2002 TAX RETURN FILING SEASON AND THE IRS BUDGET FOR FISCAL YEAR 2003

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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Tuesday, April 9, 2002

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

The Subcommittee met, pursuant to notice, at 2:05 p.m., in room 1100 Longworth House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE CONTACT: (202) 225–7601
March 28, 2002
No. OV–10

Houghton Announces Hearing on the 2002 Tax Return Filing Season and the IRS Budget for Fiscal Year 2003

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the 2002 tax return filing season and the Administration's budget request for the Internal Revenue Service (IRS) for fiscal year 2003. **The hearing will take place on Tuesday, April 9, 2002, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include IRS Commissioner Charles Rossotti, James White, Director of Tax Administration and Justice Issues, U.S. General Accounting Office, as well as representatives of the National Treasury Employees Union and groups involved in tax preparation. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The 2002 tax return filing season refers to the period from January 1st to April 15th when U.S. taxpayers will file more than 137 million tax returns, including 44.9 million e-filed returns. During this period the IRS is expected to issue over 100 million tax refunds, answer 108 million telephone calls from taxpayers asking for assistance, and its homepage will receive 3 billion hits.

The Administration's budget requests $10.4 billion to fund the IRS for fiscal year 2003. This level of funding will support approximately 101,000 employees who will collect about $1.9 trillion in taxes, according to Administration estimates.

Beyond supporting the traditional activities of the filing season, the fiscal year 2003 budget request addresses three key strategic goals by the Administration, including pre-filing assistance, filing assistance, and taxpayer compliance programs. The budget request also includes $450 million for the continued Business Systems Modernization effort, as well as $154 million for the Earned Income Tax Credit Compliance Initiative. The Business Systems Modernization effort is a continuation of the program initiated by the landmark IRS Restructuring and Reform Act of 1998 (P.L. 105–206).

In announcing the hearing, Chairman Houghton stated: "Improved customer service was the promise of the new IRS after the Restructuring and Reform Act of 1998. This hearing gives us the opportunity to ensure that the IRS is living up to its promise by processing taxpayer questions, returns, and refunds as efficiently as possible. I am looking forward to our annual review of the tax filing season and the IRS budget."

FOCUS OF THE HEARING:

The Subcommittee will review developments in the 2002 tax filing season, including progress in the customer communications system, electronic filing, and systems modernization. In addition, the Subcommittee will review the proposed budget for the IRS for fiscal year 2003.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610 by the close of business, Tuesday, April 23, 2002. Those filing written statements who wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Oversight in room 1136 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings. **Failure to do so may result in the witness being denied the opportunity to testify in person.**

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

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

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

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

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

Chairman HOUGHTON. Good afternoon, ladies and gentlemen.

Good afternoon, Commissioner, glad to see you here.

Let me make an opening statement first, and then I will ask anyone else if they have an opening statement, particularly Mr. Coyne.

As we all know, voluntary compliance is the foundation of our tax system. I cannot tell you how troubled I am about recent reports that show an erosion of trust in its fairness. This apparent erosion coincides with the persistent decline in enforcement statistics. The percentage of taxpayers who are audited has declined, and some say tax professionals can no longer convince clients to fear the Internal Revenue Service (IRS). One tax adviser has taken to posing a depiction of heaven and hell on her wall to supply the fortitude that fear of an IRS audit once supplied.

I don't want to add to this problem by failing to observe that the vast majority of taxpayers are indeed honest and comply faithfully and with great integrity. But we do need to address this problem, and I will ask each of our witnesses today what we can do to turn the situation around.

Our witnesses have specific knowledge or experience with different aspects of IRS operations. In addition to sharing their views on tax compliance, they will focus on the 2002 filing season, the President's budget request, and also current developments at the IRS.

Despite the progress of the IRS is making in customer service, as highlighted in the Commissioner's testimony, there is still troubling reports that IRS performance is lagging in some areas. For example, taxpayers continue to complain about various aspects of the Offer in Compromise Program, and independent reviewers have expressed concerns about the quality of telephone assistance and walk-in assistance to taxpayers.

On the other hand, the IRS appears to be doing better this year to encourage electronic filing and a whole variety of other things.

On Wednesday, I hope, the House is scheduled to consider the Taxpayer Protection and IRS Accountability Act of 2002, legislation that some of us have sponsored. Commissioner Rossotti played an important role in advocating the modification we are making to the so-called 10 deadly sins—I guess there are 11 of them now—provisions of the 1998 IRS Restructuring Act; and the President, in his budget request, proposed a 15-day extension for electronic filers that we are adopting. I hope that that 15-day extension will further accelerate the pace of electronic filing and that the change of the 10 deadly sins improves morale at the IRS while continuing to protect taxpayers from arbitrary and unlawful conduct.

Additionally, I would like to note that the Administration will be submitting to Congress a series of recommendations on individual tax simplification in the next several weeks. I look forward to reviewing those recommendations, and I hope we can act on them in the near future.

Now, let me turn to Commissioner Rossotti for a moment. The Commissioner has transformed the IRS. He has transformed it from an outdated structure based on geography into a modern customer-focused agency organized around the tax needs of American citizens. He has also laid the groundwork for technological change that will carry the IRS into the 21st century. We are just beginning to see the fruits of those innovations today. For example, the electronic funds transfer payment system has greatly simplified payroll taxes.

I understand, sir, that your term will expire in November and that you have announced your intention to move back to the private sector. I want to thank you on behalf of all of us for your exemplary public service; and I wish you success, obviously, in reentering the private sector.

I am pleased now to yield to our Ranking Democrat, Mr. Coyne.

[The opening statement of Chairman Houghton follows:]

Opening Statement of the Hon. Amo Houghton, a Representative in Congress from the State of New York, and Chairman, Subcommittee on Oversight

Good afternoon. Voluntary compliance is the foundation of our tax system, and I can't tell you how troubled I am about recent reports that show an erosion of trust in its fairness. This apparent erosion coincides with a persistent decline in enforcement statistics; the percentage of taxpayers who are audited has declined, and some tax professionals say they can no longer convince clients to fear the IRS. One tax advisor has taken to posting a depiction of heaven and hell on her wall to supply the fortitude that fear of an IRS audit once supplied.

I don't want to add to this problem by failing to observe that the vast majority of taxpayers are indeed honest and comply faithfully and with great integrity, but we need to address the problem. I will ask each of our witnesses today what we can do to turn this situation around.

Our witnesses have specific knowledge or experience with different aspects of IRS operations. In addition to sharing their views on tax compliance, they will focus on the 2002 filing season, the President's budget request, and current developments at the IRS.

Despite the progress the IRS is making in customer service, as highlighted in the Commissioner's testimony, there are still troubling reports that IRS performance is lagging in some areas. For example, taxpayers continue to complain about various aspects of the offer in compromise program, and independent reviewers have expressed concerns about the quality of telephone assistance and walk-in assistance to taxpayers. On the other hand, the IRS appears to be doing better this year to encourage electronic filing.

On Wednesday, the House is scheduled to consider the Taxpayer Protection and IRS Accountability Act of 2002, legislation that I sponsored. Commissioner Rossotti played an important role in advocating the modification we are making to the so-called "Ten Deadly Sins" provision of the 1998 IRS Restructuring Act, and the President, in his budget request, proposed a 15 day extension for electronic filers that we are adopting. I hope that the 15 day extension further accelerates the pace of electronic filing, and that the change to the Ten Deadly Sins improves morale at the IRS while continuing to protect taxpayers from arbitrary and unlawful conduct.

Additionally, I note that the Administration will be submitting to Congress a series of recommendations on individual tax simplification in the next several weeks. I look forward to reviewing those recommendations, and I hope we can act on them in the near future.

During his tenure, Commissioner Rossotti has transformed the IRS from an outdated structure, based on geography, into a modern, customer-focused agency organized around the tax needs of American citizens. He has also laid the groundwork for technological changes that will carry the IRS far into the 21st century. We are just beginning to see the fruits of those innovations today, for example, in the Electronic Funds Transfer Payment System that has greatly simplified the remittance of payroll taxes. I understand your term will expire in November and that you have announced your intention to move back to the private sector. Thank you, Commissioner, for your exemplary public service, and I wish you success in your future endeavors.

I am pleased to yield to our ranking Democrat, Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Once again this year, the Subcommittee on Oversight is holding a hearing on the current tax return filing season and the pending IRS budget. I thank Subcommittee Chairman Houghton for conducting this important annual oversight review of the Internal Revenue Service.

More than 137 million tax returns will be filed during the 2002 tax return filing season, which ends in 6 days from today. During the filing season, the IRS will issue over 100 million tax refunds and answer over 100 million telephone calls from taxpayers seeking assistance. I want to commend IRS Commissioner Rossotti and all IRS employees for a job well done.

Of particular interest to this Subcommittee is the proposed budget for the IRS for the year 2003. The Administration's IRS request is $10.4 billion for funding general operations plus additional amounts to continue systems modernization and Earned Income Tax Credit (EITC) compliance initiatives. We need to make sure that such funding is adequate.

I look forward to the views of the witnesses scheduled to testify before us here today. With Commissioner Rossotti, as the Chairman pointed out, planning to finish his term and leave the IRS at the end of the year, I would hope that we could use today's hearing to solicit his advice about what Congress needs to do to keep the IRS on track in implementing the IRS reform legislation 1998.

I want to also commend the Commissioner on a job well done. His outstanding service as Commissioner of the IRS has set a high mark against which future commissioners will be judged. I want to thank Mr. Rossotti and wish him the best in his future endeavors.

[The opening statement of Mr. Coyne follows:]

Opening Statement of the Hon. William J. Coyne, a Representative in Congress from the State of Pennsylvania

Once again this year, the Subcommittee on Oversight is holding a hearing on the current tax return filing season and the pending IRS budget. I thank Subcommittee Chairman Houghton for conducting this important annual oversight review of the Internal Revenue Service.

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I want to also commend the Commissioner on a job well done. His outstanding service as Commissioner of the IRS has set a high mark against which future Commissioners will be judged. I want to thank Mr. Rossotti and wish him the best in his future endeavors.

Chairman HOUGHTON. Thank you very much, Mr. Coyne. Now, is there anyone else on the Committee who would like to make an opening statement?

All right, Mr. Commissioner, you are on.

STATEMENT OF THE HON. CHARLES O. ROSSOTTI, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. ROSSOTTI. Thank you very much. I want to thank you and Mr. Coyne for the kind comments you made about me. It has been a great honor coming before you each of these years and serving in this position, I can assure you of that.

I will comment on the topic of the filing season and the budget, which is the scheduled topic, but I would be more than happy to come back and answer your questions about the compliance and enforcement issues during the hearing.

I want to also say that I think the progress that we have made, which I think has been significant, has been in no small measure due to the support that you and your Committee have provided over this period; and in particular I want to thank Chairman Thomas as well as Congressmen Portman and Coyne for sponsoring the amendments that were made to the most recent act. We think those will be very, very helpful.

I am pleased to report, with respect to the current filing season, that we are, I believe, improving performance across the board; and I think it is important to note that over the last few years our improvement in performance has been recognized by the most important judge of our performance, which is the American public. We are going to put up a chart here which just shows the trend in how the public thinks about the IRS, as measured by two very well respected surveys, one of which is the Roper Starch survey, which showed our rating, as you can see on that bottom line there, increasing in each of the last 3 years quite significantly, after regrettably reaching an all-time low in 1998.

The top line is a more recent survey done by the University of Michigan, which also measures customer satisfaction for a number of agencies, in this case the IRS; and it showed the largest gain of any Federal agency in the last 2 years.

I don't mean to put too much focus just on surveys, but I do believe that the public's rating of the IRS is fundamentally important to the health of a tax system. I really don't believe it is acceptable for a government agency that affects more Americans than any other institution to be also rated, as we were in 1998, as the lowest-rated institution that they deal with. Changing that rating, that point of view of the public, was one of the mandates of the restructuring act which the Congress passed; and I think, as noted here, we are beginning, but I do stress beginning, to deliver on that mandate. The trend is positive, but, as I will note, there is a lot more to be done.

Turning to the specific details of the current filing season, it has been smooth, with returns being processed on time, electronic filing increasing substantially, and improved quality of phone service. So I think this demonstrates how we can build on positive trends for service to taxpayers, especially as our technology and organizational initiatives take effect.

We have encountered a significant number of taxpayer errors concerning one particular item on the return having to do with the rate reduction credit, but despite encountering a number of these problems, about 6 percent of the returns are having this error, we have nevertheless been able to meet our schedules and get our refunds out in time. I actually view this as a clear demonstration of how our new organization enables us to respond rapidly, identify and fix problems which inevitably occur from time to time during the filing season.

Chairman HOUGHTON. Could I interrupt a minute? I know my eyes are old, but I cannot see that. Maybe if someone could sort of bring it up part way, in this lower level desk.

Mr. ROSSOTTI. I think we have copies of this, which we will provide for you.

The basic idea is to show the trend lines, as opposed to any specific numbers on this chart. This chart shows some of the trends over the last 2 years on a number of the key indicators of service that taxpayers are receiving during the filing season, and of course it is during the filing season that most individual taxpayers do interact with the IRS.

You will notice there is a couple of lines up there on the left which are literally going off the chart, and those reflect the use by taxpayers of our Web site, which is IRS.gov. In January, at the beginning of the season, we introduced the newly designed Web site, which was designed to be more accessible and easier to navigate for taxpayers, and that has helped the usage of this great resource really grow dramatically.

What it means to taxpayers is that there is less time and effort getting the information they need to file their returns. They can get forms, for example, without having to make last-minute trips down to the post office; and they can get information about almost any aspect of the tax system with just a few clicks on their home computer.

The second line up there that is growing quite nicely is the growth in electronically filed individual returns. For this fiscal year, 2002, we set an aggressive goal of receiving 46 million 1040 returns, which would be a 15-percent increase over last year; and I am pleased to say that, as of this time, we project we will even exceed the 46 million goal. As a matter of fact, as of yesterday, we actually already exceeded the total number of electronically filed returns that we received all year last year. So we are doing quite well.

I want to note that the provision that this Committee reported out to extend the filing date and the paying date for those that file and pay electronically will be of great help in continuing, maybe even accelerating this trend which should help us reach the congressional goal of 80 percent filing by 2007.

There are some other charts on there that show both the quality and accessibility of phone service, which is the way that most taxpayers who need help get it during the filing season. And I want to show one other chart here, which just shows by month how many calls we were receiving and what the level of accessibility was. I think what you can see is that we had, as a result of the issues I mentioned about the rate reduction credit, a bump-up in demand well above what was expected during February, which did temporarily, for a few weeks, drive down our service. But we quickly recovered and we have now, since then, been reaching more than our goal of a 71-percent level of access.

I should also note that another measure that is important to taxpayers is how long they have to wait to get through. On tax law calls, for example, we were down to a 2.58-minute wait, which is down from 4.27 minutes last year. So we are making a significant improvement in making it faster for taxpayers to get through.

The other very important dimension of our service, if you want to put the other chart back for this, is quality. It is very, very important that when taxpayers call in and ask a tax law question or ask us to update their account that it be done accurately. That is not an easy thing to do, given the complexity of the subject matter. There are a couple of those lines up there that you can see that reflect inequality of tax law and tax account service, and they, in particular, have improved substantially this year. For tax law and tax account questions we are up to 83 and 89 percent accuracy this year, as compared with 75 to 88 percent last year.

I also should note that, since September 24, only 13 days after the September 11 attack, we established a special phone line for victims of the terrorist attacks, and we have provided over 90 percent service to taxpayers on that.

So I think as we conclude the home stretch of this filing season, we do take pride in the improvement in the service that we have offered. But I also note that, while we are headed in the right direction, we are not at the end of the journey by any means. We still have a lot of work to do. We have improved service, but we were starting from a very low level, very honestly, as I noted at the beginning. And even now, a 71-percent level, which is our goal for this year, and an 89 percent accuracy rate does not meet our long-term standard of being as good as the private sector delivers.

So the continuation of modernization, adequate funding for operations and our own internal aggressive performance improvement goals are all going to be necessary year by year in order to achieve ultimately the level of service that the public expects and that we aim to deliver. I do believe that if we stay focused on these goals and that we get consistent funding and support from the Congress, we can achieve them; and I believe the main point I want to make today is that we are on the path of doing that.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Rossotti follows:]

Statement of the Hon. Charles O. Rossotti, Commissioner, Internal Revenue Service

INTRODUCTION

Mr. Chairman, I thank you for this opportunity to testify before the Subcommittee on the 2002 tax filing season, our FY 2003 budget request and some of the initiatives we are undertaking on behalf of America's taxpayers.

On a personal note, let me also thank you for your continued leadership and guidance. The progress we have enjoyed to date is due in no small measure to your active support of our modernization program and what we must do to provide quality service to America's taxpayers while meeting our other critical goals and responsibilities. I particularly want to thank Chairman Thomas, Chairman Houghton and Representatives Coyne, Portman and Cardin for your support in passing the President's proposed modifications to the IRS Restructuring and Reform Act of 1998 (RRA 98).

Mr. Chairman, I am pleased to report that we are gradually improving our performance across the board. As demonstrated by the 2002 filing season results, we are seeing further improvements in key areas, such as *e*-filing growth and telephone service. It is important to note that our most important judge of the IRS, the American public, has begun to respond to our efforts.

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

Mr. Chairman, the turnaround in the public's rating of the IRS is fundamentally important to the health of the tax system. It is not acceptable for the government agency that affects more Americans than any other to also be the lowest rated.

Changing this was a mandate incorporated in the RRA 98, and we are beginning, and I stress beginning, to deliver on it. While the trend is positive, much more remains to be done.

2002 FILING SEASON

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

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

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

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

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

Electronic Tax Administration

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

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

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

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

The following are some of the key 2002 filing season *e*-file statistics through April 4, 2002 except where noted.

- Nearly 28.6 million taxpayers have *e-filed* their tax returns electronically through an IRS-authorized Electronic Return Originator (ERO), a 12.6 percent increase over the same period last year.
- Approximately 7.2 million taxpayers have filed their tax returns on-line via their home computer through a third party transmitter. OnLine filing is running 40 percent ahead of last year and as of April 4, 2002 is already well over the 2001 total volume of 6.8 million.
- Almost 5.3 million taxpayers have chosen to use the OnLine Self-Select PINs, up 60.3 percent over last year.
- Over 3.6 million taxpayers have filed their returns over the telephone using the award winning TeleFile system.
- Overall, as of April 4, over 16 million taxpayers have chosen to file both their Federal and State tax returns simultaneously in a single electronic trans-

mission, up 23.8 percent from last year's 13.1 million at this time last year. This year, 37 States and the District of Columbia are participating in the program.

New for Individuals for the 2002 Filing Season

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

- Adding 29 forms and schedules to allow for even greater taxpayer participation in the IRS *e-file* program. This meant we opened up *e*-file eligibility to over 99 percent of all taxpayers, potentially adding 38 million new *e*-filers.
- Continuing the Self-Select Personal Identification Number (PIN) Program that in 2001 enabled approximately nine million taxpayers to file paperless returns without having to submit paper signature *jurats*. The Self-Select PIN is a five-digit PIN that taxpayers can create to sign their returns electronically.
- Continuing the Extension of Time to File by Phone. Anyone who filed a tax return last year can request over the telephone an automatic extension of time (to August 15, 2002) to file his or her tax returns. Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax return, has details on required information and explains how to pay a balance by telephone.
- Continuing the Debt Indicator Program and providing the Debt Indicator on every acknowledgment report. This information will be provided for every electronically-filed return for customer service purposes or for approval of financial products.
- Expanding the electronic payment options available to taxpayers by accepting credit cards for payment of installment agreements and delinquent taxes. As of April 4, approximately 46,449 payments averaging $2,459 were made via credit card and another 84,671 payments averaging $979 were made by Automated Clearing House (ACH) Direct Debit where taxpayers can authorize either their checking or savings account to be debited.
- Adding Maryland, Oregon and West Virginia to the FedState TeleFile program that already includes Indiana, Kentucky, Oklahoma and Georgia.
- Releasing the initial series of Web-based services for practitioners including registration and application capabilities, requesting and receiving taxpayer transcripts on-line, submitting disclosure authorization requests electronically, verifying Taxpayer Identification Numbers, and getting personal assistance to resolve taxpayer problems.

ETA Also Easing Business Taxpayer Burden

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

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

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

Mr. Chairman, to promote business *e*-filing, we have placed advertisements in publications, including *Fortune Magazine*. Businesses can now file electronically both their 940 and 941 employment tax returns. Some businesses may even qualify to file using a telephone. We have also opened the door for a number of other key forms to be filed electronically, such as Form 1099 to report other income. We are particularly pleased that we can now offer electronic filing of Form 1065, to report partnership income, and the K–1s that accompany them. We are also hard at work designing Form 1120, Corporate Tax Return *e*-file program. Implementation is slated for a year from now.

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

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

Spurring Further e-file Growth

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

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

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

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

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

Web-Based Help

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

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

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

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

Mr. Chairman, let me point to another benefit of our Web site. It is an excellent tool for alerting taxpayers and the media to various fraudulent schemes, including the slavery reparations scam, being perpetrated upon them by unscrupulous promoters. There is a quick link from our portal page to IRS Criminal Investigation

“Tax Frauds Alert” page that provides in one place a comprehensive overview of the different schemes and what we are doing to combat them. It also lists the number (1–800–829–0433) for taxpayers to report suspected tax fraud activity.

Telephone Assistance

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

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

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

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

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

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

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

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

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

Practitioner Priority Service

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

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

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

Forms By Fax and Phone

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

Recorded Tax Information

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

Automated Refund Information

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

Filing Burden Reduction

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

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

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

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

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

CD–ROMs

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

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

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

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

Taxpayer Assistance Centers

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

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

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

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

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

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

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

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

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

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

Tax Materials and Assistance in Spanish

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

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

Publication 1SP, "Derechos del Contribuyente (Your Rights as a Taxpayer)."

Publication 579SP, "Como Preparar la Declaración de Impuesto," explains who has to file a Federal tax return and other important topics, such as which form to file, who are dependents, what income is taxable and nontaxable, and what some of the more common tax credits are.

Publication 596SP, "Crédito por Ingreso del Trabajo," provides details on the Earned Income Tax Credit.

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

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

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

MODIFICATIONS TO THE IRS RESTRUCTURING AND REFORM ACT OF 1998 (RRA 98)

Mr. Chairman, in the FY 2003 budget submission, the Administration proposed modifications to RRA 98. On March 20, 2002, the House Ways and Means Committee reported out the "Taxpayer Protection and IRS Accountability Act of 2002" that contains five of these proposals. We commend the Committee for its actions and believe that these modifications preserve the intent of the Act while allowing us to administer it more efficiently and effectively.

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.

The second part adopts measures to curb the large number of frivolous submissions and filings that are intended to impede or delay tax administration. The third allows IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities. (*This provision was not contained in the Committee-reported bill.*) The fourth part streamlines jurisdiction over collection due process cases in the Tax Court, thereby reducing the cycle time for certain collection due process cases.

The fifth part permits taxpayers to enter installment agreements 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 sixth and last provision would eliminate the monetary threshold for IRS Chief Counsel reviews of offers in compromise.

NATIONAL RESEARCH PROGRAM

Earlier this year, the IRS proposed to reestablish a key component of its ongoing compliance effort to help ensure fairness for America's taxpayers. The National Research Program (NRP) is designed to accurately measure tax compliance while minimizing the need to contact taxpayers during the process.

The NRP is developing innovative approaches to measure taxpayer compliance with the tax law. It will: (1) be far less intrusive and burdensome on taxpayers than previous compliance studies; (2) help the IRS build better compliance programs to more effectively catch tax cheating and help ensure all taxpayers pay a fair share; and (3) help reduce audits of taxpayers who filed an accurate return by at least 15,000 tax returns a year.

As part of ongoing compliance operations, NRP will focus on measuring three key areas of tax administration—filing compliance, payment compliance and reporting compliance. A key element involves measuring the accuracy of reporting information on tax returns. The IRS has overhauled the reporting component to minimize disruptions to taxpayers during the study.

Ultimately, this project will help all taxpayers by giving the agency timely, accurate information about tax compliance. This information will allow the IRS to replace outdated audit selection formulas and develop compliance efforts directed toward the tax returns most likely to have errors, rather than those from honest taxpayers.

In late fall of this year, the NRP will begin reviewing a small, statistically valid sample of individual returns from the 1040 family. The IRS will work closely with tax practitioners, Members of Congress and other key stakeholders to finalize the project.

FY 2003 RESOURCE REQUEST

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

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

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

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

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

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

OPERATIONS

Highest Priority Resource Needs

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

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

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

- *Telephone Level of Service.* Taxpayers must still speak to live assistors to answer tax law and account questions as well as Automated Collection System (ACS) inquiries. Additional FTE are necessary to address current demand and to meet taxpayers' legitimate expectations that they receive service comparable to what is offered by the best private sector companies.
- *Multi-Lingual ACS.* The Multi-Lingual Automated Collection Service (ACS) will help meet taxpayer growing demands for timely, accurate and efficient services in languages other than English.
- *Improving Correspondence.* We are improving the clarity of our communications with taxpayers through a redesign of 24 of our notices over the next two years.
- *Filing Services.* We must continue to provide filing services—from *e*-filing to submission processing to timeliness of refunds—and handle a projected increase in the number of returns filed.

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

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

- *Stabilize Audit Rates.* The IRS will devote resources to stop the overall declining audit rates and will dedicate more resources to auditing partnerships and other passthrough entities.
- *Abusive Trusts.* Experts estimate that the revenue loss to our nation due to abusive trusts could run into the tens of billions of dollars. We now have a coordinated strategy to deal with this growing problem using a full range of tools from public education to civil and criminal enforcement against both promoters and participants.
- *High-Income Returns.* From 1993 to 2001, the number of returns over $100,000 and $1 million dollars grew by 163 and 259 percent respectively. However, IRS examination of these returns has not kept pace and we must now narrow the gap.
- *Highest Priority Collection.* To address the mounting employment and income tax gaps, the IRS will dedicate more resources to high priority compliance and collection cases involving unpaid employment taxes.
- *Fraud Referral.* Referrals and leads generated from the Lead Development Centers and the Fraud Detection Centers will produce more quality criminal investigations cases and help ensure public confidence in the fairness of our of tax administration system.
- *Automated Underreporter.* To improve voluntary reporting on individual income tax returns, the Remote Automated Underreporter Program will utilize a national rotational inventory approach for case selection.
- *Employment Tax.* To combat non-compliance with employment tax laws, the IRS will boost resources for legal source tax crime cases with a special emphasis on emerging problems, such as the use of temporary employment agencies/employee leasing agencies to evade employment and income taxes.
- *Money Laundering.* IRS Criminal Investigation (CI) was delegated primary investigative jurisdiction in all money laundering investigations where the underlying conduct is a violation of the income tax laws.
- *e-Crimes.* CI must continue to develop investigative knowledge and techniques to keep pace with the growing number of *e*-crimes, such as fraud and theft.
- *Criminal Tax Cases.* Continued development of a close relationship between Chief Counsel Criminal Tax and CI will help to ensure that legal errors in the investigative process are minimized and the chances for successful prosecution are maximized.

Contract Services (+$44M)

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

RESOURCES RE-DEPLOYED THROUGH INCREASED EFFICIENCY AND PRODUCTIVITY

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

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

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

- *Reengineering/Quality Improvements.* Reengineering and Quality Improvement projects and programs will focus on redesigning internal processes, policies, and procedures. Updating the antiquated workload selection system will, for example, reduce/eliminate the substantial number of returns that are ordered, classified, and never worked.
- *e-file.* In addition to the many taxpayer benefits, *e*-file also provides clear cost savings and burden reductions for the IRS, enabling us to redirect precious resources from processing to customer service and compliance programs. In addition to expanding electronic filing for individual taxpayers, the IRS will promote the electronic filing of all business tax returns in FY 2003. Our ultimate goal is to convert all business transactions with the IRS to fast, accurate, paper-free electronic methods. Through *e*-Services, we will also provide to tax practitioners easy-to-use electronic products and services.
- *Customer Relationship Management.* The funding for this project will pay for training travel, operating travel and support costs related to bringing IRS staff quickly up to speed on the newly improved Corporate Tax Analysis software. The software's main strengths are its capacity to do carryback/carryover calculations for net operating losses (and other losses), the interaction of losses and charitable contributions, alternative minimum tax calculations and the foreign tax credit calculations—including carrybacks and carryforwards.
- *Information Technology Projects.* Two projects are expected to begin realizing savings in FY 2003: the Employee Plan Determination System Redesign (EDSR) and the Remittance Transaction Register (RTR). EDSR is expected to reduce cycle time and improve quality of determination letters. RTR is projected to improve efficiency in submission processing by providing all Lockbox payment information online soon after receipt, reducing from one month to just three days response time for reconciling payment information and responding to payment information queries.

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

- *Reduced Field Innocent Spouse.* The initial high inventory of Innocent Spouse cases is expected to decline to a point where they can be processed without significant delays on our part. Revenue Agents and Tax Auditor FTEs assigned to this program will be re-deployed to address compliance in other areas.
- *Reduced Filing Season Support.* We will reduce the FTEs in the Small Business and Self-Employed operating division planned for customer service details.
- *Narcotics Program.* With redeployments realized from the narcotics program realignment, 67 FTE will be used in the Fraud Referral Program and 18 FTE will be used in the Money Laundering Strategy Program.
- *Reduced Tax Court Cases.* The number of cases filed in the Tax Court is declining. Emphasis on pre-filing resolution of cases through programs such as Advance Pricing Agreements is also expected to moderate increases in Tax Court litigation in the future, as well as Refund and Appellate litigation.

Targeted Efficiency Improvements (Redeployment of $39M)

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

MAINTAIN CURRENT OPERATIONS

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

- *Maintaining Current Services Level (+$295M).* Needed to maintain FY 2002 program levels in FY 2003 by funding pay, benefits, and non-labor inflationary costs.
- *Within-Grade Increases (+$37M).* To cover the costs of within-grade pay increases for on-board employees.
- *Homeland Security (+$10M).* For the enhanced security arrangements required by the Homeland Security supplemental. These funds were appropriated as a consequence of the September 11, 2001 terrorist attacks and other related security concerns.
- *Homeland Security Non-Recur (−$31M).* Funding in the amount of $31 million from the FY 2002 will be non-recurred in the FY 2003 budget.

EARNED INCOME TAX CREDIT INITIATIVES

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

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

BUSINESS SYSTEMS MODERNIZATION AND OTHER INFORMATION TECHNOLOGY PROJECTS

The IRS' antiquated computer systems do not efficiently or effectively serve America's taxpayers, nor meet today's business needs. They are one of the fundamental obstacles to providing consistent top-quality service. Failing to modernize IRS' tax administration business systems would require a significant increase in resources to maintain the old legacy systems while not addressing their underlying deficiencies that will only worsen with time.

Business Systems Modernization will update our antiquated technology and change the entire way the IRS interacts and conducts business with taxpayers and stakeholders. Indeed, we do not view systems modernization as a separate entity, but rather as one of the major ways we can achieve all of RRA 98's goals within realistic budget resources.

Over the past two years, BSM graduated from strategic planning and systems design to business results. As shown in the attached chart—the green blocks in FY 2001 and FY 2002—the IRS will put in place three critical building blocks. In 2001, we established a communications infrastructure to manage the enormous volume of taxpayer phone calls. In 2002, we will move the records of some taxpayers out of the 1960's tape-based system to a modern, reliable database. And we will establish an IRS-wide security system providing internal and external secure access and communications to our systems.

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

Valuable lessons were learned as we developed and implemented these projects, and we are giving equal attention to improving the quality and rigor of our management processes. Completing the first two versions of the Enterprise Architecture, as shown in the chart, was a major step. Based on my 28 years experience in the IT business, I believe that this Enterprise Architecture is the most complete and useful of such architecture in industry or government.

We are also utilizing the rigorous management processes of the Enterprise Life Cycle, while at the same time ensuring that all BSM projects adhere to the Enterprise Architecture. In addition, we are addressing remaining management weaknesses, including those identified by GAO and we are striving to achieve a standard know as the Software Acquisition Capability Maturity Model Level 2—a recognized standard that has not been achieved in any Federal Agency with the exception of DoD's Abrams Tank Division.

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

FY 2003 BSM Request

The proposed $450 million FY 2003 BSM budget request includes an increase of $58.4 million over last year's appropriation. Let me summarize the key BSM projects that are addressed in the funding request. A complete description of each can be found in our congressional justification.

Customer Account Data Engine (CADE)

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

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

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

Integrated Financial System (IFS)

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

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

Custodial Accounting Project (CAP)

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

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

Enterprise Data Warehouse (EDW)

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

e-Services

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

Customer Account Management (CAM)

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

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

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

By being able to access and update comprehensive, current account information, CSRs will be able to respond quickly and accurately to customer inquiries.

Workflow management tools and processes will also allow them to automatically inform relevant parties throughout the organization of actions taken on a particular customer's account and manage outstanding cases for follow-up work or to identify the status of an inquiry for a taxpayer.

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

Filing and Payment Compliance (FPC)

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

Information Technology Projects

The Business Systems Modernization program is aimed at developing major, IRS-wide systems that are the underpinnings of overall tax administration. BSM also sets forth the enterprise architecture that defines required standards of equipment, software, communications and data. This program is not intended to meet every need for every business application in the IRS, even in the long term. However, by establishing a well-defined architecture, it assures that specific business applications developed for specific business purposes will operate consistently and use common equipment while meeting required standards, such as security.

Through the strategic planning process, the IRS operating units identify specific business needs and prepare business cases for business applications that will not be met through the overall BSM process. There are many more projects with high returns than can possibly be funded. Therefore through the strategic planning process, these are then evaluated and those with the highest returns are selected. Many of the gains in performance projected in FY 2003 and FY 2004 are enabled by these so-called Tier B projects. Tier B project implementation time is two to three years and the projects are monitored within the Business Performance Review process.

The President's FY 2003 budget includes a $10 million increase for Tier B projects beyond the FY 2002 operating level of $39.8 million. They cut across the entire spectrum of IRS activities and functions. For example, Information Systems projects will support Criminal Investigation's activities by modernizing the equipment used to analyze forensic evidence. They will support the electronic filing of business forms and schedules and *e*-Services will provide products and services to practitioner as well as the foundation for safe and secure electronic customer account management.

Other projects will redesign and consolidate systems to support casework and the Taxpayer Advocate Service. Correspondence will be imaged and we will be able to convert existing collection systems to electronic case processing. The Employee Plan Determination System Redesign will also reduce cycle time and improve the quality of determination letters from our Tax Exempt and Government Entities operating division. The Remittance Transaction Register will improve submission processing efficiency by providing information payment online.

LEGISLATIVE PROPOSALS AND PROPOSED ADJUSTMENTS (No Net Increase in IRS Programs)

The President's budget requests $503 million (a $39 million increase over the FY 2002 appropriation as adjusted) for proposed legislative changes that change the accounting of certain pension and retiree benefit costs. These costs are transfers of funds that were previously included in other agency budgets and do not represent any net increases in IRS programs. The $39 million increase will be used as follows:

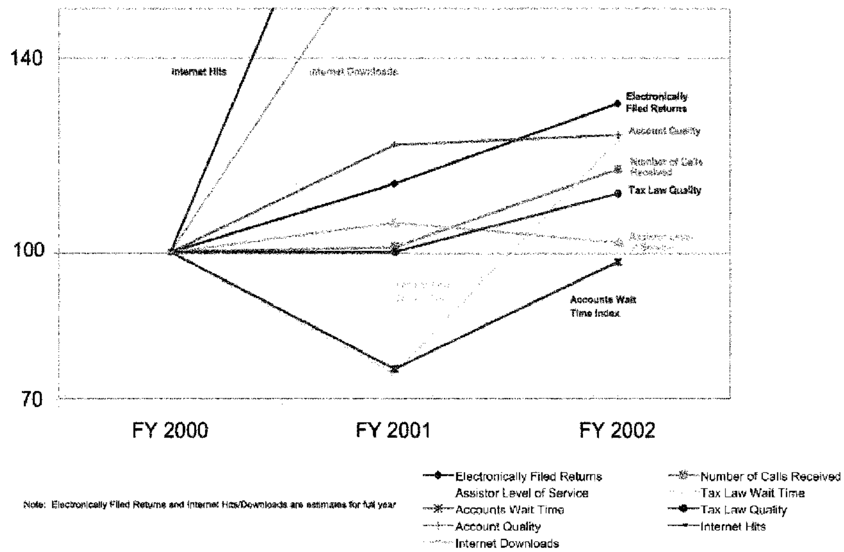
- *Federal Employees' Compensation Act (FECA) Surcharge (+$3M).* The FY 2003 President's Budget includes language in the General Provisions of the Treasury-Postal Appropriations bill to permit the Department of Labor to add an administrative surcharge to the amount it charges each agency for its Federal Employees' Compensation Act (FECA) benefits. Previously this administrative cost was borne by the Department of Labor.
- *Legislative Proposal on Full Costing of Retirement and Health Benefits (+$32M).* The budget also proposes legislation to require agencies, beginning in FY 2003, to pay the full government share of the accruing cost of retirement for current CSRS, CIA and Foreign Service employees, and the Coast Guard, Public Health Service and NOAA Commissioned Corps.
- *Inter-Departmental Reimbursements (+$5M).* This adjustment will allow permanent transfers of funds from the General Services Administration, the National Archives and Records Administration and the Department of Agriculture for services provided to IRS.

CONCLUSION

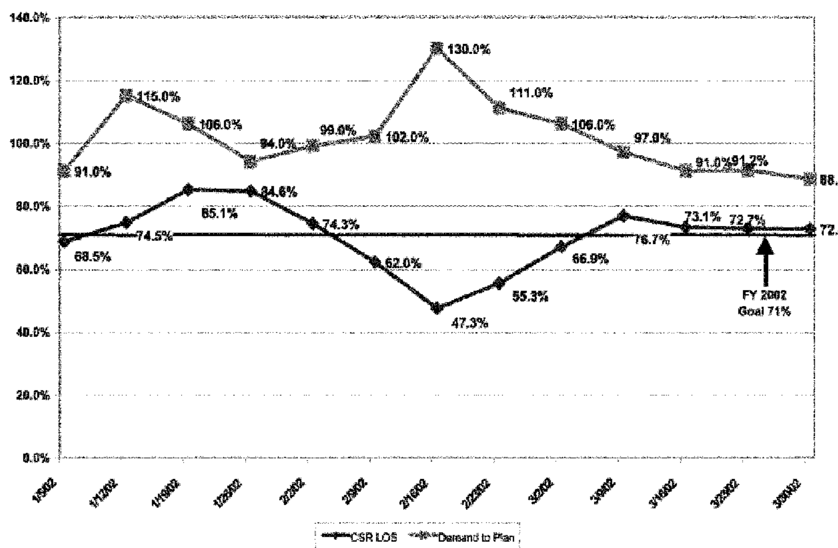
Mr. Chairman, in conclusion, I believe that we are making steady progress on our goals. We are providing improved service to America's taxpayer. We have begun to stem the decline in compliance activities. And we are doing our job more efficiently and effectively enabling us to better leverage our precious resources. Of course, we must measure our progress against the larger goals that RRA 98 and we have set for ourselves. We still have along way to go.

So, what must we do to ensure the success of IRS modernization for next year and the years beyond? I believe that we must stay focused and committed to the intent of the Restructuring Act, making adjustments as necessary; but not losing sight of the goal. If we do, I am convinced we will succeed.

IRS SERVICE IS IMPROVING
COMPARISONS FOR FIRST HALF OF FISCAL YEARS



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

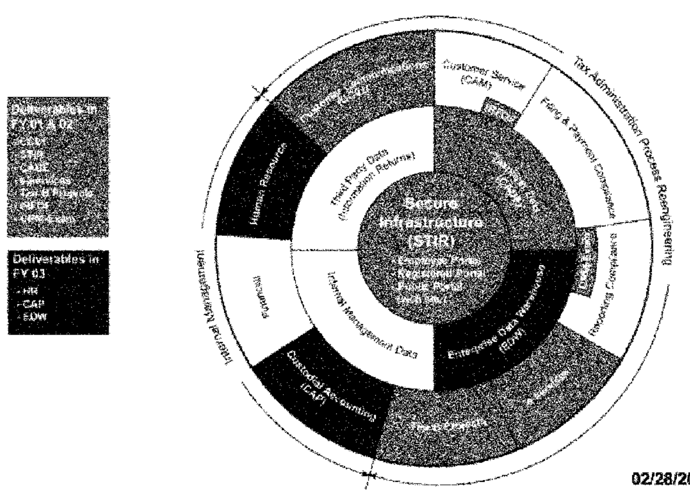


IRS WILL MEET 76% OF NEEDS FOR INCREASED SERVICE AND COMPLIANCE FROM INCREASED PRODUCTIVITY AND COST SAVINGS IN FY 2003

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

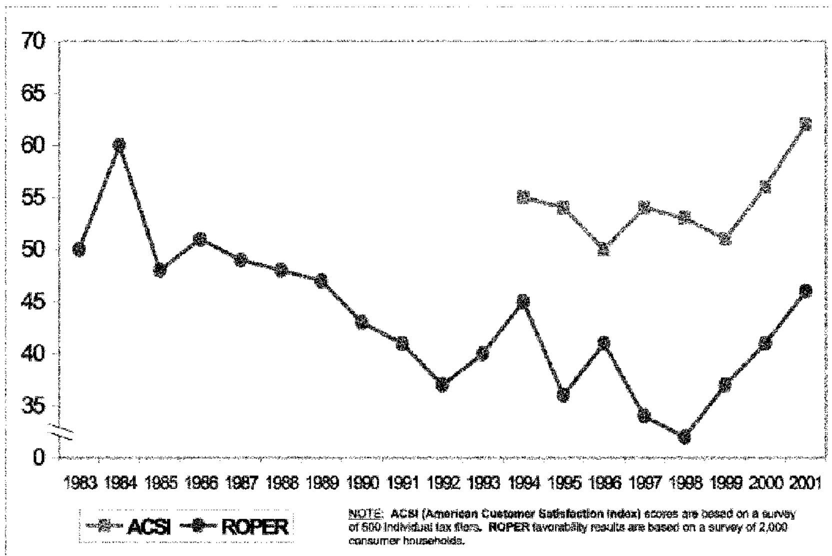
02/28/2002

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



02/28/2002

PUBLIC RATING OF THE IRS



02/28/2002

Chairman HOUGHTON. Thank you, very much. I will ask Mr. Coyne if he would like to ask the first question, but let me ask a preliminary one.

Why do the charts dive south in 2001, particularly in the tax law wait and the time index? What happened then?

Mr. ROSSOTTI. During that period we had an increase in the wait time that was due to just the volume of calls relative to how fast we were answering them. That drove down service for a period of time during 2001. But, as you can see, we have dramatically improved that back in 2002.

Chairman HOUGHTON. Now, the accounts wait time index is a little below 100 percent. Now, 100 percent was your goal, is that right, for 2000?

Mr. ROSSOTTI. No, 100 percent is just basically taking fiscal year 2000 as the base. This chart shows the increase and the decrease from year to year. So in both accounts, wait time and account quality had a decrease in fiscal year 2001. It was a goal, obviously for this year, to get that back up. It would have gone up even more if it were not for the fact, which is displayed on the other chart, that the volume of calls in February was way over what we expected due to the rate reduction credit.

Chairman HOUGHTON. Thank you very much. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. Commissioner, thank you for your testimony.

As was pointed out, you will be leaving toward the end of the year the position that you hold now, and I was wondering if there was a way you could provide for us any recommendations of what the next Commissioner ought to possess in the way of qualifications to be picked as the next Commissioner. What would you advise to be able to continue the work that has been going on at the IRS under your tenure?

Mr. ROSSOTTI. Actually, I think, as has been publicly stated and as is consistent with the Restructuring Reform Act (RRA), the IRS Oversight Board, together with the Treasury Department, is actually conducting a search, and they have laid out criteria for the next Commissioner, and they are well under way of doing that. I think the criteria they have put out I would agree with.

They tend to focus on management and leadership qualifications predominantly, work in change management in a large organization and experience with technology. Those are some of the key things that I think they have laid out, and I think those are, from my perspective, quite appropriate.

Mr. COYNE. Based on your experience, would you care to comment on what priorities you think a new Commissioner ought to emphasize?

Mr. ROSSOTTI. Well, of course I have a little prejudice here, but I really think and I have often said to myself that the problem at the IRS is not so much coming up with a vision or a concept. As a matter of fact, the commission that Congressman Portman cochaired did an excellent job of laying out a vision. I think others have similarly laid it out. It is more an implementation problem. It is getting it done. I think that that is a big job.

There are a lot of changes that need to be made and a lot of technology that is quite complex. We have made some of those changes. I think the results are showing that those changes have an effect, but they are far from complete. So my view is that what is needed is someone who will continue along that path and I believe will be able to make way more progress than I have been able to make because we had sort of a startup period we had to cope with.

What I think is most important is not to be diverted from the task of keeping this vision in mind and really achieving the IRS of the future.

Again, I refer back frequently to the commission report because I thought it really laid out what needed to be done. I think we are doing that. They are not strange things. They are reasonable, obvious things in sort of a broad sense. They involve understanding who your customer is, delivering the services those customers need, achieving accountability internally, and modernizing technology.

On the enforcement and compliance end, a lot of that has to do with making sure you target your resources where the problems are and not wasting them on things that are not necessary, that you leverage your enforcement people with technology. Those things are all laid out. They are all, I think, quite powerful. But implementing them is not a small job and it does require sustained attention over a period of time.

So I think over the next Commissioner's term there will be some opportunities that will be very exciting to continue on this path and to realize the benefits of some of this modernization, which I think will deliver. Those lines will continue to go up. We didn't have lines on this chart for compliance activities and enforcement and the degree to which we are being effective in that area, but I think we would show some up trends in those areas, too, over the next few years.

Mr. COYNE. You seem to be recommending implementation of things that are already laid out; and, relative to that, I would like to ask about the current proposed budget for the IRS, where it is at a level of $10.4 billion, a $482 million increase over last year. On the other hand, it is $92 million lower than what the Oversight Board had recommended. Are there things that the Oversight Board saw in recommending that additional $92 million that will not be able to be accomplished as a result of not having that funding?

Mr. ROSSOTTI. I think I would be lacking in plausibility if I denied we could do more if we had $92 million more. Any agency head would say that, and the speed with which we could accomplish things would obviously be improved to the extent we had more funding.

On the other hand, I have to say that Secretary O'Neill, in a tight budget year, went to bat for us to get us increases in both operational funding and modernization funding, and I really am appreciative of that.

The other thing that I want to stress, and I want to put a chart up—and I am sorry to be using so many charts, but I hope they help to convey some information—one of the key things we are trying to do in the IRS, recognizing the budget is always going to be significantly limited, is to figure out how we can make use of the resources we have, to apply them in a more productive way, to free up resources through technology especially but also through other management improvements.

What you can see here from this chart is that what we are doing is identifying the highest priority needs for 3,452 full-time equivalent personnel, which would cost $259 million. That is at the top of the chart, and they are just summarized into compliance and customer service, primarily. But we knew it would be very hard to get that much money in new money, so what we have done is identified specifically 2,287 full-time equivalent personnel, for a total of $196 million that we are going to be able to free up from tasks to apply and to improve efficiency to meet those needs. So, basically, that means that 76 percent of the need is being met through improved efficiency and only 24 percent from new resources.

When we talk about improved efficiency, what do we mean? A lot of that is the fruits of modernization and what the modernization is all about. E-filing is one example. That is an easy one to understand, but not by any means all of it. If you get more E-filed returns, you free up people that would otherwise just be processing returns and you can use those resources for something such as providing better phone service. There are dozens of other examples like that.

As we begin over the next 3 years to realize some of the bigger projects that we have in the business of modernization, we will continue to improve efficiency. Our strategy is to meet most of the needs that we think we will have for additional operational resources in order to provide adequate service to compliant taxpayers and focus on all those cases of people who are not paying what they owe or not reporting what they owe.

How do we get the resources to do this? Well, part is in additional budgetary resources, part of it is freeing up resources we already have and to make them more efficient. That is what we are attempting to do in this budget. Obviously, the more we have, the faster we could get there. But we think we have a strategy that will move us on the right path.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Thank you, Mr. Coyne. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman.

This is your last testimony before us in this capacity, Mr. Commissioner, I understand, and this will be your last filing season. You are smiling broadly.

Chairman HOUGHTON. Well, wait a minute. Let us not be too fast. We might ask him to come back.

Mr. PORTMAN. Maybe we will ask you to come back in your private sector capacity and tell us what is really going on.

I have to say, just to have survived almost 5 years as Commissioner of the IRS, you deserve a medal. It is a tough job. You took on an agency that was in disrepair. You said it started at a low ebb. I think that is an underestimate. We saw that earlier by the chart in terms of the public perception, but, more importantly, in terms of the actual inefficiencies, the lack of computer technology, software, hardware, the lack of organizational morale, and an agency that was fraught with problems and had been for years. So you have done a good job, I believe, in the last 4½ years in beginning to move the agency toward a higher level of service to the taxpayer.

There are still considerable problems, and you have outlined some of them today. My first question to you would be, what do you think the single biggest problem is that your successor will face?

Mr. ROSSOTTI. Well, you are limiting me to one, so—I answer in terms of our mission, as opposed to the internal management. Where we really have significant problems, as the Chairman alluded to in his opening statement, is with a substantial number of taxpayers who are simply not paying what they owe, not reporting what they owe and, in some cases, just hiding income. I don't know, because we have not had statistics, whether it is worse than it was a few years ago or not. But I can tell you that we are getting better and better data all the time that tells us this is a very significant problem, and it really is something that needs to be addressed, not only because of the money that is being lost to the Treasury but because of the health of the tax system.

While addressing this compliance problem, I think we need to continue to deliver the proper service to the 90 percent or so of the taxpayers who are compliant.

So I think that being more effective in addressing some of these compliance issues is an important goal.

Now, that is in terms of mission. If I go back and say what do we need to do to accomplish those compliance goals, I come back to the fact that modernization really does have something to do with that. Some people have a perception that technology modernization is only useful as a way of supporting improvements in service to taxpayers, to compliance services, to telephone service and electronic filing. I think that is not a correct perception. Because some of the very same modernization projects that we are working on are going to support improvement in our ability to conduct compliance operations as well as service operations. I could go into more detail about it, but they really support more effectiveness and more efficiency across the board in the whole agency.

Mr. PORTMAN. The fruits of modernization, which is one of the three or four key pillars of your tenure, as you look back on your legacy, would probably be the restructuring itself, literally restructuring the IRS to focus on the individual taxpayer. It would be the entirely new formulation of how to measure performance rather than how much money you squeeze out of the taxpayer, how much service you are providing. It would probably be the modernization, as we said, of the computer system?

Mr. ROSSOTTI. Those are the three.

Mr. PORTMAN. And that will relate not just to better taxpayer service—and we still have a ways to go there, but we have made substantial improvements—but also being able to target enforcement and to be able to use existing enforcement personnel more efficiently?

Mr. ROSSOTTI. Exactly.

Mr. PORTMAN. That seems to me to be probably the biggest challenge.

Just a couple of recent reports trouble all of us. As you know, the Oversight Board recently did a survey which indicated that from 1999 until today there has been a substantial erosion in people's sense as to the acceptability of cheating on taxes. We have also got a recent report that there are 2 million taxpayers who have offshore credit cards who are trying to hide income through that. So I think it is more than a perception problem.

Although that is out there, it may be that there are some noncompliance problems that need to be focused on. But what I hope we will not take from this is that the improvements that have been made in terms of taxpayer service, modernization, and restructuring are mutually exclusive with increased compliance enforcement. I think, as you do, that they go hand-in-hand.

I am also disturbed by some of the analysis recently indicating that somehow you cannot have decent service for the taxpayers and at the same time have a system which enforces this voluntary compliance system in an appropriate way. I think the two go hand-in-hand, and I think the fruits of your labor may not be seen for a couple of years.

You said in response to Mr. Coyne that you expect to see up trends over the next few years on enforcement and compliance.

Mr. ROSSOTTI. Yes.

Mr. PORTMAN. Is that correct?

Mr. ROSSOTTI. I do. Of course, part of that is dependent on budget resources. But, actually, our goal last year was to stabilize. They had been going down not just for the last 2 years but for many years, all of the indicators, audit rates and all the statistical indicators. We knew that, obviously, couldn't continue, and we were successful in most cases, not in all, to generally level those off last year. We hope to see some modest increases on a purely statistical basis this year and next year due partly to this reallocation of resources.

But I do want to stress—and I think this is important in your statement, Mr. Portman—it is not just statistics. People ask what is the right audit rate. Well, how do we know whether ½ of 1 percent is the right number or 1 percent? We really don't. But what we do know is when we can identify, which we are now starting to be able to do much more specifically, where are the cases, do we have names of people that are not paying or underreporting, whether that be because they have not paid what is owed or they have not reported or they have hidden income. We are starting to get this information. When we do, we will be able to use our enforcement resources very effectively to target those who are really not complying.

I agree with you that it is a false dilemma to believe that you are either providing good service to taxpayers or you are doing good enforcement. Most of the taxpayers that are wanting to comply, which is where we get most of our money, we do not need enforcement for them because they are already complying, with maybe a modest amount of encouragement, sometimes in the form of a notice or a phone call, they will pay and comply. But there are other taxpayers, fortunately a small percentage but still a large number in absolute terms, who are not complying, who are not paying or are hiding income or are using various kinds of abusive devices or who are just basically cutting corners.

I think, while we need to respect the rights of those taxpayers, as is indicated in the RRA, I think we view that when we take enforcement action against those taxpayers we are on the side of the honest taxpayer.

So the important thing is to understand your customer base and understand what is the appropriate treatment for each type of customer, and that is where the new restructuring of our organization is making us more effective.

Mr. PORTMAN. Thank you, Mr. Commissioner. My time is up, but I hope that thinking succeeds you. We look forward to working with you over the next several months.

It should be noted that this Subcommittee worked on the Restructuring Reform Act and came up with a system where there would be an oversight board that had 5-year staggered terms, so there is expertise on that board as well as accountability with that board, but also importantly, as you transition, continuity. So there will be people on that board who have gone through this process with you, at least through the last few years, once they finally got up and going, and those people will continue. We hope that you will work with them to be sure the transition is indeed smooth.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you. Mrs. Thurman.

Mrs. THURMAN. Thank you, Commissioner, for being here, and thank you for your service. I know that you personally have tried to continue to bring the IRS into this new decade here, and we appreciate that. I know it has been tough, because you have not always been given the resources necessary.

In fact, I have to tell you in one of our papers at home today they actually said we ought to be helping you with some resources. But at the same time they actually also are editorializing and asking some questions about the *New York Times* article, that was, I guess, on Sunday, specifically, "Wealthy Taxpayers Avoiding IRS Audits Despite Warnings That Cheating Is on the Rise."

Something we have heard about over and over in this Committee is the Earned Income Tax Credit, and I noticed in the suggestions by The Taxpayers Advocate and yourselves on the bill we will potentially be taking up tomorrow is that there will be recommendations as to how do you define, what do we do differently, and how do we get better compliance. So I guess the question I have for you is, if we can bring compliance or talk about compliance from the standpoint of what we are going to do with the Earned Income Tax Credit, can you give me suggestions as to how we might get to the lost taxes on this partnership income, which has not been included in this Taxpayers Bill of Rights tomorrow?

I think it is important for us to understand that and know that, because it is my understanding that if we just spent an additional $9 million in auditing tax returns from these partnerships we could recover somewhere around $1.8 billion, if this number is correct. But I would be curious if you could give us any ideas of what we ought to be doing in tomorrow's bill to help us.

Mr. ROSSOTTI. As a matter of fact, that is one of our top priorities. Because you are quite right and the article is right. I don't know about those specific numbers, but there has been an enormous growth in the last 10 or 15 years in the use of partnerships, trusts and S corporations, which are flow-through type organizations. But they all have the same type of characteristics, where the taxes are paid not at the entity level but by the owners. There has been growth not only in the number of these pass through organizations but also the total amount of income that flows through them, and it is really quite substantial.

It is also accurate that the IRS was not keeping up with that on the whole. We really recognized that point about 2 years ago; and, in fact, in the budget request for 2001, there was some request specifically for some additional funding to take one of the steps that we think is necessary, which is to begin matching the K–1 documents. The K–1s are the documents that are reported to the shareholders or the partners of these entities.

Mrs. THURMAN. Did you receive those dollars? I don't recall.

Mr. ROSSOTTI. Pardon me?

Mrs. THURMAN. Are you doing that now?

Mr. ROSSOTTI. Yes. We got that money, and we have started to do that. I do stress it was only the starter kit for the money, because it was only what we needed for the matching, and we will have more cases that flow out of the information we gain from this program.

In fact, I was out at one of our centers just 2 weeks ago where they are starting to do K–1 matching, and we will begin to get cases out of that which will show us whether people are not reporting some of that pass through income.

This is only one technique. The other thing we are doing is focusing on another part of this problem, which is use of devices, especially trusts, as an abusive tax evasion device. People set up and promote, in some cases, various schemes where the idea is that if you are, let's say, a businessperson or a professional of some sort, for example a medical professional or even a lawyer, you allegedly transfer your business to one of these trusts and have multiple layers of them taking out various kinds of expenses at each layer. In some cases, people actually incorporate the trust in a tax haven, which is more aggressive aspect of tax avoidance, so that the income is actually moved offshore completely. This is, we think, one of the most significant of the actively promoted schemes that people are using to hide income.

We began about 2 years ago, as was laid out in our strategy, to reallocate resources to this problem. This means not only the K–1 matching, which is one strategy, one technique, but also training field agents. We, frankly, had a small number of agents trained to do this work. So we began to train people to do this.

We also tried some techniques that are now starting to pay off, such as issuing summonses to get at the money hidden offshore. We issued a summons, initially, to one of the major credit card companies to give us records that had been issued by banks in some of these tax havens to people who were spending money in the United States. This was one of the techniques being used to repatriate the money. We started that 2 years ago, and we are now starting to get some rather substantial information out of it.

Also, if you have seen the papers, we issued some additional summonses to other credit card companies, and we are finding that there are very significant numbers of taxpayers who seem to be taking advantage of this device to put income overseas in tax havens.

I don't mean to imply that everybody using a trust or an S corp, by any means, is using them to hide income, but there are some who are. And even the ones who are not have a lot of income going through there, which we had not been paying as much attention to as we should have.

It is unfortunate that it takes a little bit of time to crank up these initiatives. It just does not happen overnight, because there are quite a few steps that you have to go through. But I am, I think, pleased that we are now at a point where we are starting to see some of the things come out of the pipeline on this; and over the next 2 years, if we can continue this, I think this will be a very, very important compliance initiative.

Mrs. THURMAN. I am trying to help you give a response to this, too, but, in saying all of that, one of the things that the paper reported was that, "When unreported partnership income is found, the IRS will send notices demanding taxes or an explanation, but the IRS was given no additional money for the actual casework," I guess to follow up, "when unreported income is found."

Is that accurate? And if it is, are there recommendations?

We are going to take this bill to the floor tomorrow. I don't know how much we can change tomorrow, but certainly it has another body to go through that we should be expediting this.

This is my concern. These are the kinds of articles that, when people don't feel that they are being treated fairly, will undo everything that you have tried to do. And when you have got somebody out there working, who doesn't get to take their health care expenses off, who doesn't get to take their travel expenses off, who doesn't get their lunch expensed, but gets hit 1 out of every 45 times, versus somebody who is having that advantage, that is not going to be a good report. And I don't want that to be the report that we hear about IRS. I would rather hear the other issues.

But I am concerned that some of these low and middle income payers are going to feel like their government is working only for those that have more than those who have less.

Mr. ROSSOTTI. I could not agree with you more. I have stated that numerous times. We feel we are on the side of the honest taxpayer, the ones you are talking about, the person who really does pay their taxes. That is why we have taken the resources that we have and begun to refocus them as strongly as we can on these larger amounts and, in some cases, more egregious forms of noncompliance and the use of these trusts and partnerships as a technique to do that.

Again, I want to stress that most of them are very legitimate, and most people that use partnerships are doing them very appropriately, but there is a significant amount that are not.

Mrs. THURMAN. We agreed with you on that on the Earned Income Tax Credit. But it always seems every time we get in this debate, the Earned Income Tax Credit was the bad guy. Now we are hearing there is another story out there.

Mr. ROSSOTTI. The truth is, as I see it after being in this job, there is noncompliance at all levels and of all kinds. Taxpayers at all levels comply, and there is a minority of taxpayers who abuse the system at all levels, too. What I believe we should do is be as effective as we can in finding those cases at all levels and especially those that are more egregious and are larger and use our resources for them.

Now, on the question about our not getting more money for these cases, initially this was in the 2001 budget. We went for the money necessary in order to do the matching. We didn't know how many cases were going to come out of that. We did not specifically request the money for that. However, in the 2003 budget, there is money in this highest priority needs.

You will notice the biggest part of this, this 1857 (FTEs, full-time employees) for compliance, some of these will be what we would use to do those kinds of cases.

Mrs. THURMAN. Thank you.

Chairman HOUGHTON. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman.

Commissioner, good to see you today. Welcome back before our Subcommittee. I would like to focus on the Electronic Tax Administration.

Of course, the Restructuring Reform Act of 1998 set a goal for the IRS to have 80 percent of returns filed electronically by the year 2007; and, while you have made progress, the U.S. General Accounting Office (GAO) and the Electronic Tax Administration's Advisory Committee said you may not be on track to achieve that 80 percent goal. Can you report on what kind of progress you are making toward this 80 percent goal, where you are today and where you expect to be?

Mr. ROSSOTTI. Yes, I can; and let me tell you exactly. We set a goal this fiscal year—and I am going to speak of the 1040s now, the individual returns—of 46 million electronically filed, which was a 15-percent increase over last year and which was actually a million more if you just did a statistical trend line. And I am pleased to say that, based on the results as late as yesterday, that I think we will not only meet the 46 million but we expect to go over the 46 million. So 46 million would be a 15-percent increase, and we will probably come close to a 16-percent increase, which is a greater increase than we had last year.

Now, if you extrapolate that all the way out to 2007, we would actually need a little bit higher rate of increase to reach 80 percent. We would actually need 19 percent. The reason for that is because we not only have to reach 80 percent of the returns currently being filed but the number of returns grows every year. There is about a 1.8 percent a year growth in the number of returns. So between 1998 and 2007, where Congress set the goal at 2007, when this goal comes in there will be actually 20 more million returns filed than in 1997, due to the increase in the number of filers.

The bottom line is, we are close to the track but not quite on the track; and I think that is why the provision that this Committee reported out concerning setting the filing date, which the Administration had proposed and the Committee supported, I think is an important step. We need some steps like that to give us that little more boost we need to get up to the 80 percent level. We are close to it with the percentage that we have this year.

Mr. WELLER. As you pointed out, the President proposed extending the deadline to April 30, essentially 2 weeks beyond the deadline, if you file electronically. We, of course, had moved legislation a few weeks ago out of this Committee for that purpose, and I expect we will be voting on it within the week. From your standpoint of administering this, how will that help you?

Mr. ROSSOTTI. I think it will help us and the taxpayer, by giving an incentive, for the taxpayers who file late, to file electronically.

See, if you were to look at the percentage of returns we have gotten in today, we are already getting a majority. If you looked at it as of this minute, April 9th, the majority of returns that have come in so far have been filed electronically. The problem is the ones that come in late are usually filed on paper, and those are also the most expensive ones to handle.

Why do the later returns come in on paper predominantly? One of the reasons is because more of them, obviously, have balances due with the returns, as opposed to refunds. Clearly, there is more of an incentive to get in quicker if you get a refund. So that is one reason.

Well, the later filing date and the payment date would give an incentive for those people.

Finally, there are just procrastinators. Some of us will procrastinate even when we are getting a refund. And the fact this gives you 2 weeks more to file gives you an opportunity to get your return in on time even later. So I think those are the reasons. It would give an incentive for people who would file in the last, say, week of the filing season and who have balance due returns to file electronically.

We have done analysis of this and have, through market research, determined that we would tap a significant block of taxpayers that would otherwise not be tapped. And I think by adding that to the growth that we otherwise would have, it would definitely boost it, and it would also be a benefit to the taxpayers because they would have that much longer.

Mr. WELLER. It will be interesting to see how this experiment works come May.

Mr. ROSSOTTI. I am quite confident it will work. I think there are a few practitioners who are concerned about extending the filing season, but I think from the point of view of the taxpayer it will be a benefit.

Mr. WELLER. Commissioner, in talking about the issue of convenience, some State agencies allow tax filings based on a Web-based application, which means that the taxpayer has no need to purchase software or to download software; and, of course, there is no cost in doing that. I was wondering, is the IRS considering offering any similar Web-based filing options?

Mr. ROSSOTTI. First, let me point out one thing. There are a number of options that a taxpayer can use for filing on the Web from various commercial providers that then transmit to us, although they usually charge a fee, usually about $10 or so to do that. So the service is available, but it is available through tax preparation software companies. And in the Administration's budget for this year, proposed by the President, there is an initiative to try to find a way to work with the private sector, to find a way to offer that service to at least some block of taxpayers in a way that will be either at no cost to the taxpayer or more accessible to the taxpayer.

As a matter of fact, we have an active program under way right now working with the software industry, some of whose members are here, I know, in the audience, to try to find a way to implement the Administration's proposal. The objective of that would be to do exactly as you say, without stepping into the problem that we really don't want to step into of getting the IRS into being a software provider. We have enough trouble with our own software.

Mr. WELLER. Well, Commissioner, there would be, I believe, certainly in the House, would be significant concern, if you were to put yourself in a position where you are competing with the private sector which is offering this service. And I would note that at least one company I know of who does provide this software at no cost to low income families to help them. I know they have done that in communities that I represent.

Mr. ROSSOTTI. What we are trying to do is exactly build on those kind of offerings, but make them something that we could make a little bit more accessible and maybe something that the IRS could join with the industry in publicizing. Right now we are very limited in what we can do to let them know about it.

Mr. WELLER. I would ask if you could keep us informed if you move forward on any initiative and keep the Members of this Subcommittee informed on what you may be doing.

Mr. Chairman, may I have one additional question?

Chairman HOUGHTON. Yes.

Mr. WELLER. Thank you, Mr. Chairman.

It has also been reported that the IRS may be delaying refunds on electronically filed returns. And, of course, as we have just discussed, many taxpayers find it convenient to file electronically, and we want to encourage taxpayers to file electronically.

Can you explain why there is a delay in providing refunds to those who filed electronically?

Mr. ROSSOTTI. The answer is there is no difference in the way that we evaluate filings, whether they are filed on paper or electronically. We have made that commitment many times because we don't want to discriminate in any way between people that file electronically or that file on paper.

We do have various screening devices to hold certain refunds based on the risk that there could be a problem with those refunds. But those screening tools are applied equally to paper and electronic returns. I know that some people get the impression that if they had a refund that was frozen for a compliance reason, and it happened to be filed electronically, people will sometimes include that, the refund was held because the return was filed electronically.

If the same exact return had been filed on paper, it would have been held for the same reasons, because we apply the same filters, if you will, to those returns.

Mr. WELLER. So you are saying that refunds for paper filing versus electronic filing are essentially treated the same if received in the same period of time?

Mr. ROSSOTTI. Well, it takes a while longer for the paper to go through the system. But, I mean, we have—as part of our processing in order to identify potentially invalid or incorrect refunds, we have various screening devices. And that includes some that are aimed at finding potential fraudulent refunds, because we do get submissions for fraudulent refunds. We have a set of techniques that we apply to try to identify those. But those techniques are applied after the return is submitted. They are applied equally to both kinds.

Mr. WELLER. What is the average period of time between electronic filing and someone receiving a refund?

Mr. ROSSOTTI. On an electronic filing, you typically get your refund in 10 to 14 days. On paper it is about 6 weeks.

Mr. WELLER. Thank you, Mr. Chairman. Thanks for the courtesy of an additional couple of minutes.

Chairman HOUGHTON. Mr. Commissioner, I would like to ask you a couple of questions. The reason, I understand it, that the lower income returns are monitored more than the higher income returns is because it is easy to match. Now, the question is, in terms of real estate trusts, in terms of partnerships and things like that, is it going to be easier to be able to put your hands on those issues? Whereas, you have never been able to get information as far as the K–1 or the forms sent to partnerships? Talk a little bit about that.

Mr. ROSSOTTI. Could I clarify a few terms here, because I think one of the things that gets a little confusing is what is an examination.

We publish statistics on what percentage of people are examined. And an examination has a specific definition in the Code, in our Internal Revenue manual. It basically has to do with us requesting or requiring a taxpayer to submit books and records to us. But we have a huge range of what we call an examination. Most of the examinations, almost all of the examinations of the earned income tax credit population, which is funded under a separate appropriation, I should note, are very, very simple exams, which have to do with—basically can be conducted by letter, almost all cases. We call them correspondence exams. They are very simple and usually they involve us sending a letter to the taxpayer and requesting them to send us substantiation for certain information about why they claimed a certain child as a qualifying child under the earned income credit or why they claimed, for example, head of household status, you know.

Those examinations are relatively low cost to do, because all they involve is sending a letter and getting information back. And we do a significant number of those in quantity because we have a large number of earned income tax credit claims that come in.

One of those is counted as an exam the same as an exam where we might send a revenue agent out to audit a high income individual and spend several weeks in their office actually auditing their books and records. They are still counted as one exam. So when you look at these statistics, they really are not necessarily revealing in and of themselves. You have to look behind them.

We do audit, in terms of pure numbers, a significant number of earned income tax credit taxpayers. But, in terms of the use of our resources it represents, I believe it is something like 6 percent of our total audit resources.

Chairman HOUGHTON. Can I just interrupt here a minute? Maybe I am not making myself clear. I guess what I am getting at is, you have the source of income which is taxable, and another way of checking it, that it is easy to sort of monitor so that there is a trust, a truthfulness going on here. If you have only have one statement, it is very difficult to do that. I mean, for example, with gross receipts on the Schedule C, or cost of assets sold or things like that. So how do you get around that?

Mr. ROSSOTTI. Well, basically, if you look at individual returns, about 75 to 80 percent of the total income, and I am only looking at income now that is reported on individual returns, is reported by a third party, what you are referring to. Okay? So for that purpose we can use matching techniques and other kinds of techniques for that.

The business income, and this includes some income that comes in through Schedule Cs as well as other sources, there is no third party source.

So the only way that you can verify that income is to go out and check the books and records of the taxpayer, which is one of the reasons we need audits, to be able to check those kinds of records. Now, some of the income that has increased that is coming in, and this is heavily concentrated in upper income individuals, does come in through partnerships and trusts on these K–1s. That is an opportunity. It is reported through a third party. And we can match that. It was not previously being matched until starting fairly recently. But we are now starting to use that. So the answer is that we need a variety of techniques. We use obviously the most efficient one. Where we can match documents, we do. And that is a very efficient way to verify income. Where we cannot match documents, we need to go out and check books and records.

Chairman HOUGHTON. Let me—the overall question which I wanted to ask you is this, and then maybe some of the others will have some additional questions. In terms of your priorities, if I were sitting in your seat, there would be three issues. One would be tax simplification. Two is moving from a pencil and pad form to an electronic system. The third is buttressing up this concept of trust and truth.

And, you know, it has been touched upon by so many people. And I guess the thing that worries me is that I don't know whether we are leveling off, if the trend is going to go up or we are continuing down, because the difference between the survey information in 1999, I guess it was, and what it was in 2001 is a big difference, big drop.

And I think one of the things that has always impressed me about our system is that there is an understanding of the value literally of paying taxes in order to be able to supply those things which our government needs and our people need. And there is a trusting relationship there. And I just don't know what the underlying erosion is. You may want to make a comment.

Mr. ROSSOTTI. Well, let me just say that I think I totally agree with you that the total system depends on trust, and it depends on the belief that people who are paying are not getting victimized or taken for suckers by someone who is getting away with it. There is indication, you know, that although I don't know how reliable that is, that there may be some erosion in that.

I do want to point out that we began an initiative called the National Research Program which we have briefed many Members of the Committee on, which was sorely needed, in my opinion, to actually to get a real handle quantitatively and to measure who is paying and who is not paying, who is reporting, I should say, and who is not reporting. And that, you know, was long overdue. The last time that was done was in 1988. It will take us about 2 years. We are starting it this year. But it will take us to the end of next year, end of 2003 to get that. That information, I think, will be extremely valuable in helping us to measure whether there is an erosion, not only in sort of surveys, but in actual behavior of taxpayers and will also help us to pinpoint where the most serious problems are. I must say we are not waiting for this survey. We know there are compliance problems. We have got cases, and we have got millions of them that we can work right now. So we are not waiting for the survey. But, in order to get the point of what the trend is and whether there is an erosion, I think we do need some information that we don't have right now. And we are going to get it. We are going to get it reasonably soon by our standards, which means possibly by the end of 2003.

Chairman HOUGHTON. All right. Let me ask you, have you got any questions, Mrs. Thurman?

Mrs. THURMAN. Commissioner, just—based on just what the Chairman said and your response to me, and looking at the budget and particularly where you put the highest priority resource needs in compliance, and to help build this trust with the American public that we are talking about, would it be safe to say then that under the 2003 budget that we might see an increased auditing and/or individuals on partnerships and overseas trusts similar to what we see in the 1 out of every 45 working poor that are subjected? Can we get to those numbers?

Mr. ROSSOTTI. Well, I got—you are definitely going to see an increase. But we are not going to wait until 2003. We are actually going to see an increase this year. The statistics, frankly, are not comparable, because we are talking about a letter audit versus something much more complicated. To give you an example, it can take us 300 to 500 hours of actual direct audit time to audit an individual with an offshore account. That can be a couple of hundred times as long as it takes to do this other audit. So these are not the same. There is a lot more money at stake. Frankly, just counting audits doesn't tell you a whole lot.

But I think what is important is looking at what we are doing with that audit and what we are targeting. I could not agree with you more. We need to target those resources where people are really abusing the system.

Mrs. THURMAN. I think that once we target some of them, we may not have so much abuse in the system.

Mr. ROSSOTTI. I hope not.

Mrs. THURMAN. Thank you.

Chairman HOUGHTON. Just one final question.

You know, this is such an important time. Not only in terms of what you have done, the way the IRS has turned, but some of these huge problems out there. I am going to request that we might have another go at this thing prior to you leaving, maybe in October, so that you can give your final swan song and we can make—make absolutely sure what you think are important as you move along these next 5 years.

Mr. ROSSOTTI. I would be delighted, Mr. Chairman. I would be honored to do that.

Chairman HOUGHTON. Thank you very much. Appreciate it.

We will now have the next panel. Mr. James L. White, Director of Tax Policy and Administration Issues, U.S. General Accounting Office, and Colleen Kelly, National President, National Treasury Employees Union. Will you please come to the stand? Thank you.

All right. Well, Mr. White, will you begin your testimony. Thank you very much. And, Ms. Kelly, nice to see you.

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

Mr. WHITE. Mr. Chairman and Members of the Subcommittee. I am pleased to participate in your review of IRS' budget request and filing season performance. I would like to begin by commending IRS for several actions.

First, IRS used its new strategic planning, budgeting and performance management process to identify internal savings that it expects will allow it to redirect over 2000 staff to higher priorities.

Second, unlike past years, IRS' request for business systems modernization funding is grounded in analyses that meet the requirements for such capital investment funding.

Third, with one major exception, the processing of returns this filing season has gone smoothly and there have been some improvements in telephone service.

Having said that, we have several cautions and concerns regarding both the budget request and filing season performance. One important caution about the budget request is that it is based on a series of assumptions that can prove optimistic, a result, to some extent, of the fact that budgets are prepared in advance.

The assumptions include the likelihood that the savings of over 2000 staff years that I just mentioned will be realized and there will be no major unexpected expenses. Unrealized savings or unexpected expenses could lead to cutbacks in planned hiring; cutbacks that historically have hit IRS' enforcement programs the hardest.

In addition, IRS' budget request does not always provide an adequate link between the resources requested and what IRS proposes to accomplish with its resources. In some cases, such as telephone service, good links exist. IRS asked for $14 million for additional staff and projects to increase the percentage of callers getting assistance by about 5 percentage points.

However, in other areas linkages are not adequate. For example, IRS asked for additional resources to fight systematic noncompliance such as abusive trusts and failure to pay employment taxes. But it is unclear how many resources will be devoted to each problem or what results are expected. Thus, it will be difficult to judge progress or hold IRS accountable. Consequently, the Subcommittee may want to ask IRS for more specifics about spending in areas with inadequate linkages to projected results.

In addition, IRS requests a continuation of the separate appropriation for earned income credit compliance. Considering other compliance problems facing IRS, the Subcommittee may want to ask IRS for its views on the value of this separate appropriation for the credit versus a combined appropriation for all compliance programs.

A third concern about the budget is the lack of justification for $1.63 billion for operation and maintenance of information systems. Rather than assess the costs, benefits and risks of specific projects, an approach taken by leading private and public organizations, IRS officials said they simply took last years spending and added an amount to fund cost of living and salary increases.

While we cannot tell from the budget information whether any spending cuts are justified, we are recommending that future information system budget requests be in accordance with leading organization practices.

On a related matter, this year's investment and business systems modernization, we have reported our concerns about the number and complexity of systems acquisition projects and the continued lack of certain management controls and capabilities. In response, IRS has committed to align the pace of the program with the maturity of management controls and is reassessing projects it plans to deploy in 2002.

Now, I want to discuss the filing season. This year, the one exception to the smooth processing of returns has been the large number of errors taxpayers are making related to the rate reduction credit and advance refund checks sent out last summer and fall. Although the errors have not affected the timeliness of processing, they have resulted in a significant error correction workload for IRS, the rejection of some electronically filed returns, and an increased demand for telephone assistance that is affecting taxpayers' access to IRS' assisters.

So far, about 7 percent, or over 3 million of the returns filed to date, contain such errors. Although IRS took steps to deal with the problem, in retrospect, IRS may have been able to prevent some of the errors if the instructions on tax returns had been clearer.

A key question related to filing season performance is whether IRS is improving its performance management so it will be better able to improve future performance. To this end, IRS has some useful performance measures but misses certain important aspects of service to taxpayers. For example, IRS does not have a measure of the service it provides to about 70 million callers who use its automated telephone services. At your request, Mr. Chairman, we are reviewing IRS' filing season performance measures and plan to issue a separate report on our results.

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

[The prepared statement of Mr. White follows:]

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

Mr. Chairman and Members of the Subcommittee:

We are pleased to participate in the Subcommittee's inquiry into the fiscal year 2003 budget request for the Internal Revenue Service (IRS) and the 2002 tax filing season.

As you requested, our statement assesses the support for various aspects of IRS' budget request, including the linkage between resources requested and expected results, and IRS' performance in processing returns and providing assistance to taxpayers during this filing season.

Our assessment is based on (1) our review of IRS' fiscal year 2003 budget request and supporting documentation; (2) the preliminary results of our review of the 2002 tax filing season; and (3) past and ongoing reviews of various IRS activities, including those related to information systems and performance measures.[1]

IRS is requesting about $10.4 billion for fiscal year 2003, an increase of about $500 million, or about 5 percent, over its appropriated level of about $9.9 billion for fiscal year 2002.[2] The proposed request is expected to fund 101,080 full-time equivalent (FTE) staff years, an increase of 1,179 FTEs over 2002. In addition to the increase of 1,179 FTEs, IRS identified internal savings that it expects will allow 2,287 FTEs to be redirected to higher-priority areas. To identify these savings, IRS used its recently implemented strategic planning, budgeting, and performance management process. This process is designed to reconcile competing priorities and initiatives with the realities of available resources. We commend IRS for using this process to reassess the allocation of resources in its base budget for 2003. With respect to IRS' request, our statement makes the following points:

- IRS' plans for hiring and redirecting staff depend on several assumptions that could be optimistic—a natural result, to some extent, of the fact that budgets are prepared so far in advance of the fiscal year involved. These assumptions include (1) labor and nonlabor savings of 2,287 staff years and $157.5 million identified by IRS operating units and (2) additional savings of $38.5 million resulting from better business practices that have not yet been identified. Also, IRS may face some unanticipated expenses, such as a larger civilian pay raise than proposed by the Administration, that could, if not funded, affect IRS' financial plan for 2003. Unrealized savings or unexpected expenses could lead to cutbacks in planned hiring—cutbacks that historically have hit IRS' enforcement programs the hardest.

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[1] Some of our analysis is based on data provided by IRS that we did not verify. These data generally came from management information systems that we have used in the past to assess IRS operations.

[2] These dollar amounts include funding for the legislative proposal on full costing of retirement and health benefits. Absent that legislation, the fiscal year 2003 budget would be $9.9 billion, an increase of $445 million over fiscal year 2002.

- IRS' congressional justification does not always provide an adequate link between the resources being requested and IRS' performance goals. In some respects, such as with telephone service, good links exist. In other areas, however, there are either no performance goals against which Congress can hold IRS accountable or there appear to be inconsistencies between the resources being requested and the expected change in performance or workload. The Subcommittee may want to pursue these issues with IRS.
- Although IRS provided adequate support to justify the $450 million request for its multiyear capital account for business systems modernization, it did not adequately support $1.63 billion of the $1.68 billion requested for its information systems. The $1.63 billion is for the operation and maintenance of existing (legacy) systems. We are recommending to IRS that it prepare its fiscal year 2004 information systems budget request in accordance with the practices of leading private and public sector organizations.

Our testimony on the 2002 filing season presents interim data on IRS' performance in processing returns and helping taxpayers who call IRS or walk into an IRS office. The following two themes predominate:

- So far this filing season, IRS has processed returns smoothly, with one major exception, and seen continued growth in electronic filing. The one exception to smooth processing has been the large number of errors taxpayers are making related to the rate reduction credit. IRS has had to correct millions of returns with errors related to the credit, and taxpayers' calls about the credit have greatly increased the demand on IRS' toll-free assistance lines, likely causing IRS' overall level of telephone service to dip significantly for a few weeks during the filing season. Some of these errors may have been avoided if the instructions for the income tax forms had been clearer.
- IRS' performance measures provide useful information on which both IRS and we rely to assess its success in assisting taxpayers. However, some measures of telephone service are constructed in a way that miss important aspects of the activity being measured, and plans to begin measuring some important aspects of IRS' walk-in service have been delayed.

IRS' Budget Request for Fiscal Year 2003

If IRS' budget request is approved, IRS will have more than 3,400 staff years that can be assigned to new or existing activities in fiscal year 2003. These include the 1,179 additional staff years requested in the budget and the 2,287 staff years that IRS determined could be redirected elsewhere in the organization due to projected savings from several improvement projects and workload decreases. These 3,400 staff years can make a real impact on IRS' performance if they are targeted to selected areas. However, the availability of these staff years depends on the projected savings being realized and no significant unanticipated expenses. In addition, it is difficult to evaluate the effect that these additional and redirected staff years will have on IRS' operations because the budget is not well-linked to performance goals in some important areas.

With respect to that part of the budget request for information technology, IRS (1) did not adequately support the $1.63 billion requested for operation and maintenance of its information systems but (2) did adequately support its $450 million request for business systems modernization.

IRS' Budget Request Is Based on Several Assumptions

IRS' fiscal year 2003 budget request is based on several assumptions that could prove optimistic. These include (1) labor and nonlabor savings of 2,287 staff years and $157.5 million from various improvement projects and workload decreases that IRS plans to use elsewhere in the organization, and (2) additional savings of $38.5 million resulting from better business practices that have not yet been identified. Also, IRS may face some unanticipated expenses that, if not funded, could cause it to revise its financial plan for fiscal year 2003. In many respects, this kind of uncertainty is the natural result of a process that requires the development of budget estimates many months before the fiscal year in question. No matter the reason, the end result could be unrealized savings or unexpected expenses that, as in the past, lead to cutbacks in planned hiring—cutbacks that historically have hit IRS' enforcement programs the hardest.

Through use of its strategic planning, budgeting, and performance management process, IRS identified a myriad of expected efficiency improvements, technological enhancements, labor-saving initiatives, and workload decreases that it projects will enable it to redirect $157.5 million in its base budget to higher-priority areas. Examples include (1) saving over $67 million from re-engineering and quality improvement efforts, such as consolidating form printing and distribution operations and updating an antiquated workload selection system to reduce or eliminate the substantial number of tax returns that are ordered but never audited, and (2) reducing the resources used for the innocent spouse program by $13.8 million due to an expected decrease in caseload.

We commend IRS for taking the initiative to reassess the allocation of resources in its base budget. However, the congressional justification submitted by IRS in support of its budget request does not explain how IRS developed the labor and nonlabor savings. IRS provided us with information on the overall method used to develop the savings and explained that, in a change from IRS' previously used top-down process, operating units determined the resource increases and decreases their programs needed. However, IRS did not provide details on how specific savings were computed, such as information on any assumptions used in developing specific estimates.

In response to the secretary of the Treasury's challenge for each Treasury bureau to review all programmatic efforts and reduce or remove those producing little or no value, IRS officials estimated that such a review could save $38.5 million. IRS' congressional justification notes that the secretary considers this review to be a work in progress and expects bureau heads and financial plan managers "to work creatively on mid-course adjustments" until the final quarter of fiscal year 2003. Accordingly, the congressional justification provides no details on how the $38.5 million will be achieved.

Any shortfall in the estimated labor and nonlabor savings or in savings from efforts to reduce or eliminate programs will only be exacerbated if IRS has to absorb unanticipated budget increases. For example, IRS officials estimated that it would cost an additional $69 million if the civilian pay raise included in this budget was increased to achieve parity with the proposed pay raise for the military.[3] In fiscal year 2002, IRS faced unbudgeted cost increases related to rent, pay raises, security, and postage rate increases. As a result, IRS had to delay hiring revenue agents and officers, tax compliance officers, and tax specialists. According to IRS, "the lack of full funding for non-labor inflation over the years has greatly reduced the IRS ability to cover pay raise costs and other legitimate cost increases by reducing non-labor costs, leaving the IRS with the sole alternative of reducing staff." IRS noted that "these budget constraints forced the IRS to reduce 1,364 FTEs in the [fiscal year] 2002 plan." Although we do not have specific evidence of how this FTE reduction affected IRS' operations, IRS data does indicate that the number of revenue agent FTEs in its current financial plan for fiscal year 2002 (11,836) is 691 fewer than the actual revenue agent FTEs in fiscal year 2000 (12,527)—despite funding of an initiative in fiscal years 2001 and 2002 that, among other things, was to increase the number of revenue agent FTEs.

Congressional Justification Not Always Well-Linked to Performance Goals

The Government Performance and Results Act of 1993 requires agencies to establish linkages between resources and results. With this requirement, Congress hoped to focus agencies on achieving better results for the American public. Congress also hoped to gain a better understanding of what is being achieved in relation to what is being spent.

In some respects, IRS' congressional justification has good links between the resources being requested and IRS' performance goals. For example, IRS' budget includes an increase of 213 FTEs and $14.1 million to improve its telephone level of service, and its performance measures show an expected increase in toll-free telephone level of service from 71.5 percent in fiscal year 2002 to 76.3 percent in fiscal year 2003.

However, in other important areas, the congressional justification is not well-linked to performance goals. In some instances, there are no performance goals against which Congress can hold IRS accountable. In other instances, there seem to be inconsistencies between the amount of resources being requested and the expected change in performance or workload.

Missing Performance Goals

A significant example of missing performance goals involves IRS' efforts to address major areas of systematic noncompliance. In February 2002, the commissioner of Internal Revenue identified four such areas: (1) misuse of devices, such as trusts and passthroughs, to hide income; (2) use of complex and abusive corporate tax shel-

[3] The Administration proposed a 2.6-percent pay increase for civilian employees in fiscal year 2003, which is the percentage IRS used in developing its budget, and a 4.1-percent pay raise for military personnel.

ters to reduce taxes improperly; (3) failure to file and pay large accumulations of employment taxes; and (4) erroneous refund claims, which include claims made under the Earned Income Credit (EIC) program. The budget request includes increased resources for compliance but, except for the EIC program, it is unclear from IRS' congressional justification how many resources IRS intends to devote to each of these problems. And, for none of these areas, including the EIC program, does the congressional justification include performance measures and goals that Congress can use to assess IRS' progress in addressing these major compliance problems.

IRS' congressional justification is clear about the amount of resources IRS plans to devote to EIC compliance efforts because the budget request calls for the continuation of a separate appropriation for that program. If approved, it will be the sixth year of targeted funding for the EIC program. IRS' compliance efforts under this program have prevented the payment of hundreds of millions of dollars of improper EIC claims. However, the most recent IRS information shows that the rate of EIC noncompliance is still very high. According to IRS' report on its analysis of EIC compliance rates on tax year 1999 returns filed in 2000, (1) about one-half of the 18.8 million returns on which taxpayers claimed the EIC involved overclaims and (2) of the estimated $31.3 billion in EIC claims made by taxpayers who filed returns in 2000, between $8.5 billion and $9.9 billion should not have been paid.

Audit coverage is another area where performance goals would help Congress assess IRS' progress. IRS states in its congressional justification that it will increase the resources for stabilizing audit rates by 368 FTEs and $24 million. Although the congressional justification states that audit rates have fallen, the justification does not include any information about current audit rates or what rates IRS expects to achieve in 2003.

Issue for Congressional Oversight

Given the amount of resources that could be involved in dealing with the four major compliance problems cited by the commissioner and increasing overall audit coverage, the Subcommittee may want to ask IRS to provide (1) more specifics on the level of resources it plans to devote to each of these areas and its performance measures and goals for each area and (2) its views on maintaining a separate appropriation for the EIC versus combining in one appropriation those resources with the resources being requested for other compliance work, which could give IRS more flexibility in deciding how best to allocate its resources among all of its compliance needs.

Inconsistencies between Budget Request and Performance Goals

The budget request and performance goals included in the congressional justification are, at times, inconsistent. Some of those inconsistencies might suggest that additional resources beyond those identified by IRS are available for redirection. Specific examples of inconsistencies include the following:

- A requested increase of 476 staff years and $20.7 million for "increased Offer-in-Compromise cases" is inconsistent with IRS' performance goal for that program, which shows that the number of cases processed is expected to decrease from 185,000 in 2002 to 104,600 in fiscal year 2003. This requested increase also conflicts with our recent evaluation of the program that shows that IRS projected that the number of staff years needed would decrease from 1,818 in fiscal year 2002 to 1,224 in fiscal year 2003.[4] In response to our question about this, IRS officials said that the staff year increase is to replace revenue officers who currently handle the cases so there is not a net increase in staff years for the offer program. This does not help explain why IRS is asking for an increase in resources when the workload is expected to decline and IRS had projected a decreased need for staff in the program.
- According to IRS' budget request, the field and electronic/correspondence exam units will receive about the same number of staff years as the year before, while in terms of dollars, the field exam unit will receive an increase of less than 3 percent and the electronic/correspondence unit will receive an increase of about 7 percent. However, IRS' performance measures show the field exam unit is expected to examine 33 percent more individual returns and almost 35 percent more business returns while the electronic/correspondence unit is expected to increase the number of correspondence examinations by 32 percent. It is not clear from the congressional justification how IRS expects to do so much more work with just a small increase in resources. IRS told us that one reason for

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

the apparent inconsistency is that correspondence audits run on a 2-year cycle, with a high number of case starts in one year and a large number of case closures in the next year.

- IRS' budget request includes an additional 197 staff years and $8.3 million for processing a projected growth in the total number of primary returns filed from about 225.9 million returns in fiscal year 2202 to about 230.0 returns in fiscal year 2003. However, according to IRS' performance measures, that projected growth is the net of an increase of about 7.6 million returns filed electronically and a decrease of about 3.4 million returns filed on paper. That decline in the more costly to process paper returns would seem to argue against the need for additional processing resources. In response to our question about this, IRS acknowledged that the number of paper returns was expected to decline but said, nonetheless, that its computation of the number of additional FTEs needed was "based on an estimate of direct hours needed to process expected paper returns."

Issue for Congressional Oversight

Because the congressional justification provides inadequate information to explain the apparent inconsistencies discussed in the preceding section and because, in some respects, those inconsistencies suggest that additional resources might be available for redirection to other purposes, the Subcommittee may want to ask IRS for additional information in support of those parts of its budget request.

Justification for Information Technology Budget Request Needs Improvement

IRS is requesting $2.13 billion and 7,449 staff years in information technology (IT) resources for fiscal year 2003. This includes (1) $450 million for the agency's multiyear capital account that funds contractor costs for the Business Systems Modernization (BSM) Program, which is adequately justified, and (2) $1.68 billion and 7,449 staff years for information systems, of which $1.63 billion for operations and maintenance is not adequately justified. With respect to the $1.63 billion request for operations and maintenance, IRS was unable to provide sufficient support for us to identify possible budget reductions.

Fiscal Year 2003 BSM Request Is Adequately Justified

Key provisions of the Clinger-Cohen Act, the Government Performance and Results Act, and Office of Management and Budget (OMB) guidance on budget preparation and submission (e.g., Circular No. A–11) require that, before requesting multiyear funding for capital asset acquisitions, agencies develop sufficient justification for these investments. This justification should reasonably demonstrate how proposed investments support agency mission operations and provide positive business value in terms of expected costs, benefits, and risks.

Since the BSM appropriation was established in fiscal year 1998, we have consistently reported that IRS has not developed adequate justification for its budget requests, and we have proposed that Congress consider reducing them.[5] During this same time, we have repeatedly recommended[6] that IRS put in place an enterprise architecture (modernization blueprint) to guide and constrain its business system investments.[7] Use of such a blueprint is a practice of leading public and private sector organizations. Simply stated, this architecture provides a high-level roadmap for business and technological change from which agencies can logically and justifiably derive their budget requests and capital investment plans. In response, IRS has developed various versions of an enterprise architecture, which we have continued to review and make recommendations for improvement in. IRS recently approved a new version of this architecture (version 2.0), which, based on a briefing to us and

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[5] U.S. General Accounting Office, *Tax Administration: IRS' 2000 Tax Filing Season and Fiscal Year 2001 Budget Request*, GAO/T–GGD/AIMD–00–133 (Washington, D.C.: Mar. 28, 2000); *Tax Administration: IRS' Fiscal Year 2000 Budget Request and 1999 Tax Filing Season*, GAO/T–GGD/AIMD–99–140 (Washington, D.C.: Apr. 13, 1999); *Tax Administration: IRS' Fiscal Year 1999 Budget Request and Fiscal Year 1998 Filing Season*, GAO/T–GGD/AIMD–98–114 (Washington, D.C.: Mar. 31, 1998); *Tax Administration: IRS' Fiscal Year 1997 Spending, 1997 Filing Season, and Fiscal Year 1998 Budget Request*, GAO/T–GGD/AIMD–97–66 (Washington, D.C.: Mar. 18, 1997).

[6] See, for example, GAO/T–GGD/AIMD–97–66; U.S. General Accounting Office, *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); and GAO/T–GGD/AIMD–00–133.

[7] An enterprise architecture provides an institutional "blueprint" for defining how an organization operates today (baseline environment), in both business and technological terms, and how it wants to operate in the future (target environment). It also includes a sequencing plan that provides a roadmap for transitioning between these environments.

others, appears to provide robust descriptions of IRS' current and target business and technology environments. IRS has also drafted, and executive management is reviewing, the associated high-level transition plan that identifies and conceptually justifies needed investments to guide the agency's transition over many years from its current to its target architectural state.

IRS' $450 million request is based on its enterprise architecture as well as related life cycle management and investment management process disciplines for its ongoing project investments. As such, this request is grounded in analyses that meet the statutory and regulatory requirements for requesting multiyear capital investment funding.

Pursuant to statute,[8] funds from the BSM account are not available for obligation until IRS submits to the congressional appropriations committees for approval an expenditure plan that meets certain conditions.[9] In November 2001, IRS submitted its fifth expenditure plan seeking approval to obligate the $391 million remaining in the BSM account at that time. In briefings to the relevant appropriations subcommittees and IRS, we reported our concerns about the escalating risk that IRS will be unable to deliver promised BSM system capabilities on time and within budget due to the number and complexity of ongoing and planned systems acquisition projects and the continued lack of certain key modernization management controls and capabilities.

In approving the expenditure plan, the appropriations subcommittees directed IRS to reconsider the scope and pace specified in the November 2001 expenditure plan to ensure that the number and complexity of modernization projects underway is commensurate with IRS' management capacity and fully establish and implement all process controls needed to effectively manage the modernization effort prior to the submission of IRS' next expenditure plan.

In response to these and other concerns raised by the appropriations committees and us, IRS has committed to aligning the pace of the BSM program with the maturity of the organization's management controls and management capacity and is currently conducting a reassessment of the projects it plans to deploy during fiscal year 2002. In addition, IRS has taken appropriate steps toward implementing missing management controls.

IRS' Information Systems Request for Operations and Maintenance Is Not Adequately Justified

Leading private and public sector organizations have taken a project or system-centric approach to managing not only new investments but also operations and maintenance of existing systems. As such, these organizations:

- identify operations and maintenance projects and systems for inclusion in budget requests;
- assess these projects or systems on the basis of expected costs, benefits, and risks to the organization;
- analyze these projects as a portfolio of competing funding options;
- and use this information to develop and support budget requests.

This focus on projects, their outcomes, and risks as the basic elements of analysis and decisionmaking is incorporated in the IT investment management approach recommended by OMB and us.[10] By using these proven investment management approaches for budget formulation, agencies have a systematic method, based on risk and return on investment, to justify what are typically very substantial operations and maintenance budget requests. These approaches also provide a way to hold IT managers accountable for operations and maintenance spending and the ongoing efficiency and efficacy of existing systems.

IRS did not develop its information systems request in accordance with these best practices of leading organizations. In particular, the largest elements of IRS' budget request are not projects or systems. Rather, they are requests for staffing levels or other services. For example, IRS is requesting $240 million for staff and equipment supporting operations and maintenance of desktop computers agencywide, as well as $111 million for staff and equipment supporting its major computing centers' op-

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[8] The Treasury and General Government Appropriations Act of 2002 (P.L. 107–67).

[9] IRS' BSM expenditure plans are required to (1) meet OMB capital planning and investment control review requirements; (2) comply with IRS' enterprise architecture; (3) conform with IRS' enterprise life cycle methodology; (4) be approved by IRS, Treasury, and OMB; (5) be reviewed by us; and (6) comply with the acquisition rules, requirements, guidelines, and systems acquisition management practices of the Federal Government.

[10] See, for example, U.S. General Accounting Office, *Information Technology Investment Management: A Framework for Assessing and Improving Process Maturity*, Exposure Draft, GAO/AIMD–10.1.23 (Washington, D.C., May 2000, Version 1).

erations. Further, it is requesting $266 million for telecommunications services contracts. Taken together, these three initiatives constitute about 38 percent of the total $1.63 billion being requested for operations and maintenance, but the budget request gives no indication regarding how these initiatives are allocated to systems. In addition, in developing these requests, IRS did not identify and assess the relative costs, benefits, and risks of specific projects or systems in these areas. Instead, according to IRS officials, they simply took what was spent last year in the categories and added the money to fund cost-of-living and salary increases.

IRS officials responsible for developing the IT operations and maintenance budget attributed the differences between IRS practices and those followed by leading organizations to the lack of an adequate cost accounting system, cultural resistance to change, and a previous lack of management priority. To better justify future budget requests, these officials said that they have assessed the strengths and weaknesses of IRS' budgeting and investment management processes against our IT investment management framework [11] and found significant weaknesses in 15 critical areas. To address the weaknesses, IRS is currently developing capital planning guidance based on our IT investment management framework. This guidance is to be issued by late summer 2002, but a schedule for implementing it has yet to be determined. In addition, IRS has adopted and is in the process of implementing a cost model that is to enable it to account for the full costs of operations and maintenance projects and determine how effectively IRS projects are achieving program goals and mission needs. IRS plans to have the cost model in place and operational by June 30 of this year so that it can validate its fiscal year 2003 information systems appropriation request and begin using it to develop the fiscal year 2004 request.

The key to making these plans reality is overcoming the very reasons that have allowed this budgetary formulation and justification weakness to continue unabated—accounting system limitations, cultural resistance, and low management priority. Although IRS has initiated actions to address these weaknesses, we are concerned whether they will be implemented in time to have meaningful impact on formulation of the fiscal year 2004 budget request. For example, IRS has not yet developed a plan and schedule for implementing its IT capital planning guidance. In addition, IRS officials told us that they are already beginning the process to develop the fiscal year 2004 budget. Consequently, until IRS overcomes its obstacles, its future information systems appropriation requests, like its fiscal year 2003 request, will not be adequately justified.

Recommendation for Executive Action

To aid IRS in overcoming the barriers to changing how it develops and justifies its information systems appropriation request, we recommend to the commissioner of internal revenue that IRS prepare its fiscal year 2004 information systems budget request in accordance with leading organizations' best practices.

Interim Results of IRS' 2002 Filing Season Show Impact of the Rate Reduction Credit

So far this filing season, IRS has processed returns smoothly with one major exception, seen continued growth in electronic filing, and achieved some improvements in telephone service. The one exception to smooth processing has been the large number of errors taxpayers are making related to the rate reduction credit. Although the errors have not affected the timeliness of processing, they have resulted in a significant error correction workload for IRS, the rejection of some electronically filed returns, and an increased demand for telephone assistance that, according to agency officials, is affecting taxpayers' access to IRS' telephone assistors. One issue that continues to affect IRS' ability to assess its filing season performance is missing performance measures. While IRS has measures that provide useful information on some aspects of its service and is making efforts to improve its performance measures, some measures of telephone service are constructed in a way that misses important aspects of the activity being measured and IRS has delayed implementation of some accuracy measures for services provided at walk-in offices.

Errors Related to the Rate Reduction Credit Have Adversely Affected an Otherwise Smooth Processing Season

This filing season, IRS experienced very few of the kinds of processing problems, such as those caused by computer programming errors, that it has often experienced at the beginning of a filing season, and the number of returns filed electronically continues to grow. The one major negative in this otherwise positive picture has

[11] GAO/AIMD–10.1.23.

been the significant number of returns IRS has received with errors related to the rate reduction credit.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. No. 107–16) directed the Secretary of the Treasury to issue advance tax refunds to eligible taxpayers. Accordingly millions of taxpayers received checks of up to $600 between July and December 2001. Taxpayers who did not receive an advance refund as part of that process or who received less than the maximum allowed by law may have been entitled to a rate reduction credit when filing their tax year 2001 returns in 2002. Accordingly, IRS added a line to the individual income tax forms for eligible taxpayers to enter a credit amount and provided a worksheet for taxpayers to use in determining if they were eligible. So far, during the 2002 filing season, the rate reduction credit has led to millions of tax returns with errors.

The result has been significant error-correction workloads for IRS and a large increase in the number of error notices sent to taxpayers. In retrospect, at least some of these errors might have been avoided if IRS had taken certain steps to better help taxpayers deal with this new tax return line item. One of the steps IRS took to deal with the large number of errors related to rate reduction credit was to reject certain electronic submissions involving rate reduction credit errors. Even so, electronic filing has continued to grow—although not at a rate that would allow IRS to meet its long-term goal.

Millions of Returns Filed with Errors Related to the Rate Reduction Credit

As Table 1 shows, of the approximate 46 million returns that IRS had processed as of March 15, 2002, about 4.7 million, or 10 percent, had errors made by taxpayers or their return preparers—more than twice the error rate at the same time last year but roughly comparable to the error rate IRS expected. Of the approximate 4.7 million returns with errors, about two-thirds, or 3.1 million, had errors related to the rate reduction credit.

TABLE 1: PROCESSED RETURNS WITH RATE REDUCTION CREDIT ERRORS MADE BY TAXPAYERS OR RETURN PREPARERS AS OF MARCH 15, 2002

Returns prepared by	Number of returns processed	Number of returns with errors	Percentage of returns with errors	Number of returns with rate reduction credit errors	Percentage of returns with rate reduction credit errors	Rate reduction credit errors as a percent of returns with errors
Taxpayers	17,778,234	2,638,705	14.8	1,506,932	8.5	57.1
Tax return preparers	28,172,854	2,042,626	7.3	1,613,689	5.7	79.0
Total	**45,951,088**	**4,681,331**	**10.2**	**3,120,621**	**6.8**	**66.7**

Note: Because some returns could contain errors related to the rate reduction credit as well as other errors, a decrease in the number of rate reduction errors would not necessarily equate to a like decrease in the overall number of returns with errors.
Source: GAO-generated from IRS data.

Taxpayers and return preparers are making various types of errors related to the rate reduction credit. Many taxpayers who did not receive an advance of their rate reduction credit in 2001 and thus should be claiming the credit on this year's return, are not. Other taxpayers are recording the amount of the credit they received in 2001 on the rate reduction credit line of this year's return instead of recording zero. And other taxpayers, who are entitled to a credit and are claiming one, are incorrectly computing the amount to which they are entitled.

Once IRS recognized that taxpayers and preparers were having problems with the rate reduction credit, it took immediate action in an attempt to minimize future errors and avoid refund delays. IRS posted information to its Web site, began a public awareness campaign that included news releases to media outlets, and provided clarifying information to preparers who file returns electronically. Despite IRS' efforts, the rate at which taxpayers and return preparers are making errors related to the rate reduction credit has remained relatively constant.

Because IRS anticipated an increase in errors this year and because IRS has been able to correct the rate reduction errors relatively quickly, we are not aware of any adverse impact on IRS' ability to process returns and refunds in a timely manner as a result of the increased error-correction workload. IRS is treating these errors as "math errors"; that is, it corrects the mistake and either adjusts the taxpayer's refund or notifies the taxpayer of additional tax owed. However, it remains to be seen what happens around April 15, when the largest volume of paper returns are filed. Even if IRS is able to effectively correct the large volumes of erroneous returns throughout the filing season, there are costs involved, including the cost of generating and mailing several million error notices to affected taxpayers and the costs of the resources IRS had to devote to working the increased error-correction workload.

IRS May Have Been Able To Prevent Some Rate Reduction Credit Errors

Although IRS took several steps after the filing season began in response to the large number of rate reduction credit errors, we believe, in retrospect, that some of those errors might have been prevented if the instructions for Forms 1040, 1040A, and 1040EZ had been more clear. For example, IRS did not highlight the rate reduction credit or the new line on the tax form related to the rate reduction credit on the cover page of the instructions, where IRS alerts taxpayers to changes from the prior year. Instead, IRS highlighted the fact that tax rates were reduced. Only if taxpayers read the paragraph under the highlighted caption “Tax Rates Reduced” would they see mention of the credit.

The instructions for Forms 1040, 1040A, and 1040EZ might have also been clearer if IRS had included some information that was included on its Web site. In that regard, the instructions indicate that if a taxpayer received—before any offset—an amount equal to either $600, $500, or $300 based on his or her filing status, the taxpayer is not entitled to a rate reduction credit. There is no further explanation of the term “before any offset”—a term that may be unclear to many taxpayers. However, IRS’ Web site spells out more clearly what is meant by this term, explaining that if taxpayers had their advance payment offset to pay back taxes, other government debts, or past due child support, they cannot claim the rate reduction credit for the amount that was offset. Although the Web site includes this more descriptive information, there is no guarantee that a given taxpayer either has access to or will use the Web site. In retrospect, including the same explanation of “before any offset” in the instructions would have made the instructions clearer.

Use of Electronic Filing Continues to Grow, but not at a Pace to Achieve IRS’ Long-Range Goal

Another step IRS took that has reduced its error-correction workload due to the rate reduction credit was to begin rejecting electronic submissions that involved certain types of errors related to the credit. By doing so, IRS required the taxpayer or return preparer to correct the error before IRS would accept the electronic return. This is consistent with IRS’ traditional practice of rejecting electronic submissions that contain other errors, such as incorrect Social Security numbers. IRS began rejecting electronic submissions with errors involving the rate reduction credit around the beginning of February. As of March 24, 2002, IRS had rejected about 226,000 such submissions.

We do not know whether these rejected submissions caused potential electronic filers to file instead on paper. However, as shown in Table 2, the number of individual income tax returns filed electronically as of March 29, 2002, has grown by 14.0 percent—an increase over the rate of growth at the same time last year. While this kind of increase is not insignificant, IRS will need larger increases in the future if it is to achieve its goal of having 80 percent of all individual income tax returns filed electronically by 2007.[12]

TABLE 2: INDIVIDUAL INCOME TAX RETURNS RECEIVED BY IRS

(Number of returns in millions)

Filing type	1/1/00 to 3/31/00	1/1/01 to 3/30/01	Percentage change: 2000 to 2001	1/1/02 to 3/29/02	Percentage change: 2001 to 2002
Paper	40.9	37.2	−9.1	35.5	−4.7
Electronic					

[12] As noted in our report on the 2001 filing season, assuming annual growth rates of 13.7 percent for individual income tax returns filed electronically and 1.85 percent for the total number of individual income tax returns filed (the growth rates experienced in 2001), about 60 percent of all individual income tax returns will be filed electronically in 2007. See U.S. General Accounting Office, *Tax Administration: Assessment of IRS’ 2001 Tax Filing Season*, GAO–02–144 (Washington, D.C.: Dec. 21, 2001).

TABLE 2: INDIVIDUAL INCOME TAX RETURNS RECEIVED BY IRS—Continued

(Number of returns in millions)

Filing type	1/1/00 to 3/31/00	1/1/01 to 3/30/01	Percentage change: 2000 to 2001	1/1/02 to 3/29/02	Percentage change: 2001 to 2002
Traditional [a]	21.4	24.0	12.3	26.9	12.1
On-line [b]	3.5	4.8	36.4	6.7	39.4
TeleFile [c]	4.4	3.7	−14.7	3.5	−6.6
Subtotal	29.3	32.6	11.2	37.1	14.0
Total	**70.2**	**69.7**	**−0.6**	**72.6**	**4.1**

Note: Subtotals, totals, and percentages may not compute due to rounding.

[a] Traditional electronic filing involves the transmission of returns over communication lines through a third party, such as a tax return preparer, to an IRS processing center.

[b] On-line returns are prepared and transmitted by the taxpayer through an on-line intermediary using a personal computer and commercial software.

[c] Under TeleFile, certain taxpayers who are eligible to file a Form 1040EZ are allowed to file using a toll-free number on touch-tone telephones.

Source: IRS data.

To encourage more electronic filing in 2002, IRS, among other things:

- mailed letters to about 250,000 tax professionals, asking those who had been filing electronically to continue supporting the program and encouraging others to file electronically;
- mailed about 23 million postcards to certain taxpayers, such as those who had received TeleFile packages in the past 2 years but did not file their tax returns via TeleFile, alerting them to the benefits of electronic filing; and
- made changes to one program that enabled electronic filers to sign their returns using a personal identification number (PIN) and reinstituted another PIN-based signature program.[13]

IRS also redirected its marketing efforts to encourage persons who have been preparing tax returns on a computer but filing on paper to file electronically. Considering that about 40 million computer-prepared returns were filed on paper in 2001, conversion of those returns to electronic filings could go a long way toward helping IRS achieve its 80-percent goal. In our report on the 2001 filing season, we recommended that IRS directly survey tax professionals and taxpayers who file computer-prepared returns on paper to get more specific information on why they are not filing electronically.[14] We have been told that IRS will be undertaking such a survey in the near future.

IRS Has Experienced Some Improvements in Telephone Service, but the Rate Reduction Credit Is Likely Affecting Taxpayers' Access

So far this filing season, taxpayers in the queue for telephone assistance are spending less time waiting to talk with an assistor and are getting accurate answers to their tax law questions more often than last year. At the same time, however, the overall rate at which callers are reaching an assistor is lower because many callers are unable to get into the queue for assistance.

Telephone assistance is a significant part of IRS' work. This fiscal year, IRS expects to answer about 108 million telephone calls, about 72 million to be answered via automated services and about 34 million to be answered by about 10,000 full- and part-time telephone assistors, called customer service representatives. Accordingly, the ease with which taxpayers reach IRS by telephone and the accuracy of the assistance they receive are important indicators of how well IRS is performing. IRS' performance in providing this service has been a perennial problem, and its struggles to improve service have been a topic at hearings held by this Subcommittee for many years. As we reported in December 2001, IRS has made limited

[13] IRS efforts to increase the use of PINs and thus avoid the need for electronic filers to send signature documents to IRS has had a positive effect. As of March 14, 2002, about 17.1 million individual returns were filed using a PIN—about 180 percent more than the 6.1 million filed for the same time period in 2001.

[14] GAO–02–144.

progress toward its long-term goal of providing taxpayers "world-class customer service"—service comparable to the best provided by other organizations.[15]

Some Improvements in Accessibility and Accuracy

In recent years, IRS has made significant strides in developing performance measures to tell how well it is serving taxpayers by telephone. IRS has established a set of measures to focus efforts on enhancing taxpayers' access to accurate assistance. As shown in Table 3, some of these measures indicate significant improvements in taxpayer service when compared to the same period last year. For example, during the first 11 weeks of the 2002 filing season:

- taxpayers, on average, waited a minute-and-a-half less to speak to an assistor,
- there was an 18 percentage point improvement in taxpayers reaching assistors in 30 seconds or less, and
- the quality of tax law assistance, which involves following IRS procedures and providing accurate responses, improved about 11 percentage points.

However, there was a 5-point decline in the percentage of callers that attempted to reach an assistor and actually got through and received service (referred to as the customer service representive (CSR) level of service). According to IRS officials, an increased demand for assistance related to the rate reduction credit has been a key factor affecting taxpayer access to assistors. (See Appendix I for more detail on the level of access this filing season compared to last and the likely impact of the rate reduction credit.) The increased call volume was not allowed to lengthen the queue. Instead, taxpayers were provided access to automated services, which often results in callers hanging up, or were advised by a recorded message that IRS could not provide assistance.

Table 3: Telephone Assistance Performance in the First Weeks of the 2001 and 2002 Filing Seasons

Measure [a]	**2001**	**2002**
Accessibility measures		
CSR level of service [b]	71%	66%
Assistor response level [c]	39%	57%
Abandon rate [d]	16%	13%
Average speed of answer [e]	299 seconds	209 seconds
Accuracy measures		
Tax law quality rate [f]	70% ± 2%	81% ± 1%
Accounts quality rate [f]	71% ± 2%	74% ± 2%
Tax law correct response rate [g]	75% ± 2%	84% ± 1%
Accounts correct response rate [g]	87% ± 2%	88% ± 1%

[a] Accessibility measures are based on actual counts from January 1 through March 16. Accuracy measures are based on representative samples and are estimated at the 90-percent confidence level from January through February.

[b] This measure is intended to show the percentage of callers who wanted to speak to an assistor that got through and received service.

[c] The percentage of callers that waited 30 seconds or less before speaking to an assistor.

[d] The percentage of callers that hung up while waiting to speak to an assistor.

[e] The average number of seconds callers waited before speaking to an assistor.

[f] The percentage of calls in which assistors followed all IRS procedures for the call type and provided correct answers.

[g] The percentage of calls in which assistors provided correct answers for the call type, discounting procedural errors.

Source: IRS data.

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

IRS Officials Attribute Improvements in Telephone Service to Several IRS Efforts

According to IRS officials, several IRS efforts have contributed to improvements in telephone performance. For example, IRS implemented a strategy to improve tax law accuracy that included hiring and training assistors earlier than in past years and putting them on the telephones in December to help hone their skills before the filing season began. IRS also required assistors to be certified that they successfully completed necessary training and could accurately answer calls in their assigned topics and used its computer-based call routing system to help ensure that assistors answered calls only in those topics for which they had been certified.

Some officials opined that improvements in accessibility may be linked to IRS' efforts to establish new performance measures and goals for the call sites this year. For example, each site has a goal for the total number of calls its assistors are to answer in a fiscal year. IRS officials say the new measures have led to improved performance by giving the call sites a clearer understanding of what they are expected to achieve and how their performance helps IRS achieve its goals. IRS executives in the Wage and Investment and Small Business/Self-Employed divisions said that they believe that IRS has been successful in getting employees at all levels of the telephone service organizations to understand and accept the measures and contribute to achieving the goals.

IRS officials cited several other service improvement efforts as potentially boosting performance, including initiatives to bring more highly skilled employees on board, increased specialization at the assistor and call site levels, and reduced hours of service to increase the number of assistors available to answer phone calls during the hours when most taxpayers call IRS. We will monitor these and other factors that may have affected IRS' telephone service as we continue to assess the 2002 filing season.

IRS' Performance Measures Provide Useful Information on Some Aspects of Its Telephone Service but Not on Others

Although IRS' telephone performance measures provide useful information on some aspects of service to taxpayers, the measures miss other aspects. For example:

- None of the measures currently reflect how many callers hung up while listening to the menu they hear when calling IRS—although IRS has that data. For example, as of March 16, 2002, according to IRS data, over 7.2 million callers had hung up when listening to the menu this filing season—almost three times greater than the number that hung up last year. IRS officials said it is unclear why more taxpayers were hanging up. However, when IRS streamlined the menu in mid-February, it noted a decline in the hang-up rate, which may indicate that taxpayers were frustrated or confused by the menu.
- Although IRS assists many callers through automated services—almost 18.2 million calls were answered by automation on the three main assistance lines and the TeleTax line as of March 2, 2002—IRS' measures only deal with the service provided by assistors.[16] IRS discontinued measuring the level of service provided through automation because this year's data are not comparable to 2001.[17]
- Contrary to what its name implies, the CSR level of service measure does not reflect only those calls handled by assistors. Some calls handled through automation are counted as having been answered in computing this measure.[18] Because it includes calls answered through automation, the CSR level of service measure may be overestimating the rate at which assistors are responding to taxpayers.

Because we recognize that it is important to limit the number of performance measures to the vital few, we are not recommending that IRS take any action at this time with respect to the matters discussed above. At your request, Mr. Chairman, we are reviewing IRS' filing season performance measures, including its telephone measures, and plan to issue a report later this year on our results.

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[16] TeleTax provides automated account information and recorded information on about 150 tax topics.

[17] At the beginning of the 2002 filing season, IRS made changes to the TeleTax system that allowed IRS to count abandoned calls, which, as of March 2, 2002, were about 31 percent of total TeleTax calls. Before the 2002 filing season, because IRS could not count abandoned calls, it assumed all calls into TeleTax were served.

[18] There were about 780,000 of these calls during the 2001 filing season.

IRS Is Measuring Tax Law Accuracy at Its Taxpayer Assistance Centers; Implementation of Two Other Accuracy Measures Has Been Delayed

Taxpayers who visit any one of IRS' 400 plus Taxpayer Assistance Centers (TAC) can make payments, obtain tax forms and publications, get answers to tax law questions, and get help resolving tax account issues and preparing tax returns. In the past, IRS has used its employees to measure the accuracy of tax law assistance provided by its TACs. In fiscal year 2002, IRS began using contract reviewers in lieu of its employees. Although the accuracy rate reported through mid-March 2002 is encouragingly high, the use of different measurement methodologies precludes valid comparison to the low accuracy rates reported by IRS and the Treasury Inspector General for Tax Administration (TIGTA) in 2000 and 2001, respectively. IRS had planned to begin measuring the accuracy of account and return-preparation assistance in January 2002, but those plans have been delayed until June.

Tax Law Accuracy Rates are Encouraging, but Cannot Be Compared to the Low Accuracy Reported in 2000 and 2001

Contract reviewers, posing as taxpayers, reported making 388 random visits to TACs between January 1 and March 15, 2002. During each visit, the reviewers asked two tax law questions from the slate of four questions that IRS developed for use this year. One question and a related scenario was developed from each of four tax law categories that most prompted taxpayers to call IRS' toll-free assistance lines in fiscal year 2001.[19] The contract reviewers reported receiving accurate responses for 652 of the 776 questions or 84 percent.[20] Although this could indicate that accuracy is improving compared to the low accuracy rates reported by IRS in 2000 (24 percent) and TIGTA in 2001 (51 percent), the use of different accuracy measurement methods in the last three filing seasons does not afford a valid basis for comparison. Although the results in each of the 3 years were based on visits to TACs by persons posing as taxpayers, there were differences in such things as the questions the persons asked, the number of weeks covered by the reviews, and the number of sites visited and how they were selected.

Implementation of Account- and Return-Preparation Accuracy Measures Has Been Delayed

IRS had planned to begin measuring the accuracy of account- and return-preparation services provided by TACS in January 2002. However, according to field assistance officials, staffing of eight new positions for doing these reviews was initially delayed by an oversight in the announcement process and then by a hiring freeze. Officials now expect to fill the eight positions by June 2002, which, they believe, will still allow time to complete enough quality reviews to establish meaningful fiscal year 2002 baselines for both measures. According to the Director, Field Assistance, the new staff would first complete post-reviews of returns prepared during the filing season. Because most account assistance occurs after the filing season, they would then begin reviewing the accuracy of account assistance provided over the remainder of the year.

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

Appendix I

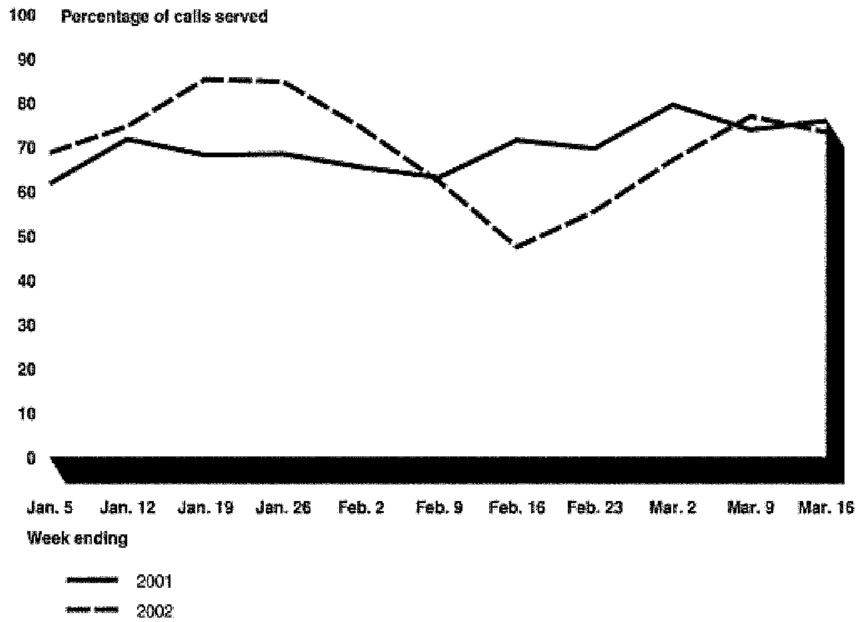
Increased Demand Related to the Rate Reduction Credit Has Likely Affected Accessibility

As noted earlier, despite some significant improvements in telephone service, the customer service representative (CSR) level of service as of March 16, 2002, was lower than at the same point in time last year. The week-to-week comparisons in Figure 1 show that CSR level of service during the first 6 weeks of this filing season was significantly better than or about the same as during the first 6 weeks of the 2001 filing season but was significantly worse during the next 3 weeks. In the following 2 weeks, CSR level of service returned to levels comparable to last year's performance.

[19] Field assistance is using the toll-free database to identify these categories until such time as it has its own database of the tax law categories causing the most questions from TAC customers.

[20] We have not assessed these results or the methodology being followed by the contract reviewers.

Figure 1: CSR Level of Service in the First 11 Weeks of the 2001 and 2002 Filing Seasons



Note: Beginning the week ending March 2, IRS revised its formula for calculating CRS level of service for both 2001 and 2002. Data in the graph prior to March 2 are based on the previous formula. Our analysis of IRS data showed the change had positive but minimal impact on the values, averaging 0.6 percent but never more than 1.89 percent.
Source: IRS data.

According to IRS officials, a key factor that may be negatively affecting telephone accessibility this year is an increase in the demand for assistance, specifically demand related to the rate reduction credit. According to IRS officials, demand was lower than expected in January 2002, which contributed to an increase in level of service. However, as the filing season progressed, demand for assistance related to the rate reduction credit increased significantly and unexpectedly. IRS officials said that taxpayer access to service began declining in early February as more taxpayers called in response to publicity about the filing problems related to the rate reduction credit and as taxpayers began receiving error notices from IRS. IRS data on the amount of demand for telephone assistance generated by the rate reduction credit is incomplete, and, therefore, the effect on telephone level of service is uncertain.

Chairman HOUGHTON. Thanks very much. Ms. Kelly.

STATEMENT OF COLLEEN M. KELLEY, NATIONAL PRESIDENT, NATIONAL TREASURY EMPLOYEES UNION

Ms. KELLY. Thank you. Chairman Houghton, Ranking Member Coyne and Member Thurman, as the National President of the National Treasury Employees Union (NTEU), representing over 97,000 IRS employees, I very much appreciate having the opportunity to appear before you today.

The past 7 months have been a very trying time for the American public. Never before has it been so clear how vulnerable our Nation is to a variety of attacks. And never before has the need to invest in a highly trained, highly skilled, and dedicated Federal workforce been so clear.

There are nearly 20,000 fewer employees at the IRS today than there were just 10 years ago. But as the size of the IRS workforce has decreased, the workload has grown and become more complex.

The number of total tax returns filed each year continues to increase, and the Tax Code continues to undergo congressionally mandated changes. The good news is that the American taxpayers are receiving better service from the IRS and this past filing season has improved even further on that service to taxpayers.

Unfortunately, it is no coincidence that the examination coverage of tax returns has declined during this same period, due to decreased staffing and increased workloads. NTEU urges your support for increased funding for the IRS in the fiscal year 2003 budget so that the workforce has the resources necessary to continue to perform current operations while simultaneously meeting its modernization goals.

Unless funding or staffing levels are increased, the IRS will not be able to increase tax compliance and enforcement activity while at the same time continuing to improve customer service to taxpayers.

In addition to increased staffing and funding for the IRS, I would also like to make some additional recommendations that will help to improve the efficiency and the effectiveness of the IRS.

As we all know, audit rates and tax compliance are down. One reason is lack of staff. Another is Section 1203 of the IRS Restructuring and Reform Act which has had a chilling effect on the ability of the IRS employees to do their jobs.

Employees continue to work in fear of Section 1203, commonly known as the 10 Deadly Sins. The Administration's fiscal year 2003 budget endorsed a package of proposals that includes changing the mandatory termination provisions of Section 1203 to allow the IRS Commissioner to provide appropriate discipline for offenses, up to and including termination.

The President, the Secretary of the Treasury, Commissioner Rossotti, the IRS Oversight Board, and NTEU all agree that this package of changes will make Section 1203 fairer. NTEU is very appreciative of the efforts of this Committee and all of you for the modifications that were included in H.R. 3991, the Taxpayer Protection and IRS Accountability Act of 2002. Without your help, I know that those changes would not have been included in H.R. 3991.

In addition to changes to Section 1203, NTEU urges this Subcommittee to reject the Administration's competitive sourcing initiative which sets arbitrary quotas for the IRS and other Federal agencies to open up thousands of jobs to the private sector.

The Office of Management and Budget has directed every agency to open up to the private sector in fiscal year 2002, 5 percent of the work on the Fair Act inventory list and an additional 10 percent in 2003 with a final goal of 50 percent.

The arbitrary privatization quotas are wrong. The one-size-fits-all quotas give no consideration whatsoever to unique circumstances at agencies like the IRS who are still in the middle of a sweeping reorganization that was mandated by Congress.

And this directive is having a negative impact on the morale of the IRS workforce. Contracting out government work does not in and of itself improve government operations. For example, last year we learned that Mellon Bank, a contractor hired by the IRS, lost or shredded 70,000 tax returns and checks worth $1.2 billion in tax revenues for the government.

Fortunately, that contract has been terminated by the IRS. But we urge this Committee to reject the use of these quotas so that the IRS can focus on achieving its mission in the most reliable, most cost-effective and efficient manner.

And finally, recent changes in the estate and gift tax laws will lead to fewer estate and gift tax attorneys, because there will be fewer returns filed each year. This will mean that most of the estate and gift tax attorney jobs at the IRS will be eliminated over the next 10 years. All of the attorneys who work on estate and gift tax returns at the IRS are in what is called excepted service, and as a result, they are not eligible to transfer into other competitive service jobs even within the IRS, which would be an excellent redeployment of resources similar to what Commissioner Rossotti already testified to.

NTEU urges this Subcommittee to work to retain these valuable employees who bring a wealth of experience to the IRS by providing them with competitive service status so that they are given fair opportunities to transfer to other jobs in the Federal Government.

The bottom line is that IRS employees are committed to delivering first class customer service to the taxpayers, and they are committed to enforcing the Tax Code in a fair manner. But without some important changes, including adequate funding, they will continue to have a difficult time meeting these goals.

And I thank you again for the opportunity to be here and look forward to any questions you may have.

[The prepared statement of Ms. Kelly follows:]

Statement of Colleen M. Kelley, National President, National Treasury Employees Union

Chairman Houghton, Ranking Member Coyne, and other distinguished Members of this Subcommittee, my name is Colleen Kelley and I am the National President of the National Treasury Employees Union. As you know, NTEU represents more than 150,000 Federal employees across the Federal Government, including the men and women who work at the Internal Revenue Service. I want to thank you for giving me the opportunity to present testimony on behalf of these dedicated employees who play such a vital role in maintaining and strengthening our democracy.

The past seven months have been a very trying time for the American public. Never before has it been so clear how vulnerable our nation is to such a wide variety of attacks. And never before has the need to invest in a highly trained, highly skilled, dedicated Federal workforce been so clear. If any American didn't appreciate the national value of our Federal employees before the tragic events of September 11th, then they sure recognize their work now. Our Nation depends on these patriots who work for the Federal Government.

That is why it is incumbent upon Congress and the Administration to ensure that the dedicated employees who perform these vital functions for America day in and day out—during times of war and times of peace—have the tools and resources they need to do their jobs.

There are nearly twenty thousand fewer employees at the IRS than there were just ten years ago. But as the size of the IRS workforce has decreased, the workload has grown and become more complex. For example, in 1988, 140 million tax returns were filed; in 2002 the IRS expects to receive 231 million returns. In 1999, taxpayers contacted the IRS for assistance approximately 117 million times, up from 105 million contacts in 1996.

And in 2001, IRS employees responded to new challenges, first expeditiously issuing millions of tax rebate checks and answering record numbers of phone calls related to the rebate. Then after the tragic events of September 11th, employees worked to provide administrative relief to the victims and their families, and worked to foster taxpayer giving to charitable organizations.

Yet, even as the number of total tax returns filed each year continues to increase and the tax code continues to undergo sweeping changes from Congress, the American taxpayers are receiving better service from the IRS. Unfortunately, it is no coincidence that examination coverage of tax returns has declined during this period of staffing cuts and increased workloads. Unless the downward trend in staffing levels is turned around, the IRS will not be able to increase tax compliance and enforcement activity, while continuing to deliver better services to the taxpayers.

In addition to increased staffing at the IRS, NTEU would like to make some additional recommendations to this Subcommittee on how Congress can help improve the efficiency and effectiveness of the IRS workforce.

One issue in particular that has had a chilling effect on the ability of IRS employees to do their jobs is Section 1203 of the IRS Restructuring and Reform Act. As mentioned earlier, audit rates are down. One reason is the lack of staff; another is Section 1203, which I believe has also contributed to the declining rates of audits and tax compliance. IRS employees continue to work in fear of Section 1203. Commonly known as the "Ten Deadly Sins," Section 1203 outlines ten infractions for which IRS employees must be fired. One of those infractions is the untimely filing of Federal income taxes even when a refund is due.

The Administration's FY 03 budget endorses a package of proposals that includes changing the mandatory termination provisions to allow the IRS Commissioner to provide appropriate punishment for offenses, "up to and including termination." In its budget request, the Administration noted that an IRS employee who fails to file a refund return is subject to termination even though any other taxpayer who files a refund return late is not subject to any penalty.

NTEU is very appreciative of the efforts of Members of this Subcommittee in supporting an amendment to include modifications of Section 1203 in H.R. 3991, the "Taxpayer Protection and IRS Accountability Act of 2002." We are hopeful the full House will vote on this legislation soon, and that Members of this Subcommittee will continue to press for these changes until they are signed into law.

The President, the Secretary of the Treasury, the IRS Commissioner, the IRS Oversight Board and NTEU all agree that this package of changes would make Section 1203 fairer. Violations of any of the ten offenses should be taken seriously, but mandatory termination in every instance should not be the only disciplinary action available. No other Federal or congressional employee is subject to similar mandatory termination and fairness demands that IRS employees not be subject to this uniquely harsh standard.

In addition to changes to Section 1203, NTEU also seeks more funding for the IRS for staffing and modernization. Unfortunately, the Administration's budget for FY 2003 does not provide the IRS with the resources necessary for the Service to continue to perform current operations, while simultaneously meeting its modernization goals. Because the IRS continues to redirect employees from tax compliance functions to help with customer service, including answering taxpayers' questions, and providing walk-in assistance to taxpayers, the Administration's budget comes up far short.

While the Administration's $10.4 billion request for IRS operations may appear to be slightly higher than last year's funding level, the funding is essentially flat in "real" dollar terms because of a budget gimmick suggested by the Administration, that would, for the first time, require agencies to pre-fund future retiree health and retirement costs from current appropriations. Fortunately, both the House and Senate Budget Committees rejected the Administration's proposal. Furthermore, the budget ignores the need to hire enough additional employees to stop the decline in audits and enforcement activities. And the budget fails to provide enough funds for additional equipment and better training for the employees.

Improving customer service, enhancing tax return processing, and increasing tax compliance can only happen if the Administration and Congress support increased funding for staffing, more advanced technology and equipment, and better training. Employees at the IRS have responded to the mandates from Congress in the IRS Restructuring and Reform Act and are making tremendous progress. However, the current IRS workforce can only do so much with its limited resources.

Next, NTEU urges this Subcommittee to take steps to reject the Administration's "competitive sourcing" initiative which sets arbitrary quotas for the IRS and other agencies to open up thousands of Federal employee jobs to the private sector. The Office of Management and Budget has directed every department and agency to open up to the private sector in fiscal year 2002 the work of five percent of the Federal jobs on their FAIR Act inventories and an additional ten percent in FY 2003. The Administration will be directing agencies and departments to ultimately open up to the private sector fifty percent—more than 425,000—of these Federal jobs considered commercial in nature.

The arbitrary privatization quotas will significantly disrupt operations at the IRS, which, as you know, is in the middle of its sweeping reorganization plan. The one-size-fits-all quotas give no consideration whatsoever to unique circumstances at the IRS or other agencies. And we know this directive is already having a negative impact on the morale of the IRS workforce.

Contracting out government work does not, in and of itself, improve government operations. In fact, NTEU believes that in most cases, the taxpayers lose when government work is contracted out. For example, last year we learned that Mellon Bank, a contractor hired by the IRS, lost, shredded, and removed 70,000 taxpayer checks worth $1.2 billion in revenues for the government. Fortunately, the IRS eventually terminated the contract and is conducting an investigation to determine the level of criminal wrongdoing. However, this issue begs the question, "how could we let this fraud go on for so long—70,000 lost checks—before we realized there was a problem?" The answer is quite simply that Congress and the Administration have never put in place reliable government-wide systems or provided adequate staffing to track the work of contractors. There is nowhere near the same level of transparency and accountability of the work performed by contractors as there is of the work performed by Federal employees.

NTEU believes the Administration's contracting out quotas will lead to more contractor waste at the IRS and other agencies. We urge this Subcommittee to reject the use of these arbitrary quotas so that the IRS can focus on achieving its mission in the most reliable, cost effective, and efficient manner.

Finally, NTEU urges this Subcommittee to take steps to correct an issue affecting estate and gift tax attorneys at the IRS. All of the attorneys who work on estate and gift tax returns at the IRS are in the "excepted service." Regular competitive civil service hiring procedures do not cover positions in the excepted service. As a result, estate tax attorneys are not eligible to be transferred to other competitive service jobs, even within the IRS. So even though they have the expertise and qualifications to work on trusts, partnerships, or countless other jobs at the IRS, because of their "excepted service" status, if their jobs are eliminated they will be treated as any other outside job seeker.

Recent changes in the estate and gift tax laws will lead to fewer estate and gift tax returns filed each year, which will mean that most of the estate and gift tax attorney jobs at the IRS will be eliminated over the next ten years. These employees bring a wealth of experience to the IRS and are real assets to the Federal Government. NTEU urges you to provide competitive status for estate and gift tax attorneys so that these valuable employees are given fair opportunities to transfer to other jobs in the Federal Government.

In closing, I have outlined just some of the areas where I believe Congress can help to make improvements at the IRS. IRS employees are committed to delivering first-class customer service to the taxpayers and they are committed to enforcing the tax code in a fair manner. But without some changes, they will continue to have a difficult time meeting these goals. The full benefits of a more efficient, more effective and higher performing IRS workforce will not be realized unless Congress and the Administration provide more funding and more staffing, and remove many of the barriers to improving morale and productivity at the IRS.

I thank you for holding this important hearing today, and I would be happy to answer any questions you may have.

Chairman HOUGHTON. Thank you very much, Ms. Kelly. I would like to ask Mr. Coyne if he would like to inquire.

Mr. COYNE. Thank you, Mr. Chairman. Mr. White, according to IRS statistics, more than 20 percent of callers to the IRS received legally incorrect answers to tax questions.

Why, in your judgment and your agency's judgment, is this happening?

Mr. WHITE. This has been a longstanding problem at IRS, not just the accuracy of the answers but also the access to the telephones. This year service on the accuracy side has actually improved considerably compared to last year. You are correct, they still have a long way to go. And I think essentially it is a matter of better management across the board. One issue we found, for example, is that managers of telephone assistance often miss opportunities to evaluate the performance of their own operations. And the advantages of doing those kind of evaluations mean that they get a better understanding of the reasons for performance. And armed with that understanding of the reasons for performance, then they would be in a better position to take actions to improve performance in the future.

Mr. COYNE. Ms. Kelly correctly points out that there is 20,000 fewer employees at the IRS currently. In your agency's assessment of the operations of the IRS, is that a contributing factor to some of the problems that still exist?

Mr. WHITE. It is undoubtedly a contributing factor. The question is the extent to which it contributes. As I indicated, there is an issue of how well you are managing the resources you have, as well as the question about the level of the resources. And right now, because of those missed opportunities to evaluate the reasons for performance, we don't have and IRS does not have as good an understanding of the reasons for the performance right now as you would like to have.

Mr. COYNE. I find it quite strange that the EITC has a separate allocation for its performance. And you ask why—you let us know that we should ask the Commissioner about that or ask someone at the IRS about that. What is your idea about why that exists? What have you been able to find out about why that separate allocation exists?

Mr. WHITE. Well, I don't know the history. I know it has existed for the last 5 years. So this—the continuation that is requested now would be the 6th year of this separate allocation. And I think it does raise the question, given the compliance issues that are there across the board, why for this one area of compliance there is a separate appropriation. And that is the reason why we felt the Subcommittee might want to ask IRS if they see any advantages to the separate appropriation.

Mr. COYNE. Now you don't in your examinations find any good reason for it?

Mr. WHITE. We don't have a position one way or the other on it. We did think the Subcommittee might want to ask IRS whether they see any advantages to combining all of the compliance appropriations into one appropriation.

Mr. COYNE. Ms. Kelly, are you confident that the taxpayers will be protected from any, quote, bad apples at the IRS under the Taxpayer Rights Bill scheduled for floor action this week?

Ms. KELLY. Yes. I am very confident of that. I believe that the issues that are on the list to be amended in Section 1203, for example, are all issues that identified behavior that was unacceptable of IRS employees before the restructuring act was ever passed. They were serious offenses, and when they were identified, they were dealt with appropriately.

The problem with Section 1203 is it just allows no consideration, if you will, of any alternative discipline should the Commissioner deem that to be appropriate. It is an automatic proposal to termination. And the mere threat of that is what is having the chilling effect on employees. But I do believe that it will be, as it was before Section 1203, appropriately administered by the IRS.

Mr. COYNE. Under the current regulations, and since the implementation of the restructuring, how many employees have been fired under current law?

Ms. KELLY. There have been very, very few. I could not even give you an exact number. I am sure that Commissioner Rossotti could because he tracks this very closely. The bottom line is there have been very few. That is because of the way in which Commissioner Rossotti, as the Commissioner, has implemented the language of Section 1203.

But the problem, if you step back from the termination, is the mere threat. And the threat itself has been issued to over 1,200 employees who were accused of something that proved to have no merit to it. But the mere fact that they were under an allegation let them know that they would face termination unless they could prove the allegation false. That is a terribly frightening threat to live under.

Now, as I said, Commissioner Rossotti has been very level-handed about this and has gone to great lengths, I think far and above what he had to do, which NTEU and IRS employees really appreciate.

But with that language in there, if someone else were the Commissioner and chose not to do it, did not make it a priority on behalf of employees, it could have a devastating effect.

Mr. COYNE. I had asked Mr. White earlier about the incorrect information that was going out to taxpayers. What do you think of this problem? Why do you think that incorrect information is being disseminated?

Ms. KELLY. I think there is not any one easy answer. I think it is about staffing. I think it is about training. I think it is about the ability of front line managers to interact with employees. I think it is about steps the IRS has taken successfully, but with more work that needs to be done to be able to direct phone calls to employees who are specifically trained on an issue.

That is an ideal situation, if every taxpayer calls with one question so they can be routed to an employee who has had that specific training. Very few taxpayers call with only one question, they often have a variety of questions. And sometimes, that could lead to error that employees want to correct through more training. They want nothing more than the reports to show a high accuracy rate and accountability and dependability.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Thank you, Mr. Coyne. Mrs. Thurman.

Mrs. THURMAN. Thank you, Mr. Chairman. And thank both of you for being here today. Mr. White, were you at all surprised by this *New York Times* article at all, as far as “Poorly Aimed Audits” is the name of one of them? This was the one that talked about—gosh, what did I do with it? I love it when my Chairman comes to my rescue.

Wealthy taxpayers avoiding IRS despite warnings that cheating is on the rise. Does that surprise you at all?

Mr. WHITE. I don't know that I have enough information to be surprised or not. One of the fundamental problems with IRS in the compliance area, and one they are working very hard to address, is the lack of information about compliance. So they have a national research program underway right now which, if successfully implemented, should give them much better compliance information than they have had for a decade and a half. And with that kind of information, they will be—they will have a much better sense of what is going on with different categories of taxpayers and how well they are targeting noncompliance in those different groups.

Mrs. THURMAN. Okay. I noticed on your report on page 8, you basically talk about, there is an example of missing performance goals, involves IRS efforts to address major areas of systematic noncompliance. Is there something that we can do congressionally or through the bill that may be up today or tomorrow that we are not doing that we could have helped in bringing these performance goals into reality for the IRS or to help us to track what is going on?

Mr. WHITE. I think the main thing is continued oversight, hearings like this, attention to IRS' budget, and demands to see linkages between the resources that IRS is requesting for particular areas of their operation and the results they expect to get. And they are getting better at developing those linkages. But they are not there in the compliance and collection area yet.

I gave as an example telephones where they are asking for additional money this year, and in the performance plan they showed that that should increase accessibility by 5 percent. That is the kind of linkage that would be helpful.

Mrs. THURMAN. Okay. So then if we have a hearing next year at the same time, we should be asking did you have that 5 percent or better compliance?

Mr. WHITE. Yes. Exactly. It is a method that can be used to hold them accountable for performance. Up front they tell you what performance should be expected given the resources they are going to get. And then they can be held accountable for that.

Mrs. THURMAN. Ms. Kelly, I notice that you were pleased with some of the changes that we have made in the bill for tomorrow on the floor. Are there some other suggestions you would have given based on—I know you also talk about the morale at the department, what is going on because of all of the people that are gone. Also, then you hear about not getting the right answers to taxpayers, those kinds of things.

Are there some other things that we should have been doing that would have also been beneficial to the taxpayers that would have also solved some of these problems?

Ms. KELLY. You know, in my experience both as the National President of NTEU, but also as a former revenue agent—I was a revenue agent in Pittsburgh for almost 15 years for the IRS. So my answer to that is really not about legislation, but it is more about the message that is sent by Congress on the support that they provide to the agency. And over the past couple of years that has definitely been a positive one. It is an important message for taxpayers to hear, to know that not because you are going to rubber-stamp everything that the IRS does, but that you are supportive of its mission, acknowledge it as a respected institution, and are going to provide it with the resources it needs to do the tax collection work that our country needs to be done.

So I think that message is important for taxpayers, but it is also important for employees. On the heels of the Senate hearings back in the late 1990s, employee morale was in a very bad place because they felt very unsupported, unvalued in the work that they were striving to do every day. So that would be the one thing that consistently I know employees watch for, whether it is in newspaper articles or in statements made from congressional offices, it is very important.

Mrs. THURMAN. Ms. Kelly, also you talked about the outsourcing a little bit here. And I am curious. And you said that the Mellon Bank actually was—I guess basically terminated their contract. Do you know of any things that we—that IRS has done to eliminate this kind of a problem if they were continuing to do the outsourcing or could we see some more of these kinds of things take place? Have you seen any changes?

Ms. KELLY. I actually have not seen many changes. But I would say it is not just about the IRS. The oversight and accountability of contracts that are let by the Federal Government are something that I believe, and NTEU believes, needs much more accountability and oversight. And I think we need to focus on this more and more as the Administration's initiative to competitively source more work to outside contractors is implemented. What will the accountability be, what will the oversight be, what will the requirements be of the contractor versus what they would be of Federal employees?

There is legislation pending that addresses all of those things. The Truthfulness, Responsibility, and Accountability in Contracting (TRAC) Act is one of the things out there that would put more accountability in place, and I think would support agencies in their interests in overseeing better the contractors. I can tell you I am taking a very personal interest these days in what kind of oversight does exist in all of the Federal agencies. And, in my opinion, it is not where it needs to be. And that is in large part because there is not a requirement for it through any kind of legislation and I am hoping that will change in the future.

Mrs. THURMAN. What do you think the objective of outsourcing was? And have we met that objective? And maybe Mr. White can tell us also in looking at the IRS.

Ms. KELLY. I really don't know what the objective was. What many will say is that the object is to see if the work can be done cheaper by someone other than Federal employees. I believe that if Federal employees are provided with the resources, the support and the encouragement to do the work, there is no one who can do the work of the Federal Government better than Federal employees, and them having the opportunity to do that is something that has to be there.

I have heard it is about cost, that is about the only thing that I hear. And in some cases that doesn't prove to be the case. It might start off cheaper, but very shortly ends up being more expensive. Then it is very difficult to bring the work back into the Federal Government. You don't hear many stories about work coming back in, only going out.

Mrs. THURMAN. Explain this to me. It said, for example, last year we learned that Mellon Bank, a contractor has lost, shredded and removed 70,000 taxpayer checks worth 1.2 billion in revenues for the government. I am not sure I understand what that means.

Ms. KELLY. The contractor was serving as a lockbox operation for the IRS and the Finance Management Service, and taxpayers were mailing their tax payments in to Mellon Bank. And the records as well as the payments—in the numbers that I identified in my testimony—disappeared. Employees of the contractor were shredding returns, removing them from the work place, destroying them. I never interviewed the contractor or the employees. But all of the reports talked about employees of the contractor doing this, I guess because they either couldn't get the work done or didn't choose to do it. So they were just disposing of the work.

Mrs. THURMAN. So we could have then lost like $1.2 billion.

Ms. KELLY. Yes.

Mrs. THURMAN. Mr. White, do you know what that contract was worth to the Mellon Bank, what they were paid?

Mr. WHITE. We have some work that we are doing at the request of the Senate Finance Committee looking at the management of IRS' lockbox program, the entire program. We have started that work, but we are not finished developing our findings. So I will be in a better position to answer that question when we are done with that work.

Mrs. THURMAN. Mr. Chairman, I would hope that, and Mr. White, I will certainly hopefully stay in contact with the Senate Finance, but I think that would be very important for us to understand and know. Because $1.2 billion is a lot of money, in my book. Plus we don't know how much money we were paying outside just for this contract in itself. So not only is it the $1.2 billion, but it is also what the costs might have been for them to have this contract. And so I think that is a very important area for us to look at as we move on and listen to more of this lockbox area.

Mr. WHITE. I don't believe that the $1.2 billion was lost. I believe that IRS became aware of the situation and is aware of the taxpayers that were affected. This occurred last filing season and they took some steps to deal with the problem then. As I said, I will have more details when we are done with this work that we are doing with Senate Finance.

Mrs. THURMAN. We appreciate that. Thank you very much.

Chairman HOUGHTON. Thanks, Mrs. Thurman.

I think one of the reasons that I suggested that Mr. Rossotti come back is because there are certain things that are going on that he has put into place and we would like to get a measure of them before he leaves. And I think what you said, Mr. White, is true. It is the linkages between the resources and the management here. What they are—as a matter of fact, it is sort of difficult for this Committee because you got different layers. I mean the IRS reports to Treasury and obviously they give them the signals. And then on top of that you have the IRS Oversight Board which Larry

Levitan is the head of, and then our board. And we don't want to sort of superimpose our own feelings, but we ought to know and we have got to be able to have those linkages and understand it very clearly before the next person comes on.

Let me just move off here, because there are two issues. One is the internal issue and the other is the external issue. Internally, are we dancing as well as we know how? That is what we keep talking about. The other thing is—that I am worried about is that as you look out over the next hill, you can see more and more opportunities to go overseas or to expand the international market. That is going to make it very difficult. So the question, I think, for you, Mr. White and Ms. Kelly, as we look at that, are we structured properly? Because there is going to be more emphasis on this than ever, next year, the year after, the year after. Or, is this just going to be a matter of better electronic equipment or more employees? Tell us a little bit about that, the structure versus just more resources.

Mr. WHITE. IRS has reorganized itself to focus on individual taxpayer groups. That is one important aspect of their overall modernization effort. That part has been implemented. There are a number of other aspects to the overall modernization effort that are still ongoing. For example, information systems modernization is another key aspect. Also, performance management and improving performance management are key aspects of IRS' structure and how well they are able to manage themselves. They have made some progress in that area. They still have a lot more to do to develop measures that will be useful both internally for management purposes and outside for purposes such as this, oversight purposes.

Chairman HOUGHTON. Would you like to make a comment, Ms. Kelly?

Ms. KELLY. I believe that the structure that is in place now with LMSB for the large and mid-size businesses and small business and self-employed, those two divisions will need to coordinate and communicate very effectively so that what you described that is most likely to happen doesn't get lost between the divisions and functions. And that is from a structure standpoint.

From an employee standpoint, I believe that employees of the IRS are highly trained, accountants by education, and they are very interested in looking at more complex issues. They would welcome the opportunity, as they are with the partnerships that Commissioner Rossotti talked about, and in the complex partnership schemes that we are seeing. But I also believe that it is going to be about staffing and it is going to be about the right training and identification of issues.

The IRS has recently started looking at a number of processes, one of which is the examination process. And they have a project that NTEU is working jointly with them on called examination reengineering. It is looking at just this. Moving employees, their audit skills as well as their training and technical tax skills into areas to be able to do the partnership schemes that didn't exist 10 years ago, and as they will exist in the future with the international schemes you described.

So I think employees are very up to the challenge. I think that the structure, as long as the communication continues, will support it.

Chairman HOUGHTON. Okay. Any other questions? Thank you very much. It has been very helpful testimony. And we hope to see you again. Thank you.

Now I would like to call the next panel, the last panel. There are four panelists. James Dougherty, Chairman, Relations with the IRS Committee, American Institute of Certified Public Accountants; Mark Ernst, President and Chief Executive Officer of H&R Block. Welcome back, Mr. Ernst. Roger Harris, President of the Padgett Business Services in Georgia, and Chair of the Legislative Affairs Subcommittee of the National Association of Enrolled Agents; and William Stevenson, President of the National Tax Consultants in Merrick, New York, and Chairman of the Federal Taxation Area, Right to Practice Committee, and also the National Society of Accountants in Virginia.

So thank you very much for coming. And maybe, Mr. Dougherty, you would like to begin your testimony.

STATEMENT OF JAMES A. DOUGHERTY, CHAIRMAN, RELATIONS WITH THE IRS COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. DOUGHERTY. Thank you.

Mr. Chairman and Members of the House Ways and Means Subcommittee on Oversight, the American Institute of Certified Public Accountants (AICPA) thanks you for the opportunity to appear here today. I am James Dougherty, Chairman of the AICPA, Relations with the IRS Committee. The AICPA is a national professional organization that certifies public accountants with over 350,000 members.

Before discussing the feedback we have received about the 2002 filing season, we would like to urge Congress to support full funding of the Internal Revenue Service fiscal year 2003 budget.

The AICPA has long advocated funding levels that would allow the IRS to efficiently and effectively administer the tax laws and collect taxes. Without sufficient funding, taxpayers and practitioners will encounter unnecessary problems and frustrations. The American taxpaying public is just beginning to benefit from the Internal Revenue Service that the Congress envisioned when it passed the 1998 IRS restructuring legislation.

While the preliminary results are promising, it is critical that Congress move the reform process ahead without delay by providing the necessary funding. As regarding the 2002 filing season, the IRS has implemented a number of improvements in the electronic filing program for 2002 filing season.

The AICPA especially appreciates nearly all 1040 forms and schedules have been made available to electronic filing; two, the electronic filers are no longer required to use a paper signature document and, three, the electronic payment options have been expanded. Similarly, the IRS has expanded electronic filing options for business taxpayers over the last year.

The AICPA looks forward to being a positive partner in the electronic filing system and to that end has recently formed a task force. We appreciate the many hurdles on the roads to achieving the goals established by Congress for the electronic filing program. For example, last year's struggles to implement the mandated electronic filing of large partnerships ought to provide a road map of things to avoid in future implementations. The IRS and its constituency can improve significantly on future electronic initiatives, but only through collaboration with critical stakeholders, collaboration that begins early and which is taken seriously by the agency.

On March 9, 2002, President Bush signed into law the Job Creation and Workers Assistance Act. The retroactive provisions of the 2002 act have contributed significantly to making this a difficult filing season for taxpayers and practitioners. Some provisions that have been problematic are, one, an additional first-year depreciation deduction equal to 30 percent for qualified property purchased after September 10th, 2000; and two, an extension in the general net operating loss carry back for 2 to 5 years. In order to take advantage of the depreciation and Net Operating Loss provision, many taxpayers and practitioners found it necessary to file extensions on business returns otherwise due on March 15, 2002.

Also we expect to see more individuals file on extensions as well as many taxpayers will have to consider amending returns that they already have filed. The IRS has done a commendable job in releasing guidance and tax forms on 2002 tax law. Nevertheless, we believe Congress should remain cognizant of the difficult task it imposed on the Service as a result of complex and constant changes in the law, particularly with respect to effective dates that do not permit adequate time to adjust.

Advance consultation with the IRS and the practitioners could do much to improve the quality and administration of our tax laws. The IRS announced a few months that the taxpayers and practitioners could obtain employer identification numbers (EINs) by calling one toll-free number or they could fax requests 24 hours a day, 7 days a week. Similarly, the IRS announced last fall to the practitioners hotline program changes that were made effective January 2002.

Since the implementation of these changes were announced, two very important administrative programs, taxpayers and practitioners have experienced significant busy signals with the toll-free numbers involved as taxpayer demand has exceeded the IRS capacity to answer these calls.

While the IRS has announced steps to address these problems, we must point out the extreme urgency in fixing the EIN and the practitioner hot line programs.

During the filing season, the AICPA has received numerous complaints from certified public accountant (CPA) members who have encountered problems in obtaining taxpayer account information from the IRS. This appears to be a direct result of the IRS difficulties with computer modernization and its inability or effect on IRS when trying to access taxpayers accounts.

This a clear contrast to the ability of financial institutions to access customer financial transactions immediately based on up-to-the-minute data, regarding the customers.

The IRS must continue to foster access to taxpayer account information through improvements in telephone services and by making secure Internet access available, with the ultimate goal of providing one-stop shopping for taxpayers so they can resolve the tax accounts in a timely, efficient way.

The AICPA appreciates this opportunity to offer our comments to the Subcommittee and would be happy to discuss any of these matters in further detail with you.

[The prepared statement of Mr. Dougherty follows:]

Statement of James A. Dougherty, Chairman, Relations with the IRS Committee, American Institute of Certified Public Accountants

Mr. Chairman and Members of the House Ways and Means Subcommittee on Oversight, the American Institute of Certified Public Accountants thanks you for the opportunity to appear before you today. I am James A. Dougherty, Chair of the AICPA's Relations with the IRS Committee. The AICPA is the national, professional organization of certified public accountants comprised of more than 350,000 members. Our members advise clients on Federal, State, and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses. It is from this broad base of experience that we offer our comments today on the 2002 tax filing season and the IRS budget.

The IRS Budget

Before discussing the feedback we have received from taxpayers and tax practitioners about the 2002 filing season, we would like to urge Congress to support full funding of the Internal Revenue Service's fiscal year 2003 budget. The AICPA has long advocated funding levels which would allow the IRS to efficiently and effectively administer the tax laws and collect taxes. Without sufficient funding, taxpayers and practitioners will encounter unnecessary problems and frustrations.

Recently, the National Taxpayer Advocate noted that taxpayers have inadequate access to IRS assistance. The AICPA believes any shortfall in budgetary support for the IRS will worsen this situation. We are also concerned that lack of funds will impede the planned modernization of the IRS' equipment and electronic capabilities. Steady progress on this front is absolutely essential to sound tax administration.

The IRS performs an essential, although unpopular, role by collecting the revenue needed to operate our government. To continue improving collection efficiency, the IRS needs adequate funding. This does not eliminate the need to implement and monitor reforms to address the problems which exist within the Service. However, budget cuts should not be used to penalize the IRS.

Many AICPA members are tax practitioners. As such, we have seen first-hand the problems caused by an IRS that is not responsive to the taxpaying public as customers. We have also witnessed the improvements initiated by Commissioner Rossotti and the reorganization mandated by Congress in the *IRS Restructuring and Reform Act of 1998*. Reducing the IRS appropriation can only delay implementation of the improvements Congress expects and we believe the nation's taxpayers will suffer as a direct result.

The AICPA has long advocated that funding for the IRS must be sufficient for the Service to efficiently and effectively administer the tax laws and collect tax. It is vital to our voluntary compliance tax system that the Service have the resources necessary to properly enforce the tax laws. When the IRS is, or appears to be, unable or unwilling to actively administer and enforce the tax law, serious damage to the effectiveness of our tax system results. Therefore, we encourage Congress to strongly support the IRS' budget needs. Obviously, we expect the Service to identify responsible ways to allocate any additional resources it receives over prior years, and Congress will through its oversight responsibilities ensure that those resources are properly utilized. We also believe Congress should pursue multi-year funding (i.e., budgeting for multiple years at once) to ensure stable funding for the IRS in the future.

The American taxpaying public is just beginning to benefit from the Internal Revenue Service that Congress envisioned when it passed the IRS restructuring legislation. While, the preliminary results are promising, it is critical that Congress facilitate moving the reform process ahead without delay by providing the necessary funding.

2002 FILING SEASON

In previous testimony before Congress, the AICPA would often report that, having heard little from our members by early April, we presumed that the filing season was progressing largely without any significant problems. Unfortunately, we cannot make the same report for the 2002 filing season.

Our comments reflect concerns raised by our member CPA practitioners about: (1) electronic filing; (2) the retroactive effect of the Job Creation and Worker Assistance Act of 2002; (3) the difficulties in obtaining Employer Identification Numbers; (4) the revamped practitioner hotline service; (5) problems in accessing taxpayer accounts; and (6) difficulties in contacting specific IRS personnel.

Electronic Filing

The IRS has implemented a number of improvements in the electronic filing program (ELF) for the 2002 filing season. The AICPA especially appreciates that (1) nearly all Form 1040 forms and schedules have been made available to electronic filers; (2) electronic filers are no longer required to use a paper signature document; and (3) the electronic payment options have been expanded. Similarly, the IRS has expanded electronic filing options for business taxpayers over the last year.

The AICPA supports electronic tax administration in general, and ELF in particular. Although we have yet to hear from our members about their experiences with ELF during the current filing season, we hope that the ELF improvements will mitigate our members' past concerns about electronic filing.

During previous filing seasons, the AICPA had expressed that the Service's inability to accept all forms and all schedules, including white paper schedules, elections and related compliance disclosures, had been the greatest barrier to widespread use of electronic filing by the Institute's members, especially for those practitioners who tend to work with the more complex returns. Because effective disclosure is the key to the modern reporting system, effective electronic filing of the more complex returns could not be expected until all forms and schedules could be filed electronically—including "white paper" schedules, elections, and compliance disclosures.

Although we support the long-range goal of converting manual processes to electronic formats, the AICPA remains frustrated by the Service's response to our attempts both to partner with the IRS in promoting ELF to our membership and in explaining to the IRS the effects of the current systems' limitations on our constituency. As the IRS shifts its electronic filing focus from individual returns to business returns, the importance of involving, listening to, and responding to the various stakeholder groups will become all the more critical. Unfortunately, our experience as a stakeholder group in this matter has not been positive to date.

The AICPA looks forward to being a positive partner in the ELF system and to that end has recently formed an Electronic Filing Task Force. We appreciate the many hurdles on the road to achieving the goals established for the electronic filing program by Congress. For example, last year's struggles to implement the mandated electronic filing of large partnerships ought to provide a "road map" of things to avoid in future implementations. As we enter the second year of this mandate there remain many circumstances in which a related schedule or form must be supplied to the IRS on paper—sometimes triggering the entire Form 1065 to be filed on paper. The IRS and its constituencies can improve significantly on future electronic initiatives, but only if there is collaboration that begins early and is truly valued by the IRS.

Job Creation and Worker Assistance Act of 2002

On March 9, 2002, President Bush signed into law the Job Creation and Worker Assistance Act of 2002. The retroactive provisions of the 2002 Act have contributed significantly to making this a difficult filing season for taxpayers and practitioners. These measures include (1) an additional first-year depreciation deduction equal to 30 percent for qualified property purchased after September 10, 2001 and (2) an extension in the general net operating loss ("NOL") carryback period from two years to five years for NOLs arising in taxable years ending in 2001 and 2002.

In order to take advantage of the depreciation and NOL (and other) provisions, many taxpayers and practitioners found it necessary to file for extensions on business returns otherwise due on March 15, 2002. The IRS has done a commendable job in releasing guidance and tax forms on the 2002 tax law; the agency released a brief summary of the Act on March 12 and provided further guidance and tax forms several days after the March 15 filing deadline for business returns. Businesses that have already filed their returns prior to March 15 might find it necessary to amend their tax returns in order to take advantage of the new tax incentives. We expect to see more individual returns filed on extension as well, reflecting those returns that are affected by these retroactive provisions (e.g., those with Schedules C and F could be affected). Finally, there will be ongoing issues regarding the differences between Federal and State laws in the tax treatment of various items or tax benefits—as a result of passage of the 2002 Act.

While reducing taxes retroactively for taxpayers, the 2002 tax law has clearly added additional complexities, compliance costs, and administrative burdens for taxpayers and practitioners during the current filing season. Congress recognized the complexity of the tax administration issue when it included Section 4021 in the IRS Restructuring and Reform Act of 1998 (RRA '98), which states "It is the sense of Congress that the Internal Revenue Service should provide the Congress with an independent view of tax administration, and that during the legislative process, the tax-writing committees of Congress should hear from front-line technical experts at the Internal Revenue Service with respect to the administrability of pending amendments to the Internal Revenue Code of 1986." We ask Congress to remain cognizant of the difficult task it imposes on the Service, tax practitioners and taxpayers when it continues to enact complex and constantly changing tax laws, especially with effective dates that do not permit adequate time to adjust. Advance consultation with the IRS and practitioners could do much to improve the quality and administrability of our tax laws.

Employer Identification Numbers

The IRS has recently announced a number of changes designed to improve the processing of requests for new Employer Identification Numbers (EINs). These modifications were developed late last year in response to concerns raised by the AICPA and other practitioner groups. For example, the AICPA detailed the difficulty taxpayers and practitioners were having in obtaining EINs to National Taxpayer Advocate Nina Olson. We also informed the IRS about problems taxpayers were having with submitting Forms SS–4, Application for Employer Identification Number, to the Service through the use of the Tele-Tin program and by fax.

In our April 5, 2001 letter to Nina Olson, the AICPA recommended that the IRS: (1) increase the number of hours the call-in procedure is available each day; (2) create a system for the Service to take taxpayer messages to facilitate EIN assignments; (3) acknowledge faxed EIN requests; and (4) commit to assigning an EIN within a specified time period.

In response, the IRS announced that beginning on December 1, 2001, practitioners can now obtain an EIN on a client's behalf by completing the new Third Party Designee section on Form SS–4, thereby eliminating the need to obtain a separate Form 2848, Power of Attorney. Also, beginning on January 2, 2002, taxpayers and practitioners can call one toll-free number or fax EIN requests 24 hours a day, seven days a week.

However, taxpayer demand has exceeded the IRS' capacity to promptly answer calls, resulting in a significant number of busy signals. We have also received complaints that taxpayers were not receiving EIN numbers in a timely fashion after sending requests in by fax or mail. Although the IRS is responding to these filing problems and resulting EIN application backlog, we must report that taxpayers and practitioners are still reporting problems. Fortunately, the number of complaints is reduced compared to the number voiced in January 2002 when the phone and fax systems were changed.

The IRS has promptly acknowledged the EIN program's shortcomings problems, and we commend this responsiveness. Nevertheless, we urge the Service to continue focusing on fixing the remaining problems taxpayers and practitioners are experiencing. Because of the importance of the EIN program to the overall tax administration process, its effective functioning must be of the highest priority.

Practitioner Hotline

Beginning in January 2002, the IRS modified its toll-free practitioner hotline, renamed the "Practitioner Priority Service." This new (centralized) program is promoted as the first point of assistance for taxpayer account-related issues. Through this revised practitioner hotline, the IRS intends to offer practitioners an opportunity to obtain fast, accurate, consistent, and comprehensive answers from specially trained IRS employees during the hours of 7:30 a.m. to 5:30 p.m. local time.

However, the AICPA has received complaints from practitioners who consistently experience busy signals when calling the hotline, because practitioner demand has exceeded the Service's ability to promptly answer calls. The IRS must address the problems that have resulted from the centralization of the hotline under the new Practitioner Priority Service. A viable and prompt response to hotline calls is imperative for fostering successful relationships with a key stakeholder constituency and effective tax administration.

Access to Taxpayer Accounts

During this filing season, the AICPA has received numerous complaints from CPA members who have encountered problems in obtaining taxpayer account information from the IRS. We believe these complaints are an outgrowth of the IRS' difficulties with computer modernization. For example, taxpayers and practitioners continue to have problems accessing estimated tax payment information. This is in clear contrast to the ability of financial institutions to access up-to-the-minute customer transaction information. In 2001, the IRS reported that it could take the agency up to 16 days to make an adjustment to a taxpayer's account due to incompatible internal computer systems—a standard that would not be tolerated by any private company or its customers.

Even a modest improvement in accessing taxpayer account information would significantly reduce needless correspondence between taxpayers and the IRS. The Service must continue to improve its telephone services toward the ultimate goal of "one stop shopping"—enabling taxpayers to resolve all their problems with a single IRS representative.

The AICPA also urges the IRS to develop ways for their employees to access taxpayer information using secure, privacy-protected Internet connections. Taxpayers should similarly be able to view their own tax account information using secure Internet connections.

Difficulty in Contacting Specific IRS Employees

Practitioners encounter problems when attempting to contact specific IRS employees, even those contact persons listed on IRS notices to taxpayers. The AICPA has learned about numerous Revenue Officers (ROs) who will not provide taxpayers with a "live" telephone number, but instead their messages only provide pager and voice mail numbers. Even though the message may state that the RO will call back as soon as possible, taxpayers and practitioners are encountering great difficulty in actually contacting the specified RO.

The AICPA recommends that all "front-line" IRS employees should be required to give their manager's name and telephone number as part of their voice mail message. We also strongly recommend that the IRS upgrade the quality of its Web site's Interactive Telephone Directory, to assist taxpayers and practitioners in identifying the most appropriate IRS employee to contact.

Conclusion

The AICPA is encouraged by today's hearing by the House Ways and Means Subcommittee on Oversight. We remain strongly committed to working closely with Congress to obtain proper funding for the IRS and to ensure continued improvements in future tax filing seasons. We are optimistic that—with the proper plan and funding levels in place—the IRS can achieve an appropriate balance between taxpayer service and enforcement. We hope that this hearing will serve as the catalyst to spur improvement in IRS service to its taxpaying "customers" and in the agency's overall operations.

The AICPA appreciates this opportunity to offer our comments to the Subcommittee and would be happy to discuss any of these matters in further detail with Subcommittee Members.

Chairman HOUGHTON. Thank you very much, Mr. Dougherty. Mr. Ernst.

STATEMENT OF MARK A. ERNST, PRESIDENT AND CHIEF EXECUTIVE OFFICER, H&R BLOCK, INC., KANSAS CITY, MISSOURI

Mr. ERNST. Thank you, Mr. Chairman, Mr. Coyne, Mrs. Thurman.

Thank you for the opportunity to our present our views.

From our perspective, the good news is the filing season has gone smoothly with a few exceptions. Overall the IRS and the tax preparation industry are working very well together.

The IRS is likely to beat this year's target of 46 million electronically filed returns. But increasing effort will be needed to advance from this year's 35 percent of all filers to Congress's target of 80 percent by 2007.

H&R Block has electronically filed 90 percent of the 12 million returns we prepared as of March 15th.

This has been an especially challenging year for the IRS, sending millions of advance refund checks, quickly responding to families affected by September 11th, and planning for return processing contingencies in case of terrorism.

The IRS, from our perspective, has earned praise for simplification of Schedule D, innovative E-filing promotions, improved communication with practitioners, and making personal identification number (PIN) signature alternatives easier to use.

Commissioner Rossotti deserves a special salute for his leadership. He has made a profound contribution for which all citizens should be grateful.

At H&R Block we continue to provide financial as well as tax advice to help clients meet their goals and we are integrating on-line and off-line tax services. Combining services is an increasing trend.

All in all, the tax season is going well.

The bad news is that it is not glitch-free. Two new tax laws have caused some problems.

This year's main problem is the rate reduction credit which caused confusion and over 3 million errors. The ordering rules applicable to the newly refundable child tax credit has also caused confusion and IRS errors. The economic stimulus package made retroactive tax law changes that required new forms, software updates and amended returns. Midstream changes made implementation of those very difficult.

Finally, poor IRS enforcement for the second year in a row gave an unfair advantage for tax preparers who file returns early without proper W–2s over firms that are in compliance with the rules.

On budget initiatives, I would make three points. First, we strongly support full funding for the IRS. One pay-off of modernization will be faster refunds for electronic filers.

Second, on E–Z tax filing, we are pleased that the Administration is backing away from an ill-advised proposal to build a free IRS on-line tax prep and e-filing system, and instead is working toward a constructive partnership with private-sector firms.

I believe that one of the reasons IRS customer satisfaction is rising is the effective public-private partnership delivering electronic filing. Let's not lose the important progress that we have been making.

Third, on extending the filing deadline to April 30th for taxpayers who file and pay electronically, we are concerned about losing focus on April 15th, creating compliance difficulties, and imposing extra costs on the tax preparation industry, all to attract only an estimated 3 percent of tax filers in the first year.

What is really needed to stimulate a massive shift to e-filing is the incentive of a tax credit available to all tax filers, not just those who have a balance due.

Briefly, on several other issues. On simplification, we welcome simplification efforts and submit for the record our annual “top 10” suggestions.

On the earned income tax credit, industry hopes to work with Congress and the Treasury to improve due diligence and simplify the law to reduce noncompliance.

On the national research audits, we commend the IRS for its design of a new compliance measurement system. Better information will lead to a fairer tax system.

On tax preparer regulation, we look forward to commenting on coming proposals. Our own training, continuing education and code of ethics reflect our longstanding commitment to integrity and professionalism and support for a system requiring meaningful minimum standards.

On helping low-income taxpayers, we support well-focused government assistance. If expanded services are needed, we hope that outsourcing tax preparation and electronic filing to private sector tax professionals will be considered.

On privacy, consideration should be given to updating 30-year old rules. The standards for tax preparation firms' use of client information should be consistent with the 1999 rules Congress adopted for financial firms. The IRS should also clarify that electronic signatures can be used for online consent.

Finally, on accounting reforms, the vast majority of the accounting profession reflects competence and ethical behavior. In crafting post-Enron reforms, care should be taken to ensure that audit firms can continue to provide tax compliance and most tax planning services and that small privately-owned business and family firms without large executive staffs should continue to be able to use CPAs to advise on a broad range of tax and business issues.

We appreciate the chance to testify, Mr. Chairman, and would be happy to respond to questions.

[The prepared statement of Mr. Ernst follows:]

Statement of Mark A. Ernst, President and Chief Executive Officer, H&R Block, Inc., Kansas City, Missouri

Mr. Chairman, Rep. Coyne, and Members of the Subcommittee:

Thank you for the opportunity to present our views on the tax filing season, the IRS budget, and other issues facing our tax system.

Filing Season Success

The good news is that the filing season has gone smoothly with few exceptions. Overall, the IRS and the tax preparation industry are working well together.

With electronic filing up over 14%, the IRS is likely to beat this year's target of 46 million e-filed returns, 35% of all filed, compared to 40 million, or 31%, last year.

H&R Block has contributed about one third of those returns, electronically filing 90% of the 12 million returns we prepared as of March 15.

This has been an especially challenging tax year for the IRS. It sent out over 200 million notices or advance payments in connection with last summer's tax cut, it quickly made special allowances for taxpayers affected by the September 11 tragedy, and it planned for mail and processing contingencies in the face of terrorism risks.

The IRS deserves praise for improvements to Schedule D (capital gains and losses), innovative e-filing promotions, improved communication with practitioners, and making PIN signature alternatives easier to use.

Commissioner Rossotti, whose term ends in November, deserves a special salute for his leadership. He has made a profound contribution for which all citizens should be grateful.

At H&R Block, we are increasingly providing financial as well as tax counsel to our clients, tailoring advice to individual circumstances, to help our clients meet their financial goals. We expect this trend to continue across the industry. For many clients, Tax Day is an opportunity for an annual financial check-up.

We are also integrating our online and offline capabilities to serve taxpayers across the spectrum from "do it yourselfers" to those needing more personal assistance. Online or software users can get questions answered by a tax advisor or have their return professionally prepared, reviewed, or transferred to a tax office to meet their individual needs.

Filing Season Problems

The bad news is that the IRS still must administer an overly complex tax code and the filing season is not glitch-free.

Let me highlight eight items, several resulting from two new tax laws.

This year's main problem is the Rate Reduction Credit, where multiple terms ("rebates," "advance payments," "refund advances," "rate reduction credits") and instructions that confused taxpayers and even tax preparers resulted in many rejected e-files and over three million errors.

The ordering rules applicable to the newly refundable Child Tax Credit caused confusion. The complex interaction of forms and worksheets resulted in IRS errors. Our IRS liaison has been especially helpful in the extra casework needed to resolve them.

Both items came from the "Economic Growth and Tax Relief Reconciliation Act of 2001" (EGTRRA), signed into law June 7, 2001. It also made welcome changes to the Earned Income Tax Credit's tie-breaker rules but the changes still require technical corrections and clarifications before 2003.

The economic stimulus package, the "Job Creation and Worker Assistance Act of 2002," signed into law March 9, made mid-filing-season retroactive tax law changes that required new forms, software updates, and amended returns. Guidance and technical corrections will also be needed.

In implementing the stimulus act's changes, one service center began accepting revised Form 4562s on April 4, and the other centers began only yesterday, requiring tax preparers to use two versions of the same form at a critical period.

Some States are not allowing e-filing of returns claiming the 30% accelerated depreciation for assets placed into service after September 10, 2001, and many States have yet to issue rulings regarding the changes, adding further complications.

Although we patiently explain the political realities of writing tax law to them, our tax professionals respectfully ask Congress to complete new tax laws by mid-September. The IRS and tax practitioners need time to create clear forms and instructions, update software, train field staff, and prepare properly to minimize problems.

Another problem this year was the late loading of student loan data, which briefly impaired the Debt Indicator, delaying delivery of many refunds.

Finally, poor enforcement, for the second year in a row, against tax preparers who file returns early without proper W–2s gave them an unfair advantage over firms that comply with the regulations.

IRS Budget and Policy

On the budget, we share the concern of the IRS Oversight Board that the IRS have adequate funds for modernization, one benefit of which will be faster refunds for electronic filers. We strongly support full funding for that as well as for customer service and compliance programs.

Two initiatives in the budget are of additional interest.

- **"EZ Tax Filing."** We are pleased that the Administration is backing away from an ill-advised proposal to build a "free" IRS online tax prep and e-filing system and is instead working toward a partnership with private-sector firms.

  Putting the government in the tax return preparation business would be costly, would detract from more important modernization priorities, would create a conflict of interest if the tax auditor also became the tax preparer, and would raise questions of privacy and security.

  Industry already provides low-cost, high-quality software and online tax preparation programs that are well received by the public. It makes available **free** tax prep and e-filing online to half of taxpayers. Absent compelling circumstances, government should not compete with the private sector—an established policy followed by the last nine Administrations.

OMB's initiative has bruised the trust and cooperative partnership that industry and the IRS had forged to increase e-filing. We hope that the current Treasury-IRS-industry discussions will put us back on a constructive path.

- **Tax Filing Deadline.** We believe the IRS may be too optimistic about the benefits of its proposal to extend the tax filing deadline to April 30 for those who file and pay electronically.

  Less than one in five taxpayers pays a balance due and only 3% of taxpayers are expected to take advantage of the program in its first year. If we aim only at the margin, alternative consideration should be given to delaying deadlines for payment but not filing. That would create a nearly equal incentive without diminishing national focus on April 15, without contributing to confusion and compliance difficulties, and without imposing extra costs on tax preparers who would otherwise reduce staff or close seasonal locations after April 15.

  What is really needed to stimulate a massive shift to e-filing is the incentive of a e-filing tax credit available to all filers.

Other Policy Issues

A brief comment on several other issues:

1. **Simplification.** We believe both the study of the Joint Committee on Taxation and the Taxpayer Advocate's annual report make excellent recommendations. We welcome the prospect of simplification legislation such as that Mr. Portman is preparing and the simplification white papers expected shortly from the Treasury. Our annual "top ten" simplification suggestions are attached.
2. **EITC.** We are concerned over reports that nearly a third of EITC claims did not comply with the rules in 1999. Changes made by EGTRRA may create more compliance problems. This requires more cooperation between Congress, Treasury, and industry to improve diligence and simplify the law.
3. **National Research Program Audits.** We commend the IRS for its care in designing new compliance measurement audits to capture needed information with minimal intrusion. Compliant taxpayers will benefit if the program results in better targeting of future enforcement.
4. **Shelters.** Abusive tax shelters are a growing problem and we recognize the need to deter them through increased disclosure and tougher penalties.
5. **Preparer Regulation.** The IRS and the Taxpayer Advocate are considering new regulation of unlicensed tax preparers. We believe need, enforcement of existing laws, costs, budget implications, administrative burdens, and alternatives should all be considered. Our own training, continuing education requirements, and Code of Business Ethics and Conduct reflect our longstanding commitment to integrity and professionalism. We look forward to a dialogue on any proposals.
6. **Low-Income Taxpayers.** Over 5 million low-income taxpayers receive assistance from the IRS and volunteer groups through programs we support. We welcome the IRS' efforts to focus aid on those most in need at its walk-in sites and this Committee's clarification that IRS-subsidized tax clinics are intended to resolve post-filing controversies, not prepare returns. If expanded services are needed, we hope the IRS will consider vouchers to outsource tax prep and e-filing to qualified private-sector tax professionals whose training, existing e-filing systems, and convenient locations may provide significant advantages.
7. **Privacy.** For 30 years, advance written client consent has been required to use or disclose tax return information. In 1999, Congress established different rules to enable financial firms to share customer data with affiliates or third parties, subject to customer notice and the opportunity to opt out of certain disclosures. Consideration should be given to updating rules for tax preparers to make the standards consistent. The IRS should also clarify that electronic signatures apply to tax preparation software and online transactions, as the 2000 E–SIGN law intended and as is common in e-commerce.
8. **Accounting Reforms.** The vast majority of the accounting profession reflects high professionalism, competence, and ethical behavior. In the wake of Enron's failure, SEC Chairman Pitt and others have proposed many useful reforms. But some proposals may do more harm than good. Restrictions on non-audit services should not prohibit an audit firm from providing tax compliance or most tax planning services. And differences between publicly-traded corporations and smaller, privately-owned businesses should be recognized. Lacking extensive executive staffs, many entrepreneurs and family firms rely on their CPA to provide trusted counsel on a broad range of tax and business issues. In such cases, benefits far outweigh risks.

We appreciate the chance to testify, Mr. Chairman, and would be happy to respond to questions.

TAX SIMPLIFICATION PROPOSALS: 2002

Since 1997, H&R Block has annually sent lawmakers, Treasury and IRS officials 10 suggestions for Federal tax simplification. The recommendations were developed by H&R Block's Training and Research Department which serves more than 80,000 H&R Block tax professionals who assist over 16 million clients at 9,000 U.S. offices. The proposals, distilled from over a million inquiries, are illustrative, not comprehensive. They complement those of the AICPA, ABA, and TEI, as well as those in annual reports of the IRS' Taxpayer Advocate (the latest of which is excellent), and those in the three-volume study by the staff of Congress' Joint Committee on Taxation (2001).

Many of our past recommendations have been adopted. In deference to the excellent work of the JCT and the Taxpayer Advocate, our 2002 proposals support many of their recommendations as well as express independent views. Our focus is on problems faced by average taxpayers.

To help ease tax burdens, we have also testified before Congress on simplification and tax reform, proposed legislation to restructure payroll taxes, helped the IRS develop simpler forms and clearer instructions, led efforts to increase the number of electronically-filed returns, and suggested improvements in earned income tax credit compliance.

Several points help keep the issue of tax code simplification in perspective:[1]

- The burden of complexity falls most sharply on about 20% of taxpayers, the small but significant fraction with higher incomes and more complicated financial lives—the self-employed, small business owners, those with income from passive activities or in the form of capital gains, rent, and pension or annuity disbursements. Low-income taxpayers who claim an earned income tax credit (16%) also face unusual complexity.
- For many other Americans, the tax system is relatively simple. Over 80% of tax code provisions relate to business, not individual tax returns. Two-thirds of individual filers take a standard deduction and do not itemize. About 40% of individual filers are able to use simplified, 1–2 page, short forms—1040EZs and 1040As.
- The main reasons for complexity arise from defining income, rewarding favored activities, and meeting budget needs, not from multiple progressive tax brackets.
- Much complexity stems from the legislative process which involves compromise, pressured last-minute drafting, and tailoring tax provisions to fit the funds available, resulting in phase-ins, sunsets, eligibility restrictions, etc. Simplification usually loses out to competing political needs as many voices press for complicating adjustments while there is little constituency for simplification. Since 1987, Congress has amended the tax code an average of 1.5 times a day.
- Congress missed an opportunity for major simplifications in 2001 by using budget surpluses for large tax rate cuts instead of adopting costly simplification proposals, but many low-cost ideas can still be implemented.
- Some complexity makes the tax code fairer by finely tuning laws to individual circumstances and avoiding a one-size-fits-all model. Some complexity comes from using the code to advance non-tax social or economic policies, encouraging activities like education, retirement savings, child care, home ownership, charity, etc. Some complexity helps reduce the taxes we pay.
- The IRS is easing complexity administratively by revising forms, notices, and instructions.
- Technology and tax software dramatically reduce the burden of complexity. Half of tax filers use professional tax preparers. Over 55% of individual tax returns are prepared using online services or software like H&R Block's *TaxCut*®. Reasons include convenience, faster refunds, and financial planning, as well as com-

[1] For earlier H&R Block views on tax code simplification, see "*Statement of Robert A. Weinberger, Vice President, Government Relations, H&R Block, on Tax Code Simplification*," before the Subcommittee on Oversight of the House Committee on Ways & Means, including H&R Block's 1998 simplification proposals, June 23, 1998 [Serial 105–46]; and "*Statement of Kathy T. Burlison, Tax Research and Training Associate, H&R Block, on Complexity of the Individual Income Tax*," before the Senate Committee on Finance, April 15, 1999.

plexity. Through the private-sector, nearly 60 million taxpayers are eligible for free tax preparation and e-filing online. Through the IRS, 15 million taxpayers are eligible to file 1040EZ returns free by telephone and aid is available at 400 IRS sites. Volunteer groups assist another 4 million low-income or elderly taxpayers.

EXECUTIVE SUMMARY

Family Issues

1. Dependent Care Credit. Conform the dependent care credit's definition of earned income to EGTRRA's new earned income definition for the earned income credit.
2. Definition of Qualifying Child. Unify the definition of qualifying child for the dependency exemption, Head of Household filing status, and applicable credits.
3. AMT. Repeal or reform the alternative minimum tax (AMT).

Education Issues

4. Education Credits. Combine the HOPE and Lifetime Learning credits.
5. Qualified Education Expenses. Unify multiple definitions of qualified education expenses.
6. Savings Bond Interest. Simplify the treatment of savings bond interest used for higher education. Eliminate the modifications to AGI for purposes of calculating the exclusion of U.S. savings bond interest.

Investments and Retirement Savings

7. Long-term Capital Gains. Replace various capital gain tax rates with a capital gain deduction.
8. Early Withdrawal Penalties. Unify penalties for early withdrawals from IRAs and employer retirement plans.
9. Required Minimum Distributions. Eliminate the minimum distribution requirements for IRAs and employer retirement plans.
10. Deductible IRA Contributions. Eliminate income phaseouts that restrict the number of taxpayers who can make deductible contributions to an IRA.

H&R BLOCK'S 2002 TAX LAW SIMPLIFICATION PROPOSALS

1. Modify Definition of Earned Income for the Child Care Credit

Proposal: Conform the definition of earned income for purposes of calculating the dependent care credit to the definition of earned income for the EITC as changed by EGTRRA.

Current Law: Earned income is a test for the child care credit, refundable child tax credit, and the earned income credit. EGTRRA changed the definition for the earned income credit (which is also used for the refundable child credit), but it did not change the definition in the dependent care credit.

Prior to 2002, the definitions of earned income for the EITC and dependent care credit are essentially the same. In EGTRRA, Congress addressed the complexity and compliance issues surrounding the add-back of nontaxable earned income items for purposes of calculating the earned income tax credit. As a result, beginning in 2002, the definition of an employee's earned income will include only taxable wages.

The dependent care credit is calculated on the lesser of (1) the taxpayer's earned income, or (2) the spouse's earned income for MFJ filers, or (3) qualified expenses, limited to $2,400 for one child or $4,800 for two children. No credit is allowed for more than two dependent children.

Benefits: The simplification impact of this change is enormous. Eliminating the need to consider nontaxable employee compensation for purposes of calculating the child tax credit would relieve taxpayers of the burden of obtaining information that often is not reported on W–2s. Given the low threshold for qualified expenses and the fact that the credit is nonrefundable, it is unlikely that the simplified calculation will result in much, if any, change in the amount of dependent care credit that is claimed.

2. Simplify the Definition of a Qualifying Child

Proposal: Conform age, relationship, and member of household tests for all definitions of qualifying child.

__Current Law:__ Five commonly used provisions benefit taxpayers with children, but each has its own definition of qualifying child:

- The dependency exemption.
- The child tax credit.
- The earned income credit.
- The dependent care credit.
- Head of household filing status.

The JCT staff recommended a uniform definition of qualifying child that would eliminate several tests such as the joint return test and the gross income test that appear in only one or two definitions of qualifying child. The JCT staff recommends that any child below a specified age that has a specified relationship to the taxpayer and lives with the taxpayer more than one half of the taxable year is a qualifying child for each of these five benefits.

__Benefits:__ A common definition of qualifying child would greatly simplify the application. Some variations may still be required.

3. Repeal or Reform the AMT

__Proposal:__ Repeal the alternative minimum tax or reform it by increasing the exemption amount and simplifying the rules.

__Current Law:__ The minimum tax—a separate, alternative tax system within the income tax code—is a major source of complexity. The current version was designed to ensure that "no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions and credits."[2] The AMT is imposed to the extent that a taxpayer's tentative minimum tax exceeds his or her regular tax liability. AMT income is the taxpayer's taxable income increased by certain preference items and adjusted for certain items (such as accelerated depreciation and incentive stock options) that have the effect of deferring taxation under the regular tax rules. The tentative minimum tax is computed using the amount of alternative minimum taxable income in excess of a phased-out exemption amount.

One problem that has caused a great deal of concern in the last year is taxation of unrealized gains associated with incentive stock options. Although these gains are exactly the kinds of "substantial economic gains" the current AMT regime is intended to tax, many taxpayers suffered unintended hardships because they were unable to convert their paper economic gains into realized gains.

__Benefits:__ Repeal of the individual AMT system would remove a major source of complexity but be very costly. Increasing the exemption amount, indexing it for inflation, simplifying the rules, and allowing personal credits to offset regular tax liability would eliminate some of the problems associated with the current system—complex calculations, definitional problems, unintended results, and a perception that the system is both unfair and irrational—while minimizing revenue loss and maintaining the goal of ensuring that taxpayers with substantial economic income incur some tax liability. Some modification is needed to halt expected sharp increases in the number of affected taxpayers over the next decade.

4. Combine the HOPE and Lifetime Learning Credits

__Proposal:__ Combine the HOPE credit and Lifetime Learning credit into one education credit. The new credit would be 20% of qualified educational expenses. The maximum credit would be $2,000 per-student beginning in 2003. The definition of eligible student would be the current definition under the Lifetime Learning credit.

__Current Law:__ The HOPE Credit is a nonrefundable credit against Federal income taxes. The maximum credit amount is $1,500 per-student, representing 100% of the first $1,000 of qualified tuition and related expenses and 50% of the next $1,000 of qualified expenses. The credit is phased-out for modified adjusted gross incomes above $40,000 ($80,000 for joint returns). The credit is available for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year. The student must be enrolled at least half-time in a degree, certificate, or other program leading to a recognized educational credential at an eligible educational institution.

The Lifetime Learning credit is also a nonrefundable credit but it varies in several ways from the HOPE credit. The Lifetime Learning credit is equal to 20% of qualified tuition and related expenses. The maximum credit is $1,000 *per return* ($2,000 for expenses paid after Dec. 31, 2002). The educational expenses must be paid to an eligible educational institution. The Lifetime Learning credit is not based on a

[2] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS–38–83), December 31, 1982, at 17–18.

student's workload and there is no limit as to the number of years for which the credit can be taken. The credit is phased-out over the same range as the HOPE credit. The HOPE and Lifetime Learning credits cannot be taken in the same year for the same student.

Benefits: The education credits serve similar purposes, but they apply different percentages to different base amounts. The HOPE credit can be taken for no more than two years. In addition, the HOPE credit is available on a per-student basis and the Lifetime Learning credit on a per-return basis. Currently, a student eligible for the HOPE credit will always receive a larger credit under the HOPE provisions. However, because the HOPE credit may only be claimed for two years, taxpayers must often make a choice whether to claim the credit for the first year (which often includes only one semester of expenses) or wait and take the credit for the following two years. After 2002, when the amount of qualifying expenses for the Lifetime Learning credit increases to $10,000, many families will need to calculate both credits to determine which is more advantageous. Combining the credits will eliminate all of these issues. Families with two or more qualifying students could benefit substantially.

5. Establish a Single Definition for Qualified Education Expenses

Proposal: Adopt a uniform definition of qualified higher education expenses for all education incentives. The uniform definition would include expenses for tuition, books, fees, supplies, and equipment required for enrollment or attendance. It would not include expenses with respect to any course or other education relating to sports, games, or hobbies other than as part of a degree program.

Current Law: Several provisions of the Internal Revenue Code refer to "higher education expenses." These provisions include the HOPE and Lifetime Learning credits, Coverdell education savings accounts, qualified tuition programs, the exclusion from income for interest on EE bonds, the student loan interest deduction, and the exception to the early withdrawal penalty for distributions from IRAs. Most of these provisions provide a definition of higher education expenses unique to that provision.

Benefits: Establishing a single definition for qualified education expenses reduces confusion because taxpayers will no longer have to decipher differences in the tax treatment of various expenses. Eliminating multiple definitions reduces the possibility of inadvertent errors by taxpayers and tax professionals.

6. Simplify Calculation of U.S. Savings Bond Interest Used to Finance Higher Education

Proposal: Simplify the treatment of savings bond interest used for higher education by using adjusted gross income (AGI) rather than modified AGI to calculate the exclusion of U.S. savings bond interest.

Current Law: Interest earned on qualified U.S. Series EE and Series I savings bonds issued after 1989 is excludable from gross income if the proceeds of the bonds do not exceed qualified higher education expenses paid by the taxpayer during the taxable year. The exclusion is phased out based on modified adjusted gross income. The phaseout range is adjusted annually for inflation. The exclusion is available only with respect to savings bonds issued to taxpayers who are at least 24 years old. A 14-line form is required to determine the income limitations. Instructions for the form include a worksheet for determining modified adjusted gross income. This calculation involves modifying total income (all gross income except taxable interest) and modifying adjustments to income (all adjustments except the deduction for student loan interest).

Benefits: The proposal eliminates two worksheets which have little effect on the exclusion and streamlines the phaseout calculation.

7. Simplify the Treatment of Capital Gains

Proposal: In place of multiple capital gains rates, use regular income tax rates with a deduction to reduce the effective tax rate on capital gains.

Current Law: In 2001, long-term capital gains may be taxed at a maximum rate of 8, 10, 20, 25, or 28% depending on the holding period and the type of investment. A taxpayer could have gains on a single year's return taxed at several of these rates. In addition, an 18% rate will be available in 2006.

Benefits: Calculation of the tax on capital gains required 36 lines on the tax year 2000 Schedule D. As a result of the addition of the 8% rate for tax year 2001, the IRS has moved several pieces of the calculation to separate worksheets. Thus, the tax calculation on the 2001 Schedule D requires only 22 lines, but several additional worksheets may be required. If the various capital gains rates are replaced with a capital gains deduction, Schedule D will be much shorter. A capital gains deduction would simplify the foreign tax credit calculation.

8. Unify Penalties for Early Retirement Plan Distributions

Proposal: Unify penalties for early withdrawals from IRAs and employer retirement plans.

Current Law: Taxable distributions from IRAs and from qualified retirement plans made before age 59½ are subject to an additional 10% tax unless they qualify for an exception. Some exceptions, such as distributions on account of death or disability, apply to all tax-favored retirement plans. However, the exceptions for distributions for higher education expenses and for first-time homebuyers apply only to IRAs. The exception for distributions made after separation from service after age 55 applies only to pension plans.

Benefits: Eliminates a source of confusion and frustration which traps unwary taxpayers. For example, if an individual retires under a qualified retirement plan at age 55, distributions from that plan are not subject to the early withdrawal penalty. If that individual rolls his money into an IRA and then begins taking distributions before age 59½, the distributions are subject to an early withdrawal penalty (unless another exception applies).

9. Eliminate Minimum Distribution Requirements from Retirement Plans

Proposal: Eliminate required minimum distributions from IRAs or qualified retirement plans during the lifetime of the recipient.

Current Law: Distributions from IRAs (other than a Roth IRA) must begin no later than April 1 of the year following the calendar year in which the IRA owner reaches 70½. Similar rules apply to qualified retirement plans, tax-sheltered annuities, and Section 457 plans. A penalty of 50% of the required distribution is imposed for failure to take a required distribution. IRS is allowed to rebate the penalty in certain situations.

Benefits: The minimum distribution rules are extremely complicated. The JCT staff recommended additional changes designed to simplify these rules.[3] We support these recommendations. However, our recommendation addresses the most significant trap for the unwary.

10. Eliminate Phaseouts for Deductible IRA Contributions

Proposal: Remove income limitations for contributions to IRAs.

Current Law: The allowable deduction for contributions to an IRA is not limited by income for unmarried individuals who are not "active participants" in a qualified retirement plan. The allowable deduction for unmarried individuals who are active participants is phased out based on modified AGI. Deductions for married individuals who are not active participants and whose spouses are not active participants are not limited by income. However, if either spouse is an active participant, income limitations apply. Different income limitations apply depending on filing status and which spouse is an active participant.

Benefits: The rules are extremely complex. The definition of active participant can be confusing. Many taxpayers find the rules to be arbitrary and unreasonable. Repeal of the income phaseouts should improve compliance and reduce taxpayer frustration. We do not have a revenue estimate for the proposal.

Chairman HOUGHTON. Thank you very much, Mr. Ernst. Mr. Harris.

STATEMENT OF ROGER HARRIS, EA, PRESIDENT, PADGETT BUSINESS SERVICES, ATHENS, GEORGIA, AND CHAIR, LEGISLATIVE AFFAIRS SUBCOMMITTEE, NATIONAL ASSOCIATION OF ENROLLED AGENTS, GAITHERSBURG, MARYLAND

Mr. HARRIS. Good afternoon, Mr. Chairman. Thank you for the opportunity to be here. On behalf of the National Association of En-

[3] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS–3–01), April 2001, Volume 2, Section III.C.7.(a).

rolled Agents and its 10,000 members, it is a pleasure to be here to talk about the filing season and the upcoming budget.

I guess the good news is for the most part we would say the filing season has gone well. A couple of observations we have seen is that taxpayers are coming in earlier, and also coming in in increasing numbers. I think the people who are coming in early probably are a reflection of the economy and their desire to get their refunds back sooner.

I think the fact that our business is growing is a signal that complexity is still very much an enemy of the average taxpayer, and as long as they are uncomfortable preparing their own return they are going to seek out professional help.

I think the IRS has done a good job in what could have been some difficult circumstances this filing season. We have had a lot of talk about the rebate checks. I think the IRS did a good job in anticipating that taxpayers, when they receive their check, would take it and spend it and not remember how much it was for, or keep the letter that came with it. Anticipation of that the IRS set up a toll-free number that has worked extremely well to verify taxpayers rebate amounts.

Also, we have heard a lot about the stimulus bill and the retroactive changes that it created. I think the IRS reacted as well to that situation as we could have expected, given the impact that it had. I think we will not know for a while what the real impact on the filing season will be. I know there is going to be a tremendous amount of amended returns that are going to have to be filed. I know I talked to one gentleman whose office alone is going to have to review 9,000 returns to see how many of them have to be amended, that many returns had already been filed prior to the passing of the bill. So the true cost of that we will find out in the coming months.

A couple of specific things. Electronic filing——

Chairman HOUGHTON. Could I interrupt a minute? I may be misreading what you are saying. Are you saying that a wave of complications are coming in because of the rebates and a variety of things this past year which may further complicate what the IRS is doing?

Mr. HARRIS. Well, I am speaking more specifically of the stimulus bill that had some retroactive provisions this year that people had already filed, had gone and filed early and now are faced with amending to comply with the benefits of the new law. Most of the people, obviously, will be better off in terms of their taxes, but there will be an offset cost of amending returns.

A couple of other things on electronic filing. Again, I think we are seeing an increase in electronic filing. I think the system is far from perfect. The self-selected PIN and the elimination of the signature has gone a long way to helping the system. I would hope that we will continue to look for ways in the future to work together, the IRS, practitioners, and Congress, to find ways to reach the 80 percent goal.

As I think the Commissioner said earlier, at the current rate of increase, we are not going to make the 80-percent goal. So I think we are going to have to look for things that will help us in that area. The extension to April 30, and let me caution you first, make sure all States are going to honor that or this will have no effect, because as a practitioner or taxpayer if I have to file by April 15 through my State I am not probably going to wait 2 weeks to file my Federal return. So I hope there is a recognition we need to get the States on board here if we want this to have a significant impact.

And I think it will have an impact, because it will make a practitioner who does not file electronically noncompetitive the last 2 weeks of the filing system. So I think it may have a surprising effect.

In reading the other members of my panel's testimony, and hearing them, I found the complaints were pretty universal in all of our testimonies. We all had concerns about the inability to get a Federal ID number, an EIN number, and we had concerns about practitioner hotlines. So I think there are things there that we all agree have some issue that needs to be dealt with.

I think the heart and soul of what we hear about is the future and the issue of balancing service and compliance, and I think what we all want to see is the pendulum stop swinging, where we see compliance getting a lot of emphasis 1 year and the next year it is service. We want to have a steady pattern of going forward where the IRS is doing their two roles, which is service and compliance, and I think, obviously, that requires an improvement in technology and it requires better staff and training. I would hope we could focus more on technology and less on people. People are just a very inefficient way to go out and build compliance in the Tax Code.

The interesting discussion I heard today, and I don't have a lot of time left but I would certainly be willing to answer any questions, in my role as a member of the IRS Advisory Council we have looked at this K–1 matching program very closely. And while I think there is a tremendous opportunity here to catch a lot of unreported income, there is an equal opportunity to embarrass the Service if it is not done properly, and I would certainly be willing to share my concerns in that area at a later date.

I could not continue my opening comments without joining all the Members of this Committee that have praised Commissioner Rossotti's 5-year term. I think we have seen remarkable change in that 5 years, and I think the Service has come a long way. It is unfortunate we cannot convince him to stay another 5 years, but I hope we can bring someone in with his vision and his understanding of what a good tax administration system should look like, because it can be very easily turned back around if we do not bring in someone like Commissioner Rossotti.

So I thank you for the opportunity to be here, and I look forward to any questions you might have.

[The prepared statement of Mr. Harris follows:]

Statement of Roger Harris, EA, President, Padgett Business Services, Athens, Georgia, and Chair, Legislative Affairs Subcommittee, National Association of Enrolled Agents, Gaithersburg, Maryland

Mr. Chairman and Members of the Oversight Subcommittee, I am honored to present this testimony on behalf of the National Association of Enrolled Agents (NAEA), which is the professional society of Enrolled Agents.

I am Roger Harris, president of Padgett Business Services, a nationwide organization providing tax and accounting services to small business and self employed taxpayers. I am enrolled to practice before the Internal Revenue Service (IRS) and chair NAEA's Legislative Affairs Subcommittee. The Association's 10,000 members are tax professionals licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the IRS.

Enrolled Agents were created in 1884 to ensure the ethical and professional representation of claims brought to the Treasury Department. Members of NAEA ascribe to a Code of Ethics and Rules of Professional Conduct and adhere to annual continuing professional education standards that exceed IRS requirements for them. Like attorneys and certified public accountants, we are governed by Treasury Department Circular Number 230 in our practice before the IRS. We are the only tax professionals who are tested by the IRS on our knowledge of tax law and procedure. Each year we collectively work with millions of individual and small business taxpayers. Consequently, Enrolled Agents are uniquely positioned to observe and comment on the average American taxpayer's experience within our system of tax administration.

As our members are on the front lines of tax administration, we are pleased to share with you the views of these practitioners.

Tax Filing Season Readiness

It appeared to many of our members that the filing season started earlier than usual this year. Under normal circumstances, we don't see people until the last week of January. This year, however, taxpayers showed up around the middle of January, two weeks earlier than normal.

We believe that there may be several factors contributing to this phenomenon. First, the downturn in the economy left some jobless taxpayers coming in early to collect any refunds they were due. Secondly, there is widespread use of electronically generated W–2s, so taxpayers were getting them earlier from their employers. Finally, we are seeing more promotion of the benefits of e-filing by the IRS, as well as by commercial return preparer firms, which has had the salutary effect of encouraging taxpayers to file early.

Overall, the tax season has run smoothly. However, we are seeing more clients than ever before. Some of this may be attributed to a gradual rise in consumer confidence and a resulting willingness to spend money on return preparation. Perhaps of greater significance is that such willingness is predicated on the fact that more and more taxpayers are opting to leave return preparation to the professionals because continued tax law complexity makes it difficult for them to prepare their tax returns with confidence.

Certainly the scaled back economic stimulus package signed into law on March 9 with retroactive provisions did little to lessen the perception that the tax laws appear too complicated for average taxpayers to figure out. Many of our members had already filed the returns of taxpayers who were affected by these changes. Although the retroactive provisions were beneficial and well intended, they will result in more amended returns, an additional compliance burden on taxpayers and practitioners. Another factor is that taxpayers want to be sure they benefit on their tax returns from last year's rebate program, and seem uncomfortable in doing it on their own.

We commend the IRS for its quick response in providing guidance and revised tax forms to deal with the stimulus package provisions. We believe the IRS acted as quickly and professionally as possible. Its actions mitigated the uncertainty facing many taxpayers and practitioners.

The IRS also should be commended for the proactive measure it took in providing taxpayers information about their rebates. Anticipating that many taxpayers would not keep or perhaps misplace the paperwork that accompanied the rebates, the IRS established a toll-free number for them to obtain the needed information. Such customer service has been very helpful to taxpayers and their practitioners.

The Continued Impact of Modernization

We now are well into the modernization and reorganization of the IRS. The pace of change has picked up considerably. Most of the changes instituted were needed and commendable. We believe Congressional confidence in the allocation of budget resources to the IRS has been warranted. The following are a few examples of good forward progress.

- This tax season, for the first time, it is possible to file virtually every tax form electronically. This has made it possible for many more practitioners to take advantage of the convenience and efficiency of this modern method of filing taxes. We hope that it will accelerate the Congressional target of 80% of tax returns filed electronically by 2007. This goal, of course, cannot be reached without additional attractions for practitioners and taxpayers to consider e-filing their expectation in filing returns.

- At the beginning of the tax season, many of our members were using or planned to use the PIN or self-selected Personal Identification Number with clients whose returns they e-filed. A typical, enthusiastic response from NAEA's Member Only message board read, "PINS are neat!" and then continued to praise the efficiency of the system.

  Last year when we spoke to you, we noted that as taxpayers and tax practitioners became increasingly familiar with the PIN program, it would be more acceptable in future filing seasons. This indeed seems to be happening. It now is a matter of reaching a suitable comfort level with this new approach.
- Centralization of practitioner hotlines in a practitioner priority service system, centralization of the ability to obtain Employer Identification Numbers and centralization of the Power of Attorney function have been started. These initiatives suggest improvements long sought by the practitioner community and have the potential of success. For reasons stated later in this statement, there are concerns that must be overcome before this can be a reality.
- The IRS Web site has been redesigned to make information more readily available to taxpayers and practitioners. Web pages designed to assist specific groups of taxpayers, such as the small business community, have been thoughtfully designed to be user-friendly and provide essential information.

There also have been disappointments.

- More than 250 NAEA members have been working with the IRS on a pilot Private Secure Messaging System. We were just informed by the IRS Electronic Tax Administration that due to a $120 million budget crisis, the pilot program will be discontinued after the filing season.

  It has long been the desire of practitioners to be able to communicate electronically with the IRS. This would be made possible by the Private Secure Messaging System. We view this is as an important incentive to bring more practitioners into e-filing tax returns. The more comfortable practitioners are in dealing with the IRS electronically, the more convenient it will be for them to e-file. We are, however, optimistic that what was learned in the pilot program will be carried forward into a permanent program. However, due to budget uncertainties, we cannot be assured that this program will be available next filing season. So we wonder, will the lessons learned in the pilot program be forgotten, laid on a shelf somewhere to gather dust?
- The IRS Web site redesign set to launch on January 2 was delayed. Unfortunately, the launch came later after the tax season had begun in earnest. Practitioners who had bookmarked specific sites found their electronic bookmarks useless. NAEA received scores of complaints from our members who rely upon the IRS Web site as a tool during their daily work with taxpayers.

Strategic Planning Issues

NAEA believes that strategic planning for fulfilling the IRS mission revolves around two important considerations. One is to be taxpayer friendly by providing the best customer service to taxpayers and practitioners that money can buy. The second concerns compliance. Collecting the correct amount of taxes from non-compliant taxpayers impacts not only the fairness of our tax system, but its very survival. Appropriate funding to make that happen is critical.

We commend IRS employees who, following the restructuring legislation, have experienced a tremendous cultural change and have weathered it well. Many consider customer service to be at the forefront in this regard. When an IRS employee may not know the answer to a question, he or she typically will go the extra mile to assist in finding someone who *can* provide the correct answer. Human resources and technology are key to making this a continued reality.

Change is going to be part of the IRS landscape for many years to come. This simply is because the reorganization cannot be accomplished at the snap of the fingers, even though we wish that it could.

Customer Service Matters

For the IRS, there is a major challenge: how to go about implementing customer service changes. For example, the practitioner priority service (formerly the practitioner hot line)—involving toll-free lines and other accoutrements—was a long-awaited improvement in service. However, the implementation has been anything but smooth.

Our members report that local practitioner hotlines that were supposed to be staffed for several more months during the transition are barely functioning because, in part, employees, concerned that they will lose their jobs, find others within the organization and depart. The rollout across the country was a thoughtful, pragmatic approach, but it was timed to coincide with the filing season. This was not a good idea. Practitioners don't know where to call—the national number or the local number. When a correct number is reached, it was and continues to be apparent that assistors are not properly trained. We want you to know that this type of transition during high-stress tax season is not helpful to the practitioner community.

NAEA supports an efficient and effective centralization of the service for obtaining needed Employer Identification Numbers (EINs). In our view, this has not happened. This in part is due to the toll-free lines having been overwhelmed from the start.

By way of background, the EIN system was shutdown from close of business December 21 until January 2 in order to accommodate essential upgrades. When the site reopened on January 2, callers quickly log jammed it. Some practitioners needed EINS to set up trusts or to accommodate year-end tax situations. Its unavailability until after long delays has not been a good thing.

Seldom have we received the torrent of complaints that we received on the implementation of this particular service. The sustained level of demand for EINs surprised even the IRS.

We believe two things happened. First, the shutdown in late December meant that those who desperately needed EINs in order to carry out year-end transactions were more desperate by January 2. Second, the information was available on the Web site, far beyond the reaches of just the practitioner community. Everyone saw it and more people than expected acted upon this information.

While the IRS did train and deploy additional staff as quickly as possible, it took several weeks to stabilize the service. Practitioners who faxed requests were advised to wait two to three weeks for replies. This was difficult for practitioners, faced with urgent deadlines, particularly during the stress of tax season.

On the other hand, we would like to thank IRS staff in the Office of Public Liaison and in SB/SE TEC who responded with a quick fix so those urgently needing EINs could be accommodated. Basically, they recommended that the words "EIN Applied For" be printed on the top of time-sensitive documents. This common sense approach alleviated a great deal of concern for many practitioners faced with absolute deadlines and who had no way to obtain an EIN.

Hand in hand with the implementation of wide-ranging changes goes training of employees. As mentioned earlier, we have been impressed with the cultural shift toward customer service achieved by the IRS. However, the training of personnel to implement IRS initiatives and making proper tools available to them are voids in the proper functioning of the "new" IRS. Many employees have asked our members to explain to them what is going on, have not had access to up-to-date materials, and have not understood what they are supposed to do. In some instances, under the new practitioner priority service, practitioners have asked to be forwarded to the Automated Collection Service. In numerous cases, customer service representatives do not know how to do this.

Compliance Matters

As indicated above, collecting the correct amount of taxes owed is important beyond measure to the fairness of our tax system and perhaps its survival. Obviously all customer service initiatives focus on that objective. However, there also must be compliance initiatives in place.

Without compliance initiatives, NAEA is concerned that there will be an increased lack of compliance. The fact there have been diminished compliance programs in recent years, such as audits, have not gone unnoticed by practitioners and taxpayers. It perhaps is beyond conjecture that returns are filed without expectation of review and enforcement. This leads to "sloppy" returns and ones taking aggressive positions that cannot be supported. In short, it might be said that there no longer is a "fear" of being audited.

It is in the best interests of our tax system to establish initiatives in the compliance arena. It is our hope that these initiatives would not dwell on compliance measures in which taxpayers are directly involved. However, technology must be such to accommodate an objective of this nature. In addition, adequate numbers of IRS personnel and their training are key to success.

NAEA acknowledges that establishing indicators and measures are important to compliance programs. We await with some trepidation the National Research Program (NRP), the successor to the TCMP audits. Again, well-trained IRS personnel will make all the difference in whether this is an incidental exercise or whether it becomes the focus of much anger and frustration. Although reportedly only 2,000 taxpayers will be subject to a line-by-line audit, some 30,000 others will find themselves in either a correspondence audit or an office audit for some portion of their tax returns. While the IRS has made great strides in its ability to interact with taxpayers and practitioners, the NRP may be a real challenge to such strides.

We wish to note the forward progress made by the IRS Criminal Investigation (CI) unit. Our membership has been concerned about the impact of tax cheats on our tax system. The improvements to the CI Web site and training examination specialists to look for cases that can be referred to CI for appropriate action are positive steps forward in compliance efforts. CI's outreach to the public and dealing with IRS personnel further the goals of sound tax administration. We encourage similar efforts be made with respect to civil tax compliance measures.

The Impact of Tax Complexity on IRS Employees and Taxpayers

Again, it is clear to NAEA that having sufficient staff who are well trained and with the proper tools to perform their jobs are integral components of sound tax administration. Further, they are key elements to successful implementation of the restructured IRS initiatives. NAEA urges your support in making this happen.

However, we also believe that tax law complexity is an area that requires your attention as it affects both taxpayers and IRS employees. We respectfully urge you to press for simplification of the tax code.

As the National Commission on Restructuring the IRS found, there is a clear connection between the complexity of the Internal Revenue Code and the difficulty of tax law administration and taxpayer frustration. Clearly, how the public perceives how well the agency is doing its job is tied directly to the level of frustration taxpayers have with the constantly changing tax code.

As frontline practitioners, NAEA believes Congress could provide significant relief and make the job of IRS employees more manageable by making immediate changes in three areas. First, Congress needs to repeal (preferably) or to modify the alternative minimum tax (AMT) for individuals. Second, it needs to simplify the rules for qualifying for the Earned Income Tax Credit. Third, phase-outs and phase-ins need to be standardized.

These changes would provide significant relief to taxpayers as well as allow the IRS to free up resources within the agency for other purposes. Without them, customer service and compliance programs are more important than ever.

Conclusion

NAEA believes that the IRS has made good forward progress and, with your help, can make even more. It is a tribute to Commissioner Rossotti's vision and leadership that the changes to the IRS have come about. We are aware that his five-year commitment is drawing to a close. If he chooses not to remain at the IRS, we hope his successor shares his vision and perpetuates its implementation. Whatever Commissioner Rossotti's decision might be, NAEA wishes him well. We consider him a person dedicated to taxpayers and the tax system, and a friend to tax practitioners.

Mr. Chairman and Members of the Subcommittee, I am pleased to have shared with you the views of NAEA members regarding the filing season and the IRS budget. If I may answer your questions or provide you with any additional information, I am happy to do so.

Thank you.

Chairman HOUGHTON. Thanks, Mr. Harris. Dr. Stevenson.

STATEMENT OF WILLIAM STEVENSON, PRESIDENT, NATIONAL TAX CONSULTANTS, MERRICK, NEW YORK, AND CHAIRMAN, FEDERAL TAXATION AREA, RIGHT TO PRACTICE COMMITTEE, NATIONAL SOCIETY OF ACCOUNTANTS, ALEXANDRIA, VIRGINIA

Mr. STEVENSON. Thank you, Chairman Houghton. My name is Bill Stevenson. I represent the National——

Chairman HOUGHTON. Could I just interrupt a minute? Mr. Ernst, I understand you have to go, and that Mr. Weinberger is going to sit in in your seat.

Mr. ERNST. If that is okay with you.

Chairman HOUGHTON. Do you have full trust and confidence in Mr. Weinberger?

Mr. ERNST. I have mostly full trust and confidence.

Chairman HOUGHTON. We appreciate very much your being with us. You can go at any time. Mr. Weinberger, we are delighted to have you with us. Sorry, Mr. Stevenson.

Mr. STEVENSON. I am representing the National Society of Accountants and its 30,000 members and affiliates. We are the professional preparers of people's taxes, and not only their individual taxes but their businesses as well.

The first time I appeared before you was March 24, 1995. I have the videotape. I deviated for a moment, as I am going to do now, and ask the Committee to address two issues. One of the issues was to figure out some way of providing more oversight to the Internal Revenue Service. While my remarks were more prophetic than they were influential, history has shown you have done this and I think we are a better Nation for it.

The second issue I asked you to address was the offer-in-compromise program, and we went a long way in trying to straighten it out during the Commissioner's restructuring the IRS, and there was some direction in the history of the Committee reports. But I must say I was disappointed when I found out that some provisions were stripped from your legislation that is going to go to the floor tomorrow. I will tell you that we are working with the Senate and, hopefully, we will get some of these provisions back in and you will have time to revisit that issue. It is a very serious matter.

But let us get to the shocking story of electronic filing. Our firm is fully committed to it. My partner and I process approximately 800 tax returns one at a time, one person at a time, and this year we have fully committed to the program. Ten years ago, the National Society of Accountants asked me to take a look at the electronic filing program and then, with the IRS' invitation as a stakeholder group, to tell them what our thoughts were. So I took it very seriously and I produced a 3-year horizontal case study using a microcosm of 50 tax preparing organizations of large and small practitioners, and I personally processed several hundred tax returns myself electronically.

I met with the IRS every 6 months for 3 years and I presented to them what they needed to do to get the practitioner community on board with electronic filing. In spite of the fact that they invited us to provide them with feedback, not only did they pretty much ignore our remarks but they came out with a more restrictive program, and the history will show there are 1 or 2 years where electronic filing instead of going up went down.

During that period of time, the professional practitioner community took electronic filing off of our radar screen, and we kept it off. And that is why the Commissioner said today if we file tax returns between April 15 and April 30 we will get more of the big returns in. These are the returns that we do. And the only reason that we electronically file is not because our clients have asked us to do it, it is because we have told them we are going to do it.

So after 9–11, our organization stepped up to the plate and told our membership that, look, this is a tough program to get started in, but it is an inconvenience of honor and this is something we can do to help this Nation defeat some potential terrorist problem. So we stepped up to the plate. My firm has prepared 99.9 percent of its returns electronically.

Now I am at the other end of tax season, and I am telling you the problem in getting the practitioner community aboard is that it takes a lot of extra time. I figured it took my partner and me 150 extra hours to produce 600 tax returns in a 9½ week period. The amount of input that individuals like me have to put into providing an electronic package is very heavy in the first year. And if the IRS wants to sell this program, they have to reduce that burden and they have to explain to practitioners that this is a new way of doing business. It is not easy.

It is kind of odd that the National Commission to Restructure the IRS sent a team of people, including a commissioner, to my office to learn about electronic filing. It is kind of odd that the Government Accounting Office is sending a team of people to learn about electronic filing before they present you with their final report. And it is kind of odd that the director of practice, who doesn't know anything about computerization, has spent a couple of days in my office over the last 2 years to learn about the process, but not one person from the IRS responsible for writing the program has been there to see what the practitioner has to go through with it to process this.

And my time is up.

[The prepared statement of Mr. Stevenson follows:]

Statement of William Stevenson, President, National Tax Consultants, Merrick, New York, and Chairman, Federal Taxation Area, Right to Practice Committee, National Society of Accountants, Alexandria, Virginia

Mr. Chairman, my name is William Stevenson, D.Ed, EA, CFP. Thank you for the opportunity to testify before the Committee today on the 2002 filing season and the IRS budget request for fiscal year 2003. I am the President of National Tax Consultants of Merrick, New York and the chairman of the Federal taxation area of the Right to Practice Committee of the National Society of Accountants (NSA). It is in my capacity as chairman of the NSA tax group that I appear before the Committee today.

The NSA and its affiliated State organizations represent 30,000 accountants, tax practitioners, business advisors and financial planners providing services to over 19 million individuals and small business. Most of our members are sole practitioners or partners in small to medium sized firms. NSA represents the accountants on Main Street, not those on Wall Street. NSA has not received any Federal grants or contracts for this fiscal year or for the preceding two fiscal years.

In order to place NSA's remarks in the proper context, we need to explain the distinction between the two basic types of tax preparers. Members of the first group usually see their walk-in customers once a year—to prepare their tax returns. Members of the second group are tax practitioners/accountants who provide continuing services to clients (return preparation, tax planning and IRS representation, and other services). NSA's comments are from the perspective of the second group.

E–FILING

NSA is committed to electronic filing and has called upon its members to become electronic return originators (EROs). In October 2001, NSA issued a Call to Arms to encourage the membership to embrace electronic filing and utilize the Electronic Federal Tax Payment System (EFTPS) to pay tax liabilities. NSA's intent was to help reduce the risks posed by mail disruptions, lessen the need of the IRS to process paper documents and do our part in helping IRS reach its mandated goal that 80% of all returns be electronically filed by 2007.

As the Committee is aware, IRS is lagging behind in reaching this goal. NSA believes that part of the reason is that many tax practitioners have not jumped on the e-filing bandwagon. Why have more tax practitioners not committed to electronic filing? Some will not e-file unless it is mandated. Some may be near retirement and do not wish to invest in new technology or change long-established business practices. NSA believes the primary reason is that the IRS has designed a system that is not user-friendly and, in fact, increases the workload (and cost) for tax practitioners in a business where time literally is money.

Perhaps the experience of my firm can illustrate the problems. My firm made the commitment to e-file as many returns as possible this filing season. This entailed capital expenditures to upgrade computers and communications equipment and required that we re-think our entire practice and restructure it to accommodate the requirements of the e-filing environment. This we understood and accepted as a cost of doing business.

As we began to prepare and file returns electronically, we quickly realized that the time needed to prepare a return had dramatically increased. For a practice such as mine that will prepare 800 returns this season, this translates into 200 to 275 hours of additional work. This required time competes with many other immediate time-consuming tasks including the preparation of several hundred-business returns and handling IRS CP 2000 notices received by clients. One point should be made clear. The actual electronic filing of the return is simple and quick; it is the extra steps involved in preparing the return and post filing activities that consume the extra time.

First of all, additional data entry is required to prepare the return. For example, on a paper return, the preparer transfers the dollar amounts from a W–2 and enters it on the appropriate line. On a return that will be filed electronically, all the data from the W–2 including not only data about the taxpayer but also employer data (such as name, address and EIN, among other data) must be entered into the computer. Multiple W–2s magnify the time factor. Similar activity occurs for a form 1099–R. Why the IRS requires this additional information has never adequately explained. In effect, IRS has shifted its data entry process from the return processing centers to the practitioner's office.

When the preparer signs a paper return, generally the job is finished. This is not true with an e-filed return. We transmit the return, wait for acceptance by the IRS and the State. Once the acceptance is received we print out a letter notifying the client that the return has been received and accepted by the taxing authority. If for some reason the return is rejected, we have to investigate the cause and correct the return immediately and resubmit. In a paper environment, most of these problems would not be discovered until after the filing season and would be handled when time pressures are much less.

The Treasury is advocating that the filing date for electronic returns be extended to April 30 and the Ways and Means Committee adopted such a provision in H.R. 3991. This initiative will not solve the time problem. Tax returns not completed several days before the filing deadline go on extension anyway. This proposal does not extend the number of hours in the day early in the filing season. It will extend the time for people who already file late. This may be a benefit to the commercial preparers and individuals filing their own returns, but for the tax practitioner, it is of marginal value.

The process to become and remain an ERO is not practitioner friendly. If one is not an Enrolled Agent, CPA or attorney, the application process requires a background check, including fingerprinting and a credit check. Preparers of paper returns are not subject to these requirements. Another burden imposed by the IRS is a program known as the Revenue Protection Strategy. Under this program, IRS will make unannounced visits to practitioner's offices. The process, which can take several hours, involves interviews with the practitioner and staff and a review of documents. Having IRS agents appear in the office in the middle of filing season and flashing their badges in front of clients is an experience tax practitioners can do without.

Electronic filing is the road of the future. How rough will the ride be? Until the IRS does a better job in making the system more practitioner-friendly, tax practitioners will be reluctant to accept this program. The IRS can do better. Not only must IRS improve its outreach to the practitioner community, it must listen and act on the advice that NSA and other groups are more than willing to provide.

If a picture is worth a thousand words, than a hands-on demonstration is the equivalent of the Encyclopedia Britannica. I invite Members of the Committee and their staff to come to my office in New York and experience first-hand a live demonstration of electronic filing from the practitioner perspective. I guarantee it shall be an eye opening experience.

FEIN DEBACLE

IRS implemented a new process for issuing Federal employer identification numbers (FEIN) in early 2002. This included the transfer of workload from ten campuses to three campuses. The result was a disaster with taxpayers and practitioners experiencing both difficulty in reaching the IRS and lengthy delays in receiving a FEIN. Sometimes taxpayers received more than one FEIN.

Another problem we are experiencing in the field is inconsistent handling of the program by IRS staff. In many instances, practitioners were advised that a power of attorney (POA) needed to be on file before the IRS would speak to the practitioner. This was incorrect. Often, the IRS would refuse to fax a FEIN to the practitioner with a valid POA on file with IRS. Again, this was incorrect. The end result has been chaos and confusion in a program that once ran smoothly.

In a recent letter to IRS Oversight Board Chairman Larry Levitan, Commissioner Rossotti stated that IRS is committed to maintaining a level of service at or above 85%. We believe the 85% service level is unacceptable. The goal should be 100%. Obtaining a FEIN is a fundamental need for many businesses and the IRS should not fail in delivery of a basic service to taxpayers entering the system. Imagine an 85% service level in obtaining a telephone number. A FEIN is a critical identification number and, among other purposes, is needed to open a bank account and apply for Subchapter S status. The IRS can and should do better. Dealing with this type of problem, particularly during filing season, burns up valuable time that could be better spent elsewhere.

On a positive note, the IRS acknowledged they should have had more involvement with stakeholders in the planning and development of this initiative, and according to the Commissioner, the IRS is "... committed to greater stakeholder involvement in the development of future initiatives." NSA hopes that this new attitude will carry over to the next Commissioner.

RETROACTIVE TAX LAW CHANGES DURING FILING SEASON

Another burden imposed on tax practitioners during filing season are tax bills that are enacted during the filing season that have provisions retroactive to the preceding tax year. The software companies scramble to modify their programs, the IRS scrambles to put out guidance and the practitioner is left in the lurch. Should returns in progress be filed under previous law and then corrected by filing an amended return? Should you delay processing affected returns until later in the filing season and hope for guidance? Also, previously filed returns must be identified and dealt with.

The Job Creation and Worker Assistance Act of 2002 (H.R. 3090, PL 107–147) contain two such provisions: the bonus depreciation provision and the net operating loss carry back. We appreciate the concern and are grateful that Congress and the Administration acted to provide tax relief to workers and small business. Unfortunately the timing of this legislation has caused problems in the field and dealing with these changes consumes time that must be obtained from another activity. We ask that Congress carefully weigh the impact on tax administration when considering legislation that contains provisions with effective dates that affect the filing season.

IRS BUDGET REQUEST

NSA supports full funding for the IRS. Simply stated, certain initiatives like business systems modernization, taxpayer outreach and pre-filing education efforts must receive adequate funding—and receive rigorous oversight from this Committee and the IRS Oversight Board as part of the deal. We do take exception to the allocation of funds to the new National Research Program (NRP) compliance study that will go into high gear the fall of 2002.

The IRS is championing the NRP audits because it says that the current audit selection system is yielding too many "no change" audits. It believes that the new data harvested from the audits of 50,000 randomly selected taxpayers will enhance the audit selection process and result in more productive audits.

NSA believes that poor audit selection is a result of factors other than poor data. The IRS is selecting the nonproductive returns because either the wrong people are involved in the selection process or the staff has not been properly trained. Furthermore, management pressures auditors and Revenue Agents to find quick adjustments and close cases as they are measured on cycled time. In other words, there is little or no incentive to close cases with adjustments, but a great deal of incentive to simply close cases quickly.

In recent years, the areas of review on a typical taxpayer's return have become far fewer than in years past. Many deductions on the Schedule A (Itemized Deductions), one of the major battlefields, on which the IRS auditors wage their attack, have been either eliminated or minimized. For example, we can no longer deduct credit card interest or sales taxes. The deduction for medical expenses used to kick in at 3% of adjusted Gross Income (AGI); now it's 7½% of AGI for the regular tax and 10% for the Alternative Minimum Tax (AMT).

The deduction for casualty and theft losses must exceed 10% of AGI plus $100. Previously, it was 100% of the loss less $100 with no AGI limitations. Not only must deductions for job related and investment expenses exceed 2% of AGI, but also, if they get too high, the alternative minimum tax (AMT) rears its uninvited head and robs the taxpayer of all subsequent deductions.

Mortgage interest is reported to the IRS by banks and mortgage companies and matched with Social Security Numbers and has limitations that affect the wealthy. The untouched areas on the Schedule A are charitable deductions and real estate taxes.

Losses that are generated from rental property begin to disappear for those with AGIs above $100,000 and completely disappear when the AGI exceeds $150,000. Furthermore, the AMT robs most taxpayers of income levels above $50,000 the benefit of a wide variety of credits: low income housing, research and so forth.

Like mortgage interest, the IRS matches most 1099s and W–2s with taxpayers' Social Security Numbers making it almost impossible to "get away with" omitting income that has been reported by a third party. It will take an initiative far greater in scope than the proposed NRP to identify those who under report cash income.

It is no secret that more taxpayers are retaining the services of skilled professionals who tenaciously fight to protect the interests of their clients. Is it any wonder that more audits are resulting in "no changes?" Randomly pulling 50,000 tax returns for audit will do very little to improve the overall audit program.

On the other hand, the IRS' ill-advised and ill-timed actions will result in frightening 50,000 citizens. The IRS admits that 50% of the NRP audits will result in "no change." Many more audit battles will percolate up to the Division of Appeals and even the United States Tax Court. In prior research programs like the Tax Compliance Measurement Program (TCMP), the results from an appeal are not included in the data pool, thereby skewing the results.

It appears that the NRP will affect two major groups of audit victims. The first group includes low-income taxpayers who are not exposed to the AMT, are minimally exposed to medical and miscellaneous expense thresholds and who cannot afford to retain competent representation. Naturally, their charitable contributions will come under IRS scrutiny.

The second target group includes small businesses. This area will generate many minor changes because many small businesses generally cannot afford to maintain efficient bookkeeping systems. In these cases the IRS will actually be auditing the work of professional preparers who have attempted to keep their clients in compliance by sculpting reality from a foundation of canceled checks and oral testimony.

Based on the Service's current performance, we are convinced that the IRS is not in a position to effectively administer its proposed National Research Program. Despite assurance of IRS management to the contrary, we fear that this program is ripe for abuse by over zealous IRS agents. Indeed, at a recent hearing of this Subcommittee, the IRS National Taxpayer Advocate in a question and answer session remarked that it may be necessary to have a third party monitor these audits to protect taxpayers.

The Service is an agency that is in transition. It has plenty of work ahead without deploying its precious assets to an ill-fated and ill-timed National Research Program. The taxpayer deserves better. We ask the Congress to put an end to this program before it gets off the ground.

Chairman HOUGHTON. Thank you very much, Mr. Stevenson. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Harris, the EITC program continues to be one of the most common errors that both taxpayers and tax preparer professionals make in filing individual tax returns. Seems to be still a high percentage.

Mr. HARRIS. Yes.

Mr. COYNE. Can you cite any reasons why you think that is the case?

Mr. HARRIS. I think probably the best thing that could be done, which I guess is the reason we have a problem, is clarifying definitions of something like a dependent, that we all understand who that qualifying dependent is. I think if you asked people on this panel and the IRS, that would go a long way, just clarification of a lot of the rules, at least from the practitioner side.

I think perhaps from people who self prepare returns, it is just another sign of complexity; that they just really do not understand it all.

Mr. COYNE. Do you see the EITC issue largely one of innocent errors or intentional fraud, in your experience?

Mr. HARRIS. Certainly from the people that we deal with it would be innocent, but I am aware of many cases where there are intentional claims made. There is no question that that exists. I think any time you make money available there are people who will abuse that opportunity.

Mr. COYNE. But could you put a percentage on it? Is it 10 percent intentional fraud or 5 percent?

Mr. HARRIS. It would simply be a guess, but I would say 10 percent is intentional, in my opinion.

Mr. COYNE. And the rest is just through complexity?

Mr. HARRIS. Complexity and confusion.

Mr. COYNE. And definitions, as you point out?

Mr. HARRIS. Definitions; right.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mrs. Thurman.

Mrs. THURMAN. Mr. Stevenson, you said you were talking with the Senate because there were some things left out of our bill. Can you give me what those were?

Mr. STEVENSON. There was a whole section on the offer-in-compromise program. The House had originally in there items that directed the IRS to consider hardship and be very specific about what the rules of hardship was, because the IRS misinterpreted hardship. Their interpretation of hardship for an offer-in-compromise program was that if a taxpayer has all the assets to pay for the tax but it is inconvenient for them to pay it, that is considered hardship. But if the person was poor enough and didn't have the assets to pay for the tax, then they could not be considered as a hardship case. It is right on their Form 656 as one of the rules for determining an offer-in-compromise.

Mrs. THURMAN. Maybe to the other three, or to all four, Mr. Coyne asked about the EITC, and I think all of us understand why that is not getting taken care of, because there are winners and losers if you expand it. If you lose, that is a problem there. However, I still think if it is causing problems out there we ought to be finding out how to fix it. But in saying that, and since it seems we have had an experience with that, we have heard some of the situations as I have referred to in this *New York Times* article and you all have been sitting here, what recommendations would you make to us in this matching issue the Commissioner has talked about? How do we match this money and make sure we are able to go over to these offshore trusts that we are not receiving the benefit from?

Any one of you.

Mr. HARRIS. I will be happy to comment since, as I have mentioned, we worked with the Commissioner and the IRS on this in some areas. I think you are going about it in the right way, trying to match the tax returns of the partnership to the individual tax returns. Where the potential for problem is, in our experience, and most of us were relating matching to something like a W–2 that has a standardized format that goes on a single place on a tax return, when you get into this matching of K–1's, first of all you have a variety of different K–1's where information can go on many, many places on that tax return and in some cases correctly not be on the tax return. Our caution to the IRS was while you need to catch the underreporting of income, the last thing you want to do is send out a lot of erroneous notices where you have not been able to find that it was correctly reported. And I think you do a lot more harm to the agency by sending out millions of notices proposing assessments of tax when the return was prepared correctly.

Mrs. THURMAN. Mr. Harris, don't you also think that at some point, as these kinds of reports come out, that we also hurt the IRS on the other end of it; that there are specifically, or at least seemingly, instances where the IRS might be targeting lower income, middle income people? That is the opposite potential you have, too.

I think there are two sides to that, and I am very concerned because I agree I think we have moved much further and have really taken some steps to help, but I do worry that there will be a feeling on either side. Somebody is not going to be happy with this.

Mr. HARRIS. I think we need to go forward with matching. I think it is part technology, in terms of giving the IRS the ability to standardize forms. It is a more encompassing problem than I think we think it is. We think it is taking K–1's, matching against returns, and we are going to find income, but I think we have to look at the bigger picture of form design standardization.

Clearly, I think this tax system is built on a belief that there is compliance being done out there, and if we don't shore up compliance I think the whole system is at risk.

Mr. STEVENSON. There is another issue, too, and I am sure Roger would agree with this. The problem really is training. The IRS will run a computer program, such as matching, and then automatically send out notices. But there is nobody really eyeballing the notices to say do they make sense. What he is saying is a lot of them, if anybody really looked at them, they would say they do not make sense.

But let me give you another foreign issue, which I am sure no one has even touched. I got a call about a year ago from a man from Belgium. He called me up to say, you know, I have set up 400 United States corporations in Delaware, and he wanted to know if these corporations were required to file a Federal tax return and get a Federal ID number. This is one man, 400 corporations in Delaware.

I have a contact in Delaware who sets up corporations all over the world, and apparently Delaware sets up a corporation for a foreign company and there is no matching with the IRS that these corporations have been set up. So there could be tens of thousands or hundreds of thousands of corporations that people set up throughout the world, acting under the rubric of an American corporation, with all the rights and privileges, but they do not even have an ID number. The guy nearly had a heart attack when I told him that, yes, you need an ID number and you are out of compliance for not filing these returns.

And the reason he got caught was because one of his clients was using a corporate return and they reported him to the IRS, and the IRS said that there was no such corporation. And the fraud people from Belgium had contacted him and he was getting quite ill about it.

Mrs. THURMAN. So you are saying that we need to be working with the States, who do this corporation set-up, so that we make sure that we in fact can do what Mr. Harris and others have said, be able to match these corporations with the IRS? Is that what you are suggesting?

Mr. STEVENSON. I am saying, first of all, Delaware seems to be the real problematic area in this, and these are not American citizens setting up these corporations. These are foreigners setting up American corporations, using our system to their benefit, and we are not getting anything out of it.

Mrs. THURMAN. I don't know if either one of you want to respond.

Mr. WEINBERGER. Just on the earned income tax credit. Congress gives the Internal Revenue Service about $147 million a year not just for increased compliance with respect to that program but also for education and outreach, because a number of the taxpayers who are eligible for the credit do not claim it, and some who claim it do not claim the full amount that they are entitled to. So it is not just a question of overpayments; there are in some cases underpayments.

As you know, it is one of the most effective antipoverty programs we have, and Congress has supported it because it gives an incentive for people who are poor to continue to work. It is also one of the most complex provisions in the Tax Code.

Several years ago the Treasury Department worked with us to develop due diligence procedures where tax practitioners could question claimants to make sure they were properly qualified to apply for the earned income tax credit. We believe that tax professional industry, working with Treasury and Congress, should sit down to look at the earned income tax credit and ask whether there are simplifications or adjustments that can be made.

Congress recently passed some changes to simplify the tie-breaker rule that helps determine which member of a family is eligible to claim a child, for example. Unfortunately, that will require some additional clarification, as is often the case when a new law is passed. But we think there may be additional simplifications that can be enacted and it is worth trying to get that program into a better posture of compliance.

Mrs. THURMAN. I would just say that one of the things in one of the articles talked about, and specifically what you talk about with regard to the EITC, it says that in the Manhattan tax office, and they suggested it is the richest in the Nation, there are only 23 auditors that remained on a staff that numbered actually 150 just a few years ago. So there certainly is a resource issue in trying to bring about compliance.

Let me ask one last question. I think all of you agreed on this issue, and that was that in our making changes so close to the tax season and not giving an opportunity to put things in it to work before tax season comes out. It is an excellent comment, because I think we so often do that thinking we are just going to hurry this up and everything is going to be wonderful.

Let me ask you this, and maybe it is something we can put everybody on notice now. We also know through the stimulus package, which was mentioned, that there will be some new requirements and some additional tax issues that will be coming into effect in 2004, 2005, and 2006. And then all of that goes away and we start another whole group of tax issues coming down the road, which of course I am very concerned about for a couple of reasons other than the complexity, but also the revenue side of it.

Are you at this time being asked or giving any input, or do you believe the rules and regulations which you might have to work under when these new tax issues come into effect—are we seeing any advance notice as to the way this might work, and would we have then a better opportunity to use the tax issue as it was intended by Congress?

Mr. WEINBERGER. Well, with respect to the stimulus package, of course that is a classic example, because that made some changes that were retroactive and made them right in the middle of the tax season. And as hard as the Internal Revenue Service works to get forms ready and so on, it is sometimes——

Mrs. THURMAN. But we also will be going into the tax bill. I think there is a new IRA, there are some educational issues, and there are some things in there. What you are telling me is that in fact we know that there is a problem when we push things too quickly or they are retroactive or right in the middle of the season, like the depreciation issue that you mentioned from this stimulus package. Are we seeing at this time IRS having the rulemaking authority to start putting rules out that would have an effect on these new tax issues that will be coming due, or not due but in place in the 2004–2005 timeframe?

Mr. STEVENSON. Well, first of all, the IRS is really historical. They are still auditing 2 years ago or year and a half ago. So a large percent of the IRS is looking back. Another large percentage is just getting ready for the next filing season.

From our perspective, they are really very—I mean, talk about chaos and confusion. They do not have enough people to deal with the future. That is really our job. And, frankly, from our perspective, we hope some of the things will change, because we know you rush some things through. And we really love the fact that you are concerned, and you are trying to do the best we can. We really understand that.

We are really struggling with this new thing because we are all still suffering and reacting to 9–11. I am from New York, as the Chairman is, and we really have not recovered from this event, I have to tell you right now. So we know that some things that have happened will change. And in the last several years, the amount of oversight and the fabulous staff that you have in bringing us together and bringing things to your attention, we just feel that things will change in the future. We cannot do a lot of tax planning for it because historically they have changed.

I don't know if that answers your question. It is hard to prepare for things. How do you prepare for the estate tax that is going to disappear in 10 years or maybe come back and be back to $1 million? We know you have to change that.

Mrs. THURMAN. Can I quote that?

Mr. STEVENSON. You have to change it.

Mr. HARRIS. If I could respond a little bit to that. I think the average taxpayer doesn't do a lot of tax planning, so right now they are not really that concerned about the changes. They find out when they have their taxes prepared where they won and where they lost.

The IRS is certainly addressing this, but I don't think there is a big demand from the average taxpayer; tell me about the changes that are coming this year, next year, the year after. Unfortunately, maybe that is an indictment of the taxpayers. They have just given up hope on figuring it out. They just gather everything together, get their taxes done after the first of the year, and they hope they won more than they lost in changes. And sometimes they do, sometimes they do not.

Mr. WEINBERGER. Two aspects of that. One, the Internal Revenue Service does consult with tax practitioners as it develops new forms and instructions and tries to identify areas where the forms and instructions are not as clear as they should be. And I am sure as they prepare for some of the changes that the Congress has mandated for 2003 and 2004, and so on, those forms and schedules will come in due course.

The other aspect that Mr. Harris was just alluding to, however, I think is even more significant, and that is that Congress passes many, many programs and tax provisions that are beneficial to individuals, and a lot of Americans simply don't know they are eligible for them. We find that we are increasingly becoming a financial counselor to our clients to help them understand provisions that may be available to them that they were not aware of.

So I think there is a financial education component which is important, an additional education component with respect to tax provisions that Congress intends to apply to Americans that they are not fully aware of.

Mr. DOUGHERTY. In the passing of the act, and, of course, everything cannot be perfect in life, so it came along at a time and so we are reacting to it. It was a little bit of a problem. We will get over that. And I think the Service has done a good job. I didn't mean to tell you that I don't think the Service has done a good job. I think the Service has done a good job. It was late. They have come out afterward and said we are going to have to amend some returns and that is going to cause some problems.

But the Service normally does a very good job if the law is there. Normally the information does come out. They do consult with you. They try to. Sometimes they don't listen to everything we tell them, but everybody in life doesn't do that. So I think they do do a good job.

And as for the future, are we doing planning? Obviously, we do some planning, too, and our clients do look at this law. We do take it serious, it is on the books to see whether it will affect them in the future. So, yes, we do have clients that are looking at the law and into the future.

Mrs. THURMAN. I appreciate your indulgence, Mr. Chairman. So I guess the bottom line is it is just us. The IRS is doing fine, if we would just quit changing things in midstream.

Mr. DOUGHERTY. No, we didn't say that.

Mr. WEINBERGER. Well, our tax preparers do——

Chairman HOUGHTON. Well, now, wait a minute. We cannot go on forever here. I appreciate your comments. This is 15 minutes and we are usually on a 5-minute basis.

I want to thank you very much for being here. It has been very helpful, and we will be in touch with you again. Thanks so much.

[Whereupon, at 4:21 p.m., the hearing was adjourned.]

[A submission for the record follows:]

Valparaiso University School of Law Tax Clinic
Valparaiso, Indiana 46383–6493
April 8, 2002

The Honorable Amo Houghton
Chairman
Subcommittee on Oversight
Committee on Ways and Means
1136 Longworth House Office Bldg.

RE: Statement to be included in the printed record of the April 9, 2002 Subcommittee Hearing on the 2002 Tax Filing Season and the IRS Budget for Fiscal Year 2003.

Mr. Chairman and Distinguished Members of the Subcommittee,

Thank you for the opportunity to offer these views concerning the 2002 fiscal year tax filing season and the IRS budget for fiscal year 2003. This statement is provided on behalf of the members of the Valparaiso University School of Law Tax Clinic. This statement has not been approved by the Valparaiso University School of Law and, accordingly, should not be construed as representing the policy of the University.

The Valparaiso University School of Law Tax Clinic functions as a law office whose primary purpose is to provide practical legal skills training for students who are close to completing their law school education. The secondary purpose of the clinic is to provide supervised legal representation to low-income individuals and groups who otherwise would have difficulty in finding affordable representation. Specifically, the Tax Clinic represents low-income individuals with Federal tax problems both at the administrative level (IRS) and before the U.S. Tax Court.

This clinic has had the opportunity to work with a significant number of clients who have had issues with the Earned Income Tax Credit ("EITC"). Through our representation of these individuals, we echo many of the concerns delineated in the National Taxpayer Advocate's Fiscal Year 2001 Annual Report to Congress. On the National Taxpayer Advocate's list of the 23 most serious problems, the EITC is a prominent component of seven such problems.

A majority of these problems result from the complexity of the Tax Code as it relates to the EITC, as well as from a lack of access to free tax assistance, accessibility and affordability of professional tax assistance, literacy limitations, language barriers, and even fear of contacting the IRS.

More specifically, taxpayers have a difficult time navigating IRS Publication 596, which explains EITC eligibility, and which contains 15 qualification rules and is more than 50 pages long. As pointed out by the National Taxpayer Advocate, Form 886–H, entitled *Explanation of Items*, is extremely difficult for unsophisticated taxpayers to understand, and many low-income taxpayers usually cannot afford to take the time off from work to collect the required documentation, and often do not maintain financial records. Oftentimes, taxpayers are asked to provide documents and information already available to IRS employees, such as Social Security numbers. The IRS' standards and processing of documentation create a heavy burden for the taxpayers least equipped to comply with these requirements. As a result, taxpayers find the EITC process intimidating and IRS notices difficult to comprehend.

The National Taxpayer Advocate's Report also indicated that one conspicuous EITC-related problem was with the access to and answers from the toll-free service lines. Internet assistance via the IRS Web site currently does little to alleviate this dilemma. For example, for those taxpayers who have the requisite sophistication and access to a computer with internet capabilities, a search on the IRS Web site to determine what constitutes a "qualifying child" will lead the taxpayer to 2,224 results. This issue is of special importance to taxpayers who qualify for the EITC, who currently have the least access to professional tax advice, and rely on government sponsored programs and resources to assist them with these questions.

Based upon the foregoing, and our experiences in providing legal representation to low-income individuals with EITC concerns, this clinic supports the Administration's IRS budget requests for fiscal year 2003 and, in particular, the $154 million requested for the Earned Income Tax Credit Compliance Initiative. Although this clinic firmly believes that substantive changes to the Tax Code are required to more completely address the problems posed by the complexity of the EITC, we support the Administration's strong commitment to addressing tax problems as they concern low-income taxpayers. The IRS must be given sufficient resources to effectively administer initiatives in improving the quality employee and volunteer training, clarification of printed materials, as well as outreach educational programs.

In closing, this clinic would like to recognize the efforts and beneficial effects of the National Taxpayer Advocate's presence. The Office of the National Taxpayer Advocate has been an enormous resource, not only in our ability to provide effective legal representation to low-income taxpayers, but in our efforts to deepen our understanding of complex tax matters as well. We reiterate our support of the Administration's commitment to the Earned Income Tax Credit Compliance Initiative, and we urge the Members of this Subcommittee and of Congress to provide the IRS with the tools necessary to improve its relations with low-income taxpayers, thereby increasing participation among the less-privileged.

Thank you again for the opportunity to address this Subcommittee.

Respectfully,

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