JOINT REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE, 2005

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
COMMITTEE ON APPROPRIATIONS
COMMITTEE ON GOVERNMENT REFORM
HOUSE OF REPRESENTATIVES

AND THE

COMMITTEE ON FINANCE
COMMITTEE ON APPROPRIATIONS
COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

One Hundred Ninth Congress

First Session

MAY 19, 2005

JCS–6–05

U.S. GOVERNMENT PRINTING OFFICE

23–854 WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

JOINT COMMITTEE ON TAXATION

109TH CONGRESS, 1ST SESSION

HOUSE

WILLIAM M. THOMAS, California, *Chairman*
E. CLAY SHAW, Jr., Florida
NANCY L. JOHNSON, Connecticut
CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California

SENATE

CHARLES E. GRASSLEY, Iowa, *Vice Chairman*
ORRIN G. HATCH, Utah
TRENT LOTT, Mississippi
MAX BAUCUS, Montana
JOHN D. ROCKEFELLER IV, West Virginia

GEORGE K. YIN, *Chief of Staff*
BERNARD A. SCHMITT, *Deputy Chief of Staff*
THOMAS A. BARTHOLD, *Deputy Chief of Staff*

COMMITTEE ON WAYS AND MEANS

William M. Thomas, California, *Chairman* — Charles B. Rangel, New York

COMMITTEE ON APPROPRIATIONS

Jerry Lewis, California, *Chairman* — David R. Obey, Wisconsin

COMMITTEE ON GOVERNMENT REFORM

Tom Davis, Virginia, *Chairman* — Henry A. Waxman, California

---

COMMITTEE ON FINANCE

Charles E. Grassley, Iowa, *Chairman* — Max Baucus, Montana

COMMITTEE ON APPROPRIATIONS

Thad Cochran, Mississippi, *Chairman* — Robert C. Byrd, West Virginia

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

Susan M. Collins, Maine, *Chairman* — Joseph I. Lieberman, Connecticut

CONTENTS

	Page
Press release of May 12, 2005, announcing joint review	VI
Press release of May 16, 2005, announcing joint review (change of time)	VII
Opening statements	2

WITNESSES

Internal Revenue Service, Hon. Mark W. Everson, Commissioner	6
Department of the Treasury, Hon. J. Russell George, Treasury Inspector General for Tax Administration	32
IRS Oversight Board, Hon. Raymond T. Wagner, Jr., Chairman	47
Internal Revenue Service, Ms. Nina E. Olson, National Taxpayer Advocate	60
U.S. Government Accountability Office, Mr. James R. White, Director, Strategic Issues	70

JOINT COMMITTEE ON TAXATION

PRESS RELEASE

JCT Press Release: 01-05
For Immediate Release: May 12, 2005
For Further Information, Contact: John Bloyer (202) 225-3621
John.Bloyer@mail.house.gov

The Internal Revenue Service Restructuring and Reform Act of 1998 requires the Chairman of the Joint Committee on Taxation to convene a joint review of the strategic plans and budget of the IRS. The joint review is to be held before June 1 of the calendar years 1999 through 2003 and 2005. The joint review is to include two Members of the majority and one Member of the minority from each of the House Committees on Ways and Means, Appropriations, and Government Reform, and the Senate Committees on Finance, Appropriations, and Homeland Security and Governmental Affairs.

Pursuant to the IRS Reform Act, Congressman Bill Thomas, Chairman, Joint Committee on Taxation, has scheduled a joint review of the IRS strategic plans and fiscal year 2006 budget for **Thursday, May 19, 2005, in room 1100 of the Longworth House Office Building beginning at 2:30 p.m.** The joint review will be open to the public.

Witness List

Panel I:

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

Panel II:

The Honorable J. Russell George, Treasury Inspector General for Tax Administration

The Honorable Raymond T. Wagner, Jr., Chairman, IRS Oversight Board

Ms. Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service

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

JOINT COMMITTEE ON TAXATION
REVISED PRESS RELEASE -- CHANGE IN TIME

JCT Press Release: 01-05R
For Immediate Release: May 16, 2005
For Further Information, Contact: John Bloyer (202) 225-3621
John.Bloyer@mail.house.gov

Congressman Bill Thomas (R-CA), Chairman, Joint Committee on Taxation, today announced that the Committee hearing on the joint review of the IRS strategic plans and fiscal year 2006 budget previously scheduled for Thursday, May 19, 2005 at 2:30 pm in the main Ways and Means Committee hearing room, 1100 Longworth House Office Building, **will now be held at 3:00 p.m.**

All other details for the hearing remain the same. (See Joint Committee on Taxation Press Release PR01-05 dated May 12, 2005.)

JOINT REVIEW OF STRATEGIC PLANS AND FISCAL YEAR 2006 BUDGET OF THE INTERNAL REVENUE SERVICE

THURSDAY, MAY 19, 2005

HOUSE OF REPRESENTATIVES,
JOINT COMMITTEE ON TAXATION,
Washington, DC.

The Joint Committee met, pursuant to call, at 3:02 p.m., in room 1100, Longworth House Office Building, Hon. Jim Ramstad presiding.

Present: Representatives RAMSTAD, Olver, Sweeney, Miller, and Beauprez.

Senators Present: Senator Akaka.

Representative RAMSTAD. The hearing will come to order.

I want to welcome the witnesses and the Members from both the House and the Senate—Senator Akaka, it is always good to see you; and Ranking Member Olver, good to see you—to the joint hearing regarding the operations of the Internal Revenue Service.

In 1998, Congress enacted the IRS Restructuring and Reform Act, fundamentally altering the way the IRS does business. That law also made a significant change to the way Congress oversees the IRS. The act required Congress to hold joint hearings with the six House and Senate committees invited here today.

The joint review is enacted in part to address the finding of the National Commission on Restructuring the IRS that there was a lack—and I am quoting now—"a lack of coordinated focus on high-level and strategic matters," among committees responsible for IRS oversight.

The views of the Commission, in fact, are reflected in a drawing that former Senator Bob Kerrey gave to then-Commissioner Rossotti, depicting all the various entities overseeing the IRS, with arrows pointing to a bull's-eye. The caption reads, from Senator Kerrey: "Good luck in the bull's-eye."

The goal of the joint review is to replace all of these different arrows with one clear message. This will help Congress ensure that the IRS is pointed in the right direction.

Today's hearing will focus on the strategic plans and budget of the IRS. The strategic plan reflects the service's complex responsibilities. The IRS is trying to improve taxpayer service while, at the same time, enhancing the enforcement of the tax law. On top of that, it is attempting to modernize its processes and computer technology, which would help achieve the first two goals. I believe there are signs of progress in all of these areas.

The past filing season saw a record number of taxpayers file electronically. More taxpayers are getting the assistance they need through the IRS Web site. A record number of taxpayers, 46 percent more than last year, were able to file their income tax returns for free through the innovative Free File program. The IRS has announced major enforcement initiatives that have saved taxpayers billions of dollars. The IRS has begun to implement significant aspects of its business systems modernization program. These are successes.

Despite these successes, however, it is clear the IRS faces significant hurdles. For example, budgetary pressures have led the Commissioner to consider significant cuts in service including the closure of Taxpayer Assistance Centers which provide valuable in-person assistance to taxpayers around the country.

The IRS also faces challenges in implementing its modernization plans. Those plans have been scaled back significantly since they were first conceived six years ago. Given the expense of this project, we need to have confidence the Service is now on the right track.

In light of the success of the 80 percent e-filing goal in motivating the IRS, it is worth considering what other goals Congress might establish to spur the IRS to realize higher rates of taxpayer satisfaction and voluntary compliance.

We are fortunate to have with us today a distinguished group of public servants. We will hear testimony from IRS Commissioner Mark Everson, Treasury Inspector General for Tax Administration Russell George, Chairman of the IRS Oversight Board Ray Wagner, Taxpayer Advocate Nina Olson, and GAO Director for Tax Issues James White.

I have a unanimous consent request. I ask unanimous consent that joint review participants who are not able to attend today's hearing be permitted to submit written statements to be included in the record.

Without objection, so ordered.

Representative RAMSTAD. At this time I would like to call on Ranking Member Olver from the Appropriations Committee for an opening statement.

OPENING STATEMENT OF HON. JOHN W. OLVER, U.S. REPRESENTATIVE FROM MASSACHUSETTS

Representative OLVER. Thank you, Mr. Chairman. I am startled to be number two in line here, and particularly ahead of a distinguished Senator. But the orders of these things sometimes do change.

Mr. Chairman, I do believe that this is an extremely important and hopefully valuable hearing. It gives all of those involved with oversight of IRS a chance to raise questions and get answers regarding specific issues to each relevant committee.

Even though this is a different venue from the Appropriations Committee hearings that we have already had, I still have the same concerns regarding private debt collection and the budget reductions for taxpayer service.

And my concern with the private debt collection plan is that the IRS is giving away the, in quote, lowest hanging fruit, end quote,

by giving collection firms the easiest to collect receivables and allow collections vendors from, what I have heard, to keep 20 or more percent of all funds they collect. So that this has the potential of being pretty easy money for the vendors.

My second concern is that it seems the emphasis within the IRS is clearly on tax enforcement—I have no problem with that—with taxpayer service accounts receiving a 1 percent decrease in the President's budget. This budget also proposed a $55 million cut associated with the closure of up to a quarter of the 400 current Taxpayer Assistance Centers, as the chairman has already alluded to, but it didn't provide any specific details, and I really would look forward to hearing some specific details on that proposal.

We have lots that can be covered, and I will yield back the remainder of my time.

Representative RAMSTAD. The distinguished Senator from Hawaii is recognized.

OPENING STATEMENT OF HON. DANIEL K. AKAKA, U.S. SENATOR FROM HAWAII

Senator AKAKA. Thank you very much, Mr. Chairman, Chairman Ramstad from the State of Minnesota, and I am delighted to be here with you, delighted to be back on the House side for a few minutes, having served here on the Appropriations Committee for a number of years. I am pleased to join you today as we examine the Internal Revenue Service strategic plan and fiscal year 2006 budget.

A constant challenge for the IRS is to strike the appropriate balance between taxpayer services and enforcement activities to ensure that taxes are collected in a fair manner.

However, as the IRS moves forward with goals and modernization efforts reflected in a strategic plan and budget, it is leaving behind the most vulnerable, low income taxpayers who depend on quality taxpayer services.

The IRS has failed low income taxpayers by cutting essential services and facilitating the exploitation of families that earn the earned income tax credit through its support of refund anticipation loans, as we call RALs. Incredibly, interest rates on RALs can range from 97 percent to 2,000 percent. Given the limited risk and the relative bargaining positions of the taxpayers and the RAL providers, these loans are predatory.

EITC was designed to help working families meet their food, clothing, housing, transportation and educational needs. More than 4 million Americans were brought above the poverty line due to the EITC in 2002. Unfortunately, due to the prevalence of RALs, a significant amount of the EITC is lining the pockets of commercial tax preparers and affiliated banks. The EITC was diminished by an estimated $1.75 billion intended to assist low income families that instead went towards commercial tax preparers and affiliated national banks for tax assistance, electronic filing of returns, and high cost refund loans in 1999.

The excessive interest rates and fees charges on RALs are not justified because of the short length of time that these loans are outstanding and the minimal risk they present. RALs carry little risk because of the debt indicator, the DI program, which is a serv-

ice provided by the IRS that informs the lender whether or not an applicant owes Federal taxes, child support, student loans or other government obligations. This service assists the tax preparer in ascertaining the applicant's ability to obtain their full refund. The IRS should not be facilitating these predatory loans that allow tax preparers to reap outrageous profits by exploiting working families.

In 1995, the use of the DI was suspended because of massive fraud in E-filed returns with RALs. This caused RAL participation to decline. RAL prices were expected to go down as a result of the reinstatement of the DI in 1999. This has not occurred. The debt indicator should once again be stopped. The DI is helping tax preparers to make excessive profits of low and moderate income taxpayers who utilize the service. If the debt indicator is removed, then the loans become riskier and tax preparers will not aggressively market them among EITC filers. The IRS should not be aiding efforts that take the earned benefit away from low income families and allow unscrupulous preparers to take advantage of low income taxpayers.

In addition, the IRS must do more to restrict RALs by providing alternatives for consumers to receive their refunds directly in a timely manner. Simple bank or credit union accounts allow taxpayers to receive direct deposit refunds into an account without the need for a refund anticipation loan. Instead of expanding access to mainstream financial institutions, the Department of the Treasury has chosen to rescind previously appropriated funds that had been designated for the purpose of banking.

Overall, I am also disappointed over the failure to provide sufficient resources for taxpayer services. The proposed cuts for taxpayer services and outreach are, I feel, irresponsible. The Tax Code is complex, especially for low income taxpayers who are eligible for the EITC and child tax credit. These cuts will unfairly deny access to taxpayers in need of assistance. Volunteer income tax assistance, VITA, sites will not be able to replace all of the service centers, so more low income taxpayers will be driven to pay tax preparers, many who ruthlessly pedal high cost refund anticipation loans and other products with high fees.

In light of my comments, Mr. Chairman, I am interested to hear today's discussion of the strategic plans and budget of the IRS, and I thank our witnesses for joining us today. We must work together to restrict predatory RALs and expand access to mainstream financial institutions.

Mr. Chairman, I also want to applaud the National Taxpayer Advocate Nina Olson for all of her courageous work on behalf of taxpayers. In addition, I want to recognize the work done by the National Taxpayer Representative in Hawaii, Don Williams, and the rest of his staff to help our taxpayers.

Thank you so much, Mr. Chairman.

Representative RAMSTAD. The Chair thanks the distinguished Senator and welcomes him back to the House side. It is good to see you back here, Senator.

At this time the Chair would recognize the distinguished member from the Government Reform committee, the gentlewoman from Michigan.

OPENING STATEMENT OF HON. CANDICE S. MILLER, U.S. REPRESENTATIVE FROM MICHIGAN

Representative MILLER. Thank you, Mr. Chairman. I am absolutely delighted to be here with all my colleagues. I am certainly looking forward to this hearing today as well.

This is an issue that we are going to be discussing today that certainly affects every taxpayer, every business in our Nation. It is vitally important that each and every taxpayer understands the Tax Code, that each and every taxpayer has the ability to comply with the law, and certainly that they have services made available by the IRS to assist them in filling out their tax forms.

The tax gap continues to widen every year. We need to get tough on those who seek to use loopholes to abuse the system and pay less than their fair share of taxes. However, the tax gap also includes average citizens and small business owners who do not have the assistance of high-priced attorneys and accountants, and, because of this, sometimes they are unable to make heads or tails of a very complex system and the paperwork that is associated with it. And then sometimes when their taxes are due to be filed, they find that they have a huge outstanding balance that in many cases are of course very difficult for them to pay.

Another issue we will be interested in exploring today, as has already been mentioned, of course, and this is an issue of concern that is the contracting out of debt collection services to private companies, an authority that was recently granted to the Internal Revenue Service. And while some might consider this a way to close the tax gap, most of the gap is actually caused by small businesses, nonfilers, and underreporters, the debt collectors who will be used to retrieve debt from individuals who file but have not yet fulfilled their tax obligations by paying. Some may have a problem with people outside of the government dealing with personal and private tax information for citizens and businesses. And if this is to be done, it certainly needs to be handled with the utmost security and sensitivity. My preference would be to simply have a better trained IRS workforce to handle this function, but we will see how this all unfolds.

It is vitally important that the IRS take advantage of the latest technology to assist taxpayers with compliance. Having served in State government before I came to Congress here, overseeing a very out-of-date and antiquated bureaucracy, I certainly understand the importance of leveraging technology to better serve the customer, and of course in this case it is the American taxpayer. The IRS must update its technology and encourage more Americans to take advantage of E-filing and approve other services available to assist our taxpayers.

Any government agency is only as good as the people who work for that agency. You can have the best technology in the entire world, but it is always about the people. I believe in the people that work in your association and in your agency there. And these employees can only perform as well as the training that they are given and the kind of resources and tools that the Congress sees fit to provide them with. The IRS must do a better job in helping to train its workers and providing them with the tools they need to succeed, and to teach them to understand that the taxpayers are

not just people that pay their taxes but in fact they are customers. And we need to think about customer service in that agency as well as many other agencies in the Federal Government.

Customer service I think is absolutely vital. The taxpayers must know that when they contact the IRS with questions about the very confusing Tax Code that they are facing, that they can trust the answers that they are given. Far too often you hear stories told about taxpayers given improper advice or answers to questions that end up perhaps harming the taxpayers. It is also very harmful to the morale and the retention of the employees if again they don't have the tools and the information that they need to be successful in their jobs.

So I certainly see this as a partnership between the Federal Government and the agency that we need to work together there.

These reviews, as we are having here today, I think are certainly crucial for the advancement of the Internal Revenue Service. There have been tremendous strides and tremendous improvements made over the years. But my view on life, I suppose on everything, is that the largest room is always the room for improvement, and we are certainly looking forward to working with you to continue to do that, to make the tax process much more friendly, user friendly, and certainly less complicated as well.

And I am particularly interested to hear the testimony of Mr. Everson. You actually, sir, have also agreed to testify next week at a subcommittee that I chair on regulatory affairs, and we will be looking at the Paperwork Reduction Act. So we will see how you do here today before we get at you next week. But I certainly appreciate your willingness to come to that subcommittee as well and appreciate hearing your testimony today.

Thank you.

Representative RAMSTAD. The Chair thanks the distinguished member from the Government Reform Committee for her opening statement.

I now call the first panel, the Honorable Mark W. Everson, Commissioner of the Internal Revenue Service. Commissioner, welcome to the hearing. We look forward to your testimony.

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

Mr. EVERSON. Thank you, Mr. Chairman, members of the joint review. I am just sorry that Mr. Pomeroy isn't here. Last week at the ACLI Capital Challenge, that is that road race that a lot of people ran in, I am pleased to say that our team got two prizes: We got the best team spirit award and the third worst team name. That was for Team IRS Pay Your Taxes. But I owe him a congratulations, because as to the captain of his team and the captain of my team, he beat me by eight seconds. So please convey when you see him my congratulations.

Thank you for the opportunity to testify on progress in implementing our strategic plan. While much remains to be done, I believe the IRS has made progress on a number of fronts since the last joint review was conducted in May, 2 years ago.

First and most importantly, last year we issued a new strategic plan for the IRS covering the years 2005 through 2009. The three

goals of the plan are as follows: One, improve taxpayer service; two, enhance enforcement of the tax law; and three, modernize the IRS through its people, processes, and technology.

I believe we are using the plan as Congress intended when it passed the Government Performance and Results Act. It is the foundation of our management of the agency and guides our decision-making.

At this stage, just over 2 years into my 5–year term, we have made significant strides in each area. GAO states in its report issued today, first, as to service, quote: IRS's most notable progress has been in IRS's taxpayer service. And second as to enforcement, quote: IRS experienced declines in enforcement staffing after 1998, but has recently stopped the declines and begun to show increases. And, third, as to modernization: IRS has made significant progress in establishing management controls in acquiring infrastructure as part of the BSM program, as well as significant progress in addressing financial management issues.

This is good news and I am thankful for it. There isn't always good news in GAO reports. However, my old boss, Governor Daniels of Indiana, always reminded me to watch out for the "buts" that come after the comma, and there are two big buts here: GAO has placed both enforcement of tax laws and business systems modernization on its high risk list. I agree with the designation of these two challenges as of governmentwide importance.

The IRS has improved services. We are just finishing a successful filing season, one where for the first time a majority of individuals have filed their returns electronically. We will continue our emphasis on service, but on balance at this stage the greater challenge to our Nation's tax administration system are, as GAO has indicated, in the areas of enforcement and modernization.

Our enforcement activities are recovering, but given the size of the tax gap they are still at inadequate levels, and while we have finally started delivering new return processing and administrative systems, the modernization program has a lot of ground to cover. Modernization remains essential to our long-term success.

Before taking your questions, I would like to turn briefly to the subject of IRS funding. In fiscal year 2002, Congress fully funded the President's request for the IRS. In fact, the enacted appropriations level was $15 million over the request. In 2003, there was a shortfall of $81 million, and in 2004 a shortfall of $252 million. In this year, fiscal year 2005, the IRS is operating with a budget $438 million below that requested.

Sitting where I am, this is a bad trend line. Over the last 4 years, this gap is over three-quarters of a billion dollars, a figure which is compounded, as you know, by higher than requested pay increases.

I want to stress that fully funding the IRS at the President's requested level of $10.679 billion for 2006 will strengthen tax administration and help drive down the deficit. I ask your full support for this request. Thank you. I will be happy to take your questions.

[The statement of Mr. Everson follows:]

WRITTEN TESTIMONY OF MARK W. EVERSON, COMMISSIONER OF THE INTERNAL REVENUE SERVICE

INTRODUCTION

Mr. Chairman and Members of the Joint Review, thank you for the opportunity to testify today on the FY 2006 budget request, the status of our modernization program, and the 2005 tax filing season. I look forward to working with all of you as you exercise your oversight responsibilities and we ensure the fair and efficient administration of taxes. I welcome your insights and suggestions on how we can increase compliance and improve both the management and processes that guide systems modernization and the critical services we provide to America's taxpayers.

I have been on the job for over two years, yet I have only had the opportunity to appear in this forum once. I was just fifteen days into my job at that point. We have come quite a way since then. I have testified about the IRS mission of service and enforcement, and about our need to modernize. I have spoken about how the IRS was doing a good job improving service, had a mixed record on modernization, and had work to do to restore enforcement to proper levels.

Our working equation at the IRS is service plus enforcement equals compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he or she owes. This is not an issue of service OR enforcement, but service AND enforcement. As you know, IRS service lagged in the 1990s. In response, we took important and necessary steps to upgrade service—we significantly improved the answering of taxpayer telephone inquiries and electronic filing to name just a couple areas. Unfortunately, improvement in service coincided with a drop in enforcement of the tax law. After 1996, the number of IRS revenue agents, officers, and criminal investigators dropped by over 25 percent.

The President's request for the IRS for Fiscal Year (FY) 2006 is crafted to continue the necessary rebuilding of our enforcement capabilities while providing adequate funding levels for taxpayer service. And it maintains a stable commitment to our important IT modernization program. Both enforcement and modernization were categorized earlier this year by the GAO as high-risk areas of government-wide importance.

As we work to reduce the deficit and hold the line on spending, we must find ways to be more efficient with tax dollars while maintaining the quality and level of customer service that American taxpayers deserve. The President's budget request for the IRS adopts just this approach. I am comfortable with this request and support it wholeheartedly. I believe that if the budget request is enacted without constraining language, the IRS will continue to provide very good service and at a lesser cost to the taxpayer.

Today, I wish to discuss the budget request for the IRS, as well as what we have accomplished in my first few years here, particularly addressing enforcement, the area where our challenges remain the greatest. Let me first update you about the budget.

CONTINUING SERVICE AND INCREASING ENFORCEMENT

We are quite aware of the need to operate efficiently, consolidate operations and drive down costs wherever we can. In today's fiscal environment, we recognize that resources are tight. Nevertheless, we are determined to do all we can to improve service and modernize the IRS. In the last several years, we have begun to strengthen enforcement and stabilize IRS enforcement staffing; now 73 percent of taxpayers completely agree that it is every American's duty to pay their fair share of taxes, up from 68 percent in 2003. A 2004 IRS Oversight Board-commissioned NOP World study revealed 79 percent of taxpayers believe it is very important for the IRS to enforce compliance from high-income individuals and 85 percent believe it is very important for the IRS to enforce compliance from corporations. But in order to continue to bolster compliance, we must continue to use our resources wisely.

The way taxpayers pay their taxes and access IRS information is changing. In recent years, the use of IRS.gov and e-Filing has increased rapidly, while paper filing and visits to walk-in taxpayer assistance centers (TACs) have declined. In fact, this year the majority of returns were filed electronically, marking the first time in history that e-Filing has outpaced paper returns.

This shift presents an opportunity to adjust the way IRS serves taxpayers and to focus on the most efficient services. Taxpayers deserve excellent customer service, but they also deserve value for the tax dollars we are spending on their behalf. Changing the way the IRS provides customer service to meet the new ways people are dealing with their taxes in the 21st century allows us to meet the needs of taxpayers while spending their tax dollars more efficiently.

Our budget estimates all these taxpayer service reengineering initiatives will yield $134 million in savings we can reinvest in other program areas. The reductions represent a balanced approach in program delivery and service to taxpayers to enable them to meet their tax obligations.

We estimate savings of $75 to 95 million from additional efficiencies in our field assistance, accounts management and toll-free telephone operations. We will achieve these savings, in part, by reducing the number of walk-in sites. In recent years, the number of taxpayers walking into a Taxpayer Assistance Center (TAC) site for assistance has decreased from a high of nearly 10 million contacts in FY 2000 to about 7.7 million contacts in FY 2004. This trend reflects the increased availability and quality of services that do not require travel or waiting in line. Examples include improved access to IRS telephone service, the increasing availability of volunteer assistance, and the many services now available through IRS.gov, such as "Free File" and "Where's My Refund." In addition, the ability to download forms online has also contributed to the decline in the number of customers walking into a TAC. Because of these other options, fewer taxpayers need to travel to an IRS office to get the services they need.

There are currently about 400 TAC sites across the country which are serviced by approximately 2,300 TAC employees. We believe that adjusting the TAC sites to more closely align to this decreased walk-in volume will yield staffing and building cost savings of $45 to 55 million of the $75 to 95 million in savings, and allow us the flexibility to improve efficiencies.

To determine which TAC sites to close, we have developed a criteria model that measures the impact on taxpayers across the country. The criteria include: location, employee cost, facilities cost, workload, and demographic measurements. In anticipation of the closing of approximately 70 TACs, we have requested authority to offer early-outs and buy-outs to all eligible IRS TAC personnel. We expect to have further announcements in the near future.

We will achieve additional savings because of our recent consolidation of our Customer Accounts Service organizations and revamping of our business processes. For example, due to the steady decline in taxpayers corresponding with us about their accounts, we will need fewer resources to manage these accounts. We are also adjusting the hours of our toll-free telephone operations from 15 to 12 hours daily, Monday through Friday in the local times zones, beginning in 2005. We expect minimal impact to our level of service for taxpayers who call us. We have also continued to improve our telephone service for taxpayers who call the IRS with questions. The use of other service alternatives, such as volunteer return assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly (TCE) sites, has steadily increased while the number of TAC contacts has decreased. In FY 1999, for example, VITA sites filed almost 584,000 returns, and TCE sites filed 446,000 returns. In the next five years, the numbers of returns filed through these sites increased 88 percent, reaching 976,000 VITA returns and 958,000 TCE returns in FY 2004.

In addition to reducing the number of TAC sites and restructuring our telephone operations, we will save $20 to $31 million in outreach programs though reductions in printing and postage and additional efficiencies in our outreach organizations. For example, we will save money in printing and postage as taxpayers shift to e-filing, and as we eliminate redundant services and publications.

We will save another $17 to $23 million by retiring Telefile, implementing program enhancements in the processing of employment tax returns, and re-engineering processes in Submission Processing. We will redirect taxpayers who previously used Telefile to e-file alternatives, such as Free File, that are available through IRS.gov so we maintain a high level of service.

Though we are re-engineering how we provide service, we will continually strive to improve service to taxpayers. Having stated this, I must address the fundamental issue of enforcement. The President's Budget Request to Congress would increase IRS enforcement activities by 7.8 percent.

Average Americans pay their taxes honestly and accurately, and have every right to be confident that when they do so, their neighbors and competitors are doing the same. Let me provide an overview of the steps we have taken over the past year to bolster this confidence, turning briefly to each of our four service-wide enforcement priorities.

Our first enforcement priority is to discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individuals, and other contributors to the tax gap.

- In 2004, audits of high-income taxpayers jumped 40 percent from the year before. We audited almost 200,000 high-income individuals last year—double the number from 2000.

• Overall, audits for individuals exceeded the one million mark last year, up from 618,000 four years earlier.

• In 2004, the number of audits of the largest businesses—those with assets of $10 million or more—finally increased after years of decline.

The centerpiece of our enforcement strategy is combating abusive tax shelters, both for corporations and high-income individuals. I will touch upon two important initiatives of the past twelve months.

We have continued our program of settlement offers for those who entered into abusive transactions in the past but would like to get their problems behind them. Last May, we made a settlement offer regarding the Son of Boss tax shelter, a particularly abusive transaction used by wealthy individuals to eliminate taxes on large gains, often in the tens of millions of dollars. In this program, for the first time, the IRS required a total concession by the taxpayer of artificial losses claimed, plus payment of a penalty. I am pleased with the response to the offer. So far, $3.2 billion in taxes, interest and penalties have been collected from the 1,165 taxpayers who are participating in the settlement initiative. The typical taxpayer payment was almost $1 million, with 18 taxpayers paying more than $20 million each and one paying over $100 million. Processing of individual settlements continues.

Based on disclosures we have received from promoter investigations and from investor lists obtained through summons enforcement litigation, we have determined that just over 1,800 people participated in Son of Boss. When the project concludes in the coming months, we expect the collected figure from this settlement initiative should top $3.5 billion.

In February 2005, we announced a second important settlement initiative—this one involving executive stock options. This abusive tax transaction involved the transfer of stock options or restricted stock to family-controlled entities. These deals were done for the personal benefit of executives, sometimes at the expense of public shareholders. This shelter was not just a matter of tax avoidance but, in some instances, raises basic questions about corporate governance. Again, the settlement offer is a tough one: full payment of the taxes plus a penalty.

A noteworthy point about the stock option settlement offer is that our actions in this matter were closely coordinated with the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

Our settlement initiatives and increased audits have sent a signal to taxpayers: the playing field is no longer as lopsided as it once was. It is now more likely noncompliant taxpayers will have to pay the entire tax, interest, and a stiff penalty. A taxpayer might have to wrestle with questions like "how much am I going to have to pay the lawyers and expert witnesses to litigate this thing?" Moreover, going to court is a public matter. Damage to one's reputation is a potential factor. Many wealthy individuals, otherwise seen as community leaders, may not want to be identified as paying less than their fair share in taxes.

Another example of cooperation in the battle against abusive shelters is in the international arena. A year ago, I announced the formation of what has come to be known as the Joint International Tax Shelter Information Centre. Since last Labor Day, we have had an operational task force of personnel from Australia, Canada, the United Kingdom, and the U.S. working together on-site here in Washington. We are exchanging information about specific abusive transactions. Results to date are promising. Thus far, we have uncovered a number of transactions which, but for the Centre, we would have unraveled only over a number of years, if ever. It makes sense that we continue to work with other countries because, in this increasingly global economy, we are up against what is, in essence, a reinforcing commercial network of largely stateless accounting firms, law firms, investment banks, and brokerage houses.

The government stepped up its use of civil injunctions in 2001 to prohibit promoters from selling illegal tax schemes on the Internet, at seminars or through other means. Since that time, the courts have issued injunctions against more than 100 abusive scheme promoters. They have issued injunctions against 17 abusive return preparers—all permanent injunctions. And an additional 49 suits have been filed by the Justice Department seeking injunctions—28 against scheme promoters and 21 against return preparers. Injunctions issued have involved schemes such as:

• Using abusive trusts to shift assets out of a taxpayer's name while retaining control
• Misusing "corporation sole" laws to establish phony religious organizations
• Using frivolous "Section 861" arguments to evade employment taxes
• Claiming personal housing and living expenses as business expenses
• Filing tax returns reporting "zero income"
• Misusing the Disabled Access Credit

The IRS has another 1,000 investigations ongoing for possible referral to the Department of Justice; and individual examinations are being conducted on thousands of scheme participants. Most of the investigations and examinations are being conducted by the IRS Small Business/Self-Employed (SB/SE) Division.

Our second 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. Altogether, there are approximately 1.2 million tax practitioners, including return preparers. The vast majority of these practitioners are conscientious and honest, but even honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures. The tax shelter industry had a corrupting influence on our legal and accounting professions.

We have done quite a bit since March 2004 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. The IRS standards set forth rules governing what does and does not qualify as an independent opinion about a tax shelter.

Last year, the government won a series of court cases on privilege. The cases confirmed that promoters who develop and market generic tax shelters can no longer protect the identity of their clients by hiding behind a false wall of privilege.

Abusive tax shelters often flourished because penalties were too small. Some blue chip tax professionals actually weighed potential fees from promoting shelters, but not following the law, against the risk of IRS detection and the size of our penalties. Clearly, the penalties were too low. They were no more than a speed bump on a single-minded road to professional riches.

But these speed bumps have become speed traps. Last fall, Congress enacted and the President signed into law, the American Jobs Creation Act. The legislation both created new penalties and increased existing penalties for those who make false statements or fail to properly disclose information on tax shelters. Under the new law, the IRS can now impose monetary penalties not just on tax professionals who violate standards, but also on their employers, firms, or other entities if those parties knew, or should have known, of the misconduct.

Our third enforcement priority is to detect and deter domestic and off-shore based criminal tax activity and related financial criminal activity.

Last year, the IRS referred more than 3,000 cases to the Justice Department for possible criminal prosecution, nearly a 20 percent jump over the previous year. We continue our active role in the President's Corporate Fraud Task Force. We are going after promoters of tax shelters—both civilly and, where warranted, criminally. This tactic is a departure from the past. Previously, during a criminal investigation, all civil activity came to a halt. The result was that in the past, our business units were reluctant to refer matters for criminal investigation lest they lose their traditional turf. But, we are now moving forward on parallel tracks with the Department of Justice. We have a number of important criminal investigations underway. The enforcement model is changing.

Our fourth enforcement priority is to discourage and deter noncompliance within tax-exempt and government entities, and misuse of such entities by third parties for tax avoidance purposes.

Consider, for example, certain credit counseling agencies. Increasingly, it appears that some credit counseling organizations have moved from their original purposes, that is, to counsel and educate troubled debtors, to inappropriately enrolling debtors in proprietary debt-management plans and credit-repair schemes for a fee. These activities may be disadvantageous to the debtors and are not consistent with the requirements for tax exemption. Further, a number of these organizations appear to be rewarding their insiders by negotiating service contracts with for-profit entities owned by related parties. Many newer organizations appear to have been created as a result of promoter activity.

Some shelter promoters use tax-exempt organizations to create abusive shelters. In some cases, the organization receives a fee for allowing the promoter to exploit its tax-free status. A tax-exempt organization that participates or allows itself to be used in an abusive transaction may be inappropriately trading on its privileged tax-exempt status.

It is heartening to see leading members of the nonprofit community taking steps to address abuses. I particularly want to salute the Independent Sector—which recently delivered a constructive report to the Senate Finance Committee. The report states that "government should ensure effective enforcement of the law" and calls for tougher rules for charities and foundations. The report calls for stronger action by the IRS to hold accountable charities that do not supply accurate and timely public information. I encourage the accounting, legal, and business communities to be

as enthusiastic about confronting abuses and the erosion of professional ethics as the nonprofit community. An interesting point to note is that the report supports mandatory electronic filing of annual information returns by all nonprofits.

The focus on problems with compliance we are now encountering in the tax-exempt sector should not overshadow the inspiring work the charitable community does day in and day out. The overwhelming majority of these organizations try hard to comply with the letter and spirit of the tax law. But we recognize tax abuse is increasingly present in the sector, and we intend to address it. We are augmenting our resources in the nonprofit area. By the end of September, we will have increased the number of our personnel who audit tax-exempt organizations by over 30 percent from two years earlier. If we do not act expeditiously, there is a risk that bad actors who abuse tax benefits for charities will tarnish those charities that do good work. If that happens, Americans may be more reluctant to give and those in need will suffer.

As we move forward with these priorities, we will leverage our success to achieve greater results within our FY 2006 budget request.

BUDGET RESTRUCTURE

To facilitate full alignment and integration of the Service's goals and measures with its resources, we are proposing to restructure our budget beginning in FY 2006. This restructuring will facilitate a more accurate assessment of the overall value of IRS programs, simplify the full costing of programs, and allow the IRS to demonstrate incremental increases in an initiative's effectiveness based on the level of funding received.

In addition, this new budget structure will enable us to manage activities more effectively. The normal processing of tax returns generally proceeds from pre-filing activities to filing activities, and finally to compliance activities, should they prove necessary. Although these activities are interrelated, we currently distribute their resources among three appropriations, with unevenly distributed support costs. This system makes it difficult to manage, track, and report the full cost of a given taxpayer service or enforcement program.

This new budget structure will enable us to prepare a true performance-based budget by providing the capability to integrate operational and support costs into one appropriation, thereby allowing us to cost budget activities and programs fully for the first time. The new structure will also facilitate the full incorporation of performance measures into the budget, as the measures could be tied to funds in one appropriation rather than a series of program activities dispersed across multiple appropriations. The proposed new budget structure will allow stakeholders to assess more accurately the overall value of IRS programs, and make program reviews, such as the Office of Management and Budget's Program Assessment Rating Tool (PART), more effective, thus providing greater accountability and results-oriented management focus.

The proposed budget structure combines the three major appropriations accounts—Processing, Assistance and Management (PAM); Tax Law Enforcement (TLE); and Information Systems (ISY)—into one appropriation called Tax Administration and Operations (TAO).

The taxpayer service and enforcement programs of the TAO appropriation are divided among eight critical program areas. These budget activities focus on Assistance, Outreach, Processing, Examination, Collection, Investigations, Regulatory Compliance, and Research. Full funding for each activity will be reflected in the budget, along with key performance measures. As we continue to move toward the development and implementation of this new structure, we will refine these program areas and the associated resource distributions to provide more accurate costing.

Let me now provide more details on the budget request for the IRS.

PRESIDENT'S FY 2006 BUDGET SEEKS INCREASE IN ENFORCEMENT TO ADDRESS GROWING TAX GAP

The President's fiscal year 2006 budget requests $10.7 billion for the IRS, a 4.3 percent increase over the fiscal year 2005 enacted level. This request represents a 1 percent decrease in Taxpayer Service and a 2 percent decrease in Business Systems Modernization (BSM), but a nearly 8 percent increase in enforcement.

This budget includes $265 million for initiatives aimed at enhancing the enforcement of tax laws. This request is above the increases to fund the pay raise and other cost adjustments ($182 million), for a total of $446 million for new enforcement investments and cost increases. It is important the Congress fully fund these cost increases and new enforcement investments. The President's budget proposal to fund

them through an adjustment to the discretionary caps reflects the importance of this investment to the Administration.

To ensure full funding of the new enforcement investments, the budget proposes to employ a budget enforcement mechanism that allows for an adjustment by the Budget Committees to the section 302(a) allocation to the Appropriations Committees found in the concurrent resolution on the budget. In addition, the Administration will also seek to establish statutory spending limits, as defined by section 251 of the Balanced Budget and Emergency Deficit Control Act of 1985, and to adjust them for this purpose. To ensure full funding of the cost increases, either of these adjustments would only be permissible if the Congress funds the base level for IRS enforcement at $6.4 million and restricts the use of the funds to the specified purpose. The maximum allowable adjustment to the 302(a) allocation and/or the statutory spending limit would be $446 million for 2006, bringing the total enforcement level in the IRS to $6.9 million.

We will use the additional funds for enforcement in several key ways to combat the tax gap, the difference between what taxpayers are supposed to pay and what they actually do pay, due to non-filing, underreporting, and nonpayment. Combating tax non-compliance is a top priority for us. Americans deserve to feel confident that when they pay their taxes, their neighbors and competitors are doing the same. These investments will yield substantial results. Even though we have increased the focus on specific areas of noncompliance, the tax gap increased slightly to between $311 billion and $353 billion in tax year 2001. IRS enforcement activities, coupled with late payments, recover about $55 billion of the tax gap, leaving a net tax gap of between $257 billion and $298 billion.

Since 2001, the year covered by the National Research Program (NRP) three-year study in which we audited 46,000 individual income tax returns, we have taken a number of steps to bolster enforcement. We increased our enforcement revenues by nearly 28 percent from $33.8 billion in 2001 to $43.1 billion in 2004. Audits of high-income taxpayers—those earning $100,000 or more—topped 195,000 in fiscal year 2004, which is more than double those conducted in 2001. Total audits of all taxpayers topped 1 million last year—a 37 percent jump from 2001.

We are ramping up our audits on high-income taxpayers and corporations, focusing more attention on abusive shelters and launching more criminal investigations. We recently announced we collected $3.2 billion in the settlement initiative for Son of Boss, a particularly abusive tax shelter.

Our enforcement efforts are designed to increase compliance and reduce the tax gap.

The preliminary results of the NRP determined a range for the tax gap, which will be refined into final, more detailed estimates by year-end 2005. It is unlikely but possible that the final estimates of the total tax gap will fall outside the established range. We need to continue our efforts in these areas and increase the investment in these areas.

We need to enforce the law so that when Americans pay their taxes, they are confident that everyone is paying his or her fair share. At the same time, the research underscores the President's call for fundamental tax reform and simplification. Complexity obscures understanding. Complexity in the tax code compromises both the service and enforcement missions of the IRS. Those who try to follow the law but cannot understand their tax obligations may make inadvertent errors or ultimately throw up their hands and say "why bother." Meanwhile, individuals who seek to pay less than what they owe often hide behind the tax code's complexity in order to escape detection by the IRS and pay less than their fair share.

The IRS yields more than four dollars in direct revenue from its enforcement efforts for every dollar invested in its total budget. In FY 2004, we brought in a record $43.1 billion in enforcement revenue—an increase of $5.5 billion from the year before, or 15 percent. Beyond the direct revenues generated by increasing audits, collection, and criminal investigations, our enforcement efforts have a deterrent effect on those who might be tempted to skirt their tax obligations.

The nearly 8 percent increase for enforcement activities in the Administration's 2006 IRS budget request will increase audits of corporations and high-income individuals as well as expand collection and criminal investigation efforts.

DETAILED BUDGET SUMMARY

Our FY 2006 request of $10.7 billion includes a transfer from the Justice Department of $53.9 million and 329 FTE for our portion of the Interagency Crime and Drug Enforcement (ICDE) appropriation, $277.6 million for a 2.3 percent pay raise and non-labor inflationary costs, and $264.6 million for initiatives aimed at enhancing our enforcement efforts. This request also includes a $22 million rent reduction

to result from consolidation of space, and the $134.1 million reduction to taxpayer service activities that we will responsibly leverage through productivity improvements and program reengineering, as previously discussed. We will take a balanced approach to these targeted reductions.

In addition to the taxpayer service reengineering initiatives, we also expect to continue to realize savings, which we will reinvest to other key areas, through the following other reengineering initiatives:

• Savings from Increased Individual Master File (IMF) E-Filing (Reduction: −$7,700,000 and −190 FTE; Reinvestment: +$7,600,000 and +12 FTE): This savings is based on processing efficiencies from the projected decrease in IMF paper returns and processing costs for electronically filed IMF returns in Submission Processing Centers. These savings will be reinvested to enable us to continue our consolidation of IMF returns processing into fewer Submissions Processing sites.

• Consolidation of Case Processing Activities to Maximize Resources Devoted to Front-Line Operations (Reduction: −$66,654,000 and −649 FTE; Reinvestment: +$66,654,000 and +585 FTE): Staffing for conducting case processing activities that support our examination, collection and lien-processing programs will be consolidated from nearly 100 sites and centralized among four campuses (Philadelphia, Cincinnati, Ogden and Memphis).

• Consolidation of Insolvency Activities to Maximize Resources Devoted to Front-Line Operations (Reduction: −$14,928,000 and −134 FTE; Reinvestment: +$14,928,000 and +156 FTE): Staff conducting insolvency operations to protect the government's interest in bankruptcy proceedings will be consolidated from numerous sites and centralized at the Philadelphia campus.

• Detection and Deterrence of Corrosive Corporate Non-Compliance (Reduction: −$6,711,000 and −52 FTE; Reinvestment: +$6,711,000 and +52 FTE): By using improved issue-management and risk-assessment strategies for examining corporations, the IRS expects to realize productivity improvements. These savings will be reinvested to fund front-line enforcement activities.

Finally, the FY 2006 request includes several program increases, totaling $264.6 million:

• Attack Corrosive Non-Compliance Activity Driving the Tax Gap (+$149,700,000 and +920 FTE): This initiative increases coverage of the growing number of high-risk compliance problems and addresses the largest portion of the tax gap—underreporting of tax. It proposes a funding increase across all major domestic and international compliance programs to leverage new workload-selection systems and case-building approaches from continuing reengineering efforts.

• Detect and Deter Corrosive Corporate Non-Compliance (+$51,800,000 and +236 FTE): This initiative addresses complex, high-risk issues in abusive tax avoidance transactions, promoter activities, corporate fraud, and aggressive domestic and offshore transactions, resulting in increased corporate and high-income return closures and audit coverage. This initiative also includes critical post-filing support provided by outside experts to expedite the resolution of issues at the field examination level, reducing taxpayer burden, and increasing the credibility of the Service's positions on the most complex and potentially highest compliance impact issues sent to court.

• Increase Individual Taxpayer Compliance (+$37,900,000 and +417 FTE): This initiative addresses the tax gap through: the identification and implementation of actions needed to address non-compliance with filing requirements; increased Automated Underreporter resources to address the reporting compliance tax gap; increased audit coverage; and expanded collection work in Taxpayer Assistance Centers.

• Combat Abusive Transactions by Entities with Special Tax Status (+$14,460,000 and +77 FTE): This initiative focuses on the most egregious cases of non-compliance and identifies compliance risks sooner, reducing burden on compliant customers and enabling the development of new interventions to curtail the growth of abusive transactions.

• Curtailing Fraudulent Refund Crimes (+$10,772,000 and +22 FTE): This initiative is aimed at attacking the increased questionable refunds and return preparer fraud identified through expanded operations of the Fraud Detection Centers located on IRS campuses. Fraudulent refund schemes are one of the most serious threats to voluntary compliance and an IRS investigative priority.

The FY 2006 request of $10.7 billion funds the IRS' three appropriations: Tax Administration and Operations (TAO) for operations, service and enforcement; Business Systems Modernization (BSM) for modernization; and, the Health Insurance Tax Credit (HITCA) for administering a refundable tax credit for qualified individuals. I will describe each in turn.

TAX ADMINISTRATION AND OPERATIONS (TAO)

For FY 2006, we request funding of $10,460,051,000, an increase of 4.6 percent over the FY 2005 appropriation of $9,998,164,640 for programs previously funded from the PAM, TLE, and ISY appropriations.

The TAO appropriation provides resources for the IRS' service and enforcement programs. The IRS is responsible for ensuring that each taxpayer receives prompt and professional service. To that end, the IRS' assistance, outreach, and processing activities funded in the TAO appropriation are dedicated to providing assistance to taxpayers in all forms—electronic interaction, published guidance, paper correspondence, telephone contact, and face-to-face communication—so that taxpayers may fulfill their tax obligations timely and accurately. It also includes the resources the IRS requires to handle the processing and disposition of tax returns, refunds, and other filing materials.

We are also responsible for the fair enforcement of the nation's tax laws. Each year, a small percentage of taxpayers file erroneous returns or, for reasons both innocent and less benign, fail to file a return at all. The IRS conducts enforcement activities using a variety of methods, including correspondence audits, matching reporting documents (such as Forms W–2) to information on taxpayer returns, in-person audits, criminal investigations of those suspected of violating tax laws, and participation in joint governmental task forces. The IRS' examination, collection, investigations, regulatory compliance, and research activities funded in the TAO appropriation provide the resources required for equitable enforcement of the tax code and the investigation and prosecution of individuals and organizations that circumvent tax laws.

HEALTH INSURANCE TAX CREDIT ADMINISTRATION (HITCA)

In August 2002, the President signed Public Law 107–210, the Trade Act of 2002, which, among other things, provides a refundable tax credit for the cost of health insurance for certain individuals who receive a trade readjustment allowance or a benefit from the Pension Benefit Guaranty Corporation (PBGC). The Health Insurance Tax Credit Administration (HITCA) Appropriation funds the costs to administer a refundable tax credit for health insurance to qualified individuals. The tax credit is equal to 65 percent of the health insurance premium paid by eligible persons for themselves and qualifying family members. For FY 2006 we request funding of $20,210,000, a decrease of 41.5 percent below the FY 2005 appropriation of $34,562,272. Costs for the HITCA program have declined since implementation due to our active program oversight and management, as well as several cost-cutting initiatives we began to implement in March 2004. We developed a comprehensive action plan outlining cost-reduction initiatives and are following it to achieve these significant savings.

BUSINESS SYSTEMS MODERNIZATION (BSM)

The IRS tax administration system, which collects $2 trillion in revenues annually, is critically dependent on a collection of 40-year-old, obsolete computer systems. Recognizing the long-term commitment needed to solve the problem of modernizing these antiquated systems, Congress and the Administration created a special business systems modernization account. They designed the BSM program to bring the IRS' business systems to a level equivalent with best practices in the private and public sectors while managing the risks inherent in a program that is unquestionably one of the largest, most visible, and most sensitive modernization programs ever undertaken.

Our most successful year ever for the modernization program was 2004; however, we realize one successful year does not a successful program make. The slow ramp-up of our modernization efforts, caused by many factors including a lack of adequate technical and application engineering, program complexity, immature management processes, infrastructure instability and role confusion between the IRS and our PRIME contractor, Computer Sciences Corporations (CSC), caused us to deliver projects late and over budget. When I came onboard in 2003, I reorganized the IRS to provide greater focus and accountability in modernization by creating and appointed a Deputy Commissioner for Operations Support. Because of this focus, we have begun to see real progress in delivering projects with business value.

In 2004, we measured our success by the number of projects we delivered, the schedule and cost targets we hit, and the substantial improvements we made in program management.

We delivered the first release of the Customer Account Data Engine (CADE) project in July 2004, allowing the IRS to process an initial set of the simplest tax

returns on a new computer system for the first time in 40 years. We launched IRS' new Integrated Financial System (IFS), and declared it the IRS' financial accounting system of record. IFS will provide the capability for improved timeliness and accuracy of the financial reports and information available to IRS management and key stakeholders, facilitating continued clean financial audit opinions of the IRS. We deployed a full suite of e-Services products, providing tax professionals and businesses with new Web-based tools that dramatically improve their interface with the IRS. Additionally, we released Modernized e-File, whereby corporations and tax-exempt organizations can file their annual income tax and information returns electronically.

Regarding the BSM budget, in 2004, the modernization budget was $387 million. Based on the challenges the modernization program was facing, we realized the program needed to be smaller in 2005 so we requested a lesser budget of $285 million. In the end, Congress appropriated $203 million. One of the ways we are accommodating these changes is by substantially lowering the costs of the core infrastructure as well as the architecture, integration, and management parts of the BSM program in 2005. These two areas are the programmatic elements of the program, and cost $160 million in FY 2004. We certainly cannot justify that level of continued investment for a program that is roughly $200 million. Therefore, we are dramatically reducing those core services to $107 million in FY 2005 and we anticipate making additional reduction in FY 2006. For FY 2006, we request funding of $199 million for all BSM activities, substantially the same funding as the FY 2005 appropriated level. This funding level allows us to focus on on-going projects to ensure they deliver the functionality we planned.

In FY 2005, BSM continues to build and improve upon our success by delivering projects, attaining cost and schedule targets, realizing benefits to taxpayers, and improving BSM program management capabilities. BSM delivered all projects and releases planned for the first half of FY 2005 on time, on budget, and met or exceed scope expectations.

In terms of improving program management, we identified four key areas that we had to address to enhance the performance of the modernization program:

- Resizing our modernization efforts to better align with our management and skill capacity;
- Engaging IRS business units to drive the modernization projects with a business focus;
- Improving contractor performance on cost, schedule, and functionality; and
- Hiring outside executives to achieve a better balance between large project management and tax administration experience.

We have made significant progress in addressing each of these major challenges.

First, the IRS will concentrate on a few key projects and will develop a track record of improved management and successful delivery of modernization projects.

Second, the IRS assigned a business unit leader to each project with responsibility for leading the related BSM Governance Committee, and sharing accountability for delivering the modernization project as stated in their annual performance commitments.

Third, we are making real progress in improving the accountability of the PRIME contractor. I meet monthly with the Chief Operating Officer of CSC to reinforce the accountability of the contractor to the IRS. Additionally, we have made major progress in restructuring BSM project contracts with the PRIME that shift an appropriate amount of financial risk to the contractor and tie costs to performance. These steps have resulted in improved contractor performance, as demonstrated in the deliverables in 2004 and the general adherence to costs and schedules.

Fourth, we have made great progress in hiring experienced executives and seasoned managers from outside the agency who have expertise in running large-scale information technology programs and projects. A little over a year ago the mix of leadership at the top of the BSM program consisted of one outside expert and six internal IRS executives. Today, that mix is four outside experienced outside experts and three internal IRS executives. This mix is a much better balance of the project management and technology talent and tax administration experience needed to successfully run the BSM program.

As I said earlier, while we were very successful in 2004, we have a lot of work ahead of us. It is critical that we continue this level of performance in 2005 and beyond.

Our focus for FY 2005 is on maintaining substantial modernization work for three key tax administration systems that will provide additional benefits to taxpayers and IRS employees, specifically:

- The Customer Account Data Engine (CADE) project;
- Modernized e-File; and

- Filing and Payment Compliance (F&PC).

CADE

CADE replaces the IRS' antiquated system called the Master File which is the Service's repository of taxpayer information. With CADE being the core fundamental component of the modernized systems, it is the IRS' highest priority technology project. It will be the single authoritative repository for account and return data.

We cannot over-emphasize the importance of CADE. The current Master Files have served the IRS for more than 40 years. However, they were developed in a different era and rely on an obsolete programming language and a flat-file system that still requires batch updates. These systems are very expensive to maintain; development of new applications costs the IRS two to three times what it would cost if they were already retired. Yet the IRS must update the Master Files every year to take into account tax law changes. As importantly, the vast majority of the workforce who are familiar with these old systems will be retiring over the next few years and we cannot hire individuals with these obsolete skills. Until the Master Files are replaced, the IRS can not offer service approaching what a typical financial services firm offers today (such as full account views for employees and real-time account updates and settlement).

The returns we are processing in CADE are the most basic of 1040EZ forms and have a narrow range of taxpayer information, but it marks the first time since the 1960s that the IRS has processed individual tax returns in a new way. The success of CADE proves that we can deliver technology that will process tax returns on a 24-hour cycle, breaking the 40-year old standard of processing on a weekly cycle. As of April 27, 2005, CADE had processed over 1.3 million returns and generated over $402 million in refunds to taxpayers. This achievement is significant. With the FY 2006 funding request, we plan to undertake improvements that will allow us to process 33 million returns by the FY 2007 filing season.

The CADE system is scheduled to be phased in over several years, processing increasingly more complex tax returns. When fully operational, CADE will be a modern database that will house tax information for more than 200 million individual and business tax returns. It will provide a variety of benefits to taxpayers, such as faster refunds (by over 50 percent) along with daily postings of transactions and updating accounts, which (with other technology elements) will significantly improve customer service and enforcement. With CADE, we will have the flexibility necessary to respond quickly to our complex tax law and tax reform changes.

One of the most significant changes that we introduced in 2004 was the segmentation of CADE releases into two annual deliveries—one in July and one in January. The July delivery will involve higher risk, more complex functionality, and the January delivery will include filing season changes combined with additional changes as capacity permits. For the July release, returns will be available from the previous six months which will enable us to test the higher risk, complex changes with high volumes, and then go live with reduced volumes, which will mitigate the operational risks. Based on our current planning, we anticipate having all individual returns processed by CADE by the year 2012.

Modernized e-File (MeF)

In FY 2004, the IRS successfully introduced e-filing to large corporations and tax-exempt organizations. These taxpayers now file their annual income tax and information returns electronically without an intermediary, significantly reducing time to file Forms 1120 and 990. MeF electronically captures 100% of the tax return information submitted by a taxpayer/practitioner, including third-party documents such as appraiser statements and state documents required at time of submission. This change is significant progress since with paper returns, the IRS can only transcribe a fraction of Form 1120 and Form 990 return data. MeF also improves communication with tax practitioners through near real-time return receipt acknowledgements, streamlined error detection, and standardization of business rules and requirements across form types. MeF is an efficient and effective way of providing data requested by tax practitioners and is required for maintaining tax audit effectiveness.

In January 2005, MeF Release 3.1 deployed Form 7004 (filing extension for corporations), Form 990PF (information return for private foundations), and tax law changes for filing season 2004. This allowed the IRS to establish regulations requiring large corporations and tax-exempt organizations to electronically file their income tax or annual information returns beginning in 2005. To date, MeF is processing 1120 and 990 returns at higher than expected volumes while still achieving

performance goals—a significant reduction in burden and time for corporate and tax-exempt taxpayers.

MeF releases funded in FY 2005 will provide an interface with state tax information retrieval systems. Adding capabilities for major corporations and tax exempt organizations to file Federal and State returns jointly with single point electronic transmission and acknowledgements will reduce taxpayer burden and simplify filing processes. MeF will also offer a Web Services interface. By FY 2007, the IRS expects more than 20,000 large corporate taxpayers and up to 10,000 tax-exempt entities will be covered by the electronic filing requirement. The use of electronic filing technology will also help improve service and enforcement missions.

Despite MeF's success, the benefits of electronic filing are not yet available to all taxpayers. Small businesses, self-employed taxpayers and some governmental entities cannot yet interface with the IRS in a manner consistent with their operational environments. During the next few years, it is our plan to extend the MeF architecture for 1065s (Partnership Income), 1041 (Estates and Trusts), 940 (Employer's Unemployment Tax Return), and 941 (Employer's Quarterly Federal Tax Return), with an ultimate goal of conversion of the legacy 1040 e-file program. Adding 1065 form processing will enable the small business community, estimated at 2.68 million in 2005, to realize the same benefits experienced by large corporations and tax exempt organizations. The volume of small business community response is expected to exceed that seen from large corporations.

Filing and Payment Compliance/Private Collection Agencies

In 2004, Congress passed and the President signed into law, the American Jobs Creation Act, a provision of which allows the IRS to use Private Collection Agencies (PCAs). The legislation authorized the IRS to augment our collection efforts by allowing us to use PCAs to pursue what has been deemed as uncollectible tax liabilities; these agencies will not have enforcement authority and will only contact delinquent taxpayers to arrange voluntary, full-payment installment agreements. We will use the Filing and Payment Compliance (F&PC) system to analyze tax collection cases and divide the complex cases requiring direct IRS involvement from the simple "balance due" cases that can be handled by PCAs.

The current volume of delinquent taxpayers exceeds the IRS' capacity and results in a serious backlog of collection cases that cannot be adequately addressed without additional resources. This backlog of collection cases creates both a lost revenue opportunity and undermines the fairness of the tax system. Today's IRS collection operations rely on 20-year-old technology and 30-year-old processes no longer compatible with the realities of today's taxpayer environment. The GAO noted significant declines between 1996 and 2001 for staff time, productivity and the amount of unpaid taxes identified, collected and resolved. The GAO noted the number of pending tax delinquent investigations rose 430 percent since 1997, while the number of confirmed tax delinquent accounts "in queue" (awaiting staff attention), rose 54 percent.

F&PC will enable taxpayers and practitioners to conduct IRS business over the Internet, for issues which previously required direct IRS employee interaction (telephone or paper correspondence), thus providing better access to government services on a 24/7 basis. F&PC will provide support for detecting, scoring, and working nonfiler and delinquency cases through advanced state-of-the-art case selection methods. This capability will improve prioritization of delinquent case inventories, improve case selection, and optimize collection and resolution rates.

F&PC Release 1.1 will analyze tax collection cases and separate complex cases requiring direct IRS involvement from those that can be handled by PCAs. The passage of the enabling legislation allowed BSM to restart F&PC activities in FY 2005. F&PC will use FY 2004 funding during FY 2005 to complete architecture engineering analysis, and development of a limited functionality release to allow initial competitive outsourcing of collection activities, with a planned operational debut of January 2006.

Future F&PC releases will increase enforcement by developing targeted treatment streams for delinquent tax cases at various stages in the collection process, which reduces the volume of cases requiring more cost intensive attention in back-end collection processes. Subsequent releases will further enhance capabilities such as an electronic inventory management, case selection and segmentation, electronic data interchange with PCAs, enhanced reporting, monitoring and control capabilities.

F&PC meets the President's Management Agenda (PMA) under the government-wide initiative for expanded e-Government and aligns with the "Government to Citizen" profile by posting information that allows citizens to access delinquent tax accounts, and offering instructions on how to resolve unpaid tax balances.

IRS PROGRAM PERFORMANCE

The IRS expects to achieve the following levels of performance after attaining full performance of the requested FY 2006 initiatives:

• Increase in field examinations for high-income individuals with complex returns; significant increase in collection processed; and closing of over 40 percent more delinquent balance-due accounts in FY 2008 than in FY 2004.

• Nearly double the audit coverage for individuals with income between $250,000 and $1 million, from 1.5 percent in FY 2004 to 2.8 percent in FY 2008.

• Auditing 15 percent more individuals earning above $1 million, from 3.4 percent projected for FY 2004 to 3.9 percent in FY 2008.

• Significantly more collection cases processed, closing 50 percent more delinquent accounts in FY 2008 than FY 2004.

• Double the audit coverage for mid-size corporations, from 7.6 percent in FY 2004 to 16 percent in FY 2008.

• Increased efforts to deter abusive tax shelters among corporations.

Let me now talk to you about our current levels of service. By service, I mean helping people understand their tax obligations and making it easier for them to participate in the tax system.

The IRS has greatly improved service to our nation's taxpayers over the last several years. We are delivering services to taxpayers and we have improved the efficiency and effectiveness for our tax administration system.

CUSTOMER SATISFACTION

The American Customer Satisfaction Index (ACSI), which began in 1994, is a measure of customer satisfaction that covers seven economic sectors, 40 industries, more than 200 private sector companies, and many governmental agencies. Scores are reported on a 0 to 100 scale based on survey data from consumer households across the nation. The ACSI is produced by the National Quality Research Center at the University of Michigan Business School, the Claes Fornell International (CFI) Group, and the Federal Consulting Group (FCG). Claes Fornell, Chairman of the CFI Group, recently praised our progress. He said,

"The Internal Revenue Service (IRS) continues to improve its services. The IRS is obviously in a special category when it comes to the satisfaction of the people it deals with, and cannot be compared with the private sector or even with most public sector services. The collection of taxes is not an activity that taxpayers look forward to or expect a great deal of satisfaction from. But even in the face of this handicap, the IRS continues to improve on taxpayer satisfaction. Since 1999, IRS' overall ACSI score has surged by 26%. While the rate of the improvement has slowed recently, it is clear that a good deal of this increase is attributable to electronic filing. Filers find it convenient, accurate, and refunds are delivered quickly. The satisfaction score for electronic filing stands at a remarkable 78, compared with paper filing at 52. The more tax filers the IRS manages to move from paper to electronic filing, the more customer satisfaction can be expected to increase."

RETURN RECEIPTS/ELECTRONIC FILING

Electronic filing continues to grow. Last year, individuals filed over 61 million electronic returns. This year, over half of all individual returns were be e-filed. Individuals who file paper tax returns are now in the minority. We take every opportunity we can to broadcast the benefits of electronic filing, including a reduction in processing errors and cost savings for taxpayers and the IRS. E-filing is fast, convenient, and gets your refund to you in half the time of paper returns.

As of May 6, 2005, we have received more than 122.1 million total individual returns. 66.1 million returns (54.1 percent) are electronically filed and 55.9 million (45.8 percent) are paper.

• The number of online returns is 16.7 million, a 17.2 percent increase from last year.

• Through April 28, 2005, 5 million Free File returns have been accepted, an increase of 46.6 percent from last year.

• We have issued 88.6 million refunds, with an average refund of $2,113 paid.

IRS.GOV

Use of our website, IRS.gov, has exceeded 134.6 million homepage visits, up 66.3 percent from 2004. Not surprisingly, during the filing season, it is one of the busiest websites in the world. We average more than one million visits a day. Many of those visits are to the "Free File" page, which allows taxpayers visiting the website to chose among several free, online filing options. As of May 7, nearly 18.9 million tax-

payers used the "Where's my Refund" feature on the web page, an increase of 52 percent from the same time last filing season. These visits decrease the need to visit a Taxpayer Assistance Center (TAC), or to call our operators, which allows them to focus on more complex calls. During the past year, we have also rolled out important new online services to tax professionals to help them better serve their clients. Tax practitioners and other third parties, such as banks and brokerage firms that file 1099s, may now access the following functionalities online: electronic account resolution, transcript delivery, secure email, disclosure authorization, and bulk Taxpayer Identification Number (TIN) matching. In fact, as of May 9, 2005, for the fiscal year tax practitioners submitted 3,370 cases for Electronic Account Resolution, 62,737 requests for transcripts, 28 million Bulk TIN matching requests, and over 15,000 powers of attorney or disclosure authorizations.

TELEPHONE SERVICE

Our efforts to improve call routing, as well as staffing and training of phone assistors have allowed us to dramatically improve service. In filing season 2005, we are maintaining the level of service that our customers have come to expect from us.

As recently as fiscal year 2002, the level of service for those taxpayers who want to speak to an assistor was 68 percent. Our improvement efforts raised the level to 80 percent in 2003 and to an all-time high of 87 percent in 2004.

In FY 2004, the number of taxpayers receiving busy signals decreased to 220,000, a 66 percent reduction from the previous year. And, that is a reduction of 99.5 percent from the 2.6 million busy signals generated as recently as FY 2002.

Our telephone service—that is, answering questions from taxpayers—continues to improve. We measure telephone quality two ways, 1) customer account accuracy and 2) tax law accuracy. For the filing season, our customer account accuracy is 91.6 percent, up from 89.3 percent; our tax law accuracy has improved from 77.7 percent in 2004 to 88 percent in 2005.

LEGISLATIVE PROPOSALS

The President's FY 2006 request includes several proposals that will assist me in managing the agency more efficiently and effectively. These proposals, if enacted, will allow us to focus more resources on high-income, high-risk areas, automate several routine transactions, use electronic data to reduce costly manual transactions, consolidate resources related to judicial and counsel review, and broaden administrative authorities and accesses to support further electronic administration and tax reform. We are seeking to:

- Make Section 1203 of the IRS Restructuring and Reform Act of 1998 more effective and fair;
- Curb the use of frivolous submissions and filings made to impede or delay tax administration;
- Allow for the termination of installment agreements for failure to file returns and for failure to make tax deposits;
- Consolidate judicial review of collection due process cases in the United States Tax Court;
- Eliminate the monetary threshold for counsel review of offers in compromise;
- Allow the Financial Management Service to retain transaction fees otherwise paid from IRS appropriations from levied amounts to recover delinquent taxes;
- Extend the due date for electronically filed returns to provide additional incentive for taxpayers to e-file and expand the authority to require electronic filing by businesses and exempt organizations; and,
- Allow IRS to access information in the National Directory of New Hires for tax administration purposes.

CONCLUSION

The IRS is committed to continuing to improve service and respect taxpayer rights while enforcing the law.

Mr. Chairman and Members of the Joint Review, the great majority of Americans honestly and accurately pay their taxes. Average Americans deserve to feel confident that, when they pay their taxes, their neighbors and competitors are doing the same.

The President's budget request will help us enforce the tax law more fairly and efficiently. I am most grateful for your support of increased enforcement, and I look forward to working with you on this important budget request.

Thank you very much. I am happy to take your questions.

Representative RAMSTAD. Thank you, Commissioner, for your testimony and for doing a tough job well.

Let me ask you, Commissioner, my friend from Massachusetts has referred to the limited number of cases that will be delegated to private collection agents as low hanging fruit that will be easy to collect. It is my understanding that private collection agencies have better access to technology that will help them locate taxpayers; and, further, the more complex tax cases where the amount of tax owed is disputed will be reserved for IRS employees. It seems to me to make sense to delegate the less complex cases to the private sector and delegate the tougher cases to IRS employees because they have the expertise and the enforcement power.

Do you agree with that?

Mr. EVERSON. Yes, sir, I do. I want to note, however, I totally agree with Mr. Olver. I mean, if we had limitless funding, of course it would make more sense to have the IRS employees do this work. But as I just indicated, talking about the funding, the budgets that we actually get, don't afford us that luxury. So we do have to choose. This is a program that will supplement the IRS efforts, enable us to do just as you say, work on the more complex, higher end cases, and I think that this is an expansion of our reach.

It is already being done, as I indicated in testimony before, in over 40 States around the country. And it is comparable in many ways to the kind of leverage we are trying to get in other areas, where right now we have agreements to look at abuse of tax shelters with something like 46 States and the District of Columbia. They are doing some work and we are doing other work, and it does help us. So I actually have to agree with both of you, frankly, which is always good practice.

Representative RAMSTAD. Let me ask another question with respect to private collection agencies. Could you just briefly explain the safeguards that are in place to prevent the misuse of taxpayer information or violation of taxpayer rights, as you implement last year's legislation?

Mr. EVERSON. Yes, sir, of course. That is one of the reasons why the program isn't up and running right now. We are taking the time to develop the systems appropriately so that we are only providing the data that these folks will absolutely have to have. We want to make sure that the systems interact correctly, that if you are getting in touch with someone and they have already made a payment, for example, that that is reflected in the data that the contracting agencies will have. We are proceeding to do that work now, and that is why we won't actually start the collection activities themselves until probably around January of this coming year.

I want to emphasize, as I have in other testimony, that all the standards that will be followed by the contractors will be those same standards that IRS employees would have as to the kind of questions they could ask. There is also, as you know, the third Debt Collections Practices Act that governs these activities as well.

So there will be a lot of controls over this, a lot of monitoring, and there will be great focus on security. IT security was a point that was mentioned. We want to make sure that we are attending to that, too.

Representative RAMSTAD. My final question concerns Taxpayer Assistance Centers. Your hand was really forced by the budget to close a number of them throughout the country. What are you planning to do to compensate—that is, to make sure tax administration will not suffer—due to the loss of this face-to-face interaction through the closures?

Mr. EVERSON. We will develop plans for each and every one of the sites that we expect to close. Right now, we are heading towards a model or a listing of about 68 sites. I expect that we will probably issue that within the next week to 2 weeks. We will do a site-by-site analysis and work on things like the nearby existing sites, remaining sites, depending on where the location is. Also, working on the VITA sites that were mentioned. As you probably know, there is something like 14,000 volunteer sites around the country. I recognize this is not a one-to-one trade-off in any way, but we will develop a targeted plan in each and every location that we close to do the best we can.

As you indicate, what is really happening here, Mr. Chairman, is we are doing some belt tightening. This is consistent with what GAO has said, that I would like to, if I could, draw this to your attention in terms of what they have concluded. It says:

We recognize that the options listed below involve trade-offs. In each case, some taxpayers would lose the service they use. However, the savings could be used to help maintain the quality of other services. We also want to give the IRS credit for identifying savings, including some on this list. The options include the following:

Closing walk-in sites. As discussed previously, taxpayer demand for walk-in services has continued to decrease and staff answer a more limited number of tax law questions in person than staff answer via telephone. And a series of other points here.

As you say, what we are trying to do is be responsible in a period of budget austerity. This is an area where we think we will save about $48 million. We have to save 150 overall, frankly, to get within the President's request.

The final point I will make on this, as Mr. Olver and others have heard me testify to, my real concern is not this; it is that if the Congress does what it did the last few years and uses the President's service request as a ceiling and then cuts it further, we will get to far harder cuts in services than this implies.

Representative RAMSTAD. Thank you, Commissioner. At this time I would recognize the distinguished member from the appropriations committee, Mr. Olver.

Representative OLVER. Thank you, Mr. Chairman. Commissioner Everson, I have read your written testimony. It is not so easy for me to assimilate your new summary of that testimony in order. You mentioned in your written testimony that the tax gap in the last year that your publishing data, your advertising data on that is for the year 2001, and you say that the tax gap is somewhere between 311 and $353 billion. And that in fact through late payments and enforcement activities, coupled with those payments, that you recovered 55 billion. So that there may be somewhere between 257 and 298 net tax gap.

You have indicated that for this year, in your written testimony, that your priorities for enforcement—and I take it the priorities for enforcement mean going at that net tax gap. The priorities for enforcement would be to discourage and deter noncompliance with emphasis on corrosive activity by corporations, high income individuals, and other contributors to the tax gap.

Then your second priority is to ensure that tax professionals are adhering to professional standards and follow the law.

The third priority is to detect and deter domestic and offshore based criminal tax activity.

And, fourth, to discourage and deter noncompliance within tax exempt and government entities.

Now, is all of that net tax gap contained among those four priorities, or are those just components of the tax gap?

Mr. EVERSON. Those are the four objectives that support the enforcement goal of the strategic plan. They were constructed to cover what we felt were the most essential elements of returning or recovering enforcement. And some of those play in a tax gap more than others.

Let us talk about the last one as an example, maintaining the integrity of charities. As you know, the tax exempt sector is a very large portion of our economy, but we aren't generating tax there. Therefore, it is not in the gap calculation.

Representative OLVER. All right. That is fine. Thank you. I have to get some questions in here.

All of the tax gap issues there require extensive work, as the chairman has suggested, on the part of professional tax personnel of the Department and so on, the enforcement audit process and so forth. I assume that these audits must be done, you will have to do those in order to identify where the underreporting of income is, and whether it can be found through document matching or whether it is small or large corporations or abusive devices or all of that. That has to be done through the audit process.

Mr. EVERSON. Sir, we have just completed the first phase of the national research program. This has generated the results that you spoke about, the tax gap range that was articulated. It was based on 46,000 detailed audits, from which we have reached conclusions on the ranges. We are refining that work now. That work will enable us to refine those ranges and update our audit tools. Ultimately, we will use the results to inform our budget decisions down the road.

Representative OLVER. Okay. Let me just ask you, where is it that you intend to use the private collectors?

Mr. EVERSON. Let us go to the tax gap map. If you look at the components of the tax gap, about 80 percent of it is in underreporting, about 10 percent is in nonfiling, and 10 percent that is this box out at the right, a little over $30 billion, is in underpayment. That is when I owe a balance, we have agreed that I owe the balance, but I haven't paid all of it.

Representative OLVER. 30 billion?

Mr. EVERSON. Yes, sir. So that is each year. We estimate right now, on the balance sheet of the U.S. Government——

Representative OLVER. This is underpayment?

Mr. EVERSON. Underpayment. Yes, sir.

Representative OLVER. So this is where it is already agreed what is owed?

Mr. EVERSON. Exactly.

Representative OLVER. And it just hasn't been paid. And this is where you will use the——

Mr. EVERSON. That is where the private collection agencies come in. That is exactly right. They are not doing audit work or anything like that. No, sir.

Representative OLVER. Okay. Now, doesn't that correspond essentially to a group of items that were included in your predecessor's Mr. Rossotti's report to the review board, to the IRS review board? Because that comes to virtually exactly $30 billion of field and phone accounts receivable, plus the cases of—other sorts of cases where they have been looked at and you didn't have enough staff to look at all of them.

Mr. EVERSON. I would have to go back and look at Charles' report.

Representative OLVER. The point I am trying to make is that in a category of $10 billion of field and phone accounts receivable, $10 billion that is understood to be owed and agreed to be owed, Mr. Rossotti suggested that hiring with about $300 million to collect those, that you could collect that $10 billion, which is $30 per dollar expended. How much is it that you plan—because I have heard and I use the number about 20 percent. How much is it that you are going to give to the collectors for what they collect?

Mr. EVERSON. I can't answer that question yet. I think that this will be a function of the competitive process in terms of the bids that will be received.

Representative OLVER. You have no estimate?

Mr. EVERSON. Well, we said we could allow it to go up to 25 percent, as you know. I don't think it will get that high, but I don't want to speculate until we get further down the road.

Representative OLVER. I just want to point out to you and to everyone else that that comes to—if it were 20 percent, which is what it costs for the collection process, that that is a 5 to 1 margin. I cannot imagine why anyone would want to use that kind of a margin versus expenditure of $300 million to collect the $9 billion.

Representative RAMSTAD. The gentleman's time has more than expired. The Chair would just ask that we try to stick within a minute or so of the 5-minute rule.

The Chair now recognizes the distinguished Senator from Hawaii.

Senator AKAKA. Thank you. Thank you very much, Mr. Chairman. The ranking member of the Senate Committee on Finance is unable to be here, Mr. Chairman. I ask unanimous consent that the statement by Max Baucus be inserted in the record.

Representative RAMSTAD. Without objection, so ordered.

[The statement of Senator Baucus follows:]

STATEMENT OF SENATOR MAX BAUCUS

In 1998, Congress and the Administration determined that it was time for the IRS to stop spinning its wheels and start advancing with the rest of the world—in technology, taxpayer service, and enforcement. Although the IRS made significant progress in taxpayer service, enforcement and technology have had fewer successes. Unfortunately, seven years later, the IRS continues to have few successes in tech-

nology; strives for increased enforcement but with concern that quality is being sacrificed; and diminishes taxpayer service under the guise of lower demand and tighter budgets. I am concerned that the IRS wheels did in fact stop spinning, but they are now going backwards.

Congress required the IRS "to revise its mission statement to provide greater emphasis on serving the public and meeting the needs of taxpayers" in the IRS Restructuring and Reform Act of 1998. The 1998 changes reflect unanimity that it was time to stop the pendulum from swinging between taxpayer service and enforcement. Further, the National Taxpayer Advocate emphasizes that investments in *both* enforcement and taxpayer service contribute to compliance.

While I agree that we need targeted, appropriate enforcement, taxpayer service cannot be the sacrificial lamb. 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 simply more efficient than back end enforcement.

One of the lambs scheduled for slaughter is the IRS Taxpayer Assistance Center program. In Montana, taxpayers already have to drive 200 miles to a Taxpayer Assistance Center. Because of cuts in hours of operation and new restrictions on the type and level of assistance that taxpayer service personnel may provide, when Montanans get to an IRS assistance center, it is often closed. It seems to me that justifying the closing of Taxpayer Assistance Centers based on a decrease in usage is simply the next step in a planned self-fulfilling prophecy. I fear that the proposed cuts in telephone service are also unwarranted cuts in taxpayer service. I urge Commissioner Everson to re-think the direction he is headed with respect to taxpayer service cuts.

The IRS's third strategic goal is to modernize the IRS through its people, processes, and technology. Simply put, the IRS cannot operate efficiently and effectively with outdated technology. Unfortunately, critically important taxpayer service and enforcement needs are going unmet because of a failure of the IRS to modernize. In 1998, the general view was that the IRS could not build the needed technology in-house. Seven years later, the IRS has not been able to build the needed technology using the private sector. Billions have been spent to modernize the IRS. Yet, the IRS is overbudget and behind schedule when it comes to the goal of advancing with the rest of the world in technology.

Worse yet, one of the few technology successes the IRS has had is now on the chopping block as well. In 2004, over four million individuals and one million employers filed income and employment tax returns by telephone via the IRS's Telefile program. Once again, we are told that usage has declined and tight budgets result in elimination of this program. However, perhaps the problem actually lies with ineffective promotion of the program, limitations on the types of taxpayers who may use the system, and inefficient maintenance of excess circuit capacity and overhead.

Finally, the IRS's struggle for a level of funding that is commensurate with its workload has existed for years. I appreciate Commissioner Everson's efforts to change the manner in which we think about IRS funding. Specifically, he argues that every dollar invested in the IRS results in a return of four dollars to the Federal government. I believe we should treat the IRS as the unique agency that it is during the appropriation process. However, I believe any change should impact the entire agency, not just enforcement.

In 1998, Members of Congress shared a vision for a restructured IRS. We shared a vision where taxpayers could ask questions and get quick and accurate responses, where paperwork was reduced and more taxpayers filed electronically, where taxpayer data was readily available on computer screens so accounts could be adjusted promptly, where honest taxpayers were treated with respect, and where tax cheats were brought to justice. In other words, we shared a vision of a modern professional organization that provides quality taxpayer service while still collecting its accounts receivable. We should not lose sight of that vision.

Senator AKAKA. Thank you, Mr. Chairman.

Mr. Everson, why does the IRS continue to facilitate the exploitation of taxpayers by providing the debt indicator service and facilitate the refund anticipation loan industry as it exploits low income taxpayers?

Mr. EVERSON. Senator, I listened very carefully to your statement, and I agree with many of the facts that you stated in it. But I do not agree with the characterization that the IRS supports RALs. I am on record as saying I don't think they are a good thing.

We have stated that with the increase in electronic filing, and this year the electronic filing has exceeded 50 percent, one of the primary benefits you get through that is it cuts in half the time of getting your refund. The other thing that we have done is in the Free File Alliance—that is a consortium of companies that provide services—this year the usage of that has increased by almost 50 percent, so that over 5 million taxpayers have filed for free, without going through the preparers that you speak of in order to process their returns. This was designed for middle and low income people.

Now, it is a complicated problem. I met with your colleague Senator Coleman just last week on this subject. He has expressed concern about it. We are going to take a look at this. There is a delicate balance, though, with the Free File Alliance doing a service, which is good for just the taxpayers you are speaking about. Some of them do provide these services and generate fees that way, you are exactly correct. I am not in favor of that, but there are a lot of competitive pressures here.

All I will say to you, sir, is we are going to take a good look at this. A lot of it is not regulated by us. As you know, it would be subject to State or other banking law.

Senator AKAKA. Yes. And I would say we look forward to your taking steps to reduce the use of refund anticipation loans.

Mr. Everson, the President's budget proposes to cut more than $134 million and 1,205 positions from customer service, and I am sure that is correct, with Taxpayer Assistance Centers targeted for drastic reductions. These cuts will decrease customer service to taxpayers who rely on their local centers to help them with their tax inquiries. This means that minorities and low income taxpayers who rely on centers to help with language barriers, the earned income tax credit, and general tax preparation, who seek cuts in tax services they rely on. You have talked a little about this. But what criteria will you use to determine which centers will be closed? Are the targeted centers predominantly in rural or metropolitan areas? Once the walk-in centers are closed, how will taxpayers receive the customer services they currently receive through the walk-in centers?

Mr. EVERSON. Yes, Senator, I am happy to explore that. We developed a model that includes five broad categories. And within those categories there is a total of 32 different criteria. The general categories are geography, employee cost, facility cost, workload, and demographics. And they consider factors such as those that you are mentioning: The number of EITC returns that were being prepared in those centers, inquiries as to the number of forms, items like distance to the nearest adjoining TAC or the distance to the next VITA site.

So we try to weigh all these factors. We had input from a variety of stakeholders and the input that we received indicated initially you want to weigh cost heavily. And what the result of that would have been was that you would have closed a smaller amount of TACs, but they would have been in the big cities, predominantly in the Northeast where you had a lot of old structure that has been there for years, if you will.

We received input that we ought to look more at workload and demographics, the kind of issues that you are talking about. And

we have reweighted this so that now almost half of the weighting in the model goes to those two figures. So we think it is a better solution. It comes up with 68 facilities that we expect to announce the closure of. We are finalizing that now, doing some quality checks, make sure we have got it all right.

And there are three business rules that we have articulated in this model. One is that we want to make sure that each of the 35 largest metropolitan areas retains a TAC presence. Secondly, we don't want to close more than half of the TACs in any individual State, and this will seem like a coincidence but we are not closing anything in Alaska or Hawaii just because of the lack of geographic proximity and—"isolation" would probably be a bad word, but just the distances, sir.

Senator AKAKA. Thank you. Mr. Chairman, my time has expired.

Representative RAMSTAD. The Chair thanks the distinguished Senator for questions. It is good to see you again.

If there is no objection, the Chair would now recognize out of order my distinguished colleague from Ways and Means, Mr. Beauprez, because, as I understand, you have to leave at 4:00 to offer an amendment on the floor.

The gentleman from Colorado.

Representative BEAUPREZ. Thank you, Mr. Chairman, and thank you for being with us today, Mr. Everson. A couple of quick questions, if I might. The number of corporate returns audited, as I understand it, has declined or the percentage, if you will, the ratio has declined rather dramatically since 1997, at least the numbers I looked at were roughly one out of 50 back then, and now more like one out of 180 or so. What is a reasonable ratio? And are we—I am assuming that you are going to tell me that that is a resources problem. I accept that if that is the answer. But tell me, what is a reasonable ratio and what must be done about it? What else are you doing at the Service to try to find the mistakes that are made? And then I want to probe that last part, the mistakes part.

Mr. EVERSON. Yes, sir. First of all, we separate corporations by type. We have a business unit that deals with the large and midsize corporations. Those are corporations that have assets of over $10 million. And then there are smaller corporations and also self-employed individuals or people doing business without incorporating that are in our small business and self-employed business unit.

The figures you are referring to refer to the aggregate of the larger corporations and the small businesses that are organized as C corporations. If you look at the larger corporations, those rates went down for years and we finally stabilized that audit rate in 2004. The 2004 audit rate on those larger businesses was actually something like 15 percent, I believe, 15, 16 percent, and that is a recovery from 12 percent the year before. So we are bringing that back.

On the other hand, last year there was a continuing decline in the audit rate of the smallest of the businesses organized as C corps. This year, that will stabilize and start to come back up. But the rate is very low. I believe it is, as you indicate, under 1 percent. The things that we are doing to try and go after problems in the

largest corporations in particular—because when I talk about corporations, I am talking about that first group, over 10 million in assets where we think we have real compliance problems. We are bringing back resources there.

The centerpiece of the President's budget the last 2 years has been corporations and high-income individuals. We are improving our tools, we have new mandatory reporting, something called the M–3 that analyzes the difference between book earnings and tax earnings. Items pop out that you then look at in your audit process. That has been changed. Just now we are starting to get the information that is really going to be terribly helpful.

We are mandating electronic filing for corporations of a certain size, and many of them are crying like stuck pigs now. But we are telling them that next year when they file they have got to do so electronically. That will cut a year and a half off of the processing.

So we are doing a whole host of things here. The last thing I will say is we formed something called a Joint International Tax Shelter Information Center with partners from Canada, Australia, and Britain, where we have a couple of their agents working side by side with our folks in Washington looking at abusive shelters and transactions between U.S. businesses and their affiliates overseas, because we see real problems in that area. As you can imagine, the accounting firms and the investment banks went overseas years ago. We are only now responding, frankly.

Representative BEAUPREZ. There is the old cliche "garbage in, garbage out." I worry a little bit—I worry a lot, frankly, that we maybe have both you at the Service and the taxpayer on a bit of mission impossible in trying to comply with this very complex Tax Code that we have given you, we here in Congress. How difficult is that job, and do we create a bit of the cat chasing the tail in that in trying to not have garbage go in, you are trying to give the advice and the service and the support to the taxpayer to file accurately in the first place? How difficult is that job?

I happen to have a prop here. This is your latest contribution to our work. Please look somewhere other than just me, if you would.

Mr. EVERSON. This is the American Jobs Creation Act of 2004, which did a lot of good things for the country, and I am not suggesting otherwise. But let us make no mistake about it, it did not do a lot of good things for the IRS. It did some good things in terms of strengthening penalties for promoters who didn't comply with our standards, but the level of complexity in here is quite significant, especially in things like the manufacturing exemption or change where there will be a lot of attempts to make sure that things qualify as manufacturing that has already required some guidance from us and a great deal of work, as I have indicated in some of my correspondence with Congress. So you do not make it easier. And, in fact, I am looking forward to the tax reform discussion, because simplification will really make compliance better and it will help the IRS. And what I would really ask for is, no matter what we do, let us get some stability in this system once we make the changes, because the constant changes are really hard.

Representative BEAUPREZ. I thank the gentleman. That is valuable information. I yield back.

Representative RAMSTAD. I think all of us will look forward to July 31, which is the date the Tax Reform Commission reports to Congress.

The gentlewoman from Michigan.

Representative MILLER. Thank you, Mr. Chairman. You know, I was in the tax collection business actually in another lifetime; in one of my former jobs I was a county treasurer. And I was delighted to hear you say that you now have a majority of the people filing electronically. But everybody won't file electronically, or I know there is an institutional resistance to that depending on demographics, ages, and such. In fact, I can remember during tax collection time in my county, the older people would come in, particularly those that sort of remember the Depression or they listen to their parents, and they would peel off that money in cash. They would never give you a credit card. And they wanted a receipt, because they wanted to see a real person. So as one generation is willing to access information and transact business and that electronically, we still have a large demographic of our population sort of resistant to that. And I know you were closing down—I was listening to you talking about your modeling for closing down your walk-ins. But what about the ones that you have left, those that you still have left? Are you doing operational audits on how you transit people in and out of there as quickly as you can, I mean, perhaps express lines? Are you doing educational kinds of services for those that might come into a walk-in where you can actually educate them on how easy it would be and encourage them to file electronically? How are you expanding the amount of the population that would do their business with you electronically?

Mr. EVERSON. We have taken a number of steps. We have expanded outreach and education programs that have been put in place in the last 4 or 5 years. I think that one of the real success stories here is with the volunteer programs which have grown now to where some 2 million returns were prepared this filing season. The GAO and others have correctly pointed out that we need to improve the quality of those programs. That is a dedicated effort right now, terribly important.

I have visited some of these sites. I have been very impressed by the spirit, the willingness of volunteers, if you will, to pick up that slack and to help out. We have a series of steps we have taken here. It is a very important area of activity for us, and I agree entirely with your assessment. The statutory objective of getting to 80 percent electronic filing is important to pursue, but it is also important for us to recognize that there are populations who are difficult to reach. And, frankly, I don't worry as much about the elderly as I worry about immigrant communities and others who are new into the system that we want to educate to be compliant.

As the country changes and the demographics change, that is of particular concern to me to make sure that we are working with those populations, because some of these folks come from cultures where respect for the rule of law wasn't as great it is here, and that is why they came here. We want to make sure that the front end is one that sends the right messages.

Representative MILLER. Thank you. If I could switch gears quickly and talk just for a moment with this debt collection with the pri-

vate collection agencies and that. What about the people that might have real consternation about having their debts collected with the IRS or having that kind of—or the private collectors? Is there any kind of a system in place or an appeals process where they would not allow for a private collection agency to do that, where they would insist on the IRS actually doing that?

Mr. EVERSON. We are looking at that issue now, and I believe we are considering whether someone would say I would prefer to talk to someone from the IRS, and I think that we are considering whether we will put that into the system.

Representative MILLER. Because I forget exactly, does the legislation preclude you from doing that, that you have to go to a private collection agency?

Mr. EVERSON. No. This is an option. It gives us the authority to do this work, and that is what we are developing.

Representative MILLER. And one other question, and I know I am running out of time here. But I do remember in the legislation we made sure that the Federal Government would never be responsible if you mishandled anybody's private information, which was nice for us I suppose. But what recourse would the taxpayer have if there was mishandling of their private information? Is there going to be something within the process as you do the construct there that they would——

Mr. EVERSON. Well, I don't think that those liabilities would be any different than any other rights that Americans enjoy, and we all know we live in a fairly litigious society where there is an ability to go after these businesses. But we are going to be very careful in how we scrub the applications, and in monitoring these companies.

I recognize this is a controversial initiative with concern as to privacy and rights, and that is why we are ramping it up relatively slowly. We are not just getting up and running. We had some experience with this some 8 or 10 years ago. It did not go well because we didn't plan it as carefully as we needed to. I think we have learned that lesson, and we have got a very good team that is working on it. I had asked them to get it going this summer, and they came to me about 60 days ago and said you need to slow it down because of some of the very issues you are raising. So that is what we have done.

Representative MILLER. Thank you.

Representative RAMSTAD. And last, but certainly not least, the gentleman from New York.

Representative SWEENEY. I thank the chairman for recognizing me on behalf of Chairman Knollenberg in the Treasury-Transportation Subcommittee. I really appreciate the opportunity, and am glad to see you, Commissioner.

Let me start by just associating myself with Senator Akaka's questioning and commentary regarding the Taxpayer Assistance Centers. I know that, in the strive to modernize not only the Department but also the filers to the Department, the assistance centers serve a really vital purpose. I happen to represent one of those very mountainous and geographically spread out communities. And I heard your responses, that you were looking at workforce issues and demographics. And I am assuming demographics includes

some of the geography, because you did mention both Alaska and Hawaii and those considerations, and I appreciate that. And I just would point out to you that it is a big concern for people in rural areas in particular.

Mr. EVERSON. Yes, sir. In fact, I think that our concerns were just this: If you only looked at workload per se, you would end up closing a lot of rural sites because you have got to close lots of small rural sites to get to the cost savings. And we have done the best we can. I think we are going to do a pretty balanced run of this.

Representative SWEENEY. Well, I hesitantly say I look forward to seeing what the final product is. But we have had that conversation. Let me really shift gears to something I don't imagine you would have been prepared, necessarily, for.

Mr. EVERSON. Those are always the fun ones.

Representative SWEENEY. This relates to the oversight that—out of Appropriations, we have had a lot of discussions about our membership. And I am concerned that, structurally—I also serve on the Homeland Security Subcommittee. In prior times, I served on Commerce-Justice-State, so I have a pretty good sense, and a number of members have a pretty good sense of the issue of—the issues attendant to money laundering and counterterrorism funding and financing.

I have a belief that the culture within Federal law enforcement, in particular, is such that be it the FBI or even DOJ or Secret Service, there isn't a real cultural bent towards doing the kind of nitty-gritty work that you need to do over the number of years—that you need to do to really investigate the complexities of the terrorist financing entities; and I have tentatively come to a conclusion that your agency may be the only entity culturally and in terms of experience that may really have the capability to quickly do—"quickly" being not an oxymoronic term, but really quickly be able to kind of indoctrinate itself to such a mission.

I asked the question of some people around the country in terms of the local JTTFs in terms of the involvement the IRS, whether the IRS indeed had seats at the table; and was told that formally that is not the case in most instances and in most jurisdictions—and, in fact, I haven't found one that that is the case.

Secondly, I have been told that part of your mission statement may actually be a preclusion that IRS, without the invitation of DOJ and/or the FBI, really has no role here.

So my simple fundamental question is, is that true? In the mission statement, are you precluded? And would the Agency, given all this discussion about how you are being asked to really kind of hone down and cut down and focus and not be too spread out, would the Agency have an aversion to such an expansion of its duties?

Mr. EVERSON. You cover a lot of ground there. And let me——

Representative SWEENEY. I know. I only have 5 minutes.

Mr. EVERSON [continuing]. Take it in pieces.

First of all, I would agree with your characterization that our people are the best, our criminal investigators, at tracking the flow of funds. I have been told that by numerous individuals, the most senior members of the Justice Department and other agencies. And

it is because our people—they are often accountants, and that is how they got into the 1811 series. They like doing that kind of work, whereas some of the other agencies are more interested in other elements of it. So there is a natural division of labor.

I believe we are participating in the work. I have not been told of being shut out. I have been many times approached by Attorneys General Ashcroft, Deputy Thompson, Comey and others. Chris Ray runs the Criminal Division, thanking us for the work we do not just there, but also as an example on the President's corporate fraud task force, same kind of thing, where we provide support to Justice-led investigations.

Now, there are other terrorism-related investigations that we initiate, some of them in charitable terrorist financing, where we do take the lead because it falls within the charitable arena. And then we are in front and we bring Justice in, but I don't think it is as stark as you are suggesting, sir.

Representative SWEENEY. Well I have a couple of cases that I have been following over the years that have fallen by the wayside. And one of the explanations on one case, in particular, that is quite disturbing is that effectively the FBI didn't know where to go with the case and they didn't go to you, and they should have. So I will follow up with you.

Mr. EVERSON. I would be happy to follow up with you, sir. Nancy Jardini runs our Criminal Division. I will ask her to come see you and cover any details you would like.

Representative RAMSTAD. Well, thank you, Commissioner. Thank you for your testimony as well as your responses to the questions. We look forward to seeing you.

The Chair would now call the second panel, the Honorable J. Russell George, Treasury Inspector General for Tax Administration; the Honorable Raymond T. Wagner, Chairman, IRS Oversight Board; Ms. Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service; and Mr. James R. White, Director, Tax Issues, U.S. Government Accountability Office.

Representative RAMSTAD. Again, I would remind the witnesses of the 5-minute rule and look forward to your testimony.

Please, Mr. George.

STATEMENT OF J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Mr. GEORGE. Thank you, Mr. Chairman. Mr. Chairman, members of the joint review, thank you for the opportunity to testify today.

As you know, the IRS Restructuring and Reform Act of 1998, or RRA 98, originally called for this hearing. I believe this hearing serves a valid purpose in bringing many different congressional committees up to date on the progress the IRS has made in achieving the goals established in its strategic plan.

And as an aside, Mr. Chairman, I served as the Staff Director of Steve Horn's subcommittee back when this legislation first required these hearings, and attended the first ones, and so for me it is a particular pleasure to be back.

TIGTA conducts audits of the areas covered by the strategic plan and provides recommendations on how this plan can be achieved.

My testimony will share some of the results of these audits. I hope it provides this panel with a more complete picture of the progress the IRS has made and the challenges it faces as it attempts to implement the strategic plan.

One of the most important and persistent challenges facing the service is the modernization of its computer systems. This has been an issue for many years and will likely remain so for the foreseeable future. Before the current modernization program is completed, it is expected to last a total of 15 years and contractor costs are estimated to exceed $8 billion.

The IRS has begun to assume more responsibility for the outcome of the modernization program. For it to succeed, the IRS must effectively manage contractor performance and hold poorly performing contractors accountable. I am concerned about the ability of the IRS to do this since we have identified weaknesses in the IRS's ability to manage contracts and to implement information security measures.

In testimony he presented last month, the Commissioner noted that the Service had substantially met its 2004 goals for the modernization program. While revised cost estimates and delivery dates were met, the IRS exceeded its original cost estimates and delivery dates, and the systems that were released provided less functionality than intended.

I remain cautious about declaring success, based on results achieved in 2004, due to TIGTA's historical perspective of the modernization effort and our familiarity with the persistent modernization challenges facing the IRS.

One particular concern in the modernization program is in the area of information security. TIGTA has found that the IRS has implemented modernized systems without protection from common security vulnerabilities. These systems cost hundreds of millions of dollars to develop and implement, yet inadequate attention has been devoted to the security of these systems. As a result, sensitive taxpayer information remains vulnerable to attack by disgruntled employees and contractors.

Modernized systems will also assist the IRS with its strategic goal of improving taxpayer service. Providing quality customer service influences the ability and desire of taxpayers to comply voluntarily with the tax law.

Since the passage of the law, the IRS has been more responsive to taxpayers' needs. The increased attention to customer service has caused taxpayer satisfaction rates to rise. Although the IRS is striving to reach its goal in the customer service area, it must avoid enhancing enforcement to the detriment of customer service.

For example, the IRS recently announced plans to close about 68 to 70 of the approximately 400 Taxpayer Assistance Centers it has nationwide. These centers provide face-to-face services to taxpayers with questions about their accounts or the tax law.

TIGTA is currently reviewing the methodology used to select which centers to close. At this point, I believe better data is needed to assess the impact that closing these centers will have on customer service. I am concerned that the IRS has insufficient data to draw conclusions on the likelihood that taxpayers who have used

these centers in the past are willing or able to use other methods of seeking help.

In addition to providing customer service to American taxpayers, the IRS must effectively administer the Tax Code. Each filing season tests the IRS's ability to coordinate tax law changes, program activities and resources. I am pleased to report that our audits thus far indicate that the 2005 tax filing season has gone well, and TIGTA has identified no major problems. However, the implementation of certain tax law provisions could be improved.

For example, the IRS needs to do a better job handling the accounts of taxpayers who serve our country in combat zones. Military personnel who are serving in combat zones are entitled to certain tax benefits, such as the ability to file late, not be audited and have collection action suspended.

TIGTA has found that when the IRS attempted to update the tax accounts of military personnel who have entered or exited a combat zone, the IRS did not identify and correct errors that resulted from missing information or mismatches between names and Social Security numbers of the personnel. As a result, our men and women in uniform who are currently serving in combat zones may not be receiving the tax benefits they deserve.

Conversely, taxpayers who are no longer serving in combat zones may still be receiving special tax treatment to which they are not entitled. In fact, we found that over 58 percent of taxpayers with an active combat zone indicator on their tax accounts appeared to be no longer serving in a combat zone.

The point is that the IRS needs to better identify who is and who is not serving in a combat zone. We have recommended that the Service work with the Department of Defense to fix this problem.

One last issue I want to raise today is potential changes to the Reform Act. In my written testimony, I have requested that Congress consider amending the law to reflect changes in the tax administration environment since the law was passed. To promote efficiency and ensure that TIGTA's resources are effectively allocated, I respectfully request that Congress consider the issue presented in my submitted testimony.

Thank you, Mr. Chairman and members of the joint review. I will be happy to answer any questions you may have at the appropriate time.

Representative RAMSTAD. Thank you, Mr. George.

[The statement of Mr. George follows:]

WRITTEN TESTIMONY OF J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Mr. Chairman and Members of the Joint Review, thank you for the opportunity to participate in this discussion of the strategic plan and budget request for the Internal Revenue Service (IRS). The IRS strategic plan consists of three primary goals:

- Improve taxpayer service;
- Enhance enforcement of the tax law; and,
- Modernize the IRS through its people, processes, and technology.

Commissioner Everson has indicated that this strategic plan provides a roadmap for IRS operations over the next five years, and that the guiding principle for the

IRS, Service + Enforcement = Compliance, relates his goal for striking the right balance necessary to achieve compliance and address the tax gap.[1]

The IRS deserves credit for its considerable accomplishments in fiscal year (FY) 2004. For example, the IRS processed approximately 224 million tax returns and collected over $2 trillion in FY 2004. Enforcement revenue collected increased by over 15 percent to more than $43 billion. The IRS implemented the first release of the Customer Account Data Engine (CADE) modernization project,[2] which processed over a million tax returns during the 2005 filing season.[3] Furthermore, the completion of the initial phases of the National Research Project allowed the IRS to recently release an updated estimate of the tax gap.[4]

However, in the midst of these accomplishments, the IRS faces some significant challenges. The IRS' updated estimates of the tax gap, which is defined as the difference between what taxpayers are supposed to pay and what is actually and timely paid, have risen to between $312 and $353 billion annually. These figures are alarmingly high and indicate a significant threat to our nation's tax system.

Although enforcement revenue has increased, gross accounts receivable grew by two percent in 2004 to an historical high of $285 billion. Cost increases and schedule delays continue to occur in business systems modernization, even though the number of projects under development has been reduced. Additionally, security vulnerabilities persist in existing IRS systems, and are even present in modernized systems developed by the IRS and the PRIME contractor.[5]

The proposed budget for FY 2006 provides additional resources to IRS enforcement in order to narrow the tax gap. However, the IRS has proposed cuts to customer service to offset a portion of the funding that is being redirected towards enforcement. I have some concerns about these decisions, which I discuss later in this testimony.

One aspect of the budget that the Treasury Inspector General for Tax Administration (TIGTA) is currently evaluating is the IRS' application of user fees to taxpayers who seek special services.[6] Opportunities may exist to charge a more accurate amount for these services, which would help offset operating costs. In addition, last year Congress authorized the IRS to use private collection agencies to collect taxes. Once the IRS implements this program, more outstanding taxes should be collected. TIGTA will be vigilant in overseeing the IRS' use of these contractors to ensure that abuses do not occur. Past experiences with bank lockbox thefts and insufficient contractor oversight have provided invaluable lessons to help prevent similar issues from plaguing the collection of tax debt.[7]

I will also address the progress the IRS has made and the challenges it faces in the security and modernization of IRS information systems, the tax filing season, customer service, and implementation of the various provisions of the IRS Restructuring and Reform Act of 1998 (RRA 98).[8] TIGTA has performed extensive work in these areas, and I appreciate the opportunity to highlight our results.

INFORMATION SYSTEMS SECURITY

In the area of information systems security, the IRS has developed security policies and procedures but has not implemented them effectively or consistently. As a result, sensitive information remains vulnerable to attack by disgruntled employees

---

[1] Internal Revenue Service, Pub. 3744, IRS Strategic Plan 2005–2009 (Rev. 2004).

[2] The CADE project is the foundation for managing taxpayer accounts in the IRS modernization plan.

[3] The tax return filing season is the period from January through mid-April when most individual income tax returns are filed.

[4] The IRS has initiated the National Research Program to measure taxpayers' voluntary compliance, to better approximate the tax gap, and to develop updated formulas to select noncompliant returns for examination. The first phase of this program addresses reporting compliance for individual taxpayers, and data from this phase were used to produce the recently updated estimates of this portion of the tax gap.

[5] The PRIME contractor, Computer Sciences Corporation, is the principal contractor responsible for modernizing IRS business systems.

[6] These special services include processing installment agreement requests; providing Employee Plans/Exempt Organization letter rulings, opinion letters, determination letters, and advisory letters; providing IRS Counsel rulings; processing Offer-In-Compromise applications; and providing copies of tax returns.

[7] Treasury Inspector General for Tax Administration, Ref. No. 2002–30–055, Federal Requirements Need Strengthening at Lockbox Banks to Better Protect Taxpayer Payments and Safeguard Taxpayer Information (2002); Treasury Inspector General for Tax Administration, Ref No. 2004–20–0063, Insufficient Contractor Oversight Put Data and Equipment at Risk (2004).

[8] Pub. L. No. 105–206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app. 3, 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.).

and contractors. While recognizing that complete security can never be achieved and that there are necessary trade-offs between security and operational needs, TIGTA continues to identify significant weaknesses in infrastructure and applications security.

Although TIGTA is not aware of a successful intrusion into the IRS network from an external source, such as the Internet, TIGTA investigations have led to two significant prosecutions for computer intrusions. One case involved an IRS contractor who installed on a large database server malicious code that was designed to destroy the information on the system. The second case involved an IRS contractor that illegally accessed and compromised several large servers in an IRS computing center. In both cases, although no taxpayer data was immediately at risk, IRS contractors were responsible, which highlights the fact that the greatest threat to IRS systems is from internal sources such as disgruntled employees or contractors.

The Government Accountability Office (GAO) recently issued a report documenting weaknesses in controls to prevent, limit, or detect unauthorized access to taxpayer and Bank Secrecy Act data from the IRS' internal network.[9] Recent TIGTA reviews of access controls over taxpayer data in IRS' Criminal Investigation function, Appeals office, and Office of Chief Counsel have noted similar exposures to unauthorized access.[10]

I am particularly concerned with weaknesses TIGTA has identified in the systems developed as part of the modernization program. We found that modernized systems had been implemented without protection against common security vulnerabilities. For example, computers were running unnecessary high-risk applications, systems were implemented without disaster recovery capability, and computer configurations did not meet IRS standards.[11] These systems cost hundreds of millions of dollars to develop and implement, yet the security of these systems has not received adequate attention. The IRS will have to correct these security deficiencies after the systems are already running; however, it is much more costly and complex to retrofit systems after-the-fact than to install security features in the design and development of the systems.

For example, the IRS paid the PRIME contractor to develop a system that tracked the activity of users on modernized systems. What is troubling is that the IRS accepted this system in late 2002 despite knowing that the system could not be used for the purpose for which it was designed.[12] Software vulnerabilities and performance issues rendered it basically useless for identifying unauthorized accesses to IRS systems. After more than two years, the IRS still has not completed corrective actions to address these weaknesses and ensure that monitoring of user activity occurs on the modernized systems currently operating.

Additionally, while security roles and responsibilities have been defined, significant security weaknesses exist throughout the IRS because IRS employees with key security responsibilities are not fulfilling their duties. For example, TIGTA has identified vulnerabilities on the network and in sensitive systems across the IRS.[13] IRS employees have not consistently assessed and accredited the security controls present on their systems. The IRS has initiated actions to improve the training of its key security employees, and we will continue to monitor whether employees receive proper training in this complex area.

Although electronic access controls can help prevent some security breaches, it is also critical to ensure employees are aware of their individual security responsibilities to protect taxpayer data from unauthorized access. When TIGTA auditors posing as IRS Information Technology employees recently called IRS employees and

---

[9] Government Accountability Office, Pub. No. GAO–05–482, Information Security: Internal Revenue Service Needs to Remedy Serious Weaknesses over Taxpayer and Bank Secrecy Act Data (2005).

[10] Treasury Inspector General for Tax Administration, Ref. No. 2004–20–081, Key Security Controls of the Criminal Investigation Management Information System Have Not Been Implemented (2004); Treasury Inspector General for Tax Administration, Ref. No. 2005–20–069, Security Controls for the Appeals Centralized Database System Could Be Improved (2005); Treasury Inspector General for Tax Administration, Ref. No. 2005–20–036, Security Controls for the Counsel Automated System Environment Management Information System Could Be Improved (2005).

[11] Treasury Inspector General for Tax Administration, Ref. No. 2004–20–135 Security Weaknesses in the Modernization Infrastructure Have Not Been Adequately Addressed (2004); Treasury Inspector General for Tax Administration, Ref. No. 2005–20–024, The Disaster Recovery Program Has Improved, but It Should Be Reported as a Material Weakness Due to Limited Resources and Control Weaknesses (2005).

[12] Treasury Inspector General for Tax Administration, Ref. No. 2004–20–135 The Audit Trail System for Detecting Improper Activities on Modernized Systems Is Not Functioning (2004).

[13] These vulnerabilities are discussed in further detail in limited official use audit reports provided to the IRS. See Treasury Inspector General for Tax Administration, supra note 10.

managers, 35 percent of them were willing to provide their user account names and change their passwords as requested.[14] With an employee's user account name and password, a hacker could gain access to IRS systems, though the IRS' strong systemic perimeter controls lessen this risk. Even more significant, a disgruntled employee could use the same social engineering tactics and obtain another employee's username and password. With some knowledge of IRS systems and applications, this disgruntled employee could more easily gain unauthorized access to IRS data as well as damage information on IRS systems.

Although many steps have been taken to limit risks, IRS systems and taxpayer information remain susceptible to threats that could impact the confidentiality, integrity, and availability of data and information systems.

BUSINESS SYSTEMS MODERNIZATION

Modernizing the IRS' computer systems has been a persistent challenge for many years and will likely remain a challenge for the foreseeable future. The latest effort to modernize the IRS' systems, the Business Systems Modernization (BSM) program, began in FY 1999.[15] The purpose of the BSM program is to modernize the IRS' technology and related business processes. The BSM program is a complex effort which will involve integrating thousands of hardware and software components. All of this must be done while replacing outdated technology and continuing tax administration.

This effort will be lengthy and costly. It is estimated to last up to 15 years, and the IRS will incur PRIME contract costs over $8 billion. The program is in its seventh year and has been allocated approximately $1.9 billion in funding for contractor activities. The IRS has further supported the modernization effort by funding the Business Systems Modernization Office (BSMO) with $213 million since FY 1999.

Key projects have made significant progress during the past year

Working with its contractors, the IRS has deployed projects that provide value to taxpayers and has built the infrastructure needed to support these projects. Two BSM projects have been deployed and delivered value to taxpayers in the past year: the Customer Account Data Engine (CADE) and the Modernized e-File (MeF) project. The CADE project is the foundation for managing taxpayer accounts in the IRS modernization plan.[16] Once completed, CADE will consist of databases and related applications to replace the IRS' existing Master File processing systems.[17] In July 2004, the IRS delivered CADE Release 1.1 which successfully processed refund and even-balance Forms 1040EZ[18] for single taxpayers with no pending tax issues. CADE Release 1.2 incorporated the tax law changes for the 2005 filing season and started processing the same type of tax returns in January 2005. It has processed over 1 million tax returns during the 2005 filing season.

The MeF project involves developing a modernized, web-based platform for electronically filing approximately 330 different IRS forms. The MeF deployed three releases from February 2004 to January 2005, which allow for the electronic filing of over 100 different tax forms, including forms filed by corporations and exempt organizations.

In addition, the IRS and its contractors issued the first release of the Integrated Financial System (IFS), which provides new capabilities for internal use. The IFS was developed to address administrative financial management weaknesses in IRS accounting systems. The first release of the IFS became fully operational in January

[14] Treasury Inspector General for Tax Administration, Ref. No. 2005–20–042, While Progress Has Been Made, Managers and Employees Are Still Susceptible to Social Engineering Techniques (2005).

[15] Prior to the BSM program, the IRS initiated the Tax Systems Modernization (TSM) program. The purpose of TSM was the same as the purpose of BSM: to modernize the IRS' technology and related business processes. The TSM program, however, encountered management and technical weaknesses. After spending over $3 billion on TSM, the program was abandoned and the BSM program was initiated.

[16] In conjunction with other applications, the CADE will eventually allow employees to post transactions and update taxpayer account and return data online from their desks. Updates will be immediately available to any employee who accesses the data and will provide a complete, timely, and accurate account of taxpayer information. In contrast, the current Master File processing system can take up to two weeks to update tax accounts, and IRS employees may need to access several computer systems to gather all relevant information related to tax accounts.

[17] The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

[18] Form 1040EZ is the income tax return used by some single and joint filers with no dependents. The initial release of the CADE does not process Forms 1040EZ for joint filers.

2005, and included accounts payable, accounts receivable, general ledger, budget execution, cost management, and financial reporting activities. A future IFS release was planned to include property, performance, and procurement management, but work was suspended in early 2005 due to budget constraints. Without this future release, the IRS will be unable to fully address a material weakness in its accounting systems.

Budget reductions have resulted in decreased development activities

During FY 2004, the IRS scaled back development activities because of reduced appropriations. The available budget caused the IRS to limit its development activity to focus primarily on the CADE, MeF, and the Filing and Payment Compliance (F&PC)[19] projects. For example, the schedule for the CADE project has been revised several times to accommodate development delays and uncertainty in program direction. The refocus of the CADE project impacts related modernization activity such as the Customer Account Management (CAM) project.[20] The CAM project is intended to improve customer service by providing more accurate and timely account maintenance and analysis. The uncertainty of CADE's development, along with reductions in available funding, affect when CAM can be developed. Without an application such as CAM, CADE can only act as a system to process tax returns that require no account adjustments.

In addition, the budget reduction prompted the IRS to suspend further development of the IFS project and cancel the Custodial Accounting Project (CAP). Canceling CAP made the initial releases unusable for its intended purpose of performing accounting work. The IRS has indicated it will leverage the work products and knowledge gained from CAP in other modernization initiatives. While leveraging may produce some residual benefits, a significant portion of the $135 million spent on CAP will result in unrecoverable costs.[21]

Weaknesses remain in certain areas of BSM program management

TIGTA has also identified weaknesses in the BSMO, which is responsible for the overall management of the BSM program. These weaknesses are in the following areas: requirements management, contract management, software testing, and security controls. To address issues in requirements management, the IRS established a Requirements Management Office in January 2005. The Office is responsible for developing processes and procedures to effectively create and manage project requirements. Weaknesses in contract management have resulted from the BSMO failing to consistently use contract provisions and negotiations that would protect the best interest of the Federal Government.[22] In the area of software testing, the BSMO needs to clearly define testing procedures,[23] improve testing practices,[24] and ensure that software is tested prior to system deployment.[25] Finally, the BSMO needs to place additional emphasis on security controls in the design of information systems.[26]

---

[19] The F&PC project was intended to provide support for detecting, scoring, and working nonfiler cases (filing compliance) and delinquency cases (payment compliance). The first release of the F&PC project is called the Private Debt Collection project. The IRS completed the planning phases for the Filing and Payment Compliance project in 2002, but suspended the project due to concerns with costs. In FY 2004, the portion of this project designed to support private debt collection was restarted.

[20] The CAM project is intended to provide improved technology and business processes to provide account and tax law assistance, manage case workflow, and support other modernization efforts by providing access to comprehensive, timely, and accurate taxpayer account information.

[21] The IRS reported that the data models developed for CAP can be used on the CADE project, and the CAP analysis and requirements can be used as the basis for a new system.

[22] For example, contract award justifications did not always provide adequate detail for not using firm fixed-price contract provisions. Contracting provisions that could balance risk between the IRS and the contractor were used inconsistently. Additionally, consistent application of best practices could further improve the contract negotiations process. Treasury Inspector General for Tax Administration, Draft, Audit No. 200420002, While Many Improvements Have Been Made, Continued Focus Is Needed to Improve Contract Negotiations and Fully Realize the Potential of Performance-Based Contracting (2005).

[23] Treasury Inspector General for Tax Administration, Ref. No. 2004–20–157, The Office of Release Management Can Improve Controls for Modernization Program Coordination (2004).

[24] Treasury Inspector General for Tax Administration, Ref. No. 2004–20–147, the Integrated Financial System Project Team Needs to Resolve Transition Planning and Testing Issues to Increase the Chances of a Successful Deployment (2004).

[25] Treasury Inspector General for Tax Administration, Ref. No. 2005–20–019, System Requirements Were Not Adequately Managed During the Testing of the Custodial Accounting Project (2004).

[26] Draft audit report has not yet been issued.

Cost increases and schedule delays continue

Since the start of the modernization effort, the BSM program has experienced cost overruns and schedule delays in its project development and deployment. In early 2005, the IRS reported project deliveries were within budget and schedule estimates for projects delivered since August 2004. This assessment was based on cost and schedule estimates that the IRS revised in May 2004.

Our analysis of the re-baselined project deliveries confirms the IRS' assessment that project releases were generally within budget and on schedule. However, our comparison of the May 2004 and February 2005 IRS BSM expenditure plan estimates shows significant project cost and schedule increases for several ongoing projects, such as MeF and F&PC.

The division of responsibilities between the IRS and the PRIME contractor

In February 2004, Commissioner Everson testified that the IRS would carefully assess the PRIME contractor's performance on current projects. The Commissioner would consider the results of the PRIME contractor's overall program management and integration efforts before awarding additional work.

In January 2005, the IRS began assuming the role of systems integrator from the PRIME contractor due to reductions in funding and concerns about the adequacy of the PRIME contractor's performance. In the IRS' new operating model as the systems integrator, the IRS will now be responsible for program-level activities such as:

- Systems integration;
- Business requirements management and validation;
- Procurement administration;
- Engineering; and,
- Architecture.

Skills needed to perform these responsibilities have been an issue of concern. Specialized skill positions, such as systems architects and engineers, have been difficult to fill. The assumption of the integrator role by the IRS is recognized in the BSM program as part of its highest priority needs.

TIGTA has found that the BSM program has begun to assign the role of systems integrator to parties other than the PRIME contractor. For example, the BSMO acted as the integrator for the MeF project, and the Northrop Grumman Corporation served as the integrator for CAP before it was cancelled. The PRIME contractor's new primary function is to deliver projects and to provide support services to the IRS. On new projects, the PRIME contractor will compete for the contracts with other contractors. The effective management of contractor performance and accountability will become even more important and difficult for the IRS as it now functions as the systems integrator for all contractors.

Previously reported challenges still exist

During the past three fiscal years, our annual BSM program assessments[27] have cited four primary challenges the IRS and its contractors must meet to achieve program success:

1) Implement planned improvements in key management processes and commit necessary resources to enable success;
2) Manage the increasing complexity and risks of the BSM program;
3) Maintain the continuity of strategic direction with experienced leadership; and,
4) Ensure contractor performance and accountability are effectively managed.

While the IRS has taken steps to address these areas, continued attention by management will be required for the IRS to succeed with its modernization activities. The GAO has also recognized the need for continued management attention and has included the modernization program as a high-risk area in its 2005 High-Risk Report,[28] as it has since 1995.[29]

Commissioner Everson testified in April 2005 that the IRS substantially met its 2004 plans for the BSM program based on the delivery of the planned CADE, MeF, e-Services,[30] and IFS project releases. Although these releases were operational on or close to revised cost estimates and delivery dates, they exceeded original cost estimates and delivery dates and did not provide all intended systems capabilities. We

[27] The annual BSM program assessments are required by RRA 98.

[28] Government Accountability Office, Pub. No. GAO–05–207, High-Risk Series (2005).

[29] It is worth noting that GAO also identified the Tax Systems Modernization program, which preceded the BSM program, as a high-risk area.

[30] The e-Services project focuses on changing the way taxpayers transact and communicate with the IRS. This web-based project expands the existing third-party tools and data collection processes.

remain cautious about declaring success based on results achieved in 2004 due to our historical perspective of the modernization effort and our familiarity with the persistent modernization challenges facing the IRS.

CUSTOMER SERVICE

To assist taxpayers in complying with the complex tax code, the IRS offers assistance through its toll-free telephone system, walk-in services, and written and electronic communications, including the IRS Web site: www.IRS.gov. The effectiveness of each of these services influences a taxpayer's ability and desire to comply voluntarily with tax laws.

RRA 98 mandated that the IRS be more responsive to customer needs. Since the passage of RRA 98, the IRS' focus on customer service has led to many improvements. Individual taxpayer satisfaction rates with the IRS have increased since the law's passage, rising from 51 to 64 percent between 1999 and 2004.[31] The ability of taxpayers to contact the IRS via telephone has improved, and customer service at the Taxpayer Assistance Centers (TACs) has shown progress.[32]

The IRS internet site, www.IRS.gov, is an excellent source for forms, publications, and other guidance, and taxpayers visited the site over 139 million times last year. The site also received an award for being the nation's most reliable government internet site.[33] Electronic filing of tax returns is continuing to grow, and the ability to check the status of tax refunds online has been a successful IRS project that is helpful to taxpayers.[34]

The following chart shows the customer service goals established by the IRS and the actual results in each area as measured by the IRS and TIGTA.

[31] American Customer Satisfaction Index, "ACSI Overall Federal Government Scores with Historic Scores of Agencies Measured 1999–2004," December 14, 2004.

[32] Taxpayer Assistance Centers are walk-in sites where taxpayers can get answers to both account and tax law questions and receive assistance with return preparation. We audited the accuracy of tax law answers given to taxpayers at these Centers and determined that the accuracy rate had increased from 54 to 67 percent from January 2002 to April 2004. Treasury Inspector General for Tax Administration, Ref. No. 2004–30–038, Access to the Toll-Free Telephone System Was Significantly Improved in 2003, but Additional Enhancements Are Needed (2004); Treasury Inspector General for Tax Administration, Ref. No. 2005–40–021, Customer Service at the Taxpayer Assistance Centers Is Improving But Is Still Not Meeting Expectations (2004).

[33] Internal Revenue Service, IRS.gov Cited As Most Reliable Government Web Site, IR–2004–131, available at http://www.irs.gov/newsroom/article/0,,id=130492,00.html (last visited May 10, 2005).

[34] Internal Revenue Service, Free File Tops Last Year's Total, IR–2005–36, available at http://www.irs.gov/newsroom/article/0,,id=137055,00.html (last visited May 10, 2005).

IRS Customer Service Results (Compiled by TIGTA)

	IRS-Reported Customers Served or Services - Fiscal Year 2004	IRS-Reported Customers Served or Services - Filing Season 2004	IRS-Reported Accuracy-Fiscal Year 2004	IRS-Reported Accuracy-Filing Season 2004	IRS Goals Fiscal Year 2004	TIGTA-Reported Accuracy	TIGTA Results[35]
Taxpayer Assistance Centers	7.7 million taxpayers; 1.6 million for tax law	3.8 million taxpayers; 790,000 for tax law	75%	75%	80%	67%	TIGTA made 125 visits and asked 250 questions in the 2004 Filing Season[36]
Referral-Mail[37]	381,561	339,105	64%	64%	Unknown	74%	TIGTA placed 70 calls during the 2003 Filing Season[38]
Toll-Free Accounts[39]	31,667,354	14,779,747	89%	89%	90%	86%	TIGTA monitored 264 calls during the 2004 Filing Season[40]
Toll-Free Tax Law[41]	5,730,632	3,907,260	80%	79%	85%	62%	TIGTA monitored 322 calls during the 2004 Filing Season[42]
Internet-Based[43]	111,203	65,737	65%	60%	78%	83%	TIGTA sampled 76 responses during the 2002 Filing Season[44]

[35] TIGTA's results are based on testing in the IRS' Wage and Investment Division.
[36] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-40-152 TAXPAYER EXPERIENCE AT THE TAXPAYER ASSISTANCE CENTERS COULD BE IMPROVED (2004).
[37] Taxpayers that call the Tax Help Line (1-800-829-1040) and ask more complex questions are transferred to the IRS' Referral Mail (R-Mail) Program. The R-Mail Program is designed to answer complex tax law questions via telephone, e-mail, or correspondence within three workdays. The IRS did not have a 2004 goal for R-mail accuracy. We are not conducting an audit of R-mail this filing season.
[38] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-40-029, IMPROVEMENT IS NEEDED IN E-MAIL RESPONSES TO COMPLEX TAX QUESTIONS SUBMITTED THROUGH TOLL-FREE TELEPHONE HELP LINES (2003).
[39] This category includes taxpayers that call the Tax Help Line and ask questions about their accounts, including information on the status of their returns/refunds, corrections of errors found during processing, and corrections resulting from adjustments or examination assessments. The Toll-Free Program counts services provided, not taxpayers served.
[40] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-40-018, TOLL-FREE ACCOUNT ASSISTANCE TO TAXPAYERS IS PROFESSIONAL AND TIMELY, AND THE QUALITY OF INFORMATION PROVIDED HAS IMPROVED (2004).
[41] This category includes taxpayers that call the Tax Help Line and ask about tax law issues including filing status and exemptions, pensions, retirement accounts, the Earned Income Tax Credit, and the Child Tax Credit. This program counts services provided, not taxpayers served.
[42] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-40-150, ADDITIONAL EFFORT ANSWERING TAX LAW QUESTIONS WOULD IMPROVE CUSTOMER SERVICE (2004).
[43] The Electronic Tax Law Assistance (ETLA) Program offers taxpayers the ability to submit tax law questions 24 hours a day, 7 days a week. The IRS is limiting taxpayer access by locating the link to ETLA in a section of its website that is difficult to find. We are conducting an ETLA audit this filing season.
[44] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2003-40-014, RESPONSE ACCURACY IS HIGHER FOR THE INTERNET PROGRAM THAN FOR OTHER OPTIONS AVAILABLE TO TAXPAYERS NEEDING ASSISTANCE WITH TAX LAW QUESTIONS (2002).

Although the IRS is striving to reach its goals in the customer service area, I am concerned about plans to reduce customer service in order to provide more funding for enforcement initiatives. The IRS recently announced plans to close a significant percentage of the TACs, which are the sites that provide face-to-face services to taxpayers. As part of a planned audit, we will review the methodology used by the IRS to determine which TACs to close. At this point, I am skeptical that the IRS has adequate data to assess the impact that closing these centers will have on customer service. I am also concerned that the IRS has insufficient data to draw conclusions on the likelihood that taxpayers, who have used these centers in the past, will be able to use other methods of seeking help, such as the internet or telephone. I strongly recommend that the IRS further research these issues before closing selected TACs.

Additionally, the IRS has decided to cancel the Telefile project. In 2003, TIGTA recommended that the IRS explore other opportunities to expand—not cancel—the Telefile program.[45] We continue to believe the Telefile program provides services to millions of taxpayers and is worth pursuing. However, the IRS has decided to discontinue the Telefile program after the 2005 filing season citing as reasons high costs, low demand, and the increased availability of e-filing options. If the IRS follows through with its decision to discontinue the Telefile program, it should at least develop a strategy to accommodate Telefilers who are unable to e-file.

FILING SEASON

In addition to providing customer service to American taxpayers, the IRS must coordinate tax law changes, programs, activities, and resources to effectively plan and manage each filing season. The tax return filing season impacts every American taxpayer and its success affects the entire Federal Government.

I am pleased to report that the 2005 Filing Season has gone well, and TIGTA has identified no major problems. As of April 29, 2005, the IRS had received approximately 121.1 million individual income tax returns with over 66 million filed electronically, an increase of nearly 11 percent compared to the same period last year. Additionally, 88 million refunds had been issued, averaging $2,127 per return. Of the total refunds, 50 million were issued using the direct deposit option.

Our audit work for the 2005 filing season is currently in progress, but preliminary results indicate that most tax forms and publications were accurately updated to reflect tax law changes. TIGTA found some errors, however, in publications regarding the calculation of the child tax credit for certain military personnel.[46]

The IRS, though, continues to struggle to ensure certain tax law provisions have been accurately implemented.[47] For example, during the 2004 filing season, the IRS did not recover $21 million in overpayments of advanced child tax credits. Additionally, approximately $152 million in advanced child tax credits remained unclaimed by taxpayers. Taxpayers also continued to receive erroneous deductions for student loan interest and were inappropriately allowed both education credits and deductions for tuition and fees. As a result, over $3.3 million in taxes was not paid. These same issues continued in the 2005 filing season.

Another issue that the IRS has not effectively addressed is ensuring the appropriate handling of accounts of taxpayers with combat zone indicators.[48] Over 58 percent of the taxpayers with an active combat zone indicator were incorrectly coded (i.e., the taxpayers were no longer serving in a combat zone). This allows taxpayers to receive special tax treatment to which they are no longer entitled, such as the ability to file late, not be audited, and have collection action suspended.

The IRS was also not identifying and correcting errors that were created when attempting to update the tax accounts of military service members who had entered or exited a Combat Zone. These errors could occur for various reasons, such as missing information or mismatches between names or Social Security Numbers. As a result, taxpayers who are serving in a Combat Zone may not have indicators on their accounts and would be at risk of not getting the Combat Zone benefits they deserve.

---

[45] Treasury Inspector General for Tax Administration, Ref. No. 2003–40–092, Opportunities Exist to Expand the Telefile Program (2003).

[46] Treasury Inspector General for Tax Administration, Draft, Audit No. 200440047, Forms, Publications, and Computer Programming Requests Were Adequately Addressed and Updated in Most Instances for the 2005 Filing Season (2005).

[47] Treasury Inspector General for Tax Administration, Ref. No. 2005–40–016, The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented (2004).

[48] Treasury Inspector General for Tax Administration, Ref. No. 2005–40–077, Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement (2005).

The IRS did not keep records of errors resulting from mismatches or missing information, which prevented TIGTA from determining the extent of this condition. TIGTA has reported these findings to the IRS and will continue to monitor whether this and other filing season recommendations have been implemented.

THE IRS RESTRUCTURING AND REFORM ACT OF 1998

RRA 98 included significant structural changes in management and oversight of the IRS, as well as provisions to strengthen and enhance the rights of taxpayers. Since the enactment of RRA 98, TIGTA has performed a series of audits to determine the IRS' progress in implementing and ensuring compliance with these provisions. The law requires TIGTA to review 10 taxpayer rights provisions, as well as two other taxpayer rights provisions from prior legislation. TIGTA is currently assessing the IRS' compliance with these provisions for the seventh consecutive year. Our most recent audit results on these taxpayer rights provisions are as follows:

• Notice of levy—RRA 98 requires the IRS to notify taxpayers at least 30 days before initiating any levy action to give taxpayers an opportunity to formally appeal the proposed levy. Prior TIGTA reports have recognized that the IRS has implemented tighter controls over the issuance of systemically generated levies. Our testing of these controls indicates that they continue to function effectively.

However, revenue officers sometimes issue to taxpayers levies that are not systemically generated. In 5 of 40 cases reviewed, we determined that revenue officers seized taxpayer assets using manual levies without notifying taxpayers of their appeal rights. Without notification of their appeal rights, taxpayers may not be aware that they are entitled to a hearing or other due process safeguards. Not offering appeal rights to taxpayers prior to issuing levies is a potential section 1203 violation of RRA 98 and could result in the revenue officer being terminated for misconduct.[49] We recommended that the IRS require managers to review and approve all manual levies prepared by revenue officers in order to ensure taxpayers are properly advised of their appeal rights.[50]

• Restrictions on the use of enforcement statistics to evaluate employees—Section 1204(a) of RRA 98 prohibits the IRS from using tax enforcement results to evaluate employees or to impose or suggest production quotas or goals. Section 1204(b) requires employees to be evaluated using the fair and equitable treatment of taxpayers as a performance standard. Section 1204(c) requires supervisors to certify quarterly whether tax enforcement results were used in a prohibited manner. TIGTA is required to evaluate annually the IRS' compliance with section 1204.[51]

Our review of performance and supervisory documentation for 75 enforcement employees found the IRS in compliance with sections 1204(a) and (b). In addition, a review of a statistical sample of 43 supervisors' certifications indicated that the IRS was in compliance with section 1204(c).[52]

• Notice of lien—The IRS attempts to collect Federal taxes from taxpayers by sending letters, making telephone calls, and meeting face-to-face with taxpayers. When initial contacts by the IRS do not result in the successful collection of unpaid taxes, the IRS has the authority to attach a claim to the taxpayer's assets for the amount of unpaid tax liabilities.[53] The IRS files a Notice of Federal Tax Lien (NFTL), which notifies the public that a lien exists. Since January 19, 1999, section 6320 of the Internal Revenue Code has required the IRS to notify taxpayers in writing within five business days of filing an NFTL.

We determined the IRS did not completely comply with the law. A statistically valid sample of 150 NFTLs identified 7 NFTLs (4.7 percent) for which the IRS did not mail lien notices within five business days. In addition, we could not determine if the IRS complied with the law for 35 NFTLs (23.3 percent) because it could not provide proof of timely mailing. Finally, in 11 of the 150 NFTLs reviewed (7.3 percent), the IRS did not follow its own internal guidelines when issuing lien notices,

[49] TIGTA's Office of Investigations is evaluating these cases.

[50] Treasury Inspector General for Tax Administration, Ref. No. 2004–30–094, Additional Efforts Are Needed to Ensure Taxpayer Rights Are Protected When Manual Levies Are Issued (2004).

[51] See 26 U.S.C. §7803(d)(1) (2005).

[52] Treasury Inspector General for Tax Administration, ref. no. 2004–40–066, fiscal year 2004 statutory audit of compliance with legal guidelines restricting the use of records of tax enforcement results (2004).

[53] See 26 U.S.C. § 6321 (2005).

including the guidelines for notifying taxpayer representatives and resending notices when they are returned as undeliverable.[54]

• Seizures—To ensure taxpayers' rights are protected, RRA 98 amended the property seizure provisions in sections 6330 through 6344 of the Internal Revenue Code. Our review of a random sample of 50 of 375 seizures conducted between July 1, 2003, and June 30, 2004, determined that the IRS did not comply with all legal and internal guidelines when conducting seizures. We identified 17 instances in 12 seizures in which the IRS did not fully comply with the law. For example, in seven instances all required forms relating to the sales of seized property were not provided to taxpayers, and in two instances proceeds resulting from seizures were not properly applied to taxpayer accounts. Although the instances we identified were technical in nature and did not adversely affect the taxpayers involved, not following legal and internal guidelines could result in abuses of taxpayer rights.[55]

• Illegal Tax Protestor (ITP) designations—Section 3707 of RRA 98 prohibits the IRS from referring to taxpayers as ITPs or any similar designations. The IRS has not reintroduced past ITP designations on the Master File, and formerly coded ITP taxpayer accounts have not been assigned similar Master File designations. In addition, the IRS does not have any current publications with ITP references and has initiated actions to remove ITP references from the various forms of the Internal Revenue Manual.[56]

However, in 309 isolated instances, IRS employees continued to make references to taxpayers as ITPs and other similar designations in case narratives.[57] TIGTA raised this issue in our FY 2003 report; however, the IRS disagreed with our determination that compliance with this provision prohibits IRS employees from using such designations in case narratives.[58]

• Assessment statute of limitations—The IRS is required to advise taxpayers of their rights when the IRS requests an extension of the statute of limitations on the assessment of additional tax and penalties. TIGTA found that 21 percent of the case files reviewed did not contain any documentation to support that taxpayers had been advised of their rights. In instances in which taxpayers filed a joint tax return, 47 percent of the case files did not contain any documentation that each taxpayer listed on the tax return was separately informed of his or her rights (i.e., dual notification). In addition, when a taxpayer made a declaration of representation, 40 percent of the case files did not contain any documentation that the IRS provided both the taxpayers and their representatives with the advisement of rights. Also, current consent forms do not provide an explanation of taxpayer rights to limit or refuse to extend the statute of limitations.

Although the IRS has revised its internal procedures over the last few years to help enhance controls, our reviews continue to identify instances in which there is no documentation that taxpayers were advised of their rights. Therefore, TIGTA recommended that the Deputy Commissioner for Services and Enforcement revise the various consent forms to include a statement that taxpayers have been informed of their rights regarding assessment statute extensions and have been provided a copy of Extending the Tax Assessment Period (Publication 1035).[59]

• Denials of requests for information under the Freedom of Information Act (FOIA)—Under section 1102(d)(3)(A) of RRA 98, TIGTA is required to conduct periodic audits of IRS denials of taxpayer requests to disclose information on the basis of Internal Revenue Code section 6103 and/or FOIA exemption (b)(7).[60] In 7.1 percent (6 of 84) of the FOIA and Privacy Act[61] cases sampled, the IRS improperly withheld information from requestors. This represents a higher percentage of improper withholdings than reported in FY 2004, where only 4.4 percent of the requests were improperly handled.[62]

---

[54] Treasury Inspector General for Tax Administration, draft, audit no. 200430026, fiscal year 2005 statutory review of compliance with lien due process procedures (2005).

[55] Treasury Inspector General for Tax Administration, draft, audit no. 200430025, FY 2005 review of compliance with legal guidelines when conducting seizures of taxpayers' property (2005).

[56] The Internal Revenue Manual is the single official source for IRS policies, directives, guidelines, procedures and delegations of authority in the IRS.

[57] Draft audit report has not yet been issued.

[58] Treasury Inspector General for Tax Administration, ref. no. 2003–40–098, fiscal year 2003 statutory audit of compliance with legal guidelines prohibiting the use of illegal tax protester and similar designations (2003).

[59] Treasury Inspector General for Tax Administration, ref. no. 2004–40–108, fiscal year 2004 statutory audit of compliance with notifying taxpayers of their rights when requested to extend the assessment statute (2004).

[60] 5 U.S.C. § 552(b)(7) (2005).

[61] 5 U.S.C. § 552a (2005).

[62] Treasury Inspector General for Tax Administration, ref. no. 2004–40–064, improvements are needed to ensure compliance with the freedom of information act (2004).

In addition, the IRS improperly withheld tax return information from requestors in 3.1 percent of the Internal Revenue Code section 6103 cases sampled. This represents a significantly lower percentage of improper withholdings than the 14.6 percent we reported last year. The percentage of untimely responses to FOIA and Privacy Act requestors also decreased significantly to 13.1 percent of the cases, as compared with percentages in previous years' audits ranging from 20 to 43 percent.[63]

• Collection due process—The Appeals Officers and Settlement Officers (hearing officers) substantially complied with the requirements of the law when conducting Collection Due Process hearings. The hearing officers verified that the IRS followed applicable laws or administrative procedures during the lien and levy process. They determined if the proposed collection actions properly balanced the need for efficient collection of taxes with any legitimate taxpayer concerns. In addition, the hearing officers followed appeals procedures by including information, such as the court in which taxpayers must file requests for judicial review, any relief given to taxpayers, and any subsequent actions to be taken by the IRS and the taxpayer.[64]

• Section 1203 allegations—Section 1203 of RRA 98 provides the IRS Commissioner with the authority to terminate the employment of IRS employees for committing certain violations in connection with the performance of their official duties. The IRS Commissioner also has the sole authority to determine whether mitigating factors exist that weigh against termination.

TIGTA's Office of Investigations is responsible for the initial investigation of most section 1203 allegations. These include allegations related to employee false statements under oath, harassment, falsification or destruction of documents, assault or battery of a taxpayer, or threat of examination of a taxpayer for personal gain.

The IRS' process for handling section 1203 allegations ensured that they were referred for action and management responses were accounted for and addressed. The IRS properly controlled referred allegations and reports of investigation. In addition, the IRS and the section 1203 Review Board adequately controlled 141 cases forwarded to the Board for final determination during the 15-month period ending March 31, 2004.

While reviewing case processing, we identified 198 cases as of March 31, 2004, that were open for over 180 calendar days without resolution. The IRS Labor Relations Office performed informal monthly reviews of cases over 180 calendar days old, but did not document their follow-up activities or reasons for the delay in the case histories. We identified some cases where no activity was noted or explanation given for the delay in resolving cases that were over 180 days old. In such cases, management oversight is needed to ensure more timely resolution of section 1203 cases to eliminate unnecessary stress to employees when cases are needlessly delayed.[65]

Neither TIGTA nor the IRS could consistently or accurately evaluate the IRS' compliance with the following three provisions since IRS information systems are inadequate to track such cases:

• Restrictions on directly contacting taxpayers and their authorized representatives;[66]

• Requirements for the disclosure of collection activity with respect to joint returns;[67] and,

• Fair Debt Collection Practices Act (FDCPA) violations.[68]

Recommended changes to RRA 98

As Inspector General, I have a duty to ensure that TIGTA's resources are effectively allocated to the highest priority, mission-critical work. Along those lines, I would like to take this opportunity to note that Congress should review certain requirements established by RRA 98 with the possibility of updating it to reflect changes in the IRS environment since the law was passed. The following areas in RRA 98 are among those I believe are appropriate for such consideration based on

---

[63] Treasury Inspector General for Tax Administration, draft, audit no. 200410032, some improvements have been made to better comply with freedom of information act requirements (2004).

[64] Treasury Inspector General for Tax Administration, ref. no. 2004–40–067, appeals complied with the provisions of the law for the collection due process (2004).

[65] Treasury Inspector General for Tax Administration, ref. no. 2004–40–176, restructuring and reform act of 1998 section 1203 allegations were properly controlled (2004).

[66] Treasury Inspector General for Tax Administration, ref. no. 2005–40–040, fiscal year 2005 statutory review of restrictions on directly contacting taxpayers (2005).

[67] Treasury Inspector General for Tax Administration, ref. no. 2005–40–041, fiscal year 2005 statutory review of disclosure of collection activity with respect to joint returns (2005).

[68] The IRS tracks potential FDCPA violations, but TIGTA cannot be certain that all violations are tracked. Treasury Inspector General for Tax administration, ref. no. 2005–10–051, there were no administrative or civil actions with respect to violations of fair tax collection practices in calendar year 2004 (2005).

TIGTA's collective experience gathered from the last seven years of performing these audits and investigations.

First, I recommend changing the annual reporting requirement for evaluating the IRS' compliance with various matters to a biennial requirement.[69] After auditing the same areas for the last seven years, it has become apparent that, due to the frequency of these audits, there is little change in TIGTA's findings from one year to the next. The IRS does not have sufficient time to implement corrective action before the next audit begins. Biennial reporting would provide a more meaningful picture of the IRS' progress in meeting congressional expectations.

Second, RRA 98 requires that TIGTA report on (1) the IRS' compliance with restrictions on directly contacting taxpayers and their authorized representatives;[70] (2) the IRS' compliance with provisions regarding the disclosure of information to an individual filing a joint return on collection activity involving the other individual filing the return;[71] and, (3) administrative or civil actions with respect to violations of the fair debt collection provisions.[72] While I recognize the public interest that could be served by these requirements, TIGTA cannot conduct substantive audit work because IRS systems do not capture the appropriate data. In the third category, fair debt collection, our audit work of incomplete data has identified only minor and limited issues. Additionally, RRA 98 created requirements that TIGTA report data on allegations and complaints that are received by TIGTA and the IRS.[73] Although TIGTA has attempted to comply with these requirements, we cannot control the IRS' activities and data collection. These mandatory reporting requirements should be eliminated in favor of discretionary reviews.

Third, I strongly urge the Congress to consider reinstating the authority of TIGTA to protect IRS employees from individuals who threaten their safety as they work to administer the tax laws. TIGTA's predecessor, the IRS Inspection Service, had primary responsibility for providing armed escorts for IRS employees working in potentially dangerous situations. The Inspector General Act of 1978,[74] as amended by RRA 98, provides that TIGTA "shall be responsible for protecting the Internal Revenue Service against external attempts to corrupt or threaten employees of the Internal Revenue Service, but shall not be responsible for . . . the providing of physical security."[75] TIGTA is not seeking to provide routine security of IRS buildings (i.e., guard services) nor is it proposing to take on program operating responsibilities. Instead, TIGTA would provide protection to individual IRS employees who encounter potentially dangerous taxpayers (PDTs) when executing their official duties to enable the IRS to fulfill its tax administration responsibilities. TIGTA's provision of armed escort services falls seamlessly in line with the unique mission that Congress gave TIGTA—to protect IRS employees against external threats.

With the IRS Commissioner's commitment to expand IRS examination and collection activities, TIGTA expects an increased need for armed escorts of IRS personnel who work in potentially dangerous environments. The responsibility for conducting armed escorts currently lies with the IRS Criminal Investigation (CI) function. In preliminary discussions, IRS CI has expressed an interest in having the responsibility for conducting armed escorts that involve PDTs transferred to TIGTA. Thus, it would be efficient and effective to expand TIGTA's statutory protection duties to include the authority to provide armed escorts to IRS employees.

Lastly, subsections 1203(b)(3) and (6) of RRA 98 should be amended to prevent IRS employees from using this law to file baseless or frivolous complaints against other IRS employees. In general, section 1203(b) of RRA 98 delineates the causes for termination of IRS employees who commit one of the offenses described. From our experience, IRS employees are misusing section 1203(b) to assert baseless or retaliatory complaints against IRS managers or fellow IRS employees. TIGTA wants to divert the resources currently allocated to addressing these complaints to more important law enforcement efforts. Outside of section 1203(b), IRS employees with

---

[69] TIGTA is currently required to report each year on the IRS' compliance with the law in the following areas: (1) notice of levy; (2) restrictions on the use of enforcement statistics to evaluate employees; (3) notice of lien; (4) seizures; (5) Illegal Tax Protestor designations; (6) extensions of the assessment statute of limitations; (7) denials of requests for information under the Freedom of Information Act; (8) collection due process; (9) section 1203 allegations; (10) restrictions on directly contacting taxpayers instead of authorized representatives; (11) requirements for disclosing collection activity related to joint returns; and, (12) violations of the Fair Debt Collection Practices Act.

[70] 26 U.S.C. § 7803(d)(1)(A)(ii).

[71] 26 U.S.C. § 7803(d)(1)(B).

[72] 26 U.S.C. § 7803(d)(1)(G).

[73] 26 U.S.C. § 7803(d)(2).

[74] 5 U.S.C. app. 3 (2005).

[75] 5 U.S.C. app. 3 § 8D(k)(1)(C).

complaints against other IRS employees have various methods of recourse including the equal employment opportunity complaint process and other personnel support resources. This proposal does not include circumscribing the authority of TIGTA to investigate assault or battery allegations between IRS employees contained in section 1203(b)(5).

TIGTA recommends that subsections 1203(b)(3) and (6) be amended so that IRS employees may no longer invoke them against other IRS employees. Those subsections, however, would still be available to taxpayers and taxpayers' representatives for complaints against IRS employees.

Mr. Chairman and Members of the Joint Review, I appreciate the opportunity to share with you today several significant challenges that confront the IRS. TIGTA will continue its efforts to provide reliable and objective assessments of the IRS' progress in addressing the security and modernization of its systems, balancing enforcement and customer service, handling the workload of the filing season, and addressing the issues raised by RRA 98. Additionally, TIGTA will continue to investigate employee misconduct and external threats that jeopardize the integrity, efficiency, and effectiveness of the nation's tax administration system.

Representative RAMSTAD. Mr. Wagner.

STATEMENT OF RAYMOND T. WAGNER, JR., CHAIRMAN, IRS OVERSIGHT BOARD

Mr. WAGNER. Thank you, Mr. Chairman, for this opportunity to present the views of the Oversight Board on the Service's progress toward meeting the letter and the spirit of RRA 98. I also want to thank and commend you and the members of the joint review for holding this hearing.

As a prelude to my remarks, I would like to take a moment to invite you to envision how a tax administration system would work in an ideal world:

With such a system, taxpayers fully understand their tax obligations. Burdens on taxpayers are low, filing is efficient and easy and enforcement is swift, certain and professional. And voluntary compliance is high. In short, taxpayers would find compliance easy to achieve and difficult to avoid.

If this describes the ideal state, what is the strategy for achieving it?

Seven years since the passage of RRA 98 is a logical time to ask the question we frequently hear when we are on a journey, Are we there yet? Well, the answer here is, Not yet.

But we can get there. And one of the most important ways is to use a road map. A strategic plan is that road map.

The current plan developed by the IRS and approved by the Oversight Board has three goals: to improve taxpayer service, to enhance enforcement of the tax laws, and to modernize the IRS through its people, processes and technology. The IRS must pursue those goals with rigor and discipline and must stay balanced between customer service and enforcement. Clearly, both are necessary if high levels of compliance are to be achieved.

I can illustrate this by restating Commissioner Everson's equation of "service plus enforcement equals compliance" in other terms—"prevention plus correction equals compliance."

Taxpayer service is prevention, per se. Preventing taxpayer errors is usually cheaper and less painful than correcting them. Enforcement corrects problems by applying appropriate actions to noncompliant taxpayers. It can be painful to the taxpayer. Looking at the equation in these terms provides greater insight into the importance of service.

The board is increasingly concerned that cutbacks in customer service functions and modernization resources will have a negative impact upon the IRS's ability to deliver quality services to taxpayers and improve overall taxpayer compliance. My written statement provides several examples of possible service cuts that are of concern.

The board has no authority to make tax policy recommendations. Yet I would be sadly remiss not to mention the corrosive effect that Tax Code complexity has on enforcement and in closing the tax gap. The board fully supports the President's Federal advisory panel to simplify the Tax Code. Simplification of the Tax Code will be the greatest boost of all for both service and enforcement.

Modernizing computer systems through the BSM program is one of the strategic plan's goals. The IRS's once deeply troubled BSM program has experienced better performance in 2004. We believe it is time to give that program another shot in the arm and to fully fund that program for the upcoming year.

Both GAO and TIGTA have reported on the cost overruns and the delays the BSM program has experienced. One cost you won't hear about, however, is the cost to taxpayers by delaying the benefits of a modernized IRS.

Let me add that individual taxpayers spend approximately $84 billion a year complying with the Tax Code. IRS modernization does more than save the IRS money. It makes taxpayers efficient as well. Online banking has revolutionized the banking industry and helps taxpayers manage savings and checking accounts, apply for loans and pay bills. IRS modernization can do the same for taxpayers. If a modernized IRS makes taxpayers only 5 percent more efficient, that would save taxpayers over $4 billion per year.

Improving its human capital is an important part of the IRS strategic plan. The board believes that human capital is the IRS's greatest resource and strength and one of its greatest challenges. The IRS possesses an extremely talented and dedicated workforce that produces very high-quality work. However, the workforce cannot be taken for granted. It must be carefully selected, trained and given the tools it needs to meet the demands of tax administration. The board expressed concerns regarding the IRS's lack of a strategic approach to human capital.

Mr. Chairman, in my opening remarks I described the ideal world of tax administration. If we are to make informed management decisions, we need to establish some meaningful, but achievable, measures for a realistic world. The work of Congress would be facilitated if there existed long-range measures for effective tax administration that were widely accepted as representing a desirable, but realistic tax administration system.

The last topic I would like to address is the budget. My written statement describes the board's budget recommendations for 2006. The appropriations process has not been able to fund the IRS at levels that many people in tax administration, including the board, believe is necessary. It is time to step back and look at this with a strategic perspective. The board recommends that Congress take a hard look at the procedures it uses to appropriate IRS funding. My statement shows how investing in the IRS is money well spent.

I see that my time has run out, so I will conclude my statement to say, Mr. Chairman, the board strongly believes that our Nation can ill afford to return to the days when the IRS fluctuated between customer service and enforcement. Our goal must to be create a tax administration system where compliance is easy to achieve, but difficult to avoid.

The IRS has been on the right track and making progress toward that ultimate goal. We must now give them the tools, guidance and resources to finish the job.

Thank you, Mr. Chairman. And I would be happy to answer any questions.

Representative RAMSTAD. Thank you, Mr. Wagner.

Just a reminder that all the witnesses statements will appear in the record in toto. Thank you again, Mr. Wagner.

[The statement of Mr. Wagner follows:]

WRITTEN TESTIMONY OF RAYMOND T. WAGNER, JR., CHAIRMAN, IRS OVERSIGHT BOARD

INTRODUCTION AND SUMMARY

Thank you, Mr. Chairman for this opportunity to present the views of the IRS Oversight Board on the current state of our tax administration system and the Internal Revenue Service's progress in meeting the letter and spirit of the IRS Restructuring and Reform Act of 1998 (RRA 98). I also want to thank and commend you and the members of the Joint Review for your continued leadership, expertise and oversight of the IRS. It is greatly appreciated.

As a prelude to my remarks, I would like to take a minute and invite you to envision how a tax administration system would work in an ideal world. With such a system, we would find:

- Taxpayers fully understand their tax obligations
- Burden on taxpayers is low
- Filing is efficient and easy
- Enforcement is swift, certain and professional
- Level of voluntary compliance is high

In short, taxpayers would find compliance easy to achieve and difficult to avoid.

It is now seven years since the passage of RRA 98. It is a logical time to ask that question we frequently hear when we are on a journey: Are we there yet? The answer is: not yet. But we can get there using a roadmap.

The IRS Strategic Plan is that roadmap. The current Strategic Plan was developed by the IRS and approved by the Oversight board in 2004. It establishes three goals for the IRS:

- Improve Taxpayer Service
- Enhance Enforcement of the Tax Law
- Modernize the IRS through its People, Processes and Technology

The IRS' first Strategic Plan in the post-RRA 98 era, approved by the Board in 2001, set the agency's direction. And during the past seven years, the IRS has achieved significant gains on a number of important fronts, although the pace of improvement has been frustrating at times, especially to taxpayers. The quality of telephone service has greatly improved, helping taxpayers navigate and comply with an extremely complex tax code. The IRS now estimates that more than half of individual taxpayers will file their returns electronically in 2005 and millions are using the IRS web site to download forms, get information on their tax law questions and track the status of their refunds.

The IRS' computer modernization program met its cost and schedule milestones in 2004, and the first taxpayers have finally been moved off the old tape-based system to a modern reliable database. Although the agency's enforcement effort had been suffering from a declining resource base, the IRS was able in FY 2004 to increase its enforcement resources and showed an impressive gain in enforcement revenue.

Enforcement activities increased substantially in 2004, with a 40 percent jump in audits of high-income taxpayers, doubling the number of audits from four years ago. Audits of large businesses also increased. And in a major victory against those who participated in a particularly abusive tax shelter known as "Son of Boss," the IRS

offered a very favorable settlement for the government and collected about $3.2 billion so far in back taxes, interest, and penalties from over 1,100 taxpayers.

What is important about this improved performance is that progress has been made in both the service and enforcement functions of the IRS' mission—something the Oversight Board has advocated since its inception. The results achieved clearly demonstrate that it is possible to reach the desired balance.

However, the IRS still confronts a number of challenges, not the least of which is closing the estimated $300 billion plus tax gap. As Senate Finance Committee Chairman Charles Grassley said last month, "[T]he tax gap—like a loaf of bread—is made up of many different slices. We need to understand each one better and look at several ways to address them. But let me make it clear, we will work to address the tax gap—we owe nothing less to the millions of honest working families who find tax day the toughest day of the year. It is absolutely wrong that families have to tighten their belts and find new ways to keep the family budget balanced because others are not paying their fair share."[1]

Other challenges confront the agency. First, although the initial results produced by the National Research Program are to be applauded, the IRS still needs to get a better handle on understanding noncompliance, particularly underreporting. Second, as I will discuss in greater detail in my testimony, the IRS is making significant cuts in customer service, such as the forthcoming closure of a number of Taxpayer Assistance Centers. The Board is concerned that the IRS has not fully estimated the potential impact of such reductions on taxpayers—the overwhelming majority of whom want to comply with the tax code but need help doing so. Third, despite the Board's recommendation in its previous annual report, the IRS has not yet addressed its near- and long-term human capital issues ranging from employee training to a potential wave of retirements beginning next year.

The IRS Strategic Plan is the vehicle by which the IRS will meet these challenges. The IRS would greatly benefit from setting outcome measures to gauge progress in achieving its goals. They could have an energizing effect on the agency, improve accountability, help measure progress, and in turn, assist Congress and the Administration in making informed budget decisions.

Lastly, to achieve the goals established in the Strategic Plan, the IRS needs a realistic budget that not only funds customer service, enforcement and Business Systems Modernization but which provides for the anticipated expenses the agency will incur, such as congressionally-mandated pay raises, inflation and rent increases.

ENSURE BALANCE

Many of the IRS' well-publicized problems can be traced to shifts between customer service and enforcement. Often compared to a swinging pendulum, the IRS would focus almost exclusively on one part of its mission to the detriment of the other.

Achieving a balance between customer service and enforcement has become the IRS' greatest challenge. Indeed, the problems that led to the enactment of RRA 98 were due in part to a zealous over-reliance on enforcement dollars at the expense of taxpayer service. RRA 98 specifically addresses this problem by stating, "The IRS shall review and restate its mission to place a greater emphasis on serving the public and meeting taxpayers' needs."[2] Only with the passage of RRA 98 has there been the recognition that both service and enforcement must be provided.

RRA 98 called upon the IRS to provide both quality customer service and fair enforcement. The Board has consistently stated that to be truly successful, and compatible with the spirit of RRA 98, the IRS had to succeed in all parts of its mission. It could no longer be an either/or proposition. This insistence on balance is also at the core of the IRS strategic plan and Commissioner Everson's formula, "customer service plus enforcement equals compliance." The balanced approach is also shared by many others in the larger tax community.

At the Board's 2005 annual public meeting, the American Institute of Certified Public Accountants observed: "Commissioner Everson recognizes 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 the needs of America's taxpayers are fulfilled."[3]

These sentiments were also embraced by the Treasury Inspector General for Tax Administration Russell George, who said, "Enhancing enforcement while improving

[1] Senate Finance Committee Chairman Charles Grassley, Opening Statement before the Senate Finance Committee, April 14, 2005.

[2] P.L. 105–206, Title I, Section 1002.

[3] American Institute of Certified Public Accountants, Statement to the Internal Revenue Service Oversight Board Public Meeting, February 1, 2005.

customer service is the proper direction for the IRS," and the National Taxpayer Advocate who argued that "taxpayer service and enforcement activities work hand in hand to promote high levels of compliance."[4]

More than just a strategy or an equation, the balanced approach to tax administration is producing positive results that the Board believes should be further encouraged. As previously noted, the IRS has made considerable strides in improving customer service since the passage of RRA 98 and these improvements are reflected in taxpayer satisfaction surveys such as the American Customer Satisfaction Index (ASCI). In 2004, the overall customer satisfaction score of individual tax filers increased by almost two percent, showing a steady increase since 1999.[5]

However, now that the tax gap has taken center stage, there is the temptation to fall back on old habits, say customer service is fixed and direct all resources to enforcing the tax laws. It's the considered opinion of the Board, that this new slant would represent a major setback to achieving RRA 98's goals. We should stay the course set by the balanced approach.

The Board's concerns in this regard are shared by Members of Congress, taxpayers and practitioners. At the April 14th Senate Finance Committee hearing on closing the tax gap, Ranking Member Baucus observed:

"But I want to offer a word of caution to the administration and to Commissioner Everson. 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."[6]

At the Board's 2005 public meeting, the National Association of Enrolled Agents made a statement in a similar vein:

"NAEA supported the creation of the [IRS Oversight Board] as a defense against the tendency of policymakers to swing wildly between two extremes: funding taxpayer service to the exclusion of funding compliance programs on the one hand, and funding compliance programs to the exclusion of funding taxpayer service on the other. At the end of the day, both of these objectives must be adequately funded for the system to work correctly."[7]

Taxpayers have also taken notice and want a balanced system too. Almost two out of three participating in the Board's 2004 taxpayer attitude survey supported additional IRS funding for enforcement (62 percent) and taxpayer assistance (64 percent).[8]

Mr. Chairman, the long-term health of our tax administration system must be our overarching goal. To succeed in meeting that goal the IRS must meet the needs of *all* parts of its strategic plan and critical mission on behalf of America's taxpayers—not just one or the other. We must have balance; we must have quality customer service and effective enforcement to achieve real compliance.

CLOSING THE COMPLIANCE GAP

The aforementioned Senate Finance Committee hearing, "The $350 Billion Question: How to Solve the Tax Gap" highlighted the growing seriousness of the tax gap problem and the IRS' difficulty in closing it. David M. Walker, Comptroller General of the United States, testified that in spite of the recent turnaround in staffing and some enforcement results, "IRS's recent compliance estimate indicates that compliance levels have not improved and may be worse than it originally estimated."[9] Indeed, the problem is so severe that "Tax Law Enforcement" has been placed on General Accounting Office (GAO)'s "high-risk" list.

The IRS National Research Program (NRP) recently completely its assessment of individual taxpayer compliance for 2001 and came up with the tax gap estimate—actually a range of $312–353 billion. Underreporting noncompliance, e.g., under-

[4] National Taxpayer Advocate Nina M. Olson, Testimony before the Senate Finance Committee, April 14, 2005.

[5] American Customer Satisfaction Index, "ACSI Overall Federal Government Scores with Historic Scores of Agencies Measured 1999–2004", December 15, 2005.

[6] Senate Finance Committee Ranking Member Max Baucus, Opening Statement before the Senate Finance Committee, April 14, 2004.

[7] National Association of Enrolled Agents, Statement to the Internal Revenue Service Oversight Board Public Meeting, February 1, 2005.

[8] Internal Revenue Service Oversight Board, Annual Taxpayer Attitude Survey, April 2005.

[9] Comptroller General of the United States David M. Walker, Testimony before the Senate Finance Committee, GAO–05–527T, April 14, 2005.

stated income, improper deductions, overstated expenses and erroneously claimed credits, represents the largest component of the tax gap—between $250–292 billion, or more than 80 percent.[10] However, as the GAO noted, it is important to get behind the NRP methodology to get a true picture of the tax gap:

"[F]or some areas of the tax gap, the estimate relies on outdated data and methodologies, including data from the 1970s and 1980s used to estimate corporate income tax underreporting and some employment tax underreporting. IRS does not have firm plans for obtaining more contemporary information on compliance for these areas of the tax gap or again measuring individual income reporting compliance." [11]

Given these challenges, the Board applauds the IRS for the progress it has made in some specific enforcement areas, such as correspondence examinations and the 40 percent increase last year of audits of high-income individuals. Working in conjunction with the Department of Justice, the agency has also won some important victories in high-profile abusive tax shelter cases. Additionally, last May the IRS made a settlement offer regarding a particularly abusive tax shelter known as "Son of Boss," and to date, $3.2 billion in taxes, interest and penalties have been collected from the more than 1,100 taxpayers who participated in the offer. The number of criminal prosecutions is also up, but still fall short of pre-1998 levels.

In 2004, legislation was enacted allowing the IRS to use private collection agencies (PCAs) to augments its collection efforts. However, expectations should be tempered regarding the PCA initiative; only 10 percent of the tax gap is due to underpayment. Let me also note, Mr. Chairman that the Oversight Board, GAO and Treasury Inspector General for Tax Administration (TIGTA) have recently agreed to meet quarterly to bring a common perspective to the oversight of the PCA program.

However, in spite of these successes, it is clear that current IRS enforcement efforts are insufficient to close the tax gap in any meaningful way. They simply will not provide the breakthrough that is required; much more is needed across the board.

The Board concurs that a multi-pronged effort must be taken to shrink the tax gap. In addition to providing additional enforcement resources, which I will discuss in the budget section of my testimony, other actions can and must be taken.

The Board believes that while the NRP assessment was a good start; it was just that—a start. The Board shares the National Taxpayer Advocate's concern that much more and better research is needed. Ms. Olson stated that the IRS should be conducting extensive research now to develop a "long-term and sustained strategy for reducing the tax gap. This strategy must focus on the indirect effects as well as the direct effects of IRS initiatives." [12]

The need for better data to measure the tax gap and the effectiveness of enforcement actions was also voiced by the Treasury Inspector General for Tax Administration J. Russell George. At the Senate Finance Committee hearing, he made a compelling case:

"Although better data will help the IRS identify non-compliant segments of the population, broader strategies and better research are also needed to determine what actions are most effective in addressing non-compliance . . . [I]n two recent audit reports, TIGTA identified examination programs that the IRS implemented nationwide before obtaining results on their possible effectiveness or before implementing an effective strategy to measure the results of the program."

"The IRS must continue to obtain accurate measures of the various components of the tax gap and the effectiveness of actions taken to reduce it. The information is critical to the IRS for strategic direction, budgeting and staff allocation. The Department of Treasury also needs these measures for tax policy purposes. Additionally, the Congress needs this information to develop legislation that improves the effectiveness of the tax system." [13]

The Board is in full agreement with this assessment as we are with TIGTA's recommendation that delays in Business Systems Modernization (BSM) must be addressed. In addition to helping provide quality customer service to taxpayers, modernizing IRS' antiquated computer systems will give IRS enforcement personnel the tools they need. For example, the Filing and Payment Compliance project will help the Private Collection Agency initiative.

---

[10] IRS Fact Sheet
[11] Walker, op. cit.
[12] Olson, op. cit.
[13] Treasury Inspector General for Tax Administration Russell George, Testimony before the Senate Finance Committee, April 14, 2005.

Although the Board has no authority to make tax policy recommendations, I would be sadly remiss not to mention the corrosive effect that tax code complexity has on enforcement and closing the tax gap. The complex tax code frustrates honest taxpayers who are trying to comply with the law while proving opportunities for those who exploit its complexities to devise sophisticated and hard-to-detect illegal tax avoidance schemes.

The Chief of Staff of the Joint Committee on Taxation George Yin made the following well-reasoned argument for simplification at the tax gap hearing:

"Much has been written about the benefits of simplification. In terms of ways to reduce the tax gap, I believe that simplification ranks as the most important. Complex laws spawn many inadvertent errors as well as opportunities for intentional non-compliance. Complex laws also contribute to taxpayer confusion and real or perceived unfairness in the tax system. Studies have shown that taxpayers are less likely to be compliant if they perceive the system to be inequitable."[14]

There are other detrimental consequences stemming from a complex tax code: IRS' enforcement workload has grown both in sheer numbers and complexity because of the code. According to a TIGTA analysis, in FY 2004, hours spent per return on examinations were up 23 percent for individual tax returns and 19 percent for corporate returns over the previous year.[15] Indeed, as we peel away the layers of many of the IRS' problems—from resources to customer service to enforcement—we often find tax code complexity at their core.

In this regard, the Board fully supports the President's federal advisory panel to simplify the tax code. In addition to reducing taxpayers' burdens, simplifying the tax code would be the greatest boost of all for both service and enforcement. It is an essential part of any broad strategy for closing the tax gap.

STABILIZE CUSTOMER SERVICE

Since the issuance of the IRS Restructuring Commission Report and the passage the following year of RRA 98, the IRS has achieved tangible gains in customer service. In 2005, the agency turned in yet another successful filing season.

Taxpayers can now get through on the IRS toll-free telephone lines and the accuracy and quality of the responses to their tax law and account questions have remained steady and at reasonable levels. Taxpayers are also afforded a number of self-serve options over the telephone and the IRS' web site that help reduce the burden of filing and paying their taxes. There were almost twice as many visits to IRS.gov this filing season than last, and more than five million taxpayers took advantage of the innovative Free File program—a more than 40 percent increase from the same period last year.

Taxpayers recognize and value the services the IRS provides to help them understand and comply with the complex and ever changing tax code. The 2004 IRS Oversight Board Tax Compliance Study found that "the most heavily relied upon source of tax information and advice are IRS representatives (82 percent see them as very/somewhat valuable), and IRS printed publications such as brochures (82 percent) and the IRS web site (77 percent). The only non-IRS provided information source that is nearly as highly rated is a paid tax professional (81 percent). Further, more than 90% of those surveyed said that IRS customer service is either very or somewhat important to them.[16]

However, the Board notes that in spite of these improvements, IRS customer service is still not on a par with private sector financial services organizations. IRS customer service is still a work in progress, and complacency is our worst enemy. At a recent hearing of the House Ways and Means Subcommittee on Oversight on the 2004 filing season and proposed FY2006 IRS budget, Government Accountability Office Director, Strategic Issues James R. White noted that there were "slippages in telephone access such as more abandoned calls and longer wait times."[17] Walk-in assistance has proven to be particularly helpful for many taxpayers who do not have access to computers and the Internet, or prefer one-on-one personal assistance. Yet, according to Treasury Inspector General for Tax Administration Russell George, service levels at these sites have improved, but are still not meeting expectations.[18]

---

[14] Joint Committee on Taxation Chief of Staff George K. Yin, Testimony before the Senate Finance Committee, April 14, 2005.

[15] George, op. cit.

[16] Internal Revenue Service Oversight Board, Annual Taxpayer Attitude Study, April 2005.

[17] Government Accountability Office Director, Strategic Issues James R. White, Testimony before the House Ways and Means Subcommittee on Oversight, GAO–05–416T, April 7, 2005.

[18] Treasury Inspector General for Tax Administration J. George Russell, Testimony before the House Ways and Means Subcommittee on Oversight, GAO–05–416T, April 7, 2005.

It is against this backdrop that the Board raises its concern that reductions in customer service and modernization resources in the proposed FY2006 IRS budget will have a negative impact on the IRS' ability to delivery quality service to taxpayers and improve overall taxpayer compliance. The cuts are troubling for a number of reasons.

The IRS has already announced that it will end its TeleFile service, used by almost four million taxpayers. The Board is concerned that these taxpayers will return to paper filing. Tax return and tax account transcripts provided by Taxpayer Assistance Centers (TACs) must now be requested by phone or mail, which requires a two-week waiting period. These transcripts are often needed urgently by those applying for mortgages or other loans. This change in procedure burdens taxpayers and is counter to the IRS commitment to provide excellent customer service.

Other possible customer service cuts include:

- Closing a large number of Taxpayer Assistance Centers, which in total serve 7.5 million taxpayers each year, many of them elderly and lower-income taxpayers and those with limited or no English proficiency;
- Reducing hours on the IRS' toll-free lines; and
- Providing fewer paper versions of forms and publications, further burdening lower-income taxpayers who do not have ready access to the Internet.

These proposed reductions in customer service are raising concerns throughout the tax community. The GAO warned at the Ways and Means Oversight Subcommittee hearing that "the risk, as IRS shifts its priorities toward enforcement, is that some of the gains in the quality of taxpayer service could be surrendered."[19]

And while these real and potential reductions may not signal a return to the days of hundreds of millions busy signals and completely unacceptable levels of customer service, they are certainly a step in the wrong direction. And as we increasingly learn, quality customer service is not an end in itself but an essential part of that balance of customer service and enforcement that leads to compliance.

Ways and Means Oversight Subcommittee Chairman Ramstad correctly observed that "retaining the good will of American taxpayers by providing professional service and detailed guidance on how to comply with the law are critical to sustaining voluntary compliance."[20] The GAO Comptroller General David M. Walker testified at the Senate Finance Committee hearing that "providing quality service to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap."[21] And TIGTA expressed similar views at the Senate hearing:

"The IRS must exercise great care not to emphasize enforcement at the expense of taxpayer rights and customer service. I believe that steps to reduce the current level of customer service should be taken only with the utmost thought and consideration of their impact, and only with all the necessary data to support these actions. Customer service goals must be met and even improved upon, or people will lose confidence in the IRS' ability to meet part of its mission of providing America's taxpayers quality service by helping them understand and meet their tax responsibilities."[22]

Indeed, as previously noted, the IRS has not provided the information we need to measure the short-term impact of these reductions on taxpayers. In the absence of such research, the Board urges that no precipitous actions be taken that could threaten the hard won improvements in customer service and further expand the tax gap. Moreover, until meaningful and substantive tax simplification is enacted into law, taxpayers will need all the help they can get to understand the tax code.

COMMIT TO MODERNIZATION

Modernizing its computer systems through the Business Systems Modernization (BSM) program is one of the IRS Strategic Plan's goals. The IRS' once deeply troubled BSM program has experienced better performance in 2004. Due to improved management focus, BSM delivered on schedule in 2004 important technology products that will generate greater efficiencies throughout the agency and create real benefits in both customer service and enforcement.

For example, the first taxpayers have been moved to a modernized reliable data base (Customer Account Data Engine) and corporate taxpayers are now able to conduct many of their transactions with the IRS electronically (Modernized e-File).

Future BSM deliverables are also critical to improved customer service. As the ACSI scores illustrate, there is still a gap between customer satisfaction levels for

[19] Ibid.

[20] Chairman Jim Ramstad, Opening Statement before the House Ways and Means Subcommittee on Oversight, April 7, 2005.

[21] Walker, op. cit.

[22] George, op. cit.

banks and the IRS. Banks offer daily updating of accounts, electronic access by customers to account records, and a full range of electronic transactions—options which the IRS cannot yet provide. With the help of modern technology, the IRS must close this gap if it is to be perceived by taxpayers as having services on a par with financial institutions.

But clearly, the IRS has made real progress in managing BSM. Given such progress in 2004, if the IRS can continue to demonstrate improvement in 2005, then in 2006 it would seem most desirable and logical to increase BSM's funding. BSM funding levels have been severely reduced in the last several years. Indeed, BSM funding was $388 million in FY2004, $203 million in FY2005, and is now requested at $199 million in FY2006.

The Board strongly believes that cutting back on modernization will force the program to take longer and cost more than necessary. Of greatest concern is the age of IRS' existing computer systems which will eventually become impossible to maintain. As time passes, a catastrophic disruption in our nation's tax system becomes more likely.

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.

Both GAO and TIGTA have reported on the cost overruns and delays the BSM program has experienced. One cost you won't hear about, however, is the cost to the taxpayers of delaying the benefits of a modernized IRS.

Let me offer one concrete example. According to the ConsumerAffairs.com web site, in the 2003 tax filing season, an estimated 12.1 million taxpayers nationwide obtained Refund Anticipation Loans (RALs). Further, the economic burden of RALs falls particularly hard on families who can least afford the cost. A report by the National Consumer Law Center (NCLC) and the Consumer Federation of America (CFA) found that roughly 57 percent of the families who purchased RALs in 2003—6.92 million of the 12.1 million—received the federal Earned Income Tax Credit (EITC). The EITC provides financial assistance to the working poor. Those 6.92 million EITC recipients spent a total of $1.74 billion on RAL-related fees, including check-cashing fees, according to the NCLC and CFA.

The Customer Account Data Base (CADE), the largest of the BSM projects, offers as a benefit the ability of the IRS to issue an electronic refund to taxpayers who electronically file in about three to five days, which I expect will take a major bite out of the RAL business. There will be no need for a RAL if the IRS can issue a refund in three days. Even if such a capability reduces the number of RALs by only 60 percent, that will still save EITC taxpayers over $1 billion a year. So, every year the IRS delays its ability to issue a three-day refund to electronic filers costs taxpayers over a billion dollars a year.

Let me offer another taxpayer-focused perspective. Professor Joel Slemrod of the University of Michigan testified to the President's Panel on Tax Reform that individual taxpayers spend approximately $85 billion a year complying with the tax code. If a modernized IRS makes taxpayers only five percent more efficient, that would still save taxpayers over $4 billion a year. That's why it pays to complete BSM as quickly as the IRS can manage the program.

HUMAN CAPITAL AND TRAINING

Improving its human capital is in the second half of goal three of the Strategic Plan. The Board believes that human capital is the IRS' greatest resource and strength, and one of its greatest challenges. The IRS possesses an extremely talented and dedicated workforce that produces very high-quality work in spite of the technological and resource limitations previously described. However, such a workforce cannot be taken for granted. It must be carefully selected, trained and given the skills and tools it needs to meet the demands of tax administration in the 21st century. Human capital cannot be an afterthought; it must be integrated into any IRS strategic plan.

As we stated in our 2004 annual report, the Board has serious concerns regarding the IRS' lack of a strategic approach to human capital. In 2003, the Board recommended that the IRS focus on its people resources—specifically on the way that it hires, trains and retains employees. We called upon the IRS to develop an agency-wide human capital strategic plan that focuses on five key areas:

1. Replace lost critical talent—The IRS has a "graying" workforce with 25 percent eligible to retire by 2006. Many of these individuals possess critical skills, such as maintaining legacy IT systems, and institutional knowledge that could easily be lost.

2. Build skills for complex work—Tax administration will become more complex in the future as demonstrated by the challenges in combating abusive tax avoidance transactions that are increasingly more sophisticated and harder to detect. Enhanced IT skills will become more important in this new environment, such as the use of technology as the preferred means of doing business.

3. Manage change—Even though the IRS customer-focused organization is firmly in place, change will continue throughout the agency. The IRS is no longer a static organization; new technology and process redesign will bring further challenges and greater change, and with it, an increased demand for leaders and managers with change management skills and experience.

4. Enhance performance—Given budgetary constraints, the IRS must enhance its performance each year to meet greater work demand and improved customer service and enforcement goals. Management skills take on greater importance in such a high performance, goal-driven environment.

5. Engage the entire workforce—Workforce engagement remains a challenge. Surveys indicate that upper management levels of the IRS are engaged in its mission and strategic goals; but the same cannot be said for front-line managers and rank-and-file employees.

So far, the IRS has yet to develop an agency-wide human capital plan that deals with these five concerns, although some are addressed in part in the agency-wide strategic plan.

Nevertheless, there have been some gains. The Board was pleased to see improvements in the IRS' third annual employee satisfaction survey, conducted by The Gallup Organization, in which approximately 75 percent of the workforce participated.

According to Gallup, the IRS made "steady progress increasing employee engagement" from 2001 to 2003. It reported that the percentage of employees who saw themselves as being engaged rose from 21 percent to 31 percent from 2001 to 2003. The ranking of the IRS increased from the 34th to the 50th percentile of comparable organizations.

However, these improvements are dwarfed by the remaining challenges. Sixty-nine percent of IRS employees are still not engaged and the Gallup survey also showed that less than a majority of employees (43 percent) can strongly agree that they know what is expected of them at work. Greater and more focused attention is needed on workforce issues.

Training at the IRS

At last year's IRS Nationwide Tax Forums and the Board's 2005 annual open meeting, the Board also heard from stakeholders and dozens of agency employees who saw workforce issues as the greatest challenge for the agency over the next five years. The lack of adequate training was a dominant issue.

Stakeholders described an expanding training gap at the IRS, where employees often lack the expertise and skills to handle difficult, complex or problem cases. IRS employees also reported that they were inadequately or unevenly trained. Stakeholders added that in the operating divisions where employees have helped plan and design training programs, employees report higher job satisfaction and empowerment.

The Oversight Board has studied IRS' division training programs and determined that there is no clear vision for training across the agency, and no real linkage between strategic training planning at the national and operating division level, nor is there an agency-wide "champion" for training. Admittedly, reduced budgets have had a negative impact on training, such as inconsistent treatment per employee across the four operating divisions and the inability to provide leadership training and effective management succession across the agency. However, TIGTA also recently reported that the IRS' Human Resources Investment Fund is so poorly managed that 60 percent of its funds were spent on administrative costs while turning away employees for lack of money.[23]

Inadequate training budgets will not allow the IRS to proceed with plans for hiring, training, and retaining qualified individuals to address the enforcement and customer service needs of the agency. Adequate funding for training is critical and will allow the IRS to develop and retain a well-trained, well-equipped workforce supported by enhanced technologies. The workforce of the future must be prepared to deal with not only the approaching gap created by the retirements of senior, experienced employees, but also to deal with the increasingly complex and abusive tax avoidance schemes that are contributing to the growing tax gap.

[23] Treasury Inspector General for Tax Administration, Audit Report, "The Human Resources Investment Fund is Not a Cost-Effective method of Providing Tuition Assistance, March 2005.

The ability of the IRS to realize its long-term vision and goals depends upon effective, efficient, well-trained and motivated employees. It also depends upon the IRS' ability to implement effective measures to assess the impact of training, and to plan and design new methods of training that address emerging critical compliance needs.

Two years after the IRS Oversight Board raised concerns on human capital issues, the same problems persist; the IRS has not adequately addressed them. The agency has not yet dealt with the reality of an aging workforce and has failed to provide clear guidance, direction and training for its employees.

The Board recommends that the IRS develop a strategic human capital plan that addresses these issues. Faced with pending retirements, the IRS must have a plan in place to refresh its workforce, preserve invaluable knowledge, and institute succession planning throughout the agency. The IRS must also have a plan to recruit and retain qualified personnel, especially future executives from the private sector who can bring to bear best practices and new ideas to the challenges and opportunities that the 21st Century brings. And lastly, the IRS must better train and equip its workforce with necessary skills. The IRS will be hard pressed to close the compliance and customer service gaps if the training gap is not closed as well.

MEASURE LONG-TERM GOALS

Mr. Chairman, in my opening remarks I described an ideal world of tax administration. If we are to make informed management decisions on tax administration, we need to establish some meaningful but achievable goals for a realistic world. Now that the IRS has made significant gains in many areas, it is important that quantifiable long-term goals be set to guide our decision-making, especially in seeking to achieve the critical balance between service and enforcement.

I believe that there is a general consensus that the IRS must begin to set long-term goals as a way to measure both performance and to help the Administration and Congress make informed decisions on resources and budgets.

This imperative was clear throughout this year's congressional hearings on the IRS. The Comptroller General David M. Walker testified that the IRS "lacks quantitative long-term goals for improving taxpayer compliance, which would be consistent with results oriented management."[24] James R. White, GAO's Director, Strategic Issues, took another tack: "IRS is developing, but currently lacks, long-term goals that can help them inform stakeholders including the Congress, and aid them in assessing performance and making budget decisions."[25] As previously noted, TIGTA came to a similar conclusion about the value of such goals. Indeed, an agreed-upon set of long term goals between the IRS and Congress could not only help the allocation of resources but prevent the wild swings in the pendulum between customer service and enforcement.

The Board appreciates the difficulty associated with developing measures and performance goals. Setting long-term goals requires a high level of consultation and consensus building. Achieving agreement among Congress, the executive branch, external stakeholders and the public will be particularly challenging. Nevertheless, some initial progress has been made.

As discussed in the Board's 2004 annual report, during the FY2005 budget formulation process, the IRS took the important step of aligning performance and requested resources. However, the agency must continue to integrate performance into its decision-making and resource allocation processes to achieve completely an integrated performance budget.

Further, the IRS modified its budget and performance plans to include more customer-focused and "end result" measures. The agency also implemented the "Embedded Quality" program/methodology to gauge the accuracy of completed actions. As the IRS expands this program to capture even more data, it can better identify and resolve specific accuracy problems—thereby, improving the work product and in turn, the level of service to taxpayers.

The work of Congress would be facilitated if there existed a set of long-range measures for effective tax administration that were widely accepted as representing a desirable but realistic tax administration system the country would like to achieve. These goals would set a valuable context for making decisions on the proper balance between service and enforcement. They would create an environment of accountability where everyone who is part of the system—taxpayers, the IRS, and decision-makers in the executive and legislative branches—are all aware of overall goals and their contributions to goal achievement.

[24] Walker, op. cit.
[25] White, op. cit.

The Board believes it is imperative to identify the key attributes of an effective tax administration system. Such attributes can identify desired outcomes and create a road map for the next decade that will complement the IRS' strategic, budget and annual performance plans. In addition, it could be integrated into the government-wide Key National Indicators Initiative whose purpose is to help assess the overall position and progress of our nation, frame strategic issues and chart future directions.

A REALISTIC BUDGET

The Oversight Board believes there is much to like in President Bush's FY2006 budget request for the IRS. First, the Oversight Board recognizes and appreciates that at a time when most budgets are being tightened, the President is asking for a greater budget increase for the IRS than for other non-defense and non-homeland security agencies. The Board is encouraged by the request for additional enforcement funding and is pleased that the Administration acknowledges that investments in IRS enforcement result in increased tax revenue.

However, the Board recommends even more funding than the President has requested; our recommendation builds on the President's budget request. The Board calls for $11.6 billion in funding for FY2006, a nine percent increase over the Administration's recommendation. A comparison of the Board's recommendation and the President's request is shown in the following table:[26]

Comparison of Administration's Request, IRS Oversight Board's Recommendation, and Enacted Appropriations

[In $ millions]

FY2005			FY2006	
Administration	Oversight board	Enacted	Administration	Oversight board
10,674	11,206	10,233	10,679	11,629

The Board believes that the IRS must begin to close the tax gap through greater enforcement. For that reason, we recommend an additional $435 million over the President's request for IRS enforcement efforts that could easily generate more than a billion and a half dollars in additional tax revenue using the Administration's return on investment of four-to-one. From its private sector perspective, the Board believes it makes perfect sense to make the additional investments in enforcement that will pay for themselves many times over.

The Board also recommends additional funding towards stabilizing customer service and supporting the BSM program. As I mentioned earlier in my testimony, the Board is concerned that proposed reductions in customer service and modernization resources in the FY2006 budget request will have a negative impact on the IRS' ability to deliver quality service to taxpayers, which ultimately, will also have an adverse effect on taxpayer compliance.

Clearly both service and enforcement are necessary if high levels of taxpayer compliance are to be achieved. Re-stating Commissioner Everson's equation in other terms illustrates this point: Prevention + Correction = Compliance.

Taxpayer service is prevention, and designed to prevent non-compliance by informing taxpayers of their tax obligations and offering assistance in filing accurate returns. Preventing taxpayer errors is usually cheaper and less painful than correcting them. Enforcement is correction, and is designed to apply appropriate treatments to non-compliant taxpayers based on the severity and cause of their non-compliance. Looking at the equation in these terms provides greater insight into the importance of service.

Indeed, Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies Chairman Christopher Bond stated at an April 7th hearing that he hears almost daily complaints that the tax code has become "unmanageable and confusing, resulting in excessive cost and administrative burdens that far exceed reasonable tax compliance."[27]

Given this environment, the Board asks, "Shouldn't public policy be tilted in favor of assisting taxpayers?" We recognize that there can be a tension between afford-

[26] Internal Revenue Service Oversight Board, FY06 Budget/Special Report.

[27] Chairman Christopher Bond, Opening Statement before Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development and Related Agencies, April 7, 2005.

ability and good public policy. However, we must not overlook the overall impact on taxpayers when making decisions on federal expenditures.

For example, the proposed closing of selected TACs, which in total served 7.7 million taxpayers in FY2004, will save about $55 million in federal expenditures, or about $7 per taxpayer served. The savings may seem attractive at first but we should be conscious of the burdens that this reduction of service imposes on taxpayers and how it affects tax revenues. Therefore, we urge the members of the Joint Review to follow the Board's FY2006 budget recommendations for customer service funding.

We are also aware of the severe limitations that Congress is under in appropriating federal monies to worthwhile needs. For example, Congress may agree with the Board's budget recommendations, but the existing budget evaluation methodology makes it difficult to act on these recommendations because enforcement initiatives are considered simply as an expense, and are not recognized for the amount of revenue that will be raised. For that reason, the Board is pleased to see the Administration's recommendation to adjust Appropriations Subcommittees 302(a) allocations to increase enforcement funding for the IRS.

However, this recommendation comes with restrictions that could limit the additional funding to enforcement functions. Because enforcement spending would be set at a fixed amount, the Board is concerned that these restrictions could result in unintended consequences, such as additional reductions in taxpayer services or modernization, should enforcement not be fully funded or unanticipated costs arise.

Rather than dwell on the Board's FY2006 budget recommendations, I believe it is more important to recognize the long-term effect of an under-funded IRS, as well as the benefits of additional IRS funding. The appropriations process has not been able to fund the IRS at all levels many people in tax administration, including the Board, but also including many IRS stakeholders, believe is necessary. It is time to step back and look at the problem from a more strategic perspective.

The Board recommends that Congress take a hard look at the procedures it uses to appropriate IRS funding. Last year, the IRS produced enforcement revenue of $43 billion, approximately four times the total IRS budget. This year, the Administration in its proposed budget recognized that there is a four-to-one direct return on investment from IRS enforcement. Any indirect effects on voluntary compliance resulting from either customer service or enforcement are in addition to those direct effects.

How can the appropriations process be changed to recognize these realities? Let me suggest for your consideration two approaches that have been used in the past, one as recently as last year.

In the late 1990s, Congress set aside approximately $144 million a year for five years, outside of the caps on discretionary spending, specifically earmarked for Earned Income Tax Credit enforcement. A similar approach could be taken again for a broader enforcement initiative.

Last year, in the JOBS bill, Congress authorized the IRS to use private collection agencies and authorized the Secretary of the Treasury to retain part of the money collected. This was the first time I can recall that the revenue stream has been used to pay for IRS operations. If this is an acceptable approach, perhaps it could be used more broadly. A mere one percent of last year's enforcement revenue of $43 billion could pay for an appreciable IRS enforcement effort. Alternatively, it could provide adequate funding for the IRS BSM program. Controls could be imposed that would still give Congress oversight over how the money was to be spent, but it would relieve the pressure on the appropriations process that seems to be failing the IRS.

Lastly, I want to raise an issue that the Oversight Board brought to the forefront in a special budget report it issued in March 2005. The IRS needs a realistic budget that recognizes and provides for the anticipated expenses it will incur, such as congressionally-mandated pay raises, inflation and rent increases. By not fully funding these costs, the IRS will be challenged yet again to make other cuts in critical programs to pay for them.

CONCLUSION

Mr. Chairman, in conclusion, the Board strongly believes that our nation can ill afford to return to the days when the IRS fluctuated between customer service and enforcement. We cannot shift resources to pursue those who knowingly avoid taxes while neglecting the needs of honest taxpayers attempting to comply with a complex tax code.

As I previously stated, our goal must be to create a tax administration system where taxpayers would find compliance easy to achieve, but difficult to avoid. Since the passage of RRA 98, the IRS has been on the right track and making progress

toward that ultimate goal. We must now give them the tools, guidance and resources to finish the job. Thank you and I would be happy to answer your questions.

Representative RAMSTAD. Ms. Olson, please.

STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE

Ms. OLSON. Mr. Chairman, thank you for inviting me to testify today.

These are challenging times for the IRS. As its 5-year strategic plan acknowledges, the IRS must balance the demands of an ever-increasing workload with the needs of an increasingly diverse taxpayer population that includes a widening income, information, and technology gap.

At the same time, outmoded IRS business systems negatively impact customer service, taxpayer rights and IRS business results. I provide several detailed examples of business systems' impact in my written testimony.

In meeting these challenges, the IRS is seeking to increase its examination, collection and criminal investigation presence, which I applaud. But I am concerned that this growth in enforcement may come at the expense of our recent progress in the quality of our taxpayer service, both within traditional taxpayer assistance functions and our enforcement divisions.

Preliminary results from the National Research Project indicate that the overall compliance rate in 2001 was about the same as that in 1988, the date of our last Taxpayer Compliance Measurement program. During this period, enforcement activities declined substantially while taxpayer service significantly improved. From 1999 to 2004, one leading study found that taxpayer satisfaction with the IRS rose from 51 percent to 64 percent. Thus, it is entirely possible that robust taxpayer service plays as large a role as, if not larger, than robust enforcement in achieving a high level of taxpayer compliance over time.

True taxpayer service involves figuring out why taxpayers don't comply before determining the appropriate IRS compliance action. To date, the IRS has not built this approach into its enforcement initiatives or its training of enforcement personnel.

The IRS should create business performance measures that track the appropriateness of the enforcement response to the reasons for noncompliance. After all, revenue agents and revenue officers aren't just in the enforcement business. They are actually in the compliance business. A failure to understand the reasons why a taxpayer is noncompliant may lead to greater short-term enforcement results, but not to a greater long-term compliance.

In meeting the needs of a diverse taxpayer population, the IRS's current strategic plan relies heavily on self-service and electronic options, and gives short shrift to the real information and literacy gap in the United States today. For example, the IRS's current approach to closing Taxpayer Assistance Centers is based on the assumption that taxpayers who need face-to-face services will easily migrate to electronic or other self-service products. The IRS overestimates taxpayers' ability or willingness to conduct complex financial transactions in an electronic or self-service format.

For example, while some in today's society are comfortable with banking online, many are not. As I have stated elsewhere, the IRS simply does not know what services various parts of our population need delivered in a face-to-face environment. Thus, the IRS has focused single-mindedly on closing Taxpayer Assistance Centers, or TACs, without researching taxpayer needs and identifying alternative means of delivering necessary face-to-face taxpayer service.

I recommend that Congress require the IRS to conduct a comprehensive taxpayer-based needs assessment once every 5 years to complement an ongoing National Research Program that measures taxpayer compliance. With this taxpayer-centric data in hand, the IRS would be able to make resource and technology application allocations that actually reflect taxpayer needs. Without this information, the IRS is making decisions about taxpayer service based on its own resource limitations.

A periodic taxpayer-needs assessment would prove very helpful when the IRS has to make difficult program decisions, some of which involve irrevocable consequences, such as closing the TACs. If the IRS decides a few years down the road that it has made a mistake, it will be hard-pressed to obtain the resources required to reopen TACs.

One final word of caution: We must all be very careful about the pressure we put on the IRS to produce. A panel of non-IRS senior executives, who were appointed by Commissioner Rossotti to review allegations of abuse from the RRA 98 hearings, noted that there has historically been considerable pressure on the IRS to improve productivity and that the importance of safeguards should not be minimized or lost in the interest of achieving greater productivity. To avoid a repeat of the pre-1998 environment, each of the entities and persons with an IRS oversight responsibility should take great care to ensure that current IRS efforts to bolster enforcement do not, however inadvertently, diminish the hard-won improvements to taxpayer service and taxpayer protections that are so essential to maintaining overall taxpayer satisfaction and, not incidentally, overall taxpayer compliance.

Thank you.

Representative RAMSTAD. Thank you, Ms. Olson.

[The statement of Ms. Olson follows:]

WRITTEN TESTIMONY OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE

Mr. Chairman and Members of the Joint Review panel: Thank you for inviting me to testify before this joint hearing regarding the Internal Revenue Service (IRS) strategic plan and its 2006 budget request. My testimony will also discuss the importance of business systems modernization to improved taxpayer service and enforcement as well as certain taxpayer protections provided by the IRS Restructuring and Reform Act of 1998 (RRA 98)[1] that the IRS has yet to implement adequately.

THE IRS MISSION STATEMENT IN TODAY'S ENFORCEMENT ENVIRONMENT

In September 1998, the IRS issued a new mission statement that was designed to reflect the priorities of the newly reorganized Service and set a tone for all of its employees in fulfilling their duties. The statement was very concise:

"Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."

[1] Pub. L. No. 105–206, 112 Stat. 685.

The IRS's mission reflects some of the lessons learned from the period preceding and subsequent to the enactment of RRA 98, including the role of quality taxpayer service in maintaining and even increasing the level of taxpayer compliance. Moreover, while tax law enforcement is not explicitly discussed, the mission statement recognizes that enforcement derives from the IRS's obligation to apply the tax law "with integrity and fairness to all."

Today, as historically, the IRS struggles to maintain the appropriate balance between quality taxpayer service and enforcement. The IRS's current five-year strategic plan for 2005–2009 recognizes the need for this balance:

"The mission statement describes our role, as well as the public's expectation regarding how we should perform that role. In the United States, the Congress passes tax laws and requires taxpayers to comply. The taxpayer's role is to understand and meet his or her tax obligations. Our role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share. We must meet the highest standards of service and integrity in performing our role."[2]

Under the IRS's controlling strategic plan, then, the IRS envisions that service and enforcement will be "poised to meet customer expectations and to respond quickly to technological and demographic changes."[3] Thus, there should be no conflict between the IRS's dual mission of providing top-quality taxpayer service and enforcing the tax laws.

THE DECLINE OF IRS EXAMINATION AND COLLECTION ACTIVITIES

In the late 1990s, as the IRS attempted to reverse some of the most significant erosions of taxpayer service, its traditional examination and collection activities and resources also declined. Although many commentators like to attribute this decline to the RRA 98 hearings and certain provisions enacted by Congress in that statute, I believe there are many causes for the decline and that ignoring other causes will result in many of the same behaviors that got the IRS into trouble in the first place.

Why the sudden drop in enforcement activities and resources? First, let's look at the numbers. In FY 1995, the IRS conducted 2.1 million examinations,[4] filed 799,000 notices of federal tax liens, and issued 2,722,000 levies.[5] By FY 2000, the IRS conducted approximately 716,000 examinations,[6] filed approximately 288,000 notices of federal tax liens, and issued approximately 220,000 levies.[7]

We know that IRS examinations dropped from 2.1 million in FY 1995 to 716,000 in FY 2000. However, by FY 2000 the IRS also issued approximately 5.8 million "math error" notices which summarily assess certain adjustments to the taxpayer's return.[8] Congress expanded the IRS's math error authority effective for tax years 1996 and 1997, and as a result, math error procedures eliminated the need for millions of correspondence and even office exams. So the decline in examinations may not be as great as some observers believe, although there is no denying that field examinations declined from 2.1 million in FY 1995 to 716,000 in FY 2000.

Now, let's examine the reasons for the drop in enforcement activities. The decline in collection actions is often attributed to the implementation of Collection Due Process (CDP) hearing procedures, by which some taxpayers unduly delay the collection of tax. However, only 1.2 percent of all IRS field and Automated Collection System liens and levies that trigger CDP rights result in a request for a hearing, and only 4 percent of those hearings result in litigation. Thus, something else must account for the drop in collection activity.

Employees often cite the enactment of RRA 98 Section 1203, which provides for immediate termination of employment when the employee commits one of "ten deadly sins."[9] Others cite the inability to evaluate individual or small groups of IRS col-

[2] IRS Strategic Plan 2005–2009, Pub. 3744 (Rev. 6–2004), 5.
[3] Id. at 4.
[4] 1995 IRS Data Book, table 11.
[5] Id. table 19.
[6] 2000 IRS Data Book, table 10.
[7] Id. table 16.
[8] IRS, Report to Congress: IRS Tax Compliance Activities (July 2003).
[9] Section 1203(b) requires the IRS to terminate an employee for certain proven violations committed by the employee in connection with the performance of official duties. The violations include: (1) willful failure to obtain the required approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets; (2) providing a false statement under oath material to a matter involving a taxpayer; (3) with respect to a taxpayer, taxpayer representative, or other IRS employee, the violation of any right under the U.S. Constitution, or any civil right established under titles VI or VII of the Civil Rights Act of 1964, title IX of the Educational Amendments of 1972, the Age Discrimination in Employment Act of 1967, the Age Discrimination Act of 1975, sections 501 or 504 of the Rehabilitation Act of

lection employees on quantitative measures. Still others blame the individual caseload of collection employees and their seemingly endless paperwork requirements.

I suspect that each of these factors plays a role, although I believe that Section 1203 is not, or should not be, an excuse for failing to take appropriate actions. After all, the IRS has the power—and is now vigorously wielding it—to bar tax professionals from practicing before it, and states have always had the authority to revoke licenses of attorneys and accountants for rule violations, thereby depriving these professionals of a livelihood. Should we expect less ethical conduct from—and impose lesser sanctions on—IRS employees?

The most persuasive explanation for the decline in examination and collection resources is the real decline in the IRS's annual budget over time while the IRS's workload continues to increase. As Commissioner Rossotti noted in his final report to the IRS Oversight Board:

"Despite significant improvements in the management of the IRS, the health of the federal tax administration system is on a serious long-term downtrend. This is systematically undermining one of the most important foundations of the American economy.

". . . 'Trends in Indicators of IRS Workload and Resources,' from 1992 to 2001, weighted average returns filed, a measure of overall IRS workload, increased by 16 percent because of the economy's growth. However, during this same period, FTEs [full time equivalents] dropped 16 percent from 115,205 in FY 1992 to 95,511 in FY 2001. Since more and more of the IRS' declining resources are required to perform essential operational functions—such as processing returns, issuing refunds and answering taxpayer mail—a disproportionate reduction occurred in Field Compliance personnel, falling 28 percent from 29,730 in FY 1992 to 21,421 in FY 2002. . . .

"Looking more closely at the most recent five years . . . , we see that the number of income tax returns increased by 12 million, while 19 tax bills were passed that changed 292 tax code sections and required 515 changes to forms and instructions. On the average, IRS workload grows at a compounded rate of 1.8 percent per year. Therefore, just to handle this increased workload, the IRS would either have to add staff—which is what occurred fairly consistently for the 45–year period from 1950 through 1995—or would have to increase productivity by 1.8 percent per year just to stay even." [10]

If budget limitations and increased workload are the real explanation for past declines in enforcement activities, then Commissioner Everson deserves significant credit for making a persuasive case for increases in the IRS budget. Without such increases, we may find ourselves in the same situation as we were in 1995, with declining enforcement activities and even greater deterioration in taxpayer service.

In January 1998, Commissioner Rossotti appointed three outside members of the Senior Executive Service to "objectively and independently review and assess evidence developed concerning allegations of misuse of enforcement statistics and to recommend, if appropriate, disciplinary actions." [11] Attempting to explain the external pressures on the IRS to meet productivity demands, the panel described the budget environment in the years leading up to RRA 98:

"The Administration through the budget process in 1994, called upon Congress and the IRS to work together on an approach to both measure and collect more of the delinquent taxes that were currently outstanding. The Administration proposed that beginning in fiscal year 1995, 5,000 full time equivalents (FTEs) be added to assist in improving tax compliance and generating additional revenues. The FY 1995 Compliance Initiatives were developed to improve compliance, generate additional revenue, and provide for additional staffing. Congress agreed to fund the initiatives by providing $2.025 billion over a five-year period. However, IRS received

---

1973 and title I of the Americans with Disabilities Act of 1990; (4) falsifying or destroying documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or a taxpayer representative; (5) assault or battery on a taxpayer or other IRS employee, but only if there is a criminal conviction or a final judgment by a court in a civil case, with respect to the assault or battery; (6) violations of the Internal Revenue Code, Treasury Regulations, or policies of the IRS (including the Internal Revenue Manual) for the purpose of retaliating or harassing a taxpayer or other IRS employee; (7) willful misuse of section 6103 for the purpose of concealing data from a Congressional inquiry; (8) willful failure to file any tax return required under the Code on or before the due date (including extensions) unless such failure is due to reasonable cause; (9) willful understatement of Federal tax liability, unless such understatement is due to reasonable cause; and (10) threatening to audit a taxpayer for the purpose of extracting personal gain or benefit. Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, at 50 and 51 (JCS–6–98).

[10] Commissioner Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System, (Sept. 2002), 12–13 (internal chart and footnote omitted).

[11] Special Review Panel Report for Charles O. Rossotti, Commissioner, Internal Revenue Service (August 1998), (response of Charles O. Rossotti dated Sept. 14, 1998).

only the first installment of $405 million. IRS had committed to generating $331 million for the first year and promptly hired new [Revenue Officers]. According to the IRS, that effort generated $803.3 million during FY 1995. However, in 1996 Congress chose not to continue funding for the Compliance Initiatives. As a result, the thousands of new employees had to be funded out of an already reduced base budget. The downsizing efforts already under way because of the reduced base appropriation were made even more complicated."[12]

The panel found that budget cuts, along with the Government Performance and Results Act of 1993 (GPRA), the Field Office Performance Indicator (FOPI), and "IRS's emphasis on specific statistical targets" essentially resulted in "a competitive environment that was driven by statistical data" and pressures for greater productivity from examination and collection personnel.[13] If we are not careful, we may find ourselves operating in a similar environment today.

THE ROLE OF CUSTOMER SERVICE IN ENFORCEMENT

Customer service—the act of listening to the customer, being professional and ethical in conduct, striving to impose the least burden possible on the customer while resolving the problem—should not be limited to the IRS's taxpayer service functions such as the phones or the Taxpayer Assistance Centers. Customer service plays an important role in enforcement activities and often makes the difference in resolving an issue. Even taxpayers who are noncompliant and are being forced to settle up can respond positively to professionalism. In fact, customer service in enforcement can save the government resources, because it helps reduce the IRS's use of more expensive enforcement measures such as seizures and sales. Thus, one of our quality measures should track how Examination and Collection employees treat taxpayers. We currently listen in on the toll-free and other phone assistance lines to monitor both professionalism and accuracy of responses. The IRS should consider expanding the monitoring of Revenue Agents and Revenue Officers along these lines.

There are many reasons why taxpayers are noncompliant with their tax obligations. The IRS acknowledges this fact in its 2005–2009 Strategic Plan:

"Noncompliance may not be deliberate and can stem from a wide range of causes, including the lack of knowledge, confusion, poor record keeping, differing legal interpretations, unexpected emergencies and temporary cash flow problems. However, some noncompliance is willful, even to the point of criminal tax evasion."[14]

True taxpayer service involves figuring out *why* taxpayers don't comply before determining the appropriate IRS compliance action. To date, the IRS has not built this approach into its enforcement initiatives or its training of enforcement personnel. The IRS should create business performance measures that track the appropriateness of the enforcement response to the reasons for noncompliance. After all, Revenue Agents and Revenue Officers aren't just in the enforcement business—they are actually in the *compliance* business. A failure to understand the reasons why a taxpayer is noncompliant may lead to greater short-term enforcement results but reduced long-term compliance.

MAINTAINING AND IMPROVING TAXPAYER SERVICE

The IRS faces formidable challenges in meeting the needs of a diverse taxpayer population. The IRS's current strategic plan relies heavily on self-service and electronic options and gives short-shrift to the real information and literacy gap in the United States today.[15] For example, the IRS's current approach to closing Taxpayer Assistance Centers (TACs) is based on the assumption that taxpayers who need face-to-face services will easily migrate to electronic or other self-service products.

The IRS overestimates taxpayers' ability or willingness to conduct complex financial transactions in an electronic or self-service format. While some in today's society are comfortable with banking on line, many are not. As I have stated elsewhere, the IRS simply does not know what services various parts of our population need delivered in a face-to-face environment.[16] Thus, the IRS has focused single-mindedly

---

[12] Special Review Panel Report for Charles O. Rossotti, Commissioner, Internal Revenue Service (August 1998), 16 (internal footnotes omitted).

[13] Id.

[14] IRS Strategic Plan 2005–2009, Pub. 3744 (Rev. 6–2004), 18.

[15] Id. at 14.

[16] See Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, The Judiciary, Housing and Urban Development, and Related Agencies, April 7, 2005; Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Committee on Finance on The Tax Gap, April 14, 2005.

on closing TACs without researching taxpayer needs and identifying alternative means of delivering necessary face-to-face taxpayer service.

I recommend that Congress require IRS to conduct a comprehensive taxpayer-based needs assessment once every five years to complement an ongoing National Research Program that measures taxpayer compliance. With this taxpayer-centric data in hand, the IRS would be able to make resource and technology allocations that actually reflect taxpayer needs. Without this information, the IRS is making decisions about taxpayer service based on its own resource needs and general demographic data. A periodic Taxpayer Needs Assessment would prove very helpful when the IRS has to make difficult program decisions, some of which involve irrevocable consequences such as closing the TACs. The IRS will be hard pressed to obtain the resources to reopen TACs if it decides a few years down the line that it made a mistake.

DECREASES IN TAXPAYER SERVICE DRIVE DECREASES IN COMPLIANCE

Preliminary results from the National Research Project (NRP) indicate that the overall compliance rate in 2001 was about the same as that in 1988, the date of the last Taxpayer Compliance Measurement Program (TCMP). As discussed above, enforcement activities during this period dropped substantially. Taxpayer service, on the other hand, improved significantly. Thus, it is entirely possible that improved taxpayer service played a major role in maintaining the level of compliance over time.

We may only need a small increase in enforcement activity to capture a significant improvement in compliance. That is, if word spreads on the street that the IRS is back in some capacity, we may see a disproportionate increase in the indirect effect of enforcement—what I call the "ripple effect" and economists call the "multiplier effect." It is also possible that a large enforcement build-up, if coupled with a decline in taxpayer service, may result in an overall reduction in compliance.

MODERNIZATION OF IRS BUSINESS SYSTEMS

Outmoded IRS business systems negatively impact customer service, taxpayer rights and IRS business results. By the IRS's own assessment:

"The current database architecture inhibits the IRS from delivering the customer service expected by the public and experienced in the private sector. Issues such as poor customer service to taxpayers, taxpayer non-compliance, poor productivity, and job satisfaction by the IRS workforce have received national attention in recent years." [17]

As the IRS acknowledges, there are many problems with IRS data systems, and to address them all would be beyond the scope of this testimony. Three examples of the technology challenges facing the IRS will demonstrate how antiquated systems can impact customer service, taxpayer rights, and business results. These examples also demonstrate that the IRS is responding to these challenges but needs continued resources and support to ensure that these technology investments reap their potential benefits.

THE ROLE OF BUSINESS SYSTEMS MODERNIZATION IN CUSTOMER SERVICE

Part of the IRS's information technology problem is that its "master file" systems are based on 1960s style business architecture. For example, the age and complexity of the Individual Master File (IMF) system causes delays and inaccuracies in providing service to taxpayers. There is lag time in the current IMF system because files are updated on a weekly basis. Consequently, taxpayers often cannot obtain current account information when they contact the IRS.

Because current data is not available to IRS employees, taxpayers are often given incorrect information on their account status, through both direct contact and notices. In an era when technology allows customers access to real-time information in almost every industry, taxpayers expect and deserve some level of sophistication from the IRS.

The cornerstone of the IRS's response to this problem is the new system known as Customer Accounts Data Engine (CADE). CADE is an on-line modernized data infrastructure that is being brought on-line in stages and will run in conjunction with the Individual Master File (IMF) until it ultimately replaces it. Some of the expected benefits of CADE are:

- Refunds will be issued faster because of daily versus weekly processing;

[17] IRS Business Systems Modernization Analysis.

• Taxpayers and employees will benefit because they will be working with more current information; and

• The system administers policy and legislative changes easily.

The IRS can only bring CADE on-line in stages. For example, in July 2004, CADE was used to process an initial set of 1040EZ returns. For 2005, CADE is expected to process approximately 1.9 million 1040EZ returns. Each year thereafter, CADE will handle greater volume and more complexity until it can take the place of the existing system for processing individual returns. The benefits of CADE cannot be realized, however, unless the IRS is able to fund and properly monitor its continued development.

LACK OF PROGRESS IN BUSINESS SYSTEMS MODERNIZATION IMPACTS TAXPAYER RIGHTS

Because of the slow progress with CADE, the IRS maintained or developed other systems to provide IRS personnel with access to tax account and tax return information, such as the Integrated Data Retrieval System (IDRS). These stand-alone systems are not integrated for cross-functional use. The IDRS is also hampered by systemic limitations that prevent the IRS from keeping pace with changes to the tax law.

The failure of the IDRS systems to fully process the changes to the tax laws that affected taxpayers' collection statute expiration dates (CSEDs) demonstrates how systems limitations can impact taxpayer rights. The IRS has 10 years from the assessment date of a tax to collect that tax.[18] Certain actions can suspend the running of the CSED such as a taxpayer's submission of an offer in compromise[19] or an installment agreement.[20] RRA 98 made several important changes to the calculation of CSEDs, including the following:

• The IRS can no longer seek extensions of the collection statute of limitations period unless the extension is sought in conjunction with an installment agreement or in conjunction with a release of levy;[21]

• In the case of an offer in compromise submitted by a taxpayer, the period for which IRS could suspend the running of the CSED was changed from the time that the offer is being considered plus one year to the time that the offer is being considered plus 30 days; and

• In cases where the extensions were entered into before December 31, 1999, the extensions would terminate on the later of the running of the original CSED or December 31, 2002, except that in the case of installment agreements the extensions terminate on the 90th day after the expiration of the extension.[22]

These changes to the laws applicable to the calculation of CSEDs require IRS systems to perform the necessary CSED calculations to ensure that the IRS is not collecting from taxpayers after the date beyond which it is permitted by law to do so. The IRS master file systems are unable to fully process all of these changes in the law. The Taxpayer Advocate Service (TAS) detected increasing numbers of cases where IRS systems failed to properly calculate the CSED for taxpayers. TAS is working with the IRS to identify and correct thousands of inaccurate CSEDs on existing taxpayer accounts. However, these systemic problems will continue to occur if the IRS does not update its systems with functionalities that can make the necessary CSED calculations.

CSED problems also arise because the current IDRS and master file systems cannot accommodate more than one CSED per tax module. Multiple CSEDs can occur, for example, when the taxpayer files a balance-due tax return, which generates a CSED for that amount, and the IRS subsequently audits the taxpayer, resulting in a second CSED for a newly assessed amount. IRS systems will only show the most recent CSED, allowing for the possibility that unlawful collection action could be taken against the taxpayer after the first CSED expires.[23]

Other CSED problems arise because IRS systems cannot separate the joint account of spouses when only one spouse files a request for relief from the liability (e.g., the spouse files an offer in compromise or requests an installment agreement). This situation requires the IRS to separate the joint account into separate accounts so that the applicable limitations period is suspended only for the requesting spouse.

---

[18] IRC § 6502(a)(1). See National Taxpayer Advocate 2004 Annual Report to Congress 180 (discussing the CSED problem in detail).

[19] IRC §§ 6331(i)(5) and 6331(k)(1).

[20] IRC § 6331(k)(2).

[21] Pub. L. No. 105–206, 112 Stat. 685.

[22] Pub. L. No. 105–206, § 3461(c)(2), 112 Stat. 685.

[23] See National Taxpayer Advocate 2004 Annual Report to Congress 185 (citing actual example of taxpayer's account which should reflect 2 CSEDs but only showed the later CSED).

Inherent limitations in the IRS systems make it cumbersome to separate out the accounts of the spouses and can lead to improper collection actions.[24]

IRS BUSINESS RESULTS AND BUSINESS SYSTEMS MODERNIZATION

The IRS's collection strategy provides one example of the potential for business systems modernization to improve business results while at the same time increasing tax compliance. Commentators inside and outside the IRS have long criticized the IRS approach to tax collection as a "one size fits all" approach that applies the same collection strategy to all taxpayers regardless of the reasons for the taxpayer's noncompliance.[25] Timeliness in contacting debtors is crucial to all debt collection efforts.[26] Yet, the IRS collection system keeps all taxpayers in a 6-month notice stream before taking any steps to make person-to-person contact, and it treats all taxpayers the same, levying on taxpayers who may comply after a phone call and ignoring chronically noncompliant taxpayers whose assets should be levied upon.

With the development of the Filing & Payment Compliance (F&PC) initiative, the IRS is making progress toward establishing a modern compliance-based collection strategy. The F&PC initiative is a multi-pronged collection strategy that would make changes to work processes, organization, and technology to increase payment compliance. The cornerstone of the technology piece of F&PC is the use of "decision analytics," which utilize data about the taxpayer to better assess the risk of the account.[27] While the IRS employs decision analytics currently, the applications are limited in part because data is limited to internal IRS information about the taxpayer. F&PC plans to procure software that will use both external data (such as credit ratings) and internal data on taxpayer characteristics to assess risk. Most importantly, the new commercially developed software will then be used to select the optimal treatment for any given taxpayer based on that taxpayer's characteristics. This process should improve business results by enabling the IRS to assign the optimal collection treatment in a timely fashion. At the same time, this process should improve taxpayer payment compliance and protect taxpayer rights by applying the right collection touch to each taxpayer.

The above examples demonstrate that technology has a profound impact on customer service, taxpayer rights, and business results. In each of these examples, the IRS has plans to address the problem with enhanced technological capabilities. However, the complex nature of these problems does not allow for a one-time technological fix. The IRS will be able to steadily improve its customer service, the protection of taxpayer rights, and its business results only if it sustains a long-term commitment to modernize IRS business systems and receives adequate funding and Congressional oversight.

DISTURBING TRENDS SINCE RRA 98

INDEPENDENCE OF APPEALS

RRA 98 requires the IRS to "ensure an independent appeals function within the [IRS]."[28] This requirement recognizes that independence is the critical ingredient of a healthy and successful IRS Appeals function. The Appeals Office itself has historically recognized that it must be independent of IRS enforcement in both fact and appearance.[29] In fact, independence is central to Appeals' mission to "resolve tax controversies, without litigation, on a basis which is fair and impartial to both the government and the taxpayer in a manner that will enhance voluntary compliance

[24] See National Taxpayer Advocate 2003 Annual Report to Congress 170.

[25] General Accounting Office, Tax Administration—New Delinquent Tax Collection Methods for IRS, 1 (May 1993); see National Taxpayer Advocate 2004 Annual Report to Congress 226 (discussing the history of the IRS's collection strategy and offering suggestions for implementation of a modern compliance-based collection strategy); Leslie Book, The Poor and Tax Compliance: One Size Does Not Fit All, 51 Kan. L. Rev. 1145 (2003).

[26] On average, the passage of time results in diminishing collection returns for the IRS, such that after 6 months the IRS loses 47¢ on the dollar, after 24 months it loses 87¢ on the dollar, and after 3 years the debt is nearly uncollectible. IRS Automated Collection System Operating Model Team, Collectibility Curve (August 5, 2002).

[27] The IRS is already using decision analytics to a limited extent. See Treasury Inspector General for Tax Administration, Ref. No. 2004–30–165, The New Risk-Based Collection Initiative Has the Potential to Increase Revenue and Improve Future Collection Design Enhancement (September 2004). The F&PC initiative contemplates a more comprehensive and sophisticated use of risk assessment software.

[28] Pub. L. No. 105–206 § 1001(a)(4).

[29] IRS Document 7225, "History of Appeals," 7–8 (Nov. 1987).

and confidence in integrity and efficiency of the [IRS]."[30] Without independence, taxpayers will view Appeals as an "arm of the Examination function or an adversary seeking to strengthen the government's case."[31] As a result of concern about Appeals' independence, the IRS has altered the Appeals reporting structure several times over the last 50 years.[32]

As I discussed in my 2004 Annual Report to Congress, several recent developments in Appeals raise concerns about its independence from the IRS enforcement function—in both perception and reality:[33]

- Appeals is centralizing most of its inventory (including Tax Court docketed "S" cases[34]) at IRS campuses—limiting taxpayer access to face-to-face Appeals conferences and reassigning cases to campus employees that have traditionally worked in enforcement;[35]
- Appeals participation in certain IRS settlement initiatives and various exceptions to the prohibition against ex parte communications by Appeals erodes the protection afforded taxpayers by that prohibition;
- Appeals actively participates with IRS enforcement in developing IRS enforcement settlement initiatives; and
- The IRS currently categorizes more than 90 percent of Appeals budget as enforcement activity.[36]

I also have concerns about the current state of Appeals' mediation programs.[37] Congress directed the IRS in RRA 98 to establish certain mediation procedures.[38] The legislative history states that mediation fosters more timely resolution of taxpayer problems and should be extended to all taxpayers.[39] However, the IRS' medi-

---

[30] IRM 8.1.1(2) (Feb. 1, 2003).

[31] IRS Document 7225, "History of Appeals," 7–8 (Nov. 1987).

[32] A 1987 IRS document summarized Appeals' history: "A 1952 reorganization established the structure of the Appeals organization along the lines we see today [i.e., 1987]. Prior to the 1952 reorganization, the Appeals function (Technical Staff) reported directly to the Commissioner through the Head of the Technical Staff. The reorganization brought about the establishment of a system of regional administration of districts under Regional Commissioners of Internal Revenue. However, to maintain the independent status of Appeals and preserve the principle of separating the Audit and Appeals operations, the Appeals function was carved out and placed under the office of the Assistant Regional Commissioner (Appellate), who had final settlement authority. . . . In 1982, the Chief Counsel was delegated line supervisory authority over Appeals by the Commissioner. The transfer of Appeals to Chief Counsel facilitates the flow of information and assistance between appeals officers and counsel attorneys." See IRS Document 7225, "History of Appeals" (Nov. 1987).

In 1995, the IRS moved the reporting structure of the Office of Appeals from Chief Counsel back to the Commissioner and Regional Commissioners. See IRS Appeals to be Under Commissioner in Chief Counsel Reorganization, 95 TNT 117–4, June 16, 1995; Linda B. Burke, TEI Says IRS Appeals Function Should Report to Deputy Commissioner, Not Chief Counsel, 95–TNT 108–89, June 5, 1995. ("The current structure of Appeals, reflecting the 1982 decision to shift Appeals to the Chief Counsel's "side of the house," has contributed to a perceived diminution in Appeals" independence. Given Counsel's role as the adviser to Examination personnel, it is hardly surprising that taxpayers are less than sanguine about Appeals' reporting to Counsel. Indeed, anecdotal evidence suggests that Counsel has generally become more involved in the management and oversight of Appeals' workload and that this involvement has affected Appeals' attitude toward settlement.")

In 1998, Congress enacted legislation to "ensure an independent appeals function within the [IRS]". Pub. L. No. 105–206 § 1001(a)(4). For examples of Congressional concerns with Appeals independence, see 144 Cong. Rec. S4182 (1998) ("One of the main concerns we've listened to throughout our oversight initiative—a theme that repeated itself over and over again—was that the taxpayers who get caught in the IRS hall of mirrors have no place to turn that is truly independent and structured to represent their concerns. With this legislation, we require the agency to establish an independent Office of Appeals—one that may not be influenced by tax collection employees and auditors") and 144 Cong. Rec. S7639 (1998) ("the bill mandates that the Commissioner's restructuring of the IRS include an independent appeals function. This appeals unit is intended to provide a place for taxpayers to turn when they disagree with the determination of front-line employees. A truly independent appeals unit will assure that someone takes a fresh look at taxpayers' cases, rather than merely rubber-stamping the earlier determination").

[33] See National Taxpayer Advocate 2004 Annual Report to Congress 264–89.

[34] S cases stem from compliance issues totaling less than $50,000 under IRC § 7463.

[35] The Taxpayer Advocate Service is currently developing this issue as a possible Most Serious Taxpayer Problem for the National Taxpayer Advocate's 2005 Annual Report to Congress.

[36] FY 2005 Congressional Submission.

[37] See National Taxpayer Advocate 2004 Annual Report to Congress 290–310.

[38] See IRC § 7123(b)(1) (directing the Secretary to "prescribe procedures under which a taxpayer or the Internal Revenue Service Office of Appeals may request non-binding mediation on any issue unresolved at the conclusion of—(A) appeals procedures; or (B) unsuccessful attempts to enter into a closing agreement under section 7121 or a compromise under 7122.").

[39] See S. Rep. 105–174 (April 22, 1998) ("The Committee also believes that mediation . . . would foster more timely resolution of taxpayers' problems with the IRS. In addition, the Com-

ation programs, Fast Track Mediation (FTM) and post-Appeals mediation are rarely used.[40] Rather than improve its mediation programs to meet taxpayer concerns and educate taxpayers about the benefits of mediation, Appeals has announced that it is reallocating its FTM program resources to its popular Fast Track Settlement program.[41]

OFFER-IN-COMPROMISE PROGRAM

The "offer in compromise" (OIC) program allows for the compromise of tax liabilities based upon "doubt as to liability" or "doubt as to collectibility," or in furtherance of "effective tax administration."[42] The IRS' goal for the OIC program is to achieve collection of what is reasonably collectible at the least cost and at the earliest possible time and to promote future compliance by providing taxpayers with a "fresh start."[43] OICs also promote future compliance by requiring, as a condition of the OIC agreement, that the taxpayer file returns and pay taxes for the following five years.[44] In RRA 98, Congress expanded the bases for compromise to include "effective tax administration" based on its belief that OICs promote voluntary compliance.[45] The intended effect of this expansion was generally to increase the IRS' flexibility in accepting OICs.[46] The conference report for this legislation explained:

"The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements."[47]

Appropriate revisions to the IRS approach to evaluating offers in compromise, as I discussed in my 2004 Annual Report to Congress, would increase revenues collected and bring more taxpayers back into compliance.[48] IRS's own research shows that for more than half of the offers from individual taxpayers that it rejected or returned, it eventually collected less than 80 percent of what taxpayers were offering, and it collected nothing in more than 20 percent of those cases.[49] The same study also shows that 80 percent of the taxpayers whose offers were accepted remained in compliance with their tax obligations over the five-year period following offer acceptance, as required by the terms of the offer. Thus, the offer in compromise program converts noncompliant taxpayers into compliant ones and brings in enforcement revenue that the IRS would not otherwise collect.

In 1998, Congress authorized the IRS to compromise tax debts based upon factors such as equity, public policy and hardship in cases where doing so would promote the effective administration of the tax laws (ETA offers). However, the IRS has interpreted the congressional authorization so narrowly that, for example, the IRS group charged with evaluating such offers accepted only a single ETA offer based upon equity or public policy in FY 2004. We believe that the IRS' reluctance to compromise in inequitable situations may lead taxpayers to disregard the law or erode their faith in the fairness of the income tax system. As I described in my 2004 Annual Report to Congress, I am not confident that the IRS will, on its own, use its ETA authority in the manner I believe Congress intended. I therefore recommend that Congress provide more specific guidance to the IRS to ensure that a new "equitable consideration" standard be applied in a broader array of cases.[50]

---

mittee believes that the ADR process is valuable to the IRS and taxpayers and should be extended to all taxpayers.").

[40] See National Taxpayer Advocate 2004 Annual Report to Congress 294.

[41] See Fast-Track Settlement Now Available to Small Business, 2005 TNT 82–2 (April 29, 2005).

[42] See Treas. Reg. § 301.7122–1, et. seq.; Form 656, Offer in Compromise (Rev. 7–2004).

[43] Policy Statement P–5–100, IRM 1.2.1.5.18 (Rev. 1–30–1992).

[44] Form 656, Offer in Compromise (Rev. 7–2004).

[45] H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288–289 (1998) (stating that "[t]he Senate amendment provides that the IRS will adopt a liberal acceptance policy for offers-in-compromise to provide an incentive for taxpayers to continue to file tax returns and continue to pay their taxes. . . . The conferees believe that the ability to compromise tax liability . . . enhances taxpayer compliance.").

[46] RRA 98, Pub. L. No. 105–206 (1998).

[47] H.R. Conf. Rep. 599, 105th Cong., 2d Sess. 289 (1998).

[48] National Taxpayer Advocate 2004 Annual Report to Congress 311–341 (describing problems in the offer-in-compromise program) and 433–450 (proposing a legislative recommendation to mitigate some of the problems).

[49] SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program (September 2004).

[50] For more detail, see National Taxpayer Advocate 2004 Annual Report to Congress 433–450.

TAXPAYER ADVOCATE SERVICE MISSION

The statutory mission of the Taxpayer Advocate Service is to help taxpayers resolve their problems with the IRS and make administrative and legislative recommendations to mitigate those problems.[51] The Taxpayer Advocate Service (TAS) was never intended to become a "shadow IRS" or to take on core IRS functions. Today, however, TAS is increasingly asked to meet taxpayer service needs that the IRS no longer wants to meet or is providing for inadequately.

I anticipate that TAS will be asked to provide more taxpayer service to fill needs that arise as a result of IRS cuts in that area. To illustrate, IRS Taxpayer Assistance Centers (TACs) last year stopped issuing transcripts to taxpayers. For the first six months of FY 2005, TAS cases involving requests for copies of tax returns and account transcripts have consequently increased by 58.4 percent as compared with the same period last year. TAS offices that are co-located with TACs subject to closure are particularly likely to see an upsurge in taxpayer requests as taxpayers seeking face-to-face assistance from IRS employees come to TAS instead. In fact, TAS cases resulting from referrals from TACs increased by 29.7 percent for the first six months of FY 2005 over the same period last year due to reduced TAC hours and reduced scope of services. Unless we turn away taxpayers who require assistance, we will increasingly be handling cases that other IRS functions have handled in the past. This situation constitutes a significant deviation from TAS's statutory mission. It is not TAS's role to provide core IRS services.

Instead of learning from how TAS resolves both individual and systemic problems—as was the intent of the RRA 98 restructuring and creation of TAS—the IRS is simply allowing TAS to pick up the slack for the services it doesn't want to provide. Ultimately, either TAS may become unable to fulfill its statutory mission or it will have to pick and choose cases, which will harm taxpayers. Continued Congressional oversight and emphasis on the importance of IRS providing core taxpayer service will ensure that TAS resources are applied to its Congressionally mandated mission—to help taxpayers resolve their problems with the IRS and to recommend systemic solutions to mitigate taxpayer problems.

Representative RAMSTAD. Mr. White, please.

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

Mr. WHITE. Thank you. Mr. Chairman and members of the committee. We are glad to participate in today's hearing. I want to cover two topics: IRS's recent progress and looking forward to challenges in managing resources to continue progress.

First, IRS has made progress in recent years in improving taxpayer service and modernizing operations, but the gains have not been uniform. The most noticeable progress has been in service. Over the last several years, both access to IRS by telephone and the accuracy of IRS answers to telephone—to taxpayers' telephone questions have noticeably improved.

IRS's Web site, a relatively new service, is heavily used and provides a variety of services including form and publication downloads, refund status checks and access to free return preparation and electronic filing.

The progress has been less clear in enforcement. The net tax gap, the uncollected part, is now estimated to be over $257 billion per year.

IRS saw declines in enforcement staffing after 1998, but has recently stopped the declines and begun to show some increases. At the same time, IRS's workload measured by, for example, the number of high-income tax returns or the emergence of sophisticated tax shelters and schemes has been increasing. Combining the trends and staffing and workload, nearly every indicator of IRS's

[51] IRC § 7803(c).

coverage of its enforcement workload has declined in recent years. As a result, tax law enforcement remains on our high-risk list.

As for system modernization, IRS has made significant progress in establishing long-overdue management controls and bringing some new systems online. New systems include the call router, which has improved telephone service, and the first phase of the customer account data engine, which has been processing very simple tax returns this year.

However, BSM remains high risk because of the scope and complexity of the program and the history of schedule delays and cost overruns.

Also of concern are serious information security weaknesses. In a recently issued report, we identify 39 new information security control weaknesses. IRS generally agreed with our recommendations to fix problems.

Looking ahead, IRS faces a number of resource management challenges, but also has opportunities to better manage resources to continue its progress. First, long-term goals would help Congress and others assess IRS's performance, evaluate budget requests and hold IRS management more accountable. For example, long-term goals would provide a framework for assessing budgetary trade-offs between service and enforcement and whether IRS is making satisfactory progress toward goals.

Second, IRS's funding might be enhanced, albeit modestly, by additional user fees which now account for less than 1 percent of IRS's budget. Additional leveraging of non-Federal partners might also enhance IRS's effectiveness at little additional cost. Currently, IRS partners with the States on enforcement and with volunteers on tax return preparation.

Third, efficiency gains from several sources could provide a bigger bang per dollar spent on IRS. Productivity gains from reengineering processes or from new technology are one source. Another source is better targeting of resources.

For example, IRS provides a menu of services, including telephone, Internet and walk-in services, as well as return preparation at volunteer sites. In light of recent service improvements, it may now be possible for IRS to consider reducing some items provided on the menu without reducing the quality of service received by taxpayers. Cuts in selected services might be offset by other new and improved services. Doing so would require prioritizing the services that IRS offers.

My statement offers some criteria for setting priorities such as demand for services by taxpayers. Similarly, with better data about noncompliance, IRS might better target its enforcement resources on suspected noncompliance.

Fourth, creating the system to enable IRS to develop accurate cost estimates could result in better resource allocations.

Fifth, succeeding in implementing recommended management improvements would help IRS bring planned new information systems on line in a timely and cost-effective manner. The new system should improve service and enforcement and reduce costs.

In addition, IRS is adjusting the BSM program in response to budget reductions resulting from concerns about cost overruns and delays. It is too soon to tell what effect the adjustment, such as

shifting more management responsibility from the prime contractor to IRS staff, will have, but they are not without risk.

Finally, making the recommended improvements to assure information system security is essential for maintaining the public's trust in our tax system.

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

Representative RAMSTAD. Thank you very much, Mr. White.

[The statement of Mr. White follows:]

United States Government Accountability Office

GAO

Testimony
Before Congressional Committees

For Release on Delivery
Expected at 3:00 p.m. EDT
Thursday, May 19, 2005

IRS MODERNIZATION

Continued Progress Requires Addressing Resource Management Challenges

Statement of James R. White, Director
Strategic Issues

David A. Powner, Director
Information Technology Management Issues

Steven J. Sebastian, Director
Financial Management and Assurance

Gregory C. Wilshusen, Director
Information Security Issues

GAO-05-707T

May 19, 2005

GAO
Accountability • Integrity • Reliability

Highlights

Highlights of GAO-05-707T, a testimony before congressional committees

IRS MODERNIZATION

Continued Progress Requires Addressing Resource Management Challenges

Why GAO Did This Study

Since the passage of the IRS Restructuring and Reform Act of 1998 (RRA 98), the Internal Revenue Service (IRS) has faced the challenge of managing its resources to simultaneously improve service to taxpayers, assure taxpayers' compliance with the tax laws, and modernize its antiquated information systems.

As requested, this statement provides our assessment of IRS's current performance in the areas of taxpayer service, tax law enforcement, and systems modernization. Looking ahead, this statement also describes the challenges that IRS faces in addressing resource constraints as well as realizing efficiency and information systems improvements.

What GAO Recommends

GAO is not making any new recommendations, but has recommendations outstanding related to taxpayer service, tax law enforcement, Business Systems Modernization (BSM), and systems security.

IRS is in general agreement with our recommendations and is in the process of implementing many of them.

www.gao.gov/cgi-bin/getrpt?GAO-05-707T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitejr@gao.gov.

What GAO Found

IRS's most noticeable progress has been in IRS's taxpayer service, which has been of special concern to the Congress. Since the passage of RRA 98, improvements in access to IRS by telephone, the accuracy of answers given to taxpayer inquiries, and the growth of IRS's Web site, which now provides a variety of services, have been noteworthy accomplishments.

IRS experienced declines in enforcement staffing after 1998, but recently stopped the declines and begun to show increases. Despite this, enforcement remains a high risk area because of the continued need to improve enforcement and make progress towards reducing the tax gap.

IRS has made significant progress in establishing management controls and acquiring infrastructure as part of the BSM program, as well as significant progress in addressing financial management issues. However, BSM remains at risk because of the scope and complexity of modernization activities and the need for better management capacity to avoid repeating the program's history of schedule delays and cost overruns.

Looking ahead, continuing the progress described above depends on IRS addressing resource constraints and realizing efficiency and systems improvements. We highlight several such opportunities:

- Developing long-term goals would help IRS and Congress assess agency performance and make budget decisions.
- Considering additional funding enhancements such as user fees and private debt collection which may help mitigate budget constraints.
- Leveraging nonfederal partners such as states to assist with tax law enforcement and volunteers to help provide taxpayer service.
- Prioritizing taxpayer service activities could help IRS minimize the impact of budget cuts.
- Targeting enforcement resources could help IRS make more efficient use of available resources and help the agency make progress towards reducing the tax gap.
- Creating the necessary systems to enable IRS to develop accurate cost accounting information would help IRS make resource allocation decisions.
- Developing and using better productivity data would help IRS make productivity improvements and thereby make better use of available resources.
- Making needed management improvements would help IRS bring planned new information systems on-line in a timely and cost-effective manner.
- Making needed improvements to assure information systems security would reduce vulnerabilities.

Mr. Chairman and Members of the Committees:

Mr. Chairman, we are pleased to participate in this joint review of the Internal Revenue Service (IRS). Since passage of the IRS Restructuring and Reform Act of 1998 (RRA 98), IRS has faced the challenge of managing its resources to simultaneously improve service to taxpayers, assure taxpayers' compliance with the tax laws, and modernize its antiquated information systems. As you are well aware, making these improvements is important. IRS is responsible for collecting the roughly $2 trillion in tax revenue used to fund the government and annually touches more Americans than any other federal agency. IRS's service and enforcement efforts influence Americans' confidence in the fairness of the tax system and their perception of the effectiveness of their government.

As requested, this statement provides our assessment of IRS's current performance in all three areas. We then look ahead, describing the challenges that IRS faces in addressing resource constraints as well as realizing efficiency and information systems improvements.

Our discussion of both recent progress and challenges facing IRS is based primarily on recently issued GAO products. We used our recent reports and testimony on IRS's budget, the tax gap, filing season reviews, financial audits, systems modernization activities, Business Systems Modernization (BSM) expenditure plans, and information security. Our work was performed in accordance with generally accepted government auditing standards.

In summary, IRS has made progress in improving service and modernizing operations, but the gains have not been uniform. The most noticeable progress has been in IRS's taxpayer service, an area that has been of special concern to the Congress. Access to IRS by telephone, the accuracy of answers given to taxpayer inquiries, and the growth of IRS's Web site, which now provides a variety of services, including forms and instructions, information on the status of refunds, and answers to frequently asked questions, have been noteworthy accomplishments in the years since passage of RRA 98. With respect to tax law enforcement, IRS experienced declines in enforcement staffing after 1998 but has recently stopped the declines and begun to show increases. However, tax law enforcement remains a high-risk area because of the need to improve enforcement and make progress towards reducing the tax gap—the

difference between taxes owed and taxes paid on time.[1] As for systems modernization, IRS has made significant progress in establishing long-overdue management controls and in acquiring foundational system infrastructure and applications as part of the BSM project, as well as significant progress in addressing financial management issues. However, BSM remains at risk because of the scope and complexity of modernization activities and the need for better management capacity to avoid repeating the program's history of schedule delays and cost overruns.

Looking ahead, continued progress depends on IRS addressing resource constraints and realizing efficiency and systems improvements. Long-term goals would help stakeholders, including the Congress, evaluate the adequacy of IRS's budget. Further, additional resources might be brought to bear by, perhaps, additional user fees or the leveraging of nonfederal partners beyond what is now done with states and volunteers. Efficiency gains may be possible by, for example, prioritizing taxpayer services in order to focus on those that provide greater benefit, targeting enforcement by using better data on noncompliance, collecting more accurate cost information to improve day-to-day and long-term decision making, and realizing productivity improvements. Finally, IRS needs to bring planned new systems on line in a timely and cost-effective manner while also assuring systems security. GAO has outstanding recommendations related to taxpayer service, tax law enforcement, BSM, and systems security. IRS is in general agreement with our recommendations and is in the process of implementing many of them.

[1] In April 2005, we discussed the tax gap in testimony before the Senate Committee on Finance (GAO-05-527T). In our statement, we reported that IRS recently released its tax gap estimate for tax year 2001. IRS estimated that the difference between taxes owed and taxes paid on time was between $312 billion and $353 billion. After tax law enforcement recovers a portion of the unpaid taxes, IRS estimates it will eventually recover some of this tax gap, resulting in a net tax gap of between $257 billion and $298 billion in tax year 2001.

IRS Has Improved Taxpayer Service but Enforcement and BSM Remain High Risk

IRS has made noticeable progress in improving taxpayer service since passage of RRA 98. While progress has also been made in the tax law enforcement and BSM areas, however, serious ongoing issues have kept both on our high-risk list.[2]

IRS Has Improved Taxpayer Service but Is Shifting Priorities

IRS has made meaningful progress in four key taxpayer service areas; paper and electronic processing, telephone assistance, IRS's Web site, and walk-in assistance. Table 1 shows IRS performance in these areas since 2002. While the progress is widespread, table 1 also shows that there are some areas of performance that merit attention, especially in light of current and proposed cuts to IRS's taxpayer service budget. In fiscal year 2005 and in its proposed 2006 budget, IRS is shifting priorities by reducing taxpayer service and increasing resources for enforcement.

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

Table 1: IRS Performance in the First Weeks of the Filing Season, 2002-2005

Volume in thousands				
Actual returns processed[e]	**2002**	**2003**	**2004**	**2005**
Paper	24,491	22,117	20,232	17,607
Electronic	35,067	38,627	42,988	45,848
Telephone assistance				
Total calls[b]	34,489	27,905	29,058	23,340
Answered by assistors	9,208	9,434	10,116	9,421
Answered by automation	25,281	18,471	18,942	13,919
Customer service representative level of service	62%	82%	84%	83%
Average speed of answer[c]	227 seconds	183 seconds	199 seconds	235 seconds
Accounts accuracy rate estimates[d]	88% +/- 1%	88% +/- 1%	89% +/- 1%	92% +/- 1%
Tax law accuracy rate estimates[d]	84% +/- 1%	81% +/- 1%	76% +/- 1%	87% +/- 1%
Internet assistance				
Forms and publications downloaded[e]	N/A	N/A	N/A	70,321
Refund status inquiries[f]	N/A	9,300	14,300	16,400
Walk-in assistance				
Total walk-in contacts[g]	N/A	2,740	2,433	2,163
Returns prepared at IRS walk-in sites[h]	436	291	186	145
Returns prepared at volunteer sites[i]	466	594	741	915

Source: IRS.

[a]From January 1 to March 22, 2002; March 21, 2003; March 19, 2004; and March 18, 2005.

[b]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; and March 12, 2005. The 2002 totals include increased call demand as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16 (2001)).

[c]From January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005.

[d]Based on a representative sample estimated at the 90 percent confidence level from January to February 2002, 2003, 2004, and 2005.

[e]As of February 28, 2005.

[f]From January 1 to March 20, 2003; 2004; and 2005.

[g]From January 1 to March 15, 2003; March 13, 2004; and March 12, 2005.

[h]From January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005.

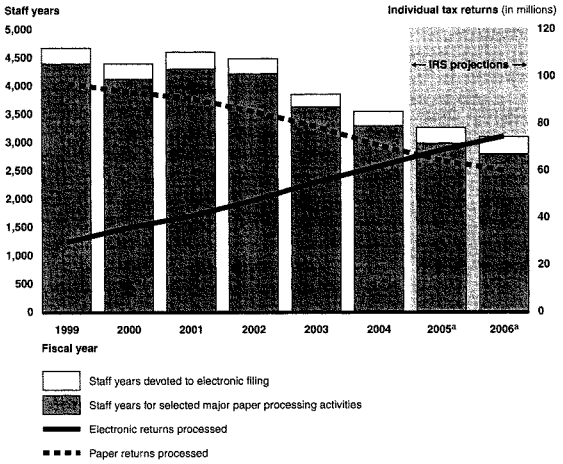
[i]From January 1 to March 9, 2002; March 8, 2003; March 13, 2004; and March 12, 2005.

Returns Processing

As shown in table 1, electronic filing has increased while paper filing has dropped. The increase in electronic filing has allowed IRS to reduce the resources devoted to processing. As shown in figure 1, IRS reduced the staff devoted to processing paper returns between 1999 and 2004 by just over 1,100 staff years. The figure also shows that as the number of e-filed returns has increased, the number of staff years used to process those returns has not increased. The decline in paper processing staff allowed IRS to close its Brookhaven processing center in 2003.[3] In addition, IRS is in the process of closing its paper processing operation in Memphis.

[3] In March 2005 we reported that IRS successfully completed the rampdown at Brookhaven without any significant disruptions in service. (GAO-05-319R)

Figure 1: Change in Methods of Tax Return Filing Since 1999



Source: GAO analysis of IRS data.

[a]Fiscal years 2005 and 2006 are IRS projections and, given the current lower e-file growth rates, the estimates may be optimistic.

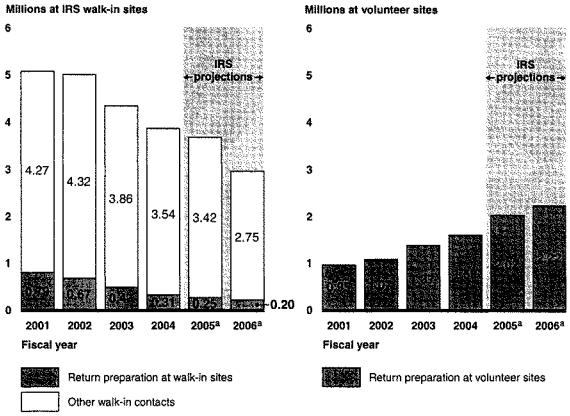
In addition to saving IRS resources, electronic filing offers benefits to taxpayers in that it allows taxpayers to receive refunds faster and is less error prone. IRS employees manually transcribe paper tax return information into IRS's computer systems, which can introduce errors.

Telephone Assistance

As shown in table 1, by several measures IRS's telephone service has improved since 2002. One measure of access, the customer service representative (CSR) level of service (the percentage of taxpayers who attempted to reach CSRs and actually got through and received service) increased from 62 percent to 83 percent. Accuracy also showed some improvement; accounts accuracy (accuracy of answers to taxpayer questions about their accounts) exceeded 90 percent in 2005. However, taxpayers are waiting somewhat longer in 2005 to get answers than in 2002, 2003, and 2004.

Web Site	IRS's Web site is performing well. A relatively recent addition to IRS's menu of services, the Web site first became available during the 1996 filing season. We found it to be user friendly because it was readily accessible and easy to navigate. An independent weekly study ranked it in the top 4 out of 40 federal government web sites in terms of accessibility. The site is used extensively. In the early weeks of the 2005 filing season the IRS Web site was visited about 83 million times by users who viewed about 628 million pages and downloaded about 70.3 million forms and publications. IRS's Web site continues to provide two very important tax service features: (1) "Where's My Refund," which enables taxpayers to check on the status of their refund and (2) Free File, which provides taxpayers the ability to file their tax return electronically for free. This filing season IRS provided new functionality for "Where's My Refund" whereby taxpayers whose refunds could not be delivered by the Postal Service (i.e., returned as undeliverable mail), could change their addresses on the Web site.
IRS and Volunteer Walk-in Sites	Taxpayer use of IRS's walk-in sites has decreased while use of volunteer sites has increased. As shown in figure 2, IRS projects it will see about 3.4 million visits to its 400 walk-in sites this year, down from over 3.5 million in 2004 and about 4.3 million in 2001. Over the same period, IRS expects taxpayer visits to volunteer sites to increase to just over 2 million visits in 2005; a substantial increase over about 1.6 million visits in 2004 and fewer than 1 million in 2001. IRS continues to encourage taxpayers to use volunteer sites for return preparation.

Figure 2: Assistance Provided by IRS Walk-in and Volunteer Sites, 2001-2006 Filing Seasons



Source: GAO-05-416T page p.33, and GAO of IRS data.

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; and December 28, 2003, through April 24, 2004. For volunteer sites, the time period covered for 2001 is January 1, 2001, through April 21, 2001; all other periods are the same as those for IRS walk-in sites.

[a]Fiscal years 2005 and 2006 are IRS projections.

This shift is important because it transfers time-consuming services, particularly return preparation, to volunteers and allows IRS to concentrate on services that only it can provide, such as account assistance or compliance work. While it reduces the demand on IRS resources, the shift from IRS to volunteer sites has raised concerns about the quality of service provided. We and the Treasury Inspector General for Tax Administration (TIGTA) have called attention to the quality of service at both IRS walk-in and volunteer sites. IRS has separate quality initiatives under way at both IRS walk-in and volunteer sites, although data remain limited and cannot be compared to prior years.

Post-Filing Taxpayer Service

Another concern is post-filing service to taxpayers when IRS has undertaken compliance or collection actions. An example of this is the release of federal tax liens against taxpayers' property. IRS is required to release a federal tax lien within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax but, as have we reported for several years as part of our financial audits, most recently in November 2004, IRS has not always met this standard.[4]

IRS Has Stopped Declines In Enforcement Staffing, but Enforcement Remains High Risk

We have long been concerned about tax noncompliance and IRS efforts to address it. Collection of unpaid taxes was included in our first high-risk series report in 1990, with a focus on the backlog of uncollected debts owed by taxpayers. In 1995, we added Filing Fraud as a separate high-risk area, narrowing the focus of that high-risk area in 2001 to Earned Income Credit Noncompliance because of the particularly high incidence of fraud and other forms of noncompliance in that program. We expanded our concern about the Collection of Unpaid Taxes in our 2001 high-risk report to include not only unpaid taxes (including tax evasion and unintentional noncompliance) known to IRS, but also the broader enforcement issue of unpaid taxes that IRS has not detected. In our high-risk update that we issued in January,[5] we consolidated these areas into a single high-risk area—Enforcement of Tax Laws—because we believe the focus of concern on the enforcement of tax laws is not confined to any one segment of the taxpaying population or any single tax provision.

Tax law enforcement is a high-risk area in part because of the size of the tax gap. IRS's recent estimate of the difference between what taxpayers timely and accurately paid in taxes and what they owed ranged from $312 billion to $353 billion for tax year 2001. IRS estimates it will eventually recover some of this tax gap, resulting in a net tax gap from $257 billion to $298 billion. The tax gap arises when taxpayers fail to comply with the tax laws by underreporting tax liabilities on tax returns; underpaying taxes due from filed returns; or "nonfiling," which refers to the failure to file a required tax return altogether or in a timely manner.

[4] GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, GAO-05-103 (Washington, D.C.: Nov. 10, 2004).

[5] GAO-05-207.

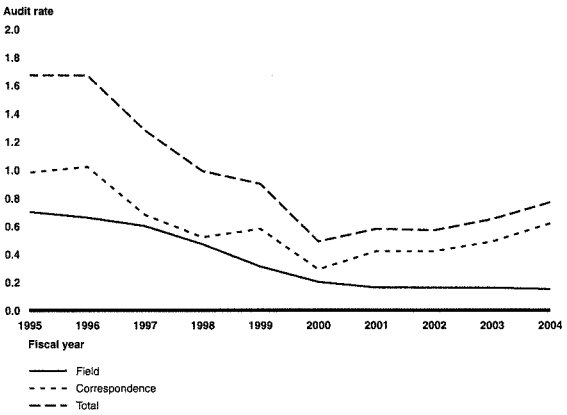
Tax law enforcement is also high risk because past declines in IRS's enforcement activities threatened to erode taxpayer compliance. In recent years, the resources IRS has been able to dedicate to enforcing the tax laws have declined. For example, the number of revenue agents (those who examine complex returns), revenue officers (those who perform field collection work), and special agents (those who perform criminal investigations) decreased over 21 percent from 1998 through 2003. However, IRS achieved some staffing gains in 2004 and expects modest gains in 2005. IRS's proposal for fiscal year 2006, if funded and implemented as planned, would return enforcement staffing in these occupations to their highest levels since 1999.[6]

Concurrently, IRS's enforcement workload—measured by the number of taxpayer returns filed—has continually increased. For example, from 1997 through 2003, the number of individual income tax returns filed increased by about 8 percent. Over the same period, returns for high-income individuals grew by about 81 percent.[7] Due to their income levels, IRS believes that these individuals present a particular compliance risk. In light of declines in enforcement staffing and the increasing number of returns filed, nearly every indicator of IRS's coverage of its enforcement workload has declined in recent years. Although in some cases workload coverage has begun to increase, overall IRS's coverage of known workload is considerably lower than it was just a few years ago. Figure 3 shows the trend in examination rates—the proportion of tax returns that IRS examines each year—for field, correspondence, and total examinations since 1995. Field examinations involve face-to-face examinations and correspondence examinations are typically less comprehensive and complex, involving communication through written notices. IRS experienced steep declines in examination rates from 1995 to 1999, but the examination rate has slowly increased since 2000. However, as the figure shows, the increase in total examination rates of individual filers has been driven mostly by correspondence examinations, while more complex field examinations continue to decline.

[6] GAO, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season*, GAO-05-416T (Washington, D.C.: Apr. 14, 2005).

[7] High-income individuals are those reporting $100,000 or more of "total positive income," which is, in general, the sum of all positive amounts shown for the various sources of income reported on individual tax returns and thus excludes net losses.

Figure 3: Audit Rate of Individual Income Tax Returns, Fiscal Years 1995-2004



Source: GAO analysis of IRS data.

Further, IRS's workload has grown ever more complex as the tax code has grown more complex. IRS is challenged to administer and explain each new provision, thus absorbing resources that otherwise might be used to enforce the tax laws. Concurrently, other areas of particularly serious noncompliance have gained the attention of IRS and the Congress, such as abusive tax shelters and schemes employed by businesses and wealthy individuals that often involve complex transactions that may span national boundaries. Given the broad declines in IRS's enforcement workforce, IRS's decreased ability to follow up on suspected noncompliance, and the emergence of sophisticated evasion concerns, IRS is challenged in attempting to ensure that taxpayers fulfill their obligations.

On the collection front, IRS's use of enforcement sanctions, such as liens, levies, and seizures, dropped precipitously during the mid and late 1990s. In fiscal year 2000, IRS's use of these three sanctions was at 38 percent, 7 percent, and 1 percent, respectively, of fiscal year 1996 levels. However, beginning in fiscal year 2001, IRS's use of liens and levies began to

increase. By fiscal year 2004, IRS's use of liens, levies, and seizures reached 71 percent, 65 percent, and 4 percent of 1996 levels, respectively.

IRS is working to further improve its enforcement efforts. In addition to recent favorable trends in enforcement staffing, correspondence examinations, and the use of some enforcement sanctions, IRS has recently 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. In addition, IRS is developing a centralized cost accounting system, in part to obtain better cost and benefit information on compliance activities, and is modernizing the technology that underpins many core business processes. It has also redesigned some compliance and collections processes and plans additional redesigns as technology improves. Finally, the recently completed National Research Program (NRP) study of individual taxpayers not only gives us a benchmark of the status of taxpayers' compliance but also gives IRS a better basis to target its enforcement efforts.

IRS Has Made Progress in Implementing BSM, but Program Has History of Cost Overruns and Schedule Delays and Is High Risk

IRS has long relied on obsolete automated systems for key operational and financial management functions, and its attempts to modernize these aging computer systems span several decades. Modernization has encountered a long history of continuing delays and design difficulties and the impact of these problems on IRS's operations led GAO to designate IRS's systems modernization as a high-risk area in 1995 and it remains so today.

IRS's current modernization program, BSM, is a highly complex, multibillion-dollar program that is the agency's latest attempt to modernize its systems. BSM 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. BSM is also important to allow IRS to provide the reliable and timely financial management information needed to account for the nation's largest revenue stream and better enable the agency both to determine and to justify its resource allocation decisions and congressional budgetary requests.

Over the past year, IRS has deployed initial phases of several modernized systems under its BSM program. The following provides examples of the systems and functionality that IRS implemented in 2004 and the beginning of 2005.

- *Modernized e-File (MeF)*. This project is intended to provide electronic filing for large corporations, small businesses, and tax-exempt organizations. The initial releases of this project were implemented in June and December 2004, and allowed for the electronic filing of forms and schedules for the form 1120 (corporate tax return) and form 990 (tax-exempt organizations' tax return). IRS reported that, during the 2004 filing season, it accepted over 53,000 of these forms and schedules using MeF.
- *e-Services*. This project created a Web portal and provided other electronic services to promote the goal of conducting most IRS transactions with taxpayers and tax practitioners electronically. IRS implemented e-Services in May 2004. According to IRS, as of late March 2005, over 84,000 users have registered with this Web portal.
- *Customer Account Data Engine (CADE)*. CADE is intended to replace IRS's antiquated system that contains the agency's repository of taxpayer information and, therefore, is the BSM program's linchpin and highest priority project. In July 2004 and January 2005, IRS implemented the initial releases of CADE, which have been used to process filing year 2004 and 2005 1040EZ returns, respectively, for single taxpayers with refund or even-balance returns. According to IRS, as of March 16, 2005, CADE had processed over 842,000 tax returns so far this filing season.
- *Integrated Financial System (IFS)*. This system replaced 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.

In prior years, IRS deployed several systems, including (1) Customer Communications 2001, to improve telephone call management, call routing, and customer self-service applications; (2) Customer Relationship Management Examination, to provide off-the-shelf software to IRS revenue agents to allow them to accurately compute complex corporate transactions; and (3) Internet Refund/Fact of Filing, to improve taxpayer self-service by providing to taxpayers via the Internet instant refund status information and instructions for resolving refund problems.

Although IRS is to be applauded for delivering important BSM functionality, the BSM program is far from complete. Future deliveries of additional functionality of deployed systems and the implementation of other BSM projects are expected to have a significant impact on IRS's

taxpayer services and enforcement capability as well as its efforts to continue to improve its financial management. For example, IRS has projected that CADE will process about 2 million returns in the 2005 filing season. However, the returns being processed in CADE are the most basic and constitute less than 1 percent of the total tax returns expected to be processed during the current filing season. IRS expects the full implementation of CADE to take several more years. Another BSM project—the Filing and Payment Compliance (F&PC) project—is expected to increase (1) IRS's capacity to treat and resolve the backlog of delinquent taxpayer cases, (2) the closure of collection cases by 10 million annually by 2014, and (3) voluntary taxpayer compliance. As part of this project, IRS plans to deliver an initial limited private debt collection capability in January 2006, with full implementation of this aspect of the F&PC project to be delivered by January 2008 and additional functionality to follow in later years. Finally, full implementation of CADE, as well as the successful implementation of future releases of IFS and efforts to address the impact of IRS's decision to discontinue the Custodial Accounting Project (CAP) will be critical to addressing many of IRS's remaining and long-standing financial management issues.

Continued Progress Depends on IRS Addressing Resource Constraints and Realizing Efficiency and Systems Improvements

For IRS to build on the gains made since passage of RRA 98, the agency must address numerous challenges related to resource management. IRS faces budgetary constraints that may be addressed in part through the development of goals for assessing performance and to help in making budget decisions, looking for opportunities to enhance its funding, and leveraging the resources of nonfederal partners. IRS also faces the challenges of improving efficiency in taxpayer service and tax law enforcement, developing useful cost accounting tools, and improving productivity. Finally, IRS faces information systems challenges in both BSM and systems security shortfalls.

Long-term Goals Would Help IRS Assess Performance and Make Budget Decisions

For IRS, the Congress, and IRS's other stakeholders, long-term goals can be used to assess performance and progress towards these goals, and determine whether budget decisions contribute to achieving those goals. Without long-term goals, the Congress and other stakeholders are hampered in evaluating whether IRS is making satisfactory long-term progress. Further, without such goals, the extent to which IRS's 2006 budget request would help IRS achieve its mission over the long term is less clear.

A recent Program Assessment Rating Tool (PART) review conducted by the Office of Management and Budget (OMB) reported that IRS lacks long-term goals.[8] As a result, IRS has been working to identify and establish long-term goals for all aspects of its operations for over a year.[9] IRS officials said these goals will be finalized and provided publicly as an update to the agency's strategic plan in the near future.

Long-term goals and results measurement are a component of the statutory strategic planning and management framework that the Congress adopted in the Government Performance and Results Act of 1993.[10] As a part of this comprehensive framework, long-term goals that are linked to annual performance measures can help guide agencies when considering organizational changes and making resource decisions. For example, long-term goals would provide IRS with a framework for assessing budgetary tradeoffs between taxpayer service and enforcement and whether IRS is making satisfactory progress towards achieving those goals. Similarly, long-term goals could help identify priorities within the taxpayer service functions (e.g., if the budget for taxpayer service were to be cut and efficiency gains did not offset the cut, long-term goals could help guide decisions about whether to make service cuts across a broad or target selected services).

Perhaps most important, long-term compliance goals coupled with periodic measurement of compliance levels would provide IRS with a better basis for determining to what extent its various day-to-day service

[8] The PART was applied during the fiscal year 2004 budget cycle to "programs" selected by OMB. The PART includes general questions in each of four broad topics to which all programs are subjected: (1) program purpose and design, (2) strategic planning, (3) program management, and (4) program results (i.e., whether a program is meeting its long-term and annual goals). OMB also makes an overall assessment on program effectiveness.

[9] IRS has one long-term goal set by the Congress in RRA 98 for IRS to have 80 percent of all individual income tax returns filed electronically.

[10] Pub. L. No. 103-62 (1993). The Government Performance and Results Act of 1993 seeks to improve the management of federal programs, as well as their effectiveness and efficiency, by requiring executive agencies to prepare multiyear strategic plans, annual performance plans, and annual performance reports. Under the act, strategic plans are the starting point for setting goals and measuring progress towards them. The act requires executive agencies to develop strategic plans that include an agency's mission statement, long-term general goals, and the strategies that the agency will use to achieve these goals. The plans should also explain the key external factors that could significantly affect achievement of these goals, and describe how long-term goals will be related to annual performance goals.

and enforcement efforts contribute to compliance in the long run. Furthermore, long-term, quantitative goals may help IRS consider new strategies to improve compliance, especially since these strategies could take several years to implement. For example, IRS's progress toward the goal of having 80 percent of all individual tax returns electronically filed by 2007 has required enhancement of its technology, development of software to support electronic filing, education of taxpayers and practitioners, and other steps that could not be completed in a short time frame. Focusing on intended results can also promote strategic and disciplined management decisions that are more likely to be effective because managers who use fact-based performance analysis are better able to target areas most in need of improvement and select appropriate interventions.

Considering Funding Enhancements Could Help Mitigate Budget Constraints

Identifying potential new sources of funds could be an opportunity for helping to mitigate IRS's budget constraints. Current examples of resource enhancers—user fees and private debt collection—may provide useful models for IRS and Congress to consider. User fees are collected from identifiable recipients of special benefits beyond those accruing to the general public. In 2004, IRS collected over $137 million in user fees for a wide range of services, including installment agreements, offers in compromise, and Freedom of Information Act (FOIA) requests.[11] In fiscal year 2004, about 82 percent of all user fees collected by IRS were for installment agreements or Employee Plans and Exempt Organizations letter rulings and determination letters.[12] The 1995 Treasury Appropriation Act specifies that IRS can keep a maximum of $119 million per year of the user fees it collects, with the rest of the user fees going into the Treasury

[11] Installment agreements are for taxpayers who cannot pay the full amount owed on their tax returns when due. IRS charges a one-time fee to these taxpayers, and allows them to make monthly installment payments. An offer in compromise (OIC) is an agreement between a taxpayer and IRS that resolves the taxpayer's tax liability for less than the full amount owed for taxes, interest, and penalties. IRS charges a one-time fee. FOIA requestors are charged a one-time fee and are provided with agency records as requested, with some exceptions.

[12] A letter ruling is a written determination issued in response to a written inquiry from an individual or an organization about its status for tax purposes or the tax effects of its acts or transactions, prior to the filing of returns or reports that are required by the revenue laws. A determination letter is a written determination that applies the principles and precedents previously announced by IRS to a specific set of facts. It is issued only when a determination can be made based on clearly established rules in a statute, a tax treaty, the regulations, a conclusion in a revenue ruling, or an opinion or court decision that represents the position of IRS.

general fund. In 2004, IRS retained about $90 million from the user fees collected (see table 2). In comparison, IRS's total spending in 2004 was $10.7 billion.

Table 2: User Fees and Reimbursable User Fees Collected by IRS, Fiscal Year 2004

Dollars in millions

Fee type	Fiscal year 2004 user fees collected	User fees to General Fund	User fees retained by IRS
Installment agreements	69.4	0.0	69.4
Offers in compromise	6.6	0.0	6.6
Employee plans and exempt organizations letter rulings and determination letters	43.1	41.2	1.9
Chief Counsel letter rulings and determination letters	9.3	5.5	3.8
Photocopy reimbursable user fees	6.4	0.0	6.4
Other	2.8	1.2	1.6
Total	**137.6**	**47.9**	**89.7**

Source: IRS officials.

In setting certain user fees, IRS must follow Internal Revenue Code (IRC) Section 7528, which authorizes user fees for letter rulings, opinion letters, determination letters, and similar requests.[13] IRC Section 7528 requires that user fees (1) vary according to categories or subcategories, (2) take into account the average time and difficulty of requests by categories or subcategories, (3) be payable in advance, and (4) be subject to appropriate exemptions and reduced fees within limits specified by Section 7528. IRS is precluded from expending any fees collected pursuant to IRC Section 7528 unless provided by an appropriations act. As mentioned earlier, the 1995 Treasury Appropriation Act specifies that IRS can keep a maximum of $119 million per year in user fee collections.

[13] Section 7528 was added to the Code by section 202 of the Temporary Assistance for Needy Families Block Grant Program, Pub. L. 108-89, and was extended to September 30, 2014, by section 690 of the American Jobs Creation Act of 2004, Pub. L. 108-357.

OMB Circular A-25, *User Charges*, establishes general federal policy for user fees assessed for government services by executive branch agencies.[14] A-25 requirements include (1) identifying services and activities that convey special benefits; (2) determining their full cost or market price, as appropriate; (3) biennial reviews of user fees for unanticipated cost or market price changes; and (4) biennial reviews of agency programs not subject to user fees to determine if such fees should be assessed.

Private debt collection provides another example of a revenue enhancement model that may be useful for IRS. The 2004 American Jobs Creation Act permitted IRS to contract with private collection agencies (PCA) to collect some federal tax debts and allows IRS to keep a portion of the funds collected by PCAs.[15] PCAs will not replace IRS's own collection resources, but will handle cases that do not require enforcement action or discretion in resolving tax liabilities. According to IRS, the private debt collection program will help reduce the significant and growing amount of uncollectable cases that are not currently collected, and enable IRS to focus existing resources to address more difficult cases. IRS will begin a limited implementation phase of the private debt collection in 2005, and full implementation is planned for 2007. The law allows IRS to retain and use up to 25 percent of any amounts collected to pay for collection services and IRS collection enforcement activities. IRS expects to retain $10 million of PCA collections in fiscal year 2007 and more in later years.

Leveraging Nonfederal Partners Is Another Way to Accomplish More

IRS has leveraged nonfederal resources to make improvements to taxpayer service and tax law enforcement. The examples below highlight the variety of such leveraging and could provide a basis for exploring whether additional such opportunities exist.

One example involving taxpayer service is the Free File Alliance. In 2003 IRS entered into a 3-year agreement with the Free File Alliance, a consortium of tax preparation companies that provides free electronic filing to taxpayers who access any of the companies via a link on IRS's

[14] Circular A-25 applies to executive branch agencies assessing charges under the general user fee statute enacted in the Independent Offices Appropriations Act of 1952 and codified at 31 U.S.C. 9701. The circular also provides guidance to agencies imposing user fees under other statutes to the extent that the circular is not inconsistent with the statute in question.

[15] The American Jobs Creation Act of 2004, P.L. 108-357.

Web site. IRS has benefited from this partnership because it encourages electronic filing of tax returns. For example, as of March 16, 2005, 3.6 million tax returns had been filed via Free File, which represents a 44 percent increase over the same time period last year.

IRS has also established partnerships with states and several cities to assist in combating abusive tax schemes.[16] In September 2003, IRS announced the establishment of a nationwide partnership to combat abusive tax avoidance. Under agreements with individual states, IRS shares information on abusive tax avoidance transactions and those taxpayers who participate in them. The agreements creating this partnership were designed to enable States and IRS to move more aggressively in addressing this tax compliance problem. The partnership also includes joint public outreach activities to more effectively counter the claims of those marketing tax schemes.

Another example of IRS's effort to leverage nonfederal resources is the over 13,500 volunteer sites run by community-based coalitions. IRS awards grants, trains and certifies volunteers, and provides reference materials, computer software and, in some cases, computers to these volunteer organizations to assist primarily low-income and elderly taxpayers prepare their returns. Since 2001, the number of taxpayers seeking return preparation assistance at volunteer sites has increased an average of 19 percent per year. During the 2004 filing season, taxpayers had over five times more returns prepared at volunteer sites than at IRS walk-in sites. This trend reflects IRS's strategy to shift return preparation to sites staffed by volunteer and community-based coalitions that are overseen by IRS. IRS has encouraged the shift by advertising the locations of these sites.

As we noted earlier, the shift of taxpayers from walk-in to volunteer sites is important because it has transferred time-consuming services, particularly return preparation, from IRS to volunteer sites and allowed IRS to concentrate on services that only it can provide, such as account assistance or compliance work. However, as we also noted earlier, there have been concerns raised about the quality of service at both walk-in and

[16] Abusive tax schemes encompass distortions of the tax system such as falsely describing the law (saying, for example, that the income tax is unconstitutional), misrepresenting facts (for instance, promoting the deduction of personal expenses as business expenses), or using trusts or offshore bank accounts to hide income.

volunteer sites. In addition, in her January 2005 report,[17] the Taxpayer Advocate expressed concern about the reduction of face-to-face services, such as those offered at walk-in sites. She stated that IRS's plan does not adequately provide for the segment of the population that continues to rely on the interaction provided by walk-in sites. Better data about the quality of service at volunteer sites would provide a baseline for making decisions about how to better manage quality.

Prioritizing Taxpayer Service Could Minimize Impacts of Budget Cuts

For at least two reasons, this is an opportune time to review the menu of taxpayer services that IRS provides. First, IRS's budget for taxpayer services was reduced in 2005 and an additional reduction is proposed for 2006. These reductions have forced IRS to propose scaling back some services, including the hours of telephone contact availability. Second, as we have reported, IRS has made significant progress in improving the quality of its taxpayer services. For example, IRS now provides many Internet services that did not exist a few years ago, and has noticeably improved the quality of telephone services. This opens up the possibility of maintaining the overall level of taxpayer service but with a different menu of service choices. Cuts in selected services could be offset by the new and improved services.

Generally, as indicated in the budget, the menu of taxpayer services that IRS provides covers assistance, outreach, and processing. Assistance includes answering taxpayer questions via telephone, correspondence, and face to face at its walk-in sites. Outreach includes educational programs and the development of partnerships. Processing includes issuing millions of tax refunds.

When considering program reductions, we support a targeted approach rather than across-the-board cuts.[18] A targeted approach helps reduce the risk that effective programs are reduced or eliminated while ineffective or lower priority programs are maintained.

With the above reasons in mind for reconsidering IRS's menu of services, we have compiled a list of options for targeted reductions in taxpayer

[17] National Taxpayer Advocate, *2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004)

[18] GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

service. The options on this list are not recommendations, but are intended to contribute to a dialogue about the tradeoffs faced when setting IRS's budget. The options presented meet at least one of the following criteria that we generally use to evaluate programs or budget requests.[19] These criteria include that the activity:

- duplicates other efforts that may be more effective and/or efficient;
- historically does not meet performance goals or provide intended results as reported by GAO, TIGTA, IRS, or others;
- experiences a continued decrease in demand;
- lacks adequate oversight, implementation and management plans, or structures and systems to be implemented effectively;
- has been the subject of actual or requested funding increases that cannot be adequately justified; or
- has the potential to make an agency more self-sustaining by charging user fees for services provided.

We recognize that the options listed below involve tradeoffs. In each case, some taxpayers would lose a service they use. However, the savings could be used to help maintain the quality of other services. We also want to give IRS credit for identifying savings, including some on this list. The options include the following:

- Closing walk-in sites. As discussed previously, taxpayer demand for walk-in services has continued to decrease and staff answer a more limited number of tax law questions in person than staff answer via telephone.
- Limiting the type of telephone questions answered by IRS assistors. IRS assistors still answer some refund status questions even though IRS provides automated answers via telephone and its Web site.
- Mandating electronic filing for some filers such as paid preparers or businesses. As noted, efficiency gains from electronic filing have enabled IRS to consolidate paper processing operations.
- Charging for services. For example, IRS provides paid preparers with information on federal debts owed by taxpayers seeking refund anticipation loans.

[19] The derivation of these criteria is detailed in our earlier testimony, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season*, GAO-05-416T (Washington, D.C.: Apr 14, 2005).

Targeting Enforcement Could Make More Efficient Use of Resources

Multiple enforcement strategies could help IRS reduce the tax gap. Given its size, even small or moderate reductions in the net tax gap could yield substantial returns. For example, based on IRS's most recent estimate, a 1 percent reduction in the net tax gap would likely yield more than $2.5 billion annually.

Although reducing the tax gap may be an attractive means to improve the nation's fiscal position, achieving this end will be a challenging task given persistent levels of noncompliance. IRS has made efforts to reduce the tax gap since the early 1980s; yet the tax gap is still large—although without these efforts it could be even larger. Also, IRS is challenged in reducing the tax gap because the tax gap is spread across the five different types of taxes that IRS administers, and a substantial portion of the tax gap is attributed to taxpayers who are not subject to withholding or information reporting requirements. Moreover, as we have reported in the past,[20] closing the entire tax gap may not be feasible or desirable, as it could entail more intrusive recordkeeping or reporting than the public is willing to accept or more resources than IRS is able to commit.

Although much of the tax gap that IRS currently recovers is through enforcement actions, a sole focus on enforcement will not likely be sufficient to further reduce the net tax gap. Rather, the tax gap must be attacked on multiple fronts and with multiple strategies on a sustained basis. For example, efforts to simplify the tax code and otherwise alter current tax policies may help reduce the tax gap by making it easier for individuals and business to understand and voluntarily comply with their tax obligations. For instance, reducing the multiple tax preferences for retirement savings or education assistance might ease taxpayers' burden in understanding and complying with the rules associated with these options. Also, simplification may reduce opportunities for tax evasion through vehicles such as abusive tax shelters. For any given set of tax policies, IRS's efforts to reduce the tax gap and ensure appropriate levels of compliance will need to be based on a balanced approach of providing service to taxpayers and enforcing the tax laws.

Furthermore, providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax

[20] GAO, *Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap*, GAO/T-GGD-97-35 (Washington, D.C.; Jan. 9, 1997).

gap. As we have reported in the past,[21] one method of improving compliance through service is to educate taxpayers about confusing or commonly misunderstood tax requirements. For example, if the forms and instructions taxpayers use to prepare their taxes are not clear, taxpayers may be confused and make unintentional errors. One method to ensure that forms and instructions are sufficiently clear is to test them before use. However, we reported in 2003 that IRS had tested revisions to only five individual forms and instructions from July 1997 through June 2002, although hundreds of forms and instructions had been revised in 2001 alone.[22]

Finally, in terms of enforcement, IRS will need to use multiple strategies and techniques to find noncompliant taxpayers and bring them into compliance. One pair of tools has been shown to lead to high levels of compliance: withholding tax from payments to taxpayers and having third parties report information to IRS and the taxpayers on income paid to taxpayers. For example, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Similarly, most wages, salaries, and tip compensation are reported by employers to employees and IRS through Form W-2. Preliminary findings from NRP indicate that more than 98.5 percent of these types of income are accurately reported on individual returns.

Regularly measuring compliance can offer many benefits, including helping IRS identify new or major types of noncompliance, identify changes in tax laws and regulations that may improve compliance, more effectively target examinations of tax returns or other enforcement programs, understand the effectiveness of its programs to promote and enforce compliance, and determine its resource needs and allocations. For example, by analyzing 1979 and 1982 compliance research data, IRS identified significant noncompliance with the number of dependents claimed on tax returns and justified a legislative change to address the noncompliance. As a result, for tax year 1987, taxpayers claimed about 5 million fewer dependents on their returns than would have been expected without the change in law. In addition, tax compliance data are

[21] GAO/T-GGD-97-35.

[22] GAO, *Tax Administration: IRS Should Reassess the Level of Resources for Testing Forms and Instructions*, GAO-03-486 (Washington, D.C.: Apr. 11, 2003).

useful outside of IRS for tax policy analysis, revenue estimating, and research.

IRS research officials have proposed a compliance measurement study that will allow IRS to update underreporting estimates involving flow-through entities. This study, which IRS intends to begin in fiscal year 2006, would take 2 to 3 years to complete. Because either individual taxpayers or corporations may be recipients of income (or losses) from flow-through entities, this study could affect IRS's estimates for the underreporting gap for individual and corporate income taxes.

While these data and methodology updates could improve the tax gap estimates, IRS has no documented plans to periodically collect more or better compliance data over the long term. Other than the proposed study of flow-through entities, IRS does not have plans to collect compliance data for other segments of the tax gap. Also, IRS has indicated that given its current research priorities, it would not begin another NRP study of individual income tax returns before 2008, if at all, and would not complete such a study until at least 2010. When IRS initially proposed the NRP study, it had planned to study individual income tax underreporting on a 3-year cycle.

According to IRS officials, IRS has not committed to regularly collecting compliance data because of the associated costs and burdens. Taxpayers whose returns are examined through compliance studies such as NRP bear costs in terms of time and money. Also, IRS incurs costs, including direct costs and opportunity costs—revenue that IRS potentially forgoes by using its resources to examine randomly selected returns, which may include returns from compliant taxpayers, as opposed to traditional examinations that focus on taxpayer returns that likely contain noncompliance and may more consistently produce additional tax assessments.

Although the costs and burdens of compliance measurement are legitimate concerns, as we have reported in the past, we believe compliance studies to be good investments. Without current compliance data, IRS is less able to determine key areas of noncompliance to address and actions to take to maximize the use of its limited resources. The lack of firm plans to continually obtain fresh compliance data is troubling because the frequency of data collection can have a large impact on the quality and

utility of compliance data. As we have reported in the past, the longer the time between compliance measurement surveys, the less useful they become given changes in the economy and tax law.[23]

In designing its recently completed NRP study, IRS balanced the costs, burdens, and compliance risk of studying that area of the tax gap. Any plans for obtaining and maintaining reasonably current information on compliance levels for all portions of the tax gap would similarly need to take into account costs, burdens, and compliance risks in determining which areas of compliance to measure and the scope and frequency of such measurement.

The NRP survey had an added benefit of including the use of casebuilding to aid examiners in determining whether IRS needs to have any contact with taxpayers to verify the accuracy of information reported on their tax returns. The casebuilding tools consisted of data from both IRS and third-party sources. IRS's NRP casebuilding included return information from the prior 3 years, audit history, payment and filing history, information return data reported by third parties (banks, lending institutions, and others), and bank reports on large cash transactions. NRP casebuilding tools also included data from third-party sources, such as external public database containing real estate and other asset ownership information (e.g., motor vehicle registrations and ownership of luxury items like watercraft and aircraft). Another third-party data source was the Dependent Data Base, which is a combination of Department of Health and Human Services and Social Security Administration data. These data were used to provide custody information that can be used to help determine the validity of dependent and Earned Income Tax Credit (EITC) claims. Use of these data helped IRS enforcement staff to rule out compliance issues that could be verified without contacting taxpayers.

As IRS moves to further strengthen enforcement and introduce enforcement initiatives, one management challenge will be coordinating across IRS programs and offices. An initiative that identifies noncompliance has resource implications for downstream activities such as collections, criminal investigations, and appeals. Without appropriate, coordinated follow-up, compliance initiatives run the risk of becoming toothless. IRS has experienced this sort of imbalance in the past. For

[23] GAO, *IRS Plans to Measure Tax Compliance Can Be Improved*, GAO/GGD-93-52 (Washington, D.C.: Apr. 5, 1993).

example, in 2002 we reported on the growing backlog of collections cases generated by the upstream exam and assessment functions that the downstream collections function lacked the capacity to pursue.[24]

Accurate Cost Information Would Help IRS Make Resource Allocation Decisions

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 at its disposal 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.

However, in its ongoing effort to make such increasingly difficult resource allocation decisions and defend those decisions before the Congress, IRS management has long been hampered by a lack of current and accurate information concerning the costs of the various options being considered. This has impaired management'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, reasoned manner is seriously impaired. Similarly, IRS should periodically reassess the prices it charges taxpayers in user fees for various services, such as entering into installment agreements and making determinations about the tax exemption status of certain organizations. The cost of providing such services is supposed to be a major factor in setting the related fees. However, without timely and reliable cost information, the basis for the fees becomes problematic. 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.

[24] *Tax Administration: Impact of Compliance and Collection Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2002).

IRS lacks reliable and timely cost information because prior to fiscal year 2005, it did not have a cost accounting system to accumulate and report the reliable cost information that managers needed to support informed decision making. Instead, management often 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. In fiscal year 2005, IRS implemented a cost accounting module as part of the first release of its IFS. However, while this module has much potential and has begun accumulating cost information, management 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. IRS has also not yet implemented a related workload management system intended to provide the cost module with detailed personnel cost information. In addition, because it generally takes several years of historical cost information to support meaningful estimates and projections, IRS cannot yet rely on this system as a significant planning tool. It will likely require several years and implementation of additional components of IFS before the full potential of IRS's cost accounting module will be realized. In the interim, IRS decision making will continue to be hampered by inadequate underlying cost information.

Productivity Improvements Could Help Offset Budget Cuts

IRS needs to make the most use of its available resources and a key to this is improved productivity. Productivity is defined as the efficiency with which inputs are used to produce outputs. It is measured as the ratio of outputs to inputs. Productivity and cost are inversely related—as productivity increases, average costs decrease. Consequently, information about productivity can inform budget debates as a factor that explains the level or changes in the cost of carrying out different types of activities. Improvements in productivity either allow more of an activity to be carried out at the same cost or the same level of activity to be carried out at a lower cost.

Sound productivity data are an important element of meaningful productivity improvement efforts. As part of our review of IRS process improvement initiatives,[25] private sector executives we met with stressed the benefits of productivity analysis. They said that an inadequate

[25] GAO, *Tax Administration: Planning for IRS's Enforcement Process Changes Include Many Key Steps But Can Be Improved*, GAO-04-287 (Washington, D.C.: Jan. 20, 2004).

understanding of productivity makes it harder to distinguish processes with a potential for improvement from those without such potential. GAO's Business Process Reengineering Assessment Guide also highlighted the importance of being able to identify processes that are in greatest need of improvement.[26]

Opportunities exist to improve enforcement productivity data and give IRS managers a more informed basis for decisions on how to make improvements. Statistical methods that are widely used in both the public and private sectors can be used to adjust productivity measures for quality and complexity. In particular, by using these methods, managers can distinguish productivity changes that represent real efficiency gains or losses from those that are due to changes in quality standards. These methods could be implemented using data currently available at IRS. The cost of implementation would be chiefly the staff time required to adapt the statistical models. Although the computations are complex, the methods can be implemented using existing software. We currently have under way a separate study that illustrates how these methods can be used to create better productivity measures at IRS.

Additional Management Improvements Needed for BSM Success

The BSM program has a long history of significant cost increases and schedule delays, which, in part, has led us to report this program as high risk since 1995.[27] In January 2005 letters to congressional appropriation committees, IRS stated that it had showed a marked improvement in significantly reducing its cost variances. In particular, IRS claimed that it reduced the variance between estimated and actual costs from 33 percent in fiscal year 2002 to 4 percent in fiscal year 2004. However, we do not agree with the methodology used in the analysis supporting this claim. Specifically, (1) the analysis did not reflect actual costs, but instead reflected changes in cost estimates (i.e., budget allocations) for various BSM projects; (2) IRS aggregated all of the changes in the estimates associated with the major activities for some projects, such as CADE, which masked that monies were shifted from future activities to cover increased costs of current activities; and (3) the calculations were based on a percentage of specific fiscal year appropriations, which does not reflect that these are multiyear projects.

[26] GAO, *Business Process Reengineering Assessment Guide*, GAO/AIMD-10.1.15 (Washington, D.C.: April 1997).

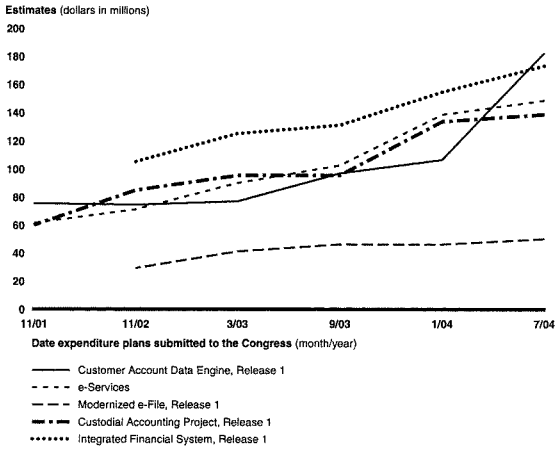
[27] GAO-05-207.

In February 2002 we expressed concern over IRS's cost and schedule estimating and made a recommendation for improvement.[28] IRS and its prime systems integration support (PRIME) contractor have taken action to improve their estimating practices, such as developing a cost and schedule estimation guidebook and developing a risk-adjustment model to include an analysis of uncertainty. These actions may ultimately result in more realistic cost and schedule estimates, but our analysis of IRS's expenditure plans[29] over the last few years shows continued increases in estimated project life-cycle costs (see fig. 4).

[28] GAO, *Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload*, GAO-02-356 (Washington, D.C.: Feb. 28, 2002).

[29] BSM funds are unavailable until the IRS submits to congressional appropriations committees for approval a modernization expenditure plan that (1) meets the OMB's capital planning and investment control review requirements; (2) complies with IRS's enterprise architecture; (3) conforms with IRS's enterprise life-cycle methodology; (4) is approved by IRS, the Department of the Treasury, and OMB; (5) is reviewed by GAO; and (6) complies with acquisition rules, requirements, guidelines, and systems acquisition management practices.

Figure 4: Life-cycle Cost Estimates for Key BSM Projects



Source: GAO analysis of IRS data.

The Assistant Chief Information Officer (CIO) for BSM stated that IRS's cost and schedule estimating has improved in the past year. Our comparison of IRS's reported project costs and milestone completion dates presented in the July 2004 and April 2005 expenditure plans shows that two BSM projects, CADE Releases 1.1 and 1.2, were delivered at the estimated cost and on or before the scheduled completion dates projected in the July 2004 expenditure plan. It is important to note that this recent success is based on project cost and schedule estimates that were re-baselined in the second quarter of fiscal year 2004 with delivery dates in late fiscal year 2004 and early fiscal year 2005. It is too early to tell whether this signals a fundamental improvement in IRS's ability to accurately forecast project costs and schedules.

The reasons for IRS's cost increases and schedule delays vary. However, we have previously reported that they are due, in part, to weaknesses in management controls and capabilities. We have previously made recommendations to improve BSM management controls, and IRS has

implemented or begun to implement these recommendations. For example, in February 2002, we reported that IRS had not yet defined or implemented an information technology human capital strategy, and recommended that IRS develop plans for obtaining, developing, and retaining requisite human capital resources.[30] In August 2004, the current Associate CIO for BSM identified the completion of a human capital strategy as a high priority. Among the activities that IRS is in the process of implementing are prioritizing its BSM staffing needs and developing a recruiting plan. IRS has also identified, and is in the process of addressing, other major management challenges. For example, poorly defined requirements have been among the significant weaknesses that have been identified as contributing to project cost overruns and schedule delays. As part of addressing this problem, in March 2005, the IRS BSM office established a requirements management office, although a leader has not yet been hired.

IRS Is Adjusting the BSM Program in Response to Budget Reductions

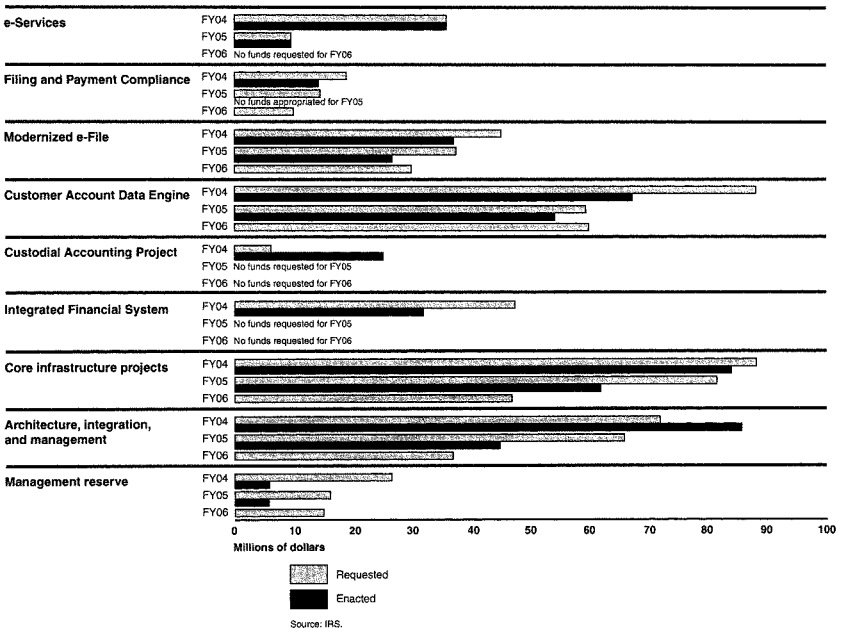
The BSM program is undergoing significant changes as it adjusts to reductions in its budget. Figure 5 illustrates the BSM program's requested and enacted budgets for fiscal years 2004 through 2006.[31] For fiscal year 2005, IRS received about 29 percent less funding than it requested (from $285 million to $203.4 million). According to the Senate report for the fiscal year 2005 Transportation, Treasury, and General Government appropriations bill, in making its recommendation to reduce BSM funding, the Senate appropriations committee was concerned about the program's cost overruns and schedule delays. In addition, the committee emphasized that in providing fewer funds, it wanted IRS to focus on its highest priority projects, particularly CADE.[32] In addition, IRS's fiscal year 2006 budget request reflects an additional reduction of about 2 percent, or about $4.4 million, from the fiscal year 2005 appropriation.

[30] GAO, *Business Systems Modernization: IRS Needs to Better Balance Capacity With Systems Acquisition Workload*, GAO-02-356 (Washington, D.C.: Feb. 28, 2002).

[31] IRS uses the appropriated funds to cover contractor costs related to the BSM program. IRS funds internal costs for managing BSM with another appropriation. These costs are not tracked separately for BSM-related activities.

[32] U.S. Senate, Senate Report 108-342.

Figure 5: Changes in the BSM budget (dollars in millions)



Source: IRS.

Note: The BSM account authorizes funds to be obligated for 3 years.

It is too early to tell what effect the budget reductions will ultimately have on the BSM program. However, the significant adjustments that IRS is making to the program to address these reductions are not without risk, could potentially impact future budget requests, and will delay the implementation of certain functionality that was intended to provide benefit to IRS operations and the taxpayer. For example,

- *Reductions in management reserve/project risk adjustments.* In response to the fiscal year 2005 budget reduction, IRS reduced the amount that it had allotted to program management reserve and project risk adjustments by about 62 percent (from about $49.1 million to about $18.6 million).[33] If BSM projects have future cost overruns that cannot be covered by the depleted reserve, this reduction could result in (1) increased budget requests in future years or (2) delays in planned future activities (e.g., delays in delivering promised functionality) to use those allocated funds to cover the overruns.
- *Shifts of BSM management responsibility from the PRIME contractor to IRS.* Due to budget reductions and IRS's assessment of the PRIME contractor's performance, IRS decided to shift significant BSM responsibilities for program management, systems engineering, and business integration from the PRIME contractor to IRS staff. For example, IRS staff are assuming responsibility for cost and schedule estimation and measurement, risk management, integration test and deployment, and transition management. There are risks associated with this decision. To successfully accomplish this transfer, IRS must have the management capability to perform this role. Although the BSM program office has been attempting to improve this capability through, for example, implementation of a new governance structure and hiring staff with specific technical and management expertise, IRS has had significant problems in the past managing this and other large development projects, and acknowledges that it has major challenges to overcome in this area.
- *Suspension of the Custodial Accounting Project (CAP).* Although the initial release of CAP went into production in September 2004, IRS has decided not to use this system and to stop work on planned improvements due to budget constraints. According to IRS, it made this decision after it evaluated the business benefits and costs to develop and maintain CAP versus the benefits expected to be provided by other projects, such as CADE. Among the functionalities that the initial releases of CAP were expected to provide were (1) critical control and reporting capabilities

[33] We did not include in our calculations reductions to specific project risk adjustment amounts that were made for reasons other than the fiscal year 2005 budget reduction.

mandated by federal financial management laws; (2) a traceable audit trail to support financial reporting; and (3) a subsidiary ledger to accurately and promptly identify, classify, track, and report custodial revenue transactions and unpaid assessments. With the suspension of CAP, it is now unclear how IRS plans to replace the functionality this system was expected to provide, which was intended to allow the agency to make meaningful progress toward addressing long-standing financial management weaknesses. IRS is currently evaluating alternative approaches to addressing these weaknesses.

- *Reductions in planned functionality.* According to IRS, the fiscal year 2006 funding reduction will result in delays in planned functionality for some of its BSM projects. For example, IRS no longer plans to include form 1041 (the income tax return for estates and trusts) in the fourth release of Modernized e-File, which is expected to be implemented in fiscal year 2007.

The BSM program is based on visions and strategies developed in 2000 and 2001. The age of these plans, in conjunction with the significant delays already experienced by the program and the substantive changes brought on by budget reductions, indicates that it is time for IRS to revisit its long-term goals, strategy, and plans for BSM. As we have previously reported, such an assessment would include an evaluation of when significant future BSM functionality would be delivered.[34] IRS's Associate CIO for BSM has recognized that it is time to recast the agency's BSM strategy because of changes that have occurred subsequent to the development of the program's initial plans. According to this official, IRS is in the process of redefining and refocusing the BSM program, and he expects this effort to be completed by the end of this fiscal year. However, clear milestones for completing these activities have not been defined and we plan to address this in our ongoing 2005 BSM expenditure plan review for the appropriations committees.

IRS Needs to Remedy Serious Information Security Weaknesses over Taxpayer and Bank Secrecy Act Information

Information security is a critical consideration for any organization that depends on information systems and computer networks to carry out its mission or business. It is especially important for government agencies where maintaining the public's trust is essential. In December 2002, the Congress enacted the Federal Information Security Management Act of 2002 (FISMA) to strengthen security of information and systems within

[34] GAO-05-416T.

federal agencies.[35] FISMA requires each agency to develop, document, and implement an agencywide information security program to provide information security for the information and systems that support the operations and assets of the agency. IRS relies extensively on interconnected information systems to perform vital functions, such as collecting and storing taxpayer data, calculating interest and penalties, and generating refunds. In addition to processing its own financial and tax information, IRS provides information processing support to the Financial Crimes Enforcement Network (FinCEN), a Treasury bureau responsible for administering and enforcing the Bank Secrecy Act (BSA) and its implementing provisions.

While IRS has made progress in correcting or mitigating previously reported information security control weaknesses, serious control weaknesses continue to exist over key financial and tax processing information systems. For example, during our review of information security at IRS facilities in 2004,[36] we determined that IRS corrected or mitigated 32 of the 53 weaknesses that we reported as unresolved at the time of our last review in 2002. In addition to the 21 previously reported weaknesses that remained uncorrected, we identified 39 new information security control weaknesses during this review that placed sensitive taxpayer and BSA data—including information related to financial crimes, terrorist financing, money laundering, and other illicit activities—at significant risk of unauthorized disclosure, modification, and destruction. These include the following:

- Access controls over the mainframe computing environment provided no logical separation between IRS's taxpayer data and FinCEN's BSA data, allowing all 7460 mainframe users—IRS employees, non-IRS employees, and contractors—regardless of their official duties, the ability to read and modify taxpayer and BSA data, including information about citizens, law enforcement personnel, and individuals subject to investigation. Thus, IRS users could read or copy BSA information, and law enforcement users could read or copy taxpayer information.
- User accounts and passwords were not adequately controlled to ensure that only authorized individuals had access to IRS's servers and networks,

[35] FISMA was enacted as title III, E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2946 (Dec. 17, 2002).

[36] GAO, *Information Security: Internal Revenue Service Needs to Remedy Serious Weaknesses over Taxpayer and Bank Secrecy Act Data*, GAO-05-482 (Washington, D.C.: Apr. 15, 2005).

thereby increasing the risk that unauthorized users could gain authorized user ID and password combinations to claim a user identity and then use that identity to gain access to sensitive taxpayer or BSA data.

- Audit and monitoring of security-related events on IRS's servers suffered from insufficient retention of security logs, heightening the risk of unauthorized system activity going undetected.
- Security over access to sensitive areas was jeopardized due to the lack of accountability over the issuance of master keys at an IRS facility, thereby increasing the likelihood that an unauthorized person could gain possession of a master key and use it to unlock sensitive computing areas within the facility.

These information security control weaknesses exist primarily because IRS has not fully implemented an agencywide information security program to effectively protect the information and information systems that support the operations and assets of the agency. Consequently, these identified weaknesses in information security controls impair IRS's ability to ensure the confidentiality, integrity, and availability of sensitive financial, taxpayer and FinCEN's BSA data hosted at its facility.

We made recommendations to the Secretary of the Treasury to direct the IRS Commissioner to take several actions to fully implement a comprehensive agencywide information security program and to determine whether taxpayer data have been disclosed to unauthorized individuals.[37] In addition, we recommended that the Secretary of the Treasury direct the FinCEN Director to perform an assessment to determine whether BSA data have been disclosed to unauthorized individuals. The Acting Deputy Secretary of the Treasury generally agreed with the recommendations and identified specific completed and planned corrective actions, which we did not verify.

Concluding Observation

IRS is operating in a difficult budget environment. On the one hand, its workload—represented by the number of returns and the complexity of those returns—is growing. On the other hand, IRS faces pressure to hold down spending.

Addressing the resource challenges summarized in this statement can help policy makers assessing IRS's budget. Long-term goals can help determine

[37] GAO-05-482.

overall budgetary requirements. Revenue enhancements and the leveraging of nonfederal resources can help, to some extent, meet those requirements. Productivity gains and successful new investments in systems can help ensure that existing resources are used as efficiently as possible, helping minimize the need for additional funding. Addressing these resource challenges does not promise a painless way out of difficult budget decisions. However, it could provide a clearer picture of the tradeoffs involved.

Mr. Chairman, this concludes my testimony. I would be happy to answer any questions you may have at this time.

Contact and Acknowledgments

For further information on this testimony, please contact James White on (202) 512-9110 or whitej@gao.gov. Individuals making key contributions to this testimony include Perry Datwyler, George Guttman, Tonia Johnson, David Lewis, Neil Pinney, Jeffrey Schmerling, Henry Sutanto, and Jenniffer Wilson.

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

PRINTED ON RECYCLED PAPER

Representative RAMSTAD. I want to thank all of the witnesses for your excellent testimony and for staying within the 5–minute rule.

The first question I have is for you, Mr. George.

It is upsetting, to say the least, to hear you say that some of our men and women serving in combat zones are not receiving the tax benefits to which they are entitled because of administrative problems at the IRS. In response to TIGTA's report that you mentioned, has the Service taken the necessary steps to address this problem?

Mr. GEORGE. While I cannot give a definitive response to that, Mr. Chairman, the report was issued last month, and from all indications, the IRS has indicated that it is working both with the Department of Defense to update computer systems so that the two can have more accurate information, as well as IRS implementing a program internally to clean up the information in the records that it has on this issue.

We will certainly follow up and report to this committee our findings in due time.

Representative RAMSTAD. We would appreciate that follow-through because certainly the last group of taxpayers that should not receive tax benefits would be those men and women in harm's way and those brave troops risking their lives in combat zones. So, we appreciate your attention to that.

I have a question for Ms. Olson.

Ms. Olson, with reference to your needs assessment recommendation, I certainly agree that the IRS should study taxpayer needs before making changes in the way services are delivered. That is only common sense.

In your judgment, is legislation required, or does the IRS, under current law, have such authority?

Ms. OLSON. I think that the IRS has the authority to do it now. It is a question of their willingness to allocate resources to it.

You know, when we talk about the model for the walk-in centers, the Taxpayer Assistance Centers, the IRS talks about how they use as a factor the—what services were demanded from the walk-in sites currently. But the IRS has been reducing and limiting the number of services over years, so their data is flawed.

I visited my New Orleans office, and they said that there were taxpayers during filing season who were literally in line, outside the walk-in site, around the entire building. The IRS only counts the taxpayers who make it through the doors in the walk-in sites. They only do 10 returns a day during filing season, and that is the data that got plugged into the model.

So I don't think the model reflects the need. And I believe that there was another need to measure what taxpayers want or need, rather than just the IRS data. IRS can do it. It is a question of whether they need some nudging.

Representative RAMSTAD. Thank you, Ms. Olson.

I would like to ask you, Chairman Wagner, in your testimony you said that in the ideal tax system, taxpayers will find "compliance easy to achieve and difficult to avoid," to quote your words. To move closer to that ideal, you say that Congress and the IRS should work together and establish measurable performance criteria.

Could you just elaborate on the measurements that you would recommend? What are the criteria?

Mr. WAGNER. Well, I think, Mr. Chairman, that there would be a whole host of measures and criteria that should be considered. It would be something that would be developed jointly between stakeholders, the IRS, various interested parties such as the board and representatives from this group.

Strategically, the electronic filing goal was certainly a very worthy goal that was set by Congress a few years ago. That strategic thinking needs to be continued and expanded.

There needs to be a focus on strategic and outcome measurement compliance, such as voluntary compliance rates, administrative burden, and end results of interactions with taxpayers that include customer service and compliance activities. You know, I think that there would be a whole range of measures that need to be considered and collaboration with stakeholders and partners would yield a better array of measures.

Representative RAMSTAD. Well, again I want to thank all of the witnesses.

At this time, the Chair recognizes Mr. Olver for questions.

Representative OLVER. Thank you very much, Mr. Chairman.

In one way or another, each of the four of you has raised some question about the closure of service centers. I think I am correct in that. And the—from my position in Appropriations, the two most important issues that we have to deal with are those closures of the service centers, and it seems to me, the private collections program.

I don't know whether you have seen Mr. Everson's testimony, his written testimony. Almost all of page 3, except for a couple of lines at the top, and the first paragraph on page 4 of that testimony go through a fairly coherent, very neat description of things that the changes in the use of electronic filings and such mean.

I would appreciate it very much if, from your point of view—for my edification and for the work that I do, if you could address yourselves in written form to that one page of his description.

And I know some of you said the information isn't yet available, isn't complete. What would be needed to decide whether what is appropriate is there? It would be great if you could do that.

Now, I would like to—if we look at the data for how we function, it is quite remarkable, actually. Compliance is voluntary up to the 85 percent level. We are getting $6 out of $7 involuntarily, essentially; the rest is a tax gap. It is a $300 billion, roughly, tax gap.

And Mr. Everson has been very eloquent about how corrosive that is for voluntary compliance, when people who pay what they owe and do so, some very willingly, some maybe just because it is the law, do not see their neighbors doing the same thing.

And so the tax gap is certainly important. If we could get at just bringing the compliance, the voluntary compliance, up to 90 percent—of course, that is $100 billion; that would be one-third of the tax gap—it would have a major impact on both the fairness of the system, as perceived, in its totality, but also on our deficits.

Now, I used some data earlier which probably were not fair. The actual voluntary input seems to be about $1.8 billion. Well, that is about $400 per dollar of tax enforcement money, the account in the

IRS budget, which is $4.5 billion for tax enforcement. As I pointed out—and I was reading from Mr. Everson's testimony—he had pointed out that the enforcement activities, coupled with late payments, recover about 55 billion of that tax gap and brings it down to a net tax gap.

Well, if you take the 55 billion of those enforcement and late payments and apply just with that 4.5 billion of expenditures for tax law enforcement, you get a 12-to-1 margin.

It seems to me that anything that is less than a 12-to-1 margin, which would be 8 percent for debt collectors—for payments to debt collectors means fairly clearly that we could do that better by using our own well-trained employees, without having any problem of potential harassment, midnight calls, or questions about privacy, which have been raised by a number of people — some of them, you who are testifying. And there again, that is a very, very rough kind of an estimate.

I pulled out—and this is for you, Mr. Wagner. I pulled out of Mr. Rossotti's document—as he was going out the door, I guess—the idea that there was one account, one set—I exaggerated the numbers there a little bit—of field and phone accounts receivable where they hadn't been able, because they didn't have the staff, to go back and get the numbers of dollars that were owed, that everybody knew were owed; and that came to $9 billion. And Mr. Rossotti was saying that $300 million would be able to collect that. That would be—in that kind of a count, in that category; there may be other categories, there are other categories—but that would be a 30-to-1 value.

If any of you would like to give me in writing some analysis or thoughts on that, on what I am talking about here, that would be very helpful to what I do in my committee.

Thank you.

Representative RAMSTAD. The gentleman's time has expired.

We have a series, as you can hear, of five votes and I don't want to keep these witnesses. That will take 45 minutes at least, if not longer. So if we could, limit our questions to a couple of minutes.

Senator, please.

Senator AKAKA. Thank you very much, Mr. Chairman.

Ms. OLSON, as you know, I have been pushing for the authorization of grant program that would link free tax preparation services for low-income taxpayers with the establishment of low-cost bank and credit union accounts. This year it has been incorporated into a bipartisan bill, S.832, the Taxpayer Protection and Assistance Act, which was introduced by Senator Bingaman.

What is your evaluation of this program, and what else can be done to reduce the use of RALs?

Ms. OLSON. Well, sir, I think that funding—linking tax preparation with financial literacy initiatives and creating low-dollar bank accounts for taxpayers in this low-income population and immigrant population is just absolutely essential, and I think that your legislation really goes a far way to that.

I will note that the IRS has just recently entered into a letter of understanding with the Justice Department in the Weed and Feed program, to provide, my understanding is, $1 million in grants to volunteer income tax assistance programs that will move

into communities that are identified as high-crime or high-drug or low-income and actually fund tax preparation in that area in conjunction with financial literacy. And I think that is a wonderful initiative.

And your program would go further. I have been encouraging Treasury and the IRS to look at other means of delivering refunds other than through direct deposit or paper checks. The United Kingdom delivers their refundable credits through either sponsoring low-dollar savings accounts, that can be accessed through an ATM card, or literally delivering the refund on a debit card such as we give food stamp benefits today, that taxpayers can go to any bank, any post office, get the dollars downloaded onto that card after showing identification; and that would just simply cut out the refund anticipation loan market without regulating it at all.

I really am enamored with that idea. I think we should be pursuing that. We do it already in other benefit programs.

Senator AKAKA. Thank you very much.

I know we are strapped for time, Mr. Chairman. I have questions, but thank you.

Representative RAMSTAD. Thank you, Senator, for your courtesy to the House Members. The gentleman from New York.

Representative SWEENEY. Very briefly, Mr. Chairman, thank you; and thanks to all the witnesses.

By no means—this is not a reflection of a lack of appreciation. I have a lot of questions actually for each one of you.

Just in response to you, Chairman Wagner, I understand there is concern about the appropriation numbers. As we work with the executive branch, trying to pay down the deficit, there are constraints upon us. As you saw by Mr. White's testimony, there are a lot of needs within the IRS that would instill a greater sense of confidence in us appropriators to a greater level of funding, and I am looking forward to your report because I think that is an important step in that process.

So I will yield back my time with that.

Representative RAMSTAD. The Chair thanks the gentleman and thanks all the witnesses for your testimony and your good work, your important work.

With no further business before the joint review, the hearing is adjourned.

[Whereupon, at 4:46 p.m., the joint review was adjourned.]

○