activities. For all the major enforcement activities listed in the budget, IRS is establishing goals in 2007 that are higher or equal to 2006 planned performance goals. Major enforcement activities include individual taxpayer examinations, collection coverage,[23] and criminal investigations completed. IRS officials anticipate increased revenue collected and other performance improvements as a result of using data from IRS's most current compliance research effort, known as the National Research Program (NRP).[24]

Budget for IS Request for Funding Is Up Slightly, and IRS Has Taken Additional Steps to Improve Budgeting for IS Operations and Maintenance

IRS is requesting about $1.6 billion for IS in fiscal year 2007, which is intended to fund information technology (IT) staff and related costs for activities such as information security and maintenance and operations of its current tax administration systems. Although the number of FTEs proposed in 2007 is up when enacted FTEs are considered, it is virtually the same as the operating level currently assumed in 2006 (see app. II for more details).

[23] The number of collection cases closed or otherwise eliminated compared to the total number of collection cases in inventory.

[24] NRP replaced the Taxpayer Compliance Measurement Program, which last measured compliance for individuals for 1988 but was canceled because of concerns about costs and burdens on taxpayers. GAO, Tax Administration: New Compliance Research Effort Is on Track, but Important Work Remains, GAO–02–769 (Washington, D.C.: June 27, 2002) and Tax Administration: Status of IRS' Efforts to Develop Measures of Voluntary Compliance, GAO–01–535 (Washington, D.C.: June 18, 2001) discuss the development of the NRP study.

In 2002, we reported that the agency did not develop its fiscal year 2003 IS operations and maintenance budget request in accordance with the investment management approach used by leading organizations. We recommended that IRS prepare its future budget requests in accordance with these best practices.[25] To address our recommendation, IRS agreed to take a variety of actions, which it has made progress in implementing. For example, IRS planned to develop a capital planning guide to implement processes for capital planning and investment control, budget formulation and execution, business case development, and project prioritization. In August 2005, IRS issued the initial version of its IT Capital Planning and Investment Control (CPIC) Process Guide, which (1) provides executives with the framework within which to select, control, evaluate, and maintain the portfolio of IT investments to best meet IRS business goals and (2) defines the governance process that integrates the agency's IT investments with the strategic planning, budgeting, and procurement processes. According to IRS officials and documentation, the agency formulated its prioritized fiscal year 2007 IT portfolio and associated budget request, including operations and maintenance requirements, in accordance with this CPIC Process Guide. We will continue to monitor the implementation of IRS's CPIC process as its IT investment management process matures.

In addition, IRS stated that it planned to develop an activity-based cost model to plan, project, and report costs for business tasks/activities funded by the IS budget. During fiscal year 2005, as part of the first release of the Integrated Financial System (IFS),[26] IRS implemented a cost module that is potentially capable of allocating costs by activity. However, agency officials stated that they needed to accumulate 3 years of actual costs to have the historical cost data necessary to provide a basis for meaningful future budget estimates. Since then, according to the Office of the Chief Financial Officer, IRS has (1) populated the cost module with all actual fiscal year 2005 expenses; (2) identified the data needed from IFS to support its budget requests; and (3) developed a system to capture, test, and analyze the cost data to devise a standard methodology to provide the necessary data from the cost module. Once the pilot results and recommendations have been reviewed, an implementation plan will be developed. IRS still expects to have the requisite 3 years of historical cost data available in time to support development of the fiscal year 2010 budget request. Although IRS has made progress in implementing best practices in developing its IS operations and maintenance budget, until IRS completes the actions necessary to fully implement the activity—based cost module, the agency will not be able to ensure that its request is adequately supported.

IRS's Proposed BSM Budget Reduction Could Impede Future Progress

BSM is a high-risk, highly complex effort that involves developing and delivering a new set of information systems that are intended to replace the agency's aging tax processing and business systems. The program is critical to supporting IRS's taxpayer service and enforcement goals. For example, BSM includes projects to allow taxpayers to file and retrieve information electronically and to provide technology solutions to help reduce the backlog of collections cases. It also helps IRS considerably in providing the reliable and timely financial management information needed to account for the nation's largest revenue stream and better enable the agency to both determine and justify its resource allocation decisions and budget requests.

IRS's fiscal year 2007 budget request of $167.3 million for the BSM program reflects a reduction of about 15 percent (and even greater when adjusted for expected inflation), or about $30 million, from the enacted fiscal year 2006 budget of $197 million.

Since our testimony before this subcommittee on last year's budget request, IRS has made further progress in implementing BSM, although some key projects did not meet short-term cost and schedule commitments. During 2005 and the beginning of 2006, IRS deployed additional releases of several modernized systems that have delivered benefits to taxpayers and the agency, including CADE, e-Services (a new Web portal and electronic services for tax practitioners), and Modernized e-File (a new electronic filing system). While three BSM project releases were delivered within the cost and/or schedule commitments presented in the fiscal year 2005 expenditure plan, others experienced cost increases or schedule delays. For example, two IFS and Modernized e-File project releases experienced cost increases of 93 per-

[25] GAO, Internal Revenue Service: Improving Adequacy of Information Systems Budget Justification, GAO–02–704 (Washington, D.C.: June 28, 2002).

[26] IFS replaces aspects of IRS's core financial systems and is ultimately intended to operate as its new accounting system of record. The first release of this system became fully operational in January 2005.

cent[27] and 29 percent, respectively. As we have previously reported,[28] the BSM program has had a history of cost increases and schedule delays that have been due, at least in part, to deficiencies in various management controls and capabilities that have not yet been fully corrected. IRS is in the process of implementing our prior recommendations to correct these deficiencies.

IRS has identified significant risks and issues that confront future planned system deliveries. For example, according to IRS, schedule delays and contention for key resources between multiple releases of CADE necessitated the deferral of some functionality. The deferral of these requirements may negatively impact the cost and schedule for two important releases, which are planned to be deployed later this year. The agency, however, recognizes the potential impact of these project risks on its ability to deliver planned functionality within cost and schedule estimates, and to its credit, has developed mitigation strategies to address them. IRS has also made additional progress in addressing high-priority BSM program improvement initiatives during the past year, including initiatives related to shifting the role of systems integrator from the prime contractor to IRS. IRS's program improvement process appears to be an effective means of assessing, prioritizing, and addressing BSM issues and challenges. However, much more work remains for the agency to fully address these issues and challenges.

In addition, in response to our prior recommendation, IRS is developing a new Modernization Vision and Strategy to address BSM program changes and provide a modernization roadmap. According to the Associate Chief Information Officer for BSM, the agency's new strategy focuses on promoting investments that provide value in smaller, incremental releases that are delivered more frequently, with the goal of increasing business value. IRS is currently finalizing a high-level vision and strategy as well as a more detailed 5-year plan for the BSM program. We believe these actions represent sound steps toward addressing our prior recommendation to fully revisit the vision and strategy and develop a new set of long-term goals, strategies, and plans consistent with the budgetary outlook and with IRS's management capabilities.

While the requested fiscal year 2007 BSM budget will allow IRS to continue the development and deployment of the CADE, Modernized e-File, and Filing and Payment Compliance (F&PC)[29] projects, the proposed reduced funding level would likely affect the agency's ability to deliver the functionality planned for the fiscal year and could result in project delays and/or scope reductions. This could, in turn, impact the long-term pace and cost of modernizing tax systems and of ultimately improving taxpayer service and strengthening enforcement. For example, according to IRS documents, the agency had planned to spend $85 million in fiscal year 2007 to develop and deploy additional CADE releases that would enable the system to process up to 50 million individual tax returns by the 2008 filing season and issue associated refunds faster. However, with a proposed budget of $58.5 million—over 30 percent less than anticipated—IRS would likely have to scale back its planned near-term work on this project. In addition, the reductions to the planned budgets for the Modernized e-File and F&PC projects may also result in IRS having to redefine the scope and/or reassess schedule commitments for future project releases.

The proposed BSM budget reduction would also significantly reduce the amount allotted to program management reserve by about 82 percent (from $13 million in fiscal year 2006 to $2.3 million in fiscal year 2007). If BSM projects have future cost overruns that cannot be covered by the depleted reserve, this reduction could result in increased budget requests in future years or delays in planned future activities.

While the BSM program still faces challenges, IRS has recently made progress in delivering benefits and addressing project and program-level risks and issues. Reducing BSM funds at a time when benefits to taxpayers and the agency are being delivered could adversely impact the momentum gained from recent progress and result in delays in the delivery of future benefits. However, until IRS addresses our prior recommendation by clearly defining its future goals for the BSM program as well as the impact of various funding scenarios on meeting these goals in its new Modernization Vision and Strategy, the long-term impact of the proposed budget reduction is unclear.

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[27] IRS recently reported that it plans to redirect about $5 million of unobligated funding from the IFS project to program management reserve, which would reduce this cost overrun.

[28] For example, see GAO, Business Systems Modernization: Internal Revenue Service's Fiscal Year 2005 Expenditure Plan, GAO–05–774 (Washington, D.C.: July 22, 2005).

[29] F&PC is a series of projects expected to provide support for detecting, scoring, and working nonfiler (filing compliance) and delinquency (payment compliance) cases. The first phase of F&PC is Private Debt Collection, which will use advanced software to analyze tax collection cases and divide them into the complex cases requiring IRS involvement and the less complex (balance due) cases that can be handled by private collection agencies.

IRS's Budget Request Identified Some Savings, but Opprotunities Exist for Enhancing Savings

In its 2007 budget request, IRS identified savings as it has done in prior years and plans to redirect some of those savings to front-line taxpayer service and enforcement activities. IRS is proposing to save over $121 million and 1,424 FTEs by, for example, automating the process of providing an individual taxpayer identification number to those taxpayers ineligible for a Social Security number and improving data collection techniques and work processes for enforcement activities through increased financial reporting requirements and scanning and imaging techniques.

IRS's history of realizing savings proposed in past budget requests provides some confidence that the agency will be able to achieve savings in fiscal year 2007. For example, IRS reported it realized 88 percent of the anticipated dollar savings and 86 percent of the anticipated staff savings identified in the fiscal year 2004 budget request. IRS also reported exceeding the savings targets in the fiscal year 2005 budget request (see app. III).

In addition to the areas identified by IRS in its budget request, there may be additional opportunities for efficiency gains.

- Increasing electronic filing: In an era of tight budgets, continued growth in electronic filing may be necessary to help fund future performance improvements. One proposal for continuing to increase electronic filing is additional use of electronic filing mandates. Currently, IRS mandates electronic filing for large corporations. The 2007 budget request proposes a legislative change that would expand its authority to require electronic filing for businesses. Moreover, 12 states now mandate electronic filing for certain classes of tax practitioners (see app. IV for more information on state mandates). As we have reported,[30] although there are costs and burdens likely to be associated with electronic filing mandates for paid tax preparers and taxpayers, state mandates have generated significant increases in electronic filing. IRS has an electronic filing strategy, which the agency is updating.
- Changing the menu of taxpayer services: IRS currently lacks a comprehensive strategy explaining how its various taxpayer services (including its telephone, walk-in, volunteer, and Web site assistance) will collectively meet taxpayer needs. In response to a Congressional directive,[31] IRS is developing such a strategy. The strategy is important because some taxpayers may not be well served by the current service offerings. IRS's attempts to reduce some taxpayer services, namely reducing the hours of telephone operations and closing some walk-in sites, have met with resistance from the Congress. Although congressional directives to study the impact of IRS's actions exist,[32] we still believe there may be opportunities to adjust IRS's menu of services to reduce costs, without affecting IRS's ability to meet taxpayers' needs.
- Consolidating telephone call sites: IRS operates 25 call sites throughout the country. Consistent with earlier plans, IRS closed two of its smallest call sites—Chicago and Houston—in March 2006, to realize savings in its toll-free telephone operations. Also, IRS has gained efficiencies from using a centralized call router located in Atlanta. As a result, there are currently more than 850 workstations that are not being used; consequently, IRS may have the potential to close several additional call sites. Consolidations would not affect telephone service and would be invisible from the taxpayer's perspective.

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[30] GAO–06–51.

[31] In the H.R. Conf. Rep. No. 109–307 (2005), the Congress directed the IRS, in conjunction with the IRS Oversight Board and the National Taxpayer Advocate, to develop a 5-year plan for taxpayer service activities and report to the House and Senate Committees on Appropriations by April 14, 2006.

[32] In Pub. L. No. 109–115, § 205, (Nov. 30, 2005), the Congress directed the IRS not to reduce taxpayer services as the IRS proposed in fiscal year 2006 until TIGTA completed a study on the impact of such reductions on taxpayer compliance and services. Further, IRS was directed, to consult with stakeholder organizations, including, but not limited to, the IRS Oversight Board, National Taxpayer Advocate, TIGTA and Internal Revenue employees with respect to any efforts by the IRS to terminate or reduce significantly any taxpayer service activity. Pub. L. No. 109–148, § 5021 (Dec. 30, 2005) extends above provisions to include any reduction in available hours of telephone taxpayer assistance below the levels in existence during the month of October 2005.

Accurate Cost Information Would Help IRS Make Resource Allocation Decisions, and Help Provide Some Information About the Return on Investment for its Programs

Managing a federal agency as large and complex as IRS requires managers to constantly weigh the relative costs and benefits of different approaches to achieving the goals mandated by the Congress. Management is constantly called upon to make important long-term strategic as well as daily operational decisions about how to make the most effective use of the limited resources at its disposal. As constraints on available resources increase, these decisions become correspondingly more challenging and important. In order to rise to this challenge, management needs to have current and accurate information upon which to base its decisions, and to enable it to monitor the effectiveness of actions taken over time so that appropriate adjustments can be made as conditions change.

In its ongoing effort to make such increasingly difficult resource allocation decisions and defend those decisions before the Congress, IRS has long been hampered by a lack of current and accurate information concerning the costs of the various options being considered. Instead, management often has relied on a combination of the limited existing cost information; the results of special analysis initiated to establish the full cost of a specific, narrowly defined task or item; and estimates based on the best judgment of experienced staff. This has impaired IRS's ability to properly decide which, if any, of the options at hand are worth the cost relative to the expected benefits. For example, accurate and timely cost information may help IRS consider changes in the menu of taxpayer services that it provides by identifying and assessing the relative costs, benefits, and risks of specific projects. Without reliable cost information, IRS's ability to make such difficult choices in an informed manner is seriously impaired. The lack of reliable cost information also means that IRS cannot prepare cost-based performance measures to assist in measuring the effectiveness of its programs over time.

Further, IRS does not have the capability to develop reliable information on the return on investment for each category of taxpayer service and enforcement. IRS lacks reliable information on both the return from services (the additional revenue collected by helping taxpayers understand their tax obligations) and the investment or cost of the services. While developing return on investment information is difficult, the cost component of that equation may be the least complex to develop. Having such cost information is a building block for developing return on investment estimates. For its enforcement programs, IRS has developed a rough measure of return on investment in terms of tax revenue that is directly assessed from uncovering noncompliance. Continuing to develop return on investment measures could help officials make more informed decisions about allocating resources.[33] The new NRP data, for example, are to be used to better identify which tax returns to examine so that fewer compliant taxpayers are burdened by unnecessary audits and IRS can increase the amount of noncompliance that is addressed through its enforcement activities. Even without return on investment information, cost information can help IRS determine if, for example, IRS should change the menu of services provided.

As discussed in the BSM section, in fiscal year 2005, IRS implemented a cost accounting module as part of IFS. However, while this module has much potential and has begun accumulating cost information, IRS has not yet determined what the full range of its cost information needs are or how best to tailor the capabilities of this module to serve those needs. Also, IRS does not have an integrated workload management system which would provide the cost module with detailed allocation of personnel cost information.[34] In addition, as noted in developing its IS budget, because it generally takes several years of historical cost information to support meaningful estimates and projections, IRS cannot yet rely on IFS as a significant planning tool. It will likely require several years, implementation of additional components of IFS, and integration of IFS with IRS's tax administration activities before the full potential of IFS's cost accounting module will be realized. Furthermore, IRS's fiscal year 2007 BSM budget request does not include funding for additional releases of IFS. In the interim, IRS decision making will continue to be hampered by inadequate underlying cost information.

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[33] Developing such measures is difficult because of incomplete information on all the costs and all the tax revenue ultimately collected from specific enforcement efforts, as well as incomplete information on the indirect tax revenues generated when current enforcement actions prompt voluntary compliance improvements in the future.

[34] IRS had planned to develop a workload management system, but has postponed this project indefinitely, due to budget constraints.

IRS Sets Long-Term Goals, but Lacks a Data-Based Plan for Achieving the Goals, and Addressing the Tax Gap Requires Solutions Beyond Funding and Staffing for IRS

For the first time, IRS's budget request sets long-term goals aimed at reducing the tax gap, although IRS does not have a data-based plan for achieving the goals. However, because of its persistence, reducing the tax gap requires solutions which go beyond funding and staffing for IRS.

IRS's Budget Proposes Long-Term Goals, but Lacks a Data-Based Plan for Achieving Them

IRS established two agencywide, long-term performance goals, as shown in table 3. IRS plans to improve voluntary compliance from 83 percent in 2005 to 85 percent by 2009, and reduce the number of taxpayers who think it is acceptable to cheat on their taxes from 10 percent in 2005 to less than 9 percent in 2010. According to IRS, these are the first in a series of quantitative goals that will link to its three strategic goals—improve taxpayer service, enhance tax law enforcement, and modernize IRS through technology and processes.

Table 3: IRS Agencywide Goals for Fiscal years 2004 through 2010

Performance level	Fiscal year 2004 actual performance	Fiscal year 2005 actual performance	Fiscal year 2006 planned performance	Fiscal year 2007 planned performance	Fiscal year 2008 planned performance	Fiscal year 2009 planned performance	Fiscal year 2010 planned performance
Improve voluntary compliance.	N/A	83.0%	N/A	N/A	N/A	85.0%	N/A
Reduce the percentage of taxpayers who think it is acceptable to cheat on their taxes.	12.0%	10.0%	10.0%	10.0%	9.0%	<9.0%	<9.0%

Source: IRS.

These goals will be challenging to meet, because for three decades, IRS has consistently reported a persistent, relatively stable tax gap. Although IRS has made a number of changes in its methodologies for measuring the tax gap, which makes comparisons difficult, regardless of methodology used, the voluntary compliance rate that underpins the gap has tended to range from around 81 percent to around 84 percent.

Because of a lack of quantitative estimates of how changes to its service and enforcement programs affect compliance, IRS is unable to show in a data-based plan how it will use those programs to reach the two long-term goals shown in table 3. If IRS could quantify the impact of its service and enforcement programs on the compliance rate or attitudes towards cheating, it could use the information to show the kinds of changes to the programs needed to achieve the long-term goals and how best to direct resources towards achieving those goals. Unfortunately, quantifying the impact of IRS's service and enforcement programs on compliance or cheating is very challenging. The type of data needed to make such a link does not currently exist, and may not be easy to collect.

Lacking such quantitative estimates, IRS must take a more qualitative approach in its plans for increasing compliance, which would likely also involve changing attitudes towards cheating. IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. We recently reported that IRS has taken a number of steps that may improve its ability

to reduce the tax gap.[35] Favorable trends in staffing of IRS enforcement personnel; examinations performed through correspondence, as opposed to more complex face-to-face examinations; and the use of some enforcement sanctions such as liens and levies are encouraging. Also, IRS has made progress with respect to abusive tax shelters through a number of initiatives and recent settlement offers that have resulted in billions of dollars in collected taxes, interest, and penalties. Finally, IRS has continually improved taxpayer service by increasing, for example, the accuracy of responses to tax law questions.

The effect of this overall approach and the 2007 budget proposal will have on voluntary compliance has not been quantified by IRS. Therefore, the Congress will have to rely on the IRS Commissioner for qualitative explanations, of why, in his judgment, IRS's mix of taxpayer service and enforcement and overall approach for reducing the tax gap, including the 2007 budget proposal, will be sufficient to start IRS on a path towards achieving its long-term goals. More specifically, such explanations could include a clear statement of which service and enforcement programs have priorities for expansion because they are expected to contribute the most to increasing the compliance rate and the evidence that supports that judgment.

In addition, IRS lacks a plan for measuring progress towards one goal—improving voluntary compliance. IRS plans to measure progress towards the second goal—reducing the percentage of taxpayers who think it is acceptable to cheat—via the IRS Oversight Board's annual Taxpayer Attitude Survey.

Nevertheless, IRS recently estimated voluntary compliance as part of the NRP study, which reviewed the compliance of a random sample of individual taxpayers and used those results to estimate compliance for the population of all taxpayers. The study took several years to plan and execute. In addition to providing an estimate of the compliance rate, the study's results will be used to better target IRS's audits of potentially non-compliant taxpayers. Better targeting reduces the burden on taxpayers because IRS is better able to avoid auditing compliant taxpayers.

At this time, however, IRS has not made plans to repeat the study in time to measure compliance by 2009. Furthermore, doing compliance studies once every few years does not give IRS or others information about what is happening in the intervening years. Annual estimating of the compliance rate could provide information that would enable IRS management to adjust plans as necessary to help achieve the goal in 2009. One option that would not increase the cost of estimating compliance would be to use a rolling sample. IRS Oversight Board officials and we agree that instead of sampling, for example, once every 5 years, one-fifth of the sample could be collected every year. The total sample could include 5 years worth of data—with each passing year the oldest year would be dropped from the sample and the latest year added. The availability of current research data would allow IRS to more effectively focus its service and compliance efforts.

Addressing the Tax Gap Requires Solutions Beyond Funding and Staffing for IRS

For years, we have reported that tax law enforcement is a high-risk area, in part because of the size of the gross estimated tax gap, which IRS most recently estimated to be $345 billion for tax year 2001. IRS estimated it would recover around $55 billion through late payments and enforcement revenue, resulting in a net tax gap of around $290 billion.[36] Reducing the tax gap would yield significant revenue and even modest progress, such as a 1 percent reduction, would likely yield nearly $3 billion annually. In recent years, IRS reported increases in enforcement revenue—revenue brought in as a result of IRS taking enforcement action. Between fiscal years 2003 and 2005, IRS reported that enforcement revenue grew from $37.6 billion to $47.3 billion, with a level of $48.1 billion estimated for 2006. However, the voluntary compliance rate has persisted at a relatively stable level.

We have reported that significant reductions in the tax gap will likely require exploring new and innovative solutions.[37] Such solutions that may not require significant additional IRS resources, but are nonetheless difficult to achieve, include

- simplifying the tax code to make it easier for individuals and businesses to understand and comply with their tax obligations;
- increasing tax withholding for income currently not subject to withholding;
- improving information reporting; and
- leveraging technology to improve IRS's capacity to receive and process tax returns.

[35] GAO–06–453T.
[36] GAO–06–453T.
[37] GAO–06–453T.

IRS's 2007 budget request includes five new legislative proposals to address some of these solutions to reduce the tax gap, along with a proposal to study independent contractor compliance that would not require additional resources. In recent testimony, the IRS Commissioner stated that the amount of enforcement revenue IRS expects from the legislative proposals will be $3.6 billion over the next 10 years (about 0.1 percent of the tax gap). However, the proposals should also increase revenue voluntarily paid without any IRS enforcement actions. The amount of that revenue is uncertain. The IRS Commissioner recognizes the implications of the tax gap and states in the budget that addressing it is a top priority. Although IRS's 2007 budget request does not propose allocating IRS resources to new initiatives to reduce the tax gap, according to IRS officials, they plan to continue initiatives identified in prior budgets. For example, IRS has two ongoing BSM projects—F&PC and Modernized e-File—which, according to IRS's Associate Chief Information Officer for BSM, could help reduce the tax gap. F&PC is expected to increase IRS's capacity to resolve the growing backlog of delinquent taxpayer cases and increase collections, while Modernized e-File is expected to help make it easier for IRS to process tax returns, look for irregularities, and track down unpaid taxes.

The budget request states that the administration will study the standards used to distinguish between employees and independent contractors for purposes of paying and withholding income taxes. We have long supported efforts aimed at improving independent contractor compliance.[38] Past IRS data have shown that independent contractors report 97 percent of the income that is reported on information returns to IRS, while contractors that do not receive these information returns report only 83 percent of income. We have also identified other options for improving information reporting by independent contractors, including increasing penalties for failing to file required information returns, lowering the $600 threshold for requiring such returns, and requiring businesses to separately report on their tax returns the total amount of payments to independent contractors.[39] We previously reported that clarifying the definition of independent contractors and extending reporting requirements for those contractors could possibly increase tax revenue by billions of dollars.[40]

Two of the legislative proposals call for more information reporting on payment card transactions from certain businesses and on payments by federal, state, and local governments to businesses. Information reporting has been shown to significantly reduce noncompliance. Although information reporting is highly effective in encouraging compliance, such reporting imposes costs and burdens on the businesses that implement it. However, information reporting is a way to significantly increase voluntary compliance without increasing IRS's budget.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other members of the subcommittee my have at this time.

Contacts and Acknowledgments

For further information regarding this testimony, please contact James R. White, Director, Strategic Issues.or David A. Powner, Director, Information Technology Management Issues. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Joanna Stamatiades, Assistant Director; Amanda Arhontas; Paula Braun; Terry Draver; Paul Foderaro; Chuck Fox; Tim Hopkins; Kathryn Horan; Hillary Loeffler; Sabine Paul; Cheryl Peterson; Neil Pinney; Steve Sebastian; Tina Younger.

Appendix I: Differences Between the 2002 and 2005 Free File Agreements

In 2002, Internal Revenue Service (IRS) entered into a 3-year agreement with the Free File Alliance, a consortium of 20 tax preparation companies to provide free electronic filing to taxpayers who access any of the companies via a link on IRS's Web site. The 2002 Free File Agreement stated that as part of the agreement, IRS would not compete with the Consortium in providing free, online tax return preparation and filing services to taxpayers. IRS and the Consortium amended the agreement in 2005. Key differences between the two agreements are: the new income limitation of $50,000 and new language in the amendment that states the Alliance

[38] GAO, Tax Administration: Approaches for Improving Independent Contractor Compliance, GAO/GGD–92–108 (Washington, D.C.: July 23, 1992).

[39] GAO–06–453T.

[40] GAO, Opportunities for Congressional Oversight and Improved Use of Taxpayer Funds, GAO–04–659 (Washington, D.C.: May 7, 2004).

members must disclose early on if state tax return services are available, and if so, whether a fee will be charged for such services; and provide the necessary support to accomplish a customer satisfaction survey. It also added language pertaining to the marketing and offering of Refund Anticipation Loans (RALs)[41] whereby:

- No offer of free return preparation and filing of an electronic return in the free file program shall be conditioned on the purchase of a RAL; and
- RALs will be offered with clear language indicating, for example, that RALs are loans, not a faster way of receiving an IRS refund; must be repaid even if the IRS does not issue a full refund; are short-term loans interest rates may be higher and customers may wish to consider using other forms of credit; and may be offered but not promoted.

IRS tests each Consortium member's software to ensure it is in accordance with the Free File provisions, including those cited previously, before allowing a link to IRS's Web site. In addition, IRS officials monitor complaints about the Free File program received via IRS.gov, including allegations regarding false, deceptive, or misleading information or advertising. While IRS does not track the number of complaints it receives, according to IRS officials, most of the complaints received thus far were a result of the taxpayer either not carefully reading or following instructions, or incorrectly entering information. GAO conducted limited testing of the Free File program and found that the Consortium members were complying with the terms outlined in the amended Free File agreement pertaining to RALs.

The amended Free File agreement contains provisions that enable IRS to monitor taxpayer participation beginning in the 2006 filing season, unlike prior years where Free File Alliance members self-reported filing figures. IRS also tracks the number of free file users who are accepting any financial products, such as RALs. As of March 16, IRS reported that 163,000 Free File returns accepted financial products. This represents 5.6 percent of all returns filed through the Free File program.

The number of taxpayers using free file to electronically file their individual income tax returns has increased steadily from 2.8 million in 2003, to 3.5 million in 2004, to 5.1 million in 2005. The substantial growth between 2004 and 2005 was due to, in part, several Consortium members offering free filing to all taxpayers through the free file program regardless of their income in 2005. However, according to IRS officials, the lack of income limitation created conflict among Consortium members as it put pressure on all Alliance members to offer free service, which may not have been economically feasible for some, threatening competition if members were to drop out of the Alliance.

IRS projected that 6.1 million taxpayers would use free file in 2006. However, this projection may be optimistic, because between January 1 and March 19, IRS has reported receiving only 2.9 million free file returns compared to 3.8 million during the same period last year, a decline of 23 percent. According to IRS officials, contributing factors to this decline are, in part, due to decreased press attention and advertising by the participating companies and the income limitation. The income limitation provides coverage to 70 percent of the nation's taxpayers, or more than 92 million people. This coverage includes taxpayers with an adjusted gross income of $50,000 or less.

Appendix II: Comparison of IRS's Actual and Enacted Funding and Full-Time Equivalents, Fiscal Years 2002 through 2007

For fiscal year 2007, the Internal Revenue Service (IRS) has requested $10.7 billion in its appropriation accounts. This request consists of $10.6 billion in direct appropriations and $135 million in revenue from new user fees, which IRS will commit to taxpayer service activities in its Processing, Assistance, and Management (PAM), Tax Law Enforcement (TLE), and Information System (IS) accounts. In addition, IRS is projecting to collect and use $282 million from existing user fees and reimbursable agreements with states and other federal agencies. This brings IRS's proposed fiscal year 2007 budget to approximately $11 billion (a 1.6 percent increase over fiscal year 2006). After adjusting for expected inflation, IRS's $11 billion budget request reflects a slight decrease from last year's enacted budget.

IRS's enacted budgets for its appropriation accounts from fiscal years 2002 through 2007 are shown in table 4. IRS's enacted budget has increased almost 8 percent since fiscal year 2002. By far, the biggest percentage increase has been TLE—almost 21 percent—and is reflective the shift in resources devoted to TLE

[41] Refund Anticipation Loans are very short-term loans issued while taxpayers wait for their refunds.

from PAM during this period. The biggest percentage decrease was in the Business Systems Modernization (BSM) program, down almost 58 percent.

Table 4: IRS's Funding for Fiscal Years 2002 through 2007

Dollars in thousands	Fiscal year 2007	Fiscal year 2006	Fiscal year 2005	Fiscal year 2004	Fiscal year 2003	Fiscal year 2002	Fiscal year 2002—2007
	Requested including new user fees	Enacted	Enacted	Enacted	Enacted	Enacted	Percentage change
PAM	$4,159,893	$4,095,212	$4,056,857	$4,009,205	$3,930,064	$3,982,971	4.44
TLE	4,764,954	4,678,499	4,363,539	4,171,244	3,849,884	3,940,741	20.92
IS	1,619,834	1,582,977	1,577,768	1,581,575	1,621,834	1,620,905	–0.07
BSM	167,310	197,010	203,360	387,699	363,621	391,593	–57.27
HITCA	14,846	20,008	34,562	34,794	69,545	NA	NA
Total appropriations requested	**$10,726,837**	**$10,573,706**	**$10,236,087**	**$10,184,517**	**$9,834,948**	**$9,936,210**	**7.96**

Source: GAO analysis of IRS data.
Notes: Numbers may not add due to rounding. Fiscal year 2007 includes $135 million in new user fee revenue distributed in PAM, TLE, and IS accounts. Without user fees, IRS is requesting $4,045,122 for PAM, $4,762,327 for TLE, and $1,602,232 for IS.

Tables 5 and 6 show IRS's enacted and actual Full-time Equivalents (FTEs) for fiscal years 2002 through 2007. Overall, actual FTEs tend to be lower than enacted FTEs due in part to the way IRS funds its unbudgeted requirements. When both enacted and actual FTEs are considered, FTEs for PAM have steadily decreased and, for the most part, FTEs for TLE have increased since fiscal year 2002. However, steady trends are not apparent when comparing enacted and actual FTEs in IRS's IS account. For example, when enacted FTEs are considered, IS staffing appears to fluctuate up and down between fiscal years 2002 through 2007; yet, when actual FTEs are considered, IS staffing decreased from fiscal year 2002 through 2005 and increased from fiscal years 2005 to 2006. IRS officials attribute these fluctuations in FTEs to reorganizations and other factors.

Tables 5 and 6 also show significant differences in percentage changes between enacted and actual FTEs in some of IRS's appropriations accounts from fiscal years 2006 to 2007. The enacted level of FTEs is the number IRS projected it could support given the level of funding the Congress enacted. According to IRS officials, enacted levels tend to be overstated compared to actual FTEs for several reasons. First, IRS, like most federal agencies, does not receive its budgets when expected and cannot fill all positions. Also, as the costs of maintaining current FTE levels increase annually, IRS is not able to realize all of the FTEs it projects to fund with the appropriations the Congress enacts.

Table 5: IRS's Enacted FTEs for Fiscal Years 2002 through 2007

	Fiscal year 2007	Fiscal year 2006	Fiscal year 2005	Fiscal year 2004	Fiscal year 2003	Fiscal year 2002	Fiscal year 2006—2007	Fiscal year 2002—2007
	Requested	Enacted	Enacted	Enacted	Enacted	Enacted	Percentage change	Percentage change
PAM	37,126	38,796	39,901	42,332	43,452	43,774	–4.30	–15.19
TLE	49,479	50,559	49,132	49,147	47,478	48,628	–2.14	1.75
IS	7,351	7,032	7,385	7,559	7,445	7,499	4.54	–1.97
BSM	0	0	0	0	0	NA	0.00	NA
HITCA	17	17	17	17	6	NA	0.00	NA
Total	**93,973**	**96,404**	**96,435**	**99,055**	**98,381**	**99,901**	**–2.52**	**–5.93**

Source: GAO analysis of IRS data.
Notes: Fiscal year 2007 requested FTEs reflect an adjustment after the budget was printed. Also, we are not reporting FTEs for user fees and reimbursable as shown in an earlier section of this statement, because we were unable to obtain this information for all years in time for this statement.

Table 6: IRS's Actual FTEs from Fiscal Years 2002 through 2007

	Fiscal year 2007	Requested	Fiscal year 2006	Operating Level	Fiscal year 2005	Actual	Fiscal year 2004	Actual
PAM	37,126	38,308	38,710	41,436	43,452	44,191	–3.09	–15.99
TLE	49,479	49,721	48,544	47,704	47,478	48,238	–0.49	2.57
IS	7,351	7,340	7,015	7,279	7,445	7,773	0.15	–5.43
BSM	0	0	0	0	0	NA	0.00	NA
HITCA	17	17	13	12	6	NA	0.00	NA
Total	**93,973**	**95,386**	**94,282**	**96,431**	**98,381**	**100,202**	**–1.48**	**–6.22**

Source: GAO analysis of IRS data.
Notes: Fiscal year 2007 requested FTEs reflect an adjustment after the budget was printed. Also, we are not reporting FTEs for user fees and reimbursable as shown in an earlier section of this statement, because we were unable to obtain this information for all years in time for this statement.

In its fiscal year 2006 budget request, IRS showed its budget distributed by taxpayer services and enforcement, including IS funding for those areas, because the agency's current appropriation accounts are not divided clearly between taxpayer service and enforcement. As table 7 shows, funding for enforcement increased 15 percent between fiscal years 2004 and 2007 to $6.96 billion, while funding for taxpayer service declined over 3 percent to almost $3.6 billion.

Table 7: IRS's Funding for Taxpayer Service and Enforcement for Fiscal Years 2004 through 2007

Dollars in Millions	Fiscal year 2007 requested	Fiscal year 2006 enacted	Fiscal year 2005 enacted	Fiscal year 2004 enacted	Percentage change 2004–2007
Taxpayer Service	$3,583	$3,533	$3,606	$3,710	–3.4
Enforcement	$6,961	$6,824	$6,392	$6,052	15.0

Source: GAO analysis of IRS data.
Note: IRS's taxpayer service and enforcement programs are funded through its PAM, TLE, and IS accounts.

Appendix III: IRS's Estimated and Actual Savings and Reinvestments

In its 2007 budget request, the Internal Revenue Service (IRS) is proposing to save over $121 million and 1,424 Full-time Equivalents (FTEs) and reinvest over $12 million and 11 FTEs. Based on IRS's ability to achieve prior year savings and reinvestments as shown in table 8, we have a basis to believe that IRS will achieve most, if not all, of these savings. For example, IRS reported it realized 88 percent of its anticipated budget savings and 86 percent of its anticipated staff savings for savings identified in its fiscal year 2004 budget request, and IRS reported exceeding savings targets in fiscal year 2005.

Table 8: IRS's Estimated and Actual Savings and Reinvestments for Fiscal years 2004 through 2007

Dollars in Thousands	Fiscal year 2004 actual		Fiscal year 2005 actual		Fiscal year 2006 estimate		Fiscal year 2007 estimate	
	Dollars	FTEs	Dollars	FTEs	Dollars	FTEs	Dollars	FTEs
Savings[a]								
Budgeted	$160,872	1,993	$110,841	1,442	$230,096	2,230	$121,596	1,424
Actual	$141,142	1,711	$127,239	1,628	$226,908	2,230	NA	NA
Percentage realized between Budgeted and Actual[b].	88	86	115	113	99	100	NA	NA

Table 8: IRS's Estimated and Actual Savings and Reinvestments for Fiscal years 2004 through 2007—Continued

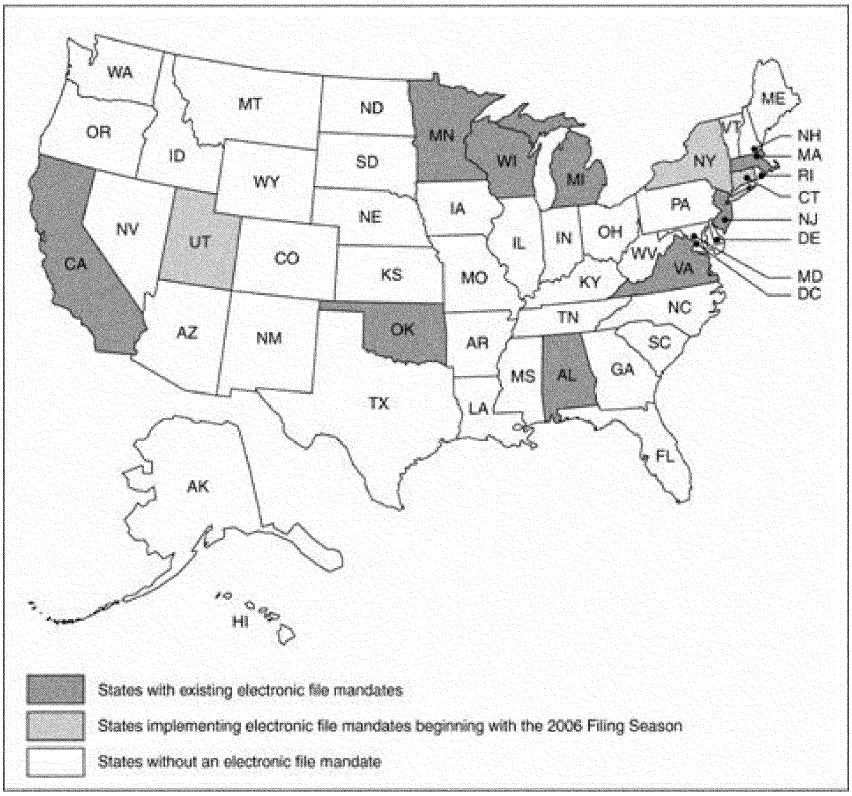
Dollars in Thousands	Fiscal year 2004 actual		Fiscal year 2005 actual		Fiscal year 2006 estimate		Fiscal year 2007 estimate	
	Dollars	FTEs	Dollars	FTEs	Dollars	FTEs	Dollars	FTEs
Reinvestments[a]								
Budgeted	$141,419	602	$66,343	359	$95,893	805	$12,237	11
Actual	$118,330	313	$96,481	958	$92,030	805	NA	NA
Percentage realized between Budgeted and Actual[b].	84	52	145	267	96	100	NA	NA

Source: GAO analysis of IRS data.
Note: Fiscal year 2007 FTE savings reflect an adjustment after the budget was printed.
[a] IRS considers savings to be gained through process or systems improvements and reinvestments to be those savings that were realized and available for other purposes.
[b] IRS reported actuals for 2004 and 2005, and year-end projections for 2006.

Appendix IV: State Mandates

Of the 50 states, 12 have electronic filing mandates for tax practitioners in effect for the 2006 filing season (see fig. 4). The mandates differ in their implementation dates and schedules, thresholds for filing, and penalties. The differences between mandates may affect the magnitude of electronic filing increases in each state.

Figure 4: States with Electronic Filing Mandates for Tax Preparers



Sources: GAO analysis; Copyright © Corel Corp. All rights reserved (map).

We recently reported that state mandates encourage electronic filing of federal tax returns and recommended that IRS develop better information about the costs to tax practitioners and taxpayers of mandatory electronic filing of tax returns for certain categories of tax practitioners.[42] These mandates require tax practitioners who meet certain criteria, such as filing 100 individual state tax returns or more, to file individual state returns electronically.

Between tax years 2001 and 2004, electronic filing had grown in the 9 states with mandates from an average of 36.7 percent to 56.8 percent, or an increase of over 20 percentage points, compared to an increase of 14 percentage points for the 41 non mandated states over the same time period. We expect this trend to continue as 3 additional states—New York, Utah and Connecticut—implemented mandates in time for the 2006 filing season. Of these 3 states, New York may have the most to gain because it currently has the lowest rate of electronic filing rate, with fewer than 38 percent of its nearly 9 million federal individual income tax returns electronically filed last year.

Appendix V: Bibliography of GAO Resources

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[42] GAO–06–51.

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Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request, GAO–05–566 Washington, D.C.: April 27, 2005.

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Financial Audit: IRS's Fiscal Years 2003 and 2002 Financial Statements, GAO–04–126 Washington, D.C.: November 13, 2003.

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Other:

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The Results Act: An Evaluator's Guide to Assessing Agency Annual Performance Plans, GAO/GGD–10.1.20 Washington, D.C.: April 23, 1998.

For more information on Department of the Treasury major management challenges, see http://www.gao.gov/pas/2005/treasury.htm

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Chairman RAMSTAD. Thank you to all four of you distinguished gentlemen for your testimony. The Chairman and each Member of the Committee appreciates the expertise that you literally bring to the table, and appreciate your testimony again here today.

Mr. George, I would like to ask you the first question, and I think it is important that we delve into a little more deeply the Free File agreement situation. I think it is important that we focus on what the agreement was all about. Now, in your written testimony, Mr. Hugo, you claim that the original intent of the agreement was to serve low-income and disadvantaged persons, taxpayers. Looking at the original agreement, I see no support for this contention.

In your view, Mr. George, what was the original purpose of the Free File agreement?

Mr. GEORGE. Thank you, Mr. Chairman. Let me quote, if I may, from the original agreement. It states that, "This agreement provides for free online tax return preparation and filing to individual taxpayers," and it delineates five points, which I will briefly summarize.

It wanted to ensure free and secure electronic preparation and filing options for additional taxpayers. It wanted to make sure that tax return preparation was easier and would reduce the burden on the individual taxpayer. Third, it wanted to support the IRS' goal to increase e-filing pursuant to the Restructuring Act 1998, and the goal of the IRS to achieve 80 percent of electronically filed returns by 2007. Four, it wanted to provide greater service and access to taxpayers, and last, it wanted to support the President's proposal in his fiscal year 2003 budget, which again, specifically encouraged further growth in electronic filing.

Nowhere in the original agreement was there any mention on restrictions placed on who could participate in the program.

Chairman RAMSTAD. That was my reading as well.

Mr. White, do you agree?

Mr. WHITE. Yes, Mr. Chairman.

Chairman RAMSTAD. Chairman Wagner?

Mr. WAGNER. Yes, sir, Mr. Chairman. I am not aware of any restrictions in the original agreement, and I would think the spirit of the original agreement should be carried forward today as well.

Chairman RAMSTAD. Mr. Hugo, do you want to respond?

Mr. HUGO. Yes, sir.

Chairman RAMSTAD. By the way, if I may—excuse my interruption—we have two votes. The first vote will last 17 minutes. I would like to finish with this panel prior to going to vote, so we will adhere to the five-minute limit so we won't have to detain you

unnecessarily, and then we will recess for 15 minutes, 20 minutes max, until the next panel.

Please proceed, Mr. Hugo.

Mr. HUGO. Mr. Chairman, thank you for the opportunity.

I think one of the things, that question arose when we came before your staff earlier a couple weeks ago, and also with TIGTA. One of the things that I wanted to clarify—again, I have been there since July of 2005. So, what we did is went back to some of the original negotiators. In fact, we conferred with Mr. Rossotti, the original Commissioner at the time this was negotiated, and got an e-mail from him, some communication from him just the other day, saying that the original intent was to make sure that low and moderate income tax payers were not deterred by the fee, that the fee was not a deterrent.

In the information that we also supplied to the Committee here, within months of that first agreement, there was an amendment, and again, I think we furnished that to your staff, that again talked about serving low and underserved communities. That was the purpose, and I think you have that information. So, that amendment that we talked about that is part of the agreement that has been part of the ongoing dialog is something that has been in place for 4 years, and then we have also received direction from Congress, not just from a bill that has passed one house, but in the Treasury Appropriations bill there has been language that talks about serving the low and underserved communities, and that was in some of the Treasury appropriation bills that have passed.

Chairman RAMSTAD. Well, I think everyone here probably agrees, or most, that the Free File Alliance should not have to provide free preparation software to people like Bill Gates and Warren Buffett, but what about a husband and wife living in the third district of Minnesota. Each, let's say, has an adjusted gross income of $26,000. The filed jointly. Why shouldn't they be allowed to use Free File this year? Mr. Hugo.

Mr. HUGO. Yes, sir. One of the things that perplexes me, what the Alliance agreement that we negotiated with the IRS, it covers $93 million Americans, 70 percent. I am perplexed, quite candidly, that we are focusing on the—you say the Warren Buffetts, the Bill Gates, that top 30 percent. I am curious why we are not focusing on maximizing that $93 million.

Mr. Chairman, I am an elected official. I am a Member of the Virginia legislature. I am even on the Finance Committee. I had a real job at one time. I was Chief of Staff to a Congressman, a job that was halfway important. For preparation for this hearing, one of the things I was thinking about—and I conferred with the IRS before. I said, "Did you tell every Member of Congress that they could let their constituents know in newsletters or communications that they can have free tax preparation for under 50 adjusted gross income?" No, didn't happen.

One of the things I think we are going to do is write every Member of Congress and every U.S. Senator next year, and say, please understand this is available to your constituents. That way we are maximizing, focusing on the $93 million, the low to moderate income, the direction we have gotten from Congress, which is direc-

tion we have gotten in legislative language that has passed, and I would be happy——

Chairman RAMSTAD. It seems to me, Mr. Hugo, that you are missing a point relative to the original agreement. Your written testimony claims that the new Free File agreement covers more taxpayers than the original agreement, but the point you are missing is that the original agreement established a floor, that 60 percent of taxpayers had to be covered, while the new agreement establishes a cap, only 70 percent of taxpayers are allowed to be covered. It seems to me that is an important distinction, and it seems to me that that point has been missed.

Let me ask Mr. White. Under the new agreement, as we have seen previously, more than 40 millon taxpayers who were eligible for Free File last year are not eligible this year, and again, that is depicted graphically over there on the screen. Has this cap that we have discussed led to the 21 percent decrease we see in Free File usage this year in your judgment, Mr. White?

Mr. WHITE. It is certainly something that it has very likely contributed to that. We don't know all the reasons that have contributed, but it seems very logical that that has to be part of the explanation.

Chairman RAMSTAD. As a follow up, has the decreased use then of Free File contributed to the lower than expected rate of growth in electronic filing, in e-filing this year?

Mr. WHITE. There are a number of factors that have contributed to that, but again, it seems very logical that this has to be one factor that is contributing to that.

Chairman RAMSTAD. The only conclusion the Chairman can reach, based on the testimony, is that, simply put, under the new agreement, fewer taxpayers are eligible for Free File, fewer taxpayers are using it, and electronic filing is not growing as projected. So, how can we call this agreement good for taxpayers, Mr. White?

Mr. WHITE. Well, the——

Chairman RAMSTAD. Let me rephrase that.

Mr. WHITE. Sir, the questions that you are asking are valid.

Chairman RAMSTAD. That is more than leading, even by Congressional standards.

[Laughter.]

Chairman RAMSTAD. Let me ask you, do you, in your view, believe this agreement is good for taxpayers?

Mr. WHITE. Mr. Chairman, the agreement involves some tradeoffs. Taxpayers, some taxpayers get free filing. The private sector agreed to provide free return filing for those taxpayers. IRS got some other things in the agreement. There is more disclosure on the terms and conditions attached to RALs, for example. It is a judgment call about whether on balance, overall, it is a good agreement or not.

Chairman RAMSTAD. Any of the other witnesses, would you like to comment? Mr. George?

Mr. GEORGE. I would just note, Mr. Chairman, that even when the program was available to any taxpayer, you had only about 5 million of an approximately 130 million eligible taxpayers taking

advantage of it. So, while giving people access to it is good, it wasn't promoted to the point where it was taken advantage of.

Chairman RAMSTAD. Chairman Wagner?

Mr. WAGNER. Mr. Chairman, I think the agreement and the Alliance is very good for 93 million taxpayers, but I also think that it ought to extend to all the other taxpayers. I think in my own personal State, my parents, I assisted them in preparing their returns through the Free File Alliance a few years or so ago, and this year they will just barely not qualify. So, we will be confronted with either buying the product or pushing the paper.

Chairman RAMSTAD. Prior to recessing for our vote, the Chairman recognizes the gentleman from North Dakota.

Mr. POMEROY. I thank the Chair. So, I get this all straight, basically this public-private partnership has its origination in trying to advance the goal of expanding electronic filing of taxpayers. Is that correct, Mr. White?

Mr. WHITE. Yes, sir.

Mr. POMEROY. That is the goal of it. Mr. Hugo, are you in the State Senate or State House?

Mr. WHITE. House.

Mr. POMEROY. Representative Hugo—I like the House, by the way.

Mr. HUGO. Yes, sir, the people's body.

Mr. POMEROY. The people's body. Would you say, Representative Hugo, that if there was a mission statement from the Alliance, expanding e-filing of taxpayers is the goal of the Alliance?

Mr. HUGO. The goal of the Alliance, and this was stated in the operating agreement and the recent MOU, it was stated, like you said, within months the comment that we put in writing——

Mr. POMEROY. The goal of the Alliance——

Mr. HUGO. Is to provide free tax preparation to low and moderate income underserved communities.

Mr. POMEROY. Okay. The goal of the Alliance is not to expand electronic filing of taxpayers?

Mr. HUGO. I think that is part of it. I think that will accomplish the fact that——

Mr. POMEROY. What is the goal? This is very important. I believe the only reason that we ought to be in a public-private partnership is if the public goal of expanding electronic filing is advanced. Is that the primary goal?

Mr. HUGO. I think it is the goal and I think it is that we are——

Mr. POMEROY. How many of the 5 million last year were over 50,000?

Mr. HUGO. I am sorry.

Mr. POMEROY. I am sorry. Representative Hugo, how many of the 5 million taxpayers were over $50,000 last year?

Mr. HUGO. That I don't know the answer. I can provide that information to you, sir.

Mr. POMEROY. It seems to me just basic, if you put a cap on who gets to use this, you are inconsistent with the goal of expanding e-filing, and I think it is related, maybe not in a huge way, but certainly related in a direct way to the comment made by Mr. George that we are falling off pace in terms of electronic filing.

Mr. HUGO. Mr. Chairman and Mr. Pomeroy, let me answer, and I would like to take from the direct testimony that the head of the Electronic Tax Administration Mr. Dumars made in front of the Senate. One of the reasons he believes the numbers are down this year is because we did not get the press. A year ago, it was on the front page of USA Today. The IRS budget to advertise this program has been slashed and——

Mr. POMEROY. My time is short, and we have got a vote. I appreciate——

Mr. HUGO. I would say——

Mr. POMEROY. —that line of argument, but let me tell you——

Mr. HUGO. No, no, I—okay.

Mr. POMEROY. —as one that is going to continue to evaluate whether we ought to have a public-private partnership in any event, I am going to look at whether or not this thing is operating with focus and as a clear priority, advance the public goal of electronic take-up rates with taxpayers. If this thing starts to be diverted where it seems like the goal is advancing the ancillary business interests of the Alliance members or the biggest alliance members, then I have got some concerns.

Mr. George, as you have evaluated this, do you see the Alliance in any of its operations having kind of a cartel effect, an anticompetitive effect on what might be the emerging enterprises in this electronic filing business?

Mr. GEORGE. Mr. Pomeroy, we are in the process of reviewing this, and we have not yet looked at that issue.

Mr. POMEROY. It is very important. I will be really eager for your report. Has the GAO had a chance to look at that, Mr. White?

Mr. WHITE. No, we have not, Mr. Pomeroy.

Mr. POMEROY. I think the message we have delivered loud and clear. We hate this 50,000 cap. I hope that it is not in the next agreement. I think the IRS did not operate consistent with Congressional intent in doing it. I think it is bad public policy, and I am disappointed with this report this year.

Moving on, though, to other issues, Chairman Wagner, we really appreciate what the Advisory Committee does.

Mr. WAGNER. Thank you, sir.

Mr. POMEROY. We think that you play a very important role in terms of oversight and sometimes advocacy beyond what the IRS can itself self-advocate.

Mr. WAGNER. Thank you.

Mr. POMEROY. Is there a——

Chairman RAMSTAD. Excuse me, Mr. Pomeroy. The Chairman will recess the Subcommittee for 20 minutes or subject to the call of the Chair. We are running out of time.

Mr. POMEROY. I think we can clarify—when you don't come up with the appropriation you need, does that diminish the ability of the Service to efficiently and effectively collect taxes?

Mr. POMEROY. When you do not get the appropriation you need, does that impact the Service's ability to efficiently and effectively——

Mr. WAGNER. It requires more creativity at that point, but I think the Service can efficiently fulfill its mission with the resources that it has been provided.

Mr. POMEROY. I am done.

Chairman RAMSTAD. The Subcommittee is in recess subject to the call of the Chair. It should not be more than 20 minutes.

[Recess.]

Chairman RAMSTAD. The Committee will come to order. While our witnesses are taking their seats, let me welcome to the Subcommittee on Oversight, Chairman Dennis Drapkin, the American Bar Association (ABA) section of Taxation; Chair Thomas Purcell, of the Tax Executive Committee of the American Institute for Certified Public Accountants (AICPA); and Francis X. Degen, President, National Association of Enrolled Agents (NAEA).

We will begin with your testimony, please, Mr. Drapkin.

STATEMENT OF DENNIS B. DRAPKIN, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. DRAPKIN. Thank you, Mr. Chairman, for the opportunity to appear before the Subcommittee this morning. My name is Dennis Drapkin. I am the Chair of the Tax section of the ABA, and my testimony is presented on behalf of the ABA.

I will focus on three keys issues essential to the administration of the tax laws and also briefly address pending legislation relating to offers in compromise.

First, the importance of adequate funding for the IRS. The ABA has consistently supported full funding of the IRS. We note that the administration's proposed 2007 budget includes an increase in IRS funding as compared with the prior year enacted level, and we urge that Congress fund the IRS at least at the level the administration has proposed.

Adequately funding is essential for the IRS to provide taxpayers with quality service. The IRS needs these resources to collect taxes fairly and efficiently without imposing undue burdens on taxpayers.

Second, let me speak to the need for balance between enforcement and taxpayer service. Achieving acceptable levels of compliance requires a balance of effective taxpayer service and vigorous enforcement. Up-front taxpayer service enhances voluntary compliance, which reduces the demands on enforcement. Credible enforcement of the tax laws, in turn, encourages greater voluntary compliance.

Complex tax laws make taxpayer service a necessity. Taxpayers must be able to obtain accurate information on the tax laws that affect them. The IRS responds in ways that are vital to providing taxpayers with the information they require. Adequate funding is also essential for effective enforcement. Taxpayers must believe that the laws will be enforced and that those who cheat will be caught. Enforcement must be apparent throughout all parts of the economy. Funding must be sufficient for those in the Service whose primary mission is compliance.

In addition, funding must be adequate to support ongoing administration of the tax laws. The Service must be able to publish clear and understandable guidance, train its personnel, continuously improve compliance programs, and obtain accurate information about how the tax system is functioning.

The third key issue is the need to simplify the tax laws. Complexity is a major obstacle to efficient and effective administration of the tax laws. For 30 years, the ABA and the section of Taxation have been on record urging tax law simplification. Making the tax system simpler is also a legislative priority of the ABA. We appreciate the efforts that the Chairman and other Members of the Subcommittee have made over the past few years to focus attention on the need for simplification and to motivate Congress to enact important simplification legislation. Achieving simplification is not easy. Often it must be weighed against concerns relating to equity and fairness. Yet simplification is worth the effort. It can ease the burden of compliance for all taxpayers and reduce the demands placed on the IRS.

As always, the Tax section stands ready to work with you and your staff to achieve simplification. We commend you for what you have done, but it is vital that your efforts continue and that they succeed.

Finally, speaking on behalf of the ABA Tax section, I would like to address pending legislation regarding offers in compromise. Offers in compromise are an important tax collection tool. The Tax Relief Act of 2005, S. 2020, would add a 20-percent downpayment requirement to lump-sum offers in compromise. The downpayment would be nonrefundable and retained by the IRS even if the offer is rejected. This change is intended to reduce offers that are not made in good faith.

We, and others, have serious concerns about the proposal. Relatives and employers are often the source of funds for offers. They will be far less willing to do so if this proposal is enacted. As a result, the new downpayment requirement could dramatically reduce outside funding for potential offers. This would decrease the number of legitimate offers submitted, the number of offers accepted, and the number of individuals re-entering the tax system. This is not a desirable outcome.

Mr. Chairman, thank you again for the opportunity to appear before the Subcommittee today, and I will be pleased to respond to any questions.

[The prepared statement of Mr. Drapkin follows:]

Statement of Dennis B. Drapkin, Chairman, Section of Taxation, American Bar Association

Thank you, Mr. Chairman. My name is Dennis Drapkin. I am the Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the American Bar Association (the "ABA").

The ABA is comprised of more than 400,000 members. The Section of Taxation includes more than 18,000 tax lawyers who work in law firms, corporations and other business entities, government, nonprofit organizations, academia, accounting firms and other multidisciplinary organizations. Our members provide advice on every substantive and procedural area of the tax laws, and interact regularly with the Internal Revenue Service (the "Service" or "IRS"), the Treasury Department, and other government agencies and offices responsible for administering and enforcing the tax laws. Many of our members have served in staff and executive-level positions at the Service, the Treasury Department, the Tax Division of the Department of Justice, and Congressional tax-writing committees.

I greatly appreciate the opportunity to appear before the Subcommittee on Oversight (the "Subcommittee") today. My testimony will focus on three key issues bearing on the administration of the tax laws: (i) the importance of adequate funding for the Internal Revenue Service, (ii) the need for a balance between enforcement

and providing services to taxpayers, and (iii) the need to simplify the tax laws. I will also briefly address pending legislation relating to offers in compromise.

IRS Funding

The ABA has consistently supported full funding of the IRS to carry out its missions of taxpayer service and fair administration and enforcement of the tax laws. We note that the Administration's proposed 2007 Budget includes an increase in IRS funding as compared with the FY 2006 enacted level. We urge that Congress fund the Service at least at the level the Administration has proposed.

Adequate funding is central to the ability of the Service to provide America's taxpayers with top quality service by helping them to understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. Fulfilling this mission is possible only if the Service has the resources necessary to collect taxes owed efficiently and effectively without imposing undue burdens on taxpayers.

The Need for Balance Between Enforcement and Service

Achieving acceptable levels of compliance requires a balance of effective taxpayer service and vigorous enforcement. Effective front-end taxpayer service enhances voluntary compliance, thereby reducing the demands on enforcement down the road. Consistent fair and credible enforcement of the tax laws, in turn, encourages greater voluntary compliance.

Given the level of complexity of our tax laws, taxpayer service is a necessity. Taxpayers must be able to obtain accurate information on complicated tax law provisions affecting them. The Service fulfills this task in a number of ways, *e.g.,* telephonic call-in lines, walk-in information sites, print publications, and, increasingly, electronic communications. All these activities are vital to providing taxpayers with the information they need to fulfill their responsibilities and to obtain the benefits to which the law entitles them. In her 2005 Annual Report to Congress, the National Taxpayer Advocate underscored the need for adequate taxpayer services, and suggested a number of areas that could be improved. At the February 8, 2006 meeting of the IRS Oversight Board, the need for greater and more effective taxpayer service was stressed by many of the speakers.

The Service must also have adequate funding to perform its fundamental enforcement mission. In order for our voluntary tax system to work, taxpayers must believe that the laws will be enforced and those who cheat will be caught. To be effective, the Service's enforcement efforts must be broad-based in two senses. First, an enforcement presence must be apparent throughout the economy. A perception that the Service's enforcement efforts are too narrowly targeted leads to noncompliance in areas perceived to be out of the spotlight. Second, funding must be sufficient for all those in the Service whose primary mission is compliance, *i.e.,* auditing revenue agents, appeals officers, tax litigators, and revenue officers, to do their jobs. Neglect of any of these inevitably compromises the ability of the others to fulfill their compliance responsibilities.

In addition to supporting adequate service and enforcement, constant attention must be given to ongoing administration of the tax laws. The economic environment in which the tax law operates is constantly changing. The Treasury Department and the Service must address these changes through publication of clear and understandable guidance to taxpayers, through training of Service personnel, and through improvements to processing, audit, and controversy resolution techniques. Techniques and procedures for prompt and efficient resolution of recurring errors must be formulated and implemented, and longer term solutions to eliminate such errors through simplifying legislation or otherwise must be identified. Such solutions, in turn, are possible only when decision makers have accurate information concerning how the system is actually functioning. Thus, adequate funding for those who compile statistics of income and perform research on administration and compliance is also vital. There have been important initiatives at the Service aimed at improving audit currency and achieving better resource targeting in audits. These are worthwhile programs that should be encouraged and continued.

The Need for Simplification

We believe that complexity is at the root of many significant obstacles to efficient and effective administration of the tax laws. Indeed, the National Taxpayer Advocate and others have demonstrated repeatedly that complex tax law provisions make life harder for everyone. They cost taxpayers time in simply trying to understand what is required of them, and they make errors by taxpayers and the IRS a virtual certainty. Reducing complexity must be a continuing priority of the Congress.

Making the tax system simpler is a legislative priority of the ABA. For 30 years, the ABA and the Section of Taxation have been on record urging tax law simplifica-

tion, so that laws can be (1) easily understood and complied with by taxpayers, and (2) fairly and consistently administered and enforced by the IRS. We know that simplification is an issue the Subcommittee takes seriously, and we appreciate the efforts the Chairman and other Members of the Subcommittee have made over the past few years to focus attention on the need for simplification and to motivate Congress to enact important simplification legislation.

In this regard, we wish to acknowledge that in 2004 Congress enacted important simplification of the definition of a "child" under the Internal Revenue Code. After the new definition was adopted, issues were raised with respect to the allocation of dependency exemptions between custodial and noncustodial parents. On September 1, 2005, we wrote to the Chairman and Ranking Members of the House Committee on Ways and Means and the Senate Committee on Finance to suggest changes to the technical corrections originally introduced to address these issues. In the Gulf Opportunity Zone Act of 2005, Congress enacted technical corrections to resolve these issues adopting the approach suggested in our letter. We applaud the quick action of Congress in addressing these issues.

Questions have since been raised about other unintended consequences of the new definition of a child. We are studying these questions and the solutions that have been proposed, including the recent proposals by the Treasury, and we stand ready to work with you and your staff to address these questions. It is important, however, that the issues that have arisen with respect to simplifying the definition of a child not deter the Congress from pursuing additional simplification of other complex provisions of the Code.

As this recent experience indicates, simplification is not easy. The new issues regarding the definition of child, for example, illustrate the difficulties inherent in balancing simplification, on the one hand, against addressing a multitude of perceived inequities, on the other. In addition to requiring careful examination of possible unintended consequences, simplification frequently requires either foregoing revenue or making choices that benefit some taxpayers and adversely affect other taxpayers. But simplification is worth the cost. Simplification pays dividends in terms of easing the burden of compliance for all taxpayers, simplifying the task of taxpayer education and law enforcement for the IRS, and improving taxpayer morale by making it easier to understand how the law operates.

In recent years, the Section of Taxation has worked with the American Institute of Certified Public Accountants ("AICPA") and the Tax Executives Institute ("TEI") to identify simplification priorities and realistic simplification initiatives. Together with these other organizations, the Tax Section will continue this important work. But it is important that Congress—in every tax bill—also join in the effort and actually enact viable simplification proposals. There is a consensus for tax simplification, and we urge you to call on us and our colleagues in the AICPA and TEI to help you make it a reality.

We would like to take this opportunity emphasize a few simplification matters requiring urgent attention. The dual tax system created by the alternative minimum tax is one of the most serious complexity problems in the current Code. The ABA recommends that the individual AMT be repealed. We recognize that replacement sources of revenue likely will have to be identified to accomplish this—but the time has come to eliminate the complexity and burden of having a growing number of middle-class Americans each year compute individual taxes under two different systems.

Even if big-ticket simplification such as AMT repeal cannot be accomplished immediately, there are other important, but smaller scale, simplification proposals that can be adopted in the near term if appropriate legislative focus is applied. For example, we have called your attention in prior testimony to the need to address the complexity arising from the numerous provisions such as educational benefits, the earned income tax credit, and retirement savings provisions that are phased out as a taxpayer's income increases. Because these provisions have typically not been coordinated, the phase-out thresholds and ranges in such provisions vary widely—and often overlap. The result is not merely mind-numbing complexity but often disappointed taxpayer expectations as the complicated calculations make it difficult for taxpayers to plan whether they will be able to utilize tax benefits subject to phase outs. Perhaps even more important are the disincentives that occur when a taxpayer attempts to avail himself of benefits under several provisions and the combined phase-outs create marginal tax rates well in excess of what the section 1 tax table says the taxpayer's marginal rate should be. We recognize the action taken by the Congress to address the phase-out problem in the context of personal exemptions and the overall limitation on itemized deductions. But much more can and should be done.

We also note that the President's Advisory Panel on Tax Reform offered a number of separate recommendations in its November 2005 report that could promote significant simplification of the federal income tax, including repeal of the individual and corporate AMT. The Panel also recommended a limited number of tax credits relating to family status; simplifying tax benefits for charitable donations, home ownership and health coverage; and restructuring numerous individual savings and retirement provisions. We commend the Panel for its focus on simplification. Its report has made numerous useful suggestions that merit further study and consideration.

We and others previously testified before the IRS Oversight Board in support of Treasury and IRS efforts to achieve simplification through the regulatory process. Fundamental to this effort is the publication of prompt and clear administrative guidance dealing with new legislation as well as new developments in the way business is transacted. The Treasury and IRS deserve commendation for their efforts to publish guidance on the 2004 Act, and we have publicly applauded the prompt guidance they issued in response to Hurricane Katrina. The guidance process is, however, continuous, and the work of the IRS and Treasury is never done. Timely, clear guidance advances the goal of simplification by reducing ambiguity and uncertainty. We believe that a strong published guidance program constitutes one of the most important contributions the Treasury and IRS can make to simplification.

As always, Tax Section members stand ready to work with you and your staff members to achieve simplification. We commend you for what you have done, but it is vital that your efforts continue and that they succeed.

Offers in Compromise

Offers in compromise are an important collection tool that can provide taxpayers with a "fresh start" and foster long term compliance. The Tax Relief Act of 2005, S. 2020, proposes adding a 20-percent down payment requirement to lump-sum offers-in-compromise. It is apparently intended that the lump-sum down payment would be nonrefundable and retained by the Service if the offer is rejected. While the apparent objective of the proposed changes—to reduce the number of offers that are not made to the IRS in good faith—is laudable, we nevertheless have serious concerns about this proposal.

A successful offer-in-compromise program raises revenue both from the offer and by bringing taxpayers back into the system. Relatives and employers of the taxpayer are often the source of funds for offers in the current system. These parties will understandably be far less willing to commit non-refundable monies under the regime that would be created by the Senate bill. Because the 20-percent nonrefundable down payment requirement could dramatically reduce available outside funding for potential offers, there is a significant risk that the proposal could decrease the number of legitimate offers submitted, the number of offers accepted and the number of individuals reentering the tax system. The provision also marks a change in direction from the 1998 Taxpayer Bill of Rights. Accordingly, we recommend that the proposal not be adopted.

Mr. Chairman, thank you for the opportunity to appear before the Subcommittee today. I will be pleased to respond to any questions.

Chairman RAMSTAD. Thank you, Mr. Drapkin. Dr. Purcell, please?

STATEMENT OF THOMAS J. PURCELL, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE FOR CERTIFIED PUBLIC ACCOUNTANTS

Mr. PURCELL. Mr. Chairman, thank you for this honor of being able to present our testimony today before the Subcommittee. I have two main points that I would like to make, and the bulk of my comments are taken from the written testimony that we have already provided to you, and I would be happy to answer questions as we have time at the end of my comments.

First, with regard to the progress so far in the filing season, we have no evidence from our members that there have been any issues, insurmountable issues that have arisen with regard to filing

individual tax returns. It seems to be a relatively typical filing season from that perspective. Obviously, there is going to be the last-minute crunch that happens in the next 2 weeks, and then also the extension period, which now is a 6-month period that will take us into the fall. Other than those types of things, we have not heard anything from members that would give us any pause.

We do have concerns, though, that continue with regard to the mandatory e-filing for larger taxpayers, the corporations with over $50 million and the nonprofit organizations of over $100 million. Our sense is that people are going slow on this, that the numbers that you are seeing that people are filing on time, these go slow at this point because there is still pushback from software providers that have not stepped up to fully implement the software necessary to make this happen. Companies are still having difficulties conforming their software and their information with the platform that will need to be used. So we anticipate that there could be a significant crunch when we get toward the 6-month filing timeframe for corporations, which would be September 15. So, we anticipate that sometime in late August, early September, there is going to be a flurry of activity. We do not know how that will be resolved because the IRS has been very adamant that they are going to be very careful on providing waivers for this, but we do not know how that will be resolved. Frankly, we are concerned about that.

The second level of concern on that would then extend to next year because the filing threshold drops to $10 million, which is a significantly larger net of taxpayers. So our concern there is that more people be pulled in that do not anticipate this, and we have only had one season to try and get it ready. So, hopefully we can continue to work with the IRS on making this be a more painless process.

As you know, there were some issues early on with regard to Schedule D reporting. We continue to work with the IRS on this, and we are grateful that they have taken the approach to try and work with us on trying to clarify the type of information and what will be acceptable to them for reporting transactions with regard to stocks and bonds and other things that might come from brokers.

We do not have a position on the free file. I have listened to the discussion today, but we have not had a position on free file because it is not an issue that many of our clients would be involved in.

On the budget side, I would echo Dennis's comments that we continue to remain very much in favor of funding for the IRS at appropriate levels so it can do the job it is expected to do. We watch with anticipation the business modernization approach because those business systems are where we interact very much with the IRS, and our concern is that as we go to a 21st century agency, a 21st century tax practice, that the technology is sufficient to support what is needed by both the taxpayer and by the IRS.

We also look at the user fees as a level of concern. The approach that was taken was that we would increase—the IRS has increased the user fees, in some cases quadrupling the size of them. Our concern is that there will be twofold impacts from this: one, if they are

anticipating an increase in revenues because of that, taxpayers could well push back and not pay the fees because they are so much higher; and, two, if you do not get that type of service as a taxpayer, it could create a situation where there is greater compliance issues on the back end and enforcement issues because you do not have the surety that the transaction that you are looking at will be given favorable treatment by the IRS.

Finally, we watch with concern the outsourcing of collections, the reduction in taxpayer services. We understand the service plus compliance attitude that the IRS has, but we do remain concerned that all taxpayers are able to get the services they need in order to fulfill their obligation, and that if the Service cuts too many services that are not available to taxpayers that otherwise we serve, there could be a deleterious effect on enforcement.

Thank you for the opportunity to testify.

[The prepared statement of Mr. Purcell follows:]

Statement of Thomas J. Purcell, Chair, Executive Tax Committee, American Institute for Certified Public Accountants

Mr. Chairman and members of the House Ways and Means Subcommittee on Oversight, the American Institute of Certified Public Accountants thanks you for the opportunity to appear before you today. I am Tom Purcell, Chair of the AICPA Tax Executive Committee; and Associate Professor of Accounting and Professor of Law at Creighton University, Omaha, Nebraska.

The AICPA is the national, professional organization of certified public accountants comprised of approximately 330,000 members. Our members advise clients on federal, state, and international tax matters and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses. It is from this broad base of experience that we offer our comments today on the IRS budget and the 2006 tax filing season.

The AICPA is happy to report that the 2006 filing season is progressing largely without any significant problems and American taxpayers and practitioners are generally pleased with the Service's performance. However, while generally not developing into problems during the filing season, tax professionals expressed strong opposition in late 2005 to sections of the 2005 Form 1040 instructions involving (1) tax preparation cost estimates and (2) the requirement to list all capital gains or loss transactions on Form 1040, Schedule D.

Our comments today focus on a number of programs of critical importance to the Service, specifically: (1) the IRS budget for fiscal year 2007, (2) Business Systems Modernization, (3) Form 1040 instructions and stakeholder outreach, (4) achieving e-filing goals, (5) the increase in user fees, (6) tax practitioners and professional responsibility, (7) private debt collection efforts, (8) offers in compromise, and (9) tax simplification.

1. THE IRS BUDGET

The AICPA urges Congress to support full funding of the Internal Revenue Service's fiscal year 2007 budget. We have long advocated funding levels which would allow the IRS to efficiently and effectively administer the tax laws and collect taxes. Giving the Service the resources necessary to properly process tax returns and enforce the tax laws is vital to maintaining our voluntary compliance tax system. We expect the Service to identify responsible ways to allocate any additional resources it receives over prior year funding; and Congress will, through its oversight responsibilities, ensure that those resources are properly utilized.

Under President Bush's fiscal year 2007 budget proposal, the IRS would have an operating budget of approximately $10.7 billion, supplemented by certain additional user fees and reimbursable resources. According to the Department of Treasury's fiscal year 2007 budget summary document, "The IRS budget request—supports the IRS's five year strategic plan. This plan underscores the IRS' commitment to provide

quality service to taxpayers while enforcing America's tax laws in a balanced manner."[1]

Giving the Service with the proper resources to fund its mission will empower the Service to fulfill both its customer service and enforcement responsibilities. We appreciate Commissioner Everson's recognition that any increase in enforcement funding must be balanced with positive responses to the taxpaying public as customers. We encourage this type of balanced approach and stand ready to work with the Service to ensure that the needs of America's taxpayers are fulfilled. As we have stated in the past, all taxpayers must have access to resources that enable them to fulfill their responsibilities, and budgetary funding must be provided to insure this access.

Many AICPA members are tax practitioners. As such, we have seen first-hand the problems caused by an IRS that is not responsive to taxpayers as customers. We have also witnessed the improvements initiated by Commissioner Everson, particularly with respect to enforcement. Reductions in IRS funding requests that focus on customer service will only undercut efforts to improve compliance, and the nation's taxpayers will suffer as a direct result.

2. BUSINESS SYSTEMS MODERNIZATION

The fiscal year 2007 budget submission generally recommends reducing the budget for the Service's Business Systems Modernization (BSM) program by 15.1 percent from the level approved by Congress for 2006. In recommending this sizable cut in the BSM budget, the Treasury (on behalf of the Administration) maintains that the "BSM program has begun to improve its performance on delivering projects and releases on time, on budget, and meeting or exceeding scope expectations."[2]

We appreciate the Treasury's view that the Service is now achieving its project costs, scheduling, and performance goals, especially after the long period of implementation difficulties. While the AICPA cannot easily discern whether a 15.1 percent cut in the BSM's fiscal year 2007 budget is prudent under the circumstances, we encourage Congress to closely scrutinize the Administration's proposed budget for BSM. In the end, it is critical for Congress to provide the Service with the appropriate funding levels for the modernization effort.

BSM must remain a central feature of the Service's strategic plan. It is designed to provide benefits to both taxpayers and IRS employees, through implementation of (1) the Customer Account Data Engine (CADE), which is designed to replace the Service's ancient Master File System, (2) Modernized e-File, and (3) the Filing and Payment Compliance system. We strongly support these objectives.

3. FORM 1040 INSTRUCTIONS AND STAKEHOLDER OUTREACH

The IRS has generally done a very good job in recent years, of seeking the input of the AICPA and other stakeholders prior to the agency's announcement of a new program, initiative, or policy change. Examples of previous initiatives in which the Service did seek the input of the practitioner community with positive results include the National Research Program, and the development of the new Schedules K–1 and M–3.

However, when the Service has inadvertently failed to consult with the practitioner community about a new initiative, the IRS has found itself at times in a difficult position. The most recent examples of what we believe were poor communications and collaboration efforts on the Service's part involve the inclusion of (1) tax return preparation cost estimates as part of the 2005 Form 1040 instructions and (2) the specific requirement in the 2005 Form 1040, Schedule D instructions for taxpayers to physically list all capital gains or loss transactions on Schedule D.

The tax return preparation cost estimates, appearing on page 79 of the 2005 Form 1040 Instructions, provide estimates of the average preparation times and expenses associated with certain Form 1040 schedules that have been (1) self-prepared without tax software, (2) self-prepared with tax software, and (3) prepared by a paid professional. We informed the Service that these cost estimates did not fully reflect marketplace reality and lacked any contextual explanation that might mitigate confusion.[3]

With respect to the requirement for taxpayers to list all capital gains and loss transactions on Form 1040, Schedule D, we suggested that the time needed to manually list each capital gains or loss transaction could create significant taxpayer

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[1] Department of Treasury—Budget in Brief Fiscal Year 2007, February 6, 2006, pages 59–60.
[2] Id., page 62.
[3] AICPA letter to Commissioner Everson (dated November 30, 2005) regarding the IRS's inclusion of tax preparation cost estimates in the 2005 Form 1040 instructions.

burden and in the case of taxpayers using paid preparers, unnecessarily raise the overall cost of preparing the return.[4]

While expressing our strong opposition to the preparer cost estimates and the Schedule D instructions matters, it is critical to mention that IRS executives have assured us that they value the input of the practitioner community on important policy initiatives; and as evidence, the Service did quickly respond to practitioner concerns regarding the preparer cost estimates and Schedule D. However, our members continue to express concern that even the recent clarifications by the IRS do not fully address the Schedule D issue and so we do not consider this issue resolved. We will continue to work with the IRS on satisfactory resolution of these issues. Unfortunately, we believe the Service has lost credibility and generated unnecessary frustration with tax professionals over the initial communication of their positions on these policy issues.

4. ACHIEVING E-FILING GOALS

Modernized E-File

The AICPA recognizes the administrative efficiencies and budgetary savings the IRS's electronic tax administration program achieves for the agency, as well as the customer service benefits that accrue to taxpayers from an effective electronic filing (e-file) program. The administrative benefits of e-filing include faster tax processing, reduced cycle time, quicker identification of emerging audit trends, and the potential for more current resolution of taxpayer uncertainties.

We applaud the success the IRS is having with the e-filing program during the 2006 filing season. According to IRS statistics, 68 percent of the 73.4 million individual returns filed through March 24 were electronically filed; with returns filed from home computers up about 16.8 percent over last year. We will continue to work closely with the Service to meet its expectations of approximately 135 million individual e-filed returns during 2006 filing season.

The IRS has done a commendable job of introducing programs—such as the Free File and the Volunteer Income Tax Assistance (VITA) programs—to help low income taxpayers (who often don't own computers) to file their own income tax returns. Another critical component of helping low income taxpayers is to consider funding for low income tax return preparation clinics, in a similar fashion to the funding low income tax (controversy) clinics receive under Internal Revenue Code section 7526. We believe funding for tax return preparation clinics would encourage e-filing and improve compliance by low income taxpayers generally.

We support the IRS's suite of web-based products for tax professionals and taxpayers called "e-services." Through e-services, practitioners and taxpayers have access to a suite of online products, including the Preparer Tax Identification Number (PTIN) Application; the Online e-file Application; Electronic Account Resolution (EAR); submission of Form 2848, Power of Attorney and Declaration of Representative; and the Service's Transcript Delivery System (TDS).

When the program was launched in 2004, e-services was made available to tax professionals who e-filed 100 or more individual returns. Last year, the IRS lowered this threshold by making the e-Services suite available to tax professionals who e-file 5 or more individual and business income tax returns. The AICPA believes this expansion of e-services to more practitioners has the added benefit of making the IRS's interaction with tax professionals more efficient, thereby generating significant cost savings to the Service. Since e-services benefits the IRS and tax professionals in so many ways, such as fostering the Service's enforcement and collection activities, we recommend that the IRS strongly consider dropping the 5 return threshold altogether.

E-File for Large Corporations and Exempt Organizations

The AICPA is closely consulting with the IRS on implementation of the mandatory e-file program during the current 2006 filing season, a program that generally requires large corporations (total assets of $50 million or more) and tax exempt organizations (total assets of $100 million or more) to file returns electronically.

As the 2006 filing season progresses, the IRS must remain mindful of the difficult experience that taxpayers and the agency had with the mandatory large partnership e-file program rolled-out several years ago. The AICPA has previously recommended that the IRS delay the start of the new mandatory e-file program for one year, and we continue to observe that it is not unreasonable for the Service to anticipate significant issues with respect to implementation of this new program for large corporations and exempt organizations. This situation is especially critical as we move

[4] AICPA letter to Commissioner Everson (dated December 23, 2005) regarding the reporting of capital gains and loss transactions on Form 1040, Schedule D.

closer to September 15, the due date for calendar year-end corporate returns on extension.

Our members remain concerned about a number of implementation issues, such as the potential for security breaches and the ability of the IRS's computer systems to handle peak load demands by taxpayers. Moreover, we continue to recommend that the IRS maintain a posture of flexibility in terms of granting hardship waivers to corporations and exempt organizations, as opposed to a policy that grants waivers only in exceptional cases.

Even though this is the first filing season for implementation of the mandatory corporate and exempt organization e-file program, we cannot over-emphasize the need for the Service to also adopt a posture of flexibility on critical implementation decisions for next year's filing season. For purposes of the 2007 filing season, the e-file thresholds will drop even further, subjecting middle-sized market corporations and exempt organizations to the mandatory e-file program, taxpayers who routinely (1) don't employ tax professionals on the entity's payroll and (2) utilize the services of tax professionals working for large and smaller-sized accounting firms. We will continue to work with the IRS in resolving the various implementation issues as e-filing is expanded.

5. INCREASE IN USER FEES

The IRS announced a series of increases in user fees in December 2005, effective for 2006. These user fees are levied to charge taxpayers for the privilege of receiving advance assurance from the IRS about the tax consequences of certain transactions. For example, under the new fee schedule, the IRS Chief Counsel has increased the fees for private letter rulings by $2,500 to $10,000 (with lower fees for taxpayers earning under $1 million); requests for changes in accounting method by $1,000 to $2,500; corporate pre-filing agreements to a flat fee of $50,000, and Advance Pricing Agreements to as much as $50,000.

We understand that these increases generally reflect an attempt to respond to an Office of Management and Budget directive for agencies to charge user fees reflecting the full cost of goods or services. Moreover, it is our understanding these user fee increases are considered as a supplement (in addition) to any final fiscal year 2007 IRS budget approved by Congress.

The AICPA is concerned these increases in user fees (many of which are dramatic increases over previous levels) will result in a substantial reduction in general taxpayer use of critical IRS programs that encourage taxpayers to seek advance assurance about the tax consequences of their proposed actions. Any actions that discourage use of these programs could result in greater compliance costs for taxpayers and enforcement costs for the IRS. The AICPA does not support the Service's possible use of fee increases as a management tool to control its workload burden.

6. TAX PRACTITIONERS AND PROFESSIONAL RESPONSIBILITY

The AICPA applauds Commissioner Everson's commitment to high standards for tax professionals and his efforts to upgrade the Office of Professional Responsibility. In this context, we have a longstanding track record of establishing high professional standards for our CPA members, including the AICPA Code of Professional Conduct and enforceable Statements on Standards for Tax Services.

We have recently sent submissions to Treasury and IRS on two very important topics involving professional responsibility, as well as presented oral testimony before the IRS on April 4, 2006. These topics involve the Circular 230 written tax advice standards and the proposed amendments to the regulations under Internal Revenue Code (IRC) section 7216. We recommend that the Subcommittee closely monitor the deliberations between the tax professional community and the federal government as these issues evolve.

Circular 230

The AICPA has been actively communicating with our membership and state CPA societies regarding the Circular 230 provisions on "best practices" and written tax advice. In this context, we are encouraged by recent comments by Treasury and the IRS officials that the government is considering whether it may be appropriate to make substantial changes to the Circular 230's standards involving written tax advice. The AICPA shares many of the concerns expressed within the practitioner community that, as currently written, these regulations are having an adverse impact on the delivery of tax advice to clients and on the role of tax advice in facilitating the administration of the tax system.

We strongly support the drafters' goals of increased public confidence in the tax system and greater transparency in the practitioner-client relationship. Like other commentators, however, we also are concerned that the breadth and specificity of the current rules are inhibiting the provision of written tax advice to taxpayers, and

increasing the expense to taxpayers of written tax advice, including for routine transactions, without a corresponding benefit to the tax system.

Both Treasury and the IRS have expressed willingness to consider a principle-based approach within the standards to better support Circular 230's essential role. We support this reconsideration to alleviate the unintended consequences that have occurred.

In a March 6, 2006 letter to Treasury and IRS, we suggested several ways that the government could adopt a principle-based approach. We also offered an alternative approach for revising the covered opinion rules (under Circular 230, section 10.35) by substituting broader principles, with examples or illustrations, for the detailed rules currently in section 10.35. A model for discussion might include AICPA Interpretation No. 1–2, *Tax Planning,* of AICPA Statement on Standards for Tax Services No. 1, *Tax Return Positions*.

Proposed Section 7216 Regulations

In December 2005, the IRS released proposed amendments to the regulations under Internal Revenue Code (IRC) section 7216, which in large part respond to (1) suggestions that the section 7216 regulations needed to be updated to reflect current common industry practices, particularly in the area of electronic preparation or filing of tax returns, and (2) concerns about the outsourcing of tax return preparation to foreign countries.

In comments we submitted to the IRS on March 8, 2006, the AICPA suggested that the Service generally not attempt to regulate the disclosure or use of tax return information by preparers in the context of section 7216—which is a criminal statute. Rather, we believe a civil penalty is a more practical mechanism for regulating a practitioner's everyday disclosure and use of taxpayer information. Civil penalties have long been recognized as effective tools for encouraging compliance, modifying behavior and deterring unwanted behavior. Criminal provisions by their very nature inject a level of complexity and concern which may well prove counterproductive in this area. One possible approach would be to prescribe primary regulations under IRC section 6713 while utilizing regulations under section 7216 to address the circumstances under which a preparer's behavior would satisfy the "knowing or reckless" standard to justify criminal sanctions.

We are also concerned about the extent to which the proposed regulations fashion an entirely new consent regime for any return preparation activities that involve parties located outside the borders of the United States. The proposed regulations are drafted in a manner that adds unnecessary and extremely burdensome steps to the current tax return processes used by many professional service providers. It appears that at the very time the IRS is eliminating barriers to the achievement of its goal for increasing electronic filings and payments, the agency is incongruously making it more complex for its partners—the professional providers of tax assistance and return preparation—to sustain their current professional business processes.

To properly complete the tax return of a U.S. or non-U.S. multinational company with offices in the United States and overseas, tax professionals located in the United States typically consult with tax professionals located overseas. The same circumstances exist when preparing returns for thousands of U.S. citizens (expatriates) stationed around the world in the employment of U.S. and non-U.S. multinational companies. In the normal course of these engagements the client generally anticipates that the tax return preparer would disclose tax return information to an overseas office, consistent with the applicable legal and ethical responsibilities of the tax preparer unless the taxpayer directs otherwise. The examples of how tax return information may be used in providing services to multinational companies go far beyond a tax return preparation context. Examples include audits of financial statements and cross border tax planning. These uses serve the needs of taxpayers and aren't efforts to market unwanted services or use information for inappropriate ways.

We do not believe that these situations should require the tax preparer to obtain consent from the taxpayer in the specific format described in proposed regulation section 301.7216–3 and the proposed revenue procedure (set out in Notice 2005–93) because these taxpayers anticipate their tax information will be disclosed outside of the United States. We believe the AICPA ethics rules (regarding outsourcing services to third-party service providers) are more in line with modern business practicesthan what is provided for under the proposed regulations.[5]

[5] Rule 102, *Integrity and Objectivity,* of the AICPA Code of Professional Conduct requires that, prior to sharing confidential client information (such as a tax return) with a service provider, the AICPA member must inform the client, preferably in writing, that he or she may be using

The AICPA strongly encourages the IRS to adopt the approaches suggested in our March 8 comments. If that is not acceptable, we urge the IRS to engage the professional service provider industry in a substantive discussion prior to issuing final regulations about how to best ensure the requisite security of tax return information in the context of today's modern (global) business practices.

7. PRIVATE DEBT COLLECTION EFFORTS

The IRS is in the process of launching a private debt collection program, as authorized by the American Jobs Creation Act of 2004. We appreciate that using private collection agencies could help the IRS resolve a portion of its collection inventory, and could potentially enable the Service to focus the energies of its employees on the more difficult or complex collections cases. The Service has announced that private debt collection agencies will be held to the "same standards of service and protection of taxpayer rights" required of IRS employees. We believe that this program is a critical test program for the Service, especially in terms of enabling the IRS to leverage private sector involvement with a reallocation of vital resources towards programs of critical needs. Nevertheless, because collections is a program area which has historically been an area of chronic taxpayer complaint and alleged taxpayer rights abuse, we strongly urge the Subcommittee on Oversight to closely monitor implementation of the private debt collection program; and work with the IRS on establishing positive and realistic performance measures for the private debt collection firms.

8. OFFERS IN COMPROMISE

Section 523 of S. 2020, the *Tax Relief Act of 2005,* generally requires a taxpayer who submits a "lump-sum" offer-in—compromise (OIC) to include 20 percent of the amount of such offer at the time the offer is submitted. The provision defines the term "lump-sum" offer to mean the payment of 5 or fewer installments. The AICPA is very concerned about the negative impact that this measure will have on the future viability of the overall OIC program.

The AICPA has received numerous reports from practitioners that the IRS's OIC program is not working, due in large part to the Service's continual classification of large numbers of offers as "non-processable" and based on the agency's high rejection rate of offers being submitted. These reports are consistent with the public comments of National Taxpayer Advocate Nina Olson on May 18, 2005. In that communication, she revealed that taxpayers submitted approximately 39,000 offers during the first six months of fiscal 2005, which amounts to a 45 percent drop in the number of offers submitted from the same period in 2004.

Based on the significant drop in the number of offer submissions, coupled with the IRS's high rejection and return rate for offers, we believe this provision—while intended to be a revenue raiser—will in actuality raise little or no revenue.

In general, a taxpayer submits an offer to the IRS because he or she is in financial distress and thus, looking for a "fresh start" financially. Under these circumstances, a taxpayer who has a significant outstanding tax liability with the government is not likely to be able to afford a 20 percent up-front "down-payment" on an offer. In all likelihood, enactment of the up-front 20 percent payment on offers is likely to shut down the OIC program and instead, because of the increased financial burden on the taxpayer, increase the attractiveness of federal bankruptcy filings.

To the extent Congress includes the 20 percent offer payment provision as part of a final bill, we recommend that there be an exemption for low-income taxpayers. If you accept this recommendation, we encourage you to use an existing statutory definition for "low-income" to avoid adding another level of complexity to the Code. For example, section 7526 of the Internal Revenue Code generally defines a low-income taxpayer as someone who has income that does not exceed 250 percent of the poverty level.

S. 2020 also requires any taxpayer who submits a "periodic payment" offer to comply with the taxpayer's proposed installment schedule during the period that the IRS is evaluating the offer for acceptance. Thus, the taxpayer is required under this

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a third-party service provider when providing professional services to the client. In addition, Rule 201, *General Standards,* and Rule 202, *Compliance With Standards,* states the AICPA's longstanding belief that members who use third-party service providers in providing professional services to clients remain responsible for the work performed by the service provider.

Finally, Rule 301, *Confidential Client Information,* of the AICPA Code of Professional Conduct was updated to require an AICPA member to (1) enter into a contractual agreement with the third-party service provider to maintain the confidentiality of the client's information and (2) be reasonably assured that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of such information.

proposal to effectively make installment payments to the IRS during the time period that the Service has the offer under review. The legislative language is not clear as to what would happen to these payments should the IRS subsequently reject the taxpayer's offer. One possible interpretation is that the taxpayer would be permitted to stop making the installment payments, but the Service would(1) keep all payments made by the taxpayer to date and (2) retain the right to begin enforcement action. Moreover, if the taxpayer does not maintain his or her proposed payment schedule, while the Service is reviewing the offer, the legislation does state that the offer would be considered withdrawn by the taxpayer at the time the payments cease.

We believe that the periodic payment offer proposal—like the 20 percent offer payment provision described above—will have a negative impact on the future viability of the overall OIC program. The periodic payment proposal does not do anything to encourage efficiency on the part of the IRS, i.e., for the Service to be more efficient in the processing and review of offers on a timely basis. In fact, the proposal would appear to create a situation in which the IRS would be better off by *not* rejecting *too quickly* an offer that the agency might otherwise find unacceptable.

There may also be circumstances in which, for legitimate reasons, the taxpayer may be required to discontinue (i.e., may no longer be able to afford financially) the periodic payments while the IRS is reviewing the taxpayer's offer submission. We do not believe that IRS consideration of the taxpayer's offer should cease under such circumstances. A fairer result would be for the IRS to provide guidance—under a reasonable cause standard—as to the circumstances that a taxpayer's offer would continue to be reviewed and considered by the Service.

9. TAX SIMPLIFICATION

Enacting tax simplification measures is integral to the success of future filing seasons. As Commissioner Everson stated in his March 3, 2005 testimony before the Tax Reform Commission:

Complexity in the tax code compromises both the [IRS's] service and enforcement missions. That is because complexity obscures understanding. Those who seek to comply but cannot understand their tax obligations may make inadvertent errors or ultimately throw up their hands and say why bother. In the enforcement context, complexity in the code facilitates behaviors at variance with those intended by Congress.

Simplification of the tax laws is a high priority of the AICPA. We have worked closely with the American Bar Association and the Tax Executives Institute to jointly identify specific proposals for simplification. Similarly, we have recently released a study entitled, *Understanding Tax Reform: A Guide to 21st Century Alternatives,* September 2005. Our study discusses how many of the goals of tax reform can be achieved by modifying the current income tax system through significant simplification. Some of the more important proposals to reduce administration and compliance costs are discussed. The text of the full study is available at: http://www.aicpa.org/taxreform/.

The IRS released updated statistics in February 2006 that the tax gap is about $345 billion. We believe tax simplification can play a significant role in helping to reduce the overall tax gap, as simplification would (1) result in fewer errors on tax returns and (2) reduce taxpayer susceptibility to the marketing of abusive tax shelters.

Thank you for the opportunity to share these views with you.

Chairman RAMSTAD. Thank you very much, Dr. Purcell. Mr. Degen, please?

STATEMENT OF FRANCIS X. DEGEN, PRESIDENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. DEGEN. Thank you, Mr. Chairman, for asking the NAEA to testify before you today. I will limit my comments pretty much to tax filing season issues.

I am happy to report that, for the most part, the 2006 filing season is progressing smoothly. Nonetheless, we need to bring a handful of issues to your attention. As we heard only too starkly at the Finance Committee hearing on Tuesday, unenrolled tax return pre-

pares continue to be a problem for taxpayers and the tax administration system. Mr. Chairman, I have previously brought this issue before your Subcommittee, and I urge you to move expeditiously to pass legislation to require all paid tax return preparers to demonstrate competency and ethical standards through licensure and continuing education. The NAEA believes that such legislation will greatly aid all taxpayers, especially low-income taxpayers, to comply with our Nation's tax laws by helping to ensure access to competent and ethical tax preparation services.

As usual, complexity rears its ugly head in the 2006 filing season. While the AMT continues to stand out as the poster child for today's taxpayers, two new issues have been particularly troublesome for practitioners this filing season. The first is the new definition of "dependent" as defined in section 152 of the Internal Revenue Code. While we applaud Congress for trying to simplify the definition of "child," the law of unintended consequences has reared its head with respect to the new definitions of "qualifying child" and "qualifying relative." Quite frankly, the definitions have probably resulted in more rather than less confusion. The examples we cite in our letter to Commissioner Everson—and I believe you have a copy of that, sir—need to be addressed.

I would also like to comment on the IRS expectation that the details of every capital transaction be reported on a Schedule D. The goal in submitting a tax return is to report the correct tax liability of the taxpayer. The NAEA fails to understand why the listing of every transaction on a Schedule D is necessary to achieve that goal. The IRS espouses that it strives to lessen the burden on taxpayers. This requirement of reporting every detail is counterproductive to that claim and greatly increases the burden on taxpayers.

Taxpayers who use professional assistance in preparing their tax returns are facing extra costs due to this requirement. Given the fact that many taxpayers now trade in the stock and bond markets, the goal should be to prepare an accurate tax return and not a meaningless exercise in reporting details.

Along a similar vein, our members cite a growing problem with information reporting on 1099 forms and cite example after example of brokerage firms sending two, three, and sometime as many as four corrections of the Form 1099. We would like to caution Congress as it considers possible legislation to expand reporting requirements in this area, to give the IRS and the industries involved plenty of lead time to develop and implement such an expansion. Otherwise, the taxpayer will suffer and be required to file amended tax returns.

While not a specific filing season problem, NAEA is concerned, as the ABA noted, that the Senate offer in compromise (OIC) proposal in the reconciliation bill now in conference is unduly burdensome to taxpayers. While the steep entry cost would certainly deter frivolous offers, it will also certainly prevent most, if not all, earnest taxpayers from making their offers as well.

We urge Congress to drop this provision or, alternatively, to work with us to put forward an alternative such as the one outlined in our written testimony, which I know you have.

Finally, NAEA has been a strong proponent of beefing up enforcement at the IRS while maintaining good customer service level for taxpayers. There are full details in my written testimony, but in the interest of time, I will only note that the IRS needs to consider building in some level of flexibility for its employees to be able to work with practitioners during the filing season. The clear result will be higher-quality audits and better responses to IRS inquiries.

In closing, Mr. Chairman and Members of the Subcommittee, NAEA and its members stand prepared to work with you and the IRS in ensuring a strong tax administration system and improving voluntary compliance, and we welcome any questions you may have.

[The prepared statement of Mr. Degen follows:]

Statement of Francis X. Degen, President, National Association of Enrolled Agents

Thank you, Mr. Chairman, Ranking Member Lewis, and members of the Oversight Subcommittee for asking the National Association of Enrolled Agents (NAEA) to testify before you today. NAEA is the premier organization representing the interests of the 46,000 enrolled agents (EAs) across the country. EAs are the only practitioners for whom the IRS directly attests competency and ethical behavior. NAEA is dedicated to increasing the professionalism of its members and the integrity of the tax administration system as a whole.

In regard to the 2006 filing season, I am happy to report that for the most part, the season is progressing smoothly. Nonetheless, a number of major issues are affecting taxpayers and tax practitioners, and we would like to take to take this opportunity to bring a handful of issues to your attention.

1. A few "bad eggs" in the paid preparer community are adversely affecting the public's faith in the tax system.
2. Complexity for individual taxpayers continues unabated, centering this year on AMT, definition of dependent, and Schedule D information.
3. The Offers-in-Compromise program is in jeopardy because of a provision of the Reconciliation bill currently in conference.
4. Increased enforcement actions during filing season are creating some significant headaches for enrolled agents and their clients.

HOW TO DEAL WITH A FEW BAD EGGS

Lately, it seems as if every day we pick up the papers only to read about another scheme with the potential for defrauding taxpayers. Last year, this subcommittee reviewed the trend of linking tax preparation with some unrelated services or goods, such as car or furniture sales. This season, the great new idea is to load tax refunds on gift cards. Further, we have been hearing a lot about the sale of questionable financial services linked to tax preparation. Last week, we awoke to headlines, however dubious, screaming of practitioners being allowed to sell tax data to the highest bidder.

Very quietly hidden behind these juicy headlines is in actuality a much more sinister yet mundane story: the growing problem of taxpayers' forum shopping to maximize their refunds at the expense of the Treasury. In other words, enrolled agents are seeing taxpayers pick up their records and move down the street looking for unscrupulous preparers who will "pump-up" their refunds. Unlicensed tax return preparers are making outrageous guarantees on refunds, saying, "Come to us and we promise you a $1,000 back from Uncle Sam." Suddenly the taxpayer is taking phony home office or business deductions or finding long lost children.

The message to taxpayers with respect to cheating is that everyone is doing it and you are a dupe if you aren't doing it too. As practitioners licensed to practice before the IRS, we too often end up representing these taxpayers once the IRS catches up with them. Unfortunately, unlicensed paid return preparers are often outside the current regulatory rules governing competency and ethical behavior. It is our contention that this issue is the key to maintaining, and even to restoring, taxpayer faith in a fair and equitable tax collection system.

To address this situation, Mr. Chairman, we urge the subcommittee to move expeditiously to pass legislation to require all paid tax return preparers to demonstrate competency and ethical standards through licensure and continuing education.

NAEA believes that such legislation will greatly aid all taxpayers—but especially low income taxpayers—to comply with our nation's tax laws by helping to ensure access to competent and ethical tax preparation services. In her 2003 and 2004 annual reports, the National Taxpayer Advocate expressed that oversight of unenrolled return preparers was one of the most serious problems facing taxpayers. In 2003, she noted that over 55 percent of the 130 million individual taxpayers paid a return preparer to prepare their returns. Close to half these preparers did not possess a legitimate license demonstrating basic competency or ethical standards. Shockingly, at least 57 percent of EITC earned income overclaims were attributable to returns prepared by unlicensed paid preparers, resulting in billions of dollars in lost revenue to the government.

NAEA supports S. 832 (the Taxpayer Protection and Assistance Act of 2005) because we believe the bill will help ensure the integrity of the tax system by promoting licensed tax professionals to the general public and ensuring strong enforcement against the unlicensed and unethical. We believe the proposed legislation:

A. Contributes significantly to taxpayer access to competent and ethical tax preparation services.

The legislation would require all paid preparers to pass an exam testing their understanding of basic tax laws and ethical standards. Further, paid preparers would be required to undergo annual continuing education and be subject to the ethical requirements of Circular 230.

This will help ensure that only qualified and ethical individuals will be preparing returns.

B. Builds on the existing regulatory framework and consolidates enforcement under one entity

Rather than constructing a parallel regulatory framework and enforcement entity for different groups of paid preparers, the legislation would consolidate all persons preparing returns (lawyers, CPAs, EAs, and paid preparers) under the current regulations (Circular 230) and the existing Office of Professional Responsibility (OPR). In other words, there would be one ethical code, coordinated exams that would allow for advancement within the profession, and standardized continuing education requirements all administrated under the already existing system.

In addition to being cost effective, this consolidation would ensure uniformity of standards and enforcement across all preparers.

C. Ensures adequate resources for administration, promotion, and, most importantly, enforcement.

The legislation would allow OPR to retain all registration fees for administration of the program, including policing all practitioners and preparers under their jurisdiction. Most importantly, the authorization to retain these fees would ensure that the office would have adequate resources to investigate and penalize unlicensed individuals. This will discourage taxpayers from shopping for the "best deal" among preparers and will help shut down many EITC mills across the country.

Additionally, the bill would authorize OPR to retain penalties administered under the program for promotion of all Circular 230 preparers to the general public. This will assist the public in understanding the importance of paying only licensed individuals for tax preparation and will assist the public in understanding the difference between the various groups allowed to do paid preparation.

D. Strikes the correct balance for creating a new tax practice credential.

Congress needs to be cognizant of the ramifications of creating a new credential in the world of tax administration. Currently, the general public is presented with three options for individuals who are licensed to practice before the IRS: lawyers, CPAs, and enrolled agents. Circular 230 is very specific as to how these individuals may advertise and generally present themselves to the public. A credential that implies a higher level of authority and competency than merely preparing basic individual tax returns will cause confusion and undermine the general intent of the legislation.

Since the passage of the IRS Restructuring and Reform Act, there has been a great deal of confusion as to the credentials and *bona fides* of Electronic Return Originators or EROs. The IRS has issued signage denoting official endorsement of individuals qualifying as EROs, as well as financed a public awareness campaign in support of the program. Anecdotal evidence (the appearance of billboards and bus

stop signage) in poorer neighborhoods demonstrates the danger of putting out to the public confusing titles or credentials that overstate competency.

Additionally, state regulators would be very leery if not outright hostile toward the creation of a new credential in the accounting/tax preparation marketplace. States regulate the use of credentials and many list a litany of titles (e.g., certified tax consultant, chartered accountant, registered accountant) and abbreviations likely or intended to be confused with CPA that may not be used. After years of conflict, the majority of state boards of accountancy have accepted that a person recognized by IRS as being enrolled may use the enrolled agent name and EA abbreviation. Creating nomenclature that might overstate its intended mission is likely to re-ignite this battle, and at the very least potentially counter the underlying intent of the legislation.

PRACTITIONER CONCERNS

While the alternative minimum tax—which holds the distinction of being both unfair and extremely complex—continues to stand out as the poster child for dazed taxpayers, two new issues have been particularly troublesome for practitioners this filing season.

The first is the new definition of dependent as defined in § 152 of the Internal Revenue Code. While we applaud Congress for trying to simplify the definition of child, the law of unintended consequences has reared its head with respect to the new definition of qualifying child and qualifying relative. (Please see our attached letter to Commissioner Everson). Quite frankly, the definitions have probably resulted in more rather than less confusion. The examples we cite in our letter need addressing. We note that the Treasury Department's Blue Book for the 2007 budget attempts to offer solutions to some of these problems, but we need to act before the 2007 tax year.

NAEA supports efforts to simplify the filing of federal taxes and its 11,000 members stand ready to assist Congress and the President in accomplishing real, practical reform for the American taxpayer. While the concept of simplifying the tax code often plays well on the campaign trail, the nitty-gritty of what is reform and how it is accomplished makes comprehensive reform a daunting political undertaking for policymakers. May I be so bold as to suggest that the practitioner community have some role in future changes? Those of us "in the trenches" may, based on practical experience, be able to see problems staff writers may not envision.

I would also like to comment on the IRS expectation that the details of every capital transaction be reported on a Schedule D. The goal in submitting a tax return is to report the correct tax liability of the taxpayer. NAEA fails to understand why the listing of every transaction on a Schedule D is necessary to achieve that goal. The IRS should strive to lessen the burden on taxpayers. This requirement of reporting every detail is counterproductive to that concept and greatly increases the burden on taxpayers. Taxpayers who use professional assistance in preparing their tax returns are facing extra costs due to this requirement. Given the fact that many taxpayers now trade in the stockand bond markets, the goal should be to prepare an accurate tax return and not a meaningless exercise in reporting details.

Along a similar vein, our members cite a growing problem with information reporting from third parties (e.g., Forms 1099 and Schedules K–1). While Congress and the IRS have become more reliant on third-party reporting to ensure compliance, the process has become incredibly complex. Our members cite example after example of brokerage firms sending two, three, and sometimes as many as four corrections of the Form 1099. The brokerage firms point out that in this complex, multinational world we live in it is becoming more and more difficult to provide the required information within the required deadlines. We would like to caution Congress as it considers possible legislation to expand reporting requirements in this area to give the IRS and the industries involved plenty of lead time to develop and implement such an expansion.

OFFERS-IN-COMPROMISE

While increasing offer quality is an admirable goal, NAEA is concerned that the approach taken by the Senate in the Reconciliation bill now in conference is unduly burdensome to taxpayers. While the steep entry cost would certainly deter frivolous offers, it will also certainly prevent most, if not all, earnest taxpayers from making their offers as well.

As you are aware, the provision requires that a taxpayer make a good faith down payment of 20 percent of any lump sum offer-in-compromise with any application for an offer. For periodic payment offers, the taxpayer is required to comply with his or her own payment schedule. The proposal also repeals the $150 user fee. Additionally, it provides that an offer will be deemed accepted if the IRS does not reject

it within twenty-four months (twelve months beginning in 2010). The proposal is estimated to raise $683 million over five years.

With IRS permitted to wait twenty-four months to accept an offer, at least until 2010, one of the common concerns is the possibility that IRS may use this new rule to further slow its processing of offers (particularly in the case of taxpayers making monthly "good faith" payments).

A further concern is that many taxpayers borrow to meet their tax obligations (often from family or friends) and such taxpayers would see this plan as a great disincentive to make an offer. We do not believe it makes sense for a taxpayer to borrow in an effort to square up with the IRS only to risk that a rejected offer would put the taxpayer even more in debt, both to IRS **and** to the source of the borrowed "good faith" payment.

It is not clear how the provision, which NAEA believes will reduce significantly the number of offers submitted to IRS, would generate the 10-year dollars that the Senate bill claims it will.

NAEA would like to offer a counter proposal that we believe would provide true reform. In short, our proposal would:

- Require that if a taxpayer uses a paid third party to prepare the offer that such preparer be a current Circular 230 practitioner;
- Create a $5,000 frivolous filing penalty for the taxpayer and for any paid preparer assisting in the preparation of the frivolous offer;
- Maintain the current user fee; and
- Deem an offer accepted if not rejected by the IRS within twelve months.

This alternative approach should eliminate most of the frivolous offers, while at the same time giving taxpayers a time-certainfor response from the IRS.

ENFORCEMENT DURING TAX FILING SEASON

NAEA has been a strong proponent of beefing up enforcement at the IRS, while maintaining good customer service levels for taxpayers. We are encouraged by the improved numbers we are seeing from the agency on both audit and collection. Many of our members, however, have reported a problem arising from this renewed emphasis. Namely, there has been a major increase in the number of audits, collections, and notices coming from the agency during the height of the tax filing season. This situation is coupled with an absolute unwillingness to work with practitioners to accommodate the sheer crush of work brought about at this time of the year. The IRS needs to consider building in some level of flexibility for its employees to be able to work with practitioners during filing season. The clear result will be higher quality audits and better responses to IRS inquiries.

In closing, Mr. Chairman and members of the subcommittee, NAEA and its members stand prepared to work with you and the IRS in ensuring a strong tax administration system and improving voluntary compliance. Thank you and I stand ready to answer any questions you may have.

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[i] The **National Association of Enrolled Agents (NAEA)** is the professional society representing enrolled agents (EAs), which number some 46,000 nationwide. Its 11,000 members are licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the IRS, including examination, collection, and appeals functions.

While the enrolled agent license was created in 1884 and has a long and storied past, today's EAs are the only tax professionals tested by IRS on their knowledge of tax law and regulations. EAs provide tax preparation, representation, tax planning, and other financial services to millions of individual and business taxpayers. EAs adhere to a code of ethics and professional conduct and are required by IRS to take continuing professional education. Like attorneys and CPAs, EAs are governed by Treasury Circular 230 in their practice before the IRS.

Since its founding in 1972, NAEA has been the enrolled agents' primary advocate before Congress and the IRS. NAEA has affiliates and chapters in forty-two states. For additional information about NAEA, please go to our website at www.naea.org.

Chairman RAMSTAD. Thank you very much, Mr. Degen, and the Chairman thanks all three distinguished members of this panel.

I would like to address the first question to any or all of you, for that matter, about the proposed regulations to expand the permis-

sible use of taxpayer information by tax return preparers. I, as other Members have expressed today, have some serious privacy concerns about the proposed regulations to expand the use of such information.

In your judgment—again, any or all of you may respond—are there any compelling reasons for the IRS to broaden tax return preparers' ability to use taxpayer information? Mr. Drapkin?

Mr. DRAPKIN. Well, the ABA and the Tax section do not have a position, so I will be speaking on my own behalf. In reviewing the materials for this hearing, it struck us that, for one thing, the sharing of information has been authorized by regulation since 1974, both by a tax return prepared with its own affiliates and at direction of the taxpayer to disclose return information to anyone. So, these authorizations have existed in the law effectively since Congress enacted the statute in 1971. The privacy——

Chairman RAMSTAD. Pursuant, of course, to taxpayer consent.

Mr. DRAPKIN. Pursuant to the taxpayer's consent in both cases.

Now, the IRS commendably spends a good deal of effort in the proposed regulation and the proposed revenue procedure on the consent side, beefing up consent, making it meaningful and apparent. This may well be a subject that this Committee might want to look into because it overlaps both the proposed regulations and the existing regulations as to whether or not this information should be shared, what are the compelling interests either way, the commercial advantages to the tax return preparer versus the concerns on privacy.

Chairman RAMSTAD. Well, let me ask the obvious question then that flows from your statements. Do you believe current regulations on disclosure of taxpayer information by preparers should be reconsidered?

Mr. DRAPKIN. Well, in light of what has happened since December, when the proposed regulations came out, and we understand in part outsourcing was one of the issues that concerned the government in coming back to this area really for the first time in 30 years, that the nature of privacy concerns and the nature of consumer interests has changed so much since 1971 to 1974, when the legislation was enacted and the rules developed, that a Committee like this one, Mr. Chairman, might well want to look into, again, what are the legitimate concerns, how well does the statute and the legislation reflect those concerns, and not just the ones raised by the proposed changes, but also by those raised by the existing rules.

Chairman RAMSTAD. Dr. Purcell, please.

Mr. PURCELL. Mr. Chairman, our concern—and we had provided testimony on Tuesday, as well as in our comments for today. The 7216 is a criminal statute, and its penalties are criminal in nature. So much of the disclosure question should be carefully considered in the fact that you are imposing criminal sanctions on people as opposed to many concerns that you might have in the relationship with your tax preparer, which might be inadvertence or oversight, but not intentional criminal conduct. So, we urge going slowly on trying to overkill with the process of legislating here or regulating something that could well be better handled through an ethical concern.

The second concern that we have is that the discussion about the disclosure really is the means to the end, and the end is whether taxpayers are being unfairly taken advantage of through the existing regimen, being asked to do something or being the victim of identity or some other type of exposure of their information because someone is trying to sell an additional service or trying to use that information for financial gain. It might be better to focus on some of the things you have already heard this morning, such as the RAL, as an entity in itself rather than the means that it's being used to get there, which is the perhaps aggressive use of taxpayer information.

So, I think it is important as a policy matter, what is the information being used for and should it even be used for this in any circumstance. Should anybody be able to do this, yes or no? Then if this is a legitimate use of information, what safeguards should we put in to make sure the information is not unfairly shared?

Chairman RAMSTAD. I certainly agree with that. I think you couched the threshold question very well, and secondary ones as well, and we need to address those questions. I also think your caveat as to proceeding with due caution is a good one. Thank you, Dr. Purcell.

Mr. Degen, please.

Mr. DEGEN. Yes, Mr. Chairman, I think it is fair to say that we would agree primarily with the position of the Taxpayer Advocate. I think she basically said that, as a policy decision, it is up to the Congress to decide whether there should be any disclosure or not. However, given the fact that their existing regulations do allow a certain amount, the proposed regulations actually enhance protection for the taxpayer. So, if the Congress is not going to make a complete change, then we would support those regulations in terms of enhancing.

I think there was also one other point—I believe this was mentioned at the hearing on Tuesday when the IRS had the hearing on the proposed regulations—that it would be seemingly in the interests of the taxpayer and the IRS to perhaps involve the practitioner community before some of these things are proposed. Quite often, we feel that the IRS would be better served, the public would be better served if they operated in a mode called "consult, then decide," as opposed to in a mode of "decide, then explain." So, I think that is something that we would hope that the practitioner community—while clearly we do not make decisions and we do not make policy, but I think there is a lot of insight and input from the trenches, so to speak, that may be in the best interest of the Service to look at beforehand.

Chairman RAMSTAD. I think that point is very well made, and you certainly bring an expertise that is important, and I think we need to work more in that collaborative way.

Let me ask you, Mr. Drapkin, in your testimony you touched on the need for simplification of tax laws. I do not think you will get much disagreement anywhere in any venue that we need to simplify the Tax Code, and we have been going in the wrong direction if you look at it en masse, in todo. I know the ABA has been advocating simplification of the Tax Code for a number of years.

I think also everyone concedes around here at least that wholesale simplification is off the table for this year. Yet are there some viable incremental steps that Congress can take now to simplify the Tax Code short of dealing with it in a comprehensive way? Or should we not deal with it an incremental way pending comprehensive reform?

Mr. DRAPKIN. Well, I think there are a number of avenues, as has been mentioned. The AMT, both in its individual and corporate form, is a source of immense complexity, and it has also become clear that in recent years, particularly the individual AMT is hitting sectors of the taxpayer community that, I think it is fair, Congress probably did not contemplate when it first enacted the provisions. So, I do not know if you could call removal of a provision of that magnitude "incremental," but short of wholesale tax reform, that is certainly one area.

We mentioned in our testimony this time and before that re-examination of the phase-out provisions and trying to coordinate and correlate them would be greatly simplifying. I would also point out, as I think the Chairman well knows, the report of the President's panel on tax reform made a number of proposals that actually could be isolated from the broader proposals, areas that could merit attention from this Committee and others, such as bringing together various provisions on education credits and other types of credits and trying to unify them into one single provision.

So, I think there are a large number of possibilities out there that the Subcommittee and other entities in Congress could examine if they wanted to find fruitful areas for simplification short of wholesale tax reform.

Chairman RAMSTAD. I certainly agree the AMT is a ticking time bomb and needs to be addressed, and I would also go further than you and say the AMT is hitting taxpayers that Congress definitely—not probably, but definitely did not intent to impact. So I appreciate that.

Do either of you gentlemen have any additional input on that point?

Mr. PURCELL. I think I would—on behalf of the AICPA, I think we would echo Dennis's comments, and certainly we have worked together, ABA and the AICPA, extensively on simplification issues.

When we look at the issues that come up, though, I think two things that would be kind of broader, I guess, cautions or concepts, we seem to have had—I have been in tax practice in one form or another since the late 1960s, early 1970s, and I keep on my shelf a copy of every tax law that has been passed. Well, there is no room on my shelf anymore because so many have been passed. We seem to have accelerated the rate of change so that we are writing not just simplification laws, but we are writing technical correction laws before the first law has even been fully enacted.

So, one caution would be just we need to slow down. We need to make sure that if we are going to pass something that it is needed. So, rather than rush to get something done, I think calling us, calling in different constituent groups to look at an issue such as education credits and education incentives or issues such as the AMT and making sure that before we try to fix it we have got a good fix that will stand up for 5 or 10 years.

The other thing is anytime Congress puts in a threshold amount, it needs to be very careful to make sure that it is inflation adjusted. We would not have the problem we have today with the AMT if the exemption had been inflation adjusted when it was first enacted. We would not have the problem we have today with the estate tax if the exemption amount had been inflation adjusted back in 1916, because most taxpayers would then not be subject to either one of those taxes.

When we look back to try to fix it after years and years and you look at the revenue cost, it becomes very problematic, if not impossible. So, as a matter of activity that if you just inflation-adjust something when you first enact it, that could certainly help.

So, those would be the two other thoughts besides the ones Dennis raised.

Chairman RAMSTAD. Thank you.

Mr. Degen, did you want to comment further?

Mr. DEGEN. Yes, I would like to, I think, echo what Dr. Purcell said in terms of new legislation going slow. I would ask that the Congress do take a look at that section 152. That has been a huge problem in the practitioner community. In a typical Ozzie and Harriet family, it is not a problem. Yet in America today, we do not have as many Ozzie and Harriet families as we used to. We have a lot of families where people are not married, they live together, they have children, they have nieces, nephews, people die. What that section has done—the intent was good. It is always easy, Mr. Chairman, to be a Monday morning quarterback. Hindsight is the best sight, isn't it? In all seriousness, the Treasury Department has recognized this. In their Blue Book, they call the 2007 budget proposal an attempt to fix some of these things. Yet their fixes seem to create just as many problems. The 152 needs to be looked at.

One of the problems that we have had is the interpretation of the IRS. In the law it says "another taxpayer." Well, the Internal Revenue Code defines a taxpayer basically as anyone that breathes. When they made the "qualifying child," I thought the intent of Congress was to prohibit two people from claiming the same child as a dependent. I do not know how the law was written. I am not an expert in that, but the IRS has interpreted "taxpayer" in the sense of anyone who breathes is qualifying. They use the phrase "another person" or "someone else." I am not terribly sure that was the intent of Congress to use that in the same—so I really believe that, in fairness to the taxpayer, because, quite frankly, practitioners—and I am not talking about Circular 230 necessarily, but just practitioners in general—are interpreting it in different ways and not everyone is being treated the same.

So, I really think that is an issue that needs to be looked at seriously.

Chairman RAMSTAD. Thank you, Mr. Degen.

I want to ask you another question, Mr. Degen. The last numbers I saw claimed that 60 percent of taxpayers use a professional tax preparer to complete their return—60 percent of taxpayers. Obviously, then, it is important that tax practitioners receive adequate assistance from the IRS when the paid preparers have questions about the Code.

Are members of your constituent group, your association, tax practitioners you represent, are they receiving the assistance they need from the IRS? Have things improved in that regard?

Mr. DEGEN. Quite frankly, Mr. Chairman, I do not believe too many of our members would actually solicit responses from the IRS in terms of typical tax situations. I think most of our members take a lot of continuing education and do not rely on the IRS for guidance on mundane issues. Clearly on the issue I brought up before about the section 152 is a different ball game. I do think that would be a fairer question to ask if taxpayers who do not use professional assistance are getting what they need from IRS. That I cannot answer, but I do think that it is not an issue for most of us in terms of the IRS providing assistance.

Chairman RAMSTAD. Maybe I should have asked the question: Which, if any, of the taxpayers services that the IRS offers are utilized by practitioners in preparing returns?

Mr. DEGEN. Well, one issue—this is not necessarily in preparing returns, but I think it may be apropos to your question—will be the notion of the e-services. E-services are something that the IRS has provided for tax practitioners to avail themselves of being able, with appropriate power of attorney, to electronically download transcripts of taxpayer information reporting and that type of thing.

Unfortunately, the Service has made a decision that access to that is predicated upon the fact whether you file five returns electronically or not. It makes no difference whether or not you have any expertise. That is the criteria.

The Service, through the Office of Professional Responsibility, monitors Circular 230 practitioners, and yet they refuse to allow the practitioners who they monitor access unless they file five tax returns. I am sure ABA has many members who do not file tax returns but do represent taxpayers. These folks, as well as enrolled agents—and I am sure certified public accountants are in the same position. These folks have the most need for these e-services, and they are not available to them. So it does not make sense that you predicate a very important service based on filing five tax returns electronically.

Chairman RAMSTAD. Dr. Purcell, did you want to address that?

Mr. PURCELL. I think I would echo Frank's comment that we are on record as supporting a drop in the threshold level for qualification for the Electronic Return Originator (ERO) because it does not make sense, and for the reasons that Frank has already outlined.

Chairman RAMSTAD. Any further comment, Mr. Drapkin?

Mr. DRAPKIN. No, Mr. Chairman.

Chairman RAMSTAD. Well, the Chairman again wants to thank all three of you for your continuing input to the Subcommittee on Oversight as well as the full Committee on Ways and Means. We appreciate your expertise and counsel, and thank you for your indulgence today. Hopefully you will be able to grab lunch despite the hour, and the Subcommittee will stand adjourned.

[Whereupon, at 12:43 a.m., the Subcommittee was adjourned.]

[Submissions for the Record follow:]

Statement of the National Society of Accountants

The National Society of Accountants (NSA) welcomes the opportunity to submit our views regarding any difficulties encountered during the current tax return filing season, the "Estimates of Taxpayer Burden" tables that appeared in the instructions for the 2005 Form 1040 and the regulation of federal income tax preparers. NSA is a voluntary association of certified public accountants, enrolled agents, licensed public accountants, licensees of State Boards of Accountancy, tax practitioners who are licensed by state agencies and accountants and tax practitioners who hold credentials from ACAT, a nationally recognized credentialing body.

NSA and its affiliated state organizations represent approximately 30,000 practitioners who provide accounting, advisory and tax related services to more than 19 million individuals and small businesses. NSA represents accountants who serve Main Street rather than Wall Street.

2006 Filing Season

NSA members have encountered a greatly increased work load during the current tax return filing period and believe that this has proven costly to taxpayers due to the increased number of hours required to prepare their returns. Some of the increase in the work load has resulted from changes to forms and instructions. For example, one NSA member was asked to prepare a return that required more than 600 stock transaction entries on Schedules D and D–1 in order to e-file the return. Another example involved one of our members whose client received a Form 1099 from a stock brokerage firm and just recently received an amended Form 1099B due to the division between ordinary and qualified dividends. This resulted in a delayed filing that will be followed by the filing of an amended return. I am sure that entities that must send and re-send Forms 1099 are frustrated by the complexity of the requirements, but a taxpayer is virtually unable to prepare a return during the early part of the filing season if there is any possibility of receiving an amended Form 1099. All of this also dramatically increases the cost of preparing a return accurately the first time.

In preparation for the current filing season the Internal Revenue Service has also encouraged taxpayers to prepare their own tax returns using computer tax software programs. A number of NSA members have heard from taxpayers who are finding it often takes an entire day to prepare their tax return, even though it may not be a complex return. In many instances, our members have been called upon to correct costly mistakes that have been made.

Preparers from all over the country are being bombarded with taxpayer complaints due to the Alternative Minimum Tax adding to the taxpayer's tax burden and tax liability. Taxpayers feel they are unable to present their views to the IRS, so preparers are forced to take the brunt of these protests. This adds more hours to the preparers' already overloaded schedule and can add significantly to the cost of preparing a return as preparers explain the AMT and why it adds to the tax that must be paid.

IRS Estimates of Taxpayer Burden

The Internal Revenue Service recently published an "Estimates of Taxpayer Burden" tables as part of its Form 1040 instructions. The National Society of Accountants (NSA) believes these estimates to be patently wrong, make no distinction with respect to the sophistication of the self-filing preparer or the complexity of a return even assuming the criteria the tables set forth. Further, the tables encourage the conclusion that business self-filers use improper and invalid assumptions to prepare their tax returns. Finally, the tables purport to set forth the fees charged by tax preparation professionals without any apparent thought to regional cost of living differences or in the types of schedules required for various types of income.

NSA questions the estimates and how they were obtained. Clearly, judging from the number of comments we and other representatives of the professional tax preparation community have received, very few if any of our members were asked to provide *any* estimates of the time spent to prepare a particular return and the fee charged. Any such request would have quickly revealed that our members believe that every taxpayer is different. For example, one table makes a particular estimate about a nonbusiness filer who files a Schedule D but not a Schedule A. How many transactions are assumed to be reflected on the Schedule D? Even if there is only one transaction, what is assumed about the availability of information related to basis, capital improvements and other necessary and relevant information? There is no way a tax professional can "blanket charge" his clients in light of those differences.

Further, the fee charged for tax preparation services is likely to vary substantially based on where the services are performed. Tax preparation professionals practicing

within a large metropolitan area such as New York or Chicago must charge more than their counterparts living in small town or farming communities because their overhead is far greater. Every area of the United States is different. For the IRS to issue a table suggesting to taxpayers how much a tax professional should charge to prepare a return is absolutely misleading and counterproductive.

Another concern is the assertion in the table that a business filer who prepares a return himself without tax software will spend less time (45.1 hours) preparing the return than if that same individual used tax software (67.1 hours) or used the services of a paid professional 47.9 hours). It seems obvious that someone who sees a particular form once per year will spend more time than a professional who is not only familiar with the form but has likely prepared the same form thousands of times. The only way this can possibly be true is if the self-preparer ignores the time needed to actually obtain the numbers required to prepare a return properly and instead relies on estimates (or the numbers on last year's return). Reputable tax professionals know that the majority of time spent on a return is the process of compiling all of the figures necessary. That being the case, the numbers are either wrong or the tables assume that taxpayers who self-file are using estimates rather than going through the tedium of looking through their records for the actual numbers. If the latter is true, where does that put the IRS's push for compliance?

We sincerely hope the IRS will reconsider the publication of these estimates of taxpayer burden contained in the tables.

S. 832

NSA members have noticed an increase in the number of fraudulent tax preparers. In fact, a recent GAO report found that, of the 19 chain tax preparer offices tested, all returns were prepared incorrectly. Further, USA Today conducted a recent study and concluded that the number of fraudulent preparers has increased substantially in the last 5 years. Competence and reliability can be very hard for taxpayers to determine, especially in light of limited government oversight. The IRS has pushed electronic filing to the forefront, and unfortunately this has led to an abundant increase of unenrolled preparers who operate from their cars, their homes, storefronts, on a table in their businesses, etc.

Senate Bill S. 832 proposes new regulation for the federal tax preparation industry. This proposed legislation would have a significant impact on the profession and the Internal Revenue Service. Estimates of the number of tax practitioners required to register in the first year of the program range from 200,000 to as high as 600,000.

The Senate bill instructs Treasury to develop (or approve) and administer an eligibility examination designed to test the knowledge and technical competency of individuals who prepare federal income tax returns. NSA has supported the concept of registration for federal income tax preparers since we first introduced the concept several years ago. NSA further supports the use of an eligibility examination. However, NSA can fully support the Senate bill, and any similar legislation, only if it provides recognition of tax practitioners who have *already* demonstrated their professional competence and their commitment to life-long learning either by earning credentials offered by a nationally recognized credentialing body or by being licensed to practice accounting by a state Board of Accountancy or by being licensed to prepare income tax returns by an agency established under state law. Allowing individuals who possess such credentials or licenses to receive a waiver from the initial examination requirement will achieve that recognition. These individuals would still be required to register, pay the appropriate fees and meet the other requirements specified in the bill.

The Accreditation Council for Accountancy and Taxation (ACAT), a nationally recognized credentialing organization, offers three credentials that fully satisfy the competency and ethical standards that the Senate bill seeks to achieve. Those credentials are: *Accredited Business Accountant (ABA), Accredited Tax Advisor (ATA)* and *Accredited Tax Preparer (ATP)*. Individuals who hold these credentials have demonstrated their knowledge and competency through a regimen that includes education, experience and examination on topics that include substantial taxation and ethical components. To maintain their credentials, they comply with rigorous annual continuing professional education requirements. ACAT credentials are recognized for licensing or regulatory purposes in a number of states, including Iowa and Minnesota, and NSA believes that S.832 should be modified to recognize that any individual who has taken and passed an ACAT examination and maintains his accreditation is exempt from any testing required by the bill.

Any individual holding a license from a state Board of Accountancy has likewise demonstrated a level of competence that is based on a long-established regulatory standard that has education, experience and examination as required components.

Every state accountancy regulatory scheme requires continuing professional education as a condition for license renewal.

The states of California and Oregon license tax preparers in their respective jurisdictions. The licensing qualifications differ slightly in each state, but both require a substantial educational element, including state and federal taxation and ethical conduct, as a prerequisite to granting a license. In both states, continuing professional education is a requirement for license renewals. California currently licenses approximately 36,000 tax preparers and Oregon licenses approximately 8,000 preparers under their respective programs. These states already impose adequate and efficient licensing requirements on their tax and accounting professionals. We do not believe additional federal requirements should be imposed on these individuals or similarly situated individuals in other states.

In addition, the Internal Revenue Service has extended Circular 230 privileges to public accountants in the States of Pennsylvania, New Jersey and Rhode Island. Under the provisions of Circular 230, a "certified public accountant" is a person duly qualified to practice as a certified public accountant in any state, territory, or possession of the United States. Certified public accountants that are not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service. A number of other states have a public accountant license class that has practice rights substantially equivalent, if not identical, to those granted to CPAs. These licensed public accountants, like their CPA counterparts, are subject to regulation and supervision by state Boards of Accountancy and must meet continuing education, professional standards and other requirements in order to maintain their practice rights. We firmly believe that if the Internal Revenue Service has already recognized the competence and integrity of these tax and accounting professionals in these states, Congress should as well.

The Senate bill has a section that "clarifies" the Enrolled Agent credential. NSA supports this concept because it will establish a uniformity of regulation and eliminate ambiguities and conflicting restrictions that have evolved in many state regulatory schemes over time. The truthful use of earned credentials is an individual right that all responsible regulatory legislation should serve. National attention to this issue is both appropriate and overdue.

The descriptor used to identify this new class of regulated tax preparers deserves the attention of your Committee. The staff notes, accompanying the Senate bill, include the term "enrolled preparer" when referencing those individuals subject to the proposed regulation. NSA believes that this term diminishes the Enrolled Agent credential and has the potential to confuse the public. Further, it does not adequately describe the services performed by this group of tax preparers. We recommend that terminology used to describe this group be neutral. We suggest "Registered Federal Tax Return Preparer."

Another section of the Senate bill provides for levying fines and then keeping the money to fund a public awareness campaign. We question the propriety of this provision and ask that Congress reconsider the potential for abuse. Principled legislation should allow Treasury to abate a punitive fine for an inadvertent human error. Perhaps there should be a "pattern of neglect or misconduct" before heavy fines are levied.

The "one-year from enactment" provision is another area that must concern everyone. Such a short time period to develop both a testing and a registration system certainly has the potential to disrupt the subsequent tax-filing season. The staff description of the Senate bill states, "Efficiencies will be gained by coordinating the exam requirement with the enrolled agent exam." Until such time as the enrolled agent exam is successfully outsourced and its structure entirely revised, we believe this conclusion is questionable at best and could lead to a disruption of the filing season in the first year of implementation. Processing the exams and the attending record keeping for 200,000 to 600,000 individuals certainly has the potential to overwhelm the system. A safer approach would be to instruct Treasury to devise a testing system independent of the Special Enrollment Examination that applicants could use throughout the year. Such a process would follow the proven model that the securities and insurance industries use. We think that development of a workable regulatory structure, as anticipated by S. 832, simply requires more time to both develop and implement. Extending the time frame to two years or perhaps three would be more realistic.

In summary, with respect to S. 832 NSA supports:

1. The concept of registration of tax preparers.
2. The use of an initial examination by those who have not taken and passed an existing national examination, including those offered by the Accreditation Council for Accounting and Taxation.

3. A requirement for ongoing continuing professional education.
4. The requirement for registration renewal every three years.
5. A waiver of initial examination for individuals who:
   a. Hold credentials offered by nationally recognized credentialing bodies; or
   b. Hold a license to practice accountancy from a state Board of Accountancy; or
   c. Hold a license to prepare tax returns established under state law.
6. The clarification of the Enrolled Agent credential.
7. Finding a better descriptor than ?enrolled preparer.
8. Reconsideration of using preparer penalty money to fund public awareness efforts.
9. Extending the time period for development and implementation of the structure.

Statement of Gerald E. Scorse, New York, NY

My testimony today will make the same point, and urge the same action, as my testimony before this honorable Subcommittee in 2003, 2004 and 2005.

With one key difference: I now count as an ally National Taxpayer Advocate Nina E. Olson. Let me quote from the legislative recommendations of the Advocate's 2005 Annual Report to Congress:

Requiring Brokers to Track and Report Cost Basis for Stocks and Mutual Funds.

Many financial institutions through which investors own stocks and mutual funds (?brokers') do not currently keep track of an investor's basis in the stocks or mutual funds, and no brokers report basis information to both taxpayers and the IRS on a Form 1099–B, *Proceeds from Broker and Barter Exchange Transactions*. The absence of information reporting creates serious problems for many taxpayers and the government alike. For taxpayers, tracking basis can be extraordinarily complex and many taxpayers seeking to comply with the law find they simply cannot do so with accuracy, leaving them exposed if audited. From the government's perspective, the absence of information reporting enables underreporting by taxpayers who deliberately overstate their basis (thereby reducing their gain or even generating a loss), because they know the IRS generally cannot detect errors in basis reporting in the absence of an audit. One recent estimate puts the revenue loss to the government from such underreporting at $250 billion over the next 10 years. We recommend that brokers be required to keep track of an investor's basis, transfer basis information to a successor broker if the investor transfers the stock or mutual fund holding, and report basis information to the taxpayer and the IRS (along with the proceeds generated from the sale) on Form 1099–B. To offset the cost of implementing such a tracking system, we note that Congress could provide a one-time tax credit for brokers."

And so the National Taxpayer Advocate comes down on the side of third-party reporting of capital gains for stock transactions. (Aside: I suggested to Ms. Olson and would suggest to the Subcommittee that the same rule should apply to home sales and other real estate transactions. Even more than with stocks, there is no defensible reason for self-reporting of this income.)

Ms. Olson bases her recommendation on the twin pillars of tax simplification for taxpayers and ending billions of dollars in annual revenue losses by the Treasury. Both are hugely worthwhile, and reason enough to translate her proposal into law.

I would add other reasons as well.

I was drawn to the issue in the beginning as a simple matter of tax fairness.

It is inequitable to have a stricter tax reporting standard for wages than for capital gains; it is inequitable to require third-party reporting of wage income and not have the same requirement for capital gains income.

I owe it to IRS Commissioner Mark Everson for pointing to another, allied reason. In remarks prepared for this Subcommittee's 2005 hearing, the Commissioner noted that "Average Americans pay their taxes honestly and accurately, and have every right to be confident that when they do, their neighbors—are doing the same."

So the integrity of the tax system, and the belief of average Americans in the integrity of the system, are also at issue here.

I respectfully ask the Subcommittee, and all the members of the House, to address the Taxpayer Advocate's recommendation and bring it to fruition. A House bill

directly along these lines is being prepared, and I urge your support when it is introduced.

In these divisive political times, allow me to offer a final thought:

Third-party reporting of capital gains is a nonpartisan issue. Tax simplification is not a Democratic or a Republican issue; billions of dollars lost to the Treasury, year after year, is not a Democratic or a Republican issue; tax fairness and the integrity of the tax system are not Republican or Democratic issues.

They are issues on which both sides of the aisle should be able to unite, and do the right thing.

Thank you.