THE INTERNAL REVENUE SERVICE: THE COMMISSIONER'S FINAL REPORT

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMENT AND INTERGOVERNMENTAL RELATIONS

OF THE

COMMITTEE ON GOVERNMENT REFORM

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CONTENTS

THE INTERNAL REVENUE SERVICE: THE COMMISSIONER'S FINAL REPORT

MONDAY, APRIL 15, 2002

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMENT AND INTERGOVERNMENTAL RELATIONS,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn and Norton.

Staff present: J. Russell George, staff director and chief counsel; Bonnie Heald, deputy staff director; Henry Wray, senior counsel; Earl Pierce, professional staff member; Justin Paulhamus, clerk; Jon Bouker, minority counsel; David McMillen, minority professional staff member; and Jean Gosa, minority clerk.

Mr. HORN. A quorum being present, the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations will come to order.

Every year on April 15th the Internal Revenue Service holds American taxpayers accountable for the accurate reporting of their tax liabilities. The Internal Revenue Service must be held equally accountable. That's the purpose of our hearing today. Specifically, we are here to examine the progress the Internal Revenue Service is making to resolve its many management and performance challenges.

Each year, our subcommittee holds an annual oversight hearing focusing exclusively on the Internal Revenue Service. As in previous years, the distinguished Commissioner of Internal Revenue, Charles Rossotti, is our lead witness today. This is a particularly notable occasion since it will be Commissioner Rossotti's last regular appearance before this subcommittee. Mr. Rossotti's 5-year statutory term as Commissioner expires in November of this year. He has done an outstanding job in an extremely challenging position.

The Internal Revenue Service is charged with enforcing the Nation's tax laws and collecting nearly 95 percent of the Federal Government's annual revenue. The agency collects about $2 trillion a year in tax payments, yet a series of management problems have plagued the agency and severely impeded its performance.

These were long-standing problems that confronted Commissioner Rossotti when he was sworn in. He knew at that time that to make the changes which would require change would be several years. He has kept the faith and stuck it out. We have the highest respect for the Commissioner, and we hope in the last few months of his term that he will do everything he can to make sure that the Internal Revenue Service is doing the best it can.

I was delighted that President Bush and Secretary O'Neill had furthered him, and when I talked to Secretary O'Neill that the Commissioner should be maintained, the Secretary said, I sure hope to, and I beat you to it. So you've got a lot of friends, despite the problems that we have all over the government.

The agency's inability to make effective use of information technology is another chronic problem. The Internal Revenue Service appears to be recovering from past failures and has developed a sound modernization blueprint. It now faces the major challenge of implementing that blueprint.

Computer security is another major challenge for the Internal Revenue Service as it is for most Federal agencies. Indeed, the agency's Inspector General has identified security, including information security, as the most serious of all risks facing the Internal Revenue Service.

The management problems at the Internal Revenue Service have taken a severe toll on its performance. Tax enforcement and collection activities have declined dramatically over the last decade. I am particularly concerned about the agency's abysmal performance in collecting delinquent debt. The General Accounting Office reports that the Internal Revenue Service had discontinued collection action on nearly $12 billion in tax delinquencies as of March 2001. The agency primarily blames this on its lack of resources. At the same time, however, the IRS consistently resists the idea of using private contractors to assist in its collection efforts; and I find that inexcusable.

Finally, the Internal Revenue Service needs to be substantially improved for its customer service. It's done a fine job in many ways. It must do a better job of picking-up the telephone when the taxpayers call and providing accurate answers.

Although I have laid out a litany of problems I am confident that Commissioner Rossotti has charted a course that will eventually overcome the agency's core problems and fundamentally improve its performance. Under Mr. Rossotti's capable leadership, there are already signs of progress. However, many deeply rooted problems remain. There is much more work to be done.

I will now swear in today's witnesses and look forward to your testimony.

[Witnesses sworn.]

Mr. HORN. I note one, two, three, four, five, six, seven, eight, nine, ten, eleven. You've got a good team today, and the clerk will note they affirmed the oath.

So, Commissioner, we're delighted to have you. Your full statement, as you know, goes into the record at this point. We'd like you to do your summary of it on the high points, and then we'll go to the other members that are going to be sitting with you. So now proceed in any way you would like.

STATEMENT OF CHARLES O. ROSSOTTI, COMMISSIONER OF INTERNAL REVENUE

Commissioner ROSSOTTI. Thank you very much, Mr. Chairman; and I especially appreciate your comments about me.

I again appreciate your holding these hearings and the opportunity to testify about what we've accomplished and what we still have to accomplish.

I will note, on the subject of a collection report, as I mentioned to you earlier, I am recused from that; and I have Mr. Bennett with me here to testify if questions come up on that subject.

I particularly, Mr. Chairman, want to express my gratitude for the support you've given for our modernization program over the years. I can remember it was about 3 years ago that I was testifying to the subcommittee about the challenges related to the year 2000 conversion, which was a subject of great concern at that time. Fortunately, that program was a complete success; and it also provided some long-term benefits in improving the standardization and management of our systems process. Since then, we have also made some of the other improvements that you have pushed for; and, of course, we're working on others.

I would like to note on one chart which we're going to put up and which you have a copy of in front of you that the improvements that we have made in the agency have been recognized by the American public. The Roper Starch Survey, a public survey, found that our rating has increased in each of the last 3 years after reaching an all-time low in 1998; and I think it's called public rating of the IRS, Mr. Chairman. There are two slides on it. One is Roper Starch. The other is the University of Michigan Customer Satisfaction survey, which also showed a considerable improvement in customer satisfaction by our individual taxpayers. This was the largest favorable gain of the 30 Federal agencies that were surveyed.

The turnaround in the public's rating of the IRS is, I think, important for the health of the tax system. It's not acceptable for the government agency that affects more Americans than any other agency to also be rated the lowest. Changing that was a mandate incorporated in the restructuring act, and we are beginning—and I do stress beginning—to deliver on the mandate of changing that. While the trend is good, as you've noted, a lot more needs to be done.

Let me briefly address our filing season which, of course, for most taxpayers is ending today. This is the period in which most individual taxpayers interact with the IRS and form their opinion of the IRS, and I'm putting up a second chart which you also have in front of you which shows some trends in some important indicators of service during the past 2 years.

There's one set of numbers which you will notice are increasing literally off the chart, in a high way off the chart; and those are the ones that relate to the use of the Internet or Web site, IRS.gov. In January, we introduced a whole new design which was designed to make this site more accessible, and its usage continues to grow, and its practical significance for taxpayers is that they are getting information and forms when they need them without having to make last-minute trips to the post office and perhaps guess at things that they really should be able to lookup very easily.

Another important line on this chart, which is loaded electronically filed returns is also up very substantially. We set an aggressive goal for this year of receiving 46 million 1040 returns electronically, which would be a 15 percent increase over the last year; and I'm pleased to say, looking at the numbers, that we are on track to even exceed our goal of 46 million.

I should also note that, with the help of a provision reported by the Ways and Means Committee a few weeks ago, which is to extend the filing date for those who file and pay electronically from April 15 to April 30, that proposal, if enacted by the full Congress, will help us to continue or even accelerate this trend.

There are a number of lines on this chart that relate to the quality of phone service, and I'm also pleased to report that we're making progress in the face, by the way, of increased customer demand. Primarily because of the increased calls concerning the rate reduction credit, the total volume of incoming calls on our toll-free lines for the fiscal year through the first half March 30th were up 13 percent, totaling 51 million calls.

There's another chart which is about to come up which just shows the service by month, and I think the important point is there was a surge of calls in February which temporarily drove down the service. We were able to respond, however; and, as you can see, it rapidly improved so that, since the beginning of March, it's been above our goal of 71 percent.

Finally, with respect to quality, to accuracy, our responses have also improved substantially. The correct response rate for tax law and account correct calls were up to 83 and 89 percent this year, up from 75 and 88 percent. So those are indicators, as noted on the trend chart, that are up in the right direction. They're still not in all cases up to the level that they need to be, but they're clearly going in the right direction.

Let me turn to the matter of efficiency, which is one of the subjects of this committee's jurisdiction. Our key here is to leverage our limited resources as much as we can through better management and fundamental reengineering of our business processes, and we've been able to do that.

Again, I'm putting up another chart that shows how we're reallocating our resources to where they are going to be needed the most. This is primarily in improving customer service and in our key enforcement and compliance activities. As you can see in this chart, Mr. Chairman, for the fiscal year that is now before the Congress, 2003, we're proposing to achieve $259 million worth of increased program delivery but with a net requested increase of only $63 million. So, in other words, 76 percent of the improvements that we are hoping to achieve will be achieved by internal efficiency; and only the rest will be achieved by increased resources. This is directly responsive, we think, to a mandate to improve efficiency.

Now, let me turn briefly to the modernization program, which I know is very important to you, Mr. Chairman. There is a $58 million increase noted—requested, rather, for our modernization projects; and I think one of the things that is important now is that business systems modernization is graduating from the planning stage to the design and implementation of business results. Again, another chart here, a very oversimplified one, I should note, but it gets the basic idea. The green blocks in fiscal year 2001 and 2002 represents some critical building blocks that will be put in place.

In 2001, last year, we established a new communications infrastructure for taxpayer telephone calls, which is one of the reasons that we are providing better service this year. Now, in 2002, this coming year, we plan to move the records of some of our taxpayers out of the 1960's tape-based system to a modern, reliable data base.

Finally, we plan to establish an IRS-wide security infrastructure to manage external and internal secure access to our systems, something that is directly responsive to the point you noted in your opening about security. I should note that, as we sometimes do, we have recently experienced a delay in one part of this program, but, nevertheless, we have adjusted to that. We still expect to achieve the important goals that are noted in the chart.

We've also gained valuable lessons as we have moved forward with these projects, and we are giving equal attention to improving the quality of the way we—and the maturity of the way we manage the program as well as in delivering specific projects.

One of the most important things that we have accomplished, has been noted by GAO, is that we have completed the second release of our enterprise architecture. That is what is behind this entire circle.

This is just a little picture of it. I can provide you with CDs if you would like to browse it, Mr. Chairman. It shows all 3,000 pages or so of what the feature of the IRS is going to be.

I have to say I am very proud of this particular product. I've worked in this industry, before taking the IRS job, for 28 years; and it's quite easy to just produce a few charts and show that you have an enterprise architecture. I think that the one that we have worked on for 2 years is really the most rigorous that I am aware of; and I believe it will provide, as you again noted in your opening, a blueprint for the future of the IRS in modernizing its business practices as well as its technology.

We are also, as I noted, working on improving the maturity of our management processes. We, I think, are in good shape of using a rigorous enterprise life-cycle methodology. We are in less good shape on some other management processes which we are working on diligently to improve and especially in addressing the recommendations of the GAO and the IG.

Now let me mention something about our financial statements, another topic of this committee.

I'm pleased to say that GAO issued an unqualified or clean opinion on IRS financial statements for fiscal year 2001 for the second year in a row on both our revenue and administrative accounts. I would say that certainly this success can in part be attributed to the hard work and dedication of both the IRS staff and the GAO staff, but it can also be traced to improvements that we have made, notwithstanding some of our systems limitations, in our internal controls and also our management focus.

For example, in February 2002, a couple of months ago, we were able for the first time to achieve a 3-day monthly close on our books, something that Secretary O'Neill is very keen on, and this was certainly a big milestone in the IRS. Some even internally thought we could not do this, but we did.

So we know that we are making progress, but we still have considerable requirements to improve financial management in part based on our improved technology, and we are working on the dual track which we have noted in every year and these hearings making those processes that—improvements that we can make and modernizing our system, which is a longer-term effort.

Finally, Mr. Chairman, let me briefly comment on the National Taxpayer Advocate's report on the problems that taxpayers face in trying to comply with the complexity of the Tax Code.

Internally, we are working, as I've noted, to improve service to taxpayers. However, even our best efforts in that regard will be limited to a significant degree unless we can somehow deal with the staggering complexity that everyone knows is woven into the Tax Code. I would say especially in those areas of the Tax Code that most average taxpayers must cope with, such as the definition of a child in a marriage. I think most taxpayers legitimately wonder why is it so hard to define what a child is. I've been wondering about that myself ever since I've been Commissioner. The taxpayer advocates report lays out the amazing items that are in the Code about the definition of a child and other related family issues.

So, in conclusion, Mr. Chairman, I think we can be proud of the progress that we have achieved over the past year—over the past years, and I think the indicators are in the right direction, but I would be the last one in the room to declare victory at this point. I know that we have so much more to do, and I think that if we stay focused on the path that we're on, and was laid out in the Restructuring Act. Our path is defined in more detail in our modernization plan and, of course, making adjustments as we learn more. We do learn every year, but if we don't lose sight of our goals I really do think we can succeed. Your support has been important in the progress we've made, and we thank you for that.

That concludes my testimony.

Mr. HORN. I thank you.

[The prepared statement of Mr. Rossotti follows:]

PREPARED TESTIMONY
OF
COMMISSIONER OF INTERNAL REVENUE
CHARLES O. ROSSOTTI
BEFORE THE
HOUSE GOVERNMENT REFORM
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY,
FINANCIAL MANAGEMENT AND
INTERGOVERNMENTAL RELATIONS
HEARING ON
"THE STATE OF THE INTERNAL REVENUE SERVICE: PROGRESS IN ADDRESSING MANAGEMENT AND PERFORMANCE ISSUES."
APRIL 15, 2002

INTRODUCTION AND SUMMARY

Mr. Chairman, thank you for this opportunity to provide you with an update on the progress the IRS is making on a number of key programs and initiatives, including the filing season, our Business Systems Modernization Program, financial audits and the major taxpayer problems identified by the National Taxpayer Advocate.

Before I begin my formal testimony, let me express my gratitude for your continued support of our modernization program. Indeed, it is hard to believe that three years ago to this day, I was testifying before the Subcommittee on how we were managing our Y2K conversion program. As you know, the Y2K program was an unqualified success and it also provided many long-term benefits in improving the standardization and management of our systems management process. I have also welcomed your keen insights and suggestions on how we can improve both the management and processes that guide systems modernization and the critical services we provide to America's taxpayers

Indeed, these annual hearings present us with the opportunity to step back and review our progress and the challenges before us, and today, I can report that we are gradually improving our performance across the board.

As shown in the chart, two respected surveys show a strong turnaround in IRS public approval. The Roper Starch Surveys found our rating increased each of the past three years after an all time low in 1998. And the University of Michigan's American Customer Satisfaction survey showed greatly improved customer satisfaction among individual taxpayers – the largest favorable gain of the 30 federal agencies surveyed.

The turnaround in the public's rating of the IRS is fundamentally important to the health of the tax system. It is not acceptable for the government agency that affects more Americans than any other to also be the lowest rated. Changing this was a mandate incorporated in the IRS Restructuring and Reform Act of 1998 (RRA 98), and we are beginning, and I stress beginning, to deliver on this mandate. While the trend is good, much more remains to be done.

One of the important trends upon which we can build is to convert more taxpayers to filing electronically – a clearly better way for all to do business. The 2002 filing season statistics underscore that an increasing number of taxpayers are taking advantage of filing their returns, receiving their refunds or paying their taxes electronically.

Through March 26, 2002, almost 37 million individual taxpayers filed using one of the three *e-file* options; a 13.87 percent increase over the same period last year. And the number of taxpayers *e*-filing from their home computers is up a very impressive 40 percent over last year. For the fiscal year, we set an aggressive goal of receiving 46 million returns electronically a 15 percent increase over last year, and I am pleased to say that we will meet or exceed this goal.

To help us to meet RRA 98's ambitious e-filing mandates, the President also proposed that the due date for returns filed and paid electronically be extended to April 30th next year. I was most gratified that the House Ways and Means Committee included this provision in the "Taxpayer Protection and IRS Accountability Act of 2002," that was reported out of Committee on March 20, 2002.

Mr. Chairman, we are also making strong improvements in efficiency. By leveraging our limited resources through better management and a fundamental reengineering of business processes – not through massive infusions of new resources – we have been able to reallocate precious resources and personnel to where they are needed most, such as improving customer service and stabilizing critical compliance activities.

The IRS proposes to achieve $259 million in increased program resources and delivery at a net requested increase of only $63 million. In other words, 76 percent of the improvements will be achieved by improved internal efficiency and redeployments. These improvements are essential to continuing the positive upward trend in programs and in making the tax system operate fairly to all.

Crucial to our success is continued support for our Business Systems Modernization (BSM) program, for which a $58 million funding increase is requested. The increase will allow us to fund these critical projects as they move from the planning and design phase to development and implementation.

Over the past two years, BSM graduated from strategic planning and systems design to business results. As shown in the chart – in the green blocks in FY 2001 and FY 2002 – the IRS will put in place three critical building blocks. In 2001, we established a communications infrastructure to manage the enormous volume of taxpayer phone calls. In 2002, we plan to move the records of some taxpayers out of the 1960's tape-based system to a modern, reliable database. And third, we plan to establish an IRS-wide security system providing internal and external secure access and communications to our systems. We encountered a delay in one part of the program, which I discuss later in my testimony, but we nevertheless expect to achieve these important goals.

These three deliveries are some of the most essential and difficult fundamentals of the modernization program. Their lack severely impeded our ability to modernize our systems and imposed enormous risks and costs on the entire tax administration system. As BSM progresses, these programs will continue to be enhanced and deployed on an ever-increasing scale until they eventually support the entire tax system.

Valuable lessons were learned as we developed and implemented these projects, and we are giving equal attention to improving the quality and rigor of our management processes. Completing the first two versions of the Enterprise Architecture, as shown in the chart, was a major step.

Based on my 28 years experience in the Information Technology business, I believe that this Enterprise Architecture is the most complete and useful of such architectures in industry or government. We are also utilizing the rigorous management processes of the Enterprise Life Cycle, while at the same time ensuring that all BSM projects adhere to the Enterprise Architecture.

In addition, we are addressing remaining management weaknesses, including those identified by GAO. Finally, we are striving to achieve a standard know as the Software Acquisition Capability Maturity Model Level 2 – a recognized standard that has not been achieved in any Federal Agency with the exception of the Abrams Tank Division of the United States Army.

Mr. Chairman, let me now describe in detail some of the key areas and subjects of interest to the Subcommittee.

2002 FILING SEASON

Mr. Chairman, the 2002 tax filing season has been smooth, with returns being processed on time, electronic filing increasing substantially and improved accessibility and accuracy of telephone service. It continues to demonstrate how we can build on positive trends in service to taxpayers, especially as our major technology and organizational initiatives take effect. We have encountered some confusion and a significant number of errors concerning the rate reduction credit, but we have been able to keep up with these and get taxpayers their refunds on time.

Projected net collections for FY 2002 will be approximately $2 trillion. During FY 2002, we also project to receive 231 million returns, including over 132 million individual returns, and expect to issue over 99 million individual refunds – 3 million more than the previous year. As of March 23, 2002, the average dollar amount per refund is up over 12 percent over last year, and the average refund is $1,980.

Mr. Chairman, so far, we discovered 3.1 million Rate Reduction Credit errors. The credit is on line 47 of Form 1040, line 30 of Form 1040A, and line 7 of Form 1040EZ. The credit is for those taxpayers who did not get the maximum benefit through last summer's Advance payments, and whose 2001 income or tax amounts qualify them for an additional amount.

We are checking all returns to see that the Rate Reduction Credit line is handled properly and will notify taxpayers of any changes we make. We are also rejecting *e*-file returns that show the Advance Payment amount on this line, or that show a dependent claiming this credit, so that the taxpayer or return preparer may quickly fix the problem and transmit a corrected return.

Although it is not directly related to the filing season, let me also note that we corrected a problem for taxpayers trying to obtain an Employer Identification Number (EIN) through our new toll-free service. This was a start-up glitch that was quickly resolved and we are now enjoying an 85 percent level of service (success rate of taxpayers seeking assistance for toll-free EIN service).

Electronic Tax Administration

In 2001, a little more than 40 million taxpayers filed electronically -- a 13.7 percent rise from last year. Since 1997, *e*-filing increased by 110 percent, and on-line filing grew by a staggering 1,700 percent. Clearly, the value taxpayers receive from all our *e*-programs is one reason behind the growth. Faster refunds, positive acknowledgement of receipt and fewer errors that require time consuming letters and telephone calls to correct are key benefits to taxpayers.

One of the important reasons for the IRS' strong showing in the ACSI survey was the very high satisfaction rate among electronic filers. It was 77.2 points (out of 100) -- higher than the previous year and the third year in a row that *e*-file taxpayers expressed increased satisfaction.

The 2002 filing season statistics underscore that an increasing number of taxpayers are taking advantage of filing their returns, receiving their refunds or paying their taxes electronically. Through April 4, 2002, almost 39 million individual taxpayers filed using one of the three *e-file* options; a 14.4 percent increase over the same period last year. Let me point out that the number of taxpayers *e*-filing from their home computers is up a very impressive 39 percent over last year.

For the fiscal year, we set an aggressive goal of receiving 46 million returns electronically a 15 percent increase over last year, and I am pleased to say that we are on track to meet or exceed this goal.

The following are some of the key 2002 filing season *e*-file statistics through

April 4, 2002 except where noted.

- Nearly 28.6 million taxpayers have *e-filed* their tax returns electronically through an IRS-authorized Electronic Return Originator (ERO), a 12.6 percent increase over the same period last year.

- Approximately 7.2 million taxpayers have filed their tax returns on-line via their home computer through a third party transmitter. OnLine filing is running 40 percent ahead of last year and as of April 4, 2002 is already well over the 2001 total volume of 6.8 million.

- Almost 5.3 million taxpayers have chosen to use the OnLine Self-Select PINs, up 60.3 percent over last year.

- Over 3.6 million taxpayers have filed their returns over the telephone using the award winning TeleFile system.

- Overall, as of April 4, over 16 million taxpayers have chosen to file both their federal and state tax returns simultaneously in a single electronic transmission, up 23.8 percent from last year's 13.1 million at this time last year. This year, 37 states and the District of Columbia are participating in the program.

New for Individuals for the 2002 Filing Season

In order to improve our ETA program and ease taxpayer burden, the IRS created a series of enhancements for the 2002 filing season and the remainder of the fiscal year. These initiatives include:

- Adding 29 forms and schedules to allow for even greater taxpayer participation in the IRS *e-file* program. This meant we opened up *e*-file eligibility to over 99 percent of all taxpayers, potentially adding 38 million new *e*-filers.

- Continuing the Self-Select Personal Identification Number (PIN) Program that in 2001 enabled approximately nine million taxpayers to file paperless returns without having to submit paper signature *jurats*. The Self-Select PIN is a five-digit PIN that taxpayers can create to sign their returns electronically.

- Continuing the Extension of Time to File by Phone. Anyone who filed a tax return last year can request over the telephone as automatic extension of time (to August 15, 2002) to file his or her tax returns. Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax return, has details on required information and explains how to pay a balance by telephone.

- Continuing the Debt Indicator Program and providing the Debt Indicator on every acknowledgment report. This information will be provided for every electronically-filed return for customer service purposes or for approval of financial products.

- Expanding the electronic payment options available to taxpayers by accepting credit cards for payment of installment agreements and delinquent taxes. As of April 4, approximately 46,449 payments averaging $2,459 were made via credit card and another 84,671 payments averaging $979 were made by Automated Clearing House (ACH) Direct Debit where taxpayers can authorize either their checking or savings account to be debited.

- Adding Maryland, Oregon and West Virginia to the FedState TeleFile program that already includes Indiana, Kentucky, Oklahoma and Georgia.

- Releasing the initial series of Web-based services for practitioners including registration and application capabilities, requesting and receiving taxpayer transcripts on-line, submitting disclosure authorization requests electronically, verifying Taxpayer Identification Numbers, and getting personal assistance to resolve taxpayer problems.

ETA Also Easing Business Taxpayer Burden

A strong ETA program may be even more important for reducing burden for businesses than for individual taxpayers. In addition to their annual income tax returns, businesses also have to file various employment tax returns and information returns. Businesses also make a lot of payments to the federal government, such as withholding and unemployment taxes. In fact, payments are a business' most frequent transaction with the IRS.

These requirements add up to a lot of transactions between businesses and the IRS – 23 million employers' quarterly tax returns; 5.5 million employers annual unemployment tax returns; 5.5 million corporate tax returns and 2 million partnership returns, including the processing of over 11 million K-1s. That is an enormous amount of paper and it does not include the millions of checks that accompany them.

We want to eliminate this blizzard of paper and convert all of these transactions to fast, accurate, paper free electronic methods. In 2002, the IRS continues to make progress serving the electronic tax administration needs of this important sector.

Mr. Chairman, to promote business *e*-filing, we have placed advertisements in publications, including *Fortune Magazine*. Businesses can now file electronically both their 940 and 941 employment tax returns. Some businesses may even qualify to file using a telephone. We have also opened the door for a number of other key forms to be filed electronically, such as Form1099 to report other income. We are particularly pleased that we can now offer electronic filing of Form 1065, to report partnership income, and the K-1s that accompany them. We are also hard at work designing Form 1120, Corporate Tax Return *e*-file program. Implementation is slated for a year from now.

I mentioned that payments from businesses, especially payroll deposits and quarterly returns are the most common transactions businesses have with the IRS. The Electronic Federal Tax Payment System (EFTPS) is an enormous success story in this regard. Through EFTPS, both businesses and individuals can make federal tax payments electronically. Since its inception in November 1996, businesses have used it to pay more than $5.7 trillion in federal taxes.

On September 6, 2001, we successfully launched IRS' first on-line payment system – EFTPS-OnLine. It provides a convenient and secure method for paying all federal taxes through a secure web site. Let me stress that confidentiality and privacy of taxpayer information are our highest priorities. EFTPs-OnLine users can feel confident that their private information will be protected.

Spurring Further e-file Growth

Mr. Chairman, in its December 21, 2001 report to you, "Assessment of IRS' Tax Filing Season," the GAO observed that in spite of the growth in electronic filing and our efforts to identify and eliminate impediments, the 13.7 percent growth in 2001 was still below our goal of 20 percent. Of particular concern to both the GAO and IRS is why approximately 40 million individual income tax returns were prepared on computer but filed on paper in 2001. The IRS and the Administration are taking and proposing actions to address the problem.

This year, we focused our *e*-file marketing campaign on taxpayers who prepare their returns by computer but file on paper, and taxpayers who use the services of tax professionals but file on paper. We also agree with GAO on the need to further survey these filers to determine why they did not file electronically and how we can overcome these barriers.

In addition, the President proposed in his FY 2003 budget that the due date for returns filed and paid electronically be extended. During the March 20th mark up of the "Taxpayer Protection and IRS Accountability Act of 2002," the House Ways and Means Committee included a provision that will extend next year's filing date for electronic returns to April 30.

The Administration also proposes in its budget submission "an easy, no-cost option for taxpayers to file their tax return online." Unfortunately, there has been some confusion regarding this proposal. The Administration's proposal to give taxpayers the option to file their tax returns on-line without charge is based on two principles: no one should be forced to pay extra just to file his or her tax return, and the IRS should not get into the software business.

In a statement issued on January 30, 2002, Treasury Secretary O'Neill stated, "I don't intend for the IRS to get into the software business, but rather to open a constructive dialogue with those who already have established expertise in this field. In the end, this effort should come up with a better way to save time and money for both taxpayers and the government." The IRS totally concurs with the cooperative approach enunciated by the Secretary and we will follow it to the letter.

Web-Based Help

The IRS web site at www.irs.gov continues to be extremely popular with taxpayers. As of March 14, the IRS web site was listed as Number 3 in the Lycos Top 50 searches. In 2001, it posted 2.7 *billion* hits with more than 336 million forms and publications downloaded. For fiscal year 2002 through March 31, there were 1.95 billion web site hits, up 36 percent over the same period last year.

I should note that in January, the IRS introduced a newly designed web site, aimed at making it easier for taxpayers to find the information they want on the web. Following our overall strategy of making the IRS customer-focused, the home page immediately provides taxpayers a way to find information based simply on whether you are an individual or business taxpayer.

The Small Business/Self-Employed Community section on our web site is an excellent example. It is dedicated to the needs of this important taxpayer group who often confront more complex tax issues than those who have their taxes withheld by an employer.

Our ultimate goal is to transform our web site from an information-only portal to a world-class transaction based gateway. However, some things have not changed. Anyone with Internet access can receive: tax forms, instructions, and publications; the latest tax information and tax law changes; tax tables and rate schedules; and hypertext versions of all taxpayer information publications, including the very popular Publication 17, "Your Federal Income Tax"; all TeleTax topics; answers to the most frequently asked tax questions; a library of tax regulations; and the weekly Internal Revenue Bulletin that contains all the latest revenue rulings, revenue procedures, notices, announcements, proposed regulations and final regulations.

Mr. Chairman, let me point to another benefit of our web site. It is an excellent tool for alerting taxpayers and the media to various fraudulent schemes, including the slavery reparations scam, being perpetrated upon them by unscrupulous promoters. There is a quick link from our portal page to IRS Criminal Investigation "Tax Frauds Alert" page that provides in one place a comprehensive overview of the different schemes and what we are doing to combat them. It also lists the number (1-800-829-0433) for taxpayers to report suspected tax fraud activity.

Telephone Assistance

To improve customer service, and based on an AT&T usage study, the IRS aligned its toll-free service hours last year to meet customer demand. Beginning October 7, 2001, IRS assistors are available 7 a.m. to 10 p.m. Monday through Friday local time. During the filing season (January 2 through April 15, 2002), assistor services are available on Saturdays from 9 a.m. to 5 p.m. Assistor services are also available on President's Day and Sunday April 7 and April 14, 2002. IRS automated assistance systems continue to be available 24 hours a day, 7 days a week.

Primarily because of increased calls concerning refunds and the rate reduction credit, the total volume of incoming calls on our toll-free lines for the fiscal year through March 30 has been up 13 percent over last year, totaling 51.1 million calls for the first half of the fiscal year.

Despite this substantial increase in the volume of calls, for the first half of the year through March 30, 2002 approximately 66 percent of taxpayers who wanted to talk to a customer service representative got through, compared to 68 percent last year. In the last four weeks, service improved further, with 74 percent of taxpayers getting through to customer service representatives. We have set a goal for the whole year of 71 percent.

Of great interest to taxpayers, the average wait time for questions on tax law was 2.58 minutes – down from 4.27 minutes last year. Wait time for calls on account questions was 4.76 minutes compared to 6.11 minutes last year.

In addition, 45.3 million taxpayers used our automated services to get information, including refund status, an increase of 8 percent since last year, and the upward trend continues.

Once connected, taxpayers must get prompt, accurate and courteous answers to their account and tax questions. Here too we have made substantial progress towards providing better service to taxpayers. The telephone correct response rates for tax law and tax account questions showed a marked improvement in FY 2002. They were up to 83 percent and 89 percent respectively as compared to 75 percent and 88 percent over the same period last year.

Let me note too, that by September 24, 2001, we established a special telephone line for victims of the terrorist attacks and since then, we have provided over 90 percent level of service on this line.

Mr. Chairman, to increase productivity and quality of service, we must give our employees the technology and tools they need to do their jobs at a high level. In this regard, our Business Systems Modernization (BSM) program is delivering both short- and long-term improvements.

The first of the BSM projects, Customer Communications 2001, was deployed in July 2001, which allows us to route calls more precisely to assistors with the necessary expertise. We must also give our assistors specialized knowledge so they can better answer taxpayer questions about a very complex, difficult and changing Tax Code. Our new technology will allow us to route calls more precisely to assistors with the necessary expertise.

Practitioner Priority Service

This new nationwide toll-free, accounts-related service for all tax practitioners is being rolled out in three phases at 45-day intervals; the first was launched on January 2, 2002. This service, which will replace the former Practitioner Hotline, will be the practitioners' first point of contact for assistance regarding taxpayers' account-related issues.

Calls will be routed to one of five IRS campus sites (Brookhaven, NY; Cincinnati, OH; Memphis, TN; Ogden, UT; and Philadelphia, PA) based on the practitioner's area code. All sites will handle both individual and business inquiries, and any issues outside the scope of the employees' authority will be priority routed to other IRS functions.

Expected benefits for practitioners include improvements in overall consistency and quality of service; improved accessibility into the system and reduced wait times; and dealing with the employees who are specially trained to handle practitioner issues.

Forms By Fax and Phone

Taxpayers can receive more than 100 frequently used tax forms 7 days a week, 24-hours-a-day from IRS TaxFax. Taxpayers can request up to three items per-call. Taxpayers use their fax machine to dial the service at 703-368-9694. The only cost to the taxpayer is the cost of the call. Taxpayers can also request forms and publications by calling 1-800-TAX-FORM.

Recorded Tax Information

TeleTax has 150 topics available 24 hours a day using a Touch-tone phone. Taxpayers can call (toll-free) 1-800-829-4477 to hear recorded information on tax subjects such as earned income credit, child care/elderly credit, and dependents or other topics, such as electronic filing, which form to use, or what to do if you cannot pay your taxes. As of March 30, 2002, over 1.9 million have taken advantage of the recorded tax information features of TeleTax this fiscal year.

Automated Refund Information

In FY 2001, more than 54 million taxpayers used the Automated Refund Information system on TeleTax to check on the issuance of their refund checks. As of March 30, 2002, the number stands at over 35.8million – up .5 million from this time last year. Taxpayers may call 1-800-829-4477 to check on their refund 24 hours a day, 7 days a week.

Filing Burden Reduction

In addition to our many popular electronic programs, such as *e*-file, the IRS is also making other efforts to reduce the time and effort it takes taxpayers to file and pay their taxes. For example, Schedule D, the form that millions of taxpayers use to calculate their capital gains and losses, was redesigned for the 2002 tax-filing season. The goal of the revision, which cuts 14 lines from the schedule, is to reduce the difficulty that individuals face when filling out their return. As noted in our press release announcing the change, "Calculating capital gains and losses should not be a capital pain."

This year's tax form for individuals also contains a small change that we hope will make a big difference to the millions of Americans who make minor errors filling out their returns. Taxpayers who fill out a new Form 1040 box selecting a third party designee will enable that person – be it friend, family member or paid preparer – to talk directly with the IRS to correct questions during the processing of the return.

Such errors include simple math errors and data omissions, such as an incorrect Social Security Number. The designation also enables the third party to discuss the status of a refund, payment or other notice with IRS representatives.

This new option balances the taxpayer's need for privacy with the reality that for millions of people a friend, family member or tax professional plays a key role in the preparation of their return. The taxpayer retains privacy but has the ability to make it easier to resolve routine problems. The bottom line is this improves customer service and reduces headaches for taxpayers, practitioners and the IRS.

The new third party designation, located just above the signature line of Form 1040, expands on the success of the paid-preparer checkbox on last year's Form 1040 by enabling the taxpayer to designate a friend or a family member as well. More than 37 million taxpayers marked the checkbox option during last year's tax season. However, the third party designation does not eliminate the need for a Power of Attorney for issues dealing with examinations, under reported income, appeals and collection notices.

CD-ROMs

The IRS has also developed a number of innovative products for small business taxpayers. *The Small Business Resource Guide 2002* on CD-ROM is a must for every small-business owner, or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications to manage a business successfully. It also includes valuable information concerning the IRS Disaster Relief Efforts and the Welfare-to-Work Credit. Up to five free copies can be ordered on-line from the IRS.

The IRS has developed two new CD-ROMs to help educate small business owners on their tax responsibilities. The first, *Introduction to Federal Taxes for Small Business/Self-Employed,* introduces business students, new small business owners, and self-employed entrepreneurs to IRS tax law in an easy to understand format.

The second CD-ROM is *A Virtual Small Business Workshop.* This powerful tool replicates the best of the IRS's years of presentations of workshops for small businesses. It provides information on all the key aspects of the tax implications involved in establishing and running a small business. The user sees the instructor along with an outline of the presentation. In addition, the closed caption option provides the instruction in English, Spanish, and Mandarin Chinese.

These two CD-ROMs are also free and can be ordered by calling 1-800-829-3676 (no on-line ordering at this time).

Taxpayer Assistance Centers

For those taxpayers who prefer to visit an IRS office, walk-in service is available at more than 400 locations nationwide. At many sites, walk-in service will be offered on 12 Saturdays between January 27 and April 14. As of March 16, 2002, we have served over 3.3 million taxpayers at all Taxpayer Assistance Centers – slightly more than at this time last year.

The Saturday Service sites were selected based on their weekend accessibility, year-round operational status, and high traffic volume. They include non-traditional locations, such as shopping malls, community centers and post offices.

Mr. Chairman, in the past, the IRS did not place as high priority as it should have on what were called, "walk-in" sites. The services offered at them was limited and often of poor quality. However, through our new Field Assistance Concept of Operations, we will better serve taxpayers at our taxpayer assistance centers. We will help them meet their filing and paying responsibilities including answering their tax law questions and providing forms and limited courtesy return preparation.

Taxpayers with incomes of $33,000 or less can receive help filing their individual income tax returns. This courtesy return preparation ensures assistance for all taxpayers qualifying for the Earned Income Tax Credit, without placing the government in competition with private industry. Taxpayers whose income or preparation needs exceed the basic service will receive service options, such as referrals.

Free tax preparation is available through the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs in most communities. Volunteers help prepare basic tax returns for low-income taxpayers, persons with disabilities, the elderly, and non-English speaking people. Taxpayers can call 1-800-829-1040 to find their nearest VITA or TCE site. They may also call AARP – the largest TCE participant – at 1-877-227-7844 to see if there is a Tax Aide site in their community.

Throughout the year, and at a variety of locations, we also schedule the highly acclaimed Problem Solving Days – the last was held on November 3, 2001 at 46 Taxpayer Assistance Centers – to resolve long-standing taxpayer issues for those who cannot take advantage of weekday problem solving services.

Problem Solving Days have an excellent track record. But we must bring what we learn from them to our daily operations. Every day should be problem solving day at the IRS, not just three or four times a year. That means using a cross-functional approach to resolve most tax account issues with a single visit or phone call at any time throughout the year.

To help us meet this need, we created a new job at the IRS, "Tax Resolution Representative." These IRS employees will receive the training and authority to provide "one-stop-service" for a broad range of issues ranging from answering tax questions to resolving payment problems.

Mr. Chairman, I want to make one more important point about out Taxpayer Assistance Centers. In its assessment of the 2001 filing season, the GAO noted that the IRS did not previously measure TAC quality; the 2002 filing season is the first year we will measure it. Indeed, this process is just beginning, much as it was for telephone service several years ago.

The Treasury Inspector General for Tax Administration (TIGTA) was also asked by Congress to perform accuracy reviews. It is our sincere desire to work closely with TIGTA to analyze their data to help us meet the challenges we confront at our Taxpayer Assistance Centers.

Tax Materials and Assistance in Spanish

Spanish-speaking taxpayers can receive information through recorded tax topics, free tax publications, toll-free telephone assistance, our web site, and at Taxpayer Assistance Centers.

TeleTax provides the same helpful 151 tax topics and refund information in Spanish and is available 24 hours a day, 7 days a week at 1-800-829-4477. Free Spanish publications are also available by calling 1-800-TAX-FORM (1-800-829-3676). Some of the more popular ones are:

- Publication 1SP, "Derechos del Contribuyente (Your Rights as a Taxpayer)"
- Publication 579SP, "Como Preparar la Declaración de Impuesto," explains who has to file a federal tax return and other important topics, such as which form to file, who are dependents, what income is taxable and nontaxable, and what some of the more common tax credits are
- Publication 596SP, "Crédito por Ingreso del Trabajo," provides details on the Earned Income Tax Credit.

Taxpayers can also talk with a Spanish-speaking IRS representative by calling toll free 1-800-829-1040 between the hours of 7:00 a.m. and 10:00 p.m. on weekdays and 9:00 a.m. and 5:00 p.m. on Saturdays through April 13. This year we provided our Customer Service Representatives with both Spanish Language supplemental training and a new Spanish language Probe and Response Guide and glossary of Spanish language technical terms. Spanish-speaking taxpayers can also go to a new special Spanish section on our web site. Spanish and English services are available too at all IRS kiosks, as well as Russian, Korean and Chinese at our Flushing, NY kiosk in the Queens Public Library.

In addition, we offer Spanish language services in every one of our approximately 416 Taxpayer Assistance Centers nationwide. Many are located in areas with high-density Spanish-speaking populations and include employees recruited from these same communities. We offer this in-person service as a matter of routine.

In these and at all other offices, we also have contract telephone interpreter services available to help us to provide service to any customers who do not speak English. These interpreter services include Spanish as well as almost every other common language in the world.

FINANCIAL AUDIT

Mr. Chairman, I am very pleased and gratified to report that the General Accounting Office issued an unqualified or "clean" audit opinion on the IRS' financial statements for Fiscal Year 2001. This marks the second consecutive year that the IRS has received a clean opinion on both the Revenue and Administrative Accounts. It is critical that an organization responsible for collecting over $2 trillion in taxes, processing more than 210 million returns and paying taxpayers refunds of $251 billion, including $36 billion in rebates under the Economic Growth and Tax Relief Reconciliation Act of 2001, receive a clean bill of health on their financial statements.

Such an unprecedented achievement did not come easily. As Comptroller General David Walker observed in his transmission letter to Treasury Secretary O'Neill, "Our unqualified opinions on IRS's fiscal years 2001 and 2000 financial statements were made possible by the extraordinary efforts of IRS senior management and staff to compensate for serious internal control and system deficiencies."

Indeed, the success can be greatly attributed to the hard work and dedication of IRS staff, as well as that of our partners at the GAO, who were with us every step of the way. The clean opinion also can be traced back to the significant improvements in IRS internal controls and management focus on the financial audits. We made advancements in a number of areas and laid the foundation for sustainable gains in others. Specifically, the IRS:

- Implemented a disposal process for property and equipment;
- Implemented a process to ensure accruals were adequately reflected as of year-end;
- Issued guidance and improved the review of and accounting for open obligations;
- Implemented continuity of operations efforts, such as enhanced business systems preparedness and contingency capabilities for potential biohazard threats, at each IRS campus;
- Established the Computer Security Incident Response Center, which became operational in FY 2001; and
- Required all personnel offices to report monthly all individuals who entered on duty prior to a fingerprint result, effective October 2001.

We are also initiating short-term actions that will further improve the timeliness and accuracy of financial information. We plan to:

- Improve guidance to the field about proper classification of property and equipment;
- Improve the accrual process in FY 2002 to address timely recording of receipt of goods and services;
- Institutionalize periodic reviews of general ledger balances during the year and post adjustments and correcting entries quarterly;
- Record imputed costs regularly; and
- Provide guidance to the field about more accurately reporting revenue activity.

However, we concur with GAO that there is a limit to what hard work and dedication can produce. In fact, our challenge is made all the greater by proposed new accelerated timelines to report financial statements. The Department of Treasury has established the goal of completing by November 15, 2002 all fiscal year 2002 component entity audits and the Department-wide Consolidated Performance and Accountability Report. I will not minimize the difficulty of our task. It will take an enormous effort on the part of IRS and the GAO to meet this goal, but we are committed to achieving it.

Indeed, we must meet the many challenges facing us through a combination of both short-and long-term solutions, as we are doing throughout our modernization program. In other words, we must continue to improve our processes in the near-term while implementing fundamental long-term solutions through our BSM program.

We have made a number of tangible, short-term gains. For example, in February 2002, we were able for the first time to achieve a three-day monthly closing of our books. This was an enormous milestone for the IRS. In prior years, the IRS also did not have an obligation subsidiary ledger to support undelivered orders. However, we have since developed a data warehouse for obligations that shows the full transaction history for each obligation, including open obligations and those that have been fully liquidated.

The warehouse contains all transactions in the acquisition cycle: obligation, purchasing, receipt, and payment. The subsidiary is updated on a nightly basis and is available online for user queries through a web-based interface. We believe this subsidiary satisfies the requirement of providing an adequate audit trail for budgetary activity. Other subsidiary ledgers, with appropriate audit trails, will be built through our systems modernization efforts.

Cost accounting is yet another good illustration. The GAO discusses at some length the IRS' inability to make good business decisions on resources due to the lack of a single cost accounting system. We agree we must have an integrated cost accounting system – and we will. However, in the short-term, our systems are providing adequate cost information for good decision-making. Granted, more work may be necessary to accumulate the data, but it is available and is being used.

In FY 2000, the IRS also established a strategic planning and budgeting process that allows us to effectively use available cost information to make sound resource allocation decisions. As a part of this major change, we developed a budgeting structure that is aligned with both organizational responsibility and program delivery. Therefore, we now have in place as part of our on-going budgeting and accounting operations, clear cost data on each major program within each major unit. Using this data, in the FY 2003 budget, we have identified over $200 million in costs that can be reallocated to top priority customer service and compliance enhancements.

However, we also realize that one of the key requirements for better financial management at the IRS in the long-term is improved technology. In this regard, the IRS is scheduled to replace its current general ledger system with a general ledger that is fully compliant with the requirements of Federal Financial Management Improvement Act.

As previously described in the section on Business Systems Modernization, the Integrated Financial System IFS has three clear goals: (1) provide core financial capabilities and financial reporting; (2) meet Joint Financial Improvement Program requirements; and (3) provide an integrated framework for retirement of current financial systems.

Also, through the Enterprise Data Warehouse/Custodial Accounting Project, the IRS will develop an integrated enterprise data warehouse to support organizational data needs, such as those that are critical to managing our new compliance initiatives. For example, it will provide a single integrated data repository of taxpayer account and payment/ deposit information, fully integrated with the general ledger. In addition, it will identify payment and deposit information at the point of receipt. The operating divisions will be given access to pertinent revenue, assessment, disbursement, and seized asset information. Furthermore, it will provide the IRS with the capability to maintain financial controls over the $2 trillion of tax revenue received annually.

In summary, I believe the IRS has demonstrated its commitment to improving financial management. We are taking, and will continue to take, the appropriate and necessary actions to improve current processes and systems while moving aggressively on our systems modernization effort.

BUSINESS SYSTEMS MODERNIZATION

As I discussed in the introduction to my testimony, over the past two years, Business Systems Modernization has graduated from strategic planning and systems design to business results. For example, the successful deployment of Customer Communications 2001 and the ongoing roll-out, deployment and training for Customer Relationship Management (CRM) Examination in 2001 provided IRS front-line staff with the right tools to do their jobs more efficiently and effectively.

Valuable lessons were also learned as we developed and implemented these projects utilizing the rigorous management processes of the Enterprise Life Cycle, while at the same time ensuring that all BSM projects adhere to the Enterprise Architecture.

In FY 2003, we will build upon last year's achievements. For example, we will continue to phase in the deployment of the Customer Account Data Engine and move additional filers into the modernized system. Of particular interest to the Subcommittee, the IRS will also greatly strengthen its core financial systems through the deployment of the first phase of the Integrated Financial System. These projects coupled with entire BSM portfolio will deliver on IRS' commitment to meet the nation's revenue collection needs and provide world class service to our taxpayers.

I want to stress, Mr. Chairman, that we will continue to use a formal methodology to prioritize, approve, fund and evaluate our portfolio of BSM investments. This methodology enforces a documented, repeatable and measurable process for managing investments throughout their life cycle. Investment decisions are approved by the IRS Core Business System Executive Steering Committee, chaired by the Commissioner.

Building Management Capability

A major program, such as BSM, requires a highly-developed management capability. It must include highly-qualified individuals, well-developed processes and practical experience in applying them to the program's real work. Such a capability cannot be instituted immediately in any organization, but must mature over time.

In the two years since the BSM program began, management processes have matured and will continue to show progress as more experience is gained. We now have a seasoned management team blending IRS and private sector experience.

Also, with the appointment in March 2001 of John Reece as the Deputy Commissioner for Modernization and Information Technology Services (MITS) and Chief Information Officer, we took a key step to better synchronize the transition of BSM from design orientation to delivery.

Earlier this month, we also announced the appointment of Dr. Fred L. Forman as the Associate Commissioner of Business Systems Modernization. In this position, he will lead the agency's multi-year business and technology modernization program.

Dr. Forman brings a unique set of leadership skills and talents to Business Systems Modernization. For the last nine months, he served as the executive program adviser to the BSM program. As the Associate Commissioner for BSM, he will manage the IRS partnership with private-sector technology and management firms helping to modernize the agency's tax administration processes.

During the past year, we also made significant progress in a number of areas to improve the program's overall management. The first was configuration management. During FY 2001, we defined a baseline process for each project. It spells out and helps us measure all of the different projects' functions, requirements and capabilities, technology, schedules and costs. Configuration management prevents the BSM program's complexity and the number of moving pieces from overwhelming us.

Closely related to configuration management is release management. This is the process of coordinating and managing the activities by which we plan, test and implement all BSM project releases. Release management is critical to a business systems plan as large as ours, as one release can have ripple effects throughout the larger universe of projects.

On May 8, 2001, in partnership with the PRIME, we also formally established a Release Management Board to manage all of the FY 2002 and subsequent releases. We now have a detailed quarterly plan that shows the sequencing and interdependencies of all of the different BSM projects.

Managing Risk

Due to its enormous size, complexity and sensitivity, the BSM Program involves considerable risk. However, risk in this context is often misunderstood. The fact that risk exists does not mean that the program will fail. It means that the program could fail if the risks are not adequately identified and appropriate action taken to address them on a timely basis.

We are actively identifying and managing the risks in BSM, and we have not hesitated to make changes in programs when necessary. Since April 2000, many serious program risks were reduced or eliminated, and new risks are constantly being identified. There is a critical point to understand about managing risks in this program: making constant adjustments to plans is an indication that they are being addressed and managed. It is one of the hallmarks of a successful systems program.

Mr. Chairman, we identified a risk in the schedule for the first release of one of our key projects, the project to build a database for taxpayer records. We responded with corrective action in order to adjust the schedule while maintaining our focus on quality deliverables and on meeting our important business objectives.

FY 2003 BSM Request

The proposed $450 million FY 2003 BSM budget request includes an increase of $58.4 million over last year's appropriation. Let me summarize the key BSM projects that are addressed in the funding request.

Customer Account Data Engine (CADE)

CADE is the foundation for all of IRS' tax administration systems. It will replace the tape-based Master Files that currently contains the only authoritative information on all individual and business tax accounts. The IRS dependence on this 1960s Master File system today constitutes an insurmountable barrier to efficient service and compliance operations and is a very serious risk to the whole tax system.

CADE will incrementally move individual filers from the 1960s tape system to a modernized database. CADE Individual Master File (IMF) will build the database that will replace the existing IMF processing systems. CADE will create applications for daily posting, settlement, maintenance, refunds processing and issue detection for taxpayer tax accounts and return data. The database and applications developed by CADE will also enable the development of subsequent modernized systems that improve customer service and compliance. Once implemented, modernized applications, such as Customer Account Management (CAM), will allow on-line posting of data in addition to daily batch processing.

CADE will be deployed over time in five releases, each related to a specific taxpayer segment, phased in over a period of six years. At the conclusion of Release 5, CADE will have replaced IMF.

Mr. Chairman, let me point out that due to a number of technical difficulties and schedule delays, Release 1 of CADE Production has been delayed by six months. We discovered in December 2001 a significant issue with Procurement of a Business Rules Engine (BRE). A key part of the overall CADE development strategy was predicated on the use of BRE software that would be used to generate some programming code. Unfortunately, the PRIME was unable to procure the BRE in time to be used in the development of Release 1 and we were forced to proceed using standard development language. We began mitigation on this situation.

In addition to the technical difficulties, we encountered in late March 2002 an additional one-month slippage to July 2002. We notified our Executive Steering Committee and Oversight Board of the problem and our corrective actions. The delay will provide time for the development, testing and implementation of the Release 1 pilot this summer. Currently, most of the software has been developed and testing has begun. Planning for production implementation in conjunction with the startup of the 2003 filing season has also started. The release will include both 1040EZ electronic and paper single refund filers – about 10 million taxpayers. Therefore, based on this plan our most important business objective, which is to move the first block of taxpayers onto a new data base will be achieved.

Integrated Financial System (IFS)

IFS has three clear goals: (1) provide core financial capabilities and financial reporting; (2) meet Joint Financial Improvement Program requirements; and (3) provide an integrated framework for retirement of current financial systems.

IFS will be accomplished in two releases, each representing a distinct usable segment. Release 1 will replace the Core Financial Systems (CFS) as defined by the Joint Financial Management Improvement Program (JFMIP). In addition to CFS, Release 1 will include budget formulation as well as implementation of a Cost Accounting System to allow the IRS to move into compliance with Statement of Federal Financial Accounting Standard Number 4. Release 1 creates a logical design for the core financial applications including Cost Accounting. The core financial applications consist of General Ledger (G/L), Accounts Payable (A/P), Accounts Receivable (A/R), Cost Management, Funds Management, Core Financial Management and Financial Reporting.

Custodial Accounting Project (CAP)

GAO identified the lack of an acceptable accounting system for the $2 trillion collected in tax revenue as one of the most significant material weaknesses in IRS' financial management. CAP will provide the IRS with the critical control and reporting capabilities mandated by Federal financial management laws.

It will also support the appropriate custodial subledgers containing data from tax operations and help the IRS meet compliance issues with both the Federal Financial Management Improvement Act (FFMIA) and federal mandates related to custodial revenue management. CAP will also help us to better manage, control and focus resources.

Enterprise Data Warehouse (EDW)

The ability of the IRS to make effective use of information about its operations is limited by the numerous fragmented databases that evolved over time. EDW provides the foundation for data mining and decision analytic tools. In addition, it enables risk-based analysis for case selection and provides the tools to report on IRS balanced performance measures.

e-Services

The *e*-Services project will support our ability to meet the overall goal of conducting most transactions with taxpayers and their representatives in an electronic format, as required by RRA '98. *e*-Services will provide to third parties over the Internet the four most requested applications: electronic taxpayer identification number matching, electronic transcript delivery, disclosure authorization and Electronic Account Resolution. *e*-Services also directly supports the President's Management Agenda's government-wide initiative to expand electronic Government.

Customer Account Management (CAM)

The Customer Account Data Engine cannot be deployed beyond its initial limited releases without Customer Account Management. CAM allows us to go into CADE and update the data and will help taxpayers to receive timely and accurate responses to requests and inquiries.

The CAM Individual Assistance and Self Assistance Operating Models will provide improved technology and business processes that will enable the IRS to: (1) better manage customer service functions; (2) maintain and utilize customer data to improve taxpayer interactions with the IRS; (3) provide comprehensive account and tax law assistance to taxpayers and practitioners; and (4) manage the case work flow of customer inquiries.

Delivering customer assistance through a live IRS Customer Service Representative (CSR) is the Individual Assistance operating model's main function. In order to provide world-class service, CSRs must be equipped with the tools to access taxpayer information quickly and accurately in response to complex customer inquiries. Individual Assistance will provide this capability from a desktop information system.

By being able to access and update comprehensive, current account information, CSRs will be able to respond quickly and accurately to customer inquiries. Workflow management tools and processes will also allow them to automatically inform relevant parties throughout the organization of actions taken on a particular customer's account and manage outstanding cases for follow-up work, or to identify the status of an inquiry for a taxpayer.

The CAM Self-Assistance operating model delivers many of the same capabilities. The main objective, however, is to provide taxpayers with the flexibility and convenience of accessing by telephone or the Internet on a 24/7 basis IRS-related information to resolve relatively simple inquiries.

Filing and Payment Compliance (FPC)

FPC is an end-to-end strategy to resolve collection issues quickly and fairly. Using industry best practices, it augments, refines and replaces existing processes and technology to enable the IRS to interact with taxpayers in a seamless and efficient manner. Protection of taxpayer rights is an important component of this strategy. The ultimate goals are to resolve all balance due cases above a minimum threshold, shorten the filing compliance lifecycle to ensure resolution before the next filing due date and shorten the payment compliance lifecycle to six-months for non-enforcement cases.

FY 2003 RESOURCE REQUEST

Mr. Chairman, the IRS budget request for FY 2003 is $10.418 billion and full-time equivalent employment (FTE) of 101,080. The request is $482 million more than last year's $9.936 billion appropriation. The largest programmatic component of this increase is $259 million to enhance customer service and compliance, of which $196 million will be funded through a redeployment of resources within our base budget.

Overall as shown in the attached chart, the IRS is proposing to achieve $259 million in increased program resources and program delivery at a net requested increase of only $63 million. Therefore, 76 percent of the improvement is being achieved by improved internal efficiency and redeployments.

The funding increase request also maintains momentum in the IRS Business Systems Modernization projects with $58 million. The budget increase for FY 2003 will allow us to fund these critical projects as they move from the planning and design phase to development and implementation. The remaining increase would fund pay raises, and inflation, $10 million for Tier B Projects (*see p. 21*) and adjustments for Homeland Security funds appropriated in FY 2002.

In addition, $39 million of the total increase is requested as part of a legislative proposal to change the accounting of pension and retiree benefits costs. Please note that although the increase of $39 million is the incremental change from the FY 2002 appropriation (as adjusted), the actual increase to our FY 2002 base for this proposal will be $503 million. These costs are transfers of funds that were previously included in other agency budgets and do not represent any net increases in IRS programs.

To help create a "World Class Treasury Department," Secretary O'Neill challenged each bureau to review all programs on a continual basis and redirect resources to meet needs, rather than asking for funding increases. Budget and performance integration, as part of the President's Management Agenda, requires this kind of business review, with an emphasis on best results at the lowest total cost.

Indeed, let me stress the process that underlies the FY 2003 request. For the first time, we fully integrated the development of our budget with the establishment of performance measures. First, we determined the highest priority resources needed to increase customer service and compliance. In addition, as part of the budget process, IRS' senior team conducted a review and prioritization of agency-wide needs for FY 2003 and searched for the most efficient allocation of resources. The realignment of resources woven throughout the FY 2003 budget comes through reengineering, efficiencies and investment in modernized systems. To this end, the review developed 2,287 FTE that could be re-deployed to high priority areas in customer service and compliance.

OPERATIONS

HIGHEST PRIORITY RESOURCE NEEDS

Customer Service and Workload Increases (+1,595 FTE, $91M)

In FY 2003, the IRS must build on the gains it has made in customer service if we are to achieve our first strategic goal, "top quality service to each taxpayer in every interaction." We are still not providing a consistent high level of service that taxpayers expect and deserve. We must continue to improve taxpayer access to our toll- free telephone lines and the accuracy of the responses we give to tax law and account questions. We must continue to improve the service at our taxpayer assistance centers. We must further reduce taxpayer burden. We must continue to increase e-file options. We must better administer the RRA 98 taxpayer rights provisions. And we must give our employees the training and tools to meet these needs. The highlights of some of the following initiatives will help us meet our goals.

- *Increased Offer in Compromise (OIC) Cases.* This initiative is designed to address the escalating OIC inventory by centralizing and streamlining the processing. Cases sent to the field will include all background financial data needed to conduct the investigation, thereby reducing the amount of time that revenue officers must spend on gathering this information.

- *Telephone Level of Service.* Taxpayers must still speak to live assistors to answer tax law and account questions as well as Automated Collection System (ACS) inquiries. Additional FTE are necessary to address current demand and to meet taxpayers' legitimate expectations that they receive service comparable to what is offered by the best private sector companies.

- *Multi-Lingual ACS.* The Multi-Lingual Automated Collection Service (ACS) will help meet taxpayer growing demands for timely, accurate and efficient services in languages other than English.

- *Improving Correspondence.* We are improving the clarity of our communications with taxpayers through a redesign of 24 of our notices over the next two years.

- *Filing Services.* We must continue to provide filing services – from *e*-filing to submission processing to timeliness of refunds – and handle a projected increase in the number of returns filed.

Enhanced Compliance Strategies (+1,857 FTE, $125 M)

In 2001, we began to stabilize the long-term decline in compliance activities while beginning to focus effectively and efficiently on the four key areas of non-compliance and maintaining adequate coverage of other areas. However, we still must address a number of challenges. For example, from 1993 to 2001, the number of returns reporting adjusted gross income in excess of $100,000 grew by 163 percent. We must keep pace with this increase by expanding the number of these returns that are examined in IRS field and office programs. We must also tackle the $66 billion in our total potentially collectable inventory. And we must focus on the proliferation of tax scams ranging from sophisticated illegal offshore trust programs to the slavery reparations scheme being perpetrated upon African-Americans. The following are the highlights of our enhanced compliance strategies for FY 2003. A detailed description can be found in our congressional justification.

- *Stabilize Audit Rates.* The IRS will devote resources to stop the overall declining audit rates and will dedicate more resources to auditing partnerships and other passthrough entities.

- *Abusive Trusts.* Experts estimate that the revenue loss to our nation due to abusive trusts could run into the tens of billions of dollars. We now have a coordinated strategy to deal with this growing problem using a full range of tools from public education to civil and criminal enforcement against both promoters and participants.

- *High-income Returns.* From 1993 to 2001, the number of returns over $100,000 and $1 million dollars grew by 163 and 259 percent respectively. However, IRS examination of these returns has not kept pace and we must now narrow the gap.

- *Highest Priority Collection.* To address the mounting employment and income tax gaps, the IRS will dedicate more resources to high priority compliance and collection cases involving unpaid employment taxes.

- *Fraud Referral.* Referrals and leads generated from the Lead Development Centers and the Fraud Detection Centers will produce more quality criminal investigations cases and help ensure public confidence in the fairness of our of tax administration system.

- *Automated Underreporter.* To improve voluntary reporting on individual income tax returns, the Remote Automated Underreporter Program will utilize a national rotational inventory approach for case selection.

- *Employment Tax.* To combat non-compliance with employment tax laws, the IRS will boost resources for legal source tax crime cases with a special emphasis on emerging problems, such as the use of temporary employment agencies/employee leasing agencies to evade employment and income taxes.

- *Money Laundering.* IRS Criminal Investigation (CI) was delegated primary investigative jurisdiction in all money laundering investigations where the underlying conduct is a violation of the income tax laws.

- *e-Crimes.* CI must continue to develop investigative knowledge and techniques to keep pace with the growing number of *e*-crimes, such as fraud and theft.

- *Criminal Tax Cases.* Continued development of a close relationship between Chief Counsel Criminal Tax and CI will help to ensure that legal errors in the investigative process are minimized and the chances for successful prosecution are maximized.

Contract Services (+$44M)

The IRS must also pay for a number of non-labor program increases, many of which are mandated by Executive Order or departmental regulations. For example, in response to concerns raised by GAO and TIGTA, we must provide for enhanced guard services at our submission processing and computer centers. In addition, we are requesting funding for physical security upgrades such as more secure gates and entrances, and barriers that can be raised and lowered. Other items include the Public Transportation Subsidy, which was increased from $65 to $100/month.

RESOURCES RE-DEPLOYED THROUGH INCREASED EFFICIENCY AND PRODUCTIVITY

A combination of strategic redeployment of staff and labor saving programs will allow the IRS to improve its level of taxpayer service without commensurate increases in the number of FTE applied. Targeted improvement projects, such as Reengineering/Quality efforts and labor savings from e-file and e-Services can be reapplied to other high priority programs. Technology modernization programs will generate the bulk of the FTE savings.

Improvement Projects (Redeployment of 1,779 FTE, $107M)

The IRS identified FTE redeployments from improvement projects that are expected to come to fruition in FY 2003 and are highlighted below. The FTE will be reinvested to fund the top priority needs identified below:

- *Reengineering/Quality Improvements.* Reengineering and Quality Improvement projects and programs will focus on redesigning internal processes, policies, and procedures. Updating the antiquated workload selection system will, for example, reduce/eliminate the substantial number of returns that are ordered, classified, and never worked.

- *e-file.* In addition to the many taxpayer benefits, *e*-file also provides clear cost savings and burden reductions for the IRS, enabling us to redirect precious resources from processing to customer service and compliance programs. In addition to expanding electronic filing for individual taxpayers, the IRS will promote the electronic filing of all business tax returns in FY 2003. Our ultimate goal is to convert all business transactions with the IRS to fast, accurate, paper-free electronic methods. Through *e*-Services, we will also provide to tax practitioners easy-to–use electronic products and services.

- *Customer Relationship Management.* The funding for this project will pay for training travel, operating travel and support costs related to bringing IRS staff quickly up to speed on the newly improved Corporate Tax Analysis software. The software's main strengths are its capacity to do carryback/carryover calculations for net operating losses (and other losses), the interaction of losses and charitable contributions, alternative minimum tax calculations and the foreign tax credit calculations – including carrybacks and carryforwards.

- *Information Technology Projects.* Two projects are expected to begin realizing savings in FY 2003: the Employee Plan Determination System Redesign (EDSR) and the Remittance Transaction Register (RTR). EDSR is expected to reduce cycle time and improve quality of determination letters. RTR is projected to improve efficiency in submission processing by providing all Lockbox payment information online soon after receipt, reducing from one month to just three days response time for reconciling payment information and responding to payment information queries.

Workload Decreases (Redeployment of 508 FTE, $50.5M)

- *Reduced Field Innocent Spouse.* The initial high inventory of Innocent Spouse cases is expected to decline to a point where they can be processed without significant delays on our part. Revenue Agents and Tax Auditor FTEs assigned to this program will be re-deployed to address compliance in other areas.

- *Reduced Filing Season Support.* We will reduce the FTEs in the Small Business and Self-Employed operating division planned for customer service details.

- *Narcotics Program.* With redeployments realized from the narcotics program realignment, 67 FTE will be used in the Fraud Referral Program and 18 FTE will be used in the Money Laundering Strategy Program.

- *Reduced Tax Court Cases.* The number of cases filed in the Tax Court is declining. Emphasis on pre-filing resolution of cases through programs such as Advance Pricing Agreements is also expected to moderate increases in Tax Court litigation in the future, as well as Refund and Appellate litigation.

Targeted Efficiency Improvements (Redeployment of $39M)

Redeployment is expected from the Treasury's approach to better business practices to remove or reduce current efforts that do not have significant programmatic value. This is targeted to produce $39 million in redeployments.

MAINTAIN CURRENT OPERATIONS

The IRS is still a labor-intensive organization and a stable work force is critical to carrying out our mission. We must maintain current operations, protect the integrity of the tax filing season, oversee tax administration programs and continue to implement organizational modernization. To do so, the IRS must have the resources to pay for the inflationary costs associated with statutory pay and other mandatory increases described below .

- *Maintaining Current Services Level (+$295 M).* Needed to maintain FY 2002 program levels in FY 2003 by funding pay, benefits, and non-labor inflationary costs.

- *Within-Grade Increases (+$37M).* To cover the costs of within-grade pay increases for on-board employees.

- *Homeland Security (+$10M).* For the enhanced security arrangements required by the Homeland Security supplemental. These funds were appropriated as a consequence of the September 11, 2001 terrorist attacks and other related security concerns.

- *Homeland Security Non-Recur (-$31M).* Funding in the amount of $31 million from the FY 2002 will be non-recurred in the FY 2003 budget.

EARNED INCOME TAX CREDIT INITIATIVES

In FY 2003, funding requirements for the Earned Income Tax Credit (EITC) Compliance Initiative Appropriation are projected to be $154,346,000, an increase of $406,000 over the FY 2002 funding level of $153,940,000. The FTE level of 2,353 is unchanged from FY 2002.

This appropriation provides for customer service and public outreach programs, enforcement activities and research efforts to reduce overclaims and erroneous filings associated with the EITC.

NATIONAL TAXPAYER ADVOCATE'S ANNUAL REPORT TO CONGRESS

Mr. Chairman, I welcome the opportunity to comment on the National Taxpayer Advocate's FY 2001 Annual Report to Congress. I found it to be a comprehensive and thoughtful document that gives an accurate portrayal of the problems that taxpayer face in trying to comply with a complex tax code and to receive quality service from the IRS.

Indeed, last year's report identified tax code complexity as the top problem facing individual and business taxpayers. This year, the concept of tax complexity is incorporated into every aspect of the National Taxpayer Advocate's report. Of the top 5 "Most Serous Problems Encountered by Taxpayers", three dealt with EITC eligibility and multiple definitions of "qualifying child."

We are devoting a great deal of attention and resources to both the service and complexity problems identified by the National Taxpayer Advocate. For example, the number one problem, "Access to Customer Service Toll-free Telephone Service" is also one of our top priorities, and as the report states and demonstrated by the filing season, we are making steady and definable progress to increase our level of service.

Mr. Chairman, this brings us full circle back to complexity and the need for simplification. It is an enormous tribute to their dedication and hard work, that our customer service representatives can correctly answer so many of the extremely complex questions put to them. However, as hard as we strive to provide correct answer to tax law questions, our efforts will always be dogged and burdened by a tax code that begs for simplification.

Mr. Chairman, in her February 28 testimony before the House Ways and Means Subcommittee on Oversight, the National Taxpayer Advocate made the following observation, which I believe, encapsulates the challenge we face:

> *" Clearly, no one in Congress or in the IRS sat down and said, 'let's try to make the Code so complicated that no one will ever be able to figure out even basic provisions like family status by himself.' Tax complexity creeps up on us – we try to eliminate a perceived abuse (as with the minimum tax in 1969), or carve out relief for one special set of circumstances (as with innocent spouse). We keep adding exceptions, limitations, and rules as other inequities reveal themselves. Certainly, revenue considerations play a role. Sometimes we actually think we've solved a problem – as with the dependency exemption between divorced or separated parents under IRC section 152(e) in 1984 – only to find that forces outside the federal tax universe – here, state courts' interpretation of their domestic relations jurisdiction – have foiled all our best efforts."*

Tax complexity has enormous consequences on burden reduction and beyond. In its recent publication, "Guiding Principles for Tax Simplification," the American Institute of Certified Public Accountants gives a telling description of the effects:

> *"In recent years, the complex nature of tax laws has undermined voluntary compliance by eroding public perceptions of tax fairness and imposing inappropriate compliance burdens. Federal and state tax agencies have difficulty providing accurate assistance to taxpayers, designing understandable forms and instructions, and promulgating timely regulatory guidance."*

The AICPA lists a number of tax provisions from a number of bills that pose complexity problems particularly for individual and business taxpayers. It even gives a "thumbs down" to provisions, such as using consistent concepts and definitions that violate tax simplification guiding principles. Other organizations, including the Joint Tax Committee, the National Taxpayer Advocate, and the IRS in its annual complexity report, have performed similar analyses.

As different as the many studies may be, I believe that there would be little disagreement that credit eligibility determinations best exemplify the many problems we face as tax administrators and the frustration the taxpayer experience in trying to be compliant with them.

A variety of definitions are used to determine a taxpayer's eligibility to claim the dependency exemptions and certain tax credits. Understanding these definitions and how to apply them is necessary for the taxpayer to file a correct return.

In addition to the filing status designation required on individual tax returns, separate but sometimes related, determinations must be made regarding dependents and qualifying individuals for personal tax credits. The definitions associated with filing status and dependents and qualifying individuals are some of the more complex issues faced by over 124 million individual taxpayers.

Frequent changes have heaped more confusion on the problem. The EITC, for example, has been changed almost annually since 1986. Changes are even more frequently proposed than enacted. For example, in the 106th Congress over 339 bills were introduced proposing new tax credits or modifying existing ones. Most of the credits would have required detailed guidance from Treasury and IRS to define precisely the items and activities that were eligible for a particular credit, thereby adding complexity to the tax system.

In fact, the problem is so wound around the complexity axle that The National Taxpayer Advocate concluded: "Our case analysis demonstrates that in some areas – the Earned Income Tax Credit and other 'family status' issues in particular – no amount of IRS process improvement will significantly reduce taxpayers problems. To achieve significant reduction in taxpayer and IRS burden, Congress must enact a uniform definition of a qualifying child that is applicable to all tax provision they key off of family status."

Mr. Chairman, I wholeheartedly concur. We can and will do our best to improve service to taxpayers, whether it is answering the telephones better or improving the quality of our written communications. To a person, the IRS is committed to that strategic goal. However, those efforts will continue to be blunted unless we deal with a staggering complexity that is woven into the tax code, and virtually every problem with which taxpayers and the IRS interact on a daily basis.

CONCLUSION

Mr. Chairman, in conclusion, I believe we can be proud of the progress the IRS has achieved over the past year. We are providing improved service to America's taxpayers in key areas such as electronic filing and over our toll-free number telephone lines. Our Business Systems Modernization program has moved from planning and development to implementation of our initial projects. Although we are confronted with many challenges, our financial house is in order. All of our key indicators are pointing in the right direction. To ensure the success of IRS modernization for next year and the years to come, we must stay focused and committed to the intent of the Restructuring Act, making adjustments as necessary, but never losing sight of our goals. If we do, I am convinced that we will succeed. Thank you and I would be happy to answer your questions.

APPENDIX

STATEMENT BY
MR. BRADY R. BENNETT
DIRECTOR OF STRATEGY, RESEARCH AND PERFORMANCE
SMALL BUSINESS/ SELF-EMPLOYED DIVISION
INTERNAL REVENUE SERVICE
APRIL 15, 2002

Mr. Chairman, as part of our overall modernization effort, we are investigating ways to improve the collection process. One of our major priority projects is Filing and Payment Compliance (FPC) that was briefly described in the section on Business Systems Modernization.

The FPC modernization project is a joint effort between the IRS and Computer Sciences Corporation (the PRIME) and is aimed at reducing overall collection time. During the strategic planning process, questions were raised as to whether modernized systems alone could sufficiently address the large inventory of collection work. Working with the PRIME, the IRS decided to perform an analysis of collection contract support (CCS) options and best practices related to receivable management and collections.

To help perform a thorough analysis, we issued in January 2002 a Request for Information (RFI) to help us determine what skills collection contract support companies could provide to the IRS. These RFI included questions regarding private collection agency experience on training, modeling, inventory management, human resources management, software products and collection services. The RFI closed on February 13, 2002.

From the information gathered, the IRS/PRIME will determine how to incorporate collection contract support companies as part of either, an interim solution or part of a long-term strategy, or both, if deemed appropriate.

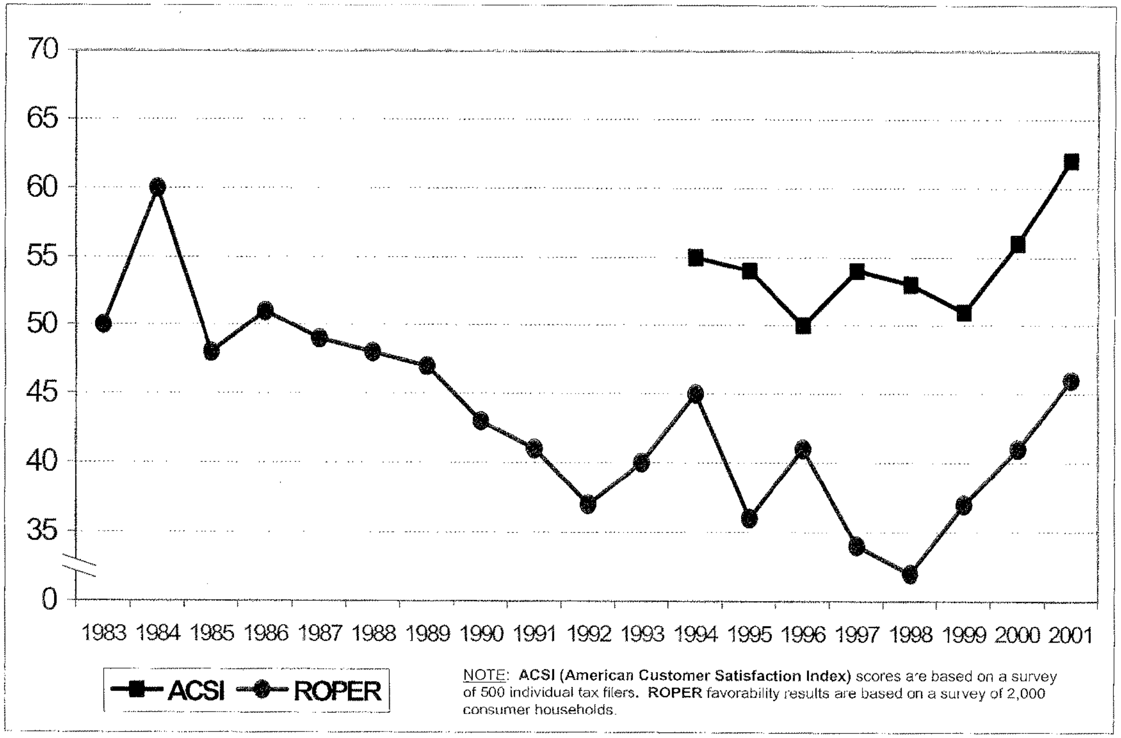
The CCS team has been working on resolving the several complex legal and technical issues inherent to contracting out collection activities. These include the protection of taxpayer rights, legal and policy implications, synchronizing accounts and data between IRS and the collection companies, identifying appropriate cases for collection agencies, collection agency personnel screening, and financial implications, i.e., funding approach and ensuring financial integrity for accounts being worked by the collection companies.

Early indications are that the use of private collection agencies is a feasible, cost-effective approach to working certain IRS delinquent accounts. However, a direct comparison of additional IRS staffing against private collection agencies is difficult to perform. Unlike private collection agencies, the IRS often takes inherently governmental actions involving judgment, such as discretionary decisions on liens and levies on delinquent accounts.

Indeed, in order for the IRS to use private collection agencies we must insure that only ministerial duties are contracted to private collection agencies and that inherently governmental functions are reserved to the IRS. This can be done in two ways: (1) by providing sufficient procedural guidance to remove all exercising of discretionary decisions; and (2) ensuring ultimate decisions, such as recommending a lien, are made by an IRS employee.

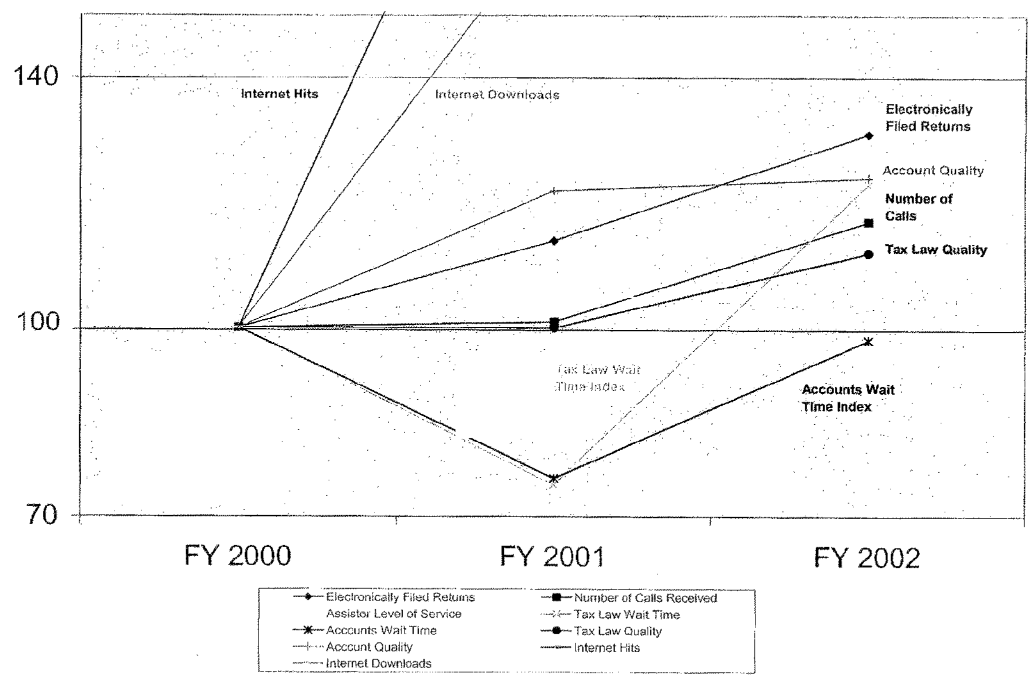
The RFI analysis is now completed and the CCS team has identified and engaged three companies to work with us as Subject Matter Experts. The RFI also provided valuable information for the comparison of options and provided the IRS with assurance that interest in this program exists in the collection agency community.

PUBLIC RATING OF THE IRS



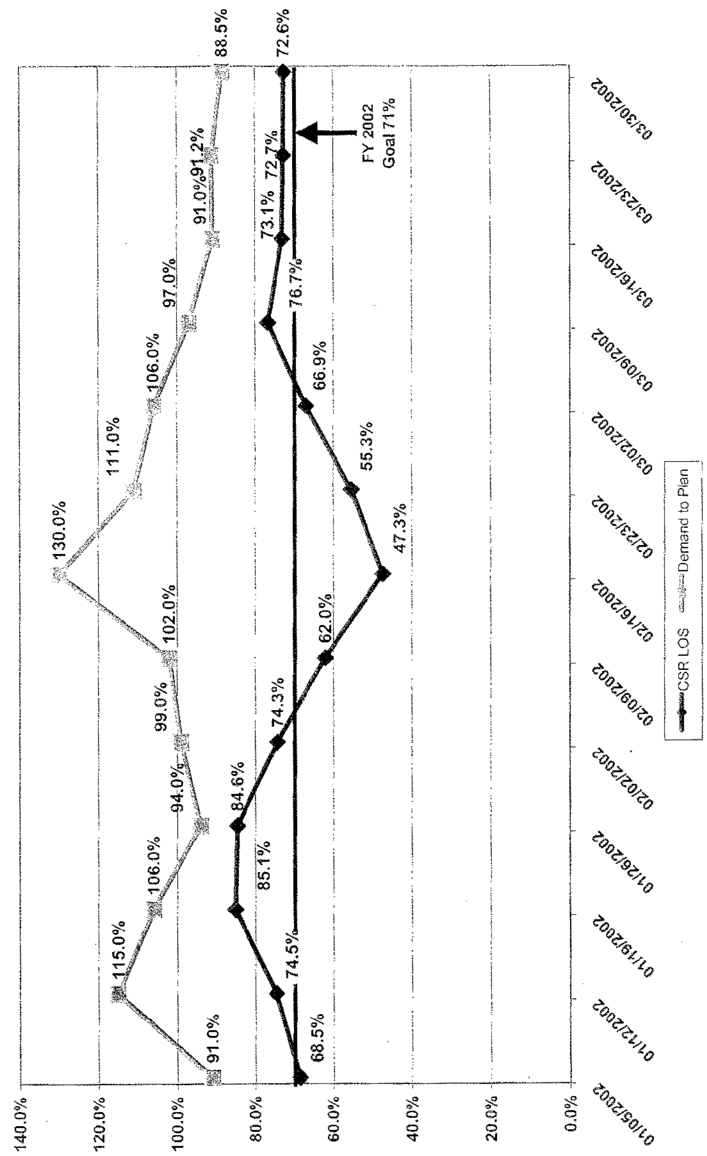
NOTE: **ACSI (American Customer Satisfaction Index)** scores are based on a survey of 500 individual tax filers. **ROPER** favorability results are based on a survey of 2,000 consumer households.

TRENDS IN IRS SERVICE
COMPARISONS FOR FIRST HALF OF FISCAL YEAR



Note: Electronically Filed Returns and Internet Hits/Downloads are estimates for full year

TOTAL CUSTOMER DEMAND TO PLAN AND CSR LOS THROUGH 3/30/02



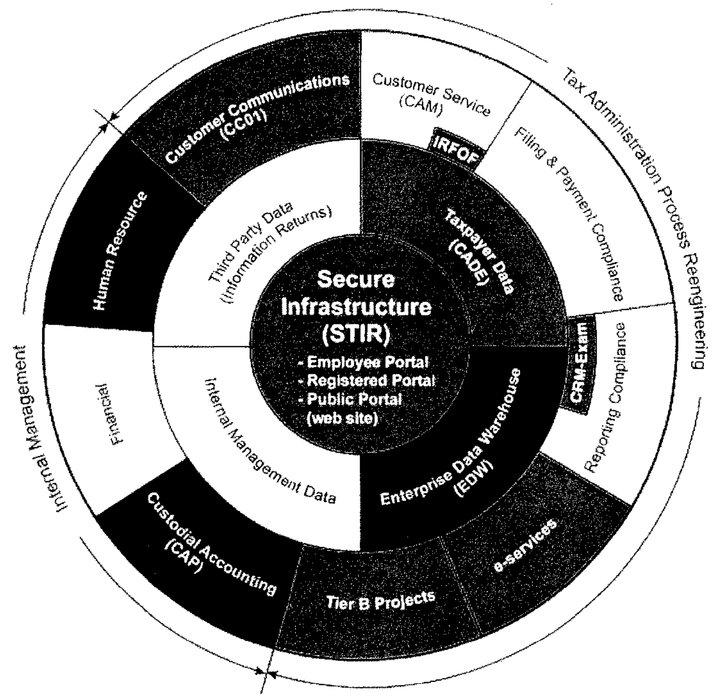
IRS WILL MEET 76% OF NEEDS FOR INCREASED SERVICE AND COMPLIANCE FROM INCREASED PRODUCTIVITY AND COST SAVINGS IN FY 2003

	Dollars (in millions)	FTEs
Highest Priority Resource Needs		
Compliance	$125	1,857
Customer Service and Workload Increases	91	1,595
Contract Services	44	0
Total Highest Priority Needs	**$259**	**3,452**
Less Redeployed Resources and Adjustments		
Reapplication of Efficiencies and Workload Savings	$157	2,287
Targeted Cost Savings	39	0
Total Resource Reapplications and Adjustments	**$196**	**2,287**
Total Increase	**$259**	**3,452**
New Funding Requested	**$63**	**1,165**
Percent of Needs Met through Budget Request	**24%**	
Percent of Needs Met through Productivity and Savings	**76%**	

IRS BUSINESS SYSTEMS MODERNIZATION IS DELIVERING KEY BUILDING BLOCKS IN FY 02 AND FY 03

Deliverables in FY 01 & 02
- CC01
- STIR
- CADE
- e-services
- Tier B Projects
- IRFOF
- CRM-Exam

Deliverables in FY 03
- HR
- CAP
- EDW



Mr. HORN. We will now have the presentation of Larry R. Levitan. The Honorable Mr. Levitan is the chairman of the Internal Revenue Service Oversight Board.

Why don't we have the others come to the chairs: Michael Brostek, Director, Tax Administration Issues, U.S. General Accounting Office; Pamela Gardiner, Deputy Inspector General for Audit, Treasury Inspector General for Tax Administration; and, finally, Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service.

So we'll start in with Mr. Levitan, and we'd like your statement to be summarized. All of these statements are automatically in the hearing record, and then we can have a better basis for questioning, and the Commissioner has done this before.

STATEMENTS OF LARRY R. LEVITAN, CHAIRMAN, INTERNAL REVENUE SERVICE OVERSIGHT BOARD; MICHAEL BROSTEK, DIRECTOR, TAX ADMINISTRATION ISSUES, U.S. GENERAL ACCOUNTING OFFICE; PAMELA J. GARDINER, DEPUTY INSPECTOR GENERAL FOR AUDIT, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION; AND NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE

Mr. HORN. So let's talk with the chairman of the Oversight Board.

Mr. LEVITAN. Thank you, Mr. Chairman. Mr. Chairman and members of the subcommittee, thank you for holding this hearing and inviting me to testify.

Let me preface my remarks by providing a brief explanation of the role of the IRS Oversight Board. The Board was created as part of the IRS Restructuring and Reform Act of 1998. That legislation assigns the Oversight Board the responsibility for overseeing the IRS in its administration and management and its supervision of the execution and application of the Internal Revenue Code. These duties closely resemble those of a corporate board of directors.

In its 2001 Annual Report, the Oversight Board reported that the IRS is still not effectively and efficiently serving the needs of the American taxpayers, although it has made significant progress since 1997. Customer service, although improved, as we've just seen, has not risen to desired levels; and enforcement activity has fallen for many years. These problems are compounded by outmoded computer systems that handicap IRS workers and prevent the delivery of effective service. It is not surprising that this environment has resulted in dissatisfied taxpayers, inadequate job satisfaction among IRS employees and difficulty in achieving improved performance.

On the positive side, the IRS is making progress and has put in place several key elements that establish a foundation for further progress. Under Commissioner Rossotti's leadership, the IRS has made major strides in the last few years. A well-formulated, high-quality strategic planning process has been put in place.

Balanced measures are also being implemented. A major reorganization focused on customers was implemented, the senior management team strengthened and a business systems modernization program that will eventually provide modern business processes and tools for employees and taxpayers is under way.

Neither the IRS nor the Oversight Board is satisfied with the state of the IRS's performance. Performance measures for the key areas of customer service and enforcement are troubling to the Oversight Board, although the IRS is beginning to show signs of improvement in customer service. The Oversight Board is very concerned that the broad decline in enforcement activity increases our reliance on voluntary compliance and fears that the public's attitude toward voluntary compliance is beginning to erode. Because of this concern the Oversight Board initiated a survey to obtain data on taxpayers' attitudes regarding their obligations to report and pay their fair share of taxes.

The most troubling result was in response to a question that asked how much, if any, do you think is an acceptable amount to cheat on your income taxes? In 1999, 87 percent of the respondents replied "not at all." In 2001, just 2 years later, the percentage of respondents who selected that answer fell to 76 percent. In short, one-fourth of U.S. citizens believe it is OK to cheat on their taxes.

My written testimony provides several examples of troublesome areas of noncompliance, including underreporting of pass-through income, use of offshore credit cards and the Earned Income Tax Credit.

These examples highlight a good news/bad news situation. On one hand, the IRS is becoming more knowledgeable about noncompliance. However, declining compliance resources make it difficult to assign additional resources in any meaningful way to investigate these situations and enforce the tax law with noncompliant taxpayers.

To better understand compliance issues, the Oversight Board believes there is an urgent need for the IRS to increase its research on taxpayer compliance so it can identify and correct broad areas of noncompliance. The National Research Program is designed to do just that, while avoiding the intrusive nature of prior research programs. The Oversight Board strongly supports this program.

The most important task the Oversight Board must perform this year is to identify candidates to replace Commissioner Rossotti. During his 5-year tenure, Commissioner Rossotti provided the IRS with the leadership it needed as it went through the most dramatic change in its history. He should be commended for what he has done to transform the IRS into a performance-based organization. I believe he would be the first to say, and did say a few minutes ago, we have much further to go.

RRA 98 requires the Oversight Board to recommend candidates to the President for the position of IRS Commissioner. The Oversight Board has exercised this responsibility by partnering with the Treasury Department to develop a Position and Candidate Specification describing the qualifications needed and hiring a search firm to identify qualified candidates.

Qualified candidates must be CEO-caliber executives with relevant operational experience, preferably gained with an intensive information processing and customer-service environment. Candidates must understand the leadership challenges of managing a 100,000 person organization. Qualified candidates must also possess credibility and stature, with a reputation for being a strong leader and having been an effective change agent.

The Oversight Board believes that Charles Rossotti has been all of this and more. We believe the country owes him a debt of gratitude for the public service he has given us in the last 5 years.

I appreciate this opportunity to meet with you this morning and would be pleased to respond to any questions that you have.

Mr. HORN. Thank you. Those are very useful ideas you've put there for the next commissioner.

[The prepared statement of Mr. Levitan follows:]

IRS
OVERSIGHT
BOARD

Statement of Larry Levitan,
Chairman, IRS Oversight Board

Testimony Before the Subcommittee on Government Efficiency,
Financial Management and Intergovernmental Relations
of the House Committee on Government Reform

April 15, 2002

Mr. Chairman, and members of the Subcommittee, thank you for holding this hearing and inviting me to testify. It is an honor for me to appear before your committee today on behalf of the IRS Oversight Board and to discuss the IRS' performance and the ongoing transition of the IRS to a modern, effective and efficient organization.

Let me preface my remarks by providing a brief explanation of the role of the IRS Oversight Board. The Board was created as part of the IRS Restructuring and Reform Act of 1998. That legislation assigns the Oversight Board the responsibility for overseeing the IRS in its administration, management, conduct, direction and supervision of the execution and application of the internal revenue laws. These duties closely resemble those of a corporate board of directors. We have the responsibility for overseeing the strategic management process and approving the strategic plan and the budget that is submitted to the Treasury Department. Another key responsibility of the Board is recommending to the President candidates for appointment as Commissioner of Internal Revenue.

In its 2001 Annual Report, the Oversight Board reported that the IRS is still not effectively and efficiently serving the needs of the American taxpayers, although it has made significant progress since 1997. Customer service, although improved, has not risen to desired levels and enforcement activity has fallen for many years. These problems are compounded by outmoded computer systems that handicap IRS workers and prevent the delivery of effective service. It is not surprising that this environment has resulted in dissatisfied taxpayers, inadequate job satisfaction among IRS employees and difficulty in achieving improved performance.

On the positive side, the IRS is making progress and has put in place several key elements that establish a foundation for further progress. Under Commissioner Rossotti's leadership, the IRS has made major strides in the last few years. A well-formulated, high quality strategic management and planning process has been put in place. The Board has high praise for the IRS strategic assessment process implemented as part of the budget and performance plan formulation activities. Balanced measures are also being implemented across the IRS. Other key elements that form the foundation for further progress include a major reorganization designed to better focus on customer needs and provide clear accountability, a strengthened senior management team, and a business systems modernization program that will eventually provide modern business processes and tools for employees and taxpayers. The entire modernization effort is being conducted in accordance with a strategic plan that has been approved by the Oversight Board, and monitored by balanced performance measures that will provide Congress, the Administration, the Oversight Board and other stakeholders a quantitative means to evaluate progress.

Neither the IRS nor the Oversight Board is satisfied with the state of the IRS' performance as reported in the Oversight Board's 2001 Annual Report. Performance measures for the key areas of customer service and enforcement are troubling to the Oversight Board. The Board has recently implemented quarterly reviews of IRS performance that focuses on three dimensions of improvement: productivity (including timeliness and quality), customer satisfaction, and employee satisfaction. In our annual report, the Board noted the deficiencies in telephone service. Progress is being made in this area and IRS is beginning to see positive results. For example, we have seen some significant improvements in timeliness and quality of IRS telephone service over the last few years, particularly in the opening months of the 2002 filing season. Although progress is being made, it is slower in some areas. In some cases, the full range of balanced measures are in the development stage. Others have only recently established baselines. Quality levels at IRS walk-in sites are just being baselined and need attention. Because of the link between employee and taxpayer satisfaction, employee satisfaction levels for these and other operations also need improvement.

With respect to compliance, the Oversight Board is concerned that the broad decline in enforcement activity increases our reliance on voluntary compliance, and fears that the public's attitude towards voluntary compliance is beginning to erode. Because of this concern, the Oversight Board initiated a survey to obtain data on taxpayers' attitudes regarding their obligations to report and pay their fair share of taxes. The survey, taken in August 2001, asked two questions from an earlier 1999 IRS survey and three new questions.

The survey results are included in the annual report, but the most troubling result was in response to a question that asked how much, if any, do you think is an acceptable amount to cheat on your income taxes. In 1999, 87 percent of the respondents replied "not at all." In 2001, the percentage of respondents who selected that answer fell to 76 percent. In short, one fourth of US citizens believe it is OK to cheat on their taxes. The Oversight Board intends to repeat the survey in 2002 using the same questions.

Other areas of noncompliance that need attention continue to be troublesome. Let me provide some examples. The IRS is just starting to match pass-through income reported on Form K-1's to individual tax returns. The IRS estimates that perhaps $100 billion of pass-through income is unreported every year. Another example of an emerging compliance problem is offshore credit cards, which can be used to hide spending and income from the IRS. While programs are now being introduced to identify these problems, the Board does not believe that the IRS will have adequate resources to follow up on many of the cases that are identified.

Lastly, a recent Treasury study found that nearly one-third of the $31.3 billion in Earned-Income-Tax-Credit refunds sent out for the 1999 tax year -- between $8.5 billion and $9.9 billion annually, shouldn't have been paid.

These items highlight what I might call a good news/bad news situation. On one hand, the IRS is becoming more knowledgeable about noncompliance. However, declining compliance resources make it difficult to assign additional resources in any meaningful way to investigate these situations and enforce the tax law with noncompliant taxpayers.

To better understand compliance issues, the Oversight Board believes there is an urgent need for the IRS to increase its research on taxpayer compliance so it can identify and correct broad areas of taxpayer noncompliance. The IRS is developing a new program, the National Research Program (NRP), that will provide the necessary data. Past approaches were viewed by Congress and taxpayers as too intrusive, and the IRS is designing the NRP to lessen taxpayer burden while still obtaining a sample sufficient to produce meaningful results. The Oversight Board supports the NRP and requests Congressional support for this program.

An effective IRS is an important part of our government, and the IRS can ill afford to fall behind. Old technology, a growing economy with more tax transactions, reduced IRS staffing levels, and an increasingly complex tax code have created a situation where the IRS must make up a lot of ground. The Board believes that a private sector company that fell behind this dramatically would find its very survival threatened. However, failure is not an option for the IRS. Our society depends on a tax administration agency that can help taxpayers understand and meet their tax obligations and effectively enforce the tax laws.

The long-range solution to many of the IRS' problems is to modernize its business processes and information technology. The IRS' Business Systems Modernization (BSM) program is designed to transform both IRS' business processes and information technology into modern, efficient processes and systems that incorporate world-class best practices. The BSM program has been progressing slowly, limited primarily by the IRS' capacity to manage the program. Efforts from inception to date have focused on establishing an enterprise life cycle, a standard architecture, and low-risk projects. In 2002, however, several major deliverables are scheduled, and the upcoming year will be a test of the IRS' ability to manage this program.

The longer it takes the IRS to modernize, the longer taxpayers will be deprived of the benefits of improved IRS processes and systems, and be forced to endure the inadequacies of the antiquated systems in place today. Even under the best of circumstances, it will take the IRS far too long to complete its modernization program. The Oversight Board recommends that BSM be accomplished as quickly as possible, consistent with the IRS' ability to manage the program and absorb change. The private sector has already learned that accomplishing programs in as short a period as practical actually lessens overall cost and risk. To successfully implement the modernization program, all organizations involved in BSM must do a better job. The Oversight Board's recommendations for key organizations include:

- The IRS must improve its program management ability, work more effectively with the PRIME Contractor, and manage/implement change more effectively.

- The PRIME Contractor must understand and achieve its responsibilities to deliver business results within budget and on schedule and improve its breadth and depth of skills.

- The Administration must understand the importance and critical nature of the situation, support the long-term plan, including increased investment levels, and hold the IRS responsible for meeting the plan.

- The Congress must accomplish the same tasks as the Administration, and, in addition, speed up the process for review and release of BSM funding.

Oversight organizations must rationalize their roles to the extent possible and eliminate unnecessary overlap, leverage assets to advise in a more effective manner; and recognize that quality cannot be achieved by repetitious, and at times, inefficient inspection.

Notwithstanding the need for a long-term modernization program, the IRS must also improve in the short term. Potential means of realizing short-term improvements may be organizational changes, process improvements, or modifications to the legacy technology base.

An IRS that performs better requires adequate funding as its workload continues to increase. As discussed in our interim report on the FY2002 budget, inadequate funding and resources will make it impossible for the IRS to meet any of its strategic objectives. The IRS still has a long way to go to reach the level of performance envisioned by both the IRS Restructuring Commission and the IRS Restructuring and Reform Act. Failure to provide adequate funding will deprive the IRS of resources it needs to make improvements in customer service and compliance.

The most important task the Oversight Board must perform this year is to help identify candidates to replace Commissioner Rossotti. During his five-year tenure Commissioner Rossotti provided the IRS with the leadership it needed as it went through the most dramatic change in its history. The changes he implemented while Commissioner will have a positive impact on the IRS for many years into the future. His accomplishments have placed the IRS on the right track to provide top-quality service and fairness to all taxpayers, and he should be commended for what he has done to transform IRS into a performance-based organization. However, I believe he would be the first to say " We have much further to go."

RRA 98 requires the Oversight Board to recommend candidates to the President for the position of IRS Commissioner. The Oversight Board has exercised this responsibility by partnering with the Treasury Department to develop a Position and Candidate Specification describing the qualifications needed and hiring a search firm to identify qualified candidates.

The Oversight Board believes the next Commissioner must have the experience and competence necessary to ensure that the IRS continues its transformation to an organization focused on customer service driven by quantity and quality measures, and must be able to chart a steady course to balance calls for increased compliance and additional customer service, all within limited resources.

Qualified candidates must be CEO caliber executives with relevant operational experience, preferably gained within an intensive information processing and customer-service environment where information technology (IT) has been used to support the business. Candidates must understand the leadership challenges of managing a 100,000 person organization. Qualified candidates must also possess credibility and stature, with a reputation for being a strong leader and manager, and having been an effective change agent. Additionally, candidates must be broad-based functionally, and be particularly adept at providing operational and technology leadership from a general management perspective.

The Oversight Board believes that Charles Rossotti has been all of this and more. We believe the country owes him a debt of gratitude for the public service he has given us in the last five years.

I appreciate the opportunity to meet with you this morning and would be pleased to respond to any questions you have.

Mr. HORN. We go with Michael Brostek, the Director of Tax Administration Issues for the U.S. General Accounting Office, which is headed by the Comptroller General of the United States. We always count on them to analyze what is going on in these hearings, and we always get good recommendations. So, Mr. Brostek.

Mr. BROSTEK. Mr. Chairman and members of the subcommittee, I'm pleased to be here today to discuss the management challenges that continue to face the IRS. At your request, our statement will cover four areas: financial management, performance management, computer security and business systems modernization.

In each of these areas the IRS is working to improve its operations and has made important progress in the past year. Each area, however, continues to have shortfalls in management controls or capacity that need to be addressed to better ensure the success of IRS's ongoing operations and its long-term reorganization and modernization.

By way of perspective, IRS has been in the midst of a major organizational transformation throughout Commissioner Rossotti's tenure. Organizational transformations of the scale under way in IRS are long-term endeavors. The Commissioner has often said that the transformation could take a decade, and we agree.

Transformations are fraught with risk, and mistakes are virtually inevitable. To succeed, organizations and leaders must learn from their mistakes. Over recent years we have observed a consistent constructive reaction from IRS to our recommendations in what appears to us to be a good-faith effort to implement the management reform agenda setout by Congress.

Turning now to financial management, for the 2nd consecutive year IRS's financial statement received an unqualified opinion, meaning that they were fairly presented. However, this last year, as in the past, was a once-a-year fair representation of IRS's finances, and it was achieved through substantial costly and time-consuming processes that compensated for serious systems and control deficiencies. Consequently, IRS did not have the timely, useful and reliable information to assist in managing the day-to-day operations of the agency, which was the intent of the reform legislation.

In addition to concerns about computer security, our audit of IRS's fiscal year 2001 financial statements continued to identify several material internal control weaknesses and other reportable issues related to financial reporting, management of unpaid tax assessments, tax revenue and refunds, taxpayer receipts and data, and accountability over administrative accounts and budgetary resources. Thus, while progress has been made, further efforts are needed to ensure that IRS has accurate, timely information to support decisionmaking.

Concerning IRS's overall performance management, IRS has continued to make progress in revamping its performance management system. For example, IRS now uses its strategic planning and budgeting process to reconcile competing priorities and initiatives with available resources. However, IRS needs to develop better performance measures and perform more and better evaluations of its business practices to determine what factors affect program performance and to identify ways to improve service.

Further, consistent with the Government Performance and Results Act, IRS's fiscal year 2003 budget justification links resources requested for telephone services to expected performance. This noteworthy step needs to be extended, for instance, by including in the budget justification the level of resources to be devoted to priority compliance problems identified by IRS and the results IRS expects to achieve with those resources.

In the computer security area, IRS has established many policies and procedures and controls to protect the security of its computing resources, and over the past year IRS has substantially improved the safeguards that control access to its electronic filing systems. During fiscal year 2002, however, we continued to find serious weaknesses with general controls designed to protect IRS's computing resources from unauthorized use, modification, loss and disclosure. Ineffective implementation of policies, procedures and controls could undermine the confidentiality, integrity and availability of data provided by the IRS.

In addition, weaknesses and other information system controls, including physical security, segregation of duties and service continuity, further increase risk to IRS's computing environment.

Finally, I would like to briefly discuss management of IRS's business systems modernization, IRS's ongoing program to leverage information technology to revamp how the Service does its business. IRS has made important progress in establishing systems, delivering system applications, and establishing the modernization management controls and capabilities needed to effectively acquire and deploy modernized systems. Although this progress has not yet produced major benefits to the taxpayers, it has been critical in laying the sound foundation from which major benefits can be realized. Despite the progress, IRS is not as far along as it committed to be, and it must implement further management controls and capabilities.

Greater progress has not been made because IRS's first priority has been getting new systems up and running. Proceeding with new systems before completely building management capacity increases the risk of not delivering promised systems on time and within budget. As IRS moves forward, this risk escalates because system interdependencies and complexity increase dramatically during the later phases of projects. IRS acknowledges these risks and is committed to making correction of management control weaknesses a priority.

Mr. Chairman, that concludes my statement. I will be happy to answer any questions you may have.

Mr. HORN. Thank you. That's very helpful, and we'll use it in the question period.

[The prepared statement of Mr. Brostek follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform, House of Representatives

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TAX ADMINISTRATION

IRS Continues to Face Management Challenges in its Business Practices and Modernization Efforts

Statement of Michael Brostek, Director, Tax Issues
Randolph C. Hite, Director, Information Technology Systems Issues
Robert F. Dacey, Director, Information Security Issues
Steven J. Sebastian, Acting Director, Financial Management Issues

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GAO-02-619T

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the management challenges that continue to face the Internal Revenue Service (IRS). At your request, our statement today will cover four areas: (1) financial management, (2) performance management, (3) computer security, and (4) business systems modernization. Our emphasis will be on the developments over the past year since we testified at your April 2001 oversight hearing on IRS's management challenges.[1]

While we will address each of these areas individually, the general theme that runs through each of them is that while IRS has made progress, it needs better management information and controls to assess and implement changes to its current business operations and modernization efforts.

Our statement, based primarily on our recent audit work, makes the following points:

- IRS was, for the second consecutive year, able to prepare financial statements that received an unqualified opinion, meaning that they were fairly presented. However, this achievement once again came through the use of substantial, costly, and time-consuming processes to compensate for serious systems and control deficiencies to produce financial statements that present information that is reliable for just a single point in time. This approach does not provide timely, useful, and reliable information to assist in managing the day-to-day operations of the agency, which was the intent of the Chief Financial Officers Act of 1990 and other important reform legislation enacted in the last decade. While IRS has made progress in addressing these issues, our audit of its fiscal years 2001 and 2000 financial statements continued to identify several material internal control weaknesses and other reportable issues. These financial management issues affect IRS's ability to routinely report reliable information for decision-making and have led to both increased taxpayer burden and lost revenue to the federal government, thus affecting IRS's ability to effectively fulfill its responsibilities as the nation's tax collector. Continued efforts are needed to devise lasting solutions to IRS's financial management challenges. Some of these solutions can be achieved in the short term;

[1] U.S. General Accounting Office, *Internal Revenue Service: Progress Continues But Serious Management Challenges Remain*, GAO-01-562T (Washington, D.C.: Apr. 2, 2001)

others are longer term in nature, as they are dependent on the successful modernization of IRS's information systems.

- IRS has continued to make progress in revamping its performance management system by using its strategic planning and budgeting process to reconcile competing priorities and initiatives with the realities of available resources. Also, it now has an evaluation system for front-line employees that is aligned to the agency's strategic goals and is developing a measure of voluntary compliance. However, IRS needs to ensure that it has comparable performance measures over time and sufficient data to assess performance. It also needs to do more and better evaluations of its business practices so it can determine the factors that affect program performance and identify ways to more effectively use resources and improve service. Further, the progress IRS is making internally to better link resource allocations to intended results also has begun to surface in its budget justifications. For instance, the fiscal year 2003 budget justification links resources requested for telephone services to expected performance. However, for some compliance problems such as abusive tax shelters that the commissioner of Internal Revenue has cited as being significant, the budget justification neither identifies the level of resources to be devoted to the problem nor the results IRS expects to achieve.

- In the area of computer security, IRS corrected or mitigated many of the previously reported weaknesses, including those affecting its electronic filing or "e-file" systems, and is implementing a computer security program that should, when fully implemented, help it manage its risks in this area. However, security weaknesses continue to exist in IRS's computing environment. Weaknesses in logical access controls introduce the risk of unauthorized access to computing resources that could, in turn, lead to the unauthorized disclosure, modification, and use of taxpayer data. Other information system controls need improvement to physically protect IRS computing resources, properly segregate incompatible functions among computer personnel, and effectively ensure the continuation of computer processing service in case of unexpected interruption. IRS has substantially improved safeguards that control external access to its e-file systems, yet additional safeguards are needed to fully protect electronically filed tax return data.

- Business Systems Modernization (BSM) is IRS' ongoing program to leverage information technology to revamp how the service does business and is integral to IRS achieving its customer-focused vision. Started in 1999, BSM has received about $968 million in congressional funding. To date, IRS has made important progress in establishing the systems infrastructure, delivering system applications, and establishing the modernization management controls and capabilities needed to effectively acquire and deploy modernized systems. This progress, while not yet producing benefit to taxpayers and IRS commensurate with costs incurred, has nevertheless laid the foundation from which the benefits of future business applications can be realized. Despite the important progress, IRS is not where it committed to be in acquiring infrastructure and business application systems and is not where it needs to be in implementing management controls and capabilities. This is because IRS' first priority and emphasis has been to get new systems up and running and thus, establishment of management capacity has not kept up. Proceeding without needed controls and capabilities increases the risk of not delivering promised system capabilities on time and within budget. As IRS moves forward, this risk is amplified because system interdependencies and complexity increase dramatically during the later phases of system projects. IRS acknowledges these risks and is currently balancing the pace of BSM with management capacity and has committed to making correction of management control weaknesses, a priority.

We will now discuss each of these areas in detail.

Financial Management

IRS's financial management has long been problematic. In fiscal year 2001, it continued to be plagued by many of the serious internal control and financial management issues that we have reported each year since we began auditing IRS's financial statements in fiscal year 1992.[2] Despite these issues, IRS was, for the second consecutive year, able to produce financial statements covering its tax custodial and administrative activities in fiscal years 2001 and 2000,[3] that were fairly stated in all material respects. However, this was achieved only through extensive reliance on costly, time-consuming processes; statistical projections; external contractors; substantial adjustments; and monumental human efforts that extended nearly four months after the September 30, 2001, fiscal year-end. These costly efforts would not have been necessary if IRS's systems and controls operated effectively. However, IRS still does not have a financial

[2] U.S. General Accounting Office, *Financial Audit: Examination of IRS's Fiscal Year 1992 Financial Statements*, GAO/AIMD-93-2 (Washington, D.C.: June 30, 1993).

[3] U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

management system capable of producing the reliable and timely information its managers need to make day-to-day decisions on an ongoing basis, which is a goal of the CFO Act. Additionally, IRS's current approach to developing its financial statements does not address the underlying financial management and operational issues that adversely affect IRS's ability to effectively fulfill its responsibilities as the nation's tax collector.

Strong commitment and hard work by both IRS's senior leadership and staff continued to be the key to its ability to overcome its fundamental systems and internal control deficiencies and achieve its goal of receiving an unqualified audit opinion on its fiscal years 2001 and 2000 financial statements. However, IRS found it extremely difficult to prepare its financial records for audit examination and issue its financial statements within the reporting timeline required by the Office of Management and Budget (OMB) for fiscal year 2001. OMB has announced the executive branch's intention to significantly accelerate this timeline for future years and by fiscal year 2004, IRS will be required to issue its financial statements by November 15, or 6 weeks after fiscal year end. Also, the Department of the Treasury has established a goal of completing its fiscal year 2002 audit, including those of its component entities, and issuing its department wide accountability report by November 15, 2002. Without significant and systemic changes in how IRS processes transactions, maintains its records, and reports its financial results to accompany its extensive compensating processes, IRS's ability to meet this accelerated reporting deadline while sustaining an unqualified opinion on its financial statements is questionable.

We would now like to summarize the major financial management challenges confronting IRS.

Financial Reporting Weaknesses Hinder Availability of Reliable and Timely Information to Support Decision-Making

IRS did not have internal controls over its financial reporting process adequate to enable it to timely, routinely, and reliably generate and report the information needed to prepare financial statements and manage operations on an ongoing basis. Information produced by IRS's financial management systems is neither current nor accurate, and must be supplemented by extensive, costly, time consuming manual procedures that take months to complete and typically result in billions of dollars in adjustments. The resulting financial statement balances are not available until months later and are only reliable at a single point in time. During fiscal year 2001, IRS continued to lack (1) an adequate general ledger system for financial reporting and management purposes, (2) adequate internal controls over material balances maintained in its general ledger system and recording of financial transactions, (3) a cost accounting system capable of providing timely and reliable cost information related to IRS's activities and programs to assist management in making resource allocation decisions, and (4) the ability to separately report several of the federal government's largest types of revenue collections.

IRS's pervasive financial reporting weaknesses prevented it from preparing timely and reliable financial statements or other financial information that Congress and senior IRS management could rely on to oversee and assist in managing operations during fiscal year 2001. Consequently, IRS was compelled to make certain business decisions affecting the disposition of tens of billions of dollars without current and reliable underlying financial information. For example, in each of the following cases involving taxpayer compliance issues, IRS indicated that resource limitations affected its ability to perform necessary follow-up.

- From 1996 to 1999, IRS only followed-up on 21 percent of the over 53 million underreported individual income tax cases it identified, which accounted for about 41 percent of the over $65 billion in underreported taxes IRS estimated on these cases; and
- As of September 30, 2001, IRS had either not started collection action or had stopped collection action in progress on unpaid tax assessment cases with outstanding balances totaling about $12 billion.

In deciding the amount of resources to devote to follow-up on these cases, IRS should consider factors such as the effects on fairness to taxpayers and efforts to deter filing fraud. The relative costs and benefits involved in following up on questionable cases should also be an integral part of such decisions. However, in each of these circumstances, IRS could not readily determine or justify whether it would be cost-beneficial to devote additional resources for such follow-up because it was not able to readily determine (1) the cost of following up on cases or (2) how much it collected on those cases for which it did follow-up. Without this information, IRS cannot perform cost-benefit analysis to assist it in determining or justifying whether the amount of resources it has devoted to each of these programs is appropriate relative to costs and potential benefits involved.[4] Consequently, IRS is hindered in its ability to justify its resource utilization decisions or provide justification for resource increases, which could result in potentially billions of dollars of revenue going uncollected, lead to further erosion in taxpayers' confidence in the equity of the tax system, and adversely affect future compliance.

Management of Unpaid Tax Assessments Hindered by Lack of Subsidiary Ledger and Record Keeping Deficiencies

Ongoing serious internal control deficiencies continued to render IRS unable to properly manage unpaid assessments and has led to increased taxpayer burden.[5] IRS still lacks a subsidiary ledger that tracks and accumulates unpaid tax assessments on an ongoing basis. As a consequence, it must rely on specialized computer programs to extract unpaid tax assessment information from its master files—its only detailed databases of taxpayer account information—and then subject this information to statistical sampling procedures in order to prepare its financial statements. This process takes months to complete and typically requires tens of billions of dollars in adjustments to correct misclassifications and eliminate duplications in order to produce a reliable balance at a single point in time. Consequently, this information is not useful for ongoing management decisions. In addition, the lack of a subsidiary ledger renders IRS unable to timely develop reliable financial and management reports and promptly identify and focus collection efforts on accounts most likely to prove collectible.

IRS's management of unpaid assessments also continued to be hindered by significant errors and delays in recording taxpayer information and payments. As in prior years, the most prevalent errors we found involved

[4]A cost-benefit analysis would consider the costs and expected benefits, both direct and indirect, in increasing resources to pursue collections of outstanding taxes or recovery of improper refund payments. These benefits could include not only increased collections of outstanding taxes and recoveries of improper refund payments, but also benefits to taxpayers through earlier IRS action that might prevent a build up of the outstanding tax liabilities. Improved compliance by taxpayers with the nation's tax laws could also be a benefit.

[5]Unpaid tax assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable); (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed; and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications, only the first is reported on the principal financial statements. As of September 30, 2001, IRS reported $20 billion (net of an allowance for doubtful accounts of $60 billion), $22 billion, and $137 billion in these three categories, respectively.

IRS's failure to record payments to all related taxpayers associated with unpaid payroll taxes.[6] IRS's current systems cannot automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or an officer pays some or all of the outstanding taxes, IRS's systems are unable to automatically reflect the payment as a reduction in the related account or accounts.

IRS also continued to experience problems in promptly releasing liens filed against the property of taxpayers who at one time owed the federal government for taxes but who had subsequently paid or otherwise satisfied these taxes. In one case we identified, IRS did not formally release a lien against a taxpayer's property until 302 days after the tax liability had been fully paid. Based on the results of our work, we estimated that for over 8 percent of unpaid tax assessment cases where IRS had filed a tax lien that was resolved in fiscal year 2001, IRS did not release the lien within the 30 day period required under section 6325 of the Internal Revenue Code.[7]

The serious internal control issues IRS continues to experience with its unpaid assessments can lead, and have led, both to undue taxpayer burden and lost revenue to the government. These conditions can also further erode the confidence of the nation's taxpayers in the integrity and fairness of the tax collection process.

Controls Over Tax Revenue and Refunds Are Not Fully Effective

During fiscal year 2001, we found that IRS's controls were not fully effective in maximizing the government's ability to collect what is owed and in minimizing the risk of payment of improper refunds. Inherent in the voluntary nature of the nation's tax collection system is the concept that IRS must, to a large degree, rely on taxpayers to report their tax liabilities. When taxpayers either intentionally or unintentionally fail to report to IRS

[6] When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability need only be paid once. Thus, IRS may record assessments against each of several individuals for the employee-withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. The assessments made against business officers are known as trust fund recovery penalties.

[7] We are 95 percent confident that the confidence interval around this estimate ranges from 3 percent to 19 percent.

the full amount of taxes they owe the federal government, IRS's ability to independently identify the taxpayers and determine the amount they owe is inherently limited. IRS does not always follow up on potential unpaid taxes it is aware of, and does not always pursue collection of those taxes it determines are owed. In addition, IRS often does not initiate follow-up of those unpaid taxes it does pursue until months after the related tax return has been filed and any related refund has been paid. This delay significantly affects IRS's prospects of collecting amounts due on these cases. The options available to IRS in its efforts to identify and pursue the correct amount of taxes owed and to ensure that only valid refunds are disbursed are currently limited. Additionally, while it processes hundreds of millions of tax returns each filing season, IRS must issue refunds within statutory time constraints or be subject to interest charges.[8]

Nonetheless, IRS does have some preventive controls that, if effectively implemented, could help to reduce the risks associated with not identifying underreported taxes owed or issuing improper refunds. For example, IRS's Examination Branch is responsible for performing examinations on tax returns with potentially invalid EITC claims[9] to determine the validity of the claim. When performed before refunds are disbursed, these examinations are an important control to prevent disbursement of improper refunds. However, these examinations are often performed after any related refunds are disbursed. Consequently, they are not an effective preventive control overall. According to IRS's report on its analysis of EITC compliance rates on tax year 1999 returns filed in 2000, (1) about one-half of the 18.8 million returns on which taxpayers claimed the EITC involved overclaims and (2) of the estimated $31.3 billion in EITC claims made by taxpayers who filed returns in 2000, between $8.5 billion and $9.9 billion was invalid. Based on an average refund rate of about 84 percent of all EITC claims in tax year 1999, we estimate that at least $7 billion in improper refunds were disbursed on these invalid claims.

IRS's decisions concerning its ability to follow-up on unpaid taxes and to forgo follow-up examinations on invalid EITC claims and potentially

[8]By statute, IRS must pay interest on refunds not paid within 45 days of receipt or due date, whichever is later (26 U.S.C. §6611).

[9]Because it is a tax credit, an EITC claim always results in a reduction of the taxpayer's calculated tax liability. However, depending on the taxpayer's amount of taxes withheld, it may or may not result in a refund for a particular tax year.

underreported taxes were based in part on perceived resource constraints. However, as discussed previously, IRS's financial management systems do not currently provide the timely, reliable information management needs to perform cost-benefit analyses to assist in determining the appropriate level of resources to devote to these compliance programs. As a result of these problems, billions of dollars of underreported taxes could remain uncollected and improper refunds could be disbursed. This, in turn, could further erode taxpayer confidence in the equity of the tax system and reduce compliance with the tax laws.

Certain Internal Controls Over Tax Receipts and Taxpayer Data Are Not Adequate

Despite continued improvement during fiscal year 2001, IRS's internal controls over cash, checks, and related taxpayer data did not adequately protect the federal government and taxpayers from vulnerability to loss from theft and inappropriate disclosure of proprietary taxpayer information. IRS has significantly reduced the average amount of time it takes to obtain the results of employee applicant fingerprint checks; further, it now requires the use of two bonded or insured couriers to transport tax receipts to depository institutions, and has limited courier access within service center premises. However, significant but readily correctable weaknesses continued to exist. For example, at IRS locations we visited as part of our fiscal year 2001 financial audit, checks were left in open, unlocked containers, and personal belongings of IRS's employees were allowed into restricted areas where taxpayer receipts were being processed. We also found that IRS had not ensured that the couriers it entrusted with transporting taxpayer receipts and data met the necessary insurance coverage requirements and had completed their fingerprint checks before beginning work. These weaknesses increase the risk that taxpayer data could be inappropriately disclosed or receipts stolen.

In April 2000, IRS issued a policy prohibiting new employees from working at IRS facilities until IRS had received and reviewed the results of their fingerprint checks. This was in direct response to a security issue we had reported for several years concerning new employees being allowed to handle tax receipts and sensitive taxpayer data before IRS received and evaluated the results of their fingerprint checks. IRS made significant progress on this issue during fiscal year 2001. However, we continued to identify instances where IRS's policy was not being followed.

A related vulnerability is that this IRS policy does not apply to individuals employed at ten commercial banks that process tax receipts for the agency. The Department of the Treasury's Financial Management Service contracts with these banks to process manual tax receipts, but the banks were not prohibited from hiring new employees before the results of their fingerprint checks were received and reviewed. Consequently, at the two banks we visited during our fiscal year 2001 audit, fingerprint checks were not always required or performed for either temporary or permanent employees.

These weaknesses subject IRS to unnecessary risk of theft or loss of tax receipts, and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS.

Controls Over Administrative Accounts and Budgetary Resources Are Not Adequate

During fiscal year 2001, IRS continued efforts to correct longstanding weaknesses in accountability over its administrative accounts and budgetary resources,[10] and is working aggressively to address issues we have raised regarding controls over its property and equipment and budgetary activity. However, it continued to experience significant internal control deficiencies in these areas during fiscal year 2001.

Significant deficiencies in accountability for property and equipment have been reported by IRS every year since 1983. IRS lacks an integrated property management system to appropriately record, track, and account for property and equipment additions, disposals, and existing inventory on an ongoing basis. While IRS has made progress in improving the timeliness and accuracy of recording such activity in its inventory records, we continued to find significant errors in these records. For example, IRS was unable to locate 25 of 210 items we selected from its inventory records; these items included computers, monitors, and printers. In addition, because of the lack of an integrated property management system that includes reliable cost information on each item, IRS continued to need the assistance of a contractor to develop and implement a process to enable it to report reliable property and equipment-related balances in its financial statements. These weaknesses seriously impair IRS's ability to ensure that property and equipment are properly safeguarded and utilized only in accordance with laws, regulations, and management policy, and preclude IRS from having reliable information on its balance of these assets throughout the fiscal year.

[10] GAO-02-414.

With respect to controls over its budgetary activity, IRS has developed additional compensating procedures to address weaknesses we previously reported. For example, IRS developed procedures to identify and eliminate from the applicable general ledger accounts transactions that were incorrectly recorded as adjustments to prior years' obligations.[11] However, IRS only employed these procedures as a one-time corrective action at fiscal year-end, rather than as a routine operating procedure throughout the fiscal year. In addition, we continued to identify instances in which IRS did not timely record obligations or expenditures. As a result, IRS's internal controls did not ensure that its budgetary resources were routinely accounted for, reported, and controlled. Without adequate budgetary controls, IRS cannot ensure the reliability of key budgetary information it needs on an ongoing basis to manage its operations and ensure that its obligations do not exceed budgetary authority.

Continued Efforts Needed To Address Financial Management Challenges

IRS acknowledges the issues raised in our financial audits, and the Commissioner and Deputy Commissioner of Operations continue to pledge their commitment to addressing these long-standing issues. We have assisted IRS in formulating corrective actions to address its serious internal control and financial management issues by providing recommendations over the years, and we will continue to work with the agency on these matters.

The challenge for IRS will be to build on the goals reached in fiscal year 2001: to not only improve its compensating processes but, more importantly, to develop and implement the fundamental long-term solutions that are needed to address the management challenges we have identified. Some of these solutions can be addressed in the near term through the continued efforts and commitment of senior IRS managers and staff. Others, such as those involving modernizing IRS's financial and operational systems, will take years to fully achieve. Until IRS's systems and processes are overhauled and internal controls strengthened, heroic efforts will have to be sustained for IRS to continue to produce reliable financial statements. Additionally, without significant and systemic changes in how IRS processes transactions, maintains its records, and reports its financial results, IRS's ability to meet OMB's accelerated

[11] An adjustment to a prior year's obligation is recorded when the dollar amount previously recorded is affected by a subsequent event, such as a change in the price of goods or services.

reporting deadline or to achieve Treasury's even more ambitious reporting goals for fiscal year 2002, while sustaining an unqualified opinion on its financial statements is questionable.

Performance Management System

IRS has continued to make progress in revamping its performance management system-a system designed to measure, assess, and improve organizational and employee performance. It has begun to implement a new employee evaluation system; develop a measure of voluntary tax reporting compliance; and use its strategic planning, budgeting, and performance management process to assess the allocation of resources in its fiscal year 2003 budget and to oversee use of resources during fiscal year 2002. While this progress is notable, our work over the past year has shown that IRS could do a better job of designing and implementing performance measures and evaluation practices that support its on-going business operations, modernization efforts, and budget requests. Further, IRS could make additional progress in linking its budget request to intended results so that Congress can make more informed budget decisions and better assess IRS's use of resources.

Key Accomplishments Over the Past Year

The key accomplishments over the year include the following:

- In October 2001, IRS rolled out its new employee evaluation system for front-line employees. This system, like that implemented earlier for executives and managers, was developed to structurally align performance expectations for employees with IRS's three strategic goals to encourage behaviors and actions that support and advance those goals. IRS recognizes that it may take a while before the new front-line employee evaluation system achieves the intended results. For example, front-line enforcement employees are asked to balance expectations that may appear to conflict, such as providing quality customer service while still enforcing the tax laws. These expectations mean enforcement employees should use appropriate enforcement actions while at the same time listening to and considering the taxpayer's point of view. Employees may need time to better understand what the new performance expectations mean in terms of their daily work and which behaviors they should change in order to put IRS's new operational environment into practice.

- IRS has made progress in developing a way to measure the voluntary compliance of individual taxpayers without placing an undue burden on them. Each year billions of dollars in taxes are not voluntarily reported and paid. To understand the overall extent of noncompliance, IRS plans to begin conducting its study of tax reporting compliance later this fall. The study should provide IRS with data to update the criteria it uses to select tax returns for audit and thereby reduce the number of compliant taxpayers selected. Also, the study is intended to provide detailed information about compliance, such as why taxpayers fail to comply with a specific tax law provision. Having such information should enable IRS to make operational changes such as modifying tax forms and instructions or to recommend tax law changes that could improve compliance. As we have reported, the importance of this study cannot be understated because the most current data IRS has on compliance levels is over 10 years old.[12] Furthermore, measures of voluntary compliance are vital to understanding the ultimate impact of IRS's taxpayer service and compliance programs. Their absence from IRS's array of organizational performance measures compromises the effectiveness of the performance management system.

- In part through use of its strategic planning, budgeting, and performance management process, IRS identified various expected efficiency improvements, technological enhancements, labor-saving initiatives, and workload decreases that it projects will enable it to redirect $157.5 million in its base fiscal year 2003 budget to higher priority areas. Examples include (1) saving over $67 million from re-engineering and quality improvement efforts, such as consolidating form printing and distribution operations and updating an antiquated workload selection system to reduce or eliminate the substantial number of tax returns that are ordered but never audited, and (2) reducing the resources used for the innocent spouse program by $13.8 million due to an expected decrease in caseload. While these actions are commendable, the likelihood that the savings from these improvements will be realized is unclear because IRS did not provide details on how specific savings were computed. Also, any shortfall in estimated labor and nonlabor savings will only be exacerbated if IRS has to absorb unanticipated cost increases such as those that could occur if civilian pay increases for fiscal year 2003 are higher than currently proposed.

Better Performance Measures and Program Evaluation Practices Needed

A key part of any performance management system is performance evaluation, which is the collection of data on performance and the analysis of those data to determine the factors that explain performance. Over the past year we reported on certain aspects of the 2001 filing season where IRS lacked comparable measures or had insufficient data to assess

[12] See U.S. General Accounting Office, *Tax Administration: Status of IRS's Efforts to Develop Measures of Voluntary Compliance*, GAO-01-535 (Washington, D.C. June18, 2001) and U.S. General Accounting Office, *Department of the Treasury: Major Management Challenges and Program Risks*, GAO-01-254 (Washington, D.C. Jan. 2001).

performance. We also reported on various compliance and taxpayer service programs where IRS managers did not consistently evaluate the performance of their program to make decisions about how to improve performance. Additionally, we recently reported on how IRS's congressional justification for its fiscal year 2003 budget was not always well linked to its performance goals.

Lack of Comparable Performance Measures and Data Hindered the Assessment of Certain Aspects of the 2001 Filing Season

Our assessment of the tax year 2001 filing season found that IRS lacked or had insufficient performance measures and data to evaluate refund processing, face-to face taxpayer assistance, returns processing initiatives, and electronic filing impediments.[13]

- In past years, our assessment of IRS's performance in processing paper tax returns and refunds included a comparison of various performance measures against IRS's goals and prior year performance. We were unable to make such a comparison for measures for 2001 because in some instances IRS revised measures that it had been using to assess processing performance. For example, IRS revised the start date for determining the way it measures the timeliness of issuing refund checks. Before 2001, IRS used the date the taxpayer signed the return as the start date for computing refund timeliness and had set a goal of processing a certain percentage of those refunds within 40 days of that date. For the 2001 filing season IRS used the IRS-received date as the start date for computing timeliness because it had control over its own operations but not over when taxpayers signed their returns. While we support IRS's efforts to develop and refine its performance measures to help assure that they are valid and balanced, frequent or extensive changes deprive the various programs of stability and comparability, thus hampering the ability to set or achieve goals.

- Measures of timeliness and quality, which IRS defines as the accuracy of the answers to tax law questions, are important for gauging how well IRS responds to taxpayers' inquiries. IRS did a good job of measuring the daily average wait time of taxpayers who visited a Taxpayer Assistance Center for face-to-face assistance during the 2001 filing season. However, unlike the 2000-filing season when IRS employees posed as taxpayers to obtain data to measure tax law accuracy, IRS did not measure the quality of the assistance in 2001 because of staffing and training challenges associated

[13] U.S. General Accounting Office, *Tax Administration: Assessment of IRS's 2001 Tax Filing Season*, GAO-02-144 (Washington, D.C.: Dec. 21, 2001).

with IRS's reorganization. Instead the Treasury Inspector General for Tax Administration (TIGTA) reviewers, posing as taxpayers, asked tax law questions of IRS representatives. This year IRS is using a contractor's employees to pose as taxpayers in order get a measure of tax law accuracy. In each of the three filing seasons a different measurement methodology was used to measure tax law accuracy and each came up with a different result. The accuracy rate reported by IRS in 2000 was 24 percent, by TIGTA in 2001 was 51 percent, and by IRS contract employees in 2002 was 84 percent. Although the results in each of the 3 years were based on visits to the assistance centers by persons posing as taxpayers, there were differences in such things as the questions the persons asked, the number of weeks covered by the reviews, and the number of sites visited and how they were selected. Given the use of different methodologies, IRS may not know if it realized improvements in quality until the 2003 filing season or later, after it has had time to analyze results using comparable methodologies.

- IRS implemented several processing initiatives for 2001 that were intended to either improve processing operations or enhance compliance. However, IRS's evaluations of such initiatives were limited. IRS officials generally drew conclusions about the effectiveness of initiatives based on broad numbers and trends. One such example deals with the evaluation of the checkbox that IRS added to the individual tax form through which taxpayers could authorize IRS to discuss tax return problems with their tax practitioner. The check box could be used instead of submitting a separate authorization form. IRS estimated that the checkbox initiative would save taxpayers about 2 million hours by not having to prepare the separate authorization form. IRS assumed that because about 28 million taxpayers checked the third-party authorization box that this directly equated to a reduction in the number of separate authorization forms it would receive from these taxpayers. However, IRS did not have sufficient data to do a detailed analysis that would support this assumption.

- While IRS experienced an increase of 13.7 percent in all individual income tax returns filed electronically in 2001 compared to 2000, that rate of increase was below IRS's goal of 20 percent and was the lowest percentage increase since 1996. This declining growth rate reduces the likelihood that IRS will achieve its long-range goal of having 80 percent of individual income tax returns filed electronically by 2007. Although IRS has taken steps to identify impediments to electronic filing, it does not have sufficient information to determine actions it could take to remove some impediments. For example, it lacked information on why about 40 million individual income tax returns were prepared on computer but filed on paper in 2001. We recommended that IRS directly survey tax professionals and taxpayers that file computer-prepared returns on paper to get more specific information on why they are not filing electronically. We have been told that IRS will be undertaking such a survey in the near future.

Once IRS has comparable performance measures and data on the several filing season issues discussed, it should be able to better evaluate the issues and take corrective actions.

Insufficient Program Evaluation Efforts for Some IRS Programs

As discussed below, IRS's efforts to improve the efficiency of its Offer in Compromise program, telephone assistance accessibility and accuracy, and employment tax compliance were hindered by insufficient program evaluation efforts.

- In our report on IRS's Offer in Compromise program, which allows taxpayers to settle their tax liability for less than the full amount,[14] we pointed out that IRS lacked program evaluation plans for various initiatives it undertook to try to reduce the offer inventory and processing time. In addition, IRS lacked performance and cost data needed to monitor program performance and had not set goals for offer processing time that were based on taxpayer needs, other benefits, and costs. Such information would give program managers, who are likely to face divergences between actual and projected results, a better understanding of the factors affecting the initiatives' performance and options for improving their performance. We recommended that IRS develop plans for evaluating offer initiatives, determine which program performance and cost data should be collected, and set goals for offer processing time.
- Our report on IRS telephone assistance[15] showed that IRS missed some opportunities to analyze data to better understand the factors affecting telephone performance, including the actions it took to improve performance. IRS collected and analyzed a variety of data about the key factors affecting telephone access and accuracy. However, IRS officials sometimes reached conclusions about these key factors without conducting analyses to test their conclusions. For example, most field

[14] U.S. General Accounting Office, *Tax Administration: IRS Should Evaluate the Changes to its Offer in Compromise Program*, GAO-02-311 (Washington, D.C.: Mar.15, 2002).

[15] U.S General Accounting Office, *IRS Telephone Assistance: Limited Progress and Missed Opportunities to Analyze Performance in the 2001 Filing Season*, GAO-02-212 (Washington D.C.: Dec. 7, 2001).

directors at IRS call sites we reviewed cited higher-than-usual attrition rates among telephone assistors and problems with computer-based research tools that assistors used to answer taxpayers questions as reasons for the limited progress IRS made toward providing world-class telephone service during the 2001 filing season. Yet, in most cases field directors had not conducted any analysis to support these conclusions. IRS officials also missed opportunities to plan evaluations to determine the effectiveness of the actions IRS took to improve access and accuracy.

- In our report on IRS's efforts to improve the compliance of small businesses with requirements that they report and pay employment taxes,[16] we found that IRS had not successfully followed through on its plans to evaluate new early intervention programs. IRS had developed three new programs designed to prevent or reduce employment tax delinquencies by speeding up or enhancing the notification to certain groups of businesses. To evaluate the program's effectiveness and to support informed judgments about whether to adopt new programs, IRS planned to compare compliance rates of test and control groups and to use customer surveys and focus groups. However, IRS efforts to evaluate these programs were adversely affected by, among other things, delays in obtaining reliable data. We recommended that IRS evaluate whether the benefits derived from expansion of the programs justify the programs' cost. IRS indicated that it would develop and execute a plan for evaluating the effectiveness of the employment tax early intervention programs.

As IRS moves forward with modernization, the capacity to conduct sound performance evaluations on its current and planned operations will be one building block for success. The Government Performance and Results Act of 1993, IRS's guidance, and our prior work all stress the need for analyses of program performance to determine the factors affecting performance and to identify opportunities for improvement.[17] We recognize that some analysis can be costly and thus the costs need to be balanced against the benefits. Considering that IRS devotes considerable resources to many of its programs, the benefits of analysis —identifying ways to more effectively use resources and improve service —could be substantial.

[16] U.S. General Accounting Office, *Tax Administration: IRS's Efforts to Improve Compliance With Employment Tax Requirements Should Be Evaluated*, GAO-02-92 (Washington, D.C.: Jan. 15, 2002).

[17] U.S. General Accounting Office, *Managing for Results: Challenges Agencies Face in Producing Credible Performance Information*, GAO/GGD-00-52 (Washington, D.C.: Feb. 4, 2000)

Budget Justification Not Always Linked to Performance Goals

The Government Performance and Results Act of 1993 requires agencies to establish linkages between resources and results so that the Congress and the American public can gain a better understanding of what is being achieved in relation to what is being spent. As we reported last week[15], IRS has made progress in linking some of its budget justification to performance goals, but in other instances the budget justification lacked performance goals or contained inconsistencies between the budget request and performance goals. For example

- IRS's congressional justification has several good links between the resources being requested and IRS's performance goals. For example, IRS's budget includes an increase of 213 FTEs and $14.1 million to improve its telephone level of service, and its performance measures show an expected increase in toll-free telephone level of service from 71.5 percent in fiscal year 2002 to 76.3 percent in fiscal year 2003.
- In some instances IRS's congressional justification contained no performance goals against which the Congress can hold IRS accountable. For example, the budget request includes increased resources for systematic noncompliance problems identified by the commissioner of Internal Revenue, such as for abusive corporate tax shelters and failure to pay large accumulations of employment taxes, yet it is unclear from IRS's budget justification how many resources IRS intends to devote to each of these problems. And, for none of these areas does the budget justification include performance measures and goals that Congress can use to assess IRS's progress in addressing these major compliance problems.
- The budget justification seems to contain some inconsistencies between the amount of resources being requested and the expected change in performance or work. For example, the budget request indicates that field examination units will have about the same number of staff years as the year before and will receive a budget increase of less than 3 percent. However, IRS's performance measures show that the units are expected to examine 33 percent more individual returns and almost 35 percent more business returns. It is not clear from the budget justification how IRS expects to do so much more work with just a small increase in resources.

[15] U.S. General Accounting Office, *Internal Revenue Service: Assessment of Budget Request for Fiscal Year 2003 and Interim Results of 2002 Tax Filing Season*, GAO-02-580T (Washington, D.C.: Apr. 9, 2002).

A major purpose of the Government Performance and Results Act and IRS's strategic planning, budgeting, and performance management system is to support better-informed decisions on allocating scarce resources by focusing on the results likely to be achieved and then supporting subsequent oversight and accountability by establishing transparent measures to assess performance. IRS's new planning process and the linkages in its budget justification between some of its resource requests and expected results are commendable steps to implement this management approach. Improved linkages in IRS's budget justifications would better enable Congress to make difficult resource allocations decisions and to hold IRS accountable for achieving results with the resources it is provided.

Computer Security

Computer security is an important 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 the public's trust is essential. The dramatic expansion in computer interconnectivity and the rapid increase in the use of the Internet are changing the way in which our government, the nation, and much of the world communicate and conduct business. Without proper safeguards, however, these developments pose enormous risks because it is easier for individuals and groups with malicious intent to intrude into inadequately protected systems and use such access to obtain sensitive information, disrupt operations, commit fraud, or launch attacks against other computer systems and networks.

IRS relies extensively on interconnected computer systems to collect and store taxpayer data, process tax returns, calculate interest and penalties, generate refunds, and provide customer service, in so doing collecting and maintaining a significant amount of personal and financial data on every American taxpayer. The confidentiality of this sensitive information is important because without it, taxpayers could be exposed to loss of privacy and financial loss and damages resulting from identity theft and financial crimes.

Although Computer Security Improvements Made, Taxpayer Data Still at Risk

IRS has corrected or mitigated many of the computer security weaknesses cited in our previous reports, and is implementing a computer security program that should, when fully implemented, help it better manage its risks in this area. Actions IRS has taken include strengthening certain controls over its networks and mainframe systems, updating security standards, and implementing an intrusion detection capability. However, we also continued to find weaknesses with general controls designed to protect IRS's computing resources from unauthorized disclosure, modification, and use. Although the agency has established many policies, procedures, and controls to protect computing resources, they were not always effectively implemented to ensure the confidentiality, integrity, and availability of the computer-processed data. Weaknesses over logical access to IRS's computing resources place data at risk of unauthorized access. Further, weaknesses in other information system controls, including physical security, segregation of duties, and service continuity, further increase risk to IRS's computing environment. Because of these weaknesses, we again reported computer security as a material weakness[19] in our audit of IRS's fiscal year 2001 and 2000 financial statements.[20]

Weaknesses in Logical Access Controls Introduce Risk

A basic management objective of any organization is the protection of its information systems and critical data from unauthorized access. Organizations accomplish this objective by establishing logical access controls that are designed to prevent, limit, and detect user access to computing resources. These controls include user accounts and passwords, access rights and permissions, network services and security, and audit and monitoring. Inadequate logical access controls diminish the reliability of computerized data and increase the risk of unauthorized disclosure, modification, or use.

IRS's logical access controls to prevent, limit, and detect access to its computing resources were sometimes implemented ineffectively. IRS did not adequately control user accounts and passwords to ensure that only authorized individuals were granted access to its servers. For example, the agency did not always securely configure password parameters, and users sometimes employed easily guessed passwords on computers, routers, and switches. IRS also did not adequately restrict user rights and allowed excessive access permissions to sensitive directories and files on its computers. Such weaknesses could compromise the integrity of the operating system and the privacy of data that reside there.

[19] A material weakness is a condition that precludes an entity's internal control from providing reasonable assurance that material misstatements in its financial statements would be prevented or detected on a timely basis.

[20] GAO-02-414

In addition, IRS did not securely control network services on its computers, routers, and switches in that it enabled unnecessary, outdated, and/or misconfigured network services. For example, intruders could have readily obtained useful system and user information on certain computers that could have facilitated an intrusion attempt. Running insecure network services increase the risks for system compromise, such as unauthorized access to and manipulation of sensitive system data, disruption of services, and denial of service.

Moreover, IRS did not effectively audit and monitor system activity on some of its computers. In some cases, its computers did not record key security-related events and security specialists did not routinely or fully examine audit logs for unauthorized activity. As a result, greater risk exists that unauthorized system activity will not be promptly detected.

)ther Information System Controls Need Improvement

In addition to logical access, controls over other important areas should be in place to ensure the confidentiality, integrity, and availability of an organization's data. These information system controls include policies, procedures, and techniques that physically secure data processing facilities and resources, properly segregate incompatible duties among computer personnel, and effectively ensure the continuation of computer processing service in case of unexpected interruption.

Although IRS implemented several physical security controls, certain weaknesses reduced their effectiveness in controlling physical access to its data processing facilities. Likewise, IRS did not segregate incompatible duties associated with certain system functions, thereby providing certain individuals with the opportunity to add fictitious users with elevated system access privileges and perform unauthorized activities without detection. In addition, because IRS has not developed or tested disaster recovery plans for certain systems, it lacks sufficient assurance that it will be able to recover essential information systems and critical business processes should an unexpected interruption occur.

In addition, internal controls over key computer applications used by IRS personnel do not provide adequate assurance that access to taxpayer data is granted only to those authorized to have it. Such weaknesses increase the vulnerability of the data processed.

IRS Has Improved Security Over Its e-file Systems, But Vulnerabilities Remain

Last year, we reported[21] and testified[22] before this subcommittee about the effectiveness of key computer controls designed to ensure the security, privacy, and reliability of IRS's electronic filing ("e-file") systems and electronically filed taxpayer data during the 2000 tax-filing season. At that time, IRS had not adequately secured access to its electronic filing systems or to the electronically transmitted tax return data those systems contained. We demonstrated that unauthorized individuals, both internal and external to IRS, could have gained access to IRS's electronic filing systems and viewed and modified taxpayer data contained in those systems during the 2000 tax-filing season. We were able to gain such access because IRS at that time had not (1) effectively restricted external access to computers supporting the e-file program, (2) securely configured the operating systems of its electronic filing systems, (3) implemented adequate password management and user account practices, (4) sufficiently restricted access to computer files and directories containing tax return and other system data, or (5) used encryption to protect tax return data on e-file systems. We also reported that these weaknesses jeopardized the security of sensitive business, financial, and taxpayer data on other critical IRS systems that were connected to e-file computers through its wide area network. We provided specific technical recommendations to IRS to improve access controls over its electronic filing systems and networks.

Today, we are pleased to report that IRS has substantially improved safeguards that control external access to its electronic filing systems and to the electronically transmitted tax return data those systems contain. IRS has taken steps to improve perimeter defenses and prevent individuals from gaining unauthorized access to e-file systems and electronically transmitted data through e-file's external connections with its trading partners.[23] To illustrate, IRS has redesigned the e-file system architecture, strengthened modem controls, and recently installed network control devices that collectively are configured to filter inbound and outbound

[21] U.S. General Accounting Office, *Information Security: IRS Electronic Filing Systems*, GAO-01-306 (Washington, D.C.: Feb. 16, 2001).

[22] U.S. General Accounting Office, *Internal Revenue Service: Progress Continues But Serious Management Challenges Remain*, GAO-01-562T (Washington, D.C.: Apr. 2, 2001).

[23] IRS trading partners are commercial firms and individuals that IRS has authorized to participate in the electronic filing program. These partners include electronic return originators, who prepare electronic returns for taxpayers, and transmitters, who transmit the electronic portion of a return directly to IRS.

computer network traffic to e-file computers and allow only authorized traffic through its filters. Although the filters on these devices can be strengthened to deny certain unnecessary network services, they reasonably limit external access to e-file computers from the trading partners' typical connections. IRS also strengthened user access, password, and operating system controls on network control devices. For example, the agency implemented access rules restricting the use of a certain service, encrypted passwords, and disabled certain risky and unnecessary computer network services on these devices. Moreover, IRS's redesigned e-file architecture provides additional safeguards against unauthorized external access to unencrypted tax return data stored on e-file computers and includes a network-based intrusion detection capability.

While IRS has substantially improved security over external access to its e-file computers, additional improvements are needed to fully protect the electronically transmitted data on those computers from unauthorized access attempts by users on IRS's internal network. The removal of one network control device and the configuration of several others do not sufficiently limit network traffic to e-file computers from the IRS wide-area network. The agency also has not fully resolved some of the previously reported control weaknesses affecting e-file computers. For example, weak password control practices continue to allow easily guessed passwords, access permissions for certain computer files and directories remain excessive, risky and unnecessary services continue to be available on e-file computers, and a host-based intrusion detection capability is not present. IRS believed it had corrected some of these weaknesses and has longer term actions planned to correct some of the others. Until these weaknesses are corrected or mitigated, e-file computers and the data they contain will continue to be vulnerable to unauthorized access attempts from the IRS wide-area network.

Despite the continued existence of certain weaknesses affecting its e-file systems, IRS's actions indicate that it has taken a systematic, risk-based approach to correcting identified weaknesses. Such an approach will continue to be important in ensuring that corrective actions are effective on a continuing basis and that new risks are promptly identified and addressed.

Also, we previously reported[24] that taxpayers who file their returns electronically may not have been fully aware of the risks of filing electronically. For example, IRS did not prescribe minimum computer security requirements for transmitters and did not assess or require an assessment of the effectiveness of computer controls within the transmitters' operating environment. In response, IRS changed their web site to recommend that taxpayers read and understand the privacy and security policies and procedures of the IRS and of any industry partner that will handle tax return information. Such cautionary language helps to clarify that the security of filing electronically is dependent upon the security of trading partner systems, for which IRS provides no assurance. Similarly, IRS should consider including such cautionary language or referring to such language on its web site in its radio advertisements and printed materials that state e-file is secure.

Business Systems Modernization

We now turn to the business systems modernization (BSM)—IRS's ongoing, multiyear, multibillion-dollar program intended to leverage the power of information technology (IT) to revamp how the service does business. Since its start in late 1999, the program has received about $968 million in congressional funding. Going forward, IRS expects to need about a half billion dollars annually in funding over the next 5 years. As of today, BSM consists of 20 ongoing system acquisition projects at different life-cycle stages, along with various program-level initiatives that are to provide IRS the means by which to manage these projects.

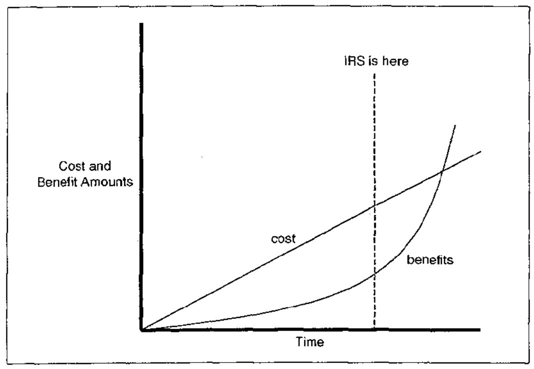
Over the past 3-plus years, IRS has made important progress in establishing the infrastructure systems that are to provide the platforms, if you will, upon which future business applications will run. Establishing this systems infrastructure is a necessary prerequisite to introducing the business applications that are in turn intended to provide benefits to taxpayers and IRS. During this time, IRS has also made important progress in delivering two systems applications—Customer Communications 2001 and Customer Relationship Management Exam—that are producing benefits as of today. For example, Customer Communications 2001, which is software improvements to IRS's customer service telephone system, was implemented last summer and is now routing routine taxpayer inquries to automated menu driven information services, thereby freeing IRS customer service representatives to answer

[24] GAO-01-306.

complex or less common inquiries. Progress has also been made over this period in establishing the modernization management controls needed to effectively acquire and implement BSM systems. For example, IRS recently issued an updated version of its enterprise architecture (modernization blueprint) for how it wants to transition its business systems environment, thus giving a high-level roadmap to guide and constrain business and technological change.

This progress, however, needs to be put into proper perspective with the long-term picture of planned BSM delivery of measurable mission value. In particular, the nature of progress thus far should not be viewed solely in the context of what taxpayer service and IRS efficiency benefits are being realized today. Rather, this progress should also be viewed in terms of laying the necessary foundation from which the benefits of future applications can be realized. As a matter of fact, at this point in time, the level of tangible mission-related benefits that have been realized from modernization investments are not yet commensurate with costs incurred. In our view, this is not unreasonable because, as depicted in figure 1, expected return on these and future investments are to materialize later when new business applications are brought on line.

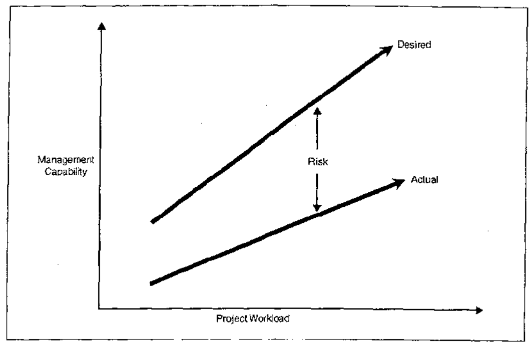
Figure 1: National BSM Benefits Versus Costs



Source: GAO

Despite important progress, IRS is not where it committed to be in acquiring both infrastructure and application systems and not where it needs to be in implementing modernization management controls. This is because IRS's first priority and emphasis has been to get the newer, more modern systems—with their anticipated benefits to taxpayers—up and running. In so doing, however, the establishment of management capacity to ensure that these systems are introduced successfully has not been given equal attention and thus has not kept up. As shown in figure 2, this emphasis on new systems progress adds significant cost, schedule, and performance risk that escalates as the program advances. Simply stated, proceeding without these controls increases the risk of not delivering promised systems capabilities on time and within budget. Moreover, these risks are amplified as IRS moves forward because interdependencies among current ongoing projects and the complexity of associated work activities to be performed, have and will continue to increase dramatically as more system projects move into the latter stages of their life-cycles and are deployed. More recently, IRS has acknowledged this risk and initiated efforts to better balance controls with project pace and workload.

Figure 2: Increasing Risk with Growing Project Workload



Source: GAO.

Testimony before this subcommittee last spring outlined the same general concern that we are stating today.[25] At that time, we feared that systems workload and pace were getting too far ahead of the agency's ability to deal with them effectively, i.e., having proper management controls and capacity in place. Since then, IRS has continued to move forward with its ongoing infrastructure and business application projects while simultaneously taking steps to implement missing management controls and capabilities. During this time, however, the imbalance in project workload and needed management capacity has remained a concern. More recently, our report of this past February[26] recommended that the commissioner of internal revenue reconsider the scope and pace of the program to better strike a balance with the agency's capacity to handle the workload. The commissioner agreed, promising action in these areas. In

[25] U.S. General Accounting Office, *Internal Revenue Service: Progress Continues, but Serious Management Challenges Remain,* GAO-01-562T (Washington, D.C.: April 2, 2001).

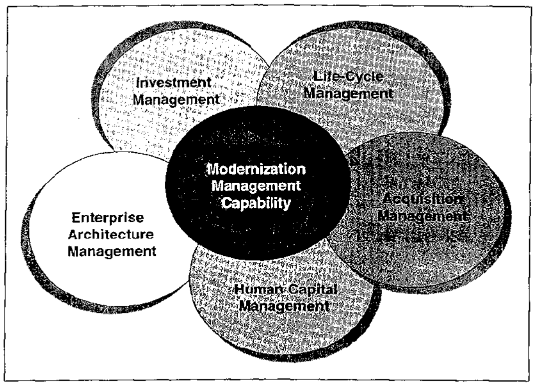
[26] U.S. General Accounting Office, *Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload,* GAO-02-356 (Washington, D.C.: February 28, 2002).

particular, the commissioner agreed to align the pace of the program with the maturity of IRS's controls and management capacity, including reassessing the portfolio of projects that it planned to proceed with during the remainder of fiscal year 2002. BSM officials plan to complete this reassessment and present it to the commissioner and BSM executive steering committee for approval in the next month or two. The commissioner also made correcting remaining management control weaknesses a priority.

For the past 7 years we have discussed with and communicated to IRS the importance of establishing sound management controls to guide its systems acquisition projects. Beginning in 1995, when IRS was involved in an earlier attempt to modernize its tax processing systems, and continuing since then, we have made recommendations to implement fundamental modernization management capabilities before acquiring new systems; we concluded then that until such controls were in place, IRS was not ready to invest billions of dollars in building modernized systems.[27] We are not unmindful of IRS's competing pressures: to implement these controls and to also field new systems. However, to the extent that essential controls are still lacking, risk is unavoidably increased. The areas in which we have reported in the past that controls are lacking and have made recommendations for improvement fall into five interrelated and interdependent IT management categories, as shown in figure 3: investment management, system life-cycle management, enterprise architecture management, software acquisition management, and human capital management.

[27] U.S. General Accounting Office, *Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed*, GAO/AIMD-95-156 (Washington, D.C.: July 26, 1995).

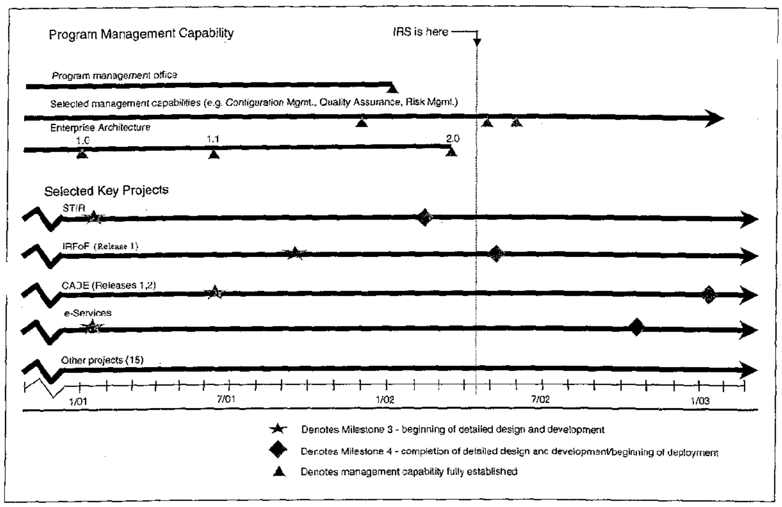
Figure 3: Categories of Management Controls Needed for Full Modernization Capability



Source: GAO.

In December 1998 IRS hired a systems integration support contractor to help it develop and implement these capabilities. In 1999, the commissioner adopted a modernization strategy that required, for example, (1) the use of incremental investment decisionmaking, (2) adherence to a rigorous systems and software life-cycle management method, and (3) development and implementation of an enterprise architecture or modernization blueprint to guide and constrain the content, sequencing, and integration of systems investments. This laudable approach, however, included simultaneously proceeding with project acquisition, in anticipation that program controls would be in place and functioning when the projects reached their later, less formative stages. Figure 4 illustrates this approach.

Figure 4: Concurrent Development of Program-Level Controls and Projects



Source: GAO.

During the modernization's first 18 months, progress in implementing these management controls was slow, while at the same time project acquisitions moved rapidly. At that time we reported to IRS's Senate and House appropriations subcommittees that projects were getting ahead of the modernization management capacity that needed to be in place to manage them effectively.[28] In response to our concerns and the

[28] See, for example, *Tax Systems Modernization: Results of Review of IRS' August 2000 Interim Spending Plan*, GAO-01-91 (Washington D.C.: November 8, 2000).

subcommittees' direction, IRS scaled back on its projects, giving priority to implementing needed management capacity.

As previously noted, IRS has since made important progress in its modernization management capacity. Most recently, we reported[29] that IRS (1) reviewed the contractor's quality-assurance function, concluding that it was not always effective and that it required a higher level of IRS–contractor oversight, and listing specific corrective actions that could reduce the probability of deliverables not meeting expectations; (2) defined risk management policies and procedures for its enterprise life-cycle approach; (3) issued version 2.0 of its enterprise architecture and implemented steps to ensure project alignment with the architecture and integration with other modernization projects; and (4) plans an independent assessment of selected projects against the Software Engineering Institute's SA-CMM [30] level 2 requirements by December 31, 2002.

In addition, IRS recently hired technical and managerial executives with substantial private-sector experience for its reorganized BSM program office.

We remain concerned, however, because projects are entering critical stages, and not all essential management controls are in place and functioning. In particular, in our ongoing work for IRS's appropriations subcommittees, we found that it is proceeding with building systems—including detailed design and software development work—before it has for example (1) fully implemented mature software acquisition management processes, (2) developed and deployed a human capital management strategy, and (3) established effective cost and schedule estimating practices.

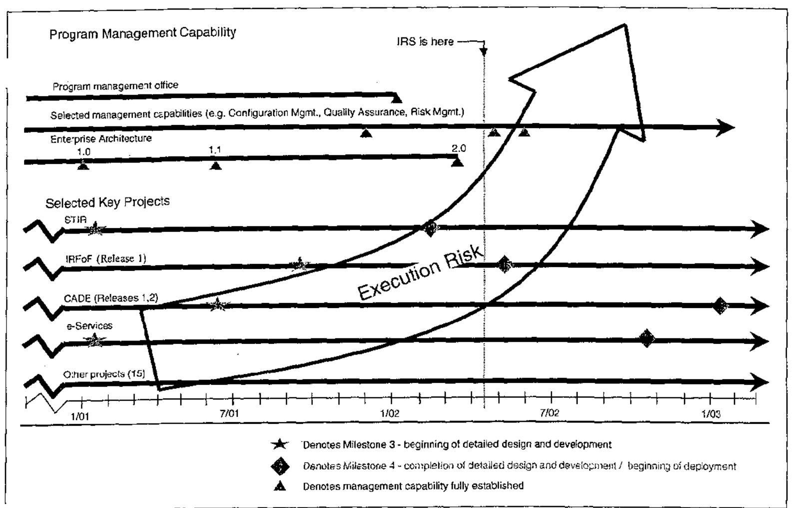
Weaknesses in any one of these modernization management controls introduces an unnecessary element of risk to the BSM program, but the

[29] U.S. General Accounting Office, *Business Systems Modernization: Results of Review of IRS's March 2001 Expenditure Plan*, GAO-01-716 (Washington D.C.: June 29, 2001), and GAO-02-356.

[30] Carnegie Mellon University's Software Engineering Institute has developed criteria, known as the Software Acquisition Capability Maturity Model (SA-CMM), for determining organizations' software acquisition management effectiveness or maturity. Capability Maturity Model and CMM are registered in the U.S. Patent and Trademark Office.

combination of these weaknesses introduces a level of risk that increases exponentially over time. IRS has reported that BSM projects have already encountered cost, schedule, and/or performance shortfalls. Our analysis has showed that weak management controls contributed directly to these problems, or were the basis for prudent, proactive IRS decisionmaking not to start or continue projects. Given that IRS's fiscal year 2002 BSM spending plan supports progress towards the later phases of key projects and continued development of other projects, it is likely that BSM projects will encounter additional cost, schedule, and performance shortfalls. Figure 5 depicts this combination of circumstances.

Figure 5: Current Time Line Depicting Escalating Program Execution Risk



Source: GAO.

IRS acknowledges these risks. According to its chief information officer, until the weaknesses are fully addressed, IRS is (1) relying on existing immature processes; (2) leveraging the knowledge, skills, and abilities of experienced senior executives to ensure that issues are proactively managed; and (3) hiring additional experienced executives. In our view, based on past experience, relying on such measures is not enough given the size and complexity of the BSM program. Past government and industry experience shows that the probability of repeated successes on projects proceeding in this manner is low, and the incidence and cost of rework is high. Again, we believe the answer lies in a more modest scope and pace of systems projects until management capacity is brought up to the level needed.

Timing is critical. While the lack of controls can be risky in a projects early stages, it is essential that such controls be in place when projects enter system design, development, and implementation. To mitigate this added risk, IRS needs to fully implement the remaining management controls that we have recommended.

Conclusion

IRS has clearly made progress toward transforming itself into a more reliable, accountable, and customer-focused organization. We recognize that this transformation is not easy and will take time. We have made recommendations over the years to assist the agency in achieving its goals, and some have been implemented. We will continue to work closely with IRS officials as they strive to develop and implement new operating systems and business practices that are key to achieving IRS's goals of improving service to taxpayers and compliance with the tax laws.

Mr. Chairman, that concludes our statement. We would be pleased to respond to any questions that you or other members of the Subcommittee may have at this time.

Mr. HORN. Pamela Gardiner is the Deputy Inspector General for Audit, Treasury Inspector General for Tax Administration.

Ms. GARDINER. Good morning. Mr. Chairman and members of the subcommittee, I appreciate the opportunity to appear here today. I've submitted to the subcommittee TIGTA's analysis of management challenges facing the IRS. I'd like to focus today on four of those areas: security of IRS employees, facilities and information systems; systems modernization; customer service performance; and the decline in enforcement.

While the IRS has long recognized the risk that violence against its infrastructure and employees poses, the events of September 11th expanded the security paradigm considerably. For instance, in the past, IRS disaster recovery plans generally addressed the risk of only one site shutting down. The al Qaeda terrorist attacks and the subsequent anthrax and bomb threats made it realistically possible that sophisticated forces could incapacitate multiple IRS locations. The IRS is now developing plans to address multiple acts of terrorism and maintain continuity of operations. Completing these actions is important because the IRS is the Nation's primary revenue collector and any disruption of these activities would have a detrimental effect on all government operations.

In addition, the increased networking of IRS computers and increased use of the Internet, combined with the growing number of destructive computer viruses, makes the IRS more vulnerable to the risk of data loss or theft.

Apart from the external risks, there is an overall lack of awareness of security within IRS among its employees, and functional managers have generally not accepted responsibility for security. For example, posing as Help Desk employees, we contacted 100 IRS employees and asked for their assistance in resolving a fictitious network problem. We asked employees to temporarily change their password to one that we had created. Of the 100 employees contacted, 71 agreed to compromise their password, effectively giving us access to IRS systems.

The second challenge that I'd like to discuss is IRS's business systems modernization. This area is considered a significant risk due to its high-cost, previous failures, and because many IRS reforms such as improved debt collection are backlogged awaiting systems modernization. While the IRS has made some progress modernizing its systems, the overall pace of these efforts has been considerably slower than expected. To its credit, the IRS has begun implementing process improvements in such areas as configuration management, risk management, schedule and cost analysis, and quality assurance. However, these improvements are recent, and we have not yet seen major improvements in the actual application of these actions at the project level. As a result, the projects continue to experience significant delays and cost increases, with significant decreases in functionality.

We attribute this to several factors, including the initiatives are still struggling with immature project management processes; the PRIME contractor has not consistently demonstrated the management and technical disciplines that it was hired to bring to the IRS; requirements have continued to evolve; and lessons learned in previous projects are not being applied adequately to other similar projects and problems.

Another significant issue facing the IRS is meeting its goal to provide quality service to taxpayers. At times taxpayers need to go to IRS for assistance. My office has conducted reviews of the IRS's toll-free telephone operations and walk-in activities during this filing season. TIGTA's auditors monitored 736 telephone calls and found IRS employees responded incorrectly to 22 percent of the questions. TIGTA auditors also visited 40 taxpayer assistance centers and asked 168 tax law questions. IRS employees provided 36 correct responses, 42 correct responses despite some procedural errors, 40 referrals to a publication in lieu of a response, and 50 incorrect responses.

Another concern with serious implications for voluntary compliance is the well-known decline in enforcement activities at the IRS. During the past decade, the number of tax returns selected for examination by the IRS has decreased, while the number of tax returns filed by taxpayers has increased. Additionally, the number of liens, levies and seizures, although up from the previous year, continue to be significantly fewer than in the past.

The IRS is at a crucial point in its reinvention process. As Commissioner Rossotti completes his term, the risks increase that IRS will not succeed in delivering its promised improvements. Commissioner Rossotti's strategic planning and leadership skills, combined with his willingness to substantially change the IRS culture, have been instrumental in guiding the IRS to the successes it has achieved thus far.

I'd be happy to answer any questions on these or any of the other management challenges.

Mr. HORN. Thank you.

[The prepared statement of Ms. Gardiner follows:]

HEARING BEFORE THE
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMENT AND INTERGOVERNMENTAL RELATIONS
COMMITTEE ON GOVERNMENT REFORM
U.S. HOUSE OF REPRESENTATIVES

APRIL 15, 2002

STATEMENT FOR THE RECORD

PAMELA J. GARDINER
DEPUTY INSPECTOR GENERAL FOR AUDIT
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Mr. Chairman, and members of the subcommittee, I appreciate the opportunity to appear today. I have submitted to the subcommittee TIGTA's analysis of management challenges facing the IRS. I would like to focus today on four of those areas:

- security of IRS employees, facilities and information systems,
- systems modernization,
- customer service performance, and
- the decline in enforcement.

While the IRS has long recognized the risks that violence against its infrastructure and employees poses, the events of September 11 expanded the security paradigm considerably. For instance, in the past IRS disaster recovery plans generally addressed the risk of only one site shutting down. The Al Qaeda terrorist attacks and the subsequent anthrax and bomb threats made it realistically possible that sophisticated forces could incapacitate multiple IRS locations. The IRS is now developing plans to address multiple acts of terrorism and maintain continuity of operations. Completing these actions is important because the IRS is the nation's primary revenue collector and any disruption of these activities would have a detrimental effect on all Government operations. In addition, the increased networking of IRS computers and increased use of the Internet, combined with the growing number of destructive computer viruses, makes the IRS more vulnerable to the risk of data loss or theft. Apart from the external risks, there is an overall lack of awareness of security within IRS among

IRS employees, and functional managers have generally not accepted responsibility for security. For example, posing as Help Desk employees, we contacted 100 IRS employees and asked for their assistance in resolving a fictitious network problem. We asked employees to temporarily change their password to one that we had created. Of the 100 employees contacted, 71 agreed to compromise their password, effectively giving us access to IRS systems.

The second challenge that I would like to discuss is IRS' business systems modernization. This area is considered a significant risk due to its high cost, previous failures, and because many IRS reforms, such as improved debt collection, are backlogged awaiting systems modernization. While the IRS has made some progress modernizing its systems, the overall pace of these efforts has been considerably slower than expected. To its credit, the IRS has begun implementing process improvements in such areas as configuration management, risk management, schedule and cost analysis, and quality assurance. However, these improvements are recent and we have not yet seen major improvements in the actual application of these actions at the project level. As a result, the projects continue to experience significant delays and cost increases, with significant decreases in functionality. We attribute this to several factors, including:

- the initiatives are still struggling with immature project management processes,
- the PRIME contractor has not consistently demonstrated the management and technical disciplines that it was hired to bring to the IRS,
- requirements have continued to evolve, and
- lessons learned in previous projects are not being applied adequately to other similar projects and problems.

Another significant issue facing the IRS is meeting its goal to provide quality service to taxpayers. At times taxpayers need to come to the IRS for assistance. My office has conducted reviews of the IRS' toll-free telephone operations and walk-in activities during this filing season. TIGTA auditors monitored 736 telephone calls and found IRS employees responded incorrectly to 22% of the questions. TIGTA auditors also visited 40 taxpayer assistance centers and asked 168 tax law questions. IRS employees provided:

- 36 correct responses;
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- 50 incorrect responses.

Another concern with serious implications for voluntary compliance is the well-known decline in enforcement activities at the IRS. During the past decade, the number of tax returns selected for examination by the IRS has decreased, while the number of tax returns filed by taxpayers has increased. Additionally, the number of liens, levies, and seizures, although slightly up from the previous year, continue to be significantly fewer than in the past. Also, delinquent accounts and delinquent investigations in inventory are increasing dramatically.

The IRS is at a crucial point in its re-invention process. As Commissioner Rossotti completes his term, the risks increase that IRS will not succeed in delivering its promised improvements. Commissioner Rossotti's strategic planning and leadership skills, combined with his willingness to substantially change the IRS culture, have been instrumental in guiding the IRS to the successes it has achieved thus far.

I would be happy to answer questions now on these or any of the other management challenges.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

January 29, 2002

MEMORANDUM FOR SECRETARY O'NEILL

David C. Williams

FROM: David C. Williams
Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service

SUMMARY

The Reports Consolidation Act of 2000 requires that we summarize for you our perspective on the most serious management and performance challenges currently facing the Internal Revenue Service (IRS) for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2001*.

The Treasury Inspector General for Tax Administration's (TIGTA) assessment of the major IRS management challenge areas for Fiscal Year (FY) 2002 has not changed substantially from the prior year. While the IRS has acted to address each challenge area, TIGTA was able to remove only the challenge that addressed the organizational restructuring of the IRS. In addition, the TIGTA believes that two other issues will challenge the IRS in the coming years. *Human Capital* and *Complexity of the Tax Law* are being added to the TIGTA's list of challenges facing the IRS.

We have also recategorized or renamed some issue areas. Challenge areas formerly titled *Financial Management* and *Implementation of the Government Performance and Results Act of 1993* have been combined under one area titled *Performance and Financial Management*. The customer service issues previously included in the challenge area titled *Customer Service and Tax Compliance Initiatives* have been moved to the *Providing Quality Customer Service* challenge, leaving a challenge area titled *Tax Compliance Initiatives*. Issues in the challenge area formerly titled *Impact of the Global Economy on Tax Administration* have been incorporated in the *Tax Compliance Initiative* challenge area. The challenge previously titled *Revenue Protection – Minimizing Tax Filing Fraud* has been renamed *Erroneous Payments* to emphasize presidential and congressional concerns in this area.

The TIGTA believes the major management challenges, in order of priority, facing the IRS in FY 2002 are:

- Security of the Internal Revenue Service
  - Employees and Facilities
  - Information Systems
- Systems Modernization of the Internal Revenue Service
- Integrating Performance and Financial Management
  - Performance Management
  - Financial Management
- Processing Returns and Implementing Tax Law Changes During the Tax Filing Season
- Complexity of the Tax Law
- Tax Compliance Initiatives
- Providing Quality Customer Service Operations
- Erroneous Payments
- Taxpayer Protection and Rights
- Human Capital

DISCUSSION

Discussion of the major IRS management challenge areas, including examples of relevant TIGTA audit work, follows.

Security of the Internal Revenue Service

The terrorist attacks on September 11, 2001, and the subsequent anthrax scare highlighted new vulnerabilities in many government agencies. Although the IRS has been security conscious because of the very nature of its work, security of IRS employees, facilities, and information systems is now considered as the number one challenge facing the IRS management for FY 2002.

Security of the Internal Revenue Service – The Employees and the Facilities

Immediately after the tragic events in New York City and Washington, DC, the IRS took steps to safeguard IRS personnel and assets. First, the IRS Security Standards were reviewed and upgraded as necessary. Second, a preliminary risk assessment survey was completed for all 785 IRS offices. The survey results will identify offices that need additional safety measures and help prioritize improvement projects. In addition, extra precautionary measures were implemented for mail and package handling.

Security of the Internal Revenue Service – The Information Systems

Considering the amount and sensitivity of the data the IRS is charged with protecting and the amount of revenue it collects, the IRS is a highly visible target for hackers, disgruntled employees, etc. Access to the Internet and the linking of internal computer systems have greatly increased the risk of loss or theft. Despite the IRS' significant efforts and accomplishments over the past few years, the overall level of security over the IRS' information systems is not yet adequate.

At the Internet gateways, which control external access into the IRS network, firewalls and routers were not upgraded to protect against commonly known weaknesses, configurations were weak, changes to configurations were not documented, activity logs were not generated or reviewed, and sufficient and capable staffing was not assigned to administer the firewalls. Furthermore, the IRS still does not have the capability to detect intrusions at all entry points from the Internet.

Internally, weaknesses with network operating system controls, physical security, and access privileges still exist. Due to the interconnectivity of systems within the IRS, these weaknesses are significant. Unauthorized persons gaining access to a computer in even the smallest post-of-duty can potentially access data in any of the computing centers. The IRS, however, still does not routinely run or review activity logs on network servers to detect potential internal security breaches.

Systems Modernization of the Internal Revenue Service

The IRS Restructuring and Reform Act of 1998 (RRA 98)[1] mandated that the IRS reorganize around groups of taxpayers with similar needs and place a greater emphasis on serving taxpayers and meeting their needs. The success of the IRS' reorganization is dependent upon revising its business processes and implementing new computer systems to better serve the specialized needs of these groups. Given the IRS' past history in modernizing its computer systems, this is a major challenge.

Some of IRS' key goals, such as 80 percent of tax returns being filed electronically by Year 2007 and significantly improving levels of service in answering taxpayer questions, are contingent on the development of new technology. Furthermore, while the development of new technology evolves, existing operations must continue plus improvements must be made to meet the needs of tax administration and to demonstrate to taxpayers the IRS' commitment to improved services.

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

Integrating Performance and Financial Management

Improving performance is an overall goal of the federal government. Furthermore, without accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people.

Performance Management

The IRS management has taken several steps to address the issues concerning implementing the Government Performance and Results Act (GPRA),[2] administering the *Customer Satisfaction Survey* process, and managing the *Annual Program Performance Report* process. The IRS Commissioner designated the Deputy Commissioner and the Chief Financial Officer as responsible for the macro-level GPRA processes and the operating unit executives as responsible for implementing the GPRA in their respective areas. The IRS has made changes to its performance management process to help better define and report on measures and is planning to qualify some data. In addition, the IRS has issued procedures for reporting on the IRS' critical measures, requiring that data and supporting documentation be verified and approved prior to being reported to the Treasury Department.

Financial Management

According to the General Accounting Office's (GAO) report for the FY 2000 audit of the IRS, the IRS continues to face most of the pervasive systems and internal control weaknesses that have been reported each year since GAO began auditing the IRS' financial statements in FY 1992. Despite these weaknesses, in FY 2000 the IRS was able to produce, for the first time, combined financial statements covering its tax custodial and administrative activities that are fairly stated in all material respects. This achievement was the culmination of two years of extraordinary effort on the part of the IRS. The IRS developed compensating processes to work around its serious systems and control weaknesses in order to derive year-end balances for its financial statements. In addition, the IRS addressed several of the management issues raised in previous reports.

Achieving this unqualified opinion relied heavily on costly, time consuming processes, statistical projections, external contractors, substantial adjustments, and monumental human effort. These costly efforts would not have been necessary if the IRS' systems and controls operated effectively. In addition, the absence of effective systems and controls means that the IRS lacks, on an ongoing basis, the

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[2] Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

timely, accurate, and useful information needed to make informed management decisions.[3]

Processing Returns and Implementing Tax Law Changes During the Tax Filing Season

The filing season impacts every American taxpayer and is, therefore, a highly critical program for the IRS. Programs, activities, and resources have to be planned and managed effectively each filing season. During the 2000 Filing Season, the IRS effectively processed paper individual tax returns. Nevertheless, the IRS could have more effectively implemented tax law changes during the 2000 Filing Season for certain program areas, such as the Child Tax Credits, Credits for the Elderly or the Disabled, Child and Dependent Care Credits, Mortgage Interest Credits, and Education Credits.

Furthermore, opportunities still exist for the IRS to more effectively implement tax law changes and process tax returns for business taxpayers. Some examples include ensuring only taxpayers liable for the corporate Alternative Minimum Tax actually pay the tax; ensuring the payment vouchers and tax returns accurately reflect the taxpayer name and identification number, developing controls to increase the accuracy of electronic partnership returns, identifying incorrectly filed Personal Service Corporation Income Tax Returns, and simplifying the estimated tax penalty computation.

Complexity of the Tax Law

Tax law complexity is the highest-ranking problem individual and business taxpayers had with the IRS, according to the *FY 2000 Taxpayer Advocate's Annual Report to the Congress*. The Advocate also identified tax law complexity as the root cause of many of the other problems on the Top 20 list, including clarity and tone of IRS communications, inability to access the toll-free number, compliance burden on small businesses, administration of the Earned Income Credit (EIC), lack of one-stop service, penalty administration, understanding federal tax deposits, and divorced and separated taxpayers issues.

In its *FY 2001 Annual Report to Congress*, the National Taxpayer Advocate takes tax law simplification a step further, focusing on key legislative proposals that create a more burdensome and confusing voluntary tax system for even the most compliant taxpayers. The report outlines proposals to simplify or clarify six areas of tax law – family status issues, joint and several liability, alternative minimum tax for individuals, penalty and interest issues, home-based service workers, and IRS collection procedures. It also lists additional legislative issues, as well as some potential legislative issues, that merit further consideration.

[3] *United States General Accounting Office Report to the Secretary of the Treasury – IRS' Fiscal Year 2000 Financial Statements*, March 2001.

The Joint Committee staff identified some causes of complexity: 1) a lack of clarity and readability of the law; 2) the use of the Federal tax system to advance social and economic policies; 3) increased complexity in the economy; and 4) the interaction of Federal tax laws with State laws, other Federal laws and standards (such as Federal securities laws, Federal labor laws and generally accepted accounting principles), the laws of foreign countries, and tax treaties. In addition, the lack of clarity and readability of the law results from 1) statutory language that is, in some cases, overly technical and, in other cases, overly vague; 2) too much or too little guidance with respect to certain issues; 3) the use of temporary provisions; 4) frequent changes in the law; 5) broad grants of regulatory authority; 6) judicial interpretation of statutory and regulatory language; and 7) the effects of the Congressional budget process.

Tax Compliance Initiatives

The IRS' goal of providing world-class service to taxpayers hinges on the theory that, if the IRS provides the right mix of education, support, and up-front problem solving to taxpayers, the overall rate of voluntary compliance with the tax laws will increase. The challenge to the IRS management is to establish a tax compliance program (examining tax returns and collecting tax liabilities) that identifies those citizens who do not meet their tax obligations, either by not paying the correct amount of tax or not filing proper tax returns.

During the last decade, the number of tax returns selected for examination by the IRS has decreased, while the number of tax returns filed by taxpayers has increased. Additionally, revenue receipts processed by the IRS increased from $1.5 trillion in FY 1996 to $1.9 trillion in FY 2000. However, revenue collected as a result of compliance activity decreased by $5 billion and gross accounts receivable increased by $41 billion during the same period. Decreases in the examination rate can be partially attributed to fewer revenue agents and tax auditors, a decline in direct examination time, and an increase in time per return by revenue agents. Decreased enforcement has been attributed to reduced resources allocated to compliance activities and IRS employees' concerns over the mandatory employment termination provision in Section 1203 of RRA 98.

Providing Quality Customer Service Operations

Providing top quality service to every taxpayer in every transaction is integral to the IRS' modernization plans. There are many ways in which the IRS provides customer service. The most direct include toll-free telephone service, electronic customer service, written communications to taxpayers, walk-in service, and accurate and timely tax refunds. Each of these services affects a taxpayer's ability and desire to voluntarily comply with the tax laws. Providing these services in a high-quality manner can also be a challenge to the IRS.

Quality service at IRS Taxpayer Assistance Centers (TAC) continues to be a major concern. Both an IRS study conducted during the 2000 Filing Season and a TIGTA audit conducted during the 2001 Filing Season reported low accuracy rates on tax law questions answered by a sampling of IRS assistors. In addition, TIGTA auditors, who posed as walk-in taxpayers, were not provided correct or sufficient answers 73 percent of the time, and, in some instances, were treated with discourtesy or had excessive wait time. Audit test calls to the Spanish language option on the IRS' toll-free telephone helpline identified a need for improvement in the quality of responses being provided to Spanish-speaking taxpayers asking tax law questions.

Internet technology affords the IRS many opportunities to dramatically improve customer service, and the IRS has made strides in using these technologies. An IRS web site that provides taxpayers with convenient access to tax forms and information received over one billion accesses during this past filing season alone. However, inadequate systems design and planning have hindered other efforts. For example, to better serve customers and relieve some of the call volumes from the toll-free system, the IRS has been planning, since 1996, to implement an Internet-based refund status application. This application is now scheduled to be available to taxpayers by the beginning of the 2002 filing season.

Erroneous Payments

Both the President and the Congress have expressed concerns with the large amount of erroneous payments made by Federal agencies. Improper payments include inadvertent errors; payments for unsupported or inadequately supported claims; payments for services not rendered; payments to ineligible beneficiaries; and payments resulting from outright fraud and abuse by program participants and/or federal employees. Stewardship responsibility over public funds is a major challenge facing IRS management.

The EIC Program continues to be a highly visible area of potential fraud. To combat potential EIC fraud, the IRS launched promising new compliance initiatives. For example, partnerships with the Department of Health and Human Services and the Social Security Administration will permit the IRS to crosscheck information on the child and the taxpayer. However, despite extensive IRS programs and efforts to address certain refund schemes, relatively little effort has been made to systematically identify those schemes involving business returns and associated credits. While a few business schemes have been identified, it has generally been through labor-intensive manual procedures. The IRS is concerned that fraudulent refund claims may be expanding to include business returns, and that scheme perpetrators may be using the Internet or other means to promote and advertise their schemes.

Taxpayer Protection and Rights

The RRA 98, which was signed into law on July 22, 1998, contains 71 provisions that increase or help protect taxpayers' rights. The IRS is now fully compliant with three provisions, i.e., *Mitigation of the Failure to Deposit Penalty (RRA § 3304(a)), Seizure of Property (RRA §§ 3401(b) and 3421),* and *Notice of Levy (RRA 98 § 3401(b)).* For another seven provisions, the IRS is taking additional corrective actions to increase compliance. However, the IRS did not fully comply with two of the RRA 98 provisions because of delays and other implementation problems. Additional actions are needed to implement these provisions: *Dual Notices for Joint Filers (RRA 98 § 3201)* and *Collection Statute Extensions (RRA 98 §§ 3461(a) and (c)).* An extension of the implementation deadline had been requested or the compliance could not be fully evaluated on another six provisions.

Additionally, the IRS Commissioner has expressed, before the Congress, concerns about treating taxpayers fairly. The IRS has indicated to the Congress its commitment to treat all taxpayers equitably, and strategic plans indicate equitable treatment of taxpayers is included in efforts to promote compliance among business taxpayers. However, the TIGTA is concerned about possible inequities between the different taxpayer groups. For example: the Wage and Investment Income (W&I) Division characterizes its taxpayers as highly compliant, which it attributes to its document-matching program. Conversely, the Small Business/Self-Employed (SB/SE) Division acknowledges that the largest part of the tax gap is attributed to the taxpayers it serves. Business income, however, is not subject to similar matching programs.

Human Capital

Like many other government agencies, the IRS faces a range of serious personnel management issues, ranging from recruiting, training, and retaining employees to problems associated with the IRS' recent reorganization and modernization efforts. During FY 2001, the IRS struggled with a continuing need to properly staff, train, and provide adequate tools for employees. In some cases, such as the lack of resources for visually impaired telephone assistors, the IRS was at risk of civil suits.

Retention of a qualified work force continues to be a challenge for the IRS, particularly the Large and Mid-size Business (LMSB) and SB/SE Divisions. During the recent reorganization, much of the experienced staff were assigned to these divisions, and many of these employees will be eligible for retirement within the next five or six years. Both the LMSB and SB/SE Divisions have taken various steps to establish a human capital plan. The LMSB Division developed an accelerated skill attainment program, a coaching/mentoring implementation plan, and an innovative recognition program. The SB/SE Division developed a learning and education organization blueprint and conducted career path reviews.

Discussion of the issue removed from the major IRS management challenge areas follows.

Modernization of the Internal Revenue Service – Organizational Restructuring

On October 1, 2000, IRS achieved the first milestone toward modernization by implementing its new organizational structure. The four major components of the new IRS – the W&I, the SB/SE, the LMSB, and the Tax Exempt and Government Entities (TE/GE) Division – substantially completed the critical elements needed for standing up. Specifically, most key management positions were filled, most employees had been realigned, finance offices and budgets were established, many delegations of authority were revised, and detailed plans of workarounds[4] were developed. In addition to the four major business units, other key IRS offices, such as the Criminal Investigation function, the Taxpayer Advocate Service, and the Appeals function, also successfully implemented a new structure. Therefore, the TIGTA believes that the organizational restructuring is complete but, to be effective, new business processes and computer systems need to be implemented. The new processes and systems implementation will be examined under the other challenge area.

The complete document reflecting the TIGTA's comprehensive analysis of the major management challenges facing the IRS in Fiscal Year 2002 can be viewed at the following Internet address: http://208.45.140.254/tigta/fy2002-challenges-jpa-rev010902.doc

[4] Temporary solution to a problem that allows a new organization to be operational until a final solution can be developed and implemented.

Mr. HORN. Our last presenter is Nina E. Olson, the National Taxpayer Advocate, Internal Revenue Service. You might give us a little summary of what the National Taxpayer Advocate does.

Ms. OLSON. Thank you. Mr. Chairman and members of the committee, thank you for inviting me to appear before you today.

Management and performance improvements are central to the Service's ability to fairly administer the tax law and thus are of concern to the National Taxpayer Advocate. In our 2001 annual report to Congress, we identified the top 23 taxpayer problems and reasons taxpayers sought assistance from the Taxpayer Advocate Service, or TAS, in fiscal year 2001. Each of these areas cry out for management and performance improvements. In many of them, the IRS already has improvement initiatives well under way and is monitoring performance on a continuing basis. In many areas, the IRS is working with TAS to learn from our experiences and our cases. In some areas, I do not believe change is happening quickly enough; and taxpayer patience is sorely being tried.

I believe this is the case with the Offer in Compromise program, which ranked in both of our 2001 top 20 lists. Taxpayer problems included denials, delays in processing, and IRS requests for updated information.

The current growth in the program and the resulting inventory backlog forces IRS management into a reactive mode and diverts our collection resources away from more productive work. However, program improvement is not just about clearing out backlogs or processing cases faster. We must respect taxpayer rights in the process of doing so. Particularly when a program is operating under pressure, the momentum is there to go for a fix. TAS is sometimes the sole voice saying you can't do that, your proposal will have these consequences. The voice that makes all the planners stop and say oh, right.

Since coming on board the IRS, I have asked my colleagues to include representatives of my office on task forces, design teams and project teams, undertaking program improvements, particularly in the compliance area. These efforts have been met with mixed success, but we are working on it. Our efforts will be discussed in detail in my upcoming 2003 objectives report to Congress due on June 30.

I am pleased to report that TAS was invited to join the current team that is studying the collection contract support feasibility analysis. Inclusion makes sense, since TAS watches out for the delicate balance between taxpayer rights and taxpayer compliance. Nowhere is this balance more difficult to achieve than in the area of collection contract support.

As the National Taxpayer Advocate, I have concerns about using private contractors to collect government tax debt, including issues relating to taxpayer privacy, due process and access to dispute resolution including the Taxpayer Advocate Service. The power to assess and collect Federal taxes is constitutionally prescribed. Thus, tax collection is an inherently governmental function. Federal tax collection is intimately related to the public interest and the public trust. Any delegation of this authority to private parties must be sufficiently circumscribed so as to ensure that this exercise of government power is neither arbitrary, discretionary nor without procedural safeguards and the appropriate level of agency oversight.

The responsibility and accountability for the collection of Federal taxes must remain with the IRS. To this end, the IRS must maintain control on its internal systems of any case sent out to a contractor so that it has continued oversight of the cases. The taxpayer must be afforded all legal rights due him or her under the Internal Revenue Code and in accordance with IRS policies and procedures. This consideration alone may prove to limit private collection contractors' successes.

Few State and private creditors are subject to the significant due process protections enjoyed by Federal taxpayers in the post RRA 98 era. My own personal experience with private contractors attempting to collect State tax debt has not been positive. In my former tax practice which included a large number of collection cases, I continually struggled with private collection employees of different skill levels and expertise. It was difficult to get a case out of the hands of the collection agency and back into the tax authority for issue resolution.

Many of my cases involved low-income taxpayers who were not represented when they negotiated payment arrangements with the private agencies. Contractors resisted revising inappropriate collection terms and agreements. I am, however, trying to keep an open mind on this issue, since I am very concerned about the current level of collections and the limited IRS resources available for the future collection of tax. It is clear that the Service must not only articulate a comprehensive philosophy of tax collection, but we must also work smarter with respect to such collections.

I am impressed with the approach that the feasibility study is taking; and I am pleased that, through Taxpayer Advocate Service participation, our concerns will be addressed upfront as part of the study rather than after the fact.

Mr. Chairman, thank you for providing me the opportunity to discuss my concerns with you today.

Mr. HORN. Thank you.

[The prepared statement of Ms. Olson follows:]

Statement of

The State of the Internal Revenue Service: Progress in Addressing Management and Performance Issues

Nina E. Olson

National Taxpayer Advocate

Before the

House of Representatives Committee on Government Reform Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations

April 15, 2002

IRS Department of the Treasury
Internal Revenue Service
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Taxpayer Advocate Service

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

Before the
House of Representatives
Committee on Government Reform
Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations

15 April 2002

Mr. Chairman and members of the committee, thank you for inviting me here today to testify about the Internal Revenue Service's progress in addressing management and performance issues. As this is my first appearance before this subcommittee, I would like to begin my remarks by focusing on the role of the National Taxpayer Advocate and the Taxpayer Advocate Service in achieving management and performance improvements within the IRS.

As you know, the Taxpayer Advocate Service serves as an advocate for taxpayers, to help them resolve their problems with the IRS in an independent, impartial, and confidential manner. We are also charged, by statute, with identifying systemic taxpayer problems and making administrative and legislative recommendations for mitigating those problems.

The systemic problem solving function of the Taxpayer Advocate Service leads to fairness and improved administration of the tax system. However, the process of advocacy can slow down an organization's efforts to bring about procedural and program improvements. An effective advocate will raise difficult issues that might be easily overlooked in the rush toward implementing apparent systemic improvements.

Congress has determined that the Taxpayer Advocate Service (TAS) should be an independent entity within the IRS rather than an agency outside of the IRS. Taxpayer Advocate Service employees report directly up to the National Taxpayer Advocate who in turn reports directly to the Commissioner. This arrangement enables TAS employees to have ready access to IRS planning and processes while protecting these employees from potential conflicts of interest and pressures from their co-workers.

This arrangement is not without problems, however. Unless the National Taxpayer Advocate receives the strong support of management, this position would flounder and be marginalized. In an organization the size of the IRS it is extraordinarily difficult to figure out what is going on in one operating division, much less all of them. And yet, advocates must literally learn the organization from top to bottom and keep on top of the agency's initiatives in order to meet their statutory mission.

I am pleased to report that since joining the Internal Revenue Service in March of 2001, I have enjoyed the unqualified support of Commissioner Rossotti. Even when the Commissioner and I "agree to disagree" about an issue, there has never been any question about the value of and necessity for the National Taxpayer Advocate's independent judgement, her access to information, or her participation in decision-making. The Commissioner's support has led to an institutional understanding of the role of the National Taxpayer Advocate in tax administration and an acceptance, albeit grudging at times, on the part of my fellow employees, that the Advocate's advocacy and intervention are not meant to be obstacles but rather milestones for systemic improvements.

When I joined the IRS a little over a year ago, I was immediately thrown into the Strategic Planning and Budget (SPB) process instituted by the Commissioner. This process is clearly the lynchpin for any IRS management and performance improvement. During the Strategic Assessment phase of the SPB cycle for a given fiscal year, each IRS operating and functional unit must identify trends, issues, and problems affecting their activities; develop a strategy for addressing those trends, issues, and problems; propose operational priorities that will achieve that strategy; and identify specific improvement projects that will facilitate the implementation of the operational priorities. The Strategic Assessment in turn drives the Commissioner's allocation of resources and budget request. It also provides the basis for measuring and evaluating the Service's performance during that fiscal year.

The Strategic Assessment process forces the IRS senior leadership team to come together over a period of weeks to examine what each of us is proposing to accomplish with our limited resources. To my knowledge, it is the only time during any given fiscal year when the IRS senior leadership learns, in a concentrated and comprehensive fashion, what the IRS is doing as a whole organization. The Strategic Assessment process imposes a discipline on the senior leadership team to truly think as "one IRS." It requires the senior leadership to think outside of the confines of each leader's own programs and to see the interrelationships among all IRS programs. It provides the framework for sustaining "cross-functional" communication throughout the rest of the year.

The Strategic Assessment process provides the National Taxpayer Advocate with an overview of the Service's proposed activities and enables her to identify issues that potentially could create problems for taxpayers or that could benefit from the Taxpayer Advocate Service's participation or scrutiny. The Strategic Assessment process also provides the Advocate with the opportunity to discuss her operating priorities. The Taxpayer Advocate Service's operating priorities are dependent, to a large extent, on the plans and actions of the rest of the IRS. During the Strategic Assessment meetings, each IRS operating and functional unit can comment on other units' assessments. Thus, I am able to point out how one unit's proposed plans will increase TAS workload; I can also identify issues and programs that should be coordinated with TAS because they coincide with our own initiatives in those areas.

One such initiative involves a reduction in a certain type of case coming in to the Taxpayer Advocate Service. Over the last year, the Taxpayer Advocate Service has developed an analysis of its casework by business operating division – Wage and Investment, Small Business/Self-Employed, Tax Exempt and Government Entities, and Large and Mid-Sized Business. We are now providing the four operating divisions with regular reports about the types of taxpayer cases that are accepted into TAS, the reasons for their acceptance, and the actions TAS takes on these cases.

The Taxpayer Advocate Service developed these reports after a study of our Fiscal Year 2000 case receipts indicated that eighty-six percent (86 %) of TAS case receipts qualified for our intervention because of IRS operational delays or failures in resolving the problem. This figure indicates that a significant portion of TAS casework could be prevented by providing better service to the taxpayer at the first point of contact.

During last year's Strategic Assessment meetings, I identified the need to work with IRS Operating Divisions on strategies to reduce inappropriate TAS workload as one of the Taxpayer Advocate Service's Major Strategies. Over the course of the past year, my employees and I have met with operating division executives and analysts to review the sources of TAS casework and to examine the underlying causes for TAS referrals. I have encouraged my counterparts in the operating and functional units to include representatives from TAS in their own program planning teams, with regard to both workload planning and initiative development. I have emphasized that all of these activities have a downstream effect on TAS cases and that it is much better to receive the benefit of our experience during the planning phase than to have us come in saying "If you'd only asked…." during post-implementation evaluations. Many of my peers have been receptive and responsive to our overtures, particularly in the area of Earned Income Tax Credit initiatives and the Offer in Compromise program.

During the current Strategic Assessment process, a number of the business units noted their partnership with TAS in exploring the causes for taxpayer problems or in planning compliance initiatives. To the Commissioner's credit, he asked the Operating Divisions to develop a separate operational priority to work with TAS to identify the underlying causes for TAS casework and to reduce the number of "overflow" referrals. Thus, TAS is now incorporated into the Operating Divisions' strategic plans. This arrangement provides us with a mechanism to impact management, performance, and policy issues and requires the Operating Divisions to report and be evaluated on their partnering with TAS.

It remains to be seen whether the Service will make significant progress toward reducing TAS receipts of overflow cases. All too often I hear the TAS caseload referred to by the rest of the IRS as "TAS cases", as if TAS had created them out of whole cloth. As noted earlier, eighty-six percent of the Taxpayer Advocate Service caseload comes to TAS because IRS processes failed to timely respond to the taxpayer, even after several contacts, or failed to do something the Service promised to do.

The IRS cannot reduce the number of TAS "overflow" cases simply by not referring them to TAS. If taxpayers meet the criteria of significant hardship outlined in Internal Revenue Code section 7811 and the matter cannot be resolved at the point of contact, the case should be referred to TAS. A real reduction in TAS overflow inventory will reflect an allocation of resources to avoid or resolve problems up front; realistic projections of work plans and adequate staffing; real time analyses of problems in programs and processes and quick responses when problems are identified; and continued modernization of our business systems. TAS case receipts are as much a measure of the Service's commitment to customer service and improved performance as is its ability to collect taxes and process returns.

There have been times during the past year when TAS has had to ask more than twice to be included in an IRS initiative, team, or task force. Not all of this resistance to TAS participation is intentional. It is not always obvious that TAS has a role to play in certain areas. I believe it is appropriate for IRS operating and functional units to question our requests when the connection is not clear to them. However, once TAS makes the case for our involvement in the initiative, our inclusion not only makes good business sense, but is consistent with the statutorily defined function of this office.

I would like to give you an example of how the Taxpayer Advocate Service's important role in systemic improvement is furthered through its involvement in the Strategic Assessment process. Last year, during the Strategic Assessment process, I learned of an initiative that is of great interest to this subcommittee – the Service's application of the federal payment levy program to social security benefits paid to persons who owe federal tax debts. As you know, these levies are authorized under the Taxpayer Relief Act of 1997 (P.L. 105-34) and Internal Revenue Code section 6331(h).

Immediately following a program briefing, I raised certain concerns with Commissioner Rossotti. The Commissioner declared a moratorium on the program until these issues were addressed. As a result of the Commissioner's intervention, the IRS developed a process to exempt certain low income social security recipients from the levy. The IRS also designed a communication campaign about the impending levies that focuses on the most vulnerable population of social security recipients – those in nursing homes, adult care residences, or under guardianship or similar arrangements. Although the program start was delayed three months to resolve these issues, the program is now designed to collect only from those social security recipients who can truly afford to pay. The program can now accomplish its objectives without causing unnecessary harm to taxpayers. This is what good tax administration and management is all about.

The lessons of the Social Security benefits issue and the federal payment levy program have encouraged some program planners to seek out the Taxpayer Advocate Service's perspective. For example, I recently received a briefing on the Internal Revenue Service's Collection Contract Support Feasibility Analysis, a sub-team of the Filing and Payment Compliance Modernization Initiative. The Taxpayer Advocate Service is currently represented on this sub-team by a supervisory analyst with a collection background.

The office of the National Taxpayer Advocate has a significant role to play in the development of IRS collection strategy. This office deals routinely with cases where the delicate balance between taxpayer rights and taxpayer compliance is askew. The Taxpayer Advocate Service watches out for this balance not only in individual cases brought to it by taxpayers but also with respect to systemic issues and policies that affect groups of taxpayers. Nowhere is this balance more difficult to achieve than in the area of collection contract support.

When discussing the use of private contractors to collect government tax debt, I must first acknowledge my concerns, which are born of experience. As a tax professional whose casework consisted of a majority of collection matters, I have had ample experience with private agencies attempting to collect state tax debt. I offer the following observations that are born of this experience.

- Collection agents' skills differ greatly within and between contractors.
- Depending on the terms of the contractor's compensation, taxpayers and their representatives experience difficulty when seeking case resolution through methods other than collection. That is, under certain contractual arrangements, if a taxpayer raises a question regarding the underlying liability, the taxpayer may encounter resistance and at times outright refusal to forward the case back to the tax agency for review and consideration.
- The contractor's success with collecting tax is dependent on the state's statutory tax collection authority, its taxpayer rights protections, the guidance, training, and oversight of contractors, and the existence of a system to refer appropriate cases to the state tax agency for resolution.
- Contractors convinced unrepresented low income taxpayers to enter into unreasonable collection arrangements. As a representative coming in to the case after these arrangements fell through, I found it very difficult to work with contractors to revise inappropriate collection terms and agreements.

Having identified these concerns, I am trying to keep an open mind on this issue, since I am very concerned about the current level of collections and the limited IRS resources available for the future collection of tax. It is clear that we must not only articulate a comprehensive philosophy of tax collection but we must also work smarter with respect to such collections.

I am intrigued by an approach currently being explored by the Small Business/Self Employed Operating Division Filing and Payment Compliance Project Team that involves decision analytics and risk-based scoring of taxpayer collection accounts. Scores are developed on the basis of third party and internal information that will enable the Service to assess a taxpayer's ability to pay, credit worthiness, and other factors. Each business unit can then develop rules based on these scores to identify the most effective collection treatment for particular groups of taxpayers. Some taxpayers may best respond to notices, some to telephone contact and systemic collection activities. Others will respond best to contact in person. Still others may be appropriate for referral to a private contractor under a private contract support agreement.

Internally, the IRS is developing an inventory management system, whereby a case is assigned to be worked under the best treatment method available for that case.

Further, the Service is moving toward a system in which each case is actually worked. That is, a determination will be made in each case as to what is the best way to address the tax debt; these treatment streams will encompass the whole of the Service's collection alternatives, including offer in compromise and currently not collectible status. In this context, collection contract support would not supplant IRS collection personnel but would expand current IRS capacity to work cases. Over time, collection contract support would be self-sustaining, similar to the Department of Education's student loan collection program.

There are, of course, significant concerns regarding the scope of the authority to be accorded to private contractors, issues related to taxpayer privacy, due process, and access to dispute resolution, including Taxpayer Advocate Service referrals. As the power to assess and collect federal taxes is constitutionally prescribed, tax collection is an inherently governmental function. Federal tax collection is intimately related to the public interest and the public trust, and as such any delegation of this authority to private parties must be sufficiently circumscribed so as to ensure that this exercise of government power is neither arbitrary, discretionary, nor without procedural safeguards and the appropriate level of agency oversight. The responsibility and accountability for the collection of federal taxes must remain with the IRS. To this end, the IRS must maintain control on its internal systems of any case sent out to a contractor so that it has continued oversight of the cases. The taxpayer must be afforded all legal rights due him or her under the Internal Revenue Code and in accordance with IRS policies and procedures. This consideration alone may prove to limit private collection contractors' successes. Few state and private creditors are subject to the significant due process protections enjoyed by federal taxpayers in the post-Restructuring and Reform Act of 1998 era.

Contractor compensation arrangements must be structured in such a way as to encourage adherence to taxpayer rights provisions. Cases must be selected for placement with these contractors in such a way as to minimize the need to refer the case back to the IRS for resolution. However, if such a referral is appropriate, procedures must provide for an easy and expedited referral. All contractors must be trained to recognize taxpayers who are eligible for assistance from the Taxpayer Advocate Service and must understand and implement the procedures for making such referrals.

There are at least three other considerations that must be addressed before the Service undertakes any attempt to supplement its collection efforts with private contract support. First, the Service must develop balanced measures for the performance of these contracts, similar to those applied to IRS collection personnel. Second, the Service must address the application of Internal Revenue Code sections 1204 and 1203(b)(6) to contract employees. Third, while effective case resolution may depend on the contractors' ability to access basic taxpayer information from the IRS and to deliver taxpayer information to the IRS, we must ensure that this access is limited to only that information which is necessary to the collection of tax within the agreed scope of the contractor's services. We must also determine what recourse, if any, taxpayers have against the contractor if taxpayer privacy and confidentiality is violated.

I hope I have demonstrated, with the preceding discussion, that the Taxpayer Advocate Service has an important role in improving the management and performance of the IRS. Our effectiveness, however, rests on the shoulders of the IRS Operating and Functional units and their willingness to work in partnership with TAS. The Taxpayer Advocate Service's ability to bring about administrative and procedural changes in the IRS is enhanced by active support from the Commissioner. On the other hand, I believe our ability to serve as a change agent would be impaired if TAS were outside the IRS.

Mr. Chairman, thank you for this opportunity to come before this subcommittee and discuss these matters.

Mr. HORN. We will now start the questioning, and I'm going to yield 5 minutes to the distinguished Mrs. Norton, the Delegate to the Congress from the District of Columbia. Five minutes, and then I will do five, she'll do five, so forth.

Ms. NORTON. Thank you very much, Mr. Chairman.

Mr. Rossotti, I want to thank you for your responsiveness to me and to the residents of District of Columbia when we had difficulties with the $5,000 home buyer credit and we got all kinds of protest calls because this Congress has given the District this D.C.-only tax credit to make sure that we make up for the loss of population, the fact that we can't tax people who come here. You were immediately responsive; and that, of course, had to do with the AMT, alternative minimum tax.

You are, of course, aware that the 600,000 people who live in the Nation's capital pay Federal income taxes and have only me in the House, no Senators. I vote in this committee and in all the committees on which I serve. I do not vote on the House floor. Increasingly, my constituents obediently file their income tax returns but file them under protest. I'm asking you whether or not a taxpayer who files under protest is more likely to be subject to an audit.

Commissioner ROSSOTTI. Well, I think that what we look at is not sort of what somebody's thinking is but what they actually do in filing their returns. So as long as someone files a return and pays the taxes that are due, you know, that's really the only concern we have. I mean, the political debate about the Tax Code is part of our democracy; and, you know, we certainly understand that.

Ms. NORTON. Well, all the evidence does seem to point in that direction. I have filed my taxes under protest for the last several years and have always gotten something back from the IRS. At least——

Commissioner ROSSOTTI. I'm glad to hear that.

Ms. NORTON [continuing]. I'm not being punished for it.

I'd like to ask you about staffing. Ten years ago, the IRS had about 120,000, more or less. Today, it has about 100,000, more or less. This committee, the full committee, the Government Reform Committee, has had a joint hearing with the Governmental Affairs Committee of the Senate, the comparable committee. Actually, Senator Voinovich was chair of the committee at that time of those hearings. They were called because half of civil servants apparently throughout the government now could either retire on early retirement or could retire. So there is great concern, bipartisan concern in the government now that, after all the downsizing, we ought to do something to make sure we don't prematurely lose people with special expertise.

I don't need to tell you about the new technology deficit expertise we have. Is the IRS facing particular problems with staffing at a time when government work has not seemed to be as sexy, if you'll forgive the expression, as going to other kinds of employment, especially in private business?

Commissioner ROSSOTTI. I think the answer—the short answer to that is absolutely yes. But I think it comes in two categories, if I could say them. One category just has to do with the total level of staffing, which is driven by our budget. Seventy percent of our budget supports salaries and budgets. That's basically the only two things we have in the IRS, are people and computers. They both are necessary.

The staffing by far is the biggest cost; and because of budget limitations over the last, say, 10 years, actually, it goes back a long time, there's been a steady erosion of the staffing. You're quite right. The staffing is about 15,000 staff years less than it was in the early 1990's. You know, at the same time, we've continued to have increased numbers of returns filed. So, just from a pure numbers standpoint, it has gone down.

Then the other point is where it has gone down, and I think the other part of your point is the skills of specific people. Unfortunately, where it's gone down the most is where it had to because most of the people were in our compliance operations. Our skilled accountants, our skilled collectors, our tax auditors are people that really understand the issues that come up when people don't necessarily report correctly and so forth.

The reason that has gone down the most is because that's where most of the money is in the IRS budget, and it's also the place where you have some limited discretion on a year-to-year basis. I mean, essentially, the people who are in the back office processing the returns, we have to process the returns. If you sent in your return and you didn't get your refund back or your constituents didn't, that would be—that would be impossible. So, as the total goes down, the only place you can really take it out of is in things like where you're doing auditing and collections.

Then looking forward finally to the future, we do have to point that the skill levels, the skilled people are the ones that are hardest to replace.

Now, having said all that background, let me say that beginning of 2001, we did come in—fiscal 2001, we did come into the Congress and request some funds to begin to turn around in a very slight way the staffing. We did get some of that funding, and we have, as a result, in the last year begun to go out into the market and hire accountants and skilled people for the first time in 6 years. I mean, for about 6 years it was essentially no hiring of any kind for permanent staff.

And I'm pleased to say that the results of that were very good. I mean, we may have been fortunate in the timing of the economy in that, you know, the economy was weaker relatively than it was in previous years, and we have done a lot of innovative things to make it clear that it really is an attractive opportunity to come and work for the IRS. We have very important work to do.

We have drastically revamped our training programs for new employees. We have improved some of the tools. Even though the technology's old, some of the at least personal tools the we give to employees has improved; and we got some very, very good people last year.

What is important, however, is that we continue this, because it's not a one-shot deal. We have to hire people every year. We hope that we will get the funding in 2003 that will allow us to hire; and if you note on the chart—I think you have the chart in front of you—we put—that showed the program. What we are trying to do is to hire especially in the compliance area and offset that with some efficiency improvements.

So, basically, my view is that we absolutely must vary the operational funds as well as the modernization funds to at least incrementally hire the skilled people we need, especially for the compliance functions. This is complementary to our modernization effort, not in lieu of it, and without that some of the negative trends that were noted in the chairman's opening statement will not be reversed or at least they will not be reversed fast enough.

Ms. NORTON. My time has expired, Mr. Chairman.

Mr. HORN. Thank you very much.

Let me ask Mr. Brostek on my 5 minutes, people often consider the management challenges you described as the technical sort of green eye shade issues that have no real consequences. Can you provide some examples of how the management problems at IRS directly affect the average American taxpayer?

Mr. BROSTEK. Yes, Mr. Chairman. Some of the performance shortfalls that myself and other witnesses described today I think are attributable at least in part to the need to tighten up some management processes. For instance, we heard about the number of people who receive incorrect answers to their questions. We know that there are a number of people who try to get through to IRS and have difficulty doing that. The level of performance there has been increasing, but it's not yet to the world-class standards that IRS would like to achieve. Those are the types of performance shortfalls that directly affect taxpayers.

Mr. HORN. You point out that the IRS is not pursuing about $12 billion in tax delinquencies because of resource limitations. Do you believe that the Internal Revenue Service should take the necessary steps to use the private sector resources to pursue those debts?

Mr. BROSTEK. Well, first, Mr. Chairman, let me say that resource limitations play a role in that. There are also again management questions that come into play. The efficiency with which the resources are used is an important factor as well, and we have noticed a decline in the productivity of the collections staff.

On the other hand, yes, it's always prudent to consider all the options that are available for improving the efficiency of an organization; and to the extent that private debt collection might offer that as an opportunity, it's a reasonable thing to consider.

Mr. HORN. The General Accounting Office, as you know, has done a number of debt collection practices by various Federal agencies, including the use of the private collection agencies. Do you believe the most Federal agencies have benefited from using private collection agencies and are you aware of any abusive practices by the private firms in pursuing Federal debts?

Mr. BROSTEK. Unfortunately, Mr. Chairman, I'm not knowledgeable enough about the range of work that we've done to give you a definitive answer to that question.

Mr. HORN. When we had that situation 5, 6 years ago—and this was before Commissioner Rossotti's time—they had a phony operation is what they were. They had 5 years where nothing had happened while you and I and everybody in this room pay their taxes and they let them get away with it, these people that are simply doing everything in the works to not pay their taxes. I think that's an outrage, and I think anybody that doesn't want private collectors, they'd better tell me a better way to do it.

Because Mr. and Mrs. Average citizen—and I'm one of them. I pay my taxes, and that's what started me on this whole thing—Mrs. Maloney and I back in 1996 where we went after debt that nobody was doing anything about, and they had $100 billion sitting there before Commissioner Rossotti got there. I just think, Ms. Olson, I disagree with you; and I think it's an outrage that we don't do that; and I think you've got a very good group. Laguna Niguel is an ombudsman role, but I would suggest that you're not doing the public interest any good when you're letting scoundrels go at bay. So that's so much for that.

Let's go back to another one. Mr. Brostek, do you have any data in the General Accounting Office that most Federal agencies have benefited from using private collection agencies? Mr. Rubin—or Secretary Rubin really knew what he was doing when he was Treasury Secretary. He asked every single agency he could find to send that debt over to the Treasury, and we made some progress as a result of that.

Mr. BROSTEK. Again, unfortunately, I'm not prepared to comment on the breadth of the GAO's work on this. My understanding is that we've had some mixed experiences with private debt collection but I can get back to you with more details on that.

Mr. HORN. OK. That's fine.

[The information referred to follows:]

Do you believe that most federal agencies have benefited from using private debt collection agencies and are you aware of any abusive practices by the private firms in pursuing federal debts?

Although we have reviewed various aspects of several federal agencies' use of private debt collection agencies, those reviews generally have not assessed how well private debt collection agencies have performed in collecting debt. Therefore, although private debt collection agencies have collected some debt on behalf of federal agencies, we do not know how efficiently or effectively they have performed the service. For example, private agencies collect some of the debts that federal agencies refer to the Financial Management Service (FMS) in the Department of the Treasury for collection. Data as of March 2002 indicate that private collection agencies have collected about $76 million of the $155 million in debt that has been collected under these referrals to FMS since the program's inception. However, we have not assessed how well private collection agencies perform this function for FMS.

In one instance, Civil Debt Collection: Justice's Private Counsel Pilot Program Should Be Expanded (GAO/GGD-94-195), we did assess the overall results of a statutorily required pilot program of debt collection. That program was intended to determine whether private counsel debt collection could (1) reduce U.S. Attorney offices' civil case backlogs and (2) cost-effectively collect delinquent nontax civil debt. We found that the program was generally successful and we believed that private counsel firms were cost effective in collecting nontax civil debt. Due to a number of issues concerning such things as differences among the size of cases and in how costs were measured, we were unable to reach unambiguous conclusions about the relative efficiency of U.S. Attorney offices and private counsel firms in collecting delinquent civil nontax debt.

We have not reviewed whether private debt collection agencies have engaged in abusive practices in pursuing federal debts and thus do not have any relevant audit work on whether abuses have occurred. GAO officials involved in reviews of private debt collection by federal agencies indicate that no abuses have come to their attention in connection with the work they have done.

Mr. HORN. Well, my time has expired. I will now give Ms. Norton 5 more minutes.

Ms. NORTON. Thank you very much, Mr. Chairman.

Mr. Rossotti, or whoever among you is best qualified to answer this question, we are all aware that audits by the IRS increased very little, and the increase was among low-income taxpayers who file the simplest returns. Taxpayers with incomes of more than $100,000 apparently had their rates of auditing lowered rather substantially.

Now, as I understand it, the return to the IRS from an audit of a lower-income taxpayer is $2,577, compared to $4,567 for a high-income taxpayer. My question is, has this large change in who gets audited had a notable effect on decrease in revenue and what is that effect?

Commissioner ROSSOTTI. Yes.

Ms. NORTON. What is that effect?

Commissioner ROSSOTTI. On revenue. There has been since 1997 with the decline in audits—there has been some decline in what's called enforcement revenue, which is the amount that's collected from specific enforcement action by the IRS. That did turn around last year. It did level off last year, which was our goal. It was about level in 1990—in 2001.

Ms. NORTON. How did it level off if you were continuing to audit taxpayers more than higher-income taxpayers?

Commissioner ROSSOTTI. I think that one of the important things—first, let me just say what we're trying to do, OK, because I think this is important before we get too wound up in the statistics, is that there is—we have as our strategy as—and in our performance plan to increase the relative auditing of upper-income taxpayers, because 62 percent—and it's just because that was the money—62 percent of the income in this country is income taxes paid by individuals over $100,000; and as it's now——

Mrs. NORTON. It's the same reason that people go to banks to rob banks. That's where the money is.

Mr. ROSSOTTI. There is more. OK. And the coverage, the coverage of upper income taxpayers is still substantially higher than it is for lower income taxpayers, although it has declined over the years. But I think the other point to make is that audits are not audits. I mean we count them as one statistic, but when we audit upper income taxpayers it's typically done with a field audit where it may take several weeks of time to actually go and look at the taxpayer's books and records.

Mrs. NORTON. But it turns out to be worth the time when you get more than——

Mr. ROSSOTTI. Absolutely. Whereas most of the—for example, earned income type audits are just a letter that we send to a taxpayer. It all counts as one audit, but it's not really comparable. What I think is most important is what I think Mr. Levitan alluded to that we target the auditing we do. We have a limited set of resources. The important thing is to put them where they're going to do the most good, where the potential noncompliance is the greatest. That is why we do intend and are working very hard to increase the targeting of our limited audit resources, especially our most expensive resources, which is our field auditing to the upper income brackets. It takes over a year to complete a field audit. So what you see in the statistics is what was started more than a year or even a year and a half ago. And it was only really in about the—you know, when we really got some information that helped us do this, it was only about I think it was in 2000 that we really began to put our strategic plan in place and retarget our resources. You really will see that a little bit in this current year, but mostly in 2003 is when you will actually see the change. And the change will be an increase in the attention to where the money is, the upper income taxpayers. Now I will say this. There is a special appropriation that we have for the earned income credit which in effect fences that money. There's $146 million a year which is specifically appropriated for tax administration. It's not all for auditing but the largest percentage of it is for auditing. So that portion of the work will continue. As long as Congress continues to fund that, it will continue at the same level. But for the rest of the money that we have, what we are going to be doing is focusing a greater percentage of that on the upper income taxpayers.

Mrs. NORTON. What is the figure for the loss and enforcement revenue from the change in who gets who got audited in last——

Mr. ROSSOTTI. Let me say it was not so much only from that, there were a lot of other things going on, including RRA. From the high point in 1997 or 1998 to the low point, it was about $3 billion a year, a drop of about $3 billion a year in enforcement revenue. That was not just from auditing, that was from everything. But I do want to point out that it did turn around or it did level off, as we saw last year.

Mrs. NORTON. Most of that would have been from auditing.

Mr. ROSSOTTI. Well, it would have been from auditing as well as collections. It was not all individual taxpayers. It could include some corporate audits and so forth. It was from all sources.

Mr. HORN. Let's move to another question. It will be to Mr. Levitan, the chairman of the Internal Revenue Service Oversight Board. In your testimony, Mr. Levitan, you cited a survey which shows that one quarter of U.S. citizens admit that it is OK to cheat on their taxes. That's very troubling. What should be done to alter this?

Mr. LEVITAN. We need to change——

Mr. HORN. I find it hard to believe because usually the IRS has a pretty good feeling around the country that, hey, they are after taxes and you can't cheat at them.

Mr. LEVITAN. Right. There are a number of things that can be done, and the IRS can and should and is doing some of those. First of all, the IRS needs to do a more effective job of using the resources that they have to do the most effective enforcement that they possibly can. Such things as the National Research Program will give them a lot better research information so they can allocate their resources much more effectively. And we think that's important.

No. 2, and this particularly focuses on the higher income taxpayers, the IRS is just initiating a program to do information matching for K–1 returns, the passthrough income for partnerships and other types of pass through income. We believe the IRS should move very aggressively in this program. We think there is significant potential.

No. 3, the IRS should do an even more effective job of publicizing cases where they are going after and catching tax cheats and aggressively prosecuting them. That has started. It is in place. But it can be particularly effective as we focus on some of the newer, more high potential areas or areas that are getting publicity, such as the use of foreign credit cards. So there are certainly things that the IRS can do to send a message out that they are efficient and effective collectors of the taxes.

Mr. Chairman, after saying all of that, and there are others, I have to tell you that in our opinion that's just playing around the edges. What the IRS can do to be a more efficient and effective collector of those taxes is just marginal. There's a lot more that Congress can do that can impact that. And there are two things in particular that I think should be acknowledged. One of them is the pure complexity of the Tax Code. The complexity of the Tax Code invites errors which take tremendous resources. It invites cheating because it's easier to cheat when the Tax Code is so complex.

No. 2 is resources. Until the IRS has adequate resources to do enough enforcement, then they're not going to do enough enforcement. As Ms. Norton mentioned earlier, the resources have been reduced over the past decade by about 17 percent. A significant amount of that has come from enforcement. As long as the IRS's resources for this are at an inadequate level, we're going to have an inadequate amount of enforcement and many taxpayers will feel that they can get away with cheating.

Mrs. NORTON. I have a question about the fencing off of the earned income tax credit matter that you mentioned, Commissioner Rossotti. Every year, and I hope other Members of Congress go out of their way to publicize and popularize the earned income tax credit—one of the landmark pieces of legislation tax legislation that if we were to look over, I think, the 20th century we would put it in that category. And the whole purpose of popularizing this is because lower income people are those least likely to know about it or to care about taxes. They pay few taxes. When they pay taxes, they can't believe it. They simply pay them. And when they learn that you can get something back from the government, of course, this has been taken up. So there's a great deal of activity that goes on to popularize this. So I'd like to know if your audits have to do with the fact that a great deal more money may be going to taxpayers and others because of the EITC. Is it because of cheating by people on the EITC? Is it because of mistakes made by people? What would you be looking for in these audits of those disadvantaged people in the society?

Mr. ROSSOTTI. Sure. Sure. Now you raise some very good points. We're very actively working on all those points now. But I do want to clarify one point, of the appropriations we have for the earned income program. It's about $146 million a year. It's not all for auditing. As a matter of fact, part of it is spent even on advertising. We only have two areas that we're allowed to do paid advertising at the IRS. One is promote electronic filing, the other is to promote the earned income credit. If you noticed some of the TV ads which we have an advertising agency, they've gotten good reviews, better than they were the previous year. And we are interested in—that's not the only method. We have a whole partnership outreach program which we've accelerated significantly in the last—part of our reorganization we have a group of people throughout the country that's called partnership education and communication and they work with local community groups. And we've had very good success in some of the big cities working with mayors and others to try to get the word out so that people who are eligible will participate. That is part of our mission. It is part of our goal.

The other side to it is that regrettably there is a high error rate in the earned income program. We finished the study based on the returns that were filed in fiscal 2000, and it showed, depending on how you look at it, that about 25 to 30 percent, I'll just use round numbers, of the claims were incorrect.

Mrs. NORTON. These are people filling out their own claims?

Mr. ROSSOTTI. Actually about 60 percent of the people use preparers. It's interesting that the preparer-prepared returns aren't any more accurate than the individually prepared returns, which is one of the points we've spent part of our money trying to educate preparers. The taxpayer advocate, Nina, here that is with us has done a fantastic job in explaining in her report the unbelievably intricate definitions that exist in not only the earned income credit program but in other programs that are related to it, such as the definition of what is the head of a household, whether you're married or not. And you could laugh at this and you would laugh if it weren't so serious. Because the intricate definitions that are—and the conflicting ones that are embedded in the Tax Code that tell somebody under these circumstances this is what a child is under these circumstances, this is what a child is, here is how you determine whether you're married or not, this is something that anybody can get confused at. So part of it is confusion. We have no way to separate really when someone makes an error on a return whether it was deliberate or whether it was—we can tell whether there was an error, but we can't tell——

Mrs. NORTON. Are there more errors on these returns than on the average return, let's say?

Mr. ROSSOTTI. The other problem is we don't have the research on the other returns. It does appear there is a higher error rate, but we don't have a comparable set of numbers on other kinds of returns. But I think the important point is what do we do about it. We got approval from Secretary O'Neill a few months back, announced this at other hearings, to really take a whole look at this program, and we have a working group that is working with Treasury and with components of the IRS, including the taxpayer advocate, to look at the entire program and see if there's a way that we can reduce this error rate. Because it's gotten a lot of attention and it is something that, you know, that no one really finds acceptable, and do that in such a way that it will also be easier, if possible, easier for taxpayers to understand the program. It's hard to reconcile. Some of those can be achieved by simplifying definitions, but some of them may also require some additional steps to help verify taxpayers' returns. So it's a hard balance to achieve.

But my objective in this program, which has been supported by the Secretary, is to try to come up with a better way to do it, whatever that means. It may mean and probably would mean recommending some legislative changes which Treasury would have to do to simplify some of these definitions. It's not that we don't know how to do it, because several people have studied it, especially Ms. Olson here studied it very well. We know how we could do some things. But getting that done is hard. It may require some additional certification steps or something where somebody could send in a piece of paper with us. We're a lot better, you know, at matching documents up than we are at trying to probe people's personal household situations. And I think if we can find a way to convert that to something that is, you know, easier to verify, maybe we can come up with something that will really stabilize this program for its objectives and still achieve the objective of getting a lower error rate. So we're really working on this. It's not a 10 year. We have a goal within 4 months to come up with a set of recommendations on this.

Now admittedly we haven't developed them yet, so I don't want to set expectations at too high a level. But what I can tell you is nothing is off the table. We have been given carte blanche by the Secretary to look at all possible things that we could recommend. We have very good cooperation from the tax policy office. We're going to see if we can come up with something that is better than what we've got now.

Mrs. NORTON. Mr. Chairman, could I just ask Mr. Rossotti, if you could, by the time we go to the public the next time, if you could—it's very—it's very good to hear you saying you're giving this priority, have them out the next time so that Congress can see and so that the public can see that this error rate is going down? I think it's important for the continuation of the program.

Mr. ROSSOTTI. I didn't quite understand your question.

Mrs. NORTON. If you will have recommendations in 4 months, for which I congratulate you——

Mr. ROSSOTTI. Well, we hope.

Ms. NORTON [continuing]. I would like to urge that by the time we get to the next tax filing season, at least some of those recommendations be in order so that we might begin to lower their error rate and continue—I'm afraid that some people, hearing that the program is under this kind of scrutiny, may not even want to file any more for it. We don't want to be competing with one another on this.

Mr. ROSSOTTI. I don't think anyone should take away that. The program is in effect. It's continuing in effect. We're continuing to advertise it. We're trying to explain. We're also trying to get the error rate in place. Whether we can get things in place for next filing season, maybe some of them, but first we have to get the recommendations out. But some of them, I think, almost certainly are going to be legislative. I don't think this is a problem, you know, I really don't think this is a problem that we in the IRS internally can solve on our own. I just don't think we can. If we really want to solve it in a way that's meaningful, we're going to have to look more broadly at better options. But I will say this, the objective that the Secretary has given us for the study is to how to make the program work better, you know, from an administrative and legislative standpoint, not to abandon the objectives of the program.

Mr. HORN. I'll give myself 10 minutes to get this—so we'll pick up the extra my colleague has had. I want to get back to the one quarter of U.S. citizens admit that it's OK to cheat. We had the views of the oversight chairman, we've had the views to be filed by GAO, and I'd like to see, Mr. Commissioner, as to what do you think we should do with this in order to make that difference that we can simply cheat on our taxes?

Mr. ROSSOTTI. I do want to make—put one more little detail into this discussion that I think is important, and I believe this was true in the most recent study that the oversight board did that, is that it's interesting they subdivided it further. You know, I think it was 76 percent said that it wasn't acceptable to cheat at all, but then there was a question of how much cheating would be acceptable, and most people said that only a little would be acceptable. Now that's not great, but it's better than the 3 or 5 percent who said that anything goes. So you really have three categories. This really is consistent with my experience is that most people really are remarkably meticulous in this country about wanting to file correctly.

At the other extreme you have some outright cheats that just say I'll get away with anything I can. We're getting a lot more information about some of those, about some initiatives that we have recently undertaken to, for example, track down people who put money in offshore bank accounts, which is a bigger problem that we might have thought.

But then you got this middle ground of people who really are influenceable. In business, where I came from before, we used to think about the part of the market that we could influence. You had some people that were already in your market and some people that were outside the market. Then you had the group in the middle.

So I think what that says is we need an array of approaches to solve this problem. For those that are in the majority, what we need to do, whether it be 76 percent or 83 percent, that really are trying to pay, we need to treat them, you know, as well as we possibly can, and that's why service is so important. They can make errors, too.

I mentioned the complexity of the Tax Code. Even if you're trying as hard as you can, you can still make an error in your tax return. We don't want to treat everybody like they are a tax cheat. The majority of them, they are, God bless them, you know, doing everything they can to pay their taxes. We need to do a better job than we are doing now.

At the other extreme, the people who are really the outright cheats, you know, we're really focusing up higher on those. One of the things that we have at our disposal is our criminal investigation division. This is a very powerful tool. When I came in, we asked Judge Webster, who was a former director of the FBI, to look at our criminal investigation division to find out what we should do about that. His recommendation was this was a very fine organization. They are. They're fine investigators. They have lost drift in their mission and gotten off into narcotics and other kinds of crimes which really have nothing to do with the tax system. The only people who can prosecute tax cheating is the IRS. So we are refocusing our criminal investigation on those people, that small percentage that are really the outright cheaters, and especially the upper income cheaters. I will say that one of the things that we've done that is seemingly going to be an unbelievably successful initiative along that line is a set of summonses that we have issued to three of the major credit card companies in this country to get the records of people who are using credit cards issued in a whole number of tax-saving companies that just hide income. We are finding out that there are much larger numbers than we might have thought of people who were doing that. These are not $2,000, $3,000 cheaters. These are people who are in the upper income brackets. Through both civil and criminal we are going to do everything we can to find those folks and track down, track them down and prosecute them, either criminally or audit them civilly. That will be our top priority, as well as going after the promoters who are promoting those kinds of schemes. That's at the other extreme. That's for the people who are the real cheaters who I think make all of us angry and upset.

Then you have this middle ground of people. That's a little more complex. You need a range of tools for those. I think that some of it is auditing to make it clear that no one is able to get away with even small cheating over a period of time. But we can't and never would have the resources to audit everybody that makes a small mistake on their tax return.

The other thing on that middle ground is we need, and Mr. Levitan mentioned this, we need to do a better job. This is part of our reorganization, to get the word out to people, to warn off people not to get sucked into schemes or to make mistakes. This is something that is new. We're devoting a relatively small amount of resources, but we think it's highly leveraged to things like working with professional societies to get the word out to them that they shouldn't fall for these schemes, things like that.

So you have really a whole range of tools that we're trying to apply that is appropriate.

The way I look at it is very much like an, even though it's a funny kind of thing to apply in business, it's understanding your market. If you understand what your market is, your taxpayer, your customers, how they're behaving, why they're behaving, you can use the appropriate mechanisms to reach those taxpayers. In our case, in some cases, that mechanism is to prosecute them and put them in jail. In other cases, it's to warn them off of temptation. And in other cases, they're doing just fine the way they are, we just have to help them make sure they get the tax returns done correctly.

Mr. HORN. Let us get the opinion of Pamela Gardiner, Deputy Inspector General for Audit under the Treasury Inspector General for Tax Administration. What would you and the Inspector General for Tax Administration propose to get people conscious that it doesn't pay to cheat?

Ms. GARDINER. Well, I agree with everything that's been said so far. Certainly some other things that the criminal investigation division is doing successfully is to publicize some of its successes so that people know that IRS is out there, it's active, and it is catching tax cheats. We often hear that the average American believes that the wealthy, you know, hire expensive attorneys and CPAs to get away with tax fraud. And the fact that this credit card initiative is under way I think will help address that. Better use of technology. The National Research Program should help IRS identify the most effective way to go after tax cheats or, like they said, just people that make mistakes. And 1203 is still a lingering problem for many IRS employees, and addressing that. And I think with 1203, time will tell that employees are being more convinced now that the repercussions that they originally thought they were going to have to pay as a result of the 10 deadly sins really haven't come to bear, that there will be employees being fired every 5 minutes like they thought they were going to be if they made a simple mistake. So I think those fears are diminishing and that should help as well.

Mr. HORN. Nina Olson, National Taxpayer Advocate, what would your office think about focusing a little more on the idea that you can get away with not filing your taxes, you can cheat and all this? Do you have any thoughts on that?

Ms. OLSON. I think in my annual report I spoke about my concern about the complexity of the code making the people just sort of shrug their shoulders and say I can't figure this out and I'm going to do whatever makes sense to me, and often what makes sense to a taxpayer is directly antipodal to what the code is requiring you to do. I think complexity has a fair part of that. I also think that the lack of street presence, you know, in enforcement gives, creates an environment in which people feel it is OK to do those little tiny cheatings where you go into a grocery store on your corner and you know that the person is running a second cash register, or you hire someone to paint your house and you're paying them and you know that person is being paid in cash, and that's not showing up on somebody's tax return, they're not getting a 1099 from you. So there is no way we catch it. And that sort of thing lets people say when they go in to their preparer as well, I don't have all of my receipts but I think I spend about, you know, $25 or $100 a month on office supplies and the tax return preparer says OK, you know, and that's—that whole environment, it's going to be impossible to audit that. But we have to create an atmosphere where that's not OK.

What you're looking at is that you're robbing someone else when do you those tiny little cheats. I am concerned about preparers, and that goes to Congresswoman Norton's earlier questions about the earned income credit environment. It is a stunning statistic that more than half of the people who claim they earned income credit are using preparers and that an enormous number of those returns are in fact filed incorrectly. And my office in particular views return preparers either as the last stop for these kinds of little cheating, certainly for the largest cheating, but for the little cheating as well as enablers. And depending on how they interview their clients, depending on the questions they ask, depending on their expertise and education in tax, you know, that's whether you get the errors or not. And so my office is looking actively and about to make recommendations about a registration and education requirement and a certification requirement for return preparers so that taxpayers know when they're going in to their preparer that person has some base level of understanding of the code.

And I guess, you know, the 1203 to me, although I think it has been painted as something draconian and there are certainly structural changes that can be made to it and we've had some recommendations in the most recently reported bill, I've always looked at 1203 as professional responsibility provision. As a lawyer I'm held accountable for my actions. And I think that if it's talked correctly up to our employees, that our employees over time will understand that actually it's the basis, it's the baseline for your professional behavior to taxpayers.

Mr. HORN. Thank you. We'll go back to the 5-minute rule now.

Mrs. NORTON. Thank you, Mr. Chairman. Mr. Rossotti, I thank you again for the participation of IRS personnel in my own tax day where we fill out the tax forms, could not have done so without the help of the IRS finance and revenue from the District. Also many of the volunteers. 400 people had their tax forms filled out free of charge. We thought that's the least I should do for my own constituents. I said to them I don't think you should have to pay in order to pay the Government.

Mr. Rossotti, let me thank you as well for appearing with me, you and the U.S. attorney here in this Capital at a press conference designed to warn people off of their reparation tax credits, taking gross advantage of people who believe that they're going to—were entitled to a tax credit of some kind as a result of slavery in the United States. I was stunned, however, to learn that more than 100,000 tax returns had been—had paid out more than $30 million just in 2000 and 2001. I know that these were not the first years in which the scam was going on that—and, of course, there was an IRS employee who was reported to have gotten from the IRS more than $43,000, a figure that comes from a magazine article, pathetically talking about 40 acres and a mule, and that's what African-Americans would be entitled to. As you know, there is a bill for reparations, for a study of reparations. That bill is only in the House, has not gotten a hearing, and there is no bill in the Senate. According to the press, the reparation, the claims for the reparation, the so-called reparation credit total $2.7 billion in 2001.

First, I have to ask you how was this discovered? How did—how did you typically get on to it? And second, I've got to ask you what do they file under? Surely they didn't say I'm filing for my reparation, my slavery reparation credit.

Mr. ROSSOTTI. Well, that's actually—I didn't bring this particular—I had some examples in my last hearing I could give you, some redacted examples of the answers. They file under a variety of different things which is one of the things that makes it—sometimes they file amended tax returns, sometimes they put a line on a tax return. I saw one where they actually even dummied up an alleged 1098 form that showed that they had gotten taxes withheld for this. There is all a variety of schemes which is why occasionally some slip through. It's true the report that you heard that, you know, roughly about—remember, they tend to charge about—they tend to claim about $40,000, sometimes $80,000 or even more. So any one claim, you know, when you multiply them by 90,000 claims, that's how you get up to $2.7 billion.

I think we were successful, if I remember the numbers correctly, at stopping about 99 percent of them. But there was maybe 1 percent that got through because they were not claimed always in the same way.

Mrs. NORTON. One percent at $2.7 billion in 2001—oh, that's the claim.

Mr. ROSSOTTI. That's the claim. So the point is that most of them, probably maybe as many as 99 percent, we were able to find and stop before we ever sent them out.

Ms. NORTON. 30 million got sent out.

Mr. ROSSOTTI. Which is maybe a little over 1 percent. Even then I will say that we do go after those, as with all erroneous refunds, we do try to get them back. In many cases we have been able to get them back.

There is one thing I do want to note that is really I think, although we don't have the final numbers in this, an excellent success story. The work that we did with you, you remember in the press conference we did with a number of other members, we had a whole set of media events to try to warn people off. It appears that from the results we've gotten so far this year that we've—the number of these claims that we've received has gone down maybe as much as 90 percent over last year as a result of that.

Mrs. NORTON. Did you find this out through audits or some other process?

Mr. ROSSOTTI. We have people in the—as the returns are—audits is after the fact. Our goal is to stop them before they're sent out. So we have a screening process that we use to screen the returns as they come in to look for these things. It has been partially a training process for people that code these returns and also now, actually with the help of the IG, we're putting in some computer screening program.

Mrs. NORTON. It's a $43,000 credit. I look at how you—I'm trying to educate myself as to how you audit. Is that a fairly large credit to——

Mr. ROSSOTTI. Sure. It would be.

Ms. NORTON. You would think that would signal anybody who saw it that let's look more closely.

Mr. ROSSOTTI. Exactly. It does. That's partly why we've been able to discover these. We have a variety of techniques. I don't want to go into too much detail about exactly how we find them, but it's a combination of training people who review the returns, computer processing, and really the goal is not to do auditing on these because we don't want to send out this money and then have to get it back. The goal is to stop it. And we have been reasonably successful, considering the statistics. But we deal with such huge numbers that even if you get a 1 percent error rate, it still amounts to a significant amount of money that is lost.

What I think is most gratifying to me, if it holds up, which it so far seems to be, is that this year right now in the season that's just finishing, it appears that the number of these claims has gone down drastically over prior years and that's because of the publicity and the educational effort that was undertaken by a cooperative effort of the IRS and Members of Congress and other people. So it appears that is working this year.

I will say that the history of these schemes is they come and go. If we've educated people now and they've gone away and we've gotten 90 percent of them down, maybe we'll do the same thing next year. Somebody will come up with some wrinkle 2 years from now or 3 years from now. So we have to be constantly on alert for these things.

Mrs. NORTON. Mr. Chairman, I'm going to be leaving. Could I ask one more question since I won't have another round?

I am very concerned, Mr. Rossotti, about preparers who promise instant refunds. Of course, these are loans. They are rampant particularly among lower income neighborhoods, and people rush to file with people who promise them they will get their money back within a week, without telling them they will get—that this money, in fact, is a loan at a very high rate of interest. You have done a very good job on slavery and EITC. I have not noticed a comparable job done on these so-called instant refunds. They call it refunds.

Mr. ROSSOTTI. Yeah, unfortunately those—I'll say those are—unlike the other things, those are legal. I think that the——

Ms. NORTON. I only want information. They're legal, and if people really need to borrow money and that—in order to get it, fine. But somebody needs to tell people what the rate of interest is.

Mr. ROSSOTTI. There should be full disclosure. Let us look into that. But I do want to tell—but one thing that is going to kill that practice, although it's going to take a couple more years, which is our modernization program, and the reason is that when we—the reason it takes a long time, even if you file electronically, it may take 3 weeks to get your refund is because of the long time in the back office processing tapes and so forth. As we begin to increase our new taxpayer data base for those who have clean returns—I stress clean returns, because if there is a problem, it still may take longer—we will get that down to a few days, 3 days.

Mrs. NORTON. Put them out of business.

Mr. ROSSOTTI. Put them out of business. That's going to take a couple more years to get in. But really that's the solution. I mean there is no reason why it should take so long to get the refunds out.

Mrs. NORTON. Thank you very much, Mr. Chairman.

Mr. HORN. Thank you. Let me ask you about the degree to which the Internal Revenue Service has been able to help find out where the so-called 501(c)3's that are really terrorists gaining money and going there and you mentioned some of these overseas havens. And how are we on that?

Mr. ROSSOTTI. You're specifically talking about the 501(c)3's that were involved in the terrorist funding, terrorist——

Mr. HORN. Right.

Mr. ROSSOTTI. Well, that has been a Treasury initiative, and the IRS actually was participating actively in those task forces. I can only limit myself to what's been in the press, but we've seen some press reports of certain search warrants and certain things that have been—certain criminal investigations that have been publicized on some of those charitable organizations. And while that hasn't been exclusively an IRS job, because it's been Treasury-wide—in many cases the Customs Service has actually led that—the IRS criminal investigation division has been involved with that. There is a counterterrorism task force that the IRS participates in and I believe that the Treasury IG participates in that as well. In looking at the intelligence, the leads for any group that is funding terrorists, the Treasury's job is primarily following the money. So that terrorism task force finds those where there's a money issue. Then they assign that out to whoever is the best qualified agency to actually investigate it and followup on it. So we have been very—obviously that has been an extremely high-priority and has gotten everything that they have asked for in that regard. It's had considerable success.

Mr. HORN. Well, another area that—this really comes under tax policy, and that is when we see American firms going overseas, putting thousands of people out of jobs and going to some Authoritarian country, it just bothers me that the Treasury hasn't said, you know, we could slow that one down if we didn't let them bring the money back in some way, or where in going after what's left of them and maybe giving them a little idea to get some individuals who would maybe slow that down and save jobs in America. Is anybody working on that?

Mr. ROSSOTTI. Well, as you noted, that's really a tax policy Treasury issue, so I'm not in a position to comment on that, Mr. Chairman.

Mr. HORN. OK. Let's go to a few things you are competent to deal with. What are the key attributes you would like to see in your successor?

Mr. ROSSOTTI. I'm sorry. I didn't hear the question?

Mr. HORN. What are the key attributes that you'd like to see in your successor?

Mr. ROSSOTTI. OK. Well, I'll give you my views. I think that at bottom basically this role of Commissioner of the IRS is primarily a leadership job. What you have is a lot of people, internal 100,000 employees, externally millions of taxpayers, but even more so, we have many constituencies. We have committees of Congress, we have taxpayer groups. Trying to keep all that aligned and moving forward in a positive direction is probably the most challenging part of the whole job. What it really is is trying to articulate and listen to especially the concerns that people have and reconcile them in some way, that you don't have people flying off in every different direction. That is quite a difficult thing. I think it is probably the most important thing.

Then beyond that, I will say that we do have a major technology challenge in the IRS. There is just no question about it. I mean, for a variety of reasons which we won't go into, it's one of the harder things to do. You have the joke about changing the airplanes on the plane while you're still flying and all those kind of analogies. It's not something that can be delegated entirely, the Commissioner and very important people that we have been able to recruit that are carrying on this program with great skill. But, you know, it's so fundamental to the agency that it can't be something that's purely delegated. So I think anyone who would be commissioner is going to have to be capable in taking an active role.

I would say, you know, there are many OK qualities that are obviously necessary that are sort of obvious, like integrity. But I think in terms of the particular things right at this moment in time in the IRS that are important is that—those leadership skills to sort of keep things aligned and the sort of—some contribution to making sure this modernization program moves forward would be two that I would mention in particular.

Mr. HORN. I think you, me and Mr. Levitan agree with that when the vacancy came that was ultimately filled was the fact that I had asked the President, President Clinton, with Mrs. Maloney, my ranking member, got her on board and said, look, we've had a lot of tax attorneys, we've had a lot of tax accountants, and they—what you want is a chief executive officer. And they took it seriously. And, Mr. Rubin, I think, talked with the chairman of IBM and started scouting around. And that's how you do it. And that's the difference. Because we need somebody that in an organization of 100,000 people in all of these management issues, we need somebody that knows something about chief executive officer's role and what they should do. And so I assume you would agree with that.

Mr. ROSSOTTI. Yes. I think that having the experience of running a large organization is part of what qualifies you potentially to do those sorts of things.

Mr. HORN. What about the people within IRS? When you go into other agencies you've got a civil service group, you've got a political group. Do you find enough talent to fill the management jobs within the professional staff?

Mr. ROSSOTTI. This is something that is also very important and this committee and others have helped with. We do have a very talented executive group in the IRS. It's remarkable, when you consider all the challenges that we have and the technology we have, it's amazing that we get—sometimes get through filing seasons and do things as well as they can. So it is very talented. But the limitation is that there is—the way it was structured prior to the recent Reform Act is there was one commissioner that was a political appointee. Then there's the chief counsel who is the political appointee, and the rest are all career. So the only limitation is you had no people with really any outside experience of how things work in other operations. As a result of the Reform Act, we were given the authority to bring in a limited number of people from the outside for limited terms, which I think is important because they're not career executives. And we've frankly, I think, been extraordinarily successful with that. We have some people from major—it's not just myself with experience, we have people with business experience and other experiences from major companies throughout the economy. And what has been gratifying to me about this is that there are people out there who have been successful that have track records who are willing to do public service for a reasonable period of time in some very challenging positions. That—I would recommend strongly that practice be continued because no matter how qualified a commissioner is, you need other people. And the internal executives, who are most of the people who run the Service, and do most of it, need to be complemented by a number, limited number of people who have some other experiences.

Mr. HORN. Well, I agree with you. If I had my way, I'd have a lot of the political appointees and other agencies to step back and have the people that are there to figure out the talents to get the job done. Because it's got to have continuity, and you can't just come in for a year or two and disappear.

Mr. ROSSOTTI. Yeah. Of course, in the IRS it's unique almost because there are no political appointees other than the commissioner and the chief counsel.

Mr. HORN. What's the enforcement mechanism within the IRS to ensure compliance with the tax laws within the IRS and how many IRS employees have been punished for failing to file or pay their taxes?

Mr. ROSSOTTI. Well, the enforcement mechanism is—consists of two things. One is that under section 1203, the Restructuring Act, the so-called 10 deadly sins, two of them have to do with failing to file and underreporting income. And even before that act was passed, there was a special employer—employee tax compliance program which checked the tax records of every employee. So it is a disciplinary issue even before section 1203 was published and was passed. And as a result of that—and I don't know that I have the statistics here with me, I may, that we have—yeah here it is. Since the beginning of the section 1203 implementation for the two sections that relate to Federal taxes, they have been the ones that have had the most significant number of inquiries and people substantiated. We had, let's see, failure to file a Federal tax return, we had 269 as I have it, and 12 for understatement of tax liability that were detected and disciplined as a result of section 1203. We do publish statistics on tax compliance by Federal employees, and there's substantially more compliance than as far as you know the rest of the tax population. Of course, the highest rate of compliance is in the IRS, partially because of the disciplinary aspects that are incorporated in section 1203 and in our tax compliance program generally. So I think we can be quite confident that if there's one thing we know, it's that IRS employees are complying with the tax law. That's not to say there aren't occasionally some violators, and they are dealt with.

Mr. HORN. The next number of questions will relate to debt collection issues, and you have to recuse on that and Brady Bennett is the IRS designee for these issues. So if we could get Mr. Bennett to the table. We will ask him the questions. And I think it's something that the next leader might be able to do it.

Mr. ROSSOTTI. I am recused from the matter of the outsourcing and that project, but I can answer questions about the more general topic of, you know, what our debts are and so forth.

Mr. HORN. Well, let me just start in on a few. The IRS has been working on resolving the several complex legal and technical issues inherent to contracting out collection activities. And exactly what are these issues? And what are you doing to resolve them? And when will they be resolved?

Mr. BENNETT. Sir, there are a number of key issues that we are——

Mr. HORN. You want to move the microphone a little.

Mr. BENNETT. There are a number of key issues——

Mr. HORN. I can't quite hear you.

Mr. BENNETT. That's better. Again there are a number of key issues that we are aggressively working as we speak. But as you've heard, we must develop a process that ensures that taxpayer rights are protected in the system that's designed. This process must ensure the taxpayers are afforded the same rights that they would have if they were working with the IRS. This would include a right to taxpayer advocacy referral or rights as afforded to taxpayers under collection of due process. So that's an important area that must be included as we go forward.

We're also working with the counsel and have gained a better understanding of the limitations that exist due to the concept of inherently governmental activities. This is an important distinction that we face in dealing with this issue. The IRS may delegate ministerial or nondiscretionary functions to a contractor. Areas of discretion, however, may not be contracted out. The program must establish clear standards under which a contractor will work and be subject to rigorous IRS government oversight. And the final decisionmaking authority, however, must reside with the IRS.

We must develop a system that allows contractors to access the data that is necessary. You've heard mention of security concerns earlier today. The system we establish will certainly raise certain security and technology issues that we must address as we design the process.

We're also looking at other Government agencies, both Federal and State, to better understand how the effort can be funded. We're looking closely at the funding models that exist with the Department of Education and FMS as we design this system.

Mr. HORN. Well, those are among the Federal agencies that have nontax debt collection. And that goes back to the Debt Collection Act of 1982 and the one in 1996. Does the IRS face issues fundamentally different from those affecting other Federal agencies? And, if so, what are the issues?

Mr. BENNETT. Yes, sir. We do. Those two acts that you mention do specifically exclude debt that arises via the Internal Revenue Code. We clearly do face challenges in this area that are not present for other Federal agencies. Federal tax collection is constitutionally considered an inherently governmental function. It is permissible, as I said earlier, for the IRS to contract out certain ministerial in nature events where vendors are governed by strict guidelines and procedures. But again, the discretion may not be contracted out. What this means is that as we do the design, it's critical that we develop clear guidelines, clear procedures, to ensure that the design that is in place is legal, prudent and protects taxpayer rights.

Mr. HORN. According to the General Accounting Office, which we depend on as our arm in the legislative branch, IRS's discontinued collection action or, as the agency puts it, shelved about $12 billion in delinquent tax debts because of inadequate staff resources. In light of this, how can you possibly justify dragging your feet on seeking additional resources from the private sector to assist in collection efforts?

Mr. BENNETT. Mr. Chairman, I personally have spent 23 years in the tax collection business with the IRS, and I share your passion around this area. This is an important area that we are aggressively working. To accomplish this, we've created a partnership with private industry experts. In the coming weeks we will be working with a select group of collection contractors to agree on the type of inventory that meets the contractor's needs while also meeting the objectives of the Internal Revenue Service to have an impact, positive impact on compliance. To identify the contractors, we've developed, posted, reviewed responses to an IRS request for information. We use data gathered in that RFI process to assess a state of the private collection industry that currently exists, to assess their ability to handle the size of debt we're talking about. We select the private sector collection agencies to partner with us. We're currently doing that right now, working with them as subject matter experts to work through the issues I described earlier.

We've also identified a number of alternatives for placing cases in the hands of the contractors. We've built on our pilot program of 1996, understood the lessons learned from that program, and are moving forward. An important piece of this is—are the type of cases that we place in their hands. We've begun to build a business case that will aid us in selection of the best alternative as we go forward.

Mr. HORN. Would it not make some sense to at least give private collection agencies a chance to collect those accounts the IRS is ignoring? Or do you not ignore a lot of cases?

Mr. BENNETT. Unfortunately, our resources are stretched extremely thin, and we do not have the capacity to work as many cases as we'd like. This is an area that where contract support, we believe, can provide some additional capacity to—as opposed to supplementing resources or, I should say, supplement our resources as opposed to supplanting resources. It will give us additional organizational capacity to deal with this particular workload. So I think it's an important area.

Mr. HORN. Well, I agree with you when I mentioned that $12 billion delinquent tax debts because of inadequate staff resources. This is why some of that's got to be put out, if you don't have the staff or get the staff, one or the other, and get people off other things that aren't as important. This is important, when people can get away with this.

Mr. BENNETT. Yes, sir, it is very important; and it could be that the answer is in a combination of additional resources to work the right type of cases, to have the expertise to work the complex cases and identify an appropriate segment of cases that can be contracted out.

However, as I mentioned, there are a number of complex areas that we need to address and be careful in terms of how we design the system in the future so we make it work.

Mr. HORN. Well, I am delighted to hear you are moving ahead in this area. It's long overdue, to say the least.

Mr. Commissioner, as you know, we all are weeping a little up here; and we would like you to have, if you'd like, a closing statement yourself to the American people. Because a lot are going to be listening on our favorite channel, C–SPAN. So what would you like to say to the average citizen?

Mr. ROSSOTTI. First of all, for the great majority of those people out there are who are not cheating on their taxes and actually submitting their returns on time, which fortunately for the country is most people, I would like to thank every taxpayer for doing that. You know, it's not the most pleasant chore, but it is something that is absolutely necessary. And people have done it and some of them are still doing it through the rest of this day, April 15th, and most of them have already done it. So I think that is an important thing in our whole American society. It's something that we are very fortunate in this country that most people do.

Second thing is that I think, as far as the IRS is concerned, we're on the side of the average American taxpayer. That's why I never accepted the idea that some people—that somehow people will always hate the tax collector. That idea has gone back to Biblical times, and I think that maybe that was because the tax collectors didn't have their thinking caps on straight. I think that we're on the side of the average American taxpayer. All those people that have filed the returns have done it correctly. So what do we have to do? We have to make sure that we give everything that those people need, give it to them when they need it.

Then the other thing we got to do is we got to go after the other minority that are not paying so they are not allowed to increase the burden on the honest taxpayer. That's basically what the IRS is all about. It's an important mission and one that we certainly have room to improve on, but at the same time I think we have made some progress in delivering on that.

Mr. HORN. I want to thank the members of the staff on both the majority and the minority, and then I will have a closing statement myself: J. Russell George, Staff Director/Chief Counsel; and Bonnie Heald, next to him, Deputy Staff Director. To my left, your right, Henry Wray, Senior Counsel; Earl Pierce, Professional Staff; Justin Paulhamus, majority clerk.

For the minority, David McMillen and Jean Gosa. Jean's the minority clerk, and Mr. McMillen is the professional staff, and Jon Bouker is the counsel for Mrs. Norton.

We also have three people as court reporters: Lori Chetakian, Julie Thomas, Nancy O'Rourke. You can see we needed three reporters when we knew you were coming, so we wanted to be prepared.

I want to thank all the witnesses for your fine contributions. The hearing I think has been very informative. We might send you a few questions for the record that some members of the minority who have not been here might want to view.

I again wish to commend you, Commissioner Rossotti, for your outstanding work over the 5 years. You certainly will be leaving the Internal Revenue Service in better shape than when it was when you took office. At the same time, the agency continues to recognize various challenges. I intend to continue to work closely with you for the remainder of your term since my term will be out as of the 108th Congress and I will be here until the end of the 107th Congress. I hope that your successor as Commissioner and my successor as Chair of this subcommittee will maintain the same close and productive working relationship we have had.

With that, we are adjourned.

[NOTE.—The report entitled, “IRS Oversight Board Annual Report, January 2002,” may be found in subcommittee files.]

[Whereupon, at 12:05 p.m., the subcommittee was adjourned.]