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JOINT REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE, 2003

HEARING

BEFORE THE

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

AND THE

COMMITTEE ON FINANCE
COMMITTEE ON APPROPRIATIONS
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

One Hundred Eighth Congress

First Session

May 20, 2003

JCS–4–05

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JOINT COMMITTEE ON TAXATION
PRESS RELEASE

JCT Press Release: 01-03
For Immediate Release: May 14, 2003
For Further Information, Contact: Kathleen Dorn (202) 225-3621
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The Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") requires the chairman of the Joint Committee on Taxation to convene a joint review of the strategic plans and budget of the IRS. The joint review is to be held before June 1 of calendar years 1999 through 2003. The joint review is to include two Members of the majority and one Member of the minority from each of the House Committees on Ways and Means, Appropriations, and Government Reform, and the Senate Committees on Finance, Appropriations, and Governmental Affairs.

Pursuant to the IRS Reform Act, Congressman Bill Thomas, Chairman, Joint Committee on Taxation, has scheduled a joint review of the IRS strategic plans and fiscal year 2004 budget for **Tuesday, May 20, 2003, in room 1100 of the Longworth House Office Building beginning at 10:00 a.m**. The joint review will be open to the public.

Witness List

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

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

Ms. Pamela J. Gardiner, Acting Treasury Inspector General for Tax Administration

The Honorable Larry R. Levitan, Member, IRS Oversight Board

Mr. James R. White, Director, Tax Issues, U. S. General Accounting Office

REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE

TUESDAY, MAY 20, 2003

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

The Joint Committee met, pursuant to call, at 10:00 a.m., in Room 1100, Longworth House Office Building, Hon. Amo Houghton presiding.

Present: Representatives Houghton, Tierney, Blackburn, Lewis of Kentucky, Pomeroy, and Portman.

Senators Present: Senators Grassley, Bennett, and Sununu.

Representative HOUGHTON [presiding]. Good morning, everybody. On behalf of Senator Grassley and myself, we are delighted to see you here. I am going to make an opening statement. I will pass the mike then to Senator Grassley, and he will make his statement, and then we will be off and running.

Today's hearing is unique in that we bring together House and Senate Members from six committees to review the operations of the Internal Revenue Service. The purpose, of course, of the joint review is to give coordinated oversight to the IRS and focus on their long-term objectives.

This joint review, established by the IRS Restructuring and Reform Act, has been going on for 5 years. And in that time, the IRS has overhauled its organizational structure, which now features four operating divisions devoted to groups of taxpayers with similar needs, and has taken other steps to improve its service to taxpayers.

For example, a new program on the IRS Web site lets taxpayers check the status of their refund, and more taxpayers are getting through to the IRS with questions by phone and in person at walk-in sites.

While the IRS has made significant progress towards reform, significant challenges clearly remain. The long-term decline in collection activity raises questions about tax compliance and fairness to the majority of taxpayers who pay all of their taxes. The result of the conflicting trends of workload increases and declining of resources over time has led to what is called a compliance gap: more taxpayers who do not file or report honestly and less IRS capacity for audit and enforcement.

So if the gap cannot be closed, the long-term fairness of tax administration—this is our major worry—may be called into question. So this hearing gives us the opportunity to look at several things: first, back on the last 5 years of IRS reforms; and, secondly, to look forward to challenges of the next 5 years with the new Commissioner.

This morning we will hear from the new IRS Commissioner, Mark Everson; and a panel consisting of Nina Olson, National Taxpayer Advocate; Larry Levitan, former Chairman of the IRS Oversight Board; Pamela Gardiner, the Acting Treasury Inspector General for Tax Administration; and James White, Director of Tax Issues at the General Accounting Office.

We look forward to their testimony, and now I would like to recognize my distinguished Senator, Senator Grassley, and any other Members for any opening statements they may have.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, U.S. SENATOR FROM IOWA

Senator GRASSLEY. Mr. Chairman, I have just a few short comments. First of all, I thank you for chairing a very important committee meeting, joint committee meeting, that meets once a year, which is part of the Restructuring Reform Act of 1998, to bring everybody together that has some congressional jurisdiction over the IRS and Treasury Department to once and for all kind of bring all issues to a focal point in one day of hearings.

I have longstanding interests in the effect of tax administration, and given my participation in crafting the Restructuring Act, I have a special interest in these proceedings.

Now, having said that, I have to apologize to Mr. Everson and to the committee members because I am not going to be able to be here, for the simple reason that there are negotiations going on on the growth and stimulus package, with a commitment on the part of leadership of the House and Senate, including the Chairman of the Senate Finance Committee, that we would get that bill to the President before the end of—or the beginning of the recess. So I will leave after making my comments.

I have three broad concerns. In all candor, none of these will surprise anyone who has been listening to me speaking about the IRS for a long period of time. First, I would again share my strong belief that the IRS must be able to balance responsibilities. IRS might be able to balance its enforcement activities, which include audit, collection and criminal investigation on the one hand, with taxpayers' rights and taxpayer service on the other hand. As far as I am concerned, achieving that balance is crucial to maintaining public confidence in our tax system and the administration that carries it out.

Second, I remain concerned about the timeliness and cost of business systems modernization programs at the IRS. The successful execution of this program is essential for the effective and efficient tax administration and for IRS to provide the customer service that taxpayers expect and deserve. And in my conversations with Mr. Everson, I have been very satisfied that he takes that very seriously as well.

Third, I would like to state that I am troubled that a critical part of the IRS restructuring may be getting short shrift. As a result of the National Commission on Restructuring, of which I was a member, and the Restructuring Act, IRS is required to first redesign its structure, and, second, modernize its computer systems.

IRS's structural redesign is largely in place. IRS created a customer-facing organization designed to meet the needs of its clients, the American taxpayers. Further, the IRS overhaul of its 1960s-based tax return processing and storage system is underway. However, in order for the modernized IRS to meet the needs of taxpayers, the agency must have the appropriate human capital in place. I am concerned that IRS may not have the appropriate training, recruitment, and retention programs in place.

Without properly qualified, trained, and motivated employees, IRS will be unable to leverage its new computer system and organizational structure. In short, it would be unable to provide top-notch customer service and ensure across-the-board compliance with the Nation's tax laws. And I trust that Commissioner Everson is going to address this, and, in fact, I have been advised that he would address—and am very satisfied of his addressing this—and I think he is as concerned about it as I am, to make sure that what is in place now is moving forward in an appropriate way.

So, having said all of that, I look forward to continuing a working relationship with Commissioner Everson that he has already demonstrated that he is willing to put in place, and which would be a continuation of what I think Commissioner Rossetti did a very good job of.

I hope at the end of your term we can look back with pride at a significantly improved agency, and I hope we see an IRS that is effective, efficient, and staffed with motivated people able to meet taxpayers' expectations.

Thank you, Mr. Chairman.

Representative HOUGHTON. Thanks very much, Senator. Are you going to have to leave now?

Senator GRASSLEY. Yes.

Representative HOUGHTON. All right. What I would like to do is thank you very much for being here. We will give you a full report on what has happened.

And then I would like to ask Mr. Pomeroy, you have no comment?

Senator GRASSLEY. I would have some questions to submit in writing.

Representative HOUGHTON. Fine. They will be submitted for the record.

[The information follows in the submissions for the record section]

Representative HOUGHTON. Mr. Pomeroy, do you have any?

OPENING STATEMENT OF HON. EARL POMEROY, U.S. REPRESENTATIVE FROM NORTH DAKOTA

Representative POMEROY. On behalf of Ranking Member Rangel, Mr. Chairman, I would simply say that I appreciate this hearing, this being the fifth of five hearings over the years, bringing together all of the committees of jurisdiction to take a detailed look at the Service. It is particularly timely now under the incoming new leadership of the Service, and I believe that the questions teed up by Chairman Grassley will be joined with others that I have relative to some internal priorities and expenditures, but we will get into that with questions of the Commissioner.

So that would be the end of any opening comments I would make, Mr. Chairman. Thank you.

Representative HOUGHTON. Senator Sununu.

OPENING STATEMENT OF HON. JOHN E. SUNUNU, U.S. SENATOR FROM NEW HAMPSHIRE

Senator SUNUNU. I thank you, Mr. Chairman. And welcome, Commissioner. I would simply underscore two points that were made by Senator Grassley in his opening remarks. First, with respect to technology. I would be very interested to hear more about the opportunities that are being created through the electronic filing process. I know the growth has been strong and consistent, maybe not what you would like to see, but I think there is tremendous potential there.

And I would be interested to hear what opportunities you see to further improve the rate of acceptance of electronic filing. And also, of course, the use of the Internet to deal with customers, to answer questions, to distribute information. I think both of these systems and technical systems create an opportunity not just to improve the cost structure and to lower the costs of delivering service of the IRS, but also to improve quality, because there are some factors of reliability and consistency that can be provided through these electronic means.

Second, with regard to the balance of taxpayer rights with the need to have a strong, motivated effective collection system, I know that you are proposing, or the administration has proposed, some modifications to some of the ten rules dealing with the discipline of IRS employees.

And I believe the goal there is and should be to strike a balance, to make sure that employees are treated fairly and justly, that you have a system that can be consistently applied, but also a system that will provide for a good motivation. We have 100,000 employees that are dedicated and committed to the work that they do. We obviously want to ensure that they are behaving properly with respect to taxpayer rights, that they are disciplined when they violate the rules, but we also want to make sure that those rules are rooted in common sense and that the punishments associated with them are appropriate.

So I look forward to hearing about those changes and the way that you believe that they might strengthen the morale and enable employees to be even more effective at the work that they do in serving the taxpayers, but also ensuring that we collect the revenue that is owed to the United States.

Welcome, and thank you, Mr. Chairman.

Representative HOUGHTON. Thank you, Senator. Mrs. Blackburn.

OPENING STATEMENT OF HON. MARSHA BLACKBURN, U.S. REPRESENTATIVE FROM TENNESSEE

Representative BLACKBURN. Thank you, Mr. Chairman. I appreciate the opportunity to serve with you all on this committee today. And to Commissioner Everson, I look forward to having the opportunity to hear what you have to say. I am the freshman in this group. I am new to this body this year and new to the Government Reform Committee which I am representing today.

Mr. EVERSON. We should get along fine, since I am a freshman, too.

Representative BLACKBURN. Well, that is true. And I will assure you I have read through your testimony, and I look forward to hearing what you have to say, specifically pointing toward the burden reduction and reducing the burden of costs on our citizens who are working to come into compliance and meet the rules and regulations and the pattern that is set forth by the IRS. Also, looking at the reduction of paperwork and reducing that burden, not only on our citizens but on your employees, and on the changes that that will make in the work environment that you have for your employees.

I think that also looking at technology and how that is progressing; the cost, and then the true savings and efficiencies that should and could be realized and must be realized in a timely manner.

I thank you all for your time today, Mr. Chairman. Thank you for allowing me to serve.

Representative HOUGHTON. Thank you very much.

Now I would like to call on Mr. Portman who has had so much to do with the Restructuring and Reform Act.

OPENING STATEMENT OF HON. ROB PORTMAN, U.S. REPRESENTATIVE FROM OHIO

Representative PORTMAN. Thank you, Mr. Chairman.

I want to thank you for putting together this joint review today. I want to thank Senator Grassley for coming over. This is a busy week for him. And he was on the IRS Commission with me. Bob Kerrey and I chaired that Commission, but Senator Grassley was a valuable and constructive member of that panel.

Senator Sununu actually took a great interest in this when he was in the House, and now he has a bigger megaphone. He will also be, I think, a key player in trying to be sure that the reforms that we put in place back in 1998 are actually properly implemented and that we can make even more progress.

I am very pleased that we have had these joint reviews. I think they are helpful. The panel may look a little sparse up here today. I don't think there are any appropriators who are here yet. But to my colleagues from the Ways and Means Committee, Finance Committee, who are here, and Governmental Affairs in the Senate, and the Government Reform Committee, I am delighted you are here. And you have to remember that a lot of staff work goes into this, both leading up to the hearing, which I think is very helpful working with your staff, Mr. Commissioner, and also the aftermath of these hearings is also significant staff work, including by the Joint Tax Committee.

And so I think these reviews are very helpful and focus us on not only the particular issues that you are going to deal with day to day, but on the big picture. After all, the goal of the joint review and really the Restructuring Act, was to change the general direction of the IRS. I think again we have made a lot of progress, but we have a ways to go.

Representative HOUGHTON. Thank you very much.

Mr. Tierney.

OPENING STATEMENT OF HON. JOHN F. TIERNEY, U.S. REPRESENTATIVE FROM MASSACHUSETTS

Representative TIERNEY. Well, thank you, Mr. Chairman. I too will be brief. I thank you for conducting this hearing this morning and for the ability to participate in it.

Mr. Everson, I simply will adopt the comments of my other colleagues and add to it that I hope to hear from you a little bit about the targeting or the allocation of resources towards auditing and collection to make sure that we are, in fact, going where the money is or hasn't been paid, actually, and make sure that we do that in a fair and equitable manner, and also maybe some comments about the morale of the people that work with the Internal Revenue Service and how they are being treated and how we can expect them to be treated in the future.

But in addition to these comments and the others of my colleagues, I think we would like to hear from you now. So I would will yield back to the Chair.

Representative HOUGHTON. Thanks so much. Senator Bennett has just arrived. Senator Bennett, would you like to make an opening statement?

OPENING STATEMENT OF HON. ROBERT F. BENNETT, U.S. SENATOR FROM UTAH

Senator BENNETT. Only that I am here to learn and I am grateful to you for allowing Members of the other body to come over here where all of the work is done.

Representative HOUGHTON. Well, thank you very much.

Okay. Mr. Lewis.

Representative LEWIS of Kentucky. No.

Representative HOUGHTON. All right. Good. Well, now what we are going to do is call on the Commissioner. Commissioner, you are on.

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

Mr. EVERSON. Mr. Chairman and Members of the joint review, thank you for this opportunity to testify. It is true that I have only been Commissioner a relatively short time, but I would like to put this into perspective. I am sorry that Senator Baucus is not here, because at my confirmation hearing he observed that of the five New Yorkers who previously served as Commissioner, one, Justin Winkle, served just 14 days. Mr. Chairman, I am pleased to report this is my 15th day on the job, and I am still here.

As I testified at my confirmation hearing and more recently before the House Appropriations Subcommittee and the Ways and Means Oversight Subcommittee, I expect to focus on three areas during my tenure as Commissioner:

One, I will reinforce and build upon the reorganization begun by Commissioner Rossetti to improve customer service.

Two, I will continue to drive the information technology modernization program. Its success is critical to establishing a more efficient and effective IRS and one which is more accessible to taxpayers.

Three, I will strengthen the integrity of our Nation's tax system through enhanced enforcement activity.

Let me expand on each of these themes. The reorganization of the Service based on customer segments is working. These reforms are sound and need not be revisited. To change now would be disruptive. In fact, I recently received a memo from the American Institute of Certified Public Accountants, asking that I not engage in any significant reworking of the structure as it, quote, would only unnecessarily confuse the taxpayers and practitioners who have begun to get comfortable with the new IRS.

I agree. Indeed, I give the IRS good marks for its improvements in key service areas. Progress has been achieved in many areas such as telephone service and electronic tax administration. For example, taxpayers were met with 19.4 million busy signals in 1999. This filing season the number dropped to less than 250,000.

Call abandons also fell over the same period from 8.4 million to 1.1 million. And level of service increased from 51 to 83 percent.

E-file has also shown impressive gains. A little more than 29 million taxpayers E-filed in 1999. Almost 52 million did this year. And compared to last year, E-file grew by over 12 percent, and filing from home computers by almost 27 percent. The service is doing a better job.

But of course much remains to be done. For example, we must improve our accuracy rates in responding to taxpayer questions.

Let me now turn to the second theme: information technology modernization. As compared to the gains in service, the results are mixed. As the members of the joint review are well aware, business systems modernization had a number of false starts. Nevertheless, there are a number of important accomplishments to date. The IRS has deployed the customer communications project that better routes taxpayer phone calls, and helped the Service cope with millions of additional phone calls resulting from last year's tax rebate.

We also expect 15 million users this fiscal year of the Internet-based Where is My Refund Application. And in the next few weeks, taxpayers, practitioners, and financial institutions will be able to apply for an employee identification number on line.

While these programs are important, the centerpiece of the modernization effort is the replacement of the decades-old master files that begins this summer. In the next few months, we are scheduled to move 6 million 1040–EZ filers to a modern, reliable database called the Customer Account Data Engine, or CADE. CADE's benefits to taxpayers are clear, such as faster refunds and daily posting of transactions and updating of accounts.

The modernization effort is a major challenge. As the GAO noted in its January assessment, modernization remains a high-risk area. It stated, quote, the scope and complexity of the program are growing. The challenge for the IRS is to make sure that the pace of systems acquisitions projects does not exceed the agency's ability to manage them effectively.

Given this assessment, with which I agree, and the important juncture we have reached with the first important deliverable for CADE, I have decided to have an outside group of experts take an independent look at the program and report back to me by the end of this summer. I haven't yet identified who will conduct this study, but I expect to do so in the next few weeks.

I want to stress that no work will stop while this review is underway. But this is a good time to assess progress, project risk, and decide whether any mid-course corrections are needed.

Before leaving IT, I want to point out that while the IRS spends nearly $2 billion each year for information technology, the modernization program itself makes up less than one quarter of that total.

Through the careful examination of our base IT activities, the remaining 1.6 billion not devoted to modernization per se, I believe we can both increase productivity and deliver meaningful service improvements to taxpayers. I will challenge the organization to do exactly this, and to act with a sense of urgency.

Our third area of focus is enforcement. It is as simple as this. People should pay what they owe. In an important recognition of the need to do more in enforcement, the President's budget requests a real increase in resources targeted towards enforcement, new money to expand enforcement efforts with a sharper focus on high-income, high-risk taxpayers and businesses. I believe this can and must be done without compromising taxpayer rights. The IRS has already launched a number of new enforcement initiatives, such as the Offshore Voluntary Compliance Initiative and identifying tax scams and schemes promoters in a limited issue-focused examination. I will be looking at each of these initiatives to see where we can do more.

One thing is already clear to me. The IRS must bring the same focus and energy to improving enforcement's business processes as we are to improving the service side of the IRS. It is unacceptable that a corporate audit takes 5 years on average from the date of filing to complete, and 2 years is too long just to get ready to present a criminal case to the Department of Justice.

In order to clarify reporting relationships in the Service and to support these three themes—reinforcement of the reorganization to improve service to taxpayers, continuation of modernization efforts, and strengthening of enforcement—later this week I will name a new Deputy Commissioner for Services and Enforcement, and a Deputy Commissioner for Operations Support.

The Deputy Commissioner for Services and Enforcement will supervise the four business units' criminal investigations and the Office of Professional Responsibility.

The Deputy Commissioner for Operations Support will supervise the CFO, CIO, the chief human capital officer, agency-wide shared services, and the Service's IR and physical security operations. There are two advantages to be gained from this approach. The Deputy Commissioner for Services and Enforcement will continue to drive for better service and be able to focus on prioritization of multiple enforcement initiatives and reduce unnecessary delays in enforcement processes while continuing to respect taxpayer rights.

The Deputy Commissioner for operations support will own the modernization program and drive productivity across the organization in order to improve service to taxpayers.

Mr. Chairman, as we approach the fifth anniversary of the enactment of this landmark legislation, the transformation of the IRS is still very much a work in progress and one that will require a great deal of effort if we are able to realize the full potential of RRA 98.

I am committed, as are the men and women of the IRS, to seeing this through to a successful conclusion. I would be happy to answer your questions.

[The statement of Mr. Everson follows:]

PREPARED TESTIMONY OF MARK W. EVERSON COMMISSIONER, INTERNAL REVENUE

INTRODUCTION AND SUMMARY

Mr. Chairman and distinguished Members of the Joint Review, thank you for this opportunity to provide an update of the IRS' progress in meeting the mandates set forth by the IRS Restructuring and Reform Act of 1998 (RRA 98).

I want to express my appreciation for your continued support of the IRS' efforts to carry out both the spirit and letter of RRA 98. As I begin my tenure as IRS Commissioner, I look forward to a productive relationship with you. I will certainly seek your counsel as to how we can improve both the management and processes that guide systems modernization and the critical services we provide to America's taxpayers.

Although I have been officially on the job as Commissioner for two weeks, I have some initial views about where the Agency stands today and what it must do in the future to succeed.

We are rapidly approaching the fifth anniversary of the enactment of this landmark legislation. But we are nowhere near realizing the full benefits of RRA 98. The modernization of the IRS is still very much a work in progress—and one that will require a great deal of hard work if we're to continue that progress.

In its January 2003 Performance and Accountability Report on the IRS, the GAO acknowledged that the IRS made progress laying the foundation for a modern agency that can respond to taxpayer needs in a more timely, accurate and cost efficient manner.

However, the GAO also warned that the "IRS must successfully manage several significant challenges that threaten continued modernization. Challenges include reversing the decline in compliance and collection programs, managing the deployment of several large business systems and implementing new performance measures and management processes."

The IRS has yet to provide the level of service that taxpayers, Congress and the IRS agree is necessary; however, progress was made this filing season, particularly in electronic tax administration. Electronic filing, while still short of the 80% RRA 98 goal, showed impressive gains. The IRS cracked the 51 million individual taxpayer mark, thanks in part to the new, innovative Free File program which attracted 2.7 million e-filers. Filing from home computers rose by 27%. IRS web site hits increased by another 25 percent. Telephone service also improved, with assistor level of service up 20% over the previous filing season.

The GAO also cited the collection of unpaid taxes as a major management challenge, and "because of the potential revenue losses and threat to voluntary compliance this is also a high-risk area." It is no secret that the IRS poached from enforcement to improve customer service and we are paying the price today with unacceptable enforcement levels that erode taxpayer confidence, and corporate audits that can take on average 5 years to complete. We must dig ourselves out of a very deep ditch.

As we work to improve taxpayer confidence in the fairness of our tax administration system, we must continue to respect taxpayer rights and work to improve the administration of RRA 98's taxpayer rights provisions. The IRS made progress on the Innocent Spouse program where centralization of receipts and better administration reduced case backlogs and processing time. Other programs, such as Offers in Compromise, are far more difficult to administer.

Business Systems Modernization (BSM) also presents many challenges. On the plus side, the IRS addressed a number of high-risk areas previously identified by GAO. First, it established the infrastructure systems on which future applications will run. Second, it began to deliver applications with tangible benefits to taxpayers, such as the "Where's My Refund" Internet-based service. Third, progress was made in establishing the modernization management controls needed to effectively acquire and implement information technology systems.

However, we are entering a critical phase of BSM and the program remains at high risk for two reasons. First, the program's scope and complexity continue to grow. Second IRS' modernization management capacity is still maturing.

Mr. Chairman, I believe the IRS is making progress implementing the letter and spirit of RRA 98, particularly on the customer service side. But we are certainly not out of the woods. There is still an enormous amount of work ahead to complete the job of modernization.

To meet these challenges and fully realize the benefits of the RRA 98, we must focus on three key areas.

One, we must continue the reorganization begun by Commissioner Rossotti to improve customer service. We must stay the course. Employees and managers at all levels of the organization must fully embrace and be engaged in the changes he launched.

Two, we must continue the information technology modernization program. Its success is critical to establishing a more efficient and effective IRS.

Three, we must strengthen the integrity of our Nation's tax system through enhanced enforcement activities. The IRS must deter those who might be inclined to evade their legal tax obligations and appropriately pursue those who actually do. I want to be clear that enforcement will be a principal responsibility of the IRS and we must bring a laser like focus to it.

Let me now describe in greater detail the progress IRS has made since the 2002 Joint Review hearing and the challenges that remain in the key areas of customer service, burden reduction, enforcement, taxpayer rights and business systems modernization. I also want to comment on the proposed modifications to RRA 98 contained in the President's FY 2004 budget.

IMPROVED CUSTOMER SERVICE

Mr. Chairman, I am pleased to report that service to taxpayers continues to improve. As demonstrated by the 2003 filing season results, key customer service indicators, such as e-filing and telephone assistor level of service went up. However, there is still a gap between the service the IRS delivers to taxpayers and what they expect and deserve. Clearly, the IRS has not met RRA 98's mandates if almost 20 percent of callers are not getting the correct answer to their tax law questions. As GAO recommended, the IRS has taken steps to improve management of the customer service functions, including improved performance measures, more program evaluation and the establishment of explicit goals.

I want to stress that top quality customer service also serves to improve voluntary compliance. In fact, the entire modernization program is premised in part on the principle that helping taxpayers to understand and meet their obligations under the law will improve compliance and result in fewer and less costly enforcement actions.

Electronic Tax Administration (ETA)

The President's Management Agenda states that "E-government initiatives will make it simpler for citizens to receive high quality service from the federal government, while reducing the cost of delivering those services." Electronic tax administration is an excellent example of this approach. E-file's benefits are clear and compelling. Taxpayers and the IRS find it more convenient and economical and less time consuming to do business electronically rather than sending paper through the mail. Moreover, the government saves money, but the real benefits are conveyed to the taxpayer. They include reduced preparation time, faster refunds, accuracy of returns and acknowledgment of return receipt.

Indeed, the American Customer Satisfaction Index shows a very high satisfaction rate among electronic filers. For 2002, it was 78 points (out of 100), compared with a mark of 53 for individual paper tax filers.

In 2002, more than 46.7 million taxpayers (36%) filed electronically—a 16.4% rise over the previous year. This filing season, all individual e-file is up by 12.4% and e-filing online has grown by 27%. It is projected that when all is said and done for this filing season that e-filing will constitute approximately 41% of individual returns filed. Part of the recent surge can be attributed to the Free File program, which clearly has been a success story.

As of April 18, Free File Alliance members have processed and transmitted more than 2.7 million tax returns. This represents approximately 22% of the total 9.2 million online e-filed returns. I do recognize some concerns about pop-up ads and we will work with the Alliance to address them.

The following key 2003 filing season e-file statistics through May 2, 2003 provide greater detail about individual e-file components and programs.

- Over 36 million taxpayers have e-filed their tax returns through an IRS-authorized Electronic Return Originator (ERO), a 10.4% increase over the same period last year.
- More than 11.7 million taxpayers have filed their tax returns on-line via their home computer through a third party transmitter. Online filing is running 26.8 per-

cent ahead of last year and exceeds by 2.5 million the 2002 total volume of 9.4 million.

- Over 32 million individual taxpayers have chosen to use the Personal Identification Numbers (PINS) in lieu of a written statement when e-filing on-line.
- Over 4 million taxpayers have filed their returns over the telephone using the TeleFile system.
- Over 42 million taxpayers have chosen direct deposit of their federal tax refund, an 11% increase from the year before.
- Over 22 million taxpayers have chosen to file both their federal and state tax returns simultaneously in a single electronic transmission, up 16% from last year's 16.2 million.

The popularity of e-file and its continued growth can be attributed to both its value to taxpayers and efforts to make it simpler, more attractive and available to more taxpayers. Since its modest beginnings as a pilot in 1986, more options were added each year, ranging from payment by credit card, direct deposit of refunds, self-select PINs, more forms and the joint filing of federal and state returns.

In addition, a group of employees within the IRS identify regulatory and administrative impediments to electronic filing and then systematically work to remove those impediments through changes to regulations, forms, etc.

For the 2003 filing season, new options, in addition to Free File were offered. This year, taxpayers were able to electronically file seven new forms related to their Individual Income Tax Returns. They also had several options for checking on the status of a refund, including the aforementioned "Where's My Refund?" service. Taxpayers can get the information they need quickly, efficiently and safely. For FY 2003, we expect 15 million uses of "Where's My Refund?"

The IRS web site at *www.irs.gov* also continues to be extremely popular with taxpayers. For the week ending March 15, 2003, it was listed as Number 2 in the Lycos Top 50 searches. In FY 2002, it posted 3.11 *billion* hits with more than 437 million forms and publications downloaded. For FY 2003 through April 25, there were 2.55 billion web site hits, up 25.59% over the same period last year.

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 many payments to the federal government, such as withholding and unemployment taxes. In fact, payments are a business's most frequent transaction with the IRS.

We want to convert all of these transactions to fast, accurate, paper-free electronic methods. And the IRS is making progress on a number of fronts.

During FY 2002, over 3.2 million taxpayers made $1.5 trillion in electronic tax payments through the Electronic Federal Tax Payment System (EFTPS), which now includes an online option. For 2003, IRS expects more than 4 million taxpayers to pay their taxes using the EFTPS System.

In FY 2002, the IRS also received more than 2.5 million 941 e-file program returns (Employer's Quarterly Federal Tax Return) and 855,000 returns for 941 TeleFile and On-Line Filing Programs. In CY 2002, over 320,000 businesses used the 940 e-file Program (Employers Annual Federal Unemployment Tax Return), and more than 24,000 partnerships chose 1065 e-file (U.S. Return of Partnership Income) in FY 2002.

In 2003, the IRS plans to better serve business's electronic tax administration needs. For example, tax professionals are able to file employment taxes for business clients for the first time as part of a new Employment Tax e-filing System. The IRS also expects that coming e-file upgrades will continue to reduce the paperwork burden on small businesses. The enhanced e-file system is part of an ongoing effort to reduce small business burden and barriers to electronic filing. This e-file option will replace outdated technology that was a burden to both businesses and the IRS. Key benefits of the new system include:

- More flexible filing—Forms 941 and 940 can be filed in a single transmission;
- Faster acknowledgements—Transmissions are now processed upon receipt and acknowledgments are returned in near real-time; and
- Integrated payment options—Eligible filers may submit a required payment along with their return, subject to limitations imposed by the Federal Tax Deposit Rules.

Businesses will also soon be able to apply for an employer identification number (EIN) by using the IRS's new on-line EIN Application at *irs.gov*. When a business applies, its EIN will display on the SS–4 for printing and record keeping and each applicant will receive their formal validation letter.

Mr. Chairman, to build practitioner interest, the IRS will offer later this year a suite of electronic services, such as disclosure authorization, transcript delivery and account resolution, to tax practitioners who file a certain number of returns electronically.

E-Services are web-based products for third parties to use over the Internet. Third parties include electronic return originators, software developers, transmitters, reporting agents, service providers, tax practitioners, payers, and states. There are two releases related to e-Services.

- Release 1 includes Registration, Preparer Tax Identification Number (PTIN) Application and Interactive Taxpayer Identification Number (TIN) Matching. (Scheduled to be released the last week of June 2003.)
- Release 2 includes e-file Application, Disclosure Authorization, Electronic Account Resolution, Transcript Delivery System and Bulk TIN Matching. Disclosure Authorization, Electronic Account Resolution and Transcript Delivery System are incentives available for authorized e-file providers who e-filed 100 or more individual returns. (Scheduled to be released in late August 2003.)

Telephone assistance

The IRS continues to provide various services through its toll-free telephone lines and service is improving. Through April 26, 2003 approximately 83.1 % of taxpayers who wanted to talk to a customer service representative got through, compared to 69.7% percent last year. The IRS set a goal of 72% for FY 2003.

The IRS is better identifying taxpayers' needs through tax law screening and then getting them to the right person to answer their question. This process has reduced the abandoned rate from 15.3% to 7.5%. In addition, the transfer rate was reduced from 22.1% to 17.2%. These two indicators illustrate that a higher percentage of taxpayers are reaching the right Customer Service Representative (CSR) without being transferred and/or having to call back while waiting to speak to a CSR.

Once connected, taxpayers must get prompt, accurate and courteous answers to their account and tax questions. The telephone correct response rates for tax law and tax account questions are about even with last year—82.5% and 87.7% respectively—as compared to 83.4% and 89.4% over the same period last year.

Taxpayer assistance centers

Taxpayers needing face-to-face help solving individual or business tax problems can get it every business day at every IRS Taxpayer Assistance Center (TAC). For the fiscal period beginning October 01, 2002 through April 26, 2003, the IRS served 5.92 million taxpayers at all TACs. For the 2003 filing season beginning January 01, 2003 through April 26, 2003 we served over 4.48 million taxpayers in all TACs. The customer satisfaction rate is 88% satisfied and 7% dissatisfied, which is on target for the FY 2003 performance plan.

Individual taxpayers with incomes of $35,000 or less can also receive free income tax return preparation and e-file help at TACs. The IRS extends this courtesy return preparation service to all taxpayers qualifying for the Earned Income Tax Credit, without placing the government in competition with private industry. All of these returns are e-filed.

Free tax preparation and *e*-file are also available in many communities through the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. To better serve low-income taxpayers, the IRS's Stakeholder Partnership, Education and Communication (SPEC) organization is establishing extensive partnerships with external groups such as local governments, non-profit organizations, private for-profit businesses, and others to create community coalitions. The IRS is also focusing its limited resources on providing technical expertise and training while encouraging the community partners to supply resources such as volunteers, space and computer equipment.

The IRS wants to make its partners as self-sufficient as possible and to identify those organizations that could make available needed resources. This new approach allows the IRS to expand access to low-income taxpayers, provide greater free tax return preparation and filing, and sustain these services over time.

BURDEN REDUCTION

Mr. Chairman, our goal is to create the least amount of burden for taxpayers to meet their responsibilities under the tax law. That is a guiding principle for the IRS's Office of Taxpayer Burden Reduction, which is the lead organization for our efforts in this critical area. I think we have made some progress, but more remains to be done.

Since last year's hearing, the IRS made progress on a number of fronts. For example, by raising the threshold for separately reporting interest and dividend income, an estimated 15 million taxpayers no longer have to file a Schedule B. In addition, because of our Industry Issue Resolution Program, family day care providers no longer have to keep detailed records and receipts of food purchased for use in their businesses. They may now choose instead to use a standardized rate to claim the deduction for meals provided to children in their care. These small businesses will save an estimated 10 million hours a year.

In addition, over 2.7 million taxpayers enjoyed the benefits of the innovative Free File initiative discussed previously in my testimony. Businesses are also finding that they can unburden themselves of even more paper and perform more of their reporting and payment transactions on line. Soon, they will even be able to apply for an Employer Identification Number by going to *www.irs.gov*. The IRS is also simplifying forms and notices to make them clearer and more easily understood. And the agency is tackling the major redesign of those schedules and forms with a huge impact on individual and business taxpayers, such as Schedule K–1 and Form 941.

Mr. Chairman, for many taxpayers, particularly business taxpayers, burden takes the classic form of time and money—the time and expense it takes to resolve an issue or problem that may affect one business or even, an entire industry. Ideally, we want to shift from addressing taxpayer problems well after returns are filed to addressing them as early as possible in the process, and in fact preventing problems wherever possible. To this end, the IRS created a number of programs in its operating and functional divisions to address issue management and problem resolution.

The Industry Issue Resolution (IIR) program began more than two years ago as an initiative under the Large and Mid-Size Business (LMSB) Operating Division's Issue Management Strategy. The IIR program provides guidance on frequently disputed or burdensome business tax issues. Benefits of the program include reduced costs and burden, and eliminating uncertainty regarding proper tax treatment, for both taxpayers and the IRS. The IRS estimates that it has provided millions of hours in taxpayer burden reduction.

The pilot program was evaluated and determined to be successful. In 2002, Notice 2002–20 was issued to announce the decision to make IIR a permanent program, expand the program to include SB/SE business issues, *establish burden reduction as an issue criterion* and invite issue submissions. For 2002, 38 issues were submitted from businesses, tax practitioners and associations and seven were accepted for the IIR program.

Fast Track Mediation (FTM) evolved from the Modernization/Re-Engineering process. It is designed to help SB/SE taxpayers resolve disputes resulting from examinations and collection (offer in compromise, trust fund recovery penalty, and certain collection due process) actions. FTM reduces taxpayer burden by resolving disputes in a fair and impartial manner, as well as on a timely basis. Disputes will be resolved within 30 to 40 days compared to several months through the regular appeals process.

FTM began as a pilot program in June 2000, in four cities. Based on the success of the pilot, on June 1, 2002, FTM was rolled out nationwide. A revenue procedure on FTM is being finalized by Chief Counsel and Treasury to expand this program. Publication 3605, Fast Track Mediation–A Process for Prompt Resolution of Tax Issues, lists cases excluded from the program.

The LMSB Fast Track Settlement (FTS) Program has reduced taxpayer burden in important ways. A recent survey of taxpayers who completed the process asked them to identify what they expected to gain from the Fast Track process. The three top expectations (in order of number of responses) were: (1) quicker resolution of their cases, (2) lower non-tax costs, and (3) reduction in staffing demands. When asked if their expectations had been substantially met, the average agreement rate was 4.21 on a five-point scale where five is "strongly agree."

The IRS estimates that the overall case resolution cycle time is reduced by approximately 920 days for cases participating in the Fast Track process. A revenue procedure on FTS is being finalized by Chief Counsel and Treasury to expand this program.

The LMSB Division is implementing a new streamlined examination process called the Limited Issue Focused Examination, or LIFE. This initiative will involve a formal agreement, a Memorandum of Understanding (MOU), between the IRS and taxpayer served by LMSB to govern key aspects of the examination. The MOU will contain dollar-limit thresholds, established on a case-by-case basis, below which the IRS will agree not to raise issues and the taxpayer will agree not to file claims. Our goal is to create an atmosphere where the examination process is less difficult, less time-consuming, less expensive and less contentious for all involved.

Clearly, the IRS has made some progress, but clearly too, reducing unnecessary taxpayer burden in all its many shapes and forms is an enormous challenge, especially when seen within the context of an extremely complex and ever changing Tax Code.

Indeed, even as the IRS seeks to cut lines, simplify or eliminate forms altogether, and reduce the number of taxpayers having to file forms and schedules, it often must add lines to other tax forms to reflect new changes in the Tax Code that may benefit millions of taxpayers. For example, the IRS added three lines to the Form 1040 for tax year 2002 to accommodate statutory tax law changes relating to retirement, deductions for educators' supplies, and tuition and fees.

Frequent changes to the tax code and tax law complexity are perhaps the greatest hurdles to overcome as the IRS works to reduce unnecessary taxpayer burden. There is even anecdotal evidence that tax law complexity may be a cause of non-compliance, and even non-filing. Confounded and confused by the complexity, some taxpayers just give up. Moreover, the IRS estimates the cost to taxpayers for complying with the Code to exceed $80 billion—8 times the cost of the IRS budget.

In a speech delivered in March 2003 to the Federal Bar Association, Assistant Treasury Secretary for Tax Policy, Pam Olson, pointed to the fundamental problem that we as tax administrators and a nation of taxpayers face:

> A key way that companies have raised productivity is by simplifying. Take every process down to its constituent parts, and cut out the inefficiencies, the points of friction, the drags that prevent the most streamlined operation and the standardization of transactions. Instead of simplifying to increase productivity in tax compliance and administration, we keep adding complexity—more rules, more limitations, more terms, more conditions, more qualifiers, more provisos, more exceptions. The result is that our system gets slower and slower and more inefficient. We burn more fuel, and emit ever more heat and smoke, and yet with all that burning, there's less and less light to show for it.

That is a fair and correct assessment of our present situation. Our myriad efforts to reduce unnecessary taxpayer burden are producing tangible benefits to taxpayers, but we must still address tax law complexity in a meaningful way. If we fail to, we will have failed in our mission to reduce taxpayer burden. Most importantly, we will have failed America's taxpayers.

ENFORCEMENT

Mr. Chairman, the IRS is committed to ensuring everyone pays his or her fair share, including those who have the resources to move money offshore or engage in abusive schemes or shelters. We must focus our efforts on achieving greater corporate accountability and ensure that high-end taxpayers fulfill their responsibilities. Honest taxpayers should not bear the burden of others who skirt their responsibility. It's as simple as this. Taxpayers should pay what they owe.

However, the poaching of enforcement personnel to bolster customer service contributed to a steady and disturbing decline in enforcement. As I stated in my introduction, the GAO identified the collection of unpaid taxes as a major and growing management challenge as reflected in the "large and pervasive declines in IRS's compliance and collection programs." Moreover, "because of the potential revenue loss and the threat to voluntary compliance this is also a high-risk area."

Although there have been improvements in some enforcement numbers; they are modest and spotty across the broad spectrum of enforcement activities. It is unacceptable that a corporate audit still takes on average 5 years to complete. The Service must examine its enforcement priorities and reduce the cycle time in its enforcement processes, albeit without compromising taxpayer rights. We must bring the same commitment and focus to improving and administering our enforcement programs as the IRS has in improving customer service.

The IRS is now working to identify and refocus its resources on the biggest areas of risk to the tax system. Toward the end of FY 2002, the IRS began realigning its resources to concentrate on key areas of non-compliance with the tax law, primarily among higher-income taxpayers and businesses. These include:

- The promotion of abusive tax schemes.
- The misuse of devices such as offshore accounts to hide or improperly reduce income.
- The use of abusive tax avoidance transactions.
- The underreporting of income by higher-income individuals.
- Non-filing by higher-income individuals.
- Earned Income Tax Credit program.
- The National Research Program.

Indeed, the principal focus of the President's proposed FY 2004 budget is strengthening enforcement in these and related areas. We are most encouraged by the new money requested to help us address these difficult issues.

The IRS Small Business/Self-Employed (SB/SE) Division is leading the new civil enforcement effort on issues affecting individuals and businesses. However, enforcement efforts will continue in other parts of the agency, such as the abusive tax avoidance transaction initiative in the Large and Mid-Sized Business (LMSB) Division. IRS Criminal Investigation also continues its investigative efforts regarding abusive schemes and promoters.

Key to the fight against abusive tax scams and schemes is better identifying their promoters; we must go the source and cut off the supply. In April 2002, SB/SE established a Lead Development Center (LDC) with the following purposes:

- To centralize the receipt and development of leads on promoters of abusive tax schemes;
- To authorize and monitor on a national level abusive tax promoter investigations (also called 6700 investigations) assigned to the field; and
- To promote and effect the coordination of parallel investigations with IRS Criminal Investigation.

Because of the LDC, the IRS has a better handle on the universe of the problem. The current receipt of new leads is averaging approximately 82 per month. As of May 2, 2003, 372 civil promoter investigations are being worked in the field, and 491 are being evaluated for further action. The leads can also be broken down into promoter brackets or "buckets," with domestic trusts, offshore transactions and frivolous constitutional arguments being the largest.

Since October 2000, the IRS has also issued a series of summonses to a variety of financial and commercial businesses to obtain information on U.S. residents who held credit, debit, or other payment cards issued by offshore banks.

And in January 2003, the IRS launched an initiative aimed at bringing taxpayers who used "offshore" payment cards or other offshore financial arrangements to hide their income back into compliance with tax law. The Offshore Voluntary Compliance Initiative led to more than 1,200 people stepping forward to participate. A partial analysis of some of the cases has already identified more than $50 million in uncollected taxes and 80 new offshore promoters.

Mr. Chairman, critical to the agency's efforts are new expedited procedures developed with the Justice Department to obtain timely injunctions. In the past, many of the scams and schemes continued to operate even when the IRS had identified them as being abusive. However, with these new procedures in place, the agency and its partners at the Justice Department are in a better position to shut these scams down before they can do any more harm.

As of May 2, 2003, the IRS had 27 promoter injunctions granted, 6 promoter injunctions pending in District Court and 24 pending at the Department of Justice, 372 civil promoter investigations in the field, and 464 ongoing criminal investigations of promoters of various tax schemes.

The IRS also emphasized abusive shelters and transactions. The Office of Tax Shelter Analysis (OTSA) provides centralized data collection and analysis on all aspects of the tax shelter program, including information required to be disclosed by regulation, developed by field agents and obtained during the course of our disclosure and settlement initiatives.

LMSB currently has 89 promoters under investigation; 245 summonses have been issued to obtain relevant information from promoters (including investor lists), of which 77 have been referred to the Justice Department for enforcement. IRS has obtained investor lists from 25 promoters covering multiple transactions. DOJ on behalf of the IRS has filed summons enforcement actions against four promoters to obtain information to which the IRS is entitled.

When a transaction is determined to be abusive, IRS and Treasury publish legal guidance as early as possible. This process is designed to deter subsequent promotion and investment in abusive transactions and to facilitate identification of investors and promoters. It also ensures consistent treatment of such transactions by IRS agents in the field. The IRS and Treasury have identified 25 abusive transactions through formal guidance.

The IRS Disclosure Initiative also brought many taxpayers into compliance and provided leads on promoters and emerging abusive transactions. Conducted from December 2001 to April 2002, it resulted in 1,664 disclosures from 1,206 taxpayers. Taxpayers have disclosed transactions in which they claimed deductions or losses amounting to billions of dollars. The IRS is analyzing the new transactions to determine whether they are abusive and warrant published guidance or other administrative response.

Reduce inappropriate payments in the EITC Program

The EITC program benefits millions of low-income workers. It lifts nearly 4 million people, especially single mothers, out of poverty each year. However, the current error rate for the EITC program is too high. In 1999, between 27 and 32 percent of EITC claims—or between $8.5 billion and $9.9 billion—were paid in error.

Again this January, the GAO included the EITC as one of two dozen "high-risk" areas across the federal government. The GAO stated, "The IRS has to balance its efforts to combat non-compliance with its efforts to help ensure that qualified persons claim the credit." I fully agree with GAO's assessment.

Some have also claimed that the audit rate for the EITC is disproportionately high. However, a better comparison would be to other benefits programs which verify a significantly higher percentage of claimants for eligibility.

The FY 2004 Budget requests an additional $100 million to begin a new strategy for improving the EITC program. Mr. Chairman, the Administration's EITC proposal became an issue during my confirmation process. I want to stress that in the coming weeks, I intend to closely review the proposed program. I pledge to work with all interested parties to ensure that any new controls put in place do not unnecessarily discourage participation in this important program.

Use of private sector contractors for collection of taxes due

There is a significant and growing backlog of cases involving individual taxpayers who are aware of their tax liabilities but are not paying them. In this regard, the budget contains an important legislative proposal that would authorize the IRS to contract with private-sector collection agencies—or PCAs—to supplement current tax collection efforts for a targeted category of debt. I would like to emphasize that this proposal is totally distinct from competitive sourcing and will not result in the loss of a single job at the IRS. While federal employees could do this work, as you know, appropriated resources are scarce. And I would like to point out that for 8 out of the last 10 fiscal years, the IRS has actually received less than its full budget request. The proposed use of PCAs is a realistic approach. As the National Taxpayer Advocate states, "PCAs appear a limited but reasonable option."

For the purposes of this initiative, the Treasury Department and the IRS identified over $13 billion in individual tax debt designated as currently "non-collectible." The cases the IRS would refer to PCAs are those where the taxpayer would likely pay the outstanding tax liability if contacted by telephone. These include situations where a taxpayer filed a return indicating an amount of tax due but did not also send in payment for that full amount. These cases also would include situations where the taxpayer has made three or more voluntary payments of tax that was assessed by the IRS.

The IRS would not refer to PCAs cases for which there is any indication that enforcement action would be required to collect the tax liabilities. The IRS will avoid referring cases that would require IRS expertise or the exercise of discretion.

I want to stress in the strongest possible terms that PCAs would be prohibited from threatening or intimidating taxpayers. Indeed, the PCAs would be governed by all of the same rules by which IRS employees are held accountable. The taxpayer protections woven throughout this proposal have also been thoroughly reviewed by the National Taxpayer Advocate who will be testifying this afternoon.

From my previous perch as Deputy Director for Management at OMB, I am also acutely sensitive to the need for proper supervision of outside contractors. I want to assure the Subcommittee that PCAs and PCA employees will receive close supervision by the IRS to insure compliance with taxpayer protections and applicable policies and procedures. The National Taxpayer Advocate will continue to be involved in this process.

Mr. Chairman, I want to make one final point. The President's initiative builds on a record of success at both the state and federal level. PCAs are common across more than 40 states, including those represented on the Subcommittee. We will work to take the best from these different approaches and we will also benefit from their lessons learned.

In the federal arena, I would like to point out that PCAs are being successfully used by both the Financial Management Service within the Treasury Department and the Department of Education. Under the Debt Collection Improvement Act of 1996, nontax debts of a certain age owed to federal agencies, such as defaulted loans, must be referred to FMS. The collection of the debt is the responsibility of PCAs and this system is working very well. In addition, I have confirmed with the Deputy Secretary of Education that the Department's experience with PCAs is also very positive.

National Research Program

Mr. Chairman, also key to successfully executing an enforcement program is better data. The IRS failed to detect new areas of non-compliance in part because of a reliance on increasingly obsolete data from the old Taxpayer Compliance Measurement Program. (TCMP was last conducted in 1988.) The agency designed and is implementing a National Research Program that will obtain the essential information with far less burden on the taxpayer. New scoring models are being developed using 21st century techniques, with interim models already deployed.

ADMINISTERING RRA 98'S TAXPAYER RIGHTS

Mr. Chairman, the IRS continues to work to administer more efficiently and effectively RRA 98's 71 taxpayer rights provisions. We clearly made progress in the Innocent Spouse program where greater efficiencies have dramatically reduced case backlogs. However, the Offers in Compromise (OIC) Program and Collection Due Process have proved to be the two most difficult RRA 98 expanded taxpayer rights to administer. Nonetheless, we believe that we are now making real progress addressing these challenges. In addition, the proposed changes to RRA 98 contained in the President's budget would go a long way to helping us ensure that these important programs work in the manner Congress intended.

Innocent spouse

The Innocent Spouse provisions implemented as part of RRA 98 were in response to concerns that the former law was not providing proper relief to innocent spouses. The new provision affords four types of relief:

- Innocent Spouse Relief—IRC section 6015(b)
- Separation of Liability—IRC section 6015(c)
- Equitable Relief—IRC section 6015(f)
- Equitable Relief for Community Property Issues—IRC section 66(c)

Each category of relief has different requirements. IRS employees processing the claims initially had difficulty reaching a determination—whether to fully grant, partially grant, or fully deny the requested relief. To address these concerns, we developed training courses and a computer-based application that took employees through a series of questions to aid them in making an accurate determination.

In addition, because of the legislation's complexity, requisite administrative procedures and the enormous number of claims initially received, the IRS could not respond to the claimants in a timely manner. To be more accurate, timely, and consistent, a centralized site was established at the Cincinnati Campus to process the claims. As a result, inventory levels have steadily decreased from FY 2000 when they stood at over 40,000 to approximately 20,000 in FY 2002.

Innocent spouse claims are determined to be "merit" or "non-merit." A claim is determined to be non-merit if it does not meet the basic eligibility requirements, such as no return filed or the claim is not signed. To date, 35.5% of innocent spouse claims were determined to be non-merit. Of the merit claims, 29.3% were allowed; 10.6% were partially allowed and 60.1% were disallowed.

Offers in compromise

Taxpayers who do not pay their full tax liability are subject to the IRS' collection process. It begins when we send the taxpayer a bill demanding full payment. For those unable to pay, or when payment would create a hardship, we defer payment of their liability by placing the account in an "uncollectible" status. While these debts are classified as "uncollectible," the debt is not written off until the statute of limitations expires.

For taxpayers who are unwilling to pay, the IRS may take enforcement action, such as a lien, levy, or seizure of property. Taxpayers who are willing to pay may qualify for an installment agreement that allows for full payment to be made over time. The vast majority of accounts are resolved through one of these methods.

Taxpayers who cannot afford to pay their full liability may be eligible for an offer in compromise. An offer in compromise is an agreement between a taxpayer and the IRS to settle or "compromise" the taxpayer's tax liability for less than the full amount owed. Upon acceptance of an offer, the remainder of the debt is forgiven. Approximately one percent of accounts are resolved through an OIC.

Section 7122 of the Internal Revenue Code gives the agency authority to settle tax debts through compromises. However, compromise authority was historically limited to cases where there was doubt about liability or whether the debt could be collected. Provisions in RRA 98 modified the OIC program so that the IRS could not reject an offer from a low-income taxpayer based solely on the amount offered.

In July 2002, IRS issued final regulations adopting the temporary regulations of 1999 with only minor changes. The final regulations established a third type of compromise—one that promotes effective tax administration. IRS can now accept the following types of compromises:

- Doubt as to Liability—Doubt exists that the assessed tax is correct.

- Doubt as to Collectibility—Doubt exists that the taxpayer could ever pay the full amount of tax owed.
- Effective Tax Administration—There is no doubt the tax is correct and no doubt that the amount owed could be collected, but an exceptional circumstance exists that allows the IRS to consider the taxpayer's offer. To be eligible for a compromise on this basis, the taxpayer must demonstrate that collection of the tax would create an economic hardship or would be unfair and inequitable.

However, the following major problems placed the OIC program at risk:

- A large case inventory of about 125,000 receipts-per-year with a projected 10 percent annual growth.
- Processing time/delays.
- High cost of the program relative to the number of taxpayers served.
- Critics have also called into question the high rejection rate of offers. The National Taxpayer Advocate stated that the IRS "needs to better train its employees to make correct determinations of who is submitting a viable offer."
- External perceptions and opinions about the viability of processing offers in a centralized environment. Many practitioners prefer to deal with their local offer specialist rather than deal by telephone or correspondence with a centralized bulk processing operation.

Case inventory levels and processing delays increased for a number of reasons. In a March 2002 report, GAO observed that the IRS was unable to keep pace with program changes even with increased staff:

> Program changes, some initiated by IRS and some mandated by the Restructuring Act, increased the demand for offers, the number of processing steps, and the number of staff hours needed to process a case. During the same period, staff hours charged to the OIC Program more than doubled, growing to 18 percent of total staff hours charged to all of IRS's programs for collecting tax debts. Yet, the demand for offers exceeded staff's capacity to process them.

There are other reasons for the large case inventory. The proliferation of electronic media marketing by firms promising settlement of IRS taxes for "pennies on the dollar" give taxpayers unrealistic expectations about the OIC program. A large number of taxpayers also seek refuge in the program to circumvent imminent or ongoing collection action. Under current policy, the mere act of submitting a processable offer (without any supporting financial documentation) is sufficient to stay collection.

Despite the fact that the latest revision (5–2001) of the Offer in Compromise package, Form 656, includes specific instructions to attach certain financial documentation when submitting an offer, we receive relatively few complete submissions. Furthermore, a large number of taxpayers lose interest when they realize that they must submit substantiation of their finances to enable the IRS to evaluate their offers.

In this regard, we believe that the OIC program will benefit from some proposed legislative changes. In its FY 2004 Budget, the Administration offered legislative proposals that would: (1) address frivolous OIC filers by establishing a $5,000 penalty for a frivolous submission, and (2) remove the barriers to granting installment agreements for less than full payment. These legislative proposals can assist the IRS in reducing inappropriate OIC receipts and contribute to our overall goal of eliminating backlogs and meeting our processing time goals.

The number of days to close an offer case also reached unacceptable levels, but we have made improvements in this area. In addition, OIC program staffing costs grew. On top of the sheer number of offers received, some program changes increased the complexity of the offer process, resulting in more processing steps and staff hours to process a case. Between FY 1997 and 2001, the number of direct collection field hours charged to the OIC program more than doubled.

To address the growing workload issue, the IRS centralized the receipt and processing of offers into two locations—Brookhaven, New York and Memphis, Tennessee. It allowed for efficiencies of scale as well as the opportunity to better focus training efforts and standardize procedures. We project that about 70 percent of all offers can be worked to completion in the centralized sites. Only the most complex cases involving business taxpayers are assigned to local field offices.

Other program enhancements enabled us to concentrate resources on those taxpayer accounts where the offer is the most appropriate collection method to resolve a longstanding liability. We accelerated the identification and resolution of inappropriate offers—those where the taxpayer has a clear ability to pay fully the liability, and/or submits an offer solely to delay the collection process. The more complex cases—those requiring assignment to field collection personnel—are now screened much earlier in the process and transferred out to field specialists. We are also automating labor intensive procedures.

These process changes improved productivity at the centralized sites and the field offices, with a corresponding positive impact on customer service. The inventory is becoming more current and the number of aged cases—those more than six months old—has decreased. The move toward centralization has allowed us to return a significant number of field employees to other collection priorities.

While productivity gains have contributed to the declining inventory, we have also seen a significant increase in the number of cases that must be closed as "not processable" or "return." We have begun an educational effort with taxpayers and tax practitioners to draw attention to the qualifications that appear in the OIC application package. The IRS Office of Performance Evaluation Research and Analysis will also conduct a study of offers that were closed (regardless of disposition), to identify areas for improvement.

Processing time has declined from an average of 317 days during FY 2002 to an average of 272 days for the first 6 months of FY 2003. In addition, the average age of open inventory dropped from 265 days at the end of FY 2002 to 240 at the end of March 2003. This is due in part to the continuing maturation of the Centralized Offer in Compromise (COIC) sites. These numbers are still too high but we are heading in the right direction.

Mr. Chairman, we continue to view the Offer in Compromise program as an effective tool to resolve tax liabilities for those taxpayers who qualify. While we have taken steps to reduce taxpayer burden and improve customer service through work process standardization and reducing the level of financial documentation required from taxpayers, we continue to seek the cooperation of tax practitioners and the general public to ensure that offers are submitted only in appropriate circumstances.

Collection due process

The collection due process (CDP) provisions require that taxpayers be given an opportunity to request a hearing with Appeals after the filing of a Notice of Federal Tax Lien and prior to proposed levy action. Some taxpayers use the hearing process to delay collection action by filing hearing requests that raise frivolous issues.

There are approximately 17,500 CDP cases currently in inventory in Appeals. About 5% or 896 cases, involve frivolous issue taxpayers. The Area Appeals Office with the most cases has about 25% of non-filer/frivolous taxpayers. Sub-offices within that area have even more substantial percentages of taxpayers with frivolous claims.

However, the actual number alone does not account for the amount of time it takes for such cases. Frivolous claims occupy a disproportionate share of time over claims from taxpayers having substantive issues. In addition, some of the representatives of these claims also file Section 1203 actions against IRS employees. These section 1203 actions are very rarely sustained but can be resource intensive to respond to.

Time spent on these frivolous claims is time spent away from taxpayers who raise legitimate issues. Collection action is also suspended on these accounts while the case is pending in Appeals. The proposed legislative change which would permit the IRS to dismiss frivolous claims, would allow us to proceed with collection on these cases and enable Appeals to focus full efforts on taxpayers with legitimate claims.

BUSINESS SYSTEMS MODERNIZATION

Critical to IRS' success in meeting all of RRA 98's goals is better managing our massive technology and Business Systems Modernization program. BSM has finally begun to deliver the first projects with tangible benefits to taxpayers, such as the new Internet Refund/Fact of Filing (IR/FoF) application that allowed them to check on the status of their return and refund 24 hours a day, 7 days a week. Of paramount importance, IRS implemented the first project on its new security system, which provides one standard for ensuring the security of all IRS data and systems.

However, this is not the time for complacency; the stakes are too high. I want to bring a strong management focus and accountability to the BSM program to ensure its success.

Chairman Houghton recently commented: "This year and next will be critical to determining whether the modernization effort will succeed. Many systems that have been under development for years—such as the new IRS database of tax records—are entering the final stages of development."

As previously noted, the GAO continues to characterize the BSM program as "challenged" and at high risk for two reasons:

> First, the scope and complexity of the program are growing. Specifically, the number of projects underway continues to expand and the tasks associated with those projects that are moving beyond design and into development are by their nature more complex and risky. Second, IRS's modernization capacity is still maturing.

Strategically, the most important objective over the next year is to increase the overall confidence in the modernization program by meeting most of the delivery goals: the initial CADE release; a new core accounting system; the first part of a new custodial accounting system; a new e-filing system for large business; and a number of electronic enhancements for third party providers. In other words, we must focus on meeting the commitments that we have in front of us for the next year.

Once that confidence is restored, we will then be able to move ahead with the broader agenda, hopefully, with the increased funding level requested in the President's FY 2004 budget and doing a better job of meeting cost and schedule targets.

It is also critical that the entire IRS leadership team works together to ensure the modernization program's success. The Business Systems Modernization Office, Modernization, Information Technology and Security Services (MITS) and the business units, must partner cohesively in planning, building and implementing modernized systems. As an organization, we must cooperate to reduce and eliminate internal impediments that could inhibit the success of the PRIME. I will also make sure that the PRIME contractor is clear on its commitments and my expectations for improvements in its track record to date.

Mr. Chairman, I want to stress that modernization does not have a clear end point that we can call completion. At some point, modernization will no longer be a specialized, separately funded program. Rather, as new business processes and enabling information technology are deployed, systems modernization planning and implementation will become a routine IRS business practice. Indications that we have done most of the heavy lifting will be when:

- The Master Files have been replaced by the Customer Accounts Data Engine (CADE) project;
- New internal management systems have been deployed and all financial material weaknesses closed;
- E-filing is pervasive for both individuals and businesses;
- New customer service and collections capabilities are in place; and
- Better systems are available to support compliance.

The FY 2003 delivery plan will move the BSM Program into a wide spectrum of critical new areas:

- Customer Account Data Engine (CADE) R1. In July 2003, CADE will begin processing single 1040EZ filers (both electronic and paper). Taxpayers covered under CADE will receive their refunds about 40% faster than under Master File processing, if they use direct deposit. More importantly, we will have taken the first of many steps to replace the 40–year old Master Files.
- Custodial Accounting Project (CAP). We will continue development and testing of CAP Release 1 scheduled for deployment in the first quarter of FY 2004. CAP will create a repository for modernized Individual Master File data and will address documented financial material weaknesses.
- Enterprise Architecture (EA) and Tax Administration Vision and Strategy (TAVS). TAVS focuses on creating a long-term vision of how the agency should work in the future. Delivery and acceptance of EA Release 2.0 was a significant achievement. We also conducted a planning effort called "TAVS Refresh" to identify gaps and outdated information in TAVS which we plan to address in FY 2003.
- e-Services. e-Services sub-releases will provide: registration of electronic return originators, Taxpayer Identification Number (TIN) matching, initial partner relationship management capabilities, electronic account resolution, transcript delivery, secure e-mail, and bulk TIN matching.
- Infrastructure (STIR and Infrastructure Shared Services [ISS]). This project provides the basic secure infrastructure necessary to support the modernization effort including e-Services R1, IR/FoF, Internet Employer Identification Number (EIN), and subsequent FY 2003 releases.
- Integrated Tax Administration Business Solutions (ITABS). Projects to ensure we understand requirements and select COTS (commercial off-the-shelf) solutions that can effectively integrate business processes in IRS functions.
- Internet EIN. This application will automate Employer Identification Number (EIN) requests over the Internet. Currently, the EIN request process is

cumbersome and people-intensive, often resulting in unacceptable delays for those starting new businesses.

- Integrated Financial System (IFS). Although the first release of the new financial system will not go live until October 1, 2003 (therefore, an FY 2004 delivery project), it is likely to be our most work-intensive project during FY 2003.
- Modernized e-file. The Modernized e-file project will be in pre-deployment testing for all of FY 2003, with initial deployment in early CY 2004, with Forms 1120 and 990 e-file capabilities.

I feel fortunate to have major deliverables in the coming months, rather than a year from now. This timetable affords me the opportunity to assess whether real progress is being made.

MODIFICATIONS TO RRA 98

Mr. Chairman, in the FY 2004 budget submission, the Administration again proposed modifications to RRA 98. Last year, the House passed legislation that contained five of these proposals; the Senate did not act before adjourning. We commend the House for its actions and believe that these modifications preserve the intent of the Act while allowing us to administer it more efficiently and effectively. We urge the Congress to take similar action this year.

There are six parts to the Administration's proposed modifications. The first modifies infractions subject to Section 1203 of RRA 98 and permits a broader range of available penalties. Our ability to efficiently administer the tax code is currently hampered by a strong fear among our employees that they will be subject to unfounded 1203 allegations, and perhaps lose their jobs as a result. This proposal will reduce employee anxiety resulting from unduly harsh discipline or unfounded allegations, while still subjecting violations to appropriate sanctions that may include termination.

The second part mentioned above adopts measures to curb the large number of frivolous submissions and filings that are made to impede or delay tax administration.

The third, as is mentioned above, permits the IRS to enter into installment agreements with taxpayers that do not guarantee full payment of liability over the life of the agreement. It allows the IRS to enter agreements with taxpayers who desire to resolve their tax obligations but cannot make payments large enough to satisfy their entire liability and for whom an offer in compromise is not a viable alternative.

The fourth allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.

The fifth streamlines jurisdiction over collection due process cases in the Tax Court, thereby reducing the cycle time for certain collection due process cases.

The sixth and last provision would eliminate the monetary threshold for IRS Chief Counsel reviews of offers in compromise.

The Administration also has two proposals to improve IRS efficiency and performance from current resources. The first would modify the way that Financial Management Services (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to retain a portion of the amount collected before transmitting the balance to the IRS, thereby reducing government transaction costs. The offset amount would be included as part of the 15-percent limit on levies against income and would also be credited against the taxpayer's liability.

The second proposal would encourage growth in electronic filing by extending from April 15 to April 30 the return filing and payment date for the filing of individual income tax returns, if the return is filed electronically and any balance due is paid electronically.

All of the proposals discussed above, with the exception of the fourth concerning installment agreements, have been included in the Taxpayer Protection and IRS Accountability Act of 2003, which was reported by the Ways and Means Committee in April. We appreciate the Committee's attention to these proposals.

Let me mention two provisions that have Treasury support, but were raised too late to be considered in the Taxpayer Protection and IRS Accountability Act of 2003.

The first is a proposal to modify the interest and penalty notification requirements such that the interest and penalty notification requirements would apply only to the first notice sent to the taxpayer. Subsequent notices would include a general description of how interest and penalties are computed, as well as a telephone number that taxpayers can call to obtain detailed account information. This proposal would appropriately balance the benefits of providing taxpayers with a full explanation of how any interest and penalties due were computed, with the burden and cost to the IRS of providing this information with each notice.

The second provision would permit the IRS to send a portion (up to 50 percent) of its notices by first class mail, instead of registered or certified mail, for a one-year test period. This would allow the IRS to determine whether it could save money on its mailings while still assuring that taxpayers receive adequate notice.

We would appreciate consideration of these proposals at some point during Congressional consideration of the Taxpayer Protection and IRS Accountability Act of 2003.

CONCLUSION

Mr. Chairman, in conclusion I believe that the IRS has made progress achieving the goals and intent of the Restructuring Act, but there is a lot more to do. One the service side, things are getting better, but much more must be accomplished. And it is not totally clear that modernization is reaching its promised results. We need and must vigorously pursue a renewed focus on enforcement but I expect the Service will make progress in all three key areas: customer service, enforcement and information technology.

Representative HOUGHTON. Thank you very much. I just have one question. We have all been involved in the different series of organizations over the years. The first question I am always interested in is tell me about your people.

In other words, you have had quite a few people recently leave the IRS. And how are your people? Are you going to be able to replace those people that have left? What are the quality of replacements? What are you doing about this?

Mr. EVERSON. Mr. Chairman, I have been very impressed with the caliber of the leadership that I have met. The confirmation process was a relatively long one. I had an opportunity during that period to meet with and be briefed by the top two or three levels of leadership within the Service. In each in instance, I was tremendously impressed by the dedication they bring to the work that they undertake, and also by the desire to get on with the reorganization of the Service to finish the job that was begun by Commissioner Rossetti.

That having been said, I do believe that what the RRA 98 achieved, by the critical pay positions, was the ability of the Service to bring in outsiders to supplement these high-caliber career individuals. Critical pay is a good innovation and one on which I will rely. I will expect, for instance, when Deputy Commissioner Wenzel, who I will name to be the first Deputy Commissioner for Service and Support, retires later this year at the end of September—I am trying to negotiate a longer departure date but he is not buying it so far—we will go outside for that position. I expect that to happen, so we get a nice blending of the inside and the outside. But I am happy with the caliber of leadership.

Representative HOUGHTON. Now, Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

Commissioner, can you talk about the E-filing rate? Your testimony says that 41 percent of individuals filed electronically this year. It is obviously up quite a bit from last year.

What is your performance metric for this benchmark and your performance goal over the next 2 to 5 years? What do you hope to get this level up to? And how do you propose to do it?

Mr. EVERSON. The RRA 98 does state a statutory objective—at the end of the fifth filing system from now, that will be 2007, that the Service get to 80 percent. My understanding is that the goal was, I don't want to say arbitrary, but it was very difficult at that stage, 5 years ago, to project just how far you could or should take that.

Some have asked whether that should be revisited. I think it is too early to consider whether that needs to be revisited. I certainly, as I look at the Service's activities in this area, am pleased with what I have seen thus far. As you know, we added a Free File Initiative this year, that actually picked up 2.7, 2.8 million taxpayers. There is a little bit of hair on this, concerns on pop-ups that came up that some of your colleagues have raised questions about.

We are going to look at efile, and try to make it an even better program. I honestly can't tell you whether 80 percent is the right long-term number. My concern in this area is there are sectors of the taxpaying population, new-immigrant communities, others that are just coming into the system, it is probably unrealistic to think that we are going to capture 100 percent.

Whether it should be 80 percent or 75 or 85 is a little too soon to tell. We are going to continue on this path, learn as we go, and reinforce it with better technology.

Senator SUNUNU. Are there any specific technical barriers to improving that number, the 41 percent number, that you see? And, are there any particularly strong opportunities that you see that current initiatives may be able to exploit in the coming 1 to 2 years?

Mr. EVERSON. I am less concerned, frankly, Senator, on the individual taxpayer side than I am on the corporate side, which is obviously a much smaller group of taxpayers, but the opportunity of being able to pull in information electronically and then immediately have it available for analysis, that would be a very significant opportunity.

As I understand it, when other countries, Canada and others have done this, they haven't been entirely successful in some of these endeavors because of the complexity, unless it is done on a voluntary basis. So there are some tough issues here if you want to tap into the full realization of the efficiencies when you get to the more sophisticated taxpayers.

Senator SUNUNU. Is there anything that Congress can do or should do to make it easier to increase the opportunity to bring more filers on electronically?

Mr. EVERSON. I don't know yet. I will be looking at that and come back to you, of course, if there are opportunities.

Senator SUNUNU. In your opening testimony, did I hear you correctly? You said, I think, that there were 19 million busy signals during last year's filing season, and that was reduced to 200,000 this year?

Mr. EVERSON. Well, thankfully that was in 1999. That is the impact of the reform efforts and to one of the first significant achievements of the modernization. People think of the modernization only as this revision of the master files. It has got many components.

I have been down and visited Atlanta where the telephone operation is controlled. We really made a huge leap forward in routing calls, 1999 to this year.

Senator SUNUNU. And the single biggest reason for that dramatic improvement was the call routing system?

Mr. EVERSON. I will tell you, it is the harnessing of that technology, that helps drive up the accuracy rate. If you go down to Atlanta and you see this, I really would recommend you do this if you get a chance, there is a whole scheme, a grid of where the experts are who can take the calls; then the call is routed to the right person at the right place, and—there is a sophisticated queuing system so that the person who knows about depreciation of home offices gets the call that deals with the subject.

Senator SUNUNU. What about the total number of calls during that period? Has the total number of calls increased, or has it been steady, or has it decreased because more people are using technology?

Mr. EVERSON. I don't recall, Senator. I would have to check the data on all of that. I think in some areas you see more calls coming in. You get spikes, like the refunds that came in 2 years ago. People call a lot on where is my refund? Now we are addressing that through this new program. So there are peaks and valleys, depending on what is happening in the Code as well.

Senator SUNUNU. I see that my time is expiring. But I did want to ask one more question about the 1203 violations. I mentioned it in my opening statement. Could you talk about the two proposed changes and what you hope the benefits of those changes to be?

Mr. EVERSON. Yes. I think that your remarks and Senator Grassley's remarks, among others, are exactly correct here. The Service has to have a balance in what it does. And if anything, 1203, set a very high standard; one I suggest that is a little too rigid because of the automatic termination in a number of areas. What has been suggested in the last year, and I concur, is there ought to be a little more discretion reserved to the Commissioner to make the appropriate disciplinary decision in certain situations, like an employee who is late filing a tax return, but in actual fact knew that they were due a refund. Should that person be automatically fired, which is the standard that is in the law right now, or should the Commissioner be able to have some discretion?

I think that the Service would be very judicious with the use of that discretion. I would make that commitment to you.

Senator SUNUNU. Thank you very much. Thank you, Mr. Chairman.

Representative HOUGHTON. Mr. Pomeroy.

Representative POMEROY. Mr. Commissioner, consultants can be extremely valuable in terms of trying to bring along the modernization of such an incredible complex system. On the other hand, consultants can turn into individual billing machines that drive you absolutely crazy with out-of-control consulting costs. I am especially concerned, in light of the efforts we make to get adequate funding for the Service to build its internal strong, professional, continuing capabilities, to see the kind of money we are spending with outsourcing.

You mentioned today another new initiative, a new contract on taking a look at how the business modernization systems have come along. As I look at, over the last few years, back to 1999 through 2002, it appears that we have spent about $760 million on outside consultants. And I am asking if this strikes you as high, and do you have, as the new leadership at IRS, a plan to get a handle on those consulting costs, and to try to, whenever possible, build in-house capacity so that less reliance on consultants going forward might be obtained?

Mr. EVERSON. I think that is a very important question, and one which I expect to address through the realignment of my office. With the appointment of a Deputy for Operations Support, that individual will own all of those entities, the CFO, the CIO, all of those entities within the Service that support the operations and that typically will generate those consulting contracts that you mentioned.

I think that what has happened over the last 5 years was entirely appropriate, given the magnitude of the change that Charles Rossetti had to address coming off of RRA 98. He turned to outside consultants to help him build the entity.

What has to happen now is that the senior and middle managers of the agency have to own it, and that will change the relationships with the vendors and the consultants. I expect that through the creation of this second deputy, we will get a lot more focus, we will get a lot more ability to drive the process. And, frankly, the individual I expect to name in that position is one of our most seasoned, knows the business processes the best, and I believe will be able to contain those costs, make sure that, if anything, we get a lot more value added out of those dollars.

Representative POMEROY. I appreciate that answer. I do think this is something I am going to keep an eye on personally. I don't dispute your comment that we have had to expend this money in light of the renovations we were making to the system, although, you know, three-quarters of a billion dollars is an awful lot of money to spend in this area. And I do think there can be a tendency for your consultants to be habit-forming, and consultants can be very good about finding the next project that has to be done by their firm.

And so I think your fresh look at all of this is going to be very helpful. And I can just think of the frustration of, you know, permanent IRS staff, people that have devoted their lives to public service, accepted lower pay scales as a result seeing high-flying 25-year-old consultants come in and, you know, without a lot of background, devise new systems and this sort of thing. I am worried about what that might do in terms of internal morale.

Mr. EVERSON. I am with you 100 percent. I am always disturbed when you turn to somebody and they say, I can't give you that answer, I have to talk to someone outside of the organization. That is not the right model. We are going to make sure that our people are driving this vehicle.

Representative POMEROY. That is an excellent answer.

Finally, we have asked, we have expressed some concern to you about the EITC precertification process. It seems to be coming on very fast, without a lot of public input and review.

Secretary Snow indicated last week that he was looking at precertification measures for other high-risk taxpayer areas, certainly including the more—the upper-end taxpayer with some of the more elaborate tax shelter schemes that have been used to inappropriately avoid taxation.

Are you considering—are you aware of this, that there is precertification being considered for groups other than the EITC group?

Mr. EVERSON. I haven't seen the specific remarks to which you refer. But, I would make two points.

First, wherever possible, I know that the chief counsel's office is very much trying to work to increase the level of published guidance that is out there, so that when people are looking at sophisticated issues they have a better road map to begin with. The start of compliance can be important educational efforts.

On top of that, the Service, LMSB, has been moving toward negotiating at the beginning of these limited issue focused examinations what they are going to look at. That is a form of precertification, I would suggest, where you are looking at things up front and getting agreement on some of these areas. So I think that what you are suggesting is consistent with what we are trying to do.

You mentioned the EITC. As you know, I am committed to taking a fresh look at that. I am glad you have raised it. I will be in Atlanta on Friday to spend the day going through some cases, including talking with some representatives of the Taxpayer Advocate's Office, so that I understand all of the issues here. And as we develop our proposal, which we will put out for public comment in early June for a 30-day period of public comment, we are going to do everything we committed to do there.

Representative POMEROY. Thank you. Thank you, Mr. Chairman.

Representative HOUGHTON. Thank you.

Senator Bennett.

Senator BENNETT. Thank you very much, Mr. Chairman. And Mr. Everson, thank you for your willingness to serve. Welcome aboard. I hope you stay a whole lot longer than just 15 days.

Mr. EVERSON. Thank you, sir.

Senator BENNETT. I am impressed with the progress that has been made in the IRS. The incredible mess that your predecessor found when he went in there kind of defied logic, but also defied solutions. And the fact that he made all of the solutions and got as far as he did is an incredible testimony to his ability. And you have big shoes to fill.

But I think from the things that have you said here this morning, you have an understanding of what needs to be done, and you are moving in the right direction to see to it that the momentum that was created continues here.

Now, let me pursue two of my areas of interest, the first one having to do with cyber crime. As you have gone through this tremendous upheaval in the IRS of finally getting computers that work, after spending billions of dollars on computers that didn't, have you addressed the question of hackers trying to get into the database either for identity theft or some other kind of criminal activity, stealing refunds, scrambling records, whatever?

Is any of that activity going on? Do you find attacks at your database? And are you looking at whether or not your firewalls are adequate to deal with it?

Mr. EVERSON. We do have a group, Senator, Mission Assurance that handles both the cyber elements of the Service's operations as well as the physical security. And there is an active program of monitoring those attempted intrusions. My understanding from my discussions with the leader of that organization is that we are comfortable that we are moving forward.

Now, that having been said, there is a lot of vulnerability in this area, a lot more needs to be done. GAO and others have highlighted this as an area of vulnerability. So am I representing to you that all is as it should be? No. Am I representing to you that this is an area of priority? Yes, I can say that absolutely.

I believe again, that by putting the CFO, the CIO, the shared services area where a lot of transaction processing takes place, the HR and this unit, right on the org chart, we have drawn Mission Assurance—that is cyber and physical security—putting that all together, I think we are going to be able to bring more, not less attention to this important issue.

Senator BENNETT. I have stood in the room in the Pentagon where they monitor the attacks on the Defense Department computers in real-time, and it is kind of a surreal experience. You almost think you are in a movie, it is so weird.

Does your CIO talk to the Defense Department CIO, and do they share experiences and share progress? Is there any cross-fertilization of experience, not just with the Defense Department, but with others in the Intelligence Community and the other parts of the government that are the targets of these kind of attacks?

Mr. EVERSON. I know there are ongoing conversations that take place from the Treasury Department and outwards. I can't tell you how regular those communications are. In my previous position as deputy director at OMB on the management side, I was a big believer in the sharing of—across government—of experiences and best practices.

I will certainly encourage my people to communicate with other agencies. I will also look into this specifically to make sure that we are reaching out as much as we can.

Senator BENNETT. One last question on an unrelated topic. As you go through this description of all of the streamlining that has occurred, do you have any sense of the financial impact on the economy as a whole, in the area of the cost of compliance with the IRS Code?

We hear numbers that suggest that the mere process of preparing returns and complying with the Code is in the hundreds of billions of dollars every year. And that is one of the arguments in favor of revising the Code, moving towards a flat tax for individuals or some other form of dramatic simplification, because they are saying the kick for the economy, in terms of cutting down the costs of compliance would be greater than the amount of money that we are talking about in the President's growth package by several times.

Do you have any sense as to how much the cost of compliance has come down as these reforms that you have described to us here this morning have taken place, and any prospects as to how much more it might come down as you continue to be successful, or is that a number that people are really just pulling out of the air?

Mr. EVERSON. I am skeptical about the number. I have seen an overall number somewhere around $80 billion that has been cited from time to time as the cost of compliance. I am not sure adequate attention and the proper methodologies are always placed on developing each and every number that goes into that kind of a calculation. I do believe that there have been these interventions, if you will, where we made progress. It comes to the question of burden reduction. But those are isolated areas.

At the same time, as you know, each time you add a new section of the Code, you add and you take away at the same time, so it is a complicated subject. I don't think that I would argue that there has been significant change in that overall figure in recent years.

What we have done is made isolated areas of progress through the call centers and other areas.

Senator BENNETT. Thank you very much.

Representative HOUGHTON. Thank you, Senator. Mr. Portman.

Representative PORTMAN. Thank you, Mr. Chairman. And Commissioner Everson, welcome for the second time in this committee room, and to your first joint review. And we are delighted that you have lasted 2 weeks, and we look forward to you serving out your term.

As you know, thanks to the Restructuring and Reform Act, we now have a term of office to encourage continuity. And you have gotten a good start. And your management expertise that you have developed over the years in the private sector and in the public sector, most recently as deputy of OMB, is exactly what we need. And this has been one of the consensus opinions coming out of the Commission's work in 1996 and 1997, and then with the Restructuring and Reform Act, that the focus is not so much on tax policy but on administering one of the largest agencies in government, second really only to DOD in terms of size. With such an enormous responsibility, it is the single most important leadership characteristic.

So we are delighted with your focus on management, and you have demonstrated today that you are going to be continually focused on that which is very important to us.

You named three areas: customer service, technology modernization, and enhanced enforcement. I would just make a couple of comments. One is that we get a lot of good information from the Joint Committee on Taxation, from the taxpayer advocates, from the Government Accounting Office, and also from the Oversight Board.

And I would encourage you to continue to work with those groups and pay heed to their concerns and their recommendations, because they have been at this a long time. And although they don't always come out of the same place, they have a lot of good input.

With regard to your second area of technology modernization, you did talk about the establishment of a new advisory group, to consult on the modernization program. I don't think that is a bad idea. But for Mr. Pomeroy's comments, I do think it is important that you talk to some of these other stakeholders as well as the private sector to be sure that there is buy-in into the group, so that its work and its recommendation to you have more credibility.

And I do think there are a lot of people, including staff here on the oversight committees, that can help you with that because this has been an ongoing concern. Really it was the start of the Commission itself, the technology concern, the $3 billion dollars that was mostly unaccounted for.

With regard to customer service, I agree with you that reforms are sound. There is no need to change them. But that doesn't mean that we don't have to continue to work very hard at pushing those reforms. My view is as soon as you stop pushing them, the pendulum is going to swing back.

I look at some of the data that we have got; 83 percent telephone service—now 83 percent of taxpayers are getting through to a customer rep. That was 69 percent as recently as last year. And the number was far lower back in 1997 and 1998 when we started. So we have seen, as you say, some improvement in some of the basic ways in which people interact with the Agency, the telephone being primary still, and now, with your Website and through electronic means.

I will also say, though, that if we don't keep pushing, we are not going to be able to even maintain the progress that we have. That is my strong view; 250,000 busy signals are still too many. So we still don't have the acceptable levels of service we would like to see.

With regard to your third one, enhanced enforcement, the goal that people should pay what they owe, is absolutely the right mission for the IRS. I do think that your focus on enforcement and collections is very appropriate right now for a couple of reasons. One, we obviously have some issues with regard to audit rates, although audit rates are up this year, I note, from last year. So we are moving in the right direction. But second is just the credibility of the tax system and those 85 percent of taxpayers who like to comply and want to comply on a voluntary basis. We need to be sure there is a sense that everybody else is doing it too.

With regard to your new position as Deputy Commissioner for Services Enforcement, I'm glad that you are willing to take that task, at least at the outset. And for operations and really owning the modernization, I think it is a good reform. I know that you have consulted with your upper management and others with regard to that decision, and I commend you for it. I think to the extent we can find more accountability in those two areas, that will be very helpful.

Overall, again, I just want to say that I think this process of having a joint review is very valuable. This is our fifth year, and under the statute, it expires this year, I would hope that we could, as a Congress, continue this process.

Again, we don't necessarily get all the members showing up here from the seven different committees that are involved with the IRS Oversight, but we do force our staffs to work together in ways they never did prior to 1998, and we also have, as I said, a good relationship with some of these other groups, the Joint Tax Committee, Taxpayer Advocate, GAO and the Oversight Board. And it is very important to bring everybody together at least once a year. So I would hope we could continue this process, and I would be happy to work with you and with the chairman and others to provide a legislative initiative to do that; or if that is not necessary, perhaps we could just have an agreement to continue the joint review.

The final comment is about the Oversight Board. You didn't mention it in your testimony. The Oversight Board took a few years to get up and going, because the prior Administration really wasn't all that enthusiastic about it. I continue to believe that the Oversight Board can play an extremely important role in providing you some counsel, expertise from the outside world, particularly on modernization, but also on change management, generally, and organizational management challenges you are facing.

Second is it provides continuity, and by this staggered five-year terms on the Oversight Board, you have expertise you can draw on now from that Oversight Board that otherwise would not be there. And I know the previous chairman is going to testify this morning, and, you know, he has been through it all and has a lot of expertise and continuity to provide for it.

Finally, there is accountability. We want to have a group out there that we could also look to from Congress and say, why aren't things going as they could from a big picture perspective? So I hope you will utilize that Board, and I hope the Board will continue to be progressive in providing us direct information on what it thinks the right direction is on some of these tough issues we face.

With that, Mr. Chairman, thank you for holding this hearing and for your continued personal interest in this issue.

Mr. HOUGHTON. Thanks, Mr. Portman.

Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman. Mr. Everson, you were kind enough to make some comments in your opening remarks about the points I raised earlier on. With respect to the EITC and the high rate of erroneous payments that you mentioned, can you tell me approximately what the amount would be if we corrected that situation, how much would be recaptured?

Mr. EVERSON. It is hard to know until we go through a pilot project. What we are looking at doing is starting with some 45,000 applications for precertification. Right now, EITC does have the highest error rate in government. It is an error rate of somewhere around 30 percent, which equates to almost $10 billion a year. If you contrast to that——

Mr. TIERNEY. $10 billion?

Mr. EVERSON. $10 billion, yes. If you contrast that, something like the Food Stamp Program where there is a seven or eight percent error rate, you just have a very different performance level. The issue here—and we had a good discussion on this two weeks ago when we were talking about this and, again, last week, is that it is really a benefits program that is embedded in the tax code and embedded in the tax administration system of the IRS. We are a hundred percent committed to not deterring people from using that program, but we have got to have a balance here so we can bring the error rate down significantly.

Mr. TIERNEY. Well, I know that you are hiring another 650 employees to work on that and asking for another hundred million dollars.

Mr. EVERSON. That is correct.

Mr. TIERNEY. So the question that I really want to ask, if I were to look at each of the other areas of interest, the tax shelter promotion, the abuse of trust in offshore accounts, the abuse of corporate tax shelters, the underpaying by high-income individuals and the accumulation and failure to pay larger amounts of employment taxes by some employers, what is the approximate amount that we could expect to recapture if we had total enforcement in all those areas?

Mr. EVERSON. I don't have a dollar figure for you, sir.

Mr. TIERNEY. If you give it to me in relation to the EITC, it would be substantially——

Mr. EVERSON. I think those relationships are at least as favorable as the EITC numbers would be, my recollection is you collect at a minimum three or four dollars for every dollar you spend. What we are doing in some of these other areas you mentioned, where we will be adding a couple thousand employees, we are building back the infrastructure——

Mr. TIERNEY. Building back some employees——

Mr. EVERSON. Yeah. What happened in this area is Commissioner Rossotti has very clearly documented, the Service has to poach from the enforcement side over a period of time as it built up the service side. So the first thing we are doing is adding some of the revenue agents and and officers who hadn't been hired in recent years, and we are going to devote them to things like the tax-shelter schemes, getting up the audit rates on the high-income people. There is some additional hiring in the terrorism area, because the criminal investigations people are working these areas, even within TEGE, the group that works with charities, because, as you know, there are vulnerabilities in terms of some of the——

Mr. TIERNEY. I think my point being, is there is at least as much, and I expect far more, to be recaptured in those areas collectively, and I'm glad to see you are putting resources there, not just on the EITC side.

Mr. EVERSON. And I would say to you, sir, that I am committed to looking at not just what we are doing this year in the President's Budget Request, but to look at the overall enforcement posture, and this is—it is the top line of the government. There is the issue of confidence of the taxpayer, willingness to comply voluntarily. We are going to get to—if we need more, we'll come back for more.

Mr. TIERNEY. I took Mr. Portman's comments on, this is a voluntary system and the fact that it has to be, in all fairness—because as I hear far more people complaining about what they think of the abuses by tax shelters and by large taxpayers who are not paying than I do about people who worry about people avoiding the EITC payment. And so I wanted to make sure that we had the right focus on each of those.

Let me just ask you briefly about the private collection agency concept. What studies have been done or what evidence do you have that hiring people or hiring on those firms and training those people with respect to all the requirements that we have for taxpayer protections and everything else is going to be, in fact, more efficient and more successful than just having employees of the Internal Revenue Service do that work?

Mr. EVERSON. I don't have any evidence that it will be more efficient than having employees. That is not the premise of the proposal. The proposal is based on the success of private collection agencies in 42 States around the country and on the success of the private collection agencies at the Department of Education that collects student loans and the success at the Department of Treasury where all debts referred to the Financial Management Service are collected by private collection agencies.

The issue here is to supplement IRS resources. Appropriated resources are limited. This is an additional tool that will help us get to some of these targeted simpler areas. We are convinced that in working with the Taxpayer Advocate that we can structure this with full taxpayer rights protections and that it can be done in a responsible way to help people clear up those outstanding debts.

Mr. TIERNEY. And a net result of more money to the government than if we kept it in-house?

Mr. EVERSON. Right now, unfortunately, sorry to say this, but there is $13 billion that is clearly due the government that is just not being pursued by us at all right now. These organizations would go after those monies and bring in a pretty good chunk of change.

Mr. TIERNEY. And is it not being pursued because we don't have the manpower?

Mr. EVERSON. That is correct.

Mr. TIERNEY. I don't want to monopolize time, but it brings me back full cycle to the question, why not put up more manpower as opposed to go outside, and how do we know which is going to be more effective on that?

Mr. EVERSON. We are going to look at all of it. We are bringing up some more manpower, but we are asking for this tool to get to this specific targeted area.

Mr. TIERNEY. Thank you.

Mr. EVERSON. Thank you.

Mr. HOUGHTON. Thanks very much.

Ms. Blackburn.

Mrs. BLACKBURN. Thank you, Mr. Chairman, and thank you, Commissioner Everson, for your remarks.

Mr. HOUGHTON. Do you want to put the mike on?

Mrs. BLACKBURN. I've got it on. Let me just move a little closer to it. How is that? All righty. That is great.

Continuing along that line of questioning, we had the opportunity to hear from Commissioner Rossotti in the Government Reform Committee, and it sounds like he has done a commendable job with moving mountains and moving everything into having a technology officer and being able to centralize some of your operations.

With that said, over the past few years and looking at the business system's modernization, why do you think the IRS has not been able to realize enough savings and efficiencies so that human capital could be moved to some of your high-priority areas, and what do you plan to do to address that? I mean, do you have any quick steps that you are going to move along that course?

Mr. EVERSON. I guess there are two points. First, this is a huge endeavor, because you've got an awful lot of data here and unfortunately, it is not as simple as putting a new computer system in your 50 or 100 retail stores around the country, where you are just worried about future sales. You've got to be able to access this data that is in these old systems that go back four or five decades. So the new program will be able to provide new methodologies, but it will link back into those old master files. This is a complex endeavor, given the complexity of the code and all of the different kinds of forms and different kinds of data that is collected.

So this is a big challenge. What I think we can do here is get more business ownership of the process. A lot of what Charles did was very centralized, and it was necessarily so because of the magnitude of the change that he was attempting to effect, but we are now at a different stage where the organization has to own the change, and I'm going to be looking to the business managers to be more actively engaged in piloting these projects so that they own it, going back to Mr. Pomeroy's point, and not the consultants. The Service has to own these changes. If we can get our arms wrapped around that concept, that will force the pacing and that will bring the savings that you are talking about.

The second point is—goes back to the remark I made in my opening statement. We spend $1.6 billion a year in base IT activities that don't have anything to do with modernization of the master files. We are looking at those areas. For example, I was in Cincinnati last week and saw some image-scanning technologies where you can scan in an application for an employee plan determination, and then instead of having to go find it someplace, you can be in Denver or in Newark and you can pull it up and read it. There are lots of things like this that the Service can tap into that is in that base funding. Hopefully we can free up some of it by getting more of the economies and efficiencies you are talking about.

Mrs. BLACKBURN. In the Inspector General's remarks that we will hear later, she mentions that Release 1 for the CADE system has experienced significant delays and significant cost overruns, and I think is about 20 months off schedule, if I'm correct there. And you have an outside contractor, PRIME, that is being paid for that delivery. Is that correct? And how long do you think that it is going to take to get that up, to get it operational, to be workable, and how much do you think it is going to end up costing?

Mr. EVERSON. You are entirely correct in your understanding. This CADE project has been delayed several times, and the costs have escalated. The scheduled rollout of this first piece that I referred to, where we'll have the 1040EZ filers, a simple application, will test this concept. It is a very real moment of truth for the modernization effort.

Frankly, I am hopeful that this is happening so early on my watch, this August, so that we'll be able to see, if we have we turned the corner, has the Service done a good job, has the PRIME done a good job? Commissioner Rossotti renegotiated the relationship with the PRIME as to the delivery of this one application, but we still don't know a hundred percent yet. We'll see this summer. I will ask for another view of CADE to make sure that if there is anything else out there along the lines that you are talking about, that we get on it now.

Mrs. BLACKBURN. Okay. Thank you.

Mr. Chairman, I have one other question. Do you mind?

Mr. HOUGHTON. Go ahead, please.

Mrs. BLACKBURN. Okay. Thank you. In talk about moving so many of the filers to the Internet and having them do the e-file and using your CADE system as your basis for moving those filers into doing that, one of the things that I had a question about—I know the Tax Code is incredibly complex, and that going through all this testimony, you realize the complexity does hinder the compliance efforts many times. Now, you have about an 85 percent correct answer rate over the telephone. With those who are asking questions over your Website, what is your correct answer rate, and what kind of response are you getting from the filers as they are asking questions over the Internet?

Mr. EVERSON. I'm sorry. I don't have the data on that. I'll have to get that back to you.

Mrs. BLACKBURN. If you don't mind, I would appreciate having that and knowing that. I think that as we are looking at moving millions of Americans to the e-file process, having a site that is easily navigated is incredibly important, and when you go to your site and you read through the list of forms and start looking for the form that you want to pull down, and then go over to your sidebar to look at where you can ask questions, I think that we need to look at that and think that through, so that we are certain that, hopefully, we have a greater accuracy rate over the Internet than we have had with our telephone.

Mr. EVERSON. I agree with you, and we'll follow up.

Mrs. BLACKBURN. Thank you.

Mr. HOUGHTON. All right.

Mr. POMEROY. Mr. Chairman.

Mr. HOUGHTON. Yes.

Mr. POMEROY. Senator Max Baucus as ranking member of the Finance Committee would normally have participated in this hearing. He has informed me that he is not available in light of the circumstances regarding the Senate at the moment, and he has submitted questions for the Commissioner. I would like to make these questions part of the record and, as well, get copies to the Commissioner for answering.

Mr. HOUGHTON. Thank you. Certainly. Well now, thank you very much, Commissioner. Great to have you with us. We'll be in touch with you.

[The information follows in the submissions for the record section]

Mr. HOUGHTON. And now, I would like to ask the next panel to come on. Ms. Nina Olson, National Taxpayer Advocate; Ms. Pamela Gardiner, Acting Treasury Inspector General for Tax Administration; the Honorable Larry Levitan, Member of the IRS Oversight Board; and Mr. James White, Director of Tax Issues, U.S. general Accounting Office.

All right. Well, thank you very much for being with us.

Ms. Olson.

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

Ms. OLSON. Mr. Chairman, thank you for inviting me here today. Five years after its enactment, RRA 98 still ranks as one of the most important pieces of legislation protecting taxpayers within the federal tax system. The act enhanced the independence of the Office of the Taxpayer Advocate. It established funding for low-income taxpayer clinics on the premise that access to tax education and representation for these taxpayers would improve the fairness of the tax system for all taxpayers.

Before the 98 Act, it seemed that the IRS expected taxpayers to be noncompliant. Today the Service's culture is beginning to change. It is acknowledging that the vast majority of taxpayers are compliant or sincerely trying to resolve their tax problems. With that acknowledgment as a starting point, the Service can vigorously seek out those taxpayers who are deliberately not in compliance with their tax obligations.

An effective tax administration system requires a balance between enforcement, taxpayer rights and customer service. These aspects of tax administration are not mutually exclusive, although they may generate tension at different times. Even when the taxpayer is out of compliance with his or her tax obligations, he or she should be treated courteously and professionally. Compliance personnel should place themselves in the taxpayer's shoes and acknowledge how powerful and intimidating the IRS can be. This acknowledgment does not diminish the Service's tax assessment or collection authority. In fact, for many taxpayers, this acknowledgment is the basis for true customer service, for it creates an opportunity for the taxpayer to enter into the system in compliance.

IRS employee performance is now evaluated by balanced measures—employee satisfaction, customer satisfaction and business results—a balance that may be tested by the Service's increased focus on compliance activities. We can learn something about how to achieve that balance by looking at two RRA 98 programs which to date have eluded success: the offer in compromise and collection due process hearings.

The IRS projects 130,000 offers in fiscal year 2003 and will use about 1,200 full-time equivalents on this program. Despite these resources, both taxpayers and practitioners are dissatisfied with the program. The source of the dissatisfaction may be twofold. First, the IRS is still not successfully implementing the policy statement on offers that it adopted in 1992. Second, taxpayers and practitioners often have unrealistic expectations of what they can achieve through an offer. The offer program is not an amnesty. It is a viable collection alternative.

To achieve success in the offer program, the IRS need not start all over again. Indeed, it needs to review all of its current processes, guidance, training and quality measures as well as data tracking, looking at it from the point of view of the taxpayer's needs and expectations as well as IRS processing requirements.

We need to encourage our employees to use national and local allowances as Congress directed in 1998, as true guidelines, not rigid requirements. We need to let our employees talk with the taxpayer, and we need to know exactly what kind of collections we achieve on accounts after offers are rejected.

The Collection Due Process procedure is another important program, one of the act's most significant improvements in collection procedures. An independent appeals officer review of these cases provides a much-needed safety valve in the collection process, as does the Court's jurisdiction over collection matters.

To date, the IRS has approached CDP as an inventory problem, not as a vitally important taxpayer protection. It has structured the program to deal with the influx of cases from taxpayers raising frivolous arguments or from taxpayers who have ignored the IRS until we issued a notice. Currently, the IRS collection function holds on to the case after the CDP hearing request is filed for up to 90 days before sending the case to appeals. Taxpayers must continue to work with the revenue officer and, later, his or her manager. Taxpayers who have been working with the IRS all along are disadvantaged by this procedure. They have nothing more to negotiate with collections; yet, their appeals hearing is delayed. This is a pre-98 approach to program design.

A post-98 customer oriented approach to this program would recognize that CDP is important and essential work for an independent appeals function and that appeals jurisdiction over the case is paramount. Thus, immediately upon the receipt of a CDP hearing request, the case should be transferred to appeals and a hearing date set. If the taxpayer is not yet attempting to resolve the case with the collection function, the case can be temporarily transferred back to collection to see if it can be resolved before the hearing. This procedure is similar to the treatment of cases docketed in the United States Tax Court.

These two programs demonstrate how far the IRS has come since 1998, and yet how much further it must go to achieve true customer service. IRS employees are among the most dedicated and professional in the federal government today, and I have no doubt that with the proper tools, training and support, they will rise to the challenge of providing excellent customer service, respecting and protecting taxpayer rights and enforcing the Federal tax laws.

Thank you for the opportunity to address you today.

Mr. HOUGHTON. Thank you very much, Ms. Olson.

[The statement of Ms. Olson follows:]

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

Mr. Chairman, a little over five years ago I testified before the House Ways and Means Subcommittee on Oversight and the Senate Finance Committee, in my capacity as a tax attorney representing low- and middle-income taxpayers, on the subject of taxpayer rights and the provisions in bills that were later enacted as the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).[1] For many of us who worked in the area of tax controversy, this landmark legislation was a formal acknowledgement of what we had known for a long time—that the IRS had become inflexible and moribund in its approach to many taxpayer problems, and that creative problem-solving was not only not encouraged, but actively discouraged within the IRS. Despite the accusatory nature of many of the proceedings surrounding RRA 98, we felt that positive changes would emerge. In my testimony today, I will discuss how far the IRS has come since RRA 98 and what challenges we still must meet.

IRS REORGANIZATION AND MODERNIZATION

Looking at where we are today, I do not think that our hopes for improvement were misplaced. However, we did expect change to occur faster than it could. There is a danger, today, in wanting to revert to the old way of doing things, when we have not given the new approach half of a chance. From my vantage point of having worked most of my professional life outside of the IRS, in an adversarial position, and having served the past two years inside the IRS in a central position, I can honestly say that we have only begun to change the organization's culture. True change takes time, and there will be (and should be) many alterations in course as unforeseen issues arise.

[1] Pub. L. No. 105–206 (1998).

The concept of organizing the Internal Revenue Service around categories of taxpayers is fundamentally sound. Individual, small business, large and midsize business, and tax-exempt and governmental entity taxpayers each have distinct characteristics and tax issues. Yet there are many areas of tax administration in which two or more of these taxpayer categories share common issues. Moreover, from one year to the next, many taxpayers migrate from one taxpayer category into another, and then back again. The IRS reorganization has not yet proved itself adept at handling these "cross-functional" issues.

The IRS reorganization has been justified on the ground that under the previous national-regional-district structure, continuity and accountability were impeded.[2] Taxpayer accounts moved from one district to another when a taxpayer relocated, and taxpayers were often required to deal with both a local district office and a service center in order to resolve one issue, or several related issues.

It is hard to see how things have improved since 1998 in this regard. A self-employed taxpayer may have to deal with one "campus" (formerly known as a service center) regarding his income tax return, another campus regarding his federal employment tax return, and either another campus or a local IRS office regarding his offer-in-compromise.[3] While this division of work may be perfectly justified from the point of view of IRS work processes under a business case analysis, the "business case" is meaningless for the taxpayer who is trying to find his way through the IRS to speak to someone about his account.[4]

As programs move to campuses and are addressed from a nation-wide perspective, the IRS will face a significant challenge in becoming flexible enough to understand and take into consideration regional and local circumstances. The Service's leadership recognizes that we are also beginning to see stove-pipes of command re-emerging, albeit now along the lines of type of taxpayer rather than geography. The Service is taking steps to address this problem in several areas. For example, the Service is now developing a Service-wide examination plan to ensure that the separate operating divisions are (i) operating with a coordinated strategy where that is appropriate and (ii) not duplicating efforts or working at cross-purposes. Similarly, the Service is coordinating a national as well as divisional non-filer strategy. The Service's Strategic Planning and Budget process affords the leadership of each functional division the opportunity to justify its strategies, operational priorities, and proposed improvement projects to the rest of the senior leadership team. These sessions can involve probing questions and disagreements, but they invariably improve IRS operations and taxpayer service.

The Service, as with many large organizations, is still struggling with inspiring its employees to exercise common sense, good judgment, and creative problem-solving while requiring them to follow specific guidelines and procedures. The sheer size of the IRS workforce, and the enormity and complexity of the task of administering the tax system, create pressure on management and the workforce to conform and adopt a narrow approach to resolving disputes: "If I can solve my little piece of the puzzle, I don't have to worry about the rest of the problem."

Thus the IRS must continue with its reorganization efforts, by retaining the "flattened" management structure so that good ideas are not stifled by too many managerial reviews; by providing its employees with ongoing training, not just about each employee's specific work but also about how that employee's work fits into the larger scheme of tax enforcement; and by encouraging innovation as well as consistency. The IRS reorganization is just beginning.

ENFORCEMENT, TAXPAYER RIGHTS, AND CUSTOMER SERVICE

An effective tax administration system requires a balance between enforcement, taxpayer rights, and customer service. These aspects of tax administration are not mutually exclusive, although they may generate tension at different times. Even when the taxpayer is out of compliance with his or her tax obligations, he or she should be treated courteously and professionally. Compliance personnel should place

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[2] *See* S. Rep. No. 105–174, Sec. 1001.

[3] A recent Taxpayer Advocate Service case involving a non-filer is instructive. The taxpayer wanted to file six years of returns, for four of which the IRS had filed substitute-for-returns (SFRs) under IRC § 6020(b). Three returns had to be filed with the campus that processes corrective SFR returns for individual taxpayers; one had to be filed in a different campus that processes corrective SFR returns for sole proprietor taxpayers; and two, for which no SFR returns were prepared, had to be filed at an entirely different campus. The returns were shipped back and forth between campuses several times, leading to processing delays and a delay in making payment arrangements for the overall liability.

[4] *See* Fiscal Year 2002 National Taxpayer Advocate Annual Report to Congress, at 7, for a more detailed discussion of "Navigating the IRS."

themselves in the taxpayer's shoes and acknowledge how powerful and intimidating the IRS can be. This acknowledgement does not diminish the Service's tax assessment or collection authority. In fact, for many taxpayers, this acknowledgement is the basis for true customer service, for it creates an opportunity for the taxpayer to enter into compliance.[5]

The IRS Restructuring and Reform Act of 1998 required the IRS to realign its method of measuring its employees' performance so that an even-handed approach to tax administration is encouraged and achieved. Thus, IRS employee performance is now evaluated by "balanced measures"—employee satisfaction, customer satisfaction, and business results. This balance between customer service, taxpayer rights, and enforcement will be tested with the Service's increased focus on compliance activities. We can learn something about how to achieve that balance by looking at two RRA 98 programs which to date have eluded success.

Offer-in-Compromise. The offer-in-compromise program is still problematical after many IRS efforts to make the program work. Although the offer inventory is declining and cases are moving, which the Service views as a success, many practitioners and taxpayers express frustration and dissatisfaction with this program.[6] One reason for this difference in perception is that the IRS has never fully embraced its policy statement on offers that it issued in 1992.[7]

There is a natural tension between the requirement to determine and collect the correct amount of tax, and the opportunity to compromise that amount. The IRS Restructuring and Reform Act of 1998 attempted to make clear that the offer program is a viable collection alternative—an alternative that certainly should not be abused, but one that is perfectly valid, nonetheless.

The Service projects that it will receive approximately 130,000 offers and will expend approximately 1,200 full time equivalents on the offer program in fiscal year 2003. Yet complaints come in from all over the nation. If offers are legitimately being returned or rejected, with proper customer service, taxpayers might not like the answer but at least they would understand the reason. The consistent customer dissatisfaction with this program indicates that there is a disconnect between what taxpayers and practitioners expect and what the Service delivers. I suspect that the proper design for an offer program lies somewhere in between these two positions.

For example, RRA 98 directed the Service to establish guidelines for national and local allowances for use in determining whether the taxpayer has an "adequate means to provide for basic living expenses."[8] The statute further directs that these guidelines shall provide that IRS employees must determine, under a "facts and circumstances" test, whether the use of such schedules is appropriate and *shall not*

[5] The Finance Committee report stated: "The Committee believes that a key reason for taxpayer frustration with the IRS is the lack of appropriate attention to taxpayer needs. . . . For example, taxpayer inquiries should be answered promptly and accurately; taxpayers should be able to obtain timely resolutions of problems and information regarding activity on their accounts; and taxpayers should be treated fairly and courteously at all times." S. Rep. No. 105–174, Sec. 1001.

[6] The RRA conferees explicitly envisioned an *expansion* of the offer program.

"[T]he conferees expect that the present regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors . . . in determining whether to compromise the income tax liabilities of individual taxpayers. . . . [T]he conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements." H.R. Conf. Rep. No. 105–599, Sec. 3462.

[7] Policy Statement P–5–100 (1992) provides:

"The Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential. An offer in compromise is a legitimate alternative to declaring a case currently not collectible or to a protracted installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government. In cases where an offer in compromise appears to be a viable solution to a tax delinquency, the Service employee assigned the case will discuss the compromise alternative with the taxpayer and, when necessary, assist in preparing the required forms. The taxpayer will be responsible for initiating the first specific proposal for compromise. The success of the compromise program will be assured only if taxpayers make adequate compromise proposals consistent with their ability to pay and the Service makes prompt and reasonable decisions. Taxpayers are expected to provide reasonable documentation to verify their ability to pay. The ultimate goal is a compromise which is in the best interest of both the taxpayer and the Service. Acceptance of an adequate offer will also result in creating for the taxpayer an expectation of and a fresh start toward compliance with all future filing and payment requirements."

[8] IRC § 7122(c); RRA 98 § 3462(a).

use such schedules where their use would result in the taxpayer's not having adequate means to provide for basic living expenses.[9]

With respect to both offers and installment agreements, however, IRS employees do not believe that they can deviate from these schedules. While some taxpayers may make unreasonable requests, other taxpayers, whose facts and circumstances warrant deviation from the schedules, are denied relief. Many IRS employees, from Automated Collection System to Appeals, apply the schedules as fixed rules. In these areas, the IRS has not successfully implemented the directives of RRA 98.

To achieve success in the offer program, the IRS does *not* need to start all over again. Instead, it needs to take its current offer processes—in the campus and in the field—and review all of its guidance, training and quality measures as well as data tracking, looking at it from the point of view of taxpayer need and expectations as well as IRS processing requirements. Do we know what happens to offers that we reject? How old are the debts that taxpayers are attempting to compromise? Are they in year one of the statutory collection period, or year nine? Will the IRS likely collect another dollar on this debt? Was the account in "inactive status" before the taxpayer submitted an offer?

How is the IRS measuring the quality of work done on offer cases? Are these quality measures encouraging employees to speak with taxpayers and to determine whether the use of national or local schedules is appropriate, given the facts and circumstances of that particular taxpayer's situation? Or is the IRS only looking at the completion of mechanical or procedural steps? Are cases involving "grey" issues being successfully resolved at the first point of contact, or are these cases rejected and passed on to Appeals? Is Appeals treating these cases in accordance with the changes made by RRA 98?[10]

Congress also directed the Secretary to accept offers for the purpose of promoting effective tax administration (ETA) on the basis of hardship, equity, and public policy.[11] The Service has struggled to develop guidance and processes that respond to Congress' and taxpayers' concerns as well as the Service's own processing and resource considerations. At the request of my office, the Service is establishing a group of revenue officers who will handle all non-hardship ETA offers—those involving equitable and public policy concerns. In turn, the work of this group will be reviewed by a cross-functional team to ensure consistency and appropriateness of the decisions and to develop future guidance for IRS employees and taxpayers.

Last year, Treasury issued a final regulation that set forth a simple construct for a viable non-hardship ETA offer.[12] First, the taxpayer cannot qualify for an offer on any other ground—doubt as to collectibility, doubt as to liability, or hardship. Second, the taxpayer must adequately explain to the IRS what is so special about the taxpayer's circumstances that the taxpayer should have its taxes reduced when all other taxpayers are assumed to pay their taxes in full. In essence, the taxpayer must be able to look his or her next-door neighbor in the eye and say, "You have to pay your taxes in full, but I should be cut a break."

This approach is consistent with the policy statement's requirement that taxpayers must bring in reasonable offers. The IRS, while recognizing that nonhardship ETA offers will be granted only in exceptional circumstances, is committed to considering those offers that come in and to learning from those that taxpayers submit. The flexibility and fundamental fairness built into this new non-hardship ETA procedure aligns with the approach Congress described in RRA 98 as well as with the IRS policy statement. We have not yet achieved this flexibility and fairness with regard to other offer processing.

Collection due process hearings

As a practitioner in controversy practice, including collections, I thought that the right to a Collection Due Process (CDP) hearing was one of RRA 98's most signifi-

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[9] *Id.* The Finance Committee report stated:

The IRS also will be required to consider the facts and circumstances of a particular taxpayer's case in determining whether the national and local schedules are adequate for that particular taxpayer. If the facts indicate that use of scheduled allowances would be inadequate under the circumstances, the taxpayer would not be limited by the national or local allowances." S. Rep. No. 105–174, Sec. 3462.

[10] At the end of February, 2003, Appeals had 6,133 assigned offer-in-compromise receipts. Two months later, on April 30, 2003, Appeals had 9,096 assigned offer receipts, almost a 50 percent increase. One must wonder whether these new cases involve issues that could not be resolved by offer examiners in the collection function if they had appropriate guidance, training and encouragement in accordance with the approach described in RRA 98 and Policy Statement P–5–100.

[11] H.R. Conf. Rep. No. 105–599, Sec. 3462.

[12] Treas. Reg. 301.7122–1.

cant improvements to IRS collection procedures. Prior to the existence of CDP hearings, there were just too many cases where I couldn't obtain a consideration of the underlying liability, which would have eliminated the collection problem. Or I couldn't get the revenue officer to listen to my points about collection alternatives. The opportunity to have an independent Appeals Officer review these cases provides a much-needed safety valve in the collection process, as does the courts' review of the aftermath of tax determinations and assessments.

It should be no surprise to anyone that many of the first CDP cases in the IRS and the courts involved constitutional challenges to the Internal Revenue Code and arguments that can best be classified as "frivolous." Many practitioners have cases that never made it to court because they used the system appropriately, actually trying to resolve the collection issues. Even the cases advancing frivolous theories raised significant procedural issues.

It is true that many taxpayers do not respond to IRS collection letters. The CDP notice, arriving by certified mail, often is the first contact that gets the taxpayer's undivided attention. In these instances, the taxpayer may not have discussed any issues with a revenue officer or Automated Collection System (ACS) employee. Thus, in some cases, it may be appropriate to provide the taxpayer with a *brief* period to discuss collection alternatives with collection personnel before transferring the file to Appeals.

However, the Service recently directed its revenue officers to continue to work a collection case after the CDP hearing request is filed. If the revenue officer and the taxpayer cannot resolve the issue, then the group manager will contact the taxpayer and attempt to resolve the collection matter. Only if the group manager and the taxpayer cannot agree, will the case be referred to Appeals for the independent review that is required by RRA 98. Appeals has acknowledged that in many instances it takes up to 90 days for a case to be sent to Appeals.[13] During this retention period, the statutory collection period is tolled; had the negotiations occurred before the issuance of a CDP notice (which is solely at the discretion of the IRS), the statutory collection period would continue to run.[14]

In many cases the taxpayer has already attempted to resolve the collection matter with collection personnel, and the CDP notice is issued because the matter is not being resolved to the Service's satisfaction. In this context, the retention of the case by collection personnel for further "negotiations" can constitute undue pressure on the taxpayer, who has elected to have an independent party—an Appeals Officer—look at the case and consider all collection alternatives offered by the taxpayer, not just the ones the collection employee is willing to accept. In fact, this independent review was the underlying premise for the statute's enactment. The Appeals Officer should bring something more to the discussion than just providing the "opportunity" for the taxpayer to have more dealings with the collection employee, who is the very person who filed the lien or is proposing the collection action that triggered the right to a CDP hearing.[15]

I recognize that since the enactment of RRA 98, the Office of Appeals has been struggling with an inventory problem attributable to the large number of CDP cases filed.[16] The Office of Appeals has hired new offer specialists to address the inventory of cases. However, there are many issues that should be explored to determine why this inventory exists. Are revenue officers or ACS employees filing liens at appropriate times, which triggers a CDP notice? Are they making premature determinations to levy? Where a taxpayer raises a challenge to the underlying liability in the context of a collection action, is the collection employee directing the taxpayer to the appropriate IRS personnel (including Taxpayer Advocate Service employees) for resolution of that matter at the earliest opportunity, rather than passing that issue on to Appeals? Once a case gets to Appeals, are Appeals Officers taking a formulaic

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[13] Statement of Felice Izen, Supervisory Program Analyst, Office of Appeals, before the American Bar Association Low Income Taxpayers Committee, May 10, 2003.

[14] IRC § 6330(e)(1).

[15] The legislative history to RRA 98 clearly demonstrates the importance Congress placed on the independent hearing.

The Congress believed that the IRS should afford taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of their property. . . . The determination of the appeals officer is to address whether the proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the taxpayer that the collection actions be no more intrusive than necessary." Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998 at 81, 83 (JCS–6–98).

"A proposed collection action should not be approved solely because the IRS shows that it has followed appropriate procedures." S. Rep. No. 105–174, Sec. 3401.

[16] The IRS had 19,199 CDP receipts in FY01, 26,666 CDP receipts in FY02, and 13,073 CDP receipts through March 2003.

approach to these cases, or looking for the easiest out (for example, placing the taxpayer in "currently not collectible" status and encouraging the taxpayer to withdraw the CDP hearing request)?

The IRS touches more U.S. taxpayers through its collection activities than any activity other than the filing requirement. Tax collection is the second most important activity of the IRS, particularly from the taxpayers'—our customers'—perspective. Thus, the Collection Due Process hearing is extremely important and essential work for an independent Appeals function and should be treated as such. The program should be treated as an important taxpayer right and not as an inventory problem.

LOW INCOME TAXPAYER CLINICS

The IRS Restructuring and Reform Act of 1998 ushered in a new era for low income taxpayers—one in which Congress recognized the importance of representation, education and outreach to low income taxpayers and taxpayers who speak English as a second language (ESL). In 1998, there were 14 academic and one nonprofit low income taxpayer clinics nationwide. Today, as a result of the matching grant program under IRC section 7526, there are 136 clinics—one in all but two states and Puerto Rico. By next year, there should be clinics in these sites.

Effective May 1st of this year, the clinic program was moved into the Office of the Taxpayer Advocate. Over the next year my office will be working with the clinics to develop standards of operation and best practices. We will be making site assistance visits to various clinics and identifying areas of success as well as improvement goals.

My office is committed to integrating the clinics into many more IRS activities and programs. For example, we developed a publication listing each clinic grantee. This publication is posted on the irs.gov internet site and is included in each audit notice for each face-to-face exam in the National Research Program (NRP). Thus, low income taxpayers who are being audited as part of this program will have access to representation.

The clinics provide the IRS and Congress with much needed insight into the problems of low income and ESL taxpayers. Many clinics are participating in community-based coalitions whose numbers provide free tax preparation, financial literacy education, and access to low-cost bank accounts in addition to tax representation, education and outreach. These activities increase the fairness of the tax system for all taxpayers and enable low income taxpayers to comply with their tax obligations.

OFFICE OF TAXPAYER ADVOCATE

In 1998, the independence, impartiality and confidentiality of the Office of the Taxpayer Advocate (OTA) were substantially enhanced.[17] There is a basic tension between the OTA's role as an agent for change inside the IRS and maintaining the office's independence within the IRS. The statutory revisions increased the effectiveness of the National Taxpayer Advocate and her office in helping taxpayers resolve their specific problems with the IRS while being a strong voice for systemic improvement and change within the IRS.

However, as I have noted in my 2002 Annual Report to Congress, there are several areas in which the Office of the Taxpayer Advocate's independence should be strengthened and its effectiveness increased. In the Report, I discussed revisions to the confidentiality provisions of IRC § 7803(c)(4)(A)(iv), the definition of "significant hardship" under IRC § 7811, and the codification of the Taxpayer Assistance Directive.

The Senate version of RRA 98 provided for an independent counsel to the National Taxpayer Advocate.[18] The IRS Restructuring and Reform Act of 1998 ultimately did not include that provision. The National Taxpayer Advocate currently receives legal advice from the Counsel to the National Taxpayer Advocate, who reports directly to the Chief Counsel of the IRS.

The National Taxpayer Advocate, who by design and by statute brings a unique perspective to the issues and problems facing taxpayers and the IRS, must have independent counsel in order to accomplish her statutory mission successfully. This counsel should report directly to the National Taxpayer Advocate (NTA) in order to avoid any conflict of interest where the Counsel's advice might differ from the position advocated by the Office of Chief Counsel. The independent counsel to the NTA should advise the Advocate on matters pertaining to the authority, jurisdiction, and operation of the Office of the Taxpayer Advocate, as well as issues relating to taxpayer rights. The counsel should also participate in discussions and development of

[17] *See* RRA 98 § 1102(a), amending IRC § 7803(c); RRA 98 § 1102(c), amending IRC § 7811(a).
[18] S. Rep. No. 105–174, Sec. 1102.

guidance, to the same extent that the current Counsel to the NTA participates today.

REGULATION OF UNENROLLED RETURN PREPARERS

The IRS Restructuring and Reform Act of 1998 did not directly address one particular aspect of tax administration that I believe would provide considerable benefits to taxpayers—the regulation of unenrolled return preparers.[19] Today, more than 50 percent of all returns are prepared by paid tax return preparers. Thus, for a majority of taxpayers, the tax return preparer is the gateway to the federal tax system. Returns prepared by unqualified or unscrupulous preparers have a negative impact on taxpayers *and* the IRS. For taxpayers, inaccurate returns mean overclaims as well as underclaims—either they pay more taxes than they should or their returns may be examined. For the IRS, these returns consume valuable resources, in terms of processing, examination, and collection.

Clearly, the federal government has an interest in protecting the integrity of the tax administration system and ensuring that products and services offered in conjunction with the taxpayer's filing, reporting and payment obligations do not operate in such a way as to undermine the taxpayer's faith and participation in the system. Moreover, taxpayers have the right to expect that the tax administrator of a complex tax code will take the appropriate and necessary steps to ensure that commercial return preparers possess the requisite skills and ethics.

We propose that unenrolled preparers—preparers who are not attorneys, CPAs, or enrolled agents—who prepare more than five returns per year for a fee be required to register with the IRS, take an initial examination about return preparation and an annual refresher examination, and display a current certification card indicating their certified status. Our proposal is described in greater detail in my 2002 Annual Report to Congress.

The lynchpin of this proposal is a consumer education campaign, which utilizes paid advertising, outreach, and partnering with other organizations, to deliver two simple messages to tax consumers who will enforce the program through their market behavior:

- If you pay for tax preparation, ask to see the preparer's certification.
- If you pay for tax preparation, don't pay until you see the preparer's name, address, and certification on the tax return and on your copy.

We believe our proposal is administrable and efficient. While it will require resources to collect and input data, develop and update examinations, and maintain the preparer database, a portion, if not all, of these costs can be offset by user fees on the regulated population.[20] Ultimately, more accurate returns will reduce the resources the IRS must devote to examining incorrect returns and collecting the resulting tax.

The requirement that return preparers demonstrate minimum competency levels will restore the connection between tax preparers, tax expertise, and tax filing. Under our plan, preparers who are providing tax preparation and filing primarily because it brings in consumers of unrelated products or financial products such as check-cashing will have to demonstrate knowledge of return preparation. This approach will benefit the taxpayer both as a taxpayer and as a consumer, and it will benefit the tax system.

CONCLUSION

The IRS has come a long way from where it was in 1998. It is much more taxpayer focused, it evaluates its employees based on balanced measures, and it has embraced a strategic planning and budgeting process that emphasizes cross-functional planning. In key aspects of its operations, however, namely those involving flexibility and the exercise of discretion, the IRS is struggling. For the IRS to continue to improve, Congress must not only continue its oversight but must also provide the IRS with appropriate resources to accomplish its continually expanding tasks.

Mr. HOUGHTON. Ms. Gardiner.

[19] The National Commission on Restructuring the IRS recommended that all preparers be made subject to the standards of conduct set forth in Circular 230. *See* Commission Report—*A Vision for a New IRS*—at G–5.

[20] The fee for taking the enrolled agent exam is $55. *See* IRS Form 2587. The fee for applying for enrolled agent status is $80. *See* IRS Form 23.

STATEMENT OF PAMELA J. GARDINER, ACTING TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Ms. GARDINER. Mr. Chairman and members of the committees, I appreciate the opportunity to appear before you today to discuss significant challenges the Internal Revenue Service continues to face in improving the overall effectiveness of tax administration.

Over the past few years, the IRS has been in the midst of a significant business restructuring. Key business systems modernization initiatives are underway to redesign IRS's outdated computer systems, and management is improving the organization's customer service operations to better serve and communicate with taxpayers. While the IRS has revamped some of its business processes and practices, much more needs to be accomplished to provide top quality service to taxpayers.

With the appointment of a new IRS Commissioner and the expected departures of key executives, the IRS is also encountering tremendous leadership changes. The Commissioner is challenged with continuing the IRS' reinvention efforts in modernizing its computer systems, protecting taxpayer rights and privacy, ensuring tax law compliance and providing improved customer service.

To achieve the IRS mission of providing top quality service to taxpayers, the IRS must modernize its outdated computer systems. The IRS has made progress in modernizing its information technology systems and some benefits have been delivered. For example, the IRS upgraded its toll-free telephone system to route taxpayers' calls to the appropriate IRS employee, and deployed an Internet application that allows taxpayers to check the status of their refunds. However, the most significant and complex projects have yet to be delivered. Most modernization projects have experienced costs and schedule overruns. Project delays can be attributed to underestimating the complexity of the overall modernization effort and difficulties in identifying and managing the project requirements. These setbacks are magnified by the fact that so many other reforms are dependent on modernizing IRS computer systems.

The IRS has developed adequate computer security policies and procedures but has not implemented them effectively. As a result, sensitive information remains vulnerable to attack by hackers, terrorists and disgruntled employees and contractors. While recognizing that total security can never be achieved and that there are necessary trade-offs between security and operational needs, TIGTA continues to identify significant weaknesses in infrastructure and applications security. TIGTA attributes many of IRS's security problems to misplaced accountability. The IRS needs to enhance the security awareness of its managers and employees, and provide better training to those employees with key security responsibilities.

Another challenge to IRS management is to establish a tax compliance program 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. While the decline in enforcement actions has been dramatic since fiscal year 1996, there are recent indications that the decline in some categories of enforcement actions and results have stabilized and, in some cases, shown improvement.

The IRS Restructuring and Reform Act of 1998 (RRA 98) also mandated that the IRS be more responsive to customer needs. The IRS has made progress in enhancing its customer service activities. For example, taxpayers have several options from which to choose when they need assistance from the IRS in answering tax law questions. Two of these options, walk-in service at nationwide Taxpayer Assistance Centers and toll-free telephone assistance, have shown improvement in terms of accuracy over the past year. Overall, the IRS has made improvements in providing service to the taxpaying public.

The tax return filing season impacts every American taxpayer and is, therefore, always a highly critical program for the IRS. In addition to providing customer service to taxpayers, the IRS must coordinate tax law changes, programs, activities, and resources to effectively plan and manage each filing season. Overall, the 2003 filing season has gone well. Based on TIGTA's review, it appears that the IRS should complete its processing of individual returns and issue all tax refunds on time.

The IRS has accomplished a great deal since the passage of RRA 98, though much more remains to be done. TIGTA resources are devoted to providing useful, balanced information to IRS management and other decision-makers. TIGTA's audit and investigative coverage will continue to focus on the management and performance challenges facing the IRS as part of our overall effort to promote economy, efficiency, and effectiveness in the Nation's tax administration system.

This concludes my statement.

Mr. HOUGHTON. Thank you very much.

[The statement of Ms. Gardiner follows:]

JOINT HEARING BEFORE THE COMMITTEES OF THE

UNITED STATES SENATE

AND

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 20, 2003

"The Strategic Plans and Budget of the IRS"

STATEMENT FOR THE RECORD

Pamela J. Gardiner
Acting Inspector General
Treasury Inspector General for Tax Administration

Mr. Chairman and Members of the Committees, I appreciate the opportunity to appear before you today to discuss the challenges and vulnerabilities the Internal Revenue Service (IRS) continues to face in improving the economy, efficiency, and effectiveness of tax administration. My comments will also address the IRS' compliance with the IRS Restructuring and Reform Act of 1998 (RRA 98).

Three years ago when the former Treasury Inspector General for Tax Administration (TIGTA) appeared before you and reported on the IRS' progress in implementing the RRA 98 provisions, the IRS was in the midst of a significant business restructuring. The IRS was reorganizing itself into four operating divisions to have end-to-end responsibility for defined groups of taxpayers with similar characteristics. Key business systems modernization initiatives were underway to redesign the IRS' outdated computer systems, and management was improving the organization's customer service operations to better serve and communicate with taxpayers. As of today, while the IRS has revamped some of its business processes and practices, progress has been slow in implementing critical improvements to IRS operations to provide world-class service to taxpayers.

With the appointment of a new IRS Commissioner and the expected departures of key executives, the IRS is also encountering tremendous leadership changes. The new Commissioner is challenged with continuing the IRS' reinvention efforts in modernizing its computer systems, protecting taxpayer rights and privacy, and ensuring tax law compliance and enforcement while providing improved customer service. In addition to turnover in the top IRS management positions, there are also membership changes on the IRS Oversight Board that could impact the direction of ongoing IRS initiatives.

In this environment, TIGTA continues to devote its efforts to provide useful, balanced information to IRS management and other decision-makers. TIGTA audit coverage focuses on the management and performance challenges facing the IRS. We are providing critical information on the IRS' operational and programmatic issues such as business systems modernization (BSM), tax compliance, computer and physical security, performance and financial management, customer service, returns processing, and the filing season. In order to safeguard the IRS' ability to collect revenue and combat fraud, waste, and abuse, TIGTA's investigative work is centered on:

- IRS employee integrity.
- IRS employee and infrastructure security.
- External attempts to corrupt federal tax administration.

As a result of our audit and investigative work, I believe the following issues are the most significant challenges facing the IRS.

Information Systems Security

After September 11, 2001, the IRS and TIGTA's Office of Investigations took significant actions to protect IRS employees, facilities, and computer data infrastructure from the threat of terrorism. The process that TIGTA established to share information with the IRS about potential terrorist threats was very positively evaluated in an October 2002 General Accounting Office (GAO) audit report entitled, *IRS and Terrorist Related Information Sharing* (GAO-03-50R).

The IRS has developed adequate security policies and procedures but has not implemented them effectively. As a result, sensitive information remains vulnerable to attack by hackers, terrorists, and disgruntled employees and contractors. While recognizing that total security can never be achieved and that there are necessary trade-offs between security and operational needs, TIGTA continues to identify significant weaknesses in infrastructure and applications security.

TIGTA attributes many of the IRS' security problems to misplaced accountability. As we reported last year, the IRS does not hold its business unit (functional) managers accountable for the security of their systems. Instead, the Office of Security Services took primary responsibility for this function. As a result, functional managers did not annually assess the security of their systems, as required by both the Office of Management and Budget Circular A-130, *Management of Federal Information Resources,* and the *Federal Information Security Management Act.* Significant effort will be required to transfer primary responsibility for systems security from the Office of Security to business unit managers. In addition, attention is needed to enhance the security awareness of IRS managers and employees, and employees with key security responsibilities must be better trained.

Business Systems Modernization

The IRS' goal of providing efficient and responsive information services to its operating divisions is heavily dependent on modernizing its core computer systems while maintaining the existing systems. Since 2001, the BSM Program has been deploying projects and learning valuable lessons that should help improve future projects. Deployed projects have included an upgraded IRS toll-free telephone system to provide capacity to route taxpayers' calls to the appropriate IRS employee; an Internet application that allows taxpayers to check the status of their returns and refunds; and portions of an IRS-wide secure technology environment and a system designed to improve the availability and performance of modernized systems. The IRS also released an update to its Enterprise Architecture that serves as the roadmap for current and future modernization projects. However, the most significant and complex projects have yet to be delivered.

One of these projects, the Customer Account Data Engine or CADE, will eventually replace the existing Master File of taxpayer accounts. The Master File is the IRS' database that stores various types of taxpayer account information and includes individual, business, and employee plans and exempt organizations data. Therefore, CADE will be the foundation for managing taxpayer accounts in the IRS' modernization plan. CADE will consist of databases and related applications that will include processes for daily posting, settlement, refund processing, and issue detection for taxpayer account and return data.

The CADE databases and related applications will also enable the implementation of other modernized systems that will improve customer service and compliance and allow the on-line posting and updating of taxpayer account and return data. The portion of the CADE related to individual tax accounts will be incrementally deployed in five releases, each related to a specific taxpayer segment, over several years.

	RELEASE ONE	RELEASE TWO	RELEASE THREE	RELEASE FOUR	RELEASE FIVE
Tax Return Types	1040EZ	1040EZ 1040A 1040 (without Sch. C,E,F)	1040EZ 1040A 1040 (without Sch. C,E,F)	1040 with Sch. C,E,F, 94X[1] 720[2]	All remaining individual tax returns
Filing Status	Single	All (Single, Married, Head of Household)	All	All	All
Account Characteristics	Refund or even balance No open account issues	Refund or even balance No open account issues	Full paid, refund or balance due No open account issues	Full paid, refund or balance due No open account issues	All accounts not included in previous releases
Est. Returns[3]	6 Million	29 Million	41 Million	34 Million	12 Million
Est. Delivery					
As of April 2000	January 2002	August 2002	July 2003	July 2004	July 2005
As of March 2001	January 2002	January 2003	January 2004	January 2005	January 2006
As of April 2003	August 2003	January 2005	TBD	TBD	TBD

The IRS and its contractor (PRIME) have made progress in delivering the CADE project by building a substantial portion of Release I and creating a comprehensive foundation for all five releases. However, the contractor's development of the CADE project has experienced significant delays and

[1] The Form 94X family of returns is used by employers to report income and unemployment taxes withheld from employee wages.
[2] Form 720 is the Quarterly Federal Excise Tax Return.
[3] Estimated tax returns (electronic and paper) based on 1999 statistics.

increased costs. As shown in the previous table, the Release 1 deployment date is now estimated to be August 2003, which is about 20 months behind its planned delivery date.

The IRS and PRIME contractor initially estimated that Release 1 could be delivered for approximately $51.9 million, an estimate that was revised 6 months later to $64.6 million. The IRS and PRIME contractor have agreed to cap the Release 1 development costs at $54.5 million. Project delays can be attributed to underestimating the complexity of this effort and difficulties in identifying and managing the project requirements. Specifically, these difficulties occurred in developing the balancing, control, and reconciliation process; comprehensive documentation for the CADE Computer Operations Handbook; computer system naming standards, and testing activities.

As a result of delays in deploying the CADE, approximately 35 million taxpayers did not receive the benefits of faster tax return processing, and thus faster refunds, during the 2002 and 2003 Filing Seasons. In addition, the modernization projects that will provide improved customer service and compliance activities will be delayed because they are dependent upon CADE. Based on current schedules, these customer service and compliance improvement projects will not be deployed until at least Fiscal Year (FY) 2006 or later. Delays in these projects will have the following adverse effects on the IRS and taxpayers:

- The time it takes the IRS to initiate a compliance contact with a taxpayer will not be reduced.
- The IRS' ability to offer one-stop service to taxpayers by allowing Customer Service Representatives to identify all issues a taxpayer might have with the IRS when a contact is initiated will be delayed.
- The IRS' ability to answer taxpayer account-related questions with timely and complete data will be limited.

Customer Service

RRA 98 mandated that IRS be more responsive to customer needs. To refocus its emphasis on helping taxpayers understand and meet their tax responsibilities, the IRS revised its mission statement. The IRS has made some progress in enhancing its customer service activities. For example, taxpayers have several options from which to choose when they need assistance from the IRS in answering tax law questions. These options include walk-in service at nationwide Taxpayer Assistance Centers (TAC) and toll-free telephone assistance.

During this calendar year, TIGTA assessed the service provided by representatives at the TACs and through the Toll-Free Telephone System. Overall, the IRS has made improvements in providing service to the taxpaying public. For example, during January through April 2003, IRS employees correctly answered 25 percent more questions, provided 19 percent fewer incorrect answers, and referred 87 percent fewer taxpayers to publications than for this same period last year.

During our review of the TACs, TIGTA personnel visited 72 centers and posed 283 questions to IRS representatives. Results of our review are synopsized in the following chart:

	Number of Responses	***Percentage***
Correct Answers	199	70
Incorrect Answers	73	26
No Answer Provided – Referred to Publication In Lieu of a Response	8	3
Other	3	1

In January 2003, TIGTA also began assessing whether IRS employees were adhering to operating guidelines by referring the tax law questions we asked, which were outside the scope of services they have been trained to answer. The auditors asked 157 "out of scope" questions and determined that employees did not follow referral procedures for 105 (67 percent) of these questions.

The IRS' accuracy in responding to taxpayers' questions using the IRS' Toll-Free Telephone System was somewhat better than that at the TACs. Between January 27 and March 13, 2003, our reviewers performed on-line monitoring of 259 taxpayers calls and determined that IRS representatives correctly answered the taxpayers' questions in 71 percent of the cases.

<u>Filing Season</u>

The tax return filing season impacts every American taxpayer and is, therefore, always a highly critical program for the IRS. In addition to providing customer service to American taxpayers, the IRS must coordinate tax law changes, programs, activities, and resources to effectively plan and manage each filing season.

Overall, the 2003 Filing Season has gone well and tax returns are being processed timely. Based on TIGTA's review, it appears that the IRS should complete processing of individual returns on schedule with all tax refunds being timely issued within the required 45 days from the filing season closing date of

April 15. IRS data show that, as of May 9, 2003, over 52 million electronic returns had been received. The official projection for total electronic returns is 54.3 million. Electronic returns have increased by 12 percent from this time last year. In addition, over 69 million paper returns had been received. The official projection for total paper returns is 78 million. Paper returns have decreased by 8 percent from this time last year.

Many new and significant tax law provisions affected taxpayers' Tax Year (TY) 2002 individual income tax returns, including two *Economic Growth and Tax Relief Reconciliation Act of 2001* provisions involving education expenses and retirement savings. These provisions included changes to education savings accounts, qualified tuition programs, and individual retirement arrangements (IRA). In addition, the Act created a new tuition and fees deduction and a new retirement savings contribution credit (also referred to as "saver's credit"). These changes were considered significant because they could affect an estimated 86.5 million taxpayers by providing tax benefits of up to $7.6 billion in FY 2003. Properly implementing such changes required the IRS to reprogram its computer systems to ensure that taxpayers received the tax benefits allowed by the new provisions.

TIGTA's analysis of IRS computer programming requests to prepare for the filing season showed that the requests were timely submitted and were generally accurate; however, some errors and omissions were identified. For example, computer programming requests to implement the new retirement savings contribution credit and request changes to the IRA deduction contained errors that could have denied credits or deductions to some taxpayers. Also, omissions in computer programming requests may have resulted in the loss of tax revenue by allowing certain taxpayers to receive larger credits or deductions than they were eligible to receive. This possibility exists for the new retirement savings contribution credit, the IRA deduction, and the student loan interest deduction.

<u>The IRS Restructuring and Reform Act of 1998</u>

Due to the comprehensive nature of this reform law, the IRS has dedicated significant attention and resources toward implementing the RRA 98 provisions. RRA 98 included fundamental changes to tax law procedures and 71 provisions that increase or further protect taxpayers' rights. The IRS has taken several actions to improve compliance with these provisions. For example, in some instances, the IRS added a higher level of managerial review, implemented new computer controls to prevent certain violations from occurring, and provided additional training and guidance to help employees and managers understand the provisions' requirements. TIGTA has reported that the IRS has fully implemented three taxpayer rights provisions - *Mitigation of Failure to Deposit Penalty, Seizure of Property, and Taxpayer Advocate-Hardships.* The IRS is generally compliant with two other provisions – *Illegal Tax Protestor Designation and Collection Due Process for Liens and Levies*.

RRA 98 required TIGTA to review 10 of the 71 taxpayer rights provisions, as well as 2 other taxpayer rights provisions in prior legislation. TIGTA is currently in the fifth review cycle assessing the mandatory RRA 98 provisions. TIGTA's most recent audit results on these taxpayer rights provisions are as follows:

- *Notice of Levy* – Most levies are computer generated and subjected to systemic controls that effectively ensure that taxpayers are informed of their appeal rights at least 30 days prior to receiving a systemically generated levy. In some circumstances, however, IRS employees must issue manual levies. Though managers approve and review manual levies issued by Automated Collection System employees, manual levies issued by revenue officers are not required to be reviewed and approved by managers. This significantly increases the risk of taxpayers not having their appeal rights properly protected.
- *Restrictions on the use of enforcement statistics to evaluate employees* – A review of 74 judgmentally sampled enforcement employees' performance and related supervisory documentation prepared between October 1, 2001, and August 31, 2002, revealed no instances of the use of tax enforcement results, production quotas, or goals to evaluate employee performance. There was also improvement over the previous year in documenting the evaluation of employees on the fair and equitable treatment of taxpayers. In addition, a review of 21 statistically sampled supervisors showed the IRS completed the required consolidated office certification memoranda on whether tax enforcement results were used in a prohibited manner.
- *Notice of Lien* – An estimated 14,695 lien notifications, out of a population of 367,385 lien notices prepared between August 1, 2001, and June 30, 2002, were not mailed to the taxpayer, the taxpayer's spouse, or to the taxpayer's business partners; or were not mailed to the taxpayer's or spouse's last known address. Taxpayer rights could be affected because the taxpayer who failed to receive a notice or who received a late notice might not be aware of the right to appeal or could have less than the 30-day period allowed by the law to request a hearing.
- *Seizures* – TIGTA determined that in a statistical sample of 102 seizures from the 218 seizures conducted by the IRS between October 2001 and June 2002, the IRS complied with legal provisions and internal procedures when seizing taxpayers' property for payment of delinquent taxes.
- *Illegal Tax Protestor (ITP) Designations* – The IRS has not reintroduced past ITP codes on the Master File, and formerly coded ITP taxpayer accounts have not been reassigned to a similar ITP designation. In

addition, the IRS does not have any current publications with ITP references. However, IRS employees continue to make references to taxpayers as ITPs and other similar designations in case narratives. TIGTA identified 321 taxpayers that were potentially affected due to improper designations. We have not reported that these taxpayers have been harmed by the designations. Only a thorough review of each taxpayer's case and the treatment accorded that taxpayer would determine if these taxpayers have been harmed. In our most recent report on this subject, TIGTA recommended that the IRS review each case where the reference to ITP or similar designation had been identified and make such determinations.

In its response to the draft report, the IRS disagreed with our determination that in order to comply with this provision, IRS employees should not designate taxpayers as ITPs or similar designations in case histories.

- *Assessment Statute of Limitations* – Employees properly advised taxpayers of their rights to refuse or restrict the scope of the statute extension in 32 of 48 (67 percent) of the tax returns sampled. In 16 of 48 (33 percent) of the tax returns sampled, TIGTA could not determine if employees advised taxpayers of their rights because related case files did not contain a record that taxpayers had been advised of their rights. In 22 of the 24 (92 percent) jointly filed returns sampled, there was no documentation in the related case files that each taxpayer listed on the return was separately informed of his or her rights (i.e., dual notification).

- *Denials of Requests for Information Under the Freedom of Information Act* – TIGTA identified an estimated 458 responses to Freedom of Information Act or Privacy Act requests where information was improperly withheld, out of 4,610 requests for information that were denied in whole or part, or where the IRS replied that responsive records were not available. There were also an estimated 1,052 responses to Internal Revenue Code Section 6103 requests where information was improperly withheld, out of an estimated population of 8,612 requests that were denied or partially denied or where requesters were told that records could not be located.

- *Collection Due Process* – The IRS substantially complied with the requirements of the law and ensured taxpayers' appeal rights were protected in 85 of 87 (98 percent) appeal cases reviewed. In the remaining 2 cases, TIGTA did not conclude that the noncompliance resulted in a legal violation of the taxpayer's Collection Due Process (CDP) rights since collection actions were not initiated. In addition, approximately 94 percent of the CDP determination letters provided to taxpayers (82 of 87 letters) followed the established IRS guidelines. This was a noticeable improvement over prior audit results when approximately 14 percent of the determination letters were determined deficient.

Neither TIGTA nor the IRS could evaluate the IRS' compliance with the following four provisions since IRS management information systems are not available to track the specific cases:

- Restrictions on directly contacting taxpayers instead of authorized representatives.
- Taxpayer complaints.
- Separated or divorced joint filer requests.
- Fair Debt Collection Practices Act (FDCPA) Violations – The IRS does track potential FDCPA violations on its computer systems; however, we determined that data on one system may not always be complete and accurate. Based on information recorded as potential FDCPA violations on the IRS' computer system, TIGTA identified two violations that occurred after July 22, 1998, that resulted in administrative actions being taken against employees. The IRS had no closed cases in which the IRS paid any money to taxpayers for civil actions resulting from FDCPA violations.

Tax Compliance Efforts

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 compliance program (examining tax returns and collecting tax liabilities) would then address those taxpayers who purposefully did not comply. The challenge to IRS management is to establish a tax compliance program 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.

Enforcement actions against individuals and businesses that purposefully conceal tax liabilities or even refuse to submit tax returns have fallen dramatically, despite concerns that tax cheating remains at high levels. The following chart exhibits the fact that, since FY 1996, the level of IRS enforcement activities has significantly declined.

Enforcement Action	Overall Decline FY 1996 – FY 2002
Face-to-Face Audits	70%
Correspondence Audits	56%
Liens	34%
Levies	79%
Seizures	97%

The overall decline in enforcement actions has been primarily attributed to a long-term reduction in enforcement staffing, to redirection of resources to customer service functions during the filing season, a decline in direct examination time, and to IRS employees' concerns over the mandatory termination provision in Section 1203 of RRA 98.

IRS management and many stakeholders have been concerned about the decline in enforcement activities. However, the IRS has not conducted Taxpayer Compliance Measurement Program audits since 1988. Therefore, it currently has no reliable method to measure voluntary compliance or the effect that increased customer service and diversion of compliance resources are having on voluntary compliance. TIGTA believes that the ongoing National Research Program is a much-needed first step for providing the information necessary to gauge compliance levels and direct IRS compliance resources towards areas where attention is most needed.

While the decline in enforcement actions since FY 1996 has been dramatic, there are recent indications that the decline in some categories of enforcement actions and results has stabilized and, in some cases, shown improvement. For example, the IRS' FY 2002 compliance efforts and results were mixed, but showed some continuing positive changes that started in FY 2001. Specifically, the level of compliance activities and the results obtained in many, but not all, Collection areas in FY 2002 showed a continuing increase. The number of examinations of tax returns increased in FY 2002, but the overall percentage of tax returns examined stayed about the same due to increases in the number of tax returns filed. The IRS is taking a number of steps to enhance its compliance programs, including:

- Conducting the National Research Program, which is designed to measure the level of compliance nationwide.
- Restructuring many Collection and Examination processes.
- Focusing on known compliance problems through programs like the Offshore Voluntary Compliance Initiative and the use of Private Collection Agencies.

Section 1203 Violations

In addition to our audit responsibilities, RRA 98 charges TIGTA with investigating Section 1203 violations. Section 1203 identifies standards of conduct for IRS employees that are intended to address serious and willful acts of misconduct. Section 1203 requires the Commissioner of Internal Revenue to terminate the employment of any IRS employee found guilty of any 1 of 10 specific acts or omissions. TIGTA's role in investigating these allegations of employee misconduct serves to protect taxpayer rights and assure integrity in IRS operations.

The IRS monitors Section 1203 complaints in its Automated Labor and Employee Relations Tracking System - known by its acronym, "ALERTS." The vast majority of Section 1203 complaints recorded in ALERTS have alleged that an IRS employee violated a provision of the Internal Revenue Manual or the Internal Revenue Code in order to retaliate against or harass another person. The second category, as measured by the number of complaints, involves the employee's understatement of Federal tax liabilities.

The IRS receives and adjudicates numerous Section 1203 allegations where no independent TIGTA investigation is needed. When TIGTA involvement is warranted, our focus is to determine the facts of the situation as well as the intent of the violating employee. An employee's intent is an essential element that must be present for Section 1203 disciplinary action to be taken. As of March 31, 2003, ALERTS indicated that 96 employees have been fired and 202 employees have resigned or retired as a result of TIGTA and IRS investigations. Since the inception of Section 1203, TIGTA and the IRS have received a combined total of 5,605 Section 1203 complaints.

TIGTA and the IRS are working together to continuously improve the process of receiving, investigating, and adjudicating alleged violations of Section 1203. In March 2002, a streamlined process was implemented which, enabled TIGTA to make an early differentiation between those 1203 allegations that are valid and those that are not. As a result, TIGTA has been able to devote its resources to the investigation of bona fide 1203 allegations and other employee misconduct.

Mr. Chairman and Members of the Committees, I appreciate the opportunity to share with you today the more significant challenges that confront the new Commissioner and IRS senior management. Although the IRS has accomplished a great deal since the passage of RRA 98, much more remains to be done. TIGTA will continue its efforts to provide reliable and objective assessments of the IRS' progress in balancing compliance and customer service, and to investigate employee misconduct or external threats that jeopardize the integrity, efficiency, and effectiveness of the nation's tax administration system.

Mr. HOUGHTON. Mr. Levitan, nice to have you back.

STATEMENT OF HON. LARRY LEVITAN, MEMBER, IRS OVERSIGHT BOARD

Mr. LEVITAN. Thank you, sir. Mr. Chairman, thank you for the opportunity to testify before the annual joint review.

The IRS has made progress over the past 5 years to achieve RRA 98's goals, but the next few years will be difficult and challenging. While much has been accomplished to make the IRS a more effective organization, modernization of the IRS remains a work in progress.

The IRS, the Administration and Congress must work together to close the compliance gap. The IRS must engage its entire workforce in its transformation, and it must begin to show real progress and benefits from its Business Systems Modernization Program.

Mr. Chairman, despite some recent signs of a turnaround, compliance activities have declined dramatically since 1998. The American public senses that the IRS is more bark than bite. True or not, this perception can undermine confidence in the tax system. Commissioner Everson clearly sees this threat and rightly intends to enhance enforcement activities.

Yet, the Board believes that a more robust enforcement program is only part of the equation. We believe that making it easier, faster and more efficient for Americans to meet their tax obligations will also pay off in better compliance. I believe we are in agreement that both compliance and customer service must improve if we are to meet RRA 98's vision for a new IRS.

In our annual report released earlier this month, the Board states that the IRS is both understaffed and outmanned. In the past decade, the number of full-time employees has dropped 16 percent. The number of field-compliance personnel has decreased 28 percent.

At the same time, the IRS workload continues to grow steadily. To boost enforcement, the IRS is focusing its very limited resources on key areas of noncompliance, particularly on high-income, high-risk taxpayers. The Board applauds these initiatives, and it is also pleased with the Administration's request for additional funding in fiscal year 2004 for enforcement.

The Board believes, however, that better compliance begins with quality customer service. We must ensure that the IRS is able to do a better job serving the vast majority of honest taxpayers who face an increasingly complex tax code. That means providing the information and support needed so taxpayers are able to do the right thing at tax time.

During fiscal year 2002, only seven out of ten taxpayers got the help they sought over the IRS toll-free phone lines. Although we do understand that this improved during the recently completed tax season, solving a problem quickly with the IRS is still the exception, not the rule. It takes on average 220 days, that is seven months, for an individual to complete an audit at an IRS Tax Assistance Center. Account information is rarely current. It still takes days to post changes due to their outdated computer systems.

Customer service must improve. At the same time IRS must have the enforcement capabilities to pursue those that ignore their tax obligations by underreporting, by participating in abusive tax schemes or by simply failing to report or pay their taxes. To meet these challenges, the Board calls for additional funding to improve both customer service and compliance.

In addition to recommending an additional $44 million to the Administration's $133 million to expand enforcement, the Board also recommends an additional $172 million to bolster customer service. The Board believes that its budget recommendations would result in very specific and very quantifiable improvements in both service and enforcement.

Mr. Chairman, I must also emphasize the importance of staying the course in modernizing the IRS computer systems. Until its processes and supporting information systems are modernized, the IRS cannot become a modern financial services institution. The Board supports full funding of the Business Systems Modernization Program in fiscal year 2004, and that would include $71 million more than the President's budget request.

While results to date for this critical program have been mixed, the Board believes that the IRS has improved its management of this program and expects to see significant progress this year.

Mr. Chairman, the Board is also very pleased to welcome Mark Everson as the new Commissioner of the IRS. We know he will do an exceptional job in this very difficult position, and we look forward to developing a close working relationship with him. We have already discussed the organizational changes that Commissioner Everson announced during his testimony and support these initiatives.

Mr. Chairman, thank you, and I would be happy to answer your questions.

Mr. HOUGHTON. Thanks very much.

[The statement of Mr. Levitan follows:]

STATEMENT OF THE HONORABLE LARRY LEVITAN, MEMBER, IRS OVERSIGHT BOARD

Mr. Chairman, and members of the Joint Committee, 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 Internal Revenue Service (IRS) Oversight Board and to discuss the IRS' performance and the importance of the IRS Restructuring and Reform Act of 1998 (RRA 98).

On July 22nd we will mark the fifth anniversary of the IRS Restructuring and Reform Act of 1998. At this five-year point, the Board believes it is important to check the true progress of the IRS. Where is the IRS in the transformation process? Is the IRS on track? What are the greatest challenges the IRS faces, and how can they be overcome?

PROGRESS MADE SINCE RRA 98

The American tax system is at a crossroads. Following the enactment of the IRS Restructuring and Reform Act of 1998, the IRS embarked on a ten year modernization program and is now at its mid-point. During the past five years, the IRS made enormous progress in setting the stage to provide better service and ensure fair treatment under the law for taxpayers. The agency has refocused, redefined, and rebuilt itself, with dramatic changes in its mission, organization, management processes, and governance. In the past five years, the IRS:

- Adopted a new mission statement to "Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."
- Emphasized the specific needs of different taxpayer segments by implementing a modern organizational structure with four major customer-focused operating divisions.

- Held senior executives and organizations accountable for performance by developing and implementing a balanced measures program.
- Integrated a performance and budget plan based upon a sound strategic assessment and planning process.
- Began to transform the IRS into a modern financial services institution with redefined business processes and information technology by designing and implementing a vision and new architecture.
- Implemented modern call routing, so taxpayers get to the right person to answer their questions quickly.
- Promoted electronic tax filing, which continues to grow; so much so that one paper processing pipeline was closed.
- Weaved many services into the internet, so taxpayers can check the status of their refunds, download forms, and get information easily over www.irs.gov.
- Hired executives with private sector backgrounds to bring new business knowledge and practices, while setting processes to ensure the effectiveness of its streamlined critical pay authority.
- Implemented a number of new and/or expanded taxpayer rights, such as the Innocent Spouse program.
- Strengthened advocacy for taxpayer rights through the Taxpayer Advocate Service, which is handling a case load far larger than originally anticipated.
- Began to gather and analyze valuable taxpayer information through the National Research Program. The program's data will help the IRS allocate resources more effectively and fairly, resulting in better compliance.

STRATEGIC CHALLENGES

However, in its 2003 Annual Report to Congress, the Oversight Board reported that the American tax system is still plagued with two long-term conflicting trends: a steady increased demand on tax administration services, and a steady decline in IRS resources due to budget constraints. In the past decade, the IRS workload has increased steadily. The number of tax returns filed continues to grow; particularly complex returns, such as those filed by individuals earning more than $100,000 each year and small corporations. The tax revenue stream is now dominated by sources that provide greater opportunities for manipulation and for error.

At the same time, the number of IRS employees continues to shrink, due to budget constraints. From 1992 to 2002, IRS workload increased by 16 percent, while at the same time, the number of full time equivalent employees (FTEs) decreased 16 percent from 115,205 in FY1992 to 96,714 in FY2002. As more resources were needed for the IRS to provide essential services, such as processing returns and answering correspondence, resources were shifted from discretionary operations, such as compliance activities. These trends are creating a huge gap between what taxpayers need and what the IRS can do.

Before he left office, the Board asked Commissioner Charles O. Rossotti to assess the state of the IRS and of the tax system. He reported that the effect of these conflicting trends created a huge gap between the number of taxpayers who are not filing, not reporting, or not paying what they owe, and the IRS' capacity to require them to comply. In addition, the tax revenue stream is now dominated by sources that provide greater opportunities for manipulation by those who wish to take advantage of the decline in IRS compliance resources. According to his report:

- 60 percent of identified tax debts are not pursued
- 75 percent of taxpayers who do not file a tax return are not pursued
- 79 percent of identified taxpayers who use abusive devices (e.g., offshore accounts and abusive tax shelters) to evade tax are not pursued
- 56 percent of identified taxpayers with incomes of $100,000 or more and underreported tax are not pursued
- 78 percent of partnerships and similar document matching are not pursued.

IRS PERFORMANCE IN FY2002

These long-term trends impact the IRS' ability to meet taxpayers' needs. In reviewing the IRS' performance for FY2002, the IRS Oversight Board found that:

- Customer service showed some improvement, but not enough. The number of returns filed electronically by individuals rose 16 percent. The IRS also improved its accuracy in correctly answering questions regarding tax law and taxpayer accounts on its toll-free telephone lines. Yet only seven out of ten callers to the IRS toll-free phone line were assisted. This is an improvement from the year before, and may indicate a trend, but this level is not acceptable to the Board. Voluntary compliance is at the heart of the nation's tax system, and the easier it is for taxpayers to meet their tax obligations, the more likely they will be to comply with the law. More resources are needed for the IRS to provide the services taxpayers need.

- Compliance activities increased, but not enough to close the gap. In FY2002, collection activities generated $371 million more than the year before—a laudable improvement, but not nearly enough to address the growing compliance gap. The number of levies issued increased nearly 50 percent over the previous year, while the number of liens filed increased by nearly 15 percent. Audits of high-income taxpayers—those earning $100,000 and up—increased by 22 percent from the previous year. The IRS launched a number of initiatives aimed to clamp down on abusive tax shelters and offshore accounts. However, other compliance related measures declined. The gap between new delinquent accounts received and the number closed grew again. The exam coverage rate for large businesses over $10 million declined from 25 percent to 15.5 percent. In areas of high growth in returns filed, such as partnerships and mid-sized businesses filing 1120S returns, coverage rates have also declined dramatically.

While the improvements in both areas are welcome, the Board remains concerned with the overall state of customer service and the IRS' ability to ensure that the tax law is enforced. The National Taxpayer Advocate's 2002 report cited access to the IRS as fundamental to the achievement of universal taxpayer rights. The Board agrees that taxpayer accessibility to the IRS is imperative. The vast majority of taxpayers want to do the right thing in an increasingly complex tax system. They must be able to get help from the IRS, whether it is over the phone, in person, or over the internet. Resources must be made available so the IRS can provide the level of service expected by the public.

ACTIONS REQUIRED FOR SUCCESS

The IRS Oversight Board's role is to provide long-term guidance and direction to the IRS. Given the IRS' present situation, we believe that the agency, with the support of the Administration and Congress, must take the following actions if it is to succeed:

- Close the compliance gap: The IRS Oversight Board believes that modernizing the IRS and a three percent annual productivity gain alone will not close the compliance gap. In his end-of-term report to the Board, Commissioner Charles O. Rossotti recommended an annual two percent per year staff growth through 2010. The Board fully endorses this approach.
- Boost customer service: Millions of taxpayers are filing electronically. Hundreds of millions of forms and publications are downloaded from the IRS web site. Yet the demand for customer service—over the phone, at walk-in centers, and through the mail—grows each year. So too does the complexity of the tax code. Only seven out of ten taxpayers can get help over the phone at tax time given the IRS resource constraints. The IRS has direct contact with more Americans than any other federal agency; the Board believes its customer service must continue to improve to a long-term level agreed upon by Congress and the Administration, and backed up with the resources needed to meet that level.
- Commit to modernization: Until both its processes and supporting information systems are modernized, the IRS cannot become a modern financial services institution. The Board is deeply concerned with the progress of this program. Results have been delayed and both the PRIME contractor and the IRS need to continue to improve their management's ability to handle a program of this scope. Despite this, the Board remains committed to the modernization program, and believes it should be accomplished as quickly as possible consistent with the IRS' ability to manage and implement it.
- Focus on people resources: As the IRS modernizes, it must recruit, retain and develop employees who have the knowledge and skills needed to do their jobs. The IRS will also face a dramatic loss of institutional knowledge in the next five years when waves of federal employees retire. In the past five years, the IRS has concentrated on business processes and information technology. Now is the time for the IRS to make the most of its people resources by developing a comprehensive, agency-wide strategic human resources initiative.
- Measure long-term goals: The IRS made strides in measuring its progress in the past five years with the implementation of an agency-wide balanced measures approach to performance management. The agency and decision-makers now have a much better sense of the IRS' performance. Yet there is no universal consensus on what constitutes the appropriate level of performance in the long-term, for both compliance and customer service. Two efforts are underway to address this. First, at the Board's recommendation, the IRS Executive Steering Committee will propose and seek consensus among key executive

branch agencies, Congress, stakeholders, and the public in determining appropriate levels and strategic goals for IRS long-term performance objectives. The second is the work underway by the National Research Program, which will provide data on taxpayer compliance levels. The Board believes it is necessary for the IRS to set its long-term goals so it can evaluate its progress effectively.

To accomplish all of these things, the IRS needs stable, additional funding. The IRS cannot close the gap or implement a successful modernization effort unless it receives additional and sustained funding over a long period of time. The Board is well aware of the challenges now facing our nation, but believes that short-term solutions to reduce spending will result in larger challenges in tax administration in the future and endanger the source of revenue collection.

FY2004 IRS BUDGET RECOMMENDATIONS

The IRS Restructuring and Reform Act (RRA 98) gives the Oversight Board specific responsibilities to review and approve the budget request of the IRS prepared by the Commissioner, and submit this request to the Treasury Department. RRA 98 also provides that the President shall submit the Oversight Board's budget recommendation to the Congress, without revision, together with his own budget request, and gives the Oversight Board the responsibility to ensure that the budget request supports the annual and long-range strategic plans.

In developing its recommendations, the Oversight Board is evaluating first and foremost the needs of taxpayers. The Board wants to ensure that taxpayers get the help they need at both ends of the tax administration spectrum. Up front, do taxpayers receive the education and service they need to understand and meet their tax obligations? Post-filing, do taxpayers believe the tax laws are being enforced fairly so that all taxpayers pay their fair share?

The Oversight Board is cognizant that the present war on terrorism and the budget deficit increase the need to ensure that all federal spending be thoroughly justified and deliver value to taxpayers. Nonetheless, the Oversight Board has statutory responsibilities for IRS governance and must ensure that it makes an honest and independent assessment of the performance levels the IRS must deliver and the budgetary implications of achieving that performance. The Oversight Board worked closely with the IRS, as well as with Treasury and the Office of Management and Budget (OMB) in producing its budget recommendation. The Oversight Board believes that its budget recommendation supports the annual and long-range strategic plans of the IRS, as required by RRA 98.

Moreover, especially in this difficult budgetary time, the Oversight Board believes that there is great value in having the government collect the revenue it is due by ensuring that all taxpayers pay what they honestly owe. Taxpayers expect that this be done, and fairness dictates it.

Table 1 shows the Oversight Board's FY2004 budget recommendations for each account compared to the FY2003 IRS budget and the Administration's budget request.

TABLE 1.—COMPARISON OF IRS' FY2003 BUDGET WITH ADMINISTRATION REQUEST AND OVERSIGHT BOARD RECOMMENDATIONS FOR FY2004

[All $ in 000s]

Account	FY2003 IRS Appropriation [1]	Administration FY2004 Budget Request	Oversight Board FY2004 Budget Recommendation	Difference between Administration and Oversight
PAM	$3,930	$4,075	$4,247	$172
TLE	3,705	3,976	4,021	44
IS	1,621	1,670	1,670	
BSM	[2] 364	429	500	71
EITC	145	251	251	
HCTC	70	35	35	
Total	9,835	10,437	10,724	287

[1] FY2003 actual appropriation. Administration FY2003 request was $9,916 million.
[2] The original FY2003 budget request was $450 million, which was subsequently reduced to $380 million.

The Board's recommended budget provides for two percent growth in IRS resources. The Oversight Board recommends an additional 2,120 FTEs over FY2003 levels compared with the Administration request of 238 additional FTEs. An additional 650 FTEs are proposed for the EITC Reform Initiative, which was proposed by the Administration and added by the Board to its budget recommendation.

The Oversight Board has recommended this budget for several reasons. First, and most importantly, it provides the IRS with resources to address the five strategic actions I described earlier. The proposed budget is also consistent with the Oversight Board's goal of achieving two percent in real growth for a five year period, which it believes is necessary.

Secondly, it provides for additional investment in the BSM program, which the Oversight Board believes is essential to the transformation of the IRS. Unfortunately, the Oversight Board believes the Administration request will result in the delay of delivery of important benefits to taxpayers.

Third, it restores resources for customer service and enforcement that have been lost in recent years to unexpected costs. Each year, the IRS must cover unexpected costs. These costs reduce the IRS' ability to hire the number of employees (full-time equivalents, or FTEs) planned by both the Administration and the Board in their recommended budgets. Examples of unexpected costs that caused this reduction include:

- $43 million to cover the unfunded increase in the FY2002 annual pay raise from the President's request of 3.6 percent to the enacted 4.6 percent raise;
- $68 million of unfunded increase in the FY2003 annual pay raise from the President's request of 2.6 percent to the enacted 4.1 percent raise.
- $23 million when legislation was not enacted that would have allowed for savings on postage and the Financial Management System payment levy;
- $22 million in postage costs that increased above initial budget projections; and
- $20 million of unfunded increases in security costs after September 11.

In FY2002 and FY2003, unfunded costs resulted in decreases in the number of FTEs requested in the Administration's budget as shown below:

Fiscal Year	Administration FTE request (less EITC)	FTEs Achieved by the IRS (less EITC)	Difference
2002	99,116	96,714	−2,402
2003	98,727	96,802	−1,925

The stage has already been set for this to happen again, resulting in a lower number of FTEs in FY2004. In the FY2004 budget, the Administration proposed a two percent pay raise for civil service employees and a 4.1 percent raise for military personnel. Pay parity between civilian and military personnel was provided in 15 of the last 17 Treasury Appropriation bills. Furthermore, both the House and Senate versions of the FY2004 budget resolution contain a "sense of the Congress" provision supporting military-civilian pay parity for federal employees. If past years are any indication, Congress will again provide pay parity to military and civilian personnel.

The Board's FY2004 budget proposal, as does the Administration's, assumes a two percent pay increase. The Board urges that Congress provide the necessary funds for any pay raise it may pass in the coming year. Otherwise, as in previous years, the IRS will be forced to freeze future hiring initiatives and cut any discretionary spending such as employee training programs to absorb the impact of an unfunded pay raise.

CONCLUSION

Chairman Thomas, before I conclude I would like to add a personal note. Two years ago, on May 8, 2001, GAO, TIGTA, and I testified before you at a Joint Tax Committee hearing on the same subject. You challenged the three organizations to share information and develop common perspectives on the strategic challenges facing the IRS. I'm pleased to say that since that hearing we have responded to your challenge and meet periodically to do just that. The result has been a fruitful and rewarding exchange for all three organizations. I'm confident my fellow panelists would agree.

The Board believes that the IRS has accomplished much, but must do more. We have a tough five years ahead of us. Up to this point, the agency focused on planning and developing major programs. Those programs are now being implemented. The Board intends to work closely with the IRS and its new leadership to provide guidance to improve the implementation process. The Board also will work with the Administration and Congress to do all it can to ensure that the IRS gets the resources needed to succeed.

The future is now. It is time for the IRS to begin to produce the tangible benefits for taxpayers envisioned five years ago.

Mr. HOUGHTON. Mr. White.

STATEMENT OF JAMES R. WHITE, DIRECTOR, STRATEGIC ISSUES, U.S. GENERAL ACCOUNTING OFFICE

Mr. WHITE. Mr. Chairman and members of the committees, we are pleased to be here at this Joint IRS Oversight hearing.

Five years ago Congress passed the IRS Restructuring and Reform Act in response to frustration with IRS's performance. Now, halfway through the ten years that the then commissioner projected modernization would take, is a good time to take stock, to look back on what has been accomplished to date and to list the challenges the new commissioner will face.

Both can be understood in terms of the graphic on the easel, also on the bottom of the first page of my statement. The right side shows IRS's goals, to improve service to taxpayers while ensuring compliance with the tax laws. The left side shows four key means to achieve these goals. While still far from realizing the goals on the right, IRS's modernization progress gives it more of the means it needs for reaching the goals.

IRS has increased its capacity to manage. Looking at the arrows, IRS has put in place many, but not yet all, of the controls needed to effectively acquire new information systems. IRS has established, but not yet implemented, a substantial set of policy standards and guidelines for computer systems security that would protect taxpayer data from many threats. IRS put in place a new organizational structure focused on taxpayers, not geography, put in place a new management process for setting strategic priorities and allocating resources, put in place new organizational employee performance measures, and has issued reliable annual financial statements.

These modernization accomplishments on the left side of the graphic are beginning to affect the goal of improving service. Taxpayers are more likely to get through to IRS's centers when they call and now use the Internet to download hundreds of millions of tax forms and check the status of their returns. Nevertheless, the IRS is still not where taxpayers and Congress expect it to be.

Perhaps IRS's most significant challenge is its compliance goal. IRS does not have a reliable measure, the extent to which taxpayers are currently complying with the tax laws. This is risky, because many, but not all of IRS's compliance and collection programs, such as audits, have experienced large and pervasive declines in recent years. The declines show up in staffing, cases deferred and the inventory of uncollected tax debts with some collection potential, which is now at $112 billion.

The declines have caused concern that taxpayers may have less confidence that their friends, neighbors and business competitors are paying their fair share and thus less incentive to fully report and pay their own taxes.

In addition, IRS still faces challenges improving service. For example, despite progress, callers get either busy signals or a hang-up before receiving service too often. Modernization is the means for achieving IRS's goals, but there are challenges in each of the areas on the left side of the graphic. The scope and complexity of business systems modernization projects continue to increase, while IRS's systems management capacity is still maturing.

IRS will be challenged to ensure that the pace of acquiring systems does not exceed the agency's ability to manage such acquisitions. The policies and guidelines for computer systems security are not fully implemented. In managing and judging its performance, IRS needs to have objective measures that are comparable across time, set goals so the progress can be judged against the goals, conduct more program evaluations to learn what worked and why and better link budget requests with program results.

Despite clean opinions on its financial statements, the information is available only after the year's end. Managers need current financial information for day-to-day decision making.

IRS needs to employ a strategic approach for managing human capital that includes identifying staffing and training needs. Finally, IRS has been challenged to increase staff in priority areas, especially compliance, as called for in recent budget requests. The number of staff who conduct audits and collect delinquent taxes is lower in 2002 than in 2000. Reasons for this include unbudgeted costs and an inability to fully realize internal savings intended to allow staff reallocations.

Also, the growth in electronic filing is slowing. Based on current growth rates, IRS will not achieve its goal of having 80 percent of returns electronically filed by 2007. Slower growth in electronic files will reduce IRS's ability to shift resources out of paper return processing.

In conclusion, IRS has come a long way from where it was in the mid–1990s. Taxpayers and Congress are beginning to see some payoff from the oversight and money invested in IRS. However, the challenges facing the new Commissioner are significant. The same focus on management fundamentals, the means to the end that proved successful over the past 5 years should help deal with those challenges.

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

Mr. HOUGHTON. Thanks very much.

[The statement of Mr. White follows:]

United States General Accounting Office

GAO

Testimony
Before Congressional Committees

For Release on Delivery
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IRS MODERNIZATION

Continued Progress Necessary for Improving Service to Taxpayers and Ensuring Compliance

Statement of James R. White
Director, Strategic Issues

Robert R. Dacey
Director, Information Technology Systems Issues

Steven J. Sebastian
Director, Financial Management and Assurance

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GAO-03-796T

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Accountability·Integrity·Reliability

Highlights

Highlights of GAO-03-796T, a report to Congressional Committees

Why GAO Did This Study

Congress passed the IRS Restructuring and Reform Act of 1998 in response to frustration with Internal Revenue Service's (IRS) inability to effectively carry out its mission. IRS's inability to deliver new computer systems that worked, allegations of abuse of taxpayers by IRS employees, and taxpayers greeted by busy signals when calling IRS for assistance all fed the frustration. The act set two goals for IRS—improve service to taxpayers while continuing to enforce compliance with the tax laws. The act also mandated annual joint congressional oversight hearings, of which this is the fifth and final.

What GAO Recommends

GAO is not making any new recommendations. However, numerous recommendations made in previous GAO reports about how to deal with the challenges facing IRS are cited.

www.gao.gov/cgi-bin/getrpt?GAO-03-796T.

To view the full report, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

May 20, 2003

IRS MODERNIZATION

Continued Progress Necessary for Improving Service to Taxpayers and Ensuring Compliance

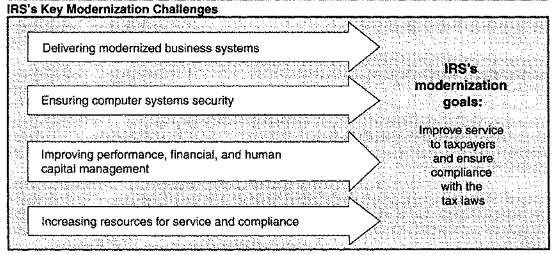
What GAO Found

IRS's accomplishments in the 5 years since the act was passed are significant. IRS has increased its capacity to manage with, for example, more effective controls over information system acquisition and better performance measures. In addition, the improvements have had a noticeable impact on service to taxpayers. Taxpayers have an easier time reaching IRS by telephone and are increasingly using IRS's Web site to download tax forms and publications and check the status of their refunds. Nevertheless, IRS is only part of the way to where taxpayers and Congress expect it to be.

Compliance is perhaps IRS's greatest challenge looking forward. Although IRS lacks current data about the level of voluntary compliance, what is known is that there have been significant and pervasive declines in many of IRS's key compliance and collections programs. As a result of these declines, taxpayers have less incentive to voluntarily comply, thereby potentially undermining the integrity of the tax system and risking revenue collections. Reversing this decline will be a challenge. Another challenge will be closing the gap between the level and quality of taxpayer services that IRS provides and what Congress and taxpayers want and expect. Despite improvements, almost one-third of callers receive busy signals or hang up without receiving service, and almost 20 percent get incorrect answers to tax law questions.

The means for realizing IRS's goals is continued progress modernizing, but this will be a challenge. The scope and complexity of the business systems modernization is growing, but management capacity is still maturing. Long-standing computer security weaknesses continue to threaten the confidentiality, integrity, and availability of sensitive systems and taxpayer data. Performance, financial, and human capital management all need further improvement. IRS is also challenged to realize the increased staffing levels for service and compliance called for in recent IRS budget requests.

IRS's Key Modernization Challenges



Source: GAO.

Mr. Chairman and Members of the Committees:

We are pleased to be here today to contribute to this joint oversight hearing on the Internal Revenue Service (IRS). Five years ago, Congress passed the IRS Reform and Restructuring Act of 1998[1] (Restructuring Act), as part of an effort to modernize IRS and provide taxpayers with additional rights and protections. In this hearing, the fifth and final one mandated by the Restructuring Act, we will report on IRS's accomplishments over recent years and the challenges ahead.

Throughout the 1990s, Congress grew increasingly frustrated with IRS's inability to effectively carry out its mission. IRS's inability to deliver new computer systems that worked, allegations of abuse of taxpayers by IRS employees, and taxpayers greeted by busy signals when calling IRS for assistance all fed the frustration. In response, Congress established the National Commission on Restructuring IRS in 1997 and passed the Restructuring Act in 1998, which increased Congress's oversight of the agency. In passing the act, Congress set two basic goals for IRS: improve service to taxpayers while continuing to enforce compliance with the tax laws.

Since passing the Restructuring Act, Congress has maintained its increased oversight of IRS. For example, Congress has reviewed IRS's expenditure plans for its Business Systems Modernization (BSM) program before allowing authorized funds to be spent. Congressional committees have also held numerous hearings on IRS's modernization progress, including the five joint oversight hearings.

In addition to oversight, Congress has invested in IRS. In the last 5 years, Congress has appropriated $1.35 billion for BSM. Congress also has virtually fully funded IRS's annual budget requests for each year.

Now, halfway through the 10 years that the then Commissioner projected modernization would take, is a good time to take stock—to look back on what has been accomplished to date. We are pleased to report that, while still far from realizing the goals set by the Restructuring Act, what has been accomplished is significant.

[1]Pub. L. 105-206.

- IRS has increased its capacity to manage. While still only partway to where it needs to be, IRS has put in place an organizational structure and improved processes to set strategic priorities, allocate resources, and achieve results aligned with priorities. IRS has established a strategic planning and budgeting process, put in place many of the management controls needed to effectively acquire and implement modernized business information systems, reorganized around taxpayer groups, established a balanced performance measurement system, implemented a new employee evaluation system, and issued reliable annual financial statements.

- The modernization accomplishments to date have had a noticeable impact on service to taxpayers. For example, taxpayers are more frequently reaching, and waiting less time to speak to, telephone assistors and are increasingly using IRS's Internet Web site to download forms and publications and get other types of information, such as the status of their refund.

The service improvements mean that the congressional oversight, efforts made by IRS managers and employees, and dollars invested in modernization are beginning to show payoffs that American taxpayers can see. Less apparent on the list of accomplishments is compliance. While several significant compliance efforts have been started, few have been completed.

With a new commissioner just confirmed, now is also a good time to list the challenges facing IRS in the coming 5 years. Last year in this same hearing, we said that IRS was at a critical juncture, in part, because of the impending change of commissioners and the challenges a new commissioner would face. With the change just completed, IRS remains at essentially the same critical juncture. Both of IRS's goals—improving taxpayer service and ensuring compliance—are challenges. Similarly, the means for achieving these goals—modernization of management and systems—is a challenge. Without continued focus by managers and employees on modernizing, IRS would put the progress made to date at risk and jeopardize the possibility of realizing Congress's twin goals for modernization.

- The area where progress is least apparent—compliance—is perhaps IRS's most significant risk and greatest challenge looking forward. Compliance is a risk, in part, because neither IRS nor we know the level of voluntary compliance, which compliance problems are the most significant, and what the impact changes and IRS's compliance programs and efforts have on the level of voluntary compliance. What is known is that there have been significant and pervasive declines in many of IRS's key compliance and collections programs. The declines can be seen in measures such as cases closed per employee, staffing levels, cases not worked and the inventory of uncollected tax debt. As a result of these declines, taxpayers have less incentive to voluntarily comply, thereby potentially undermining the integrity of the tax system and risking revenue collections. Reversing this decline will be a challenge.

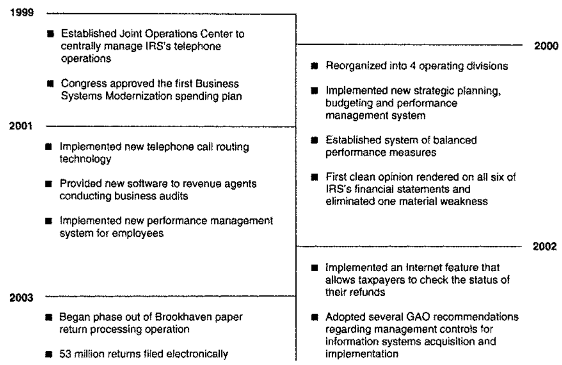
- While service to taxpayers has improved, gaps remain between the quality of taxpayer services that IRS provides and what Congress and taxpayers want and expect. For example, while the percentage of callers who receive busy signals or hang up without receiving service has fallen since 1997, it still remains at 32 percent.
- Continuing the progress that has been made, modernizing management remains another challenge. The scope and complexity of the BSM is growing, but management capacity is still maturing. Long-standing computer security weaknesses continue to threaten the confidentially, integrity, and availability of sensitive systems and taxpayer data. Performance, financial, and human capital management all need further improvement. Finally, realizing the increased staffing levels for service and compliance called for in recent IRS budget requests has not always been possible.

Our assessment of both major accomplishments and key challenges is based primarily on recently issued GAO products and ongoing reviews.

IRS Has Improved Management and Taxpayer Service

Over the 5 years since the Restructuring Act was passed, IRS has made significant progress in modernizing. Figure 1 shows some of the major accomplishments of the last 5 years. The figure includes actions that have been implemented or completed and that represent significant steps in the overall modernization effort. The figure is meant to illustrate important progress—it does not show every accomplishment.

Figure 1: Selected Major IRS Accomplishments in Modernizing, 1999-2003



Source: GAO.

Most of the accomplishments shown in figure 1 are internal management improvements that will not be noticed by taxpayers, such as management controls for information systems acquisition and implementation. While such improvements do not directly affect taxpayers, they should lay a foundation for improving service and ensuring compliance.

Figure 1 does include some accomplishments that are noticeable to taxpayers such as the ability to check the status of their refund using the Internet and the increase in electronically filed returns. One accomplishment—the new software for revenue agents to help conduct business audits—involves IRS's enforcement programs.

IRS Has Made Management Improvements

IRS has completed a number of major modernization steps to help improve management of its operations. While IRS still faces challenges in each of the areas discussed below, the steps completed to date are major accomplishments.

Modernizing Business Systems

IRS's multibillion dollar BSM program is critical to the success of the agency's efforts to transform its manual, paper-intensive business operations and fulfill its obligations under the Restructuring Act. To date, about $1.35 billion has been appropriated and released for BSM.

IRS's challenges in modernizing its business systems date back to the mid-1990s, when we reported on a number of technical and management weaknesses and made a series of recommendations for correcting them and limiting modernization activities and spending until they were corrected.[2] It was then that we designated the modernization program as a high-risk area.[3] These challenges remained virtually unchanged until 1999, as IRS made limited progress in correcting its weaknesses and our ongoing reviews of the program continued to identify additional weaknesses and produce additional recommendations.

Beginning in 1999, IRS started making progress in strengthening its modernization management controls and capabilities. For example, IRS submitted and Congress approved the first of a series of expenditure, or spending, plans for BSM. These plans facilitate congressional oversight and provide a description of the expenditures, functionality, and delivery schedule planned for each project. Other notable accomplishments since 1999 include (1) developing and using a modernization blueprint, commonly called an enterprise architecture, to guide and constrain its modernization projects and (2) investing incrementally in its projects, both of which are leading practices of successful public and private sector organizations.

Since 2001, IRS has progressed in establishing the infrastructure on which future business applications will run. Establishing this infrastructure is a necessary prerequisite for business applications that are intended to provide benefits to taxpayers and IRS. In addition, it has delivered three applications that are today producing benefits. For example, the Customer Communications 2001 project improved the telecommunications

[2]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), and *Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems*, GAO/AIMD/GGD-98-54 (Washington, D.C.: Feb. 24, 1998).

[3]U.S. General Accounting Office, *High-Risk Series: An Overview*, GAO/HR-95-1 (Washington, D.C.: February 1995).

infrastructure, including telephone call management, call routing, and customer self-service applications.[4]

In response to congressional direction and our previous concerns about projects getting ahead of the agency's ability to manage them effectively,[5] IRS scaled back its projects, giving priority to implementing needed management capacity. In our February 2002 report,[6] we again recommended that the Commissioner of Internal Revenue reconsider the scope and pace of the program to better balance it with the agency's capacity to handle the workload. In response, IRS took steps to better align the pace of the program with the maturity of IRS's controls and management capacity, including reassessing the portfolio of projects that it had planned to proceed with during the remainder of fiscal year 2002 and reducing the planned scope and pace of the program for fiscal year 2003.

Securing Taxpayer Information

Information security is a critical consideration for any organization that depends on information systems and computer networks to carry out its mission or business. It is especially important for government agencies, like IRS, 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 IRS communicates and conducts business. Without proper safeguards they also pose enormous risks that make it easier for individuals and groups with malicious intent to access sensitive information, commit fraud, or disrupt operations.

Due to the nature of its mission, IRS collects and maintains a significant amount of personal and financial data on each American taxpayer. These data typically include the taxpayer's name, address, Social Security number, dependents, and income. The confidentiality of this sensitive information is important because if this information is disclosed to

[4]The other two are Customer Relationship Management Examination, which provides off-the-shelf software to IRS revenue agents to allow them to accurately compute complex corporate transactions, and Internet Refund/Fact of Filing, which improves customer self-service by providing taxpayers with instant refund status information and instructions for resolving refund problems via the Internet.

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

[6]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.: Feb. 28, 2002).

unauthorized individuals, taxpayers could be exposed to a loss of privacy and to financial loss and damages resulting from identity theft and financial crimes.

IRS has made important progress toward improving information security over taxpayer data and implementing a comprehensive agencywide information security program. It has established and updated a substantial set of information security policies, standards, and guidelines that generally provide appropriate guidance to personnel responsible for securing IRS information systems and data. If effectively implemented, these would protect IRS information systems and taxpayer data from many threats. IRS has also increased the resources devoted to securing its systems and data—increasing, for example, the number of specialists assigned to the office responsible for ensuring that IRS has effective security programs in place. To help improve the security of IRS's systems and taxpayer data, IRS has also (1) implemented and improved control measures that limit physical access to facilities and computing resources and (2) established a virus protection and eradication program that helps to protect against new malicious software threats as they emerge.

Reorganizing IRS and Managing Performance

A major principle of IRS's modernization strategy is that understanding the taxpayer's point of view and improving service is fundamental to helping the majority of taxpayers who are willing to comply with the tax laws and pay what they owe. To help realize this customer-focused approach to providing service, in October 2000 IRS reorganized into four divisions, each responsible for a group of taxpayers with similar needs, such as IRS's Small Business/Self-Employed Division.

A sound organizational performance and human capital management system is essential for assessing how well IRS meets its goals and for identifying and making programmatic improvements. IRS has made progress by establishing a system of balanced measures to hold managers and frontline staff more accountable for improving performance. For example, IRS determined that the three elements of balanced measures were customer satisfaction, employee satisfaction, and business results (quality and quantity measures) to ensure balance among priorities. Similarly, in October 2001, IRS implemented its new employee evaluation system for frontline employees. This main human capital management system, like the one implemented earlier for executives and managers, was designed to structurally align performance expectations for employees with IRS's three strategic goals to encourage behaviors and actions that support and advance those goals.

In 2000, IRS implemented a new strategic planning and budgeting process that provides the framework for developing goals, objectives, and measures at the operating division level. Although we have not evaluated the effect of the process on IRS performance, the operating divisions are identifying strategic goals intended to be tailored to the specific characteristics and needs of their taxpayers. IRS senior management is also using the process to reconcile competing priorities and resource needs of the operating divisions.

Improving Financial Management

Current and accurate financial information is critical to informed decision making by senior management. IRS has made considerable progress towards improving financial management, including achieving unqualified (clean) audit opinions on financial statements.

When former Commissioner Rossotti was confirmed in November 1997, IRS was exhibiting virtually the same pervasive financial management weaknesses we had been reporting since we began auditing IRS's financial statements in 1992. These weaknesses, which led GAO to add IRS financial management to its high-risk list in 1995,[7] stemmed not only from IRS's reliance on obsolete and inadequate financial management systems, but also from the serious weaknesses in IRS's policies and procedures. In the five years that have passed since 1997, however, IRS has made considerable progress in addressing weaknesses in its financial management systems and internal controls by, for example, committing extensive additional resources. This and other efforts have resulted in reducing the number of material internal control weaknesses and attaining unqualified opinions on its financial statements. This achievement was due in no small part to the strong commitment made by senior IRS management.

During our audit of IRS's custodial financial statements[8] in fiscal year 1997, we found material weaknesses in IRS's internal controls that had shown little improvement since our first audit in fiscal year 1992. These weaknesses included an inadequate financial reporting process,

[7]GAO/HR-95-1.

[8]The Custodial Financial Statements report the assets, liabilities and results of activities related to IRS responsibilities for implementing federal tax legislation, including collecting federal tax revenue, refunding overpayments of taxes, and pursuing collections of amounts owed. IRS also has administrative activities, which include managing costs funded by appropriations and reimbursements from other federal agencies, state and local governments, and the public.

deficiencies in controls to properly manage unpaid assessments, and deficiencies controls over tax refunds and computer security. To overcome these weaknesses, IRS implemented extensive compensating procedures that enabled it to derive reliable balances related to its custodial activity such as taxes receivable, enabling IRS to receive, for the first time in fiscal year 1997, an unqualified opinion on its custodial financial statements.

During fiscal years 1998 and 1999, we were unable to issue a clean opinion on five of IRS's six financial statements due to the continued affects of the material weaknesses in IRS's internal controls. We were able to continue to issue unqualified opinions on IRS's statements of custodial activity, primarily due to IRS's extensive use of compensating procedures.

Beginning in fiscal year 2000, IRS received an unqualified opinion on all six of its financial statements by successfully producing a single set of financial statements that were fairly stated in all material respects. This significant achievement was made possible by years of strong commitment and hard work by both IRS senior management and staff to develop and implement compensating procedures to overcome the fundamental systems and internal control deficiencies that continued to exist and enable IRS to report reliable financial balances at fiscal year-end. IRS also instituted monthly reconciliations of its Fund Balance with Treasury, a process similar to companies or individuals reconciling their checkbooks to monthly bank statements, thereby eliminating this issue as a material weakness.

In fiscal year 2002 IRS reported its financial results and received an unqualified audit opinion 6 weeks after the close of the fiscal year—about 75 days ahead of the reporting deadline required by the Office of Management and Budget. As before, this achievement, and continued progress in addressing its material internal control weakness, was the culmination of years of IRS efforts to refine the compensating procedures it has relied on to overcome material weaknesses, in its internal controls, as well as making substantive improvements in the way it records transactions, maintains records, and reports financial results.

Taxpayers Have Seen Some Improvements in Service

IRS has improved and expanded service to taxpayers, including the accessibility of telephone assistance and increased electronic filing and Internet services. These improvements are a significant accomplishment, but IRS taxpayer service is not yet at the level that taxpayers and Congress want. Also, IRS has begun to reap some rewards from electronic filing—

for example, the closing of its paper processing operations at its Brookhaven, New York, location.

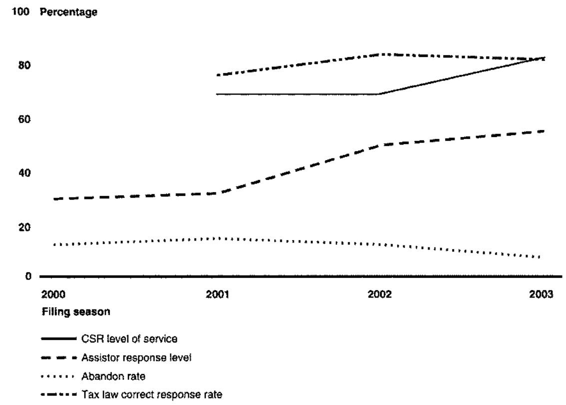
Improved Telephone Service

Since the mid-1990s, access to telephone assistance, an important function that affects millions of taxpayers, has improved. In 1997, about 49 percent of calls to IRS primary assistance lines either received a busy signal or were abandoned before being answered. This compares to about 32 percent of calls to date in 2003. As figure 2 illustrates, other measures of access show improvement as well. The percentage of calls where taxpayers attempted to reach an assistor and received service increased from about 70 to 83 percent between the 2001 and 2003 filing seasons. The figure also shows that callers are waiting less time to speak with an assistor and are hanging up less frequently before getting through. Telephone service is important because it affects so many taxpayers. In 2002, IRS received over 100 million phone calls.

IRS's telephone service improvements are, in part, the results of numerous improvement efforts sustained over time. In 1999, IRS centralized its toll-free telephone operations and established the Joint Operations Center to enable it to route calls to assistors across the country based on actual availability data. Similarly, from 2000 through 2003, IRS made several business process changes and implemented new technology. For example, in 2001, IRS shifted millions of calls to its automated service so it could use its assistors to answer more challenging taxpayer calls. Also, as part of its Customer Communications Project, IRS enhanced its call routing system.

Figure 2 shows that the accuracy of tax law information provided to taxpayers by assistors has remained relatively stable. According to IRS officials, accuracy stayed stable despite simpler calls being routed away from assistors to automated systems.

Figure 2: Improvements in IRS's Service and Assistor Response, 2000-2003



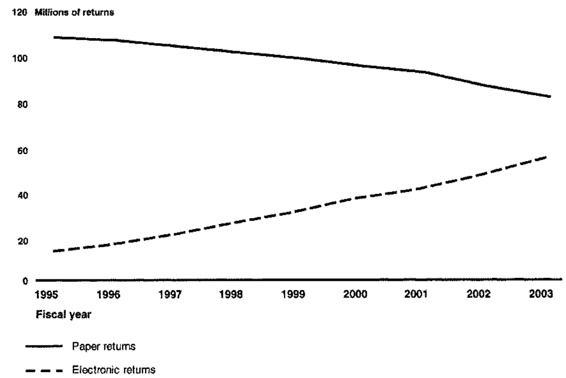
Source: GAO analysis of IRS data.

Note: CSR level of service–of the calls that IRS estimates were from taxpayers attempting to reach an assistor, the calls that received service; Assistor response level–of the calls that reached an assistor, the percentage in which the caller waited 30 seconds or less; Abandon rate–of the calls routed to an assistor, the percentage that hung up before speaking to an assistor; and Tax law correct response rate–of the calls in which IRS provided tax law information, the percentage in which the assistor provided correct answers. IRS has comparable data only for the years shown. Accessibility data covers the period of January through mid-April. The correct response rate covers the period January through April and is an estimate (90-percent confidence level +/- 1 percentage point).

Increased Electronic Filing and Internet Services

Although it still represents less than half of all individual income tax returns, electronic filing grew from almost 12 million returns in 1995 to an estimated 53 million in 2003, as shown in figure 3. The figure also shows that the number of paper returns is declining. The growth of electronic filing is one key to IRS's modernization strategy, because electronic filing allows IRS to control costs and improve customer service by reducing labor-intensive processing of paper tax returns. As a result, IRS is phasing out its paper processing operations in Brookhaven, New York.

Figure 3: Increase in Individual Electronic Returns and Decrease in Paper Returns, 1995-2003



Source: GAO analysis of IRS data.

Note: GAO estimated that, based on the number of returns received electronically to date, IRS will receive a total of 53 million returns filed electronically in 2003.

Another indication that taxpayers are receiving payoffs from modernization is the breadth and quality of the services provided on IRS's Internet Web site. The services being offered to taxpayers and tax practitioners via the Web site have grown considerably over the last few years, and it is used more each year by taxpayers and tax practitioners. As of March 31, 2003, about 283 million forms and publications had been downloaded since the beginning of the filing season.

IRS's Web site is a critical part of modernization because, according to IRS, it is more cost-effective than other methods of providing taxpayer assistance, such as answering telephone calls. The IRS Web site currently provides a way for taxpayers and tax practitioners to receive assistance without having to call or visit an IRS office. Among other things, the site provides the potential to download hundreds of tax forms and publications, contains current information on tax issues and electronic filing, and, in a more recent feature, gives taxpayers the opportunity to check the status of their refunds. The capability to check the status of refunds is particularly important because IRS data shows it has decreased the refund call inquiries handled by IRS's telephone operations and has the potential to further decrease those calls, enabling assistors to handle more complicated calls about tax laws or customer accounts that cannot be answered through automation.

Key Challenges, Especially in Compliance, Remain

Despite the progress modernizing and the improvements in taxpayer service, IRS faces significant challenges looking ahead. Perhaps IRS's most significant risks and biggest challenges are in the area of compliance—an area wherein accomplishments have not been very apparent. Compliance is a risk, in part, because IRS does not have current data on how well taxpayers are complying with the tax laws and therefore cannot appropriately target areas for improvement nor can assess the impact changes to its compliance program have on the level of voluntary compliance. However, the available data show declines in many of IRS's enforcement activities, such as collections. The declines have prompted concerns that taxpayers' willingness to voluntarily comply could be put at risk. Meeting IRS's goal of ensuring compliance is a challenge because of the effort and resources that will be required to reverse these program declines.

Meeting IRS's goal of improving taxpayer service also presents a challenge. Despite IRS's accomplishments, there remains a gap between the quality of service that taxpayers currently receive and the service that taxpayers and Congress want and expect.

A key to ensuring compliance and improving taxpayer service is continuing to modernize IRS's management and systems. This includes delivering modernized systems; ensuring computer systems security; improving performance, financial, and human capital management; and increasing resources for taxpayer service and compliance.

Declines in Enforcement Programs Make Ensuring Compliance a Challenge

A visible enforcement program is considered by many as critical for our tax system to encourage voluntary compliance with the tax laws. While improving taxpayer service may enhance voluntary compliance, taxpayers' willingness to voluntarily comply with the tax laws depends in part on their having confidence that their friends, neighbors, and business competitors are paying their fair share of taxes. To provide that confidence, IRS operates a number of compliance and collection programs, including computerized checks for nonfiling and underreported income, audits, and telephone and field collections. Collecting taxes due the government[9] has always been a challenge for IRS, but in recent years the challenge has grown.

Limited Information on Voluntary Compliance

Understanding taxpayers' compliance with the nation's tax laws is essential to IRS improving the effectiveness of its programs to enforce and promote voluntary compliance. While IRS strives to ensure that enforcement audits are targeted at noncompliant taxpayers, this has become increasingly difficult to do because the information used to identify potentially noncompliant tax returns is out of date. We remain concerned about IRS's ability to appropriately allocate its enforcement resources, including staff, to its various compliance and collections activities. Without current data on voluntary compliance, IRS does not know which is the highest priority area of noncompliance.

IRS's new effort to review compliance, the National Research Program (NRP), should, if implemented as planned, provide IRS with the first up-to-date information on compliance rates and sources of noncompliance since it last measured the compliance rate using 1988 tax returns. IRS has agreed with recommendations we made regarding implementation of NRP and more effective use of such data in the strategic, planning, budgeting, and performance management process.

Enforcement Program Declines

Absent measures of voluntary compliance, the only compliance-related data available are on IRS's enforcement programs. In recent years, steep declines have occurred in some of IRS's compliance programs for individual taxpayers and in programs to collect delinquent taxes. These trends have triggered concerns that taxpayers' motivation to voluntarily comply with their tax obligations could be adversely affected. Since the

[9]Total unpaid taxes due the government include (1) delinquent taxes that IRS is attempting to collect, (2) taxes that IRS knows are due but has decided not to pursue collecting, and (3) an unknown amount of unpaid taxes that IRS has not identified.

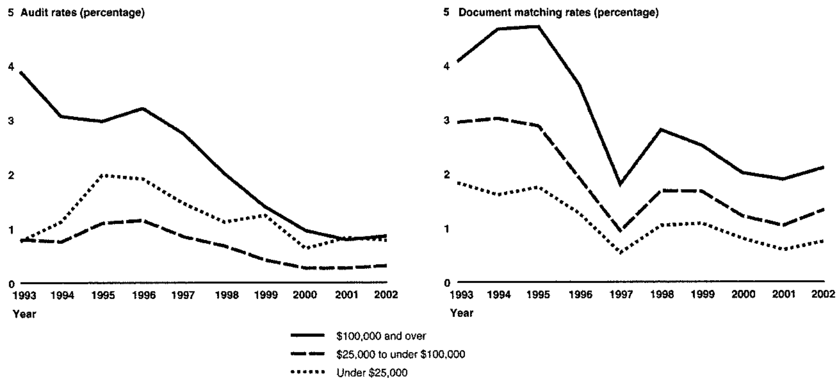
mid-1990s, we have issued six reports on IRS compliance and collection trends in response to congressional concerns.[10]

Figure 4 shows compliance program trends for various income ranges. The audit contact rates for the highest and lowest income individuals essentially converged at around .8 percent in fiscal years 2001 and 2002. Most of the audits of the lowest income individuals dealt with earned income credit claims. Document matching contact rates[11] for all three income ranges rose somewhat from 2001 through 2002. However, rates for all three income ranges ended significantly lower in 2002 than 1993.

[10] U.S. General Accounting Office, *Tax Administration: Audit Trends and Results for Individual Taxpayers*, GAO/GGD-96-91 (Washington, D.C.: Apr. 26, 1996); *Tax Administration: IRS' Audit and Criminal Enforcement Rates for Individual Taxpayers Across the Country*, GAO/GGD-99-19 (Washington, D.C.: Dec. 23, 1998); *Tax Administration: Use of Nonaudit Contacts*, GAO/GGD-00-7 (Washington, D.C.: Mar. 16, 2001); *IRS Audit Rates: Rate of Individual Taxpayers Has Declined With the Effect on Compliance Unknown*, GAO-01-484 (Washington, D.C.: Apr. 25, 2001); *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2002); and *Tax Administration: IRS Should Continue to Expand Reporting on Its Enforcement Efforts*, GAO-03-378 (Washington, D.C.: Jan. 31, 2003).

[11] Document matching is where IRS compares information provided by a third party, for example a bank, against taxpayer return information to identify discrepancies.

Figure 4: IRS Individual Audit and Document Matching Contact Rates by Income Level, Fiscal Years 1993-2002

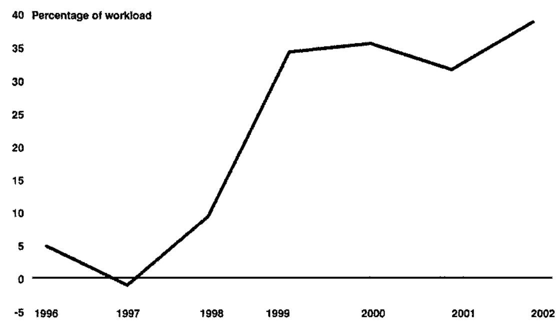


Source: GAO analysis of IRS data.

Collection programs have also declined as shown in figure 5. As we reported in May 2002, from fiscal years 1996 through 2001 trends in the collection of delinquent taxes showed almost universal declines in collection program performance, whether measured in terms of percentage of workload completed,[12] cases closed, direct staff time, productivity, or unpaid taxes collected.[13] From 1996 through 2002, IRS was unable to keep up with the growth in collections workload.

[12]Workload is the number of delinquent accounts assigned to field and telephone collection. Work completed is the number of delinquent accounts worked to closure, excluding accounts for which collection work has been deferred.
[13] GAO-02-674.

Figure 5: Percentage of Collections Workload Not Completed, Fiscal Years 1996 to 2002



Source: GAO analysis of IRS data.

The increasing gap between collection workload and work completed led IRS in March 1999 to start deferring collection action on billions of dollars in delinquencies. By the end of fiscal year 2002, after the deferral policy had been in place for about 3 and one-half years, IRS had deferred taking collection action on about $15 billion in unpaid taxes, interest, and penalties. As of 2002, IRS was deferring collection action on about one out of three collection cases. As of September 30, 2002, IRS had a total inventory of $112 billion of known unpaid taxes with some collection potential.[14]

Earned Income Credit Noncompliance

There are significant compliance problems associated with the EIC that have led us to list IRS's tax administration of the credit as a high-risk area

[14]The $112 billion includes two categories of known unpaid taxes: (1) taxes due from taxpayers for which IRS can support the existence of a receivable with a taxpayer agreement or a favorable court ruling (federal taxes receivable), and (2) compliance assessments in which neither the taxpayer nor the court has affirmed that the amounts are owed.

for the federal government.[15] Under the code, taxpayers who meet earned income, family size, and other requirements are authorized to claim the EIC. The credit offsets the impact of the Social Security taxes paid by low-income workers and is intended to encourage low-income persons to seek work rather than welfare. For most recipients, the credit amount exceeds the amount of their income tax liability; in such cases, because the credit is refundable, the taxpayers receive a refund.

IRS estimates that of the $31.3 billion in EICs claimed by taxpayers in tax year 1999, about $8.5 billion to $9.9 billion should not have been paid.[16] This level of noncompliance has remained relatively unchanged even after a 5-year effort to reduce it. IRS has to balance its efforts to combat noncompliance with its efforts to ensure that qualified persons claim the credit. With the data available, we were able to estimate that for every three households that claimed the credit, there was an additional eligible household that did not.[17] Because IRS has struggled to reduce the overclaim rate and because of the magnitude of the financial risk, EIC noncompliance has been and remains both a management challenge and a high-risk area.

Early in 2002, the Assistant Secretary of the Treasury and the IRS Commissioner established a joint task force to seek new approaches to reduce EIC noncompliance. The task force sought to develop an approach to validate EIC claimants' eligibility before refunds are made, while minimizing claimants' burden and any impact on EIC's relatively high participation rate. Through this initiative, administration of the EIC program would become more like that of a social service program such as Food Stamps or Social Security Disability, for which proof of eligibility is required prior to receipt of any benefit. IRS's 2004 budget proposes new spending to implement this strategy and it intends to ramp up rapidly. Planning and implementation for this initiative will proceed simultaneously. The success of the initiative will depend on careful planning and close management attention as IRS's implementation progresses.

[15]U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of the Treasury*, GAO-03-109 (Washington, D.C.: January 2003).

[16]IRS estimated that $1.2 billion would be recovered as a result of enforcement efforts.

[17]U.S. General Accounting Office, *Earned Income Tax Credit Eligibility and Participation*, GAO-02-290R (Washington, D.C.: Dec. 14, 2001).

Closing the Gap between Actual and Desired Taxpayer Service Remains a Challenge

Despite progress, improving service to taxpayers remains a challenge for IRS. The progress that IRS has made to date in modernizing has, as noted, improved service but not to the level that taxpayers, Congress, and IRS management agree is needed.

Providing good service to taxpayers by making it as easy as possible for them to understand and meet their tax obligations could improve voluntary compliance—payments and tax returns filed without IRS audit and collection action—and reduce the need for these intrusive and costly enforcement activities. According to IRS, preventing compliance problems by educating and informing taxpayers, or helping taxpayers resolve problems early on, is less expensive and time-consuming for both IRS and the taxpayer than enforcement action taken later. Facilitating voluntary compliance is especially important because the U.S. tax system relies on it. About 98 percent of all tax revenue collected is paid through withholding, remittances sent with tax returns, or other forms of payment without any IRS enforcement action.

While IRS has improved service in some areas, millions of taxpayers still have difficulty reaching IRS by telephone, and when they do, they may not be able to rely on the accuracy of information IRS provides. For example, IRS data shows that 32 percent of calls to IRS either received a busy signal or were abandoned without receiving service. In addition, about 20 percent of callers received inaccurate information when calling IRS with tax law questions.

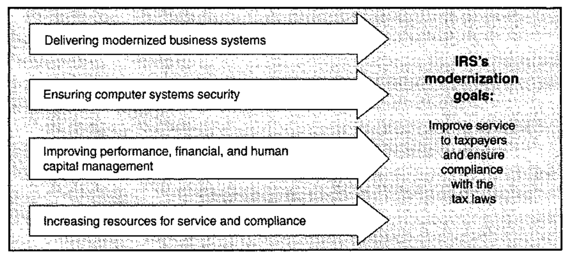
Similarly, the accuracy of the assistance provided at IRS's walk-in sites is below expectations. While it has improved in recent years, 25 percent of answers provided were incorrect so far in 2003.

Revamping taxpayer service will require that IRS simultaneously meet the other significant management challenges discussed in this testimony. For example, to ensure that changes result in efficient, improved service, IRS will need to establish consistent, comparable measures and conduct more and better program evaluations to identify ways to improve service.

Modernization Is Key to Improving Service and Ensuring Compliance

Modernization is the means for achieving IRS's two goals of improving service and ensuring compliance. Figure 6 shows four key components of modernization. Each alone is a significant challenge—in combination they are an even greater challenge.

Figure 6: IRS's Key Modernization Challenges



Source: GAO.

Delivering Modernized Business Systems

IRS's modernization strategy includes reengineering efforts intended to automate or eliminate work, improve productivity, and free up staff time that can then be redirected to service and compliance programs. Reengineering efforts rely heavily on IRS's BSM program.

Despite important progress in IRS's BSM program, it remains a high-risk challenge for two reasons.[18] First, the scope and complexity of the program are growing. Specifically, the number of projects under way continues to increase, and the tasks associated with those projects that are moving beyond design and into development are by their nature more complex and risky. Second, IRS's modernization management capacity is still maturing. For example, IRS has yet to fully implement a strategic approach to ensuring that it has sufficient human capital resources. It has also yet to fully implement management controls in such areas as estimating costs and employing performance-based contracting methods.

The continuing challenge for IRS is to ensure that the pace of acquiring systems does not exceed the agency's ability to manage them effectively, a problem we have reported[19] in the past. The imbalance between program pace and management capacity adds significant cost, schedule, and performance risks that escalate as a program advances. For example, as

[18] U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-03-119 (Washington, D.C.: January 2003).

[19] GAO-01-716 and GAO-02-356.

indicated in IRS's March 2003 expenditure plan, most of the BSM initiatives or project milestones experienced cost increases and/or schedule delays exceeding 10 percent of the estimated cost and duration stated in the November 2001 plan. Moreover, these risks increase as IRS moves forward because interdependencies among current ongoing projects and the complexity of associated workload activities to be performed increase dramatically as more system projects are built and deployed.

IRS has acknowledged these risks and has initiatives planned or under way to address them. The timely implementation of these initiatives is critical. While the lack of controls can be risky in a project's early stages, it is essential that such controls be in place when multiple interdependent projects are being designed, developed, and implemented. To mitigate this added risk, IRS needs to fully implement the remaining management controls that we have recommended. Until that time, the BSM program remains high risk, and we will continue to monitor IRS's progress in this area.

As the BSM program moves forward, there are several other challenges and risks to the successful and timely implementation of future planned modernized systems. A major issue is the ability to successfully integrate modernized systems with the reengineered business processes being implemented in the operating divisions. Failure to coordinate the acceptance and operation of new systems may result in increased costs and delayed delivery of benefits to taxpayers. Finally, a major concern for all aspects of the program is the extent to which the program will be consistently funded in an environment of budgetary deficits and competing priorities. Without a consistent level of funding, IRS will have difficulty establishing the infrastructure needed to build and sustain additional modernized systems and expediting the replacement of the outdated systems currently in use.

Ensuring Computer Systems Security

Although IRS has made important progress securing its systems, information security remains a challenge. Long-standing computer control weaknesses continue to threaten the confidentiality, integrity, and availability of sensitive systems and taxpayer data. IRS's inconsistent implementation of electronic access controls at its facilities did not effectively prevent, limit, or detect access to computing resources. In addition, weaknesses in other information system controls (including physical security, segregation of duties, software change controls, and service continuity) reduced IRS's effectiveness in protecting and controlling physical access to assets, minimizing the risk of errors or fraud, mitigating the risk of unauthorized or inappropriate software programs, and ensuring the continuity of data processing operations when unexpected interruptions occur. Further, access to key computer applications was not always limited to authorized persons for authorized purposes. These weaknesses increased the vulnerability of data processed by IRS's information systems and continued to expose IRS's tax processing operations to disruption. As a result, we continued to report information security as a material weakness in our report on IRS's fiscal year 2002 financial statements.[20]

An underlying cause of these weaknesses is that, although it has made important progress, IRS had not yet fully implemented certain elements of its agencywide information security program. The challenges facing IRS are to adequately (1) identify and assess information security risks to determine needed security measures, (2) implement and comply with its security policies and controls to meet those needs, (3) promote awareness and provide security-related training so that employees understand the risks and the policies and controls that mitigate them, (4) monitor the effectiveness of established policies and controls, and (5) mitigate known security vulnerabilities. IRS has acknowledged the seriousness of its information security weaknesses and has revised its approach to implementing the agencywide information security program. Until IRS can fully implement an effective program and adequately mitigate its information security weaknesses, it will remain at heightened risk of access to critical hardware and software by unauthorized individuals, who could intentionally or inadvertently read, add, alter, or delete sensitive data or computer programs. Such individuals could possibly obtain personal taxpayer information and use it to commit financial crimes in the taxpayer's name (identity fraud), such as establishing credit and incurring debt.

Improving Performance, Financial, and Human Capital Management

Challenges remain in three important areas of management—performance, financial, and human capital. As noted in our discussion of accomplishments, IRS has made significant progress in these three areas. By continuing to show progress in these areas, IRS will be better able to improve taxpayer service and better ensure compliance.

[20]U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2002 and 2001 Financial Statements*, GAO-03-243 (Washington, D.C.: Nov. 15, 2002).

Performance Management

Our work over recent years shows that IRS faces challenges in managing and judging its performance.

- First, IRS needs to ensure that its organizational performance measures are objective and reliable, consistent through time, and limited to key performance indicators. Such performance measures would enable IRS managers to monitor progress over time without being overwhelmed by too much information.
- Second, IRS needs to associate explicit goals with its performance measures. Without goals, it is difficult to determine if appropriate progress is being made.
- Third, IRS needs to conduct more and better programs evaluations. Such evaluations could help managers and staff better understand what they are trying to accomplish, how their actual performance compares to their objectives, and the reasons for any gaps. This would provide a more informed basis for determining how to improve performance.
- Finally, in keeping with the Government Performance and Results Act of 1993,[21] IRS should continue its efforts to better link budget requests with program results. Such a link could allow Congress to make more informed budget decisions and better oversee IRS's use of resources.

Financial Management

Financial systems and internal control weaknesses continue to preclude IRS from providing managers current, accurate financial information with which to make day-to-day decisions affecting IRS's operations. These weaknesses include

- an inadequate financial reporting process, resulting in IRS not being able to prepare reliable financial statements without extensive compensating procedures or not having current and reliable ongoing information to support management decision making and to prepare cost-based performance measures;

[21] Pub. L. 103-62 was enacted to hold federal agencies accountable for achieving program results.

- weaknesses in controls over billions in unpaid tax assessments, resulting in IRS's inability to properly manage unpaid assessments and leading to increased taxpayer burden;
- weaknesses in controls over the identification and collection of tax revenues due the federal government and the issuance of tax refunds, resulting in potentially billions of dollars in improper payments and lost revenue to the federal government; and
- weaknesses in controls over property and equipment, resulting in IRS's inability to have reliable and timely information on its balance of property and equipment throughout the year and to reasonably ensure that its property and equipment are safeguarded and used only in accordance with management policy.

These weaknesses and the computer security control weaknesses previously discussed render IRS incapable of reporting current, reliable information regarding its operations to management, Congress, and the public and adversely affect its ability to effectively fulfill its responsibilities as the nation's primary collector of federal revenue. IRS's financial management has been on our list of high-risk government operations since 1995.[22]

The future challenge for IRS will be to continue the improvements made in recent years and develop and implement the fundamental long-term solutions that are needed to address the internal control weaknesses we have identified. Resolving many of IRS's most serious financial management challenges will depend on the successful implementation of its new financial management system, which will not occur for several years. For example, IRS's Integrated Financial System (IFS) is intended to provide IRS with a single general ledger that is compliant with existing standards and integrated with its subsidiary records. However, IFS is not scheduled to be fully functional and able to provide reliable cost information that can be used by IRS in routine management decision making until at least fiscal year 2005. IRS is also implementing the Customer Account Data Engine and the Custodial Accounting Project to replace the current primary taxpayer database and address IRS weaknesses in management of unpaid assessments. However, these systems are not scheduled for full implementation until at least fiscal year

[22]U.S. General Accounting Office, *Major Management Challenges and Program Risks: A Governmentwide Perspective*, GAO-03-95 (Washington, D.C.: January 2003).

2007, at which time IRS's custodial transactions will be fully integrated with IFS. In the interim, several serious financial management issues will continue to exist.

In the near term, however, some problems can be addressed through the continued efforts and commitment of IRS senior management and staff. IRS will need to continue to refine the accounting procedures it relies on to compensate for the deficiencies in its automated systems. More important, IRS will need to continue its efforts to enhance the way it processes transactions, maintains records, and reports financial results. Other problems, which involve IRS modernizing its financial management systems, will take years to fully achieve and require the continued commitment of the new Commissioner if they are to be brought to a successful conclusion.

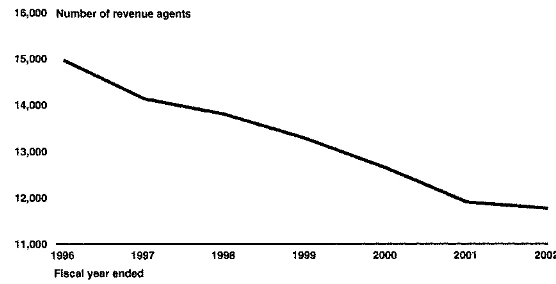
Human Capital Management

IRS's new human capital performance management system could be a powerful tool in helping the agency achieve its mission. The system could reinforce behaviors that support strategic goals by clearly aligning employee and organizational objectives, ensuring that managers' expectations are specific and output- or outcome-oriented, and monitoring whether employee feedback is useful and aligned with IRS's goals. To help ensure IRS achieves such benefits, we have made several recommendations. For example, for telephone performance, we have called for systems and evaluations to identify gaps in assistors' skills, meet training needs to fill those gaps, monitor and address the causes of attrition, and ensure that human capital management practices help IRS achieve taxpayer service goals. Similarly, with respect to BSM, we have recommended full implementation of its strategic approach for ensuring sufficient human capital resources.

Increasing Resources for Service and Compliance

Realizing increased staffing levels for taxpayer service and compliance programs, called for in IRS's recent budget requests, has proven to be challenging. Since 2001, IRS's budget requests have made increasing its compliance and collection staff one of several key priorities. In its 2001 budget request, IRS asked for funding for the Staffing Tax Administration for Balance and Equity initiative, which was designed to provide additional staff for examination, collection, and other enforcement activities. However, as shown in figures 7 and 8, staffing in two key compliance and collections occupations were lower in 2002 than in 2000. This continues a general trend of declining staffing in these occupations for a number of years.

Figure 7: Number of Revenue Agents, Fiscal Years 1996-2002



Source: Treasury Inspector General for Tax Administration.

Figure 8: Number of Revenue Officers, 1996-2002

Source: Treasury Inspector General for Tax Administration.

The declines in compliance and collection staffing occurred for several reasons, including increased workload and unfunded costs. In September 2002, the Commissioner attributed the decline in compliance staffing to increases in workload in other essential operations, such as processing returns, issuing refunds, and answering taxpayer mail. In the most recently completed fiscal year, 2002, IRS faced unbudgeted cost increases, such as rent and pay increases, of about $106 million. As a result, IRS had to delay hiring revenue agents and officers. IRS noted in its 2002 budget request that any major negative changes in the agency's financial posture, such as unfunded salary increases, will have a negative effect on staffing levels.

IRS has also been unable to realize internal savings that would allow it to shift staff to higher priority areas. Our review of IRS's 2004 budget request, as well as its experience thus far in fiscal year 2003, raises questions about whether IRS will be able to achieve the proposed internal savings. According to IRS officials, four of the seven most significant efforts outlined in its 2004 budget request—in terms of staff years and dollars to be saved—will not achieve all of their projected savings because the projections were based on assumptions that will not be realized.

Recent trends in the electronic filing program also have implications for IRS's ability to shift resources to higher priority areas. The increase to an estimated 53 million returns represented the smallest percentage increase in the last 9 years. The current growth rate will not allow IRS to achieve its goal to have 80 percent of all tax returns filed electronically by 2007. Instead, based on current growth rates, IRS will achieve about 61 percent of all individual returns by 2007.

This year, like every other year since the initiation of electronic filing, IRS has taken actions to alleviate impediments to electronic filing and encourage taxpayers to file electronically. IRS entered into an agreement with the Free File Alliance, a consortium of 17 tax preparation companies, to offer free on-line tax preparation and filing services for at least 60 percent of all taxpayers. However, as of April 16, 2003, only about 2.7 million taxpayers file via the Free File Alliance consortium, and IRS estimated that only about 1 million were new electronic filers. Slower growth in electronic filing will reduce IRS's ability to shift resources out of paper return processing.

Concluding Observations

IRS has come a long way from where it was in the mid-1990s. It is easy to lose sight of progress when it is gradual, but over the last 5 years, IRS has significantly enhanced its management capabilities and has succeeded in improving service to taxpayers. This progress in modernizing was achieved with a consistent, sustained focus on certain fundamentals of good management, such as controls over systems acquisition, financial data, and performance measures.

Looking forward, IRS will be challenged to meet the expectations of taxpayers and Congress. The same focus on management fundamentals that proved successful over the last 5 years should help the new Commissioner deal with these challenges.

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

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Mr. HOUGHTON. I just really have a general question on compliance, and anybody who wants to sort of chime in, I would appreciate it.

We have had the commissioner here, and we have talked about compliance, and we know there's a problem, and we have got to do something about it, but, you know, I look, Mr. White, at those key modernization challenges as you spell out in your testimony. First is delivering modernized business systems. Second is ensuring computer systems security. The third is improving performance, financial and so on and so forth. And way down at the end is compliance. It always seems that compliance comes at the end. We have given the IRS quite a bit of money over the years, but we haven't really touched the compliance area now. So now, Mr. Levitan, I think that you've mentioned something like—I haven't got it right here in front of me—$172 million more for the compliance issue. Is that it? Why will that go into compliance? Why won't it go into the business systems or the computer systems? Why is it always get short thrift here?

Mr. LEVITAN. Mr. Chairman, our budget recommendation includes additional money over and above the President's recommendation for both service, compliance and business systems modernization. We think each of these areas deserve additional funding, and we can get specific payback in each of these areas. We are very concerned about compliance.

We have seen some very positive steps, in that the IRS is trying to use the resources it has more efficiently and more effectively than they have in the past. We applaud that. They should continue to do that.

The President has recommended increased resources for compliance, and we recommend additional resources over and above that. We think that that will pay back well above the investment made.

Mr. HOUGHTON. Well, I can't disagree with you at all, but we have heard this before. I'm not trying to pick on you, but we have heard this before, and we know there has been a steady deterioration in number of the compliance people. And trying to pick it up from the bottom now is going to take a human task.

But my question is, with all these other objectives out here whether the money is ever going to filter down to the compliance area. Maybe others would have a comment here.

Mr. WHITE. Mr. Chairman, the four key modernization challenges there are all meant to improve management in IRS and improve the efficiency with which it uses resources, and in that sense, they all—they would all contribute to achieving IRS's goals, both the service goal and the compliance goal.

I would also note that IRS has been challenged in the last several budgets when they have requested additional compliance resources. Those budgets were generally fully funded, but they've been unable to actually realize the increased resources. Unbudgeted costs and so on have eaten up the resources that were intended to go into compliance.

Mr. HOUGHTON. Why won't that happen again?

Mr. WHITE. That is a real concern.

Ms. OLSON. Mr. Chairman, I can only say that in our internal conversations among the senior leadership of the Internal Revenue

Service, that daily and weekly we discuss that very issue, and it is our commitment—and I can say even as the National Taxpayer Advocate, it is my commitment—that funding for compliance is used for compliance, and we are all taking a hard look at our individual entities and organizations' priorities to make sure that we are protecting the compliance monies.

I think we all feel that it is a fundamental need for the IRS to be out there with a presence. Some of the modernization is keyed tightly to better enforcement activity. The ability to select appropriate cases for audit or the appropriate cases for collection and the right kind of collection effort, whether it is a letter or a human contact or a phone contact or a face-to-face contact—all of that depends on modernization.

Mr. HOUGHTON. Well, unless the Lord thinks otherwise, we'll all be here next year, and we'll remember your words.

Have you got any comments, Ms. Gardiner?

Ms. GARDINER. Well, actually, in my testimony I also alluded to the fact that modernization—one of the reasons that it is so key is because it impacts almost every other aspect of the IRS, and that would be customer service as well as compliance. And I will say, though, that it does appear that things are getting a little better than they were in '96. All of the things—like leins, levies, seizures, those numbers are going up. The compliance activities have improved. It is accounts receivable and nonfiled returns that seem to be the one thing that really hasn't turned around as quickly as folks would like to see that change.

Mr. LEVITAN. Mr. Chairman, we can't hide from the fact that over the past ten years the head count at the IRS is down 16 percent. The workload is up dramatically. Those are facts. We have to process the tax returns. We have to answer the telephone. Something is going to get squeezed out.

Ms. GARDINER. If I may add also, the National Research Program is—you don't want to use your compliance resources ineffectively, obviously, so getting more to do the same thing isn't a great solution either. The National Research Program, hopefully, will provide information that will allow them to use their resources in the best possible way to not look at people and do examinations on taxpayers where there is no change. So they don't go through all the effort and burden without any outcome.

Mr. HOUGHTON. Well, just a final—and going back to Mr. Levitan's comments, something is going to get squeezed out, but it has always gotten squeezed out, and it has all been in terms of compliance. And there are always going to be dollar pressures here. I guess the thing that we have all worried about is the whole concept of the trust that people have in the IRS system. That is the thing we can't erode any further.

Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman. Continuing on in your theme, I'm going to direct my comments to the testimony of Mr. Levitan. And I do think it is striking, from 1992 to 2002, IRS workload increased by 16 percent, while at the same time the number of full-time equivalent employees decreased 16 percent. As more resources were needed for IRS to provide essential services such as processing returns and answering correspondence, resources were shifted from discretionary operations such as compliance activities.

Now, North Dakota, where I come from, we would call that eating your seed corn. You diminish compliance, you diminish revenue collected, and, indeed, you can get to the point where the integrity of enforcement itself is broadly called into question or worse yet, disrepute.

Mr. Levitan, as long as I'm working with your testimony here, you indicate a number of actions that you recommend as part of the Oversight Board. Close the compliance gap, focus on people resources. You talk about a pending crisis with departure of seasoned personnel that have put their career at the IRS, retiring in large numbers in the next 5 years, don't see people come along in the pipeline to do it? In your opinion, is developing this professional capacity within the Service one of its greatest imperatives at this time?

Mr. LEVITAN. I think that this is one of the greatest challenges that the IRS has now. It is not that dissimilar from many government agencies today. We have an aging workforce. We have much of that workforce either at or approaching retirement age. It is going to be a real challenge to rebuild that workforce.

In addition to that, if you look at the history over the past decade, the IRS has been out of the recruiting market. They have not been recruiting new people for the past ten years. So that makes the problem even more serious. We have recommended to the IRS that they take a very hard and strategic look at their entire human resources programs and make sure that there is a program in place to handle this as this eventuality comes to play.

Mr. POMEROY. I think that is something we'll want to keep a very close eye on, whether or not they are getting plans in place to build that professional capacity. I see something quite different. I see a reliance on outside consultants. You know, three quarters of a billion dollars spent so far on the business systems modernization and the Inspector General's office telling us the heavy lifting is still to come.

Ms. Gardiner, do you have any evaluation at all in terms of the reasonableness of these costs and whether or not we are becoming too dependent on consultants versus in-house——

Ms. GARDINER. Well, if I comment only on modernization. I think IRS, because of the prior problems with modernization and the fact that they spent $3 billion and didn't get much, recognized that they really didn't have the expertise in-house. And I think it was very legitimate for them to turn to consultants to help them, but that has been, probably, the biggest problem, that they recognize. IRS didn't even know the right questions to ask in many cases, and they thought that the PRIME would provide that kind of expertise. You know, think about doing it this way or do it that way, or here is the latest technology. And that really hasn't come to bear as much as one had hoped, and that has caused some of the problems, that they don't understand the IRS processes as well as they should, and sometimes they aren't asking the right questions. It really has required IRS to ask the questions of themselves, and they knew that they really weren't that good at that.

Mr. POMEROY. I am struck by the fact under the law the Oversight Committee prepares a budget and Congress gets to see the budget, even though the Administration recommends a different figure, and that the difference between what the Oversight Committee believes a service needs, and what has been recommended, is $287 million, with a big bite of it coming out of the processing, administration and management function and another out of tax law enforcement and business systems modernization.

These I think are very seriously disturbing developments which raise a question in terms of whether we are on track to build back this in-house capacity.

Ms. Olson, I think for a taxpayer, what does this mean to them, do you have an evaluation in terms of what is in the taxpayers' interest, a strong professionally-staffed IRS versus an understaffed IRS, dependent upon outside consultants here, private bill collectors there, and this kind of jerry-rigged system we seem to be launching into?

Ms. OLSON. Well, I have a concern about the use of outside consultants, particularly, as Ms. Gardiner addressed, with regard to the work processes of the IRS. And what I have witnessed coming into the IRS the last two years is some of the most knowledgeable employees of the IRS deferring to outside consultants on process issues, on structural issues, on redesign issues. I've not had as much experience with the actual information technology side, and I have expressed my concern about that. We actually had an experience of having the benefit of some consultants in reviewing the vision of the Taxpayer Advocate Service, where it should be in 5 years. It was an interesting education, I think, for the consultants, because you had an informed business owner who was saying, excuse us, we'll tell you where we are going to be in 5 years, and you will help us design what that is going to—you know, how we are going to get there, but we have our vision, thank you very much.

I think that arrangement was very successful, but I do not see that being reproduced in the rest of the IRS. So weaning us off consultants would be a very good thing.

And once you wean them you have to have a trained workforce, and the IRS really is trying but is very much behind in training its employees and putting its resources into training. If you don't train your employees, they don't feel professional, they don't feel on top of the job, and in customer service jobs, they feel threatened by the taxpayer who may know more than they do. It is a very difficult situation, and a serious one.

Mr. POMEROY. I used to run an agency, an insurance department, and I think the concerns you have go to just general management issues, public or private sector. We have got to give our people the training they need to feel professional, and they can professionally and competently perform their responsibilities.

I thank the panel for their response to my questions.

Thank you very much, Mr. Chairman.

Mr. HOUGHTON. Thank you very much.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman, and I thank the panelists for not just being here today, but for what they are doing as they are stakeholders in this system along with the taxpayers in being watchdogs and making sure that the IRS continues to try to meet—as Commissioner Everson said, the promise of the 1998 reforms which are not fully realized.

I'm glad to see some IRS folks are still here to listen to this testimony, and I am sure they will be reviewing what you are saying.

Five years out and we have made progress, but we haven't achieved what we had hoped to. I would say, although this is dangerous to apply a grade to it, being a father of three children who get report cards on a quarterly basis, I guess I have some basis, but I would say about a B minus. You can't ignore the fact that we have made progress in almost every category, and that includes electronic filing which was about 16 percent when we started this enterprise, now it's about 41 percent. That is a huge advantage to the IRS and to the taxpayer, because about half of the 22 percent error is caused by the IRS, which then comes back to the taxpayer and all the hassles downstream.

So the 16 percent reduction in employment doesn't worry me as much as we have these sorts of things happening. Modernization will require fewer people to do the same job better.

The opinion surveys conclude the American customer satisfaction index survey shows that we are doing better. The IRS was at the bottom of the pile. Now, they are partway up in terms of the way people view the Service. So customer satisfaction or taxpayer satisfaction has increased. Still it is not what it should be, but it has increased. Phone service is now better. We talked earlier about the fact that we have gone from millions of busy signals to 250,000 busy signals. Eighty-four percent of taxpayers got through instead of 69 percent just last year, so we are doing better. Still not where we should be in terms of modern service institutions around the country providing better and better service, and the IRS hasn't caught up, but we are doing better. The walk-in centers are working well. The assistance is better according to GAO, Mr. White. The Oversight Board makes the point continually, which it should, that Congress keeps complicating the tax code. We talk about simplification, and we are constantly changing the law. Even if it is not making it more complicated, just a change sometimes causes enormous disruption at the IRS. So that is an additional burden you have on you.

The 16 percent, again, increase in workload is not too troubling to me over the last decade. I think—I'm surprised it is not higher. I guess it depends what you consider to be workload. But it is that change in the tax code and the continual challenge to keep up with that and be able to provide information to taxpayers that I find interesting.

I think it was GAO that studied whether people were getting the correct answer or not. I think that is now up to 70 to 80 percent where people are getting the correct answer when they ask the IRS a question based on your listening in on phone calls, and that is a vast improvement from when we started this process, where I believe it was under 50 percent. But I wonder how your people know it is the right answer. If you put eight accountants in a room, they will give you eight different answers to some of these complicated questions, and the IRS will give you a ninth and tenth answer. I don't know much about your methodology, but the point is it is better, but we still have some challenges, some of which you state right here. I think there are two challenges you all have identified that are obvious ones, and otherwise the grade would be even higher, and one is that even though we have made the point continually, and I to ask the panel whether they agree with it still, that better service is not inconsistent with more and better and more efficient enforcement compliance. Certainly the private sector has found that, whether it is a credit card company or an airline or anybody else in the service business. As they improve their service to the customer, they actually improve their compliance, and that was the goal with regard to the Commission and the reform legislation.

I would just ask that general question, do you all still believe that? Were we wrong? Have we improved service, and yet compliance has gone down? The notion was to improve service and compliance would increase. I guess without prejudging your answers to that, one issue obviously is that modernization has not caught up yet to where we want it to be, and, modernization meaning just better service through better technology, will help on compliance once we turn the corner, which, hopefully, will start happening here in the next 12 months as we begin to get our systems even further in place.

And second is the question of, I guess, the natural thing here in Washington, which is the pendulum tends to swing when you focus on customer service in terms of the fiscal side. In other words, the budget gets increased there, you have less resources on the other side. But do you all still think that by focusing on service, we can improve compliance? Maybe Mr. White could begin, then Mr. Levitan, Ms. Gardiner.

Mr. WHITE. Mr. Portman, you are right that there needs to be a balance. There's no doubt that better service will help compliance to some extent. There are also a group of taxpayers, however, that will not comply because of better service. So you need both enforcement efforts and service.

One of the fundamental problems here is the lack of basic management information, because IRS does not have a current measure of the—of voluntary compliance. It is difficult to know what the impact of service is on compliance right now.

Mr. PORTMAN. Do we expect to have that with the new compliance program? While the national research program, if they implement it as planned, should provide them much better management information than they have now about voluntary compliance, and should help them better make decisions about the most effective way to increase compliance.

Not just measure it, but be able to target it more efficiently?

Mr. WHITE. Yes.

Mr. PORTMAN. Good point.

Larry.

Mr. LEVITAN. The Board absolutely believes that customer service, that is service to taxpayer, and compliance enforcement are two absolutely necessary roles and responsibilities of the IRS.

They cannot be separated. You should not have a pendulum swinging back and forth, although clearly what we have seen is, from a noise level, that pendulum has swung.

Back in the time of the restructuring commission, there was a tremendous concern about service. Now, there is a much greater concern about enforcement. But we need to have a steady course. One of the major recommendations that the board has made is that the IRS establish long-term goals in both of these areas: Where do we want to be in service in the long-term? We talk about improvement from 50 percent to 70 percent. But is that enough? We need to have a long-term goal that all of our programs are focused on in both the enforcement and compliance area as well as the service area.

We did establish a long-term goal for electronic filing. That has been a useful tool because the entire—the programs have been focused on trying to attain these goals. So we would hope to see that the IRS would, working with Congress and with the administration, establish those kinds of goals.

Representative PORTMAN. It is extremely important. I know the goal of 80 percent electronic filing by 2007 was criticized a little earlier this morning, and I understand that may be unrealistic. We won't know, as the Commissioner said, until a couple of years, because we are seeing some improvements in the technology side, particularly with regard to outreach.

And he did mention that the more complicated returns and business returns is where we ought to focus, not just on a percentage. But I think that is very helpful to have that goal out there. To go from 16 to 41 percent in electronic filing only happened because we put a lot of pressure on the system.

Ms. Gardiner.

Ms. GARDINER. Yes, I certainly believe that the customer service improvements help compliance. The examples in our testimony were toll-free and walk-in. It actually was my office that did the monitoring of the telephone calls. We monitored them with an IRS employee, and we worked with them to ensure that we both agreed that it is correct or incorrect. So we are somewhat relying on their opinion as well as ours.

For customer service in terms of walk-in, at one point in time it literally was a flip of the coin. If a taxpayer came in and asked a question it was, like as you had indicated, about 50 percent. I think it was actually 52 percent. But now, it is a little closer to 70 percent.

But another feature that is very important to us that has improved dramatically over the past year is that about a year ago when we sent our auditors in anonymously and they posed questions, basic tax law questions to IRS employees, in many cases the IRS employees said, Oh, it is in this publication, and just handed to it our folks. We didn't consider that customer service. And yet the IRS considered that a correct answer if the publication had an answer in it.

That has changed dramatically. They now will either not refer to the publication and just give the answer, which is, of course, the best scenario. But in other cases, they will turn to the page in the publication, explain where it is. So those kinds of things help people comply with the tax law, obviously.

Representative PORTMAN. Ms. Olson.

Ms. OLSON. I do not think that you can have enforcement without customer service. I am concerned about the day-to-day experiences of taxpayers, and our employees not feeling like they have permission to treat taxpayers in the appropriate way, or the tools to treat them. That is one of the reasons why I covered CDP in my testimony, because what you see there are the day-to-day experiences of IRS employees viewing these taxpayer protections as nuisances because they can't get their job done, which is enforcement.

The quality measures, the way that you measure IRS employees and what you measure them on, is vitally important to getting the message across that customer service counts as much as the business results. And if you just measure them on did they hand them the Publication 1, and you don't measure them on did you discuss what were the issues that are covered by Publication 1, then you are going to get results that are just lip service to customer service and not meaningful.

I think it has to start at the top. And I don't think it has entirely filtered down in our management processes that these are equal measures. I am concerned about that.

Representative PORTMAN. Well, Mr. Chairman, my time is way over, and I appreciate your indulgence. Can I just throw one other out there?

I said that there were two issues where there seems to be some consensus that we have existing challenges in order to get that grade a little higher.

One is obviously the whole issue we have talked about of compliance enforcement. The other is personnel generally. And, Larry, you have talked a lot about this over the years in terms of the concern in government generally about retirements and not having the workforce.

The other is morale. And I think morale at the IRS is much higher than it was in 1998; certainly it is. But still we have issues. The "deadly sins" are something that this Congress is trying to legislate on, working with the IRS to try to come up with more reasonable ways in which to deal with the issue you raised, Nina, which is what tools do they have; what can IRS employees on the line do or not do?

And the other is just implementing these changes in a cultural way through a huge institution. And you talked about, I think early on, this notion of measuring someone's progress as an employee at the IRS, not based on how much money they get out of the taxpayer, but how professional they are in terms of providing good service. And that includes training, courtesy, the right answer, and so on. That is a cultural shift that, moving from the enforcement mentality more to the service mentality, that probably is going to take a while longer.

Thank you, Mr. Chairman.

Representative HOUGHTON. Thank you. Mrs. Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman.

I have a constituent who likes to say that he thinks the two most frustrating acronyms in the English language are the HMO and the IRS.

And listening to all of you all today, I think that probably you find our very complex Tax Code very frustrating, not only for yourself and your employees but also for the taxpayers.

I do have a couple of questions. Mrs. Olson, going back to your testimony, and addressing the complexity of the Tax Code and doing taxpayer clinics, would you please speak briefly to what you plan to do for our electronic filers as we are moving these through the process and to the E-file?

Ms. OLSON. I think particularly for low-income taxpayers who may not have computers with which to file, or may not be computer literate, some of the things the IRS is doing that we are certainly working with the IRS about are building coalitions with community groups where taxpayers can come in and receive free access to electronic filing—they may be able to do it themselves, they may have someone else do it—and move them away from going to those sites that I have a lot of concerns about: check cashing places, pawn shops, gun stores; you know, folks who are offering electronic filing in order to get access to the refunds.

Representative BLACKBURN. A follow-up to that, then. If you are going to do this—and in someone's testimony I read about doing some training—you were looking at implementing a program for training some of those who would be tax preparers, and maybe even a certification process. Would you involve these individuals in that process?

Ms. OLSON. Absolutely. Those would actually—the unenrolled preparers are definitely the target, in fact, of those requirements, to make sure that taxpayers know when they go to get their returns prepared, and they are paying a fee for it, that the folks who are doing it are competent in tax, not just opening a storefront.

Representative BLACKBURN. Excellent. Thank you.

Mr. White, going to your testimony, the top paragraph on page 8 says: In 2000 the IRS implemented a new strategic planning and budgeting process that provides the framework for developing goals, objectives, and measures at the operating division level, although we have not evaluated the effect of the process on IRS performance, the operating divisions, or identifying strategic goals.

Now, we have talked a lot, going back to the Chairman's first question, we have talked about morale, human capital, process and priorities, and the importance of that, and how there is, you know, it is kind of like the big elusive "they" that is out there.

We are talking all around it but not talking about setting down some solid priorities, some solid benchmarks, the goals, how they will be met. Why have you all chosen not to evaluate the strategic planning and budgeting process?

Mr. WHITE. That is a good question. And the Restructuring Act, I think, did a very good job of setting some very high-level strategic goals for IRS to improve customer service while ensuring compliance.

IRS has put in place this process for trying to set priorities internally. And I think the fundamental answer to your question is the lack of management information inside IRS; that without better data about compliance, for example, it is very difficult to evaluate the impact this new process has had.

IRS managers get together with the Commissioner to allocate resources internally, to decide whether to put more resources into up-front education programs, for example, or more resources into compliance efforts.

All of those programs are intended to have an impact on compliance. But without a measure of compliance, IRS and outside observers are unable to determine the effectiveness of it. And so it shows the importance of investing and collecting better information about compliance.

So you have got this kind of fundamental management information. And the NRP program that we have discussed a couple of times here is intended to do that. They have started implementing that. It is going to be a couple of more years, though, before they have the data available for that, so they have got a more data-based basis for making these kinds of decisions.

Mr. LEVITAN. Mrs. Blackburn, if you don't mind, we have—while I absolutely agree with what Mr. White is saying about the need for better data, particularly about enforcement and compliance, one of the areas that I think the IRS has done quite a good job on is strategic planning and laying out a plan, objectives, setting goals, where they do have good data for their organizational units, and then integrating that planning process into their budgeting process.

We have been intimately involved in reviewing that and discussing that with IRS, and think that they do quite a good job of that. We think the primary challenge that they have is not so much the planning and defining what they need to do, but the executing of that and making it happen.

Representative BLACKBURN. Thank you. I see my time has expired.

Representative HOUGHTON. Thank you very much.

Well, Ms. Olson, Ms. Gardiner, Mr. Levitan, Mr. White, thank you very much for being with us today.

There being no further business before the joint review, the hearing is adjourned.

[Whereupon, at 12:10 p.m., the committee was adjourned.]

QUESTIONS FOR THE RECORD ADDRESSED TO IRS COMMISSIONER EVERSON BY SENATOR CHARLES E. GRASSLEY

1. You testified that you plan to bring in a contractor to review Business Systems Modernization, in an effort to determine progress to date, risks facing the program, and any potential midcourse corrections. I would like to know who will be undertaking this study for you, how long you expect it to take, and how much it will cost. I would also like to know whether you would be able to brief my staff on the results of this study and on the actions you decide to take because of it.

Answer. At this time, we have not yet identified who will be conducting this "health check" of the Business Systems Modernization effort. We are evaluating several independent firms, and hope to have an announcement within the next few weeks. We do expect that any review will last between four and six weeks, and cost the IRS about $200,000. We will be happy to brief you when we have the results of this work.

2. RRA '98 authorizes the Commissioner of Internal Revenue to hire 40 "critical pay" staff. These people are executive level employees who are hired, outside of the conventional Senior Executive Service Parameters, for a fixed term. A number of these slots are vacant and a number of the filled slots are, quite candidly, devoted to positions that RRA '98 writers did not envision. Former Commissioner Rossotti indicated to me at the end of his term that he simply could not keep the IRS on the right path (i.e., organizational redesign and technology modernization) without these critical people. I would like to know how you plan to use your critical pay authority. Specifically, do you see yourself focusing critical pay employees in a particular area of the organization? Do you plan to retain all of the positions that you inherited?

Answer. The streamlined critical pay authority has been a highly flexible, indispensable tool to the IRS and has proven enormously beneficial as we plan, direct, and implement our extensive reorganization and modernization efforts. As I have previously testified, there are three areas on which I intend to focus during my tenure as Commissioner: (1) continue to build upon the reorganization begun by Commissioner Rossotti; (2) continue to drive the information technology modernization program, and (3) strengthen the integrity of our nation's tax system through enhanced enforcement activities.

I believe the model of matching experienced IRS executives with business executives from outside the Service has been very effective in bringing other perspectives and new ideas to tax administration. With that in mind, I intend to continue to use the critical pay authority to recruit and retain exceptionally well qualified business executives from outside the Service to fill positions that are critical to the Service's successful accomplishment of its mission, and that require expertise of an extremely high level with significant experience outside the IRS.

I will continue to establish streamlined critical pay positions based on the needs of the organization. Although I anticipate our strongest needs for outside expertise will fall mostly in the areas of information technology, enforcement, and customer service, I do not plan to focus on a particular area of the organization. Rather, I will strive to maintain a balance across the organization of leaders from both inside and outside the Service. All positions established to date have made significant contributions to the Service; however, positions will not automatically be backfilled as they become vacant. In each case, we will reassess the need for the position, as well as the need for outside expertise and the continued use of critical pay authority.

3. As I indicated in my opening statement, I am quite concerned about human capital issues at the IRS. The agency's senior human resources position is vacant. Many of the agency's employees are eligible for retirement, or will be eligible within the next five years. Steve Nickles, who recently left the IRS Oversight Board, tells me of his concern that the agency does not effectively manage its training dollars either a) in the sense of having a rational medium-to-long term training plan for individual employees or b) in the sense of being able to track training expenditures to individual employees). I suspect that you are in a position in which, if you manage human capital issues, you will be able to make a significant difference in the satisfaction of the agency's employees and in the medium and long term performance of the entire agency. How do you plan to ensure that human capitol issues are aggressively managed? What near term goals do you have? How will those who oversee IRS be able to tell that the agency is moving in the right direction, at an acceptable speed and cost?

Answer. I agree with the observation that IRS needs to do more to increase the effectiveness of its training programs. In this regard, we are replacing our legacy training management system with a new Learning Management System (LMS) that will greatly improve the amount of information available to IRS managers about employees regarding organizational training needs. The LMS will allow the Service to more closely link training to competencies and to employees' career plans by allowing them to electronically create and monitor individual development plans. Our managers will use competency-based skills assessments and "gap" analyses to design customized training plans to meet their organizational and employee needs. This new capability should contribute to increased employee satisfaction and improved individual and organizational performance. In addition, we have developed an evaluation approach that measures how much time it takes to build a critical mass of skills in key occupations. This methodology will give our business units the much-needed ability to gauge how quickly their key human capital talent needs are being addressed.

We have also made significant progress in assessing and improving the quality, quantity, and effectiveness of leadership training and development within the IRS. We continually monitor a comprehensive set of performance indicators relating to front-line manager, senior manager, and executive leadership development activities to ensure their on-going effectiveness and continuous improvement. Some of the factors taken into account in the assessment include instructor effectiveness, cost, curriculum usefulness, timeliness, student satisfaction, and enhanced job proficiency. As a next step, we are developing more rigorous performance measures for evaluating our development efforts to provide a more systematic, in-depth assessment of organizational impact. Finally, we are making a determined effort to improve the financial data available to our senior leaders by integrating, where possible, our training and development activities with our corporate financial systems to improve the tracking of expenditures in the core training curricula.

As we all have learned, changing times demand new thinking and new approaches to the way we manage our people. Designing, implementing, and maintaining effective human capital strategies are critical to me. I intend to be actively engaged in assessing and improving human capital management practices as part of my effort to bring more accountable, results-oriented management to the IRS. Very shortly, I will appoint a Chief Human Capital Officer who will be charged with leveraging the Service's human capital policies, programs, and practices to more fully integrate and align them with the IRS' overall planning and decision-making processes. The "bottom line" is that I want the IRS' human capital program to be strategically focused and demonstrate how and where it adds value to our core mission and strategic priorities. Specific initiatives we will undertake include:

- Continuing the effort to streamline, modernize, and automate recruitment, marketing, hiring, and succession planning systems to bring quality people on the job more quickly.
- Continuing the effort to develop an enterprise e-learning strategy to shift from a classroom-based to a technology-enabled learning environment by partnering with OPM to leverage the use of the Go Learn initiative to increase the efficiency and effectiveness of our training activities.
- Continuing the refinement of our employee performance management system to strengthen the correlation of individual accomplishments to business results. IRS managers are currently evaluated and rewarded on their individual contribution to specific business results and I would like to provide this opportunity to all employees.
- Expanding broadband pay-for-performance systems to all IRS supervisors and managers with consideration given to applying it to the general workforce. From a business standpoint, pay-for-performance is critical since it provides higher pay for higher performance and gives IRS managers flexibility similar to what exists in private sector knowledge-based professional services organizations.
- Reorganizing the Office of Strategic Human Resources to better position this function to where it can best support the core mission and move that office to a more focused, streamlined, integrated, and results-oriented organization. This effort will also include a broader examination of IRS' three-part human capital organizational structure/mission (a strategic component, embedded expertise, and shared services) to ensure that it is best suited to efficiently and effectively lead the transformation of IRS to a true human capital organization.

The President's Management Agenda initiative for the Strategic Management of Human Capital requires the IRS to rigorously assess its human capital policies and practices to ensure they are moving in the right direction at an acceptable speed and cost. With this impetus, we are currently developing a hierarchy of new strategic human capital metrics that will provide a more systematic, data-driven assessment of our progress towards achieving our human capital aims and assist us in analyzing root causes of problems and issues—thereby improving our ability to maximize the value of our human capital investments while managing the related risks. When implemented, the data will be made available to those who oversee the IRS.

QUESTIONS FOR THE RECORD ADDRESSED TO IRS COMMISSIONER EVERSON BY SENATOR MAX BAUCUS

Background: Congress created the earned income tax credit in 1975 as a bipartisan effort to reduce the tax burden on low income Americans, while giving a powerful incentive to work. President Reagan hailed the expansion of the EITC in 1986, as the "best anti-poverty, the best pro-family, the best job creation measure to come out of Congress." It is estimated that nearly 4.8 million people, including 2.6 million children, are lifted out of poverty every year because of the earned income tax credit.

Questions.

1. There is some confusion regarding IRS's plans with regard to its proposed EITC "precertification" program, especially with regard to whether there will be a public comment period for the new forms that selected families will be required to submit. Will there be a public comment period on the forms and documentation requirements? If not, why not? If there will be a public comment period, when will it be announced? Will the comments be reviewed and considered before the forms are mailed to the first 45,000 families this summer?

Answer. We are working closely with affected stakeholders, and have incorporated many of their concerns and comments into the draft form. In addition, on June 13th, we issued an announcement (Announcement 2003–40) requesting public comment on the EITC residency certification pilot. We welcome all comments and suggestions on how taxpayers can establish that they are entitled to the credit because a qualifying child resided with them for more than half the year. Concerns expressed by stakeholders prior to and in response to this Announcement will be carefully considered by the IRS and Treasury Department in developing the certification pilot and will be considered before contacting the initial 45,000 participants in the pilot project. During the comment period, we will continue to work with Congress and other interested stakeholders to ensure the best possible program.

2. Since becoming IRS Commissioner, have you had a chance to thoroughly evaluate the proposed pre-certification program? Did your evaluation examine not only the impact of the program on compliance, but also its impact on participation? To what extent will the pre-certification initiative deter or block families who are truly eligible from receiving the credit? How does the IRS intend to remedy the potential adverse impact on eligible recipients of the EITC?

Answer. I have evaluated both the current administration of the EITC and the administrative proposals (which include the certification initiative). The EITC participation rate is very high, and we will make every effort to ensure that any changes in the administration of the program do not deter participation by eligible claimants. As a result of my review, the IRS has announced a 5–point EITC initiative to (1) reduce the backlog of pending EITC examinations to ensure that eligible claimants receive the refunds quickly, (2) minimize the burden and enhance the quality of communications with taxpayers by improving the existing audit process, (3) encourage eligible taxpayers to claim the EITC by increasing outreach efforts and making the requirements for claiming the credit easier to understand, (4) ensure fairness by refocusing compliance efforts on taxpayers who claim the credit but are ineligible because their income is too high, and (5) pilot a certification effort to substantiate qualifying child residency eligibility for claimants whose returns are associated with a high risk of error.

The IRS will evaluate the effects of the certification pilot on participation, and will use this information to further refine the certification process.

3. We understand that the IRS plans to expand these new requirements to two million filers starting next summer without waiting for the full evaluation results, and in particular, without waiting for results on the impact of the initiative beyond roughly the 45,000 level before the evaluation has been completed and the answers to these questions are known? If so, please explain the rational for proceeding without conducting an appropriate evaluation?

Answer. We will not expand the qualifying child certification proposal arbitrarily. The IRS intends to evaluate the qualifying child certification pilot during pre-filing, filing and post-filing stages. A decision to expand the certification program will only be made after consideration of claimant response to, and IRS operational experience with, the pilot.

4. The latest draft of the new pre-certification forms and requirements available from the IRS would require tax filers to produce documents that will be impossible for significant numbers of eligible tax filers to secure despite their best efforts. Spe-

cifically, it appears that if eligible filers cannot find a third party to fill out the affidavit who fits one of the IRS' categories, the filers could be denied the EITC. What is the IRS doing to address this problem so that eligible filers are not denied the EITC because they cannot produce documents that are impossible for them to secure?

Answer. Under the certification pilot, taxpayers will only be asked to submit documentation showing that the claimed child lived with them for more than half the year and will not be asked to submit relationship documentation. Affected taxpayers will be given multiple ways and multiple sources to demonstrate that they meet the EITC residency requirement. The IRS is continuing to seek outside stakeholder feedback, through Announcement 2003–40 and through taxpayer and practitioner focus groups, on suggestions for other credible sources of documentation. In addition, claimants who cannot obtain the suggested documentation can seek help at an IRS Taxpayer Assistance Center or through a special toll-free number to speak with IRS personnel specializing in the EITC qualifying child certification process. The IRS will evaluate the effects of the certification pilot on compliance, participation, and taxpayer burden, and will use this information to further refine the certification process.

5. The pre-certification initiative would require a group of hard-working, low-income families to submit forms to IRS and go through a procedure required of no other group of tax filers. Treasury Secretary Snow was recently asked about the EITC pre-certification program during a luncheon speech he gave at the University Club. Secretary Snow indicated that the IRS also would be doing something to "pre-certify the rich." Could you explain how the IRS intends to "pre-certify the rich?" How would this program work? What taxpayers would be targeted? When will it be initiated?

Answer. We already collect information about many sources of income and some deductions and credits. For example, mortgage interest is reported to taxpayers and to the IRS by mortgage companies on Form 1098. Divorced, noncustodial parents must attach a waiver from the custodial parent to their tax return in order to claim a dependent exemption. Employers must obtain state certification that an employee is a targeted group employee before claiming the Work Opportunity Tax Credit. In other situations, the IRS requires taxpayers to provide additional information about claimed tax benefits. For example, we recently issued regulations requiring the disclosure of tax shelters that may be abusive. In addition, we are developing a process for the Health Coverage Tax Credit (HCTC) that would require certain taxpayers applying for the advance payment of the HCTC to provide documentation (the COBRA election form) to the IRS before payments are made to the insurer on their behalf. We continually try to balance the need to collect information for tax law enforcement with the need to minimize taxpayer burden.

QUESTIONS FOR THE RECORD ADDRESSED TO IRS COMMISSIONER EVERSON BY SENATOR CARL LEVIN

Questions from Senator Carl Levin:

1. Please describe the new EITC rule to be proposed by the IRS, including a detailed description of any heightened certification, verification or documentation requirements that would be placed on EITC claimants; identify precedents and requirements that would be placed on EITC claimants; identify precedents and equivalent existing requirements for taxpayers claiming similar tax credits; and indicate whether these requirements would apply only to EITC claimants or also to other groups of taxpayers claiming federal tax benefits.

Answer. The pre-certification pilot will require certain taxpayers to demonstrate that they meet the residency requirement with respect to a child before their EIC claims are accepted. The taxpayers required to demonstrate residency will be those who, based on IRS research, are more likely to claim children who do not satisfy the residency requirement (such as caregivers other than the child's parents and fathers who do not file joint returns.)

Under the pre-certification pilot, a taxpayer will be encouraged to fill out a form and provide certain documentation that establishes that the taxpayer meets the residency requirement with respect to a child in advance of the filing season. To establish residency, taxpayers can use records, letters on official letterhead, or affidavits from third parties, such as clergy, health care providers, community based organizations, and social services agencies, that have information about the residency of the claimant and child—either through their records or personal experience. Claimants who cannot obtain the suggested documentation can seek help at an IRS Taxpayer Assistance Center or through a special toll-free number to speak with IRS personnel specializing in the EITC qualifying child certification process. Additionally, we will assign these claimants a qualifying child specialist who will handle his or her qualifying child issues from start to finish.

If the chosen taxpayers choose not to pre-certify, they will be required to send in the same forms and documentation with their tax returns. Taxpayers who pre-certify will receive their EIC refunds faster than taxpayers who send information with their tax returns. Taxpayers who do not pre-certify or send in the required information with their tax returns will be given an additional opportunity to certify residency, after which time, they will be denied the EIC with respect to a claimed child, subject to normal appeals rights and the ability to contest the denial in Tax Court.

We are currently developing a process to register taxpayers for the advance payment of the Health Coverage Tax Credit, which will be similar to a "pre-certification program." As discussed in our response to question 2 below, there are other circumstances in which we request taxpayers to provide documentation prior to receiving a tax benefit.

2. Does the IRS plan to ask taxpayers, in some circumstances, to submit an affidavit to support an EITC claim? If so, please identify precedents for requiring taxpayer affidavits in similar circumstances.

Answer. If a taxpayer uses an affidavit to prove residency, then it must be filled out by someone other than the taxpayer or the taxpayer's spouse. As stated above in response to question 1, an affidavit from third parties is one way to prove residency. We also require taxpayers to obtain verification before claiming certain other tax benefits. For example, employers must obtain state certification that an employee is a targeted group employee before claiming the Work Opportunity Tax Credit (WOTC). Although certification for the WOTC does not require affidavits, it does require certain forms to be completed by the employer.

3. Please indicate whether the IRS intends to issue the EITC rule in a form that will require taxpayers immediately to comply with new documentation requirements to obtain the credit, and, if so, why the IRS is failing to solicit or consider any public comment or analysis prior to these requirements taking effect?

Answer. The 45,000 taxpayers selected for the pilot will be contacted in the latter half of August. These taxpayers will have until December 31, 2003 to submit documentation before the filing season. Taxpayers who respond by December 31, will avoid any delay in receiving their EITC refund. A taxpayer who fails to submit documentation before the filing season does not have his or her claim denied at that time. Rather, the taxpayer can still submit the required documentation with the tax return. There will be a minor delay in the receipt of the EITC-portion of the refund, while the documentation is processed. If a taxpayer has not pre-certified and has not submitted the required documentation with the tax return, the EITC-portion of the refund will be frozen and the IRS will contact the taxpayer to request the documentation. If the taxpayer fails to submit the documentation, the claim will be denied (just as it is currently denied in the correspondence examination context) and the taxpayer will be afforded all rights to Appeals and judicial determination of his or her claim.

The IRS has been briefing stakeholder groups and receiving their input since March. The Stakeholder Partnerships, Education and Communication (SPEC) organization within the Wage and Investment (W&I) Division of IRS provides comprehensive EITC services through education, outreach and assistance to low-income taxpayers.

The following SPEC national partners attended a briefing and roundtable discussion on the EITC task force proposals on March 25, 2003: U.S. Department of Health & Human Services (HHS) (national); National Credit Union Administration (NCUA) (national); Federal Deposit Insurance Corporation (FDIC) (national); Center on Budget & Policy Priorities (national); Community Action Agency (national); National League of Cities (national); and Armed Forces Tax Council (national).

The following SPEC local partners and/or community based coalitions that also participated in discussions of the EITC task force proposals, in roughly the same March 25th time period: Boston EITC Coalition (Boston, MA); Family Economic Success Services (Denver, CO); Indianapolis Asset Building Coalition; Milwaukee Asset Building Coalition; Central City Asset Building Coalition (New Orleans, LA); Technical Vocational Institute (Albuquerque, NM); City of Tempe Coalition (Tempe, AR); Central Region Coalition for Building Family Wealth (San Diego, CA); and San Antonio EITC Coalition.

The National Taxpayer Advocate also holds regular roundtable discussions. The following groups were invited to participate in an NTA roundtable discussion about the EITC task force proposals: American University, Washington College of Law LITC; Annie E. Casey Foundation; Brooklyn Legal Service Corporation LITC; Center for Economic Progress LITC; Center on Budget and Policy Priorities; Community Action Project of Tulsa County LITC; Community Food Resource Center; Council on

La Raza; DNA-People's Legal Services, Inc. LITC; Georgia State College of Law LITC; H&R Block; Legal Aid Society of Middle Tennessee and the Cumberlands LITC; Los Angeles Legal Aid Society; Military Armed Forces Counsel; National Women's Law Center; Pine Tree Legal Services LITC; Quinnipiac College School of Law LITC; Taxpayer Advocacy Panel, EITC Issue Committee; The Community Tax Law Project LITC; The Legal Aid Society of Cleveland; University of Connecticut School of Law LITC; University of Washington School of Law LITC; University of Wisconsin, Milwaukee School of Business Administration LITC; and Villanova University School of Law LITC.

The IRS National Public Liaison also coordinates regular meetings between the IRS and various stakeholder groups. The following groups were briefed on approximately March 18, 2003: IRS Advisory Council (IRSAC) W&I subgroup; American Institute of Certified Public Accountants (AICPA); National Society of Accountants (NSA); National Association of Tax Professionals (NATP); National Association of Enrolled Agents (NAEA); American Society of CPAs (AAA–CPA); National Conference of CPA Practitioners (NCCPAP); AARP Foundation; HR Block; and Jackson Hewitt.

In addition, on June 13, 2003, we issued an announcement seeking public comments on aspects of the pre-certification pilot. Throughout the pre-filing and filing season, we will evaluate all aspects of the verification process, including claimant response. We will use this feedback to determine our next steps. If we decide to move forward, we will use the results of the pilot to refine the process and to determine how to maximize participation and minimize burden for legitimate claimants.

4. A May 2002 report published by the Brookings Institution concluded that, in 1999, "an estimated $1.75 billion in EITC refunds was diverted toward paying for tax preparation, electronic filing and high-cost refund loans." Please explain how the proposed EITC rule would address the issue of substantial EITC funds being diverted away from low-income taxpayers to tax preparation professionals.

Answer. At this time we do not know whether there will be any change in the amount of EITC funds spent on tax preparation services. However, the IRS has programs and services to provide low-income taxpayers with free tax preparation assistance. For example, Free File is an Internet-based tax preparation and electronic filing program that is cost-free for eligible taxpayers. Generally eligibility is based on factors such as age, eligibility to file for the EITC, adjusted gross income, state residency, or military status. Each participating software company sets its own eligibility requirements and these may differ company to company. Because individuals who file their return electronically receive their refunds fairly quickly, electronic filing could reduce the demand for refund anticipation loans. Other free services including tax preparation are offered through the Volunteer Income Tax Assistance (VITA) program, the Tax Counseling for the Elderly (TCE) program, the American Association of Retired Person's Tax-Aide program, and our Taxpayer Assistance Centers.

IRS will send to taxpayers a question and answer brochure and a listing of low cost/free taxpayer assistance clinics along with the Form 8836. The accompanying letter (which will be printed in English and Spanish) and the Form 8836 instructions will include a phone number that's dedicated to helping taxpayers with precertification problems. We have also included the phone number for the Taxpayer Advocate office in the instructions.

5. One 2003 press report asserted that those applying for the EITC have a one in 47 chance of being audited, while those making more than $100,000 a year have one in 208 chance of being audited. For the most recently available tax year, please provide IRS statistics showing:

- the total number of EITC claimants;
- the total number of EITC claimants audited by the IRS;
- the total amount of additional revenues resulting from the EITC claimant audits;
- the total number of individual taxpayer returns with gross income in excess of $100,000;
- the total amount of additional revenues resulting from the audits of individual taxpayer returns with gross income in excess of $100,000.

Answers. For examinations, we define the audit rate as the number of examinations closed in a given fiscal year (e.g., FY 2002) divided by the number of returns filed in preceding calendar year (e.g., CY 2001). Presenting the data by tax year would only permit me to give you accurate data up to tax year 1999 because of the time involved in completing some audits. I have taken the liberty of using the preceding format in order to give you an accurate picture with more recent data.

- The total number of EITC returns: CY 2001—19.1 million.

• the total number of EITC claimants audited by the IRS: FY 2002—377,758 audits closed.

• The total amount of additional revenues resulting from the EITC claimant audits: TY 2001—$965,169,000 (revenue assessed).

• The total number of individual taxpayer returns with gross income in excess of $100,000: CY 2001—13,020,100.

• The total number of individual taxpayer returns with gross income in excess of $100,000 audited by the IRS: FY 2002—109,242.

• The total amount of additional revenue resulting from the audit of individual taxpayer returns with gross income in excess of $100,000: FY 2002—$1,497,943,000 (revenue assessed).

The above data indicates that EITC claimants are more heavily audited than those individuals with gross income in excess of $100,000. We note, however, that 97% of EITC audits are correspondence audits that are used when there are only 1 or 2 relatively simple issues on a return. In contrast, 51% of audits of taxpayers with gross incomes in excess of $100,000 required face-to-face contact with the taxpayer. Face-to-face audits are used for more complex returns with numerous issues and are believed to be more daunting to the taxpayer than a correspondence audit.

When looking at audit coverage rates by traditional audit classes (i.e., comparing audit coverage of high income taxpayers to the audit coverage of all low income taxpayers and not merely EITC recipients), the IRS has higher coverage rates in the higher income classes than the lower income classes. For cases closed in FY 2002, only 1 in 130 taxpayers with income less than $25K were audited (0.78% coverage) versus 1 in 120 for those with income over $100K (0.86% coverage). After removing the EITC cases, only 1 in 580 taxpayers with income less than $25K were audited in FY 2002 (0.17% coverage).

QUESTIONS FOR THE RECORD ADDRESSED TO IRS COMMISSIONER EVERSON BY HONORABLE MARSHA BLACKBURN

Questions from Representative Marsha Blackburn:

1. Why has the IRS been unable to realize internal savings sufficient to shift staff to high priority areas?

Answer. We have mined our internal resources to generate efficiencies that could be applied to high priority areas. In the FY 2003 Budget Request, the IRS generated $158 million internally that were intended to meet increased enforcement, enhanced customer service and increased return workload. However, a number of unfunded and unanticipated costs arose that reduced the funding available for hiring these additional staff. Since the IRS Operating budget consists of over 70% for salaries and benefits, any unanticipated costs that must be paid requires the reduction of labor costs (i.e., FTE).

For example, the FY 2002 annual pay raise of 4.6% cost an additional $43 million from the 3.6% budgeted amount. The IRS had also expected savings resulting from legislative proposals for postage and the FMS levy that were not passed that required us to fund an additional $23 million. The postage increase that was unfunded increased our postage costs by $22 million. Moreover, an unfunded increase in security costs resulting from 9/11 cost the agency an additional $20 million. These changes and others amounting to $170 million that were unexpected, unfunded and were mandatory to meet our mission consumed the internally generated resources.

2. The Inspector General testified that the Customer Account Data Engine (CADE) has experienced significant delays and increased costs and that Release 1 will be 20 months behind its delivery date. How long will this take to implement and what is the total expected cost?

Answer. The Customer Account Data Engine project (CADE) Release 1 is running about five or six months behind the plan to deploy in production this summer as indicated in the FY2003 Expenditure Plan. This delay is disappointing given that the target date of this summer already reflected a six-month schedule slip from the target date of January 2003 set last summer. We are currently re-planning the initial production operation of CADE R1 for the 2004 filing season.

While we have incurred some costs for capacity increases for CADE and for the costs of contractors to support testing, we have not paid any additional monies to the PRIME contractor during FY2003 for CADE R1, as it is a fixed price engagement. The costs to date for CADE since 1999 are $69.2 million. A finer breakout of these costs follows:

Lifecycle Phase	PRIME ($MM)	Non-PRIME ($MM)
Planning (6/99–8/00)	2.2	
Design (9/00–6/01)	18.4	
Development (7/01–6/03)	37.2	10.5
Filing season changes	0.9	
Total	58.7	10.5

Filing season changes are new requirements that we implement as new tax laws are enacted or other changes are made to the current IRS systems with which CADE interfaces. Additional costs are being incurred for filing season changes not yet implemented. Non-PRIME costs include hardware capacity increases and contract support for IRS product assurance testing.

There are several reasons for this delay and for the difficulty in predicting exactly when CADE would be in production. CADE is inherently complex insofar as its integration with the current processing environment and the instability of that environment as it changes to adapt to the many new tax actions throughout the year. Second, the PRIME mis-estimated the complexity of the balancing and control feature and has struggled to design and code those parts of the application. The final code was only delivered last April and the PRIME has experienced difficulty in getting that code to operate smoothly and in conjunction with the other CADE software. As a measure of the impact, the overall size of CADE nearly doubled due to the impact of the balance and control features.

Third, we believe that the IRS and PRIME underestimated the degree of business change required. While few users are directly affected by the start of CADE, the complexities of going from a weekly operation of the IMF to a mixed daily/weekly operation is far more complex from a business process and operations perspective than initially estimated.

Questions for the Record Addressed to Pamela Gardiner by Honorable Marsha Blackburn

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

June 27, 2003

Mr. George K. Yin
Chief of Staff, Joint Committee on Taxation
1015 Longworth House Office Building
Washington, DC 20515-6675

Dear Mr. Yin:

In response to your June 3, 2003, letter on behalf of Representative Marsha Blackburn, I am providing the following comments regarding the security of Internal Revenue Service (IRS) systems and data.

What has prohibited the IRS from effectively implementing security procedures?

The IRS has developed adequate security policies and procedures but has not implemented them effectively. As a result, sensitive information remains vulnerable to attack by hackers, terrorists, and disgruntled employees and contractors.

The Treasury Inspector General for Tax Administration (TIGTA) attributes many of the IRS' security problems to misplaced accountability. The IRS does not hold its business unit (functional) managers accountable for the security of their systems. Instead, the Office of Security Services (OSS) took primary responsibility for this function as a result of its creation in 1997. Other factors prohibiting the IRS from effectively implementing security procedures include:

- **Roles and responsibilities for carrying out key IRS security responsibilities have not been assigned** – Many security roles and responsibilities became unclear during the recent major IRS reorganizations when lines of authority and functions changed. Specific examples include: access privileges have not always been removed from employees who separated from the IRS because of confusion over who is responsible for removing the privileges; and responsibility for reviewing audit trails run on the IRS' computer systems has not been assigned.
- **Employees with key security responsibilities have not been trained** – Since IRS managers are not clear on their security employees' roles and responsibilities, selecting appropriate training is problematic. In addition, the IRS computer security training program does not follow National Institute of Standards and Technology (NIST) and General Accounting Office (GAO) recommendations. Curricula for key security roles have only recently been

developed, and many courses are not yet available. Finally, testing and other follow-up techniques are not used to determine whether security training was adequate and successful.

- **IRS employees are not always aware of their security responsibilities –** TIGTA audits have shown that employees were not always encrypting taxpayer data on their laptop computers, and that employees were often willing to provide their password over the telephone to strangers.

Should the IRS begin to hold business unit managers accountable for the security of their systems? Why was the authority placed with the Office of Security Services instead of with managers, as required by the Office of Management and Budget Circular A-130, Management of Federal Information Resources and the Federal Information Security Management Act?

The IRS should hold business unit managers accountable for the security of their systems and data. The OSS should continue to be responsible for the security of the IRS computer infrastructure (i.e., the networks, operating systems, Internet gateways, etc.)

The OSS has limited staffing resources and authority and, consequently, cannot implement sufficient security policies and procedures in the IRS without functional managers assuming primary responsibility for maintaining the security of their systems. Prior to the creation of the OSS in1997, there was no central authority for computer security in the IRS. To quickly bolster security, the OSS took full responsibility over security and started to conduct facility-based reviews to assess security and to dictate changes to IRS field offices. As a result, other IRS offices deferred all security-related issues to the OSS. Today, functional managers are focused primarily on their programmatic responsibilities and rely upon the OSS to provide the appropriate security. This status has led to friction between the OSS and functional managers when weighing the need for security controls against operational needs and convenience.

To address this issue, the IRS has initiated three executive committees comprised of functional managers and security executives to improve communications and decision making between the business units and the OSS. Beginning in Fiscal Year 2003, the IRS has placed with functional managers the accountability for ensuring that systems are reviewed at least annually to comply with the Federal Information Systems Management Act. To date, TIGTA is not aware of any annual security reviews being completed.

Please contact me at (202) 622-6510 if you have any questions or your staff may contact Margaret E. Begg, Acting Assistant Inspector General for Audit (Information Systems Programs), at (202) 622-8510.

Sincerely,

Pamela J. Gardiner

Pamela J. Gardiner
Deputy Inspector General for Audit

QUESTIONS FOR THE RECORD ADDRESSED TO JAMES R. WHITE BY HONORABLE MARSHA BLACKBURN

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

June 27, 2003

The Honorable William M. Thomas
Chairman
Joint Committee On Taxation

Subject: *May 20 Oversight Hearing on the Internal Revenue Service – Questions for the Record*

It was a pleasure to appear before the Joint Committee on Taxation on May 20, 2003, to discuss the Internal Revenue Service's (IRS) accomplishments in the 5 years since the IRS Restructuring and Reform Act of 1998 was passed. Enclosed are our answers to questions from the Honorable Marsha Blackburn, dated June 3, 2003, which required a written response. I hope this information is helpful.

Sincerely yours,

James R. White

James R. White
Director, Strategic Issues

Enclosure

(1) How much money has IRS spent on upgrading its security? Are the challenges associated with ensuring information security technological or managerial?

According to IRS officials, spending for security in fiscal year 2003 is about $132 million, including about $39 million dedicated to information technology security improvements. For fiscal year 2004, IRS officials state that they have requested about $136 million for information technology security, with about $40 million dedicated to improvements.

The challenges facing IRS in ensuring information security are largely managerial. Ensuring that known weaknesses affecting IRS's computing resources are promptly mitigated and that computer controls effectively protect its systems and data requires support and leadership from senior management of IRS's information technology and operating divisions, disciplined processes, and consistent oversight. We have reported that an underlying cause for the hundreds of information security weaknesses identified during our reviews of IRS's computer controls was that IRS has not fully implemented its agencywide information security program.[1] Implementing such a program requires that IRS take a comprehensive approach that includes assessing risks and evaluating needs, establishing and implementing appropriate policies and controls, enhancing awareness and technical skills, and monitoring the effectiveness of controls on an ongoing basis. Further, a successful program will need the active and accountable involvement of both (1) operating division executives and managers who understand which aspects of their missions and information systems are the most critical and sensitive and (2) technical experts who know the agency's systems and understand the technical aspects of implementing security controls. At the same time, technology is certainly part of the answer.

While there are no silver bullets, there are many tools today that are very helpful in implementing information security and could assist IRS in its efforts to strengthen security. Until IRS effectively and fully implements its agencywide information security program, assurance will remain limited that IRS's financial information and taxpayers' personal information are adequately safeguarded against unauthorized use, disclosure, and modification, and its exposure to these risks will remain unnecessarily high.

(2) Is IRS taking sufficient steps to eliminate overpayments to the Earned Income Credit?

Because IRS's latest compliance study uses tax year 1999 data and its new initiatives are in the early planning stages, it is too early to determine whether IRS's steps to reduce Earned Income Credit (EIC) overpayments will be sufficient. IRS has plans to evaluate the success of its initiatives, but data will not be available for some time. We

[1] U.S. General Accounting Office, *Information Security: Progress Made, but Weaknesses at the Internal Revenue Service Continue to Pose Risks*, GAO-03-44 (Washington, D.C.: May 30, 2003).

are preparing a report on the precertification initiative, due in late July, which discusses, among other things, IRS's evaluation efforts for that program.

IRS has and continues to take steps aimed at reducing EIC overpayments. IRS received about $875 million in special appropriations for EIC compliance initiatives between 1998 and 2003. The most recent data available, for tax year 1999, showed that overpayments for the EIC are estimated to be between about 27 and 32 percent of dollars claimed or between $8.5 billion and $9.9 billion.

For fiscal year 2004, IRS has asked for a total of $251 million. This included $100 million to enhance its EIC compliance initiatives—about $45 million for technology improvements and about $55 million for direct casework. The direct casework involves three new initiatives, each of which would be tested over the next year and, depending on the results, expanded in future years. The initiatives cover (1) qualifying child verification, (2) income misreporting, and (3) filing status.

- **Qualifying Child Verification Initiative:** Filers that improperly claim qualified children represent the single largest area of EIC overclaims. Under this proposed initiative, IRS would notify taxpayers of their need to provide certain documentation to prove EIC eligibility and taxpayers would send in the required documentation prior to receiving the EIC portion of their refund, thus providing an opportunity for examiners to either accept or deny the claim. IRS plans to test this proposal beginning in late summer 2003 by mailing 45,000 notices to taxpayers considered to be high risk because IRS could not verify eligibility for EIC through any available means.

- **Income Misreporting Initiative:** Income misreporting is another common problem with EIC claims. IRS plans to use document matching to identify EIC filers who have a history of misreporting income in order to increase (or receive) the EIC. Based on that history, 175,000 taxpayers' returns would be flagged when their 2003 EIC claims are filed in the spring of 2004. Any EIC refund would then be frozen until IRS could verify the taxpayer's income through document matching or audit procedures in the fall of 2004.

- **Filing status Initiative:** Another common problem associated with EIC claims is improper filing status. IRS plans to verify the filing status for 5,000 cases, but the criteria for selecting the cases have not yet been determined.

We are sending copies of this letter to the Commissioner, Internal Revenue, and interested congressional committees. We will also make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you have any questions about this letter or need additional information, please call me on 202-512-9110 or Joanna Stamatiades, Assistant Director, on 404-679-1984. Key contributors to this letter included Libby Mixon and Greg Wilshusen.