

**2003 TAX RETURN FILING SEASON AND THE IRS
BUDGET FOR FISCAL YEAR 2004**

HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

APRIL 8, 2003

Serial No. 108-20

Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PRINTING OFFICE

90-816

WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
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**2003 TAX RETURN FILING SEASON AND THE
IRS BUDGET FOR FISCAL YEAR 2004**

TUESDAY, APRIL 8, 2003

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

The Subcommittee met, pursuant to notice, at 9:05 a.m., in room B-318, Rayburn 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
April 01, 2003
No. OV-3

CONTACT: (202) 225-7601

Houghton Announces Hearing on 2003 Tax Return Filing Season and the IRS Budget for Fiscal Year 2004

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 2003 tax return filing season and the Internal Revenue Service (IRS) budget for fiscal year 2004. **The hearing will take place on Tuesday, April 8, 2003, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include IRS Acting Commissioner Robert Wenzel, U.S. General Accounting Office Director of Tax Issues James White, and IRS Oversight Board Chairwoman Nancy Killefer. 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 2003 tax return filing season refers to the period from January 1 to April 15 when U.S. taxpayers will file more than 175 million tax returns, including more than 50 million e-filed returns. During this period the IRS is expected to issue more than 104 million tax refunds, answer nearly 90 million telephone calls from taxpayers asking for assistance, and its homepage is projected to receive more than 3 billion hits.

The Administration's budget requests \$10.4 billion to fund the IRS for fiscal year 2004. This level of funding will support approximately 100,043 employees who will collect about \$1.74 trillion in taxes (net of refunds), according to Administration estimates. Beyond supporting the traditional activities of the filing season, the fiscal year 2004 budget request addresses the Administration's key strategic goals for the IRS.

In announcing the hearing, Chairman Houghton stated, "Every indication says that this year's filing season has progressed well and without serious problems, but that does not mean Congress can afford to be complacent, of course, about tax administration. The IRS has done a great job in the manner which it continues to handle the massive volume of tax returns. Our goal now is to work to improve the IRS's interaction with taxpayers and its core business systems."

FOCUS OF THE HEARING:

The hearing will focus on the 2003 tax return filing season and the IRS budget for fiscal year 2004.

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 22, 2003. 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.

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. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

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

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

Chairman HOUGHTON. The hearing will come to order. Thank you very much, everybody, for being here this morning, a good early start.

I am pleased to have before us today the Acting Commissioner, Robert Wenzel, who continues his dedicated service to our Nation, and I understand that you have delayed your retirement and are going to retire in 2050, is that right, Robert?

[Laughter.]

I hope so. By all accounts, this year's tax filing season is progressing smoothly, but that does not mean that Congress can afford to be complacent, of course, about tax administration. The Internal Revenue Service (IRS) has done an outstanding job in the manner in which it continues to handle the massive volume of tax returns. Yet taxpayers and professionals continue to report difficulty in communicating with the IRS, and the multi-billion-dollar business systems modernization program has yet to fully deliver on its promises.

Now, our goals are to oversee the IRS, and yet also to challenge it to improve its interaction with taxpayers and its core business systems. One obvious way to improve the interaction with the IRS is to continue to encourage electronic filing of tax returns. As the Subcommittee heard in February, the IRS had entered into an innovative agreement with a consortium of software companies to provide free online electronic filing of tax returns for up to 60 percent of taxpayers. This partnership so far has been a success.

The IRS, however, is still not on track to meet the 80 percent electronic filing goal by 2007, and it is well understood that taxpayers, particularly those with a balance due in April, need a greater incentive to abandon the habit of filing on paper. The Administration's proposal to give electronic filers a few extra days in which to file their returns is one way to provide such an incentive, and I am pleased that the Committee on Ways and Means was able to report legislation including this proposal to the U.S. House of Representatives on Thursday.

Another area that deserves our attention is the multi-billion-dollar program to overhaul the computer systems of the IRS. The IRS has faltered in this area before, and although there are signs of progress behind the scenes, taxpayers are not yet experiencing the fruits of modernization. This year and next will be critical in determining whether the modernization effort will succeed. Many systems that have been under development for years, such as the new IRS database of tax records, are entering the final stages of development. We will hear an evaluation of the IRS' efforts to date from the U.S. General Accounting Office (GAO), from the IRS Oversight Board, and from the panel of tax practitioners who have generously volunteered their time to be here today.

So, I am pleased now to yield to the Ranking Member, Mr. Pomeroy.

[The opening statement of Chairman Houghton follows:]

Opening Statement of The Honorable Amo Houghton, Chairman, and a Representative in Congress from the State of New York

Good morning. I am pleased to have before us today Acting Commissioner Robert Wenzel, who continues his dedicated service to our Nation.

By all accounts, this year's tax filing season is progressing smoothly, but that does not mean Congress can afford to be complacent, of course, about tax administration. The IRS has done a great job in the manner which it continues to handle the massive volume of tax returns, but taxpayers and tax professionals continue to report difficulty in communicating with the IRS, and the multi-billion dollar business systems modernization program has yet to deliver fully on its promises. Our goals now must be to challenge the IRS to improve its interaction with taxpayers and its core business systems.

One way to improve the interaction with the IRS is to continue to encourage electronic filing of tax returns. As this Subcommittee heard in February, the IRS has entered into an innovative agreement with a consortium of tax software companies to provide free online electronic filing of tax returns to up to sixty-percent of taxpayers. This partnership has so far been a success.

Nevertheless, the IRS is still not on track to meet the 80% electronic filing goal by 2007, and it is well understood that taxpayers—particularly those with a balance due in April—need a greater incentive to abandon the habit of filing on paper. The Administration's proposal to give electronic filers a few extra days in which to file their returns is one way to provide such an incentive, and I am pleased that the Ways and Means Committee was able to report legislation including this proposal to the House of Representatives on Thursday.

Another area that deserves our attention is the multi-billion dollar program to overhaul the IRS's computer systems. The IRS has faltered in this area before, and,

although there are signs of progress behind the scenes, taxpayers are not yet experiencing the fruits of modernization. This year and next will be critical to determining whether the modernization effort will succeed. Many systems that have been under development for years—such as the new IRS database of tax records—are entering the final stages of development. We will hear an evaluation of the IRS's efforts to date from the General Accounting Office, from the IRS Oversight Board, and from the panel of tax practitioners who have generously volunteered their time to be here today.

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

Mr. POMEROY. Mr. Chairman, thank you for convening this hearing. We are well into the tax filing season, about 7 days remaining, an estimated 175 million tax returns to be filed through the 2003 tax season. During this filing season, the IRS will issue over 100 million tax refunds and answer nearly 100 million telephone calls from taxpayers seeking assistance.

Now, the reports we have been getting show that, so far, so good this tax season. I would be interested to hear from the Acting Commissioner in terms of how that continues to proceed.

Of particular interest to the Subcommittee is the proposed budget for the next year, including an increase of 5 percent over that enacted for 2003. While I think this is a much more positive indication that—this bipartisan agreement that the IRS needs to have the competencies to do its job effectively, and that takes budget dollars.

I was interested that the Oversight Board recommended an additional \$287 million as required in order to keep up to the very important tasks you have been charged to perform, so I will be interested in your comments on that.

I have also had called to my attention some concerns regarding the process, the speed, and the outcome of the pre-certification form being designed for those wishing to claim the Earned Income Tax Credit (EITC). I will be interested this morning in hearing and getting more information on that, as well.

I think that we have turned an important corner in terms of Congressional interaction with the IRS. Just a few years ago, they were talking about pulling the tax code out by the roots and attacking the IRS as a way to achieve that objective. Obviously, let us debate tax reform, but let us not take it out on the professional men and women charged to answer those 100 million phone calls, get those 100 million refunds out the door, and discharge the responsibilities they have been tasked to perform under the Federal Code.

So, I commend you for your long public service. I echo the Chairman's appreciation that you have continued to play a guiding hand during this interim and after the new Commissioner is on board. It is our pleasure to hear from you again. Thank you, Mr. Chairman.

[The opening statement of Mr. Pomeroy follows:]

Opening Statement of The Honorable Earl Pomeroy, a Representative in Congress from the State of North Dakota

Once again this year, the Subcommittee on Oversight is holding a hearing on the current tax return filing season and pending IRS budget. I thank Subcommittee

Chairman Houghton for conducting this important annual oversight review of the Internal Revenue Service.

More than 175 million tax returns will be filed during the 2003 tax return filing season which ends in seven days. During the filing season, the IRS will issue over 100 million tax refunds and answer nearly 100 million telephone calls from taxpayers seeking assistance.

Reports indicate that the 2003 tax return filing season is progressing smoothly. I want to commend all IRS employees for a job well-done.

Of particular interest to this Subcommittee is the proposed IRS budget for fiscal year 2004 of \$10.4 billion. (This is an increase of 5% over the enacted fiscal year 2003 budget level of \$9.9 billion.) Importantly, the IRS Oversight Board recommends \$287 million more than the Administration requested for fiscal year 2004. I look forward to the witnesses' discussion of whether the proposed amount is sufficient and how such resources can be used to provide a fair and balanced approach to administering our tax laws.

Thank you.

Chairman HOUGHTON. Thank you very much, Mr. Pomeroy. We are honored to have once again Robert E. Wenzel, who is the Acting Commissioner of the IRS. Mr. Wenzel?

STATEMENT OF THE HONORABLE ROBERT E. WENZEL, ACTING COMMISSIONER, INTERNAL REVENUE SERVICE; ACCOMPANIED BY JOHN DALRYMPLE, COMMISSIONER, WAGE AND INVESTMENT DIVISION, INTERNAL REVENUE SERVICE; AND TODD GRAMS, CHIEF FINANCIAL OFFICER, INTERNAL REVENUE SERVICE

Mr. WENZEL. Mr. Chairman, thank you for this opportunity to testify on the 2003 tax filing system, our 2004 budget request, and some of the other initiatives we are undertaking on behalf of America's taxpayers.

Accompanying me today are Mr. John Dalrymple, the Commissioner of our Wage and Investment Division, and Mr. Todd Grams, the IRS's Chief Financial Officer. Mr. Dalrymple, as I mentioned, is the Commissioner of the Wage and Investment Division and has principal lead responsibility inside the IRS for the filing season and a number of the other programs that you have already stated that you have an interest in.

Mr. Chairman, the 2003 tax filing season has been smooth. Returns are being processed on time, electronic filing is still increasing, and our telephone service is more accessible and accurate. Projected net collections for calendar year 2003 will be approximately \$1.74 trillion. We also project we will receive 175 million returns during the calendar year, which will include over 132 million individual returns, and we expect to issue over 104 million individual refunds. As of March 28, the average dollar amount per refund, \$2010, is up a little over 2 percent from last year.

Mr. Chairman, e-file continues to be the preferred method of filing for a growing number of taxpayers. This filing season, all individual e-file is up by 10 percent and e-filing online has grown by 27 percent. E-filing now approaches 41 percent of individual returns filed.

Part of the recent surge can be attributed to the innovative Free File program. As of March 26, the Free File Alliance Members have processed and transmitted more than 2.1 million Free File tax returns. This represents approximately 22 percent of the total online

e-file returns. I would urge passage of legislation that extends to April 30 the deadline for e-file returns. This incentive could further prompt e-file growth.

The IRS website continues to be extremely popular with taxpayers. For fiscal year 2003 through March 30, there were 2.4 billion website hits, up 24.5 percent over the same period last year.

Our telephone service is also improving. Through March 22, approximately 83.8 percent of taxpayers who wanted to talk to a customer service representative got through, which compares to 69.4 percent last year.

Once connected, taxpayers must get prompt, accurate, and courteous answers to their account and tax questions. The telephone correct response rates for tax law and tax account questions are about even with last year.

Taxpayers needing face-to-face help solving individual or business tax problems can get it every day at IRS's Taxpayer Assistance Centers. For this filing season, through March 22, we served over 3.15 million taxpayers at all of our centers. The customer satisfaction rate was 88 percent satisfied and 7 percent dissatisfied, which is right on schedule as it relates to our 2003 performance plan.

Mr. Chairman, let me very briefly describe the President's 2004 budget request. Simply put, it keeps us on track. The funding provided will help us to build on the improvements we have made in enforcement, in service, and productivity while continuing to make longer term investments in our business systems modernization program.

The principal strategic focus of the budget is strengthening our enforcement activities. The additional funding will help us carry out our new strategy that focuses on key areas of noncompliance, such as offshore credit card users and the promoters of abusive schemes and scams.

The second focus of the proposed budget is reinvestments. By re-investing \$166 million, primarily from increased productivity, we will be able to deliver increases in the performance of key tax administration programs. Now, these are significantly higher than the additional dollar and manpower increases requested in the budget.

The third and final focus is business systems modernization. Increased funding is requested for the coming fiscal year, and over the course of the business systems modernization program, these investments will benefit the IRS and taxpayers by reducing operating cost, increasing cost avoidance, reducing taxpayer burden, and boosting tax receipts.

Mr. Chairman, in conclusion, we are producing yet another successful filing season and trends in customer service and compliance are pointing us in the right direction. The President's budget will help us to maintain this upward course to succeed in achieving our mission. Thank you.

[The prepared statement of Mr. Wenzel follows:]

**Statement of The Honorable Robert E. Wenzel, Acting Commissioner,
Internal Revenue Service**

INTRODUCTION

Mr. Chairman, thank you for this opportunity to testify before the Subcommittee on the 2003 tax filing season, our FY 2004 budget request and some of the initiatives we are undertaking on behalf of America's taxpayers.

Let me also thank you for your continued leadership and guidance as we work to provide quality service to America's taxpayers, ensure compliance with the tax laws and seek greater efficiencies throughout the agency.

Mr. Chairman, I am pleased to report that we are gradually improving our performance across the board. As demonstrated by the 2003 filing season results, we are seeing further improvements in key areas, such as *e*-filing growth and telephone service.

2003 FILING SEASON

Mr. Chairman, the 2003 tax filing season has been smooth, with returns being processed on time, electronic filing increasing, and improved accessibility and accuracy of telephone service. It continues to demonstrate how we can build on positive trends, especially as our major technology and organizational initiatives take effect.

Projected net collections for CY 2003 will be approximately \$1.74 trillion. During CY 2003, we also project to receive 175 million returns, including over 132 million individual returns, and expect to issue over 104 million individual refunds. As of March 28, 2003, the average dollar amount per refund is up almost 2.33% over last year, and the average refund is \$2,010.

Electronic Tax Administration

E-file continues to be the preferred method of filing for a growing number of taxpayers. Faster refunds, positive acknowledgement of receipt and fewer errors are key benefits. Indeed, the American Customer Satisfaction Index shows a very high satisfaction rate among electronic filers. For 2002, it was 78 points (out of 100), compared with a mark of 53 for individual paper tax filers.

In 2002, more than 46.7 million taxpayers (36 percent) filed electronically—a 16.4% rise over the previous year. This filing season, all individual *e*-file is up by 10% and *e*-filing online has grown by 27%. It is projected for CY 2003 that *e*-filing will constitute approximately 41% of individual returns filed. Part of the recent surge can be attributed to the innovative Free File program that was the subject of the Subcommittee's February 13, 2003 hearing.

Free File reports are most encouraging. As of March 19, Alliance members have processed and transmitted more than 2.1 million tax returns. This represents approximately 22% of the total 9.2 million online *e*-filed returns.

Key Statistics

The following are key 2003 filing season *e*-file statistics that provide greater detail about individual *e*-file components and programs. All are through April 3, 2003, unless noted.

- Nearly 31 million taxpayers have *e*-filed their tax returns electronically through an IRS-authorized Electronic Return Originator (ERO), a 8.51% increase over the same period last year.
- Approximately 9.2 million taxpayers have filed their tax returns on-line via their home computer through a third party transmitter. Online filing is running 27 percent ahead of last year and is near the 2002 total volume of 9.4 million.
- Almost 27 million individual taxpayers have chosen to use the Personal Identification Numbers (PINS) in lieu of a written statement when *e*-filing on-line.
- Over 3.4 million taxpayers have filed their returns over the telephone using the TeleFile system.
- Nearly 30 million taxpayers have chosen direct deposit of their federal tax refund, a 12.6% increase from the year before.
- Over 18 million taxpayers have chosen to file both their federal and state tax returns simultaneously in a single electronic transmission, up 16% from last year's 16.2 million.

New And Popular Options Help Spur E-File Growth For Individual Taxpayers

The enormous popularity of e-file and its continued growth can be attributed to both its value to taxpayers and our efforts to make it simpler, more attractive and available to more taxpayers.

Since its modest beginnings as a pilot in 1986, we have added more options each year, ranging from payment by credit card, direct deposit of refunds, self-select PINs to adding more forms and joint filing of federal and state returns. Free File is a natural outgrowth of this approach. For the 2003 filing season, we kept many of the options popular with taxpayers and added some new ones.

Seven New Forms for 2003

For 2003, taxpayers are able to electronically file seven new forms related to their Individual Income Tax Returns:

- Form 970—Application to Use LIFO Inventory Method
- Form W-2G—Guam Wage and Tax Statement
- Form 1099-G—Certain Government and Qualified State Tuition Program Payments
- Form 1310—Statement of Person Claiming Refund Due to a Deceased Taxpayer
- Form 8594—Asset Allocation Statement Under Sections 338 and 1060
- Form 8880—Credit for Qualified Retirement Savings Contributions
- Form 8885—Health Insurance Credit for Eligible Recipients

Check Your Refund Status Electronically

Taxpayers have several options for checking on the status of a refund, including a new Internet-based service available on the IRS web site, called “Where’s My Refund?” Taxpayers can get the information they need quickly, efficiently and safely. For FY 2003, we expect 15 million uses of “Where’s My Refund?”

Simple online instructions guide taxpayers through a process that checks the status of their refund after they provide identifying information shown on their tax return. Once the information is processed, results can include one of several responses, including:

- That a return was received and is in processing;
- The mailing date or direct deposit date of the taxpayer’s refund; or
- Whether a refund has been returned to the IRS because it could not be delivered.

The results also include links to customized information that is based on the taxpayer’s specific situation. The links guide taxpayers through the next steps needed to resolve any issues that may be affecting their refund.

Mr. Chairman, the “Where’s My Refund?” service meets stringent IRS security and privacy certifications. Taxpayers enter identifying information that includes their Social Security Number, filing status and the exact amount of their refund. The information must be entered exactly as it appears on the tax return filed with the IRS, especially the expected refund amount. The exact information verifies that the person is authorized to access that account and avoids an unsuccessful response. As of April 2, 2003, the volume for “Where’s My Refund?” is 10.6 million.

“Where’s My Refund?” is accessible to visually impaired taxpayers with the Job Access with Speech (JAWS) screen reader used with a Braille display and is compatible with different JAWS modes.

Taxpayers without access to the Internet can check the status of their refund by calling the toll-free IRS TeleTax System at 1-800-829-4477. It must be approximately four weeks (3 weeks for e-file and 6 weeks for paper, on average) since a return was filed for the information to be on the system. If the refund information is not available, the taxpayer is prompted to wait at least six weeks. The taxpayer is told to call a different number the following week where he or she can speak to a Customer Service Representative about the refund. Taxpayers must provide the first Social Security number shown on the return, filing status and the amount of the refund. If the IRS has processed the return, the system will state the date the refund will be sent. TeleTax’s refund information is updated each weekend.

In FY 2002, more than 27 million taxpayers used TeleTax to check on the issuance of their refund checks. As of March 22, 2003, the number stands at over 15.2 million—down 3.9 million from this time last year.

Another option is the IRS Refund Hotline. This service is available to Form 1040-type Individual and Joint Filers who want to check the status of their current year

refund. It offers Automated Refund Self-Service Interactive Applications. The toll-free hotline number is 1-800-829-1954.

E-Payment Options For 2003

Taxpayers can pay taxes electronically by authorizing an electronic funds withdrawal from a checking or savings account, or by using a credit card. E-payments can be used to: (1) pay taxes owed on a 2002 income tax return; (2) pay projected tax due when requesting an automatic extension of time to file; (3) pay estimated taxes for Tax Year 2003; and (4) make a credit card payment on an active installment agreement for past due tax owed for years 1999 and after.

The IRS entered into partnerships with private industry, including credit card processors and tax preparation software developers, to make these electronic payment options available.

Electronic funds withdrawal is free and the taxpayer decides when the tax payment is withdrawn from the bank account. Electronic funds withdrawal is only available to those who e-file, either by computer or by phone. A taxpayer may file early and, at the same time, schedule the withdrawal as late as April 15, 2003. For returns filed after April 15, the payment is effective on the filing date.

A 2003 estimated tax payment can be made through electronic funds withdrawal only when filing a 2002 tax return via computer, whether or not there is a balance due on the return. The estimated tax payment may be the one due in April, June or September. Only one estimated tax payment can be made through electronic funds withdrawal. This payment cannot be made by phone.

Last calendar year, 454,278 taxpayers paid their taxes through electronic funds withdrawal, an increase of 24% over the prior year. So far this filing season, 207,688 taxpayers have used this option, a 48.7% increase over the same period in 2002.

Taxpayers can also make credit card payments whether they file electronically or file a paper return. Credit card payments can be submitted via the tax software when filing electronically. Credit card payments can also be made over the telephone. Last year, 313,385 taxpayers paid by credit card, an increase of 10 percent over the prior year. This filing season, 116,810 taxpayers have used this option.

The IRS does not set or collect any fees for credit card payments, but the private sector companies the IRS authorized to process these payments do impose convenience fees. The tax payment sent to the U.S. Treasury and the convenience fee are listed separately on the cardholder's credit card statement.

Some tax software developers offer integrated e-file and e-pay combinations for those who want to pay a balance due with a credit card. The software accepts both the electronic tax return and the credit card information. Subsequently, the tax return and tax payment data are forwarded to the IRS and the credit card data is forwarded to the payment processor.

For the 2003 filing season, the IRS awarded contracts to two companies to accept credit card charges from both electronic and paper filers. Each company has its own fee schedule and each offers both phone and Internet payment services. The two companies are:

- Official Payments Corporation, 1-800 2PAY-TAX (1-800-272-9829) 1-877-754-4413 (Customer Service) www.officialpayments.com, and
- Link2Gov Corporation, 1-888-PAY-1040 (1-888-729-1040) 1-888-658 5465 (Customer Service) www.PAY1040.com.

Anyone may use these services to charge taxes to an American Express Card, Discover Card, MasterCard or VISA account. VISA joined the IRS credit card program in March 2002.

Electronic Signatures—Personal Identification Numbers (Pins)

For the 2003 filing season, taxpayers are able to select one of two options for signing their e-filed return. The Self-Select PIN and Practitioner PIN methods allow taxpayers to electronically sign their e-filed return by entering a five-digit PIN. The five-digit PIN can be any five numbers except all zeros. Receipt of the taxpayer's PIN eliminates the requirement for Form 8453 (U.S. Individual Income Tax Declaration for an IRS e-file Return). The Self-Select PIN method requires the entry of each taxpayer's date of birth and prior year original Adjusted Gross Income (AGI), which are used to authenticate the taxpayer. By contrast, the Practitioner PIN method does not require the entry of the taxpayer's date of birth or prior year AGI.

Paperless filing is available to those who prepare their own returns using tax preparation software or those who use a tax professional. On a joint return, two PINs are required, acting as electronic signatures for both people.

The Self-Select PIN Program began in 2001, and by 2002, PINs were used to e-file 9.8 million returns. For 2003, certain taxpayers under the age of 16, and those who are filing on behalf of a deceased taxpayer, can sign the return using a Self-Select PIN.

The Practitioner PIN is an additional electronic signature option for taxpayers who use an Electronic Return Originator. Those using the Practitioner PIN method are required to complete Parts I and II of Form 8879, IRS e-file Signature Authorization, which the ERO retains. In 2002, Practitioner PINs were used in e-filing 14.9 million returns. So far this filing season, the number stands at 18.4 million.

For 2003, the Practitioner PIN is open to all electronic return originators (no agreement required). First time filers and taxpayers under the age of 16 are eligible to use the Practitioner PIN method.

Web-Based Help

The IRS web site at www.irs.gov continues to be extremely popular with taxpayers. For the week ending March 15, 2003, our web site was listed as Number 2 in the Lycos Top 50 searches. In FY 2002, it posted 3.11 *billion* hits with more than 437 million forms and publications downloaded. For FY 2003 through March 30, there were 2.4 billion web site hits, up 24.5% over the same period last year.

A user-friendly format allows even novice users to quickly find the information they need. For 2003, taxpayers will notice improvements in the “Search” features and capabilities. The embedded thesaurus within the search engine has been expanded to contain an updated repository of the most-frequently searched words, phrases, and variations.

With the help of the site’s interactive features, taxpayers can also calculate proper withholding amounts. There is also information about if the interest they pay is fully deductible or determine whether they are eligible to claim the child and dependent care credit.

In addition, the site provides instructions for obtaining copies of prior-year tax returns and has a useful tax event calendar. Taxpayers can even get help with a particular tax question.

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.

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

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

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

In 2003, the IRS plans to make even further progress serving business’ electronic tax administration needs. For example, tax professionals are able to file employment taxes for business clients for the first time as part of a new Employment Tax e-filing System.

We also expect that coming e-file upgrades will continue to reduce the paperwork burden on small businesses. The enhanced e-file system is part of an ongoing effort to reduce small business burden and barriers to electronic filing. This e-file option will replace outdated technology that was a burden to both businesses and the IRS. Key benefits of the new system are:

- More flexible filing—Forms 941 and 940 can be filed in a single transmission;
- More specific error conditions—New error conditions pinpoint the location of the error and provide complete information for each error identified;
- Faster acknowledgements—Transmissions are now processed upon receipt and acknowledgments are returned in near real-time; and

- Integrated payment options—Eligible filers may submit a required payment along with their return, subject to limitations imposed by the Federal Tax Deposit Rules.

Businesses will also soon be able to apply for an employer identification number (EIN) by using our new on-line EIN Application at irs.gov. When a business applies, its EIN will display on the SS-4 for printing and record keeping and they will receive their formal validation letter within 7 days.

New E-Services for Practitioners

We must make it not only technologically possible, but also attractive to both practitioners and taxpayers to make a permanent change from paper to electronic filing. To build practitioner interest, the IRS will offer later this year a suite of electronic services, such as disclosure authorization, transcript delivery and account resolution, to tax practitioners who file a certain number of returns electronically.

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

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

The following are the processes and key components of the e-Services program:

- *Registration*—the first online process a tax professional completes to begin conducting business with the IRS electronically. All tax professionals must register as individuals. Transacting business over the Internet allows practitioners to complete applications 24 hours a day/ seven days a week. Furthermore, an on-screen acknowledgment confirms that the firm has successfully completed the application. Registration is free and easy to use and also enables subsequent access to e-Services products in Release 2 with approved application.
- *PTIN Application*—the online alternative to the paper Form W-7P, Application for Preparer Tax Identification Number. This automated system enables a preparer to request a new or replacement PTIN card and is quick, convenient, and easy to use.
- *TIN Matching (For Payers Only)*—a pre-filing service offered to payers of income subject to backup withholding. Payers can match the payee's TIN and name combinations against the IRS records prior to submitting an information return for up to 25 TINs and name combinations per session. TINs include Social Security number, employer identification number, adoption taxpayer number, and individual taxpayer identification number. Results are provided during the session, within 5 seconds.
- *On-Line e-File Application*—the new online, integrated application to complete for participation in both individual and business IRS e-file programs. This online process permits users to update their records and supplements the paper Form 8633 and Form 9041. Applications are acknowledged via e-mail. This application also offers a delegation of authority feature that allows principals and/or responsible officials of the firm/organization to delegate e-services (Disclosure Authorization, Electronic Account Resolution and Transcript Delivery System) access to their employees.
- *Disclosure Authorization*—allows for the electronic transmission of most Forms 2848, Power of Attorney (POA) and Declaration of Representatives, and Form 8821, Tax Information Authorizations (TIA) to the Centralized Authorization File. This transmission also provides the capability for authorized, authenticated, and registered users to create, update, revoke, inquire and delete POA and TIA records via the Internet.
- *Electronic Account Resolution*—a new method for improving the process of receiving and responding to account related-inquiries from practitioners over the Internet, e.g., account problem, complex refunds, installment agreement, notice and payment tracers). Practitioners are provided with immediate confirmation of receipt of inquiry and have the capability to make follow-up requests. Responses are provided within 3 business days.

- *Transcript Delivery System*—will provide secure, online transmission of return and return information (e.g., account transcripts, return transcripts, records of account, wage and income documents and verification of non-filing letters) in professional, standardized formats to authorized users, such as a tax practitioner.
- *Bulk Taxpayer Identification Number (TIN) Matching*—a new service to payers that allows for the matching of up to 100,000 TIN and name combinations. TINs include Social Security number, employer identification number, adoption taxpayer number, and individual taxpayer identification number. Results provided electronically within 24 hours. Responses are sent to requestor's secure electronic mailbox address.

Telephone Assistance

The IRS provides various services through its toll-free telephone lines. Taxpayers can call the IRS Tax Help Line for Individuals, 1-800-829-1040, to get answers to their federal tax law and account questions. They can also order tax forms, instructions and publications by calling 1-800 TAX-FORM, and listen to pre-recorded tax information on over 100 topics by calling our TeleTax number at 1-800-829-4477.

Help for small businesses, corporations, partnerships and trusts who need information or help preparing business returns is also available at the Business and Specialty Tax Line at 1-800-829-4933. Customers calling this number can apply for a new EIN and receive help on employment, partnership, corporation, estate, gift, trust and excise taxes, as well as issues related to Federal Tax Deposits.

These toll-free numbers are available from 7:00 a.m. to 10:00 p.m. (local time) weekdays. In addition, the 1-800-829-1040 customer service line is available from 10:00 a.m. to 3:00 p.m. (local time) on Saturdays from January 25 through April 12 and on Sunday, April 13.

Telephone service is improving. Through March 22, 2003 approximately 83.8% of taxpayers who wanted to talk to a customer service representative got through, compared to 69.4% percent last year. We set a goal of 72% for FY 2003.

We are also providing better service by identifying taxpayers' needs through our tax law screening and then getting them to the right person to answer their question. Our process has reduced the abandoned rate from 13.8% to 7.8%. In addition, the transfer rate was reduced from 21.6% to 17.5%. These two indicators illustrate that a higher percentage of taxpayers are reaching the right Customer Service Representative (CSR) without being transferred and/or having to call back while waiting to speak to a CSR.

Once connected, taxpayers must get prompt, accurate and courteous answers to their account and tax questions. The telephone correct response rates for tax law and tax account questions are about even with last year—81.1% and 87.9% respectively—as compared to 83.5% and 88.4% over the same period last year.

In addition, 26.7 million taxpayers (includes "Where's My Refund" through 3/22) used our automated services to get information, including refund status, a 5.5% increase since last year, and the upward trend continues.

Taxpayer Assistance Centers

Taxpayers needing face-to-face help solving individual or business tax problems can get it every business day at every IRS Taxpayer Assistance Center (TAC). Taxpayers can receive assistance with issues such as, IRS notices, payment plans, federal tax liens and levies, innocent spouse claims and offers in compromise. For the fiscal period beginning October 01, 2002 through March 22, 2003, we served over 4.53 million taxpayers at all TACs. For the 2003 filing season beginning January 01, 2003 through March 22, 2003 we served over 3.15 million taxpayers in all TACs. The customer satisfaction rate is 88% satisfied and 7% dissatisfied, which is on target for our FY 2003 performance plan.

At many sites, walk-in service is being offered on 12 Saturdays through April 12. 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.

We encourage taxpayers to call ahead for appointments at their convenience or to hear a recorded message with office hours and locations. Local phone numbers for TACs are available in telephone directories and are posted on the IRS web site under "The Newsroom" and other pages. Look for "Contact My Local Office" under the "Resources" section.

Individual taxpayers with incomes of \$35,000 or less can also receive free income tax return preparation and e-file help at our TACs. We extend this courtesy return preparation service to all taxpayers qualifying for the Earned Income Tax Credit,

without placing the government in competition with private industry. All of these returns are e-filed; we do not deal with paper individual returns.

Free tax preparation and e-file are also available in many communities through the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. Volunteers help prepare basic tax returns for low-income taxpayers, persons with disabilities, the elderly, and non-English speaking people. This filing season through March 22, 2003, return preparation at VITA and TCE sites has increased approximately 28% over the same period on 2002. 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 1-877-227-7669 to see if there is a Tax Aide site in their community.

To better serve low-income taxpayers, the IRS's Stakeholder Partnership, Education and Communication (SPEC) organization is establishing extensive partnerships with external groups such as local governments, non-profit organizations, private for-profit businesses, and others to create community coalitions. We are focusing our limited resources on providing technical expertise and training while encouraging the community partners to supply resources such as volunteers, space and computer equipment. This business model has rapidly gained national recognition and acceptance.

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

Tax Materials And Assistance In Spanish *(Ayuda en Español)*

Taxpayers needing federal tax information in Spanish can find it in the form of our recorded tax topics, free tax publications and toll-free telephone assistance.

TeleTax, the toll-free automated service, is also offered in Spanish, providing helpful tax topics and refund information.

Free Spanish publications are available by calling toll free 1-800-TAX-FORM (1-800-829-3676) or on the IRS Web site, www.irs.gov, under "Forms and Publications." 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," which 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, "Créditor Ingreso del Trabajo," which 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 10:00 a.m. and 3:00 p.m. (local time) on Saturdays through April 13. Spanish-speaking taxpayers can also go to a 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 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.

To improve outreach and service to Spanish-language taxpayers, the IRS also joined with the nationwide Spanish-language Telemundo Network to host a special, one-hour tax program on March 8. The program, called "Los Impuestos y Usted" focused on practical tips for claiming tax credits, preparing the federal income tax return, free electronic filing and other helpful topics.

CD-ROMs

Joining our small catalogue of taxpayer CD-ROMs, the Small Business/Self Employed Electronic Marketing Card is an exciting and innovative product designed to help the Small Business owner and the Self-Employed taxpayer learn more about the IRS Small Business/Self Employed Division. The CD-ROM is the size of a business card and contains our mission, interactive information on outreach products,

e-filing and e-paying, stakeholder groups, contacts, and live links to our web site. Taxpayers may order the CD-ROM by visiting www.irs.gov/smallbiz and ordering Publication 4115.

Braille Tax Material

A variety of Braille material may be ordered at no charge by calling the IRS at 1-800-TAX-FORM (1-800-829-3676). This can also be downloaded from the "Accessibility" portion of the IRS Web site at *IRS.gov*. The Braille print files are in .brf format and can be sent directly to an embosser for high-quality Braille output.

Included in this offering of accessible materials are 50 of the most popular individual tax forms in accessible PDF format. Also called "Talking Tax Forms," these files may be opened, filled-in, and printed for filing purposes by blind taxpayers using screen readers. The Alternative Media Center prepares accessible versions of IRS tax materials for disabled employees and taxpayers alike. Inquiries regarding accessible IRS documents and materials may be sent via email to altmc@irs.gov.

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

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

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

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

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

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

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

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

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

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

FY 2004 RESOURCE REQUEST

For FY 2004, the IRS is requesting resources totaling \$10.437 billion and 100,043 FTE (full time equivalent). This represents an increase of \$521 million (5%) over the President's FY 2003 request.

Mr. Chairman, the FY 2004 budget request can be best viewed through its three strategic drivers that are derived from the IRS performance-based budgeting process.

First is Compliance. The principal strategic focus of the President's FY 2004 IRS budget is strengthening compliance activities, especially in the area of high-income, high-risk taxpayers and businesses, and abusive tax avoidance schemes and offshore trusts. A legislative proposal would also authorize the IRS to contract with private-

sector collection agencies to supplement current IRS tax collection efforts. The budget further includes a major initiative to reduce erroneous payments in the Earned Income Tax Credit (EITC) Program.

Second is Reinvestments. We are committed to better utilizing the resources the IRS already has by “reinvesting” base resources. By reinvesting \$166 million, primarily from increased productivity within the base budget, the IRS will be able to deliver increases in the performance of key tax administration programs that are significantly higher than the additional dollar and FTE increases requested in the budget.

Third is Business Systems Modernization. Investments in modernization through the BSM program would continue with a total request of \$429 million, an increase of \$65 million above the FY 2003 appropriation. Over the course of the BSM program, these investments will benefit the IRS and taxpayers by reducing operating costs, increasing cost avoidance, reducing taxpayer burden and increasing tax receipts.

Mr. Chairman, I also want to draw the subcommittee’s attention to a new task that was added to the IRS’s traditional tax administration duties and operations. In August 2002, the President signed Public Law 107–210, the Trade Adjustment Assistance Act of 2002. Title II of this statute provides a refundable tax credit for the cost of health insurance for certain individuals who receive a trade readjustment allowance or a benefit from the Pension Benefit Guaranty Corporation (PBGC). The tax credit is equal to 65% of the health insurance premium paid by eligible persons to cover them and qualifying family members. The IRS must implement the Health Coverage Tax Credit provisions.

We are requesting \$35 million for Health Insurance Tax Credit Administration. The amount provided in the Consolidated Appropriations Resolution, 2003 (\$70 million) will be used to provide software, hardware, and contract services to develop the system mandated by Public Law. The IRS will oversee the contractor’s work.

Let me now provide the highlights of our proposed FY 2004 budget.

Compliance

Additional Funds Requested to Strengthen Tax Administration Compliance (+\$133M and +1,700 FTE)

The Internal Revenue Service is realigning its audit resources to focus on key areas of noncompliance with the tax laws. The strategy represents a new direction for the agency’s compliance effort. Following months of research and planning, the new approach is focusing on high-risk areas of noncompliance: (1) the promotion of abusive tax schemes; (2) the misuse of devices such as offshore accounts to hide or improperly reduce income; (3) the use of abusive corporate tax avoidance transactions; (4) the underreporting of income by higher-income individuals; (5) non-filing by higher-income individuals; and (6) the Earned Income Tax Credit program.

Our effort will generally focus first on promoters and then on participants in these various schemes. The initiative will feature new and enhanced efforts on these most serious compliance problem areas.

Our Small Business/Self-Employed (SB/SE) Operating Division will handle the new effort in these key areas affecting individuals and businesses. Compliance efforts will continue in other parts of the agency, such as the tax shelter initiative in the Large and Mid-Sized Business (LMSB) Division.

To strengthen compliance programs across the board, the IRS budget request includes \$133 million to fund numerous compliance initiatives. Key examples of these initiatives are:

Address Complex Enforcement Issues of Small Business/Self Employed Taxpayers (+\$56M and 887 FTE): Additional staff will be provided to all major compliance programs in SB/SE and new workload selection systems and case building techniques will be employed. New revenue agents (exam work) and revenue officers (collections work) will be applied in the field to address offshore credit cards, abusive trusts and shelters, high-risk/high-income taxpayers, and other priority work. Additional staff at call sites will be employed to specialize in out-going calls and offset levies. Greater resources in the Automated Substitute for Return (ASFR) program will allow us to focus on high-income taxpayers who do not file returns. Also, staff devoted to frivolous returns and frivolous refund claims will be increased to counteract recent growth and aggressiveness by promoters in this area.

Address Passthrough Entities and Abusive Trusts of Large Business Taxpayers (+\$22M and 258 FTE): This increase will allow the IRS to apply the most experienced revenue agents to the highly complex and technical issues of passthrough entities—such as partnerships, trusts and S-corporations—and abusive corporate tax shelters while maintaining minimum coverage of other priority exam work.

Counterterrorism (+\$6M and 24 FTE): The IRS is heavily involved in the fight against both global and domestic terrorism. Demand for the financial investigative skills of Criminal Investigation (CI) special agents remains high. After September 11, 2001, over 273 FTE in FY 02 and 206 FTE projected in FY 03 were redirected from CI tax enforcement activities to counterterrorism related activities. CI is working on counterterrorism with the Treasury Executive Office of Terrorism Financing and Financial Crimes and is an integral part of the nation's war on terrorism.

Use of Private Sector Contractors for Collection of Taxes Due

There is a significant and growing backlog of cases involving individual taxpayers who are aware of their tax liabilities but are not paying them. We believe that many of these individuals are capable of paying their outstanding tax liabilities. This is unfair to every hard-working American who pays his or her fair share of taxes. To address this problem, the President's budget proposes to support the IRS's collection efforts with private collection agencies (PCAs) that will engage in specific, limited activities, allowing the IRS to concentrate its resources on more complex cases and issues.

By eliciting the assistance of PCAs, the IRS expects to be able to address this important part of the existing backlog of collection cases. Over time, the IRS expects that PCAs would assist the IRS in handling more collection cases at an earlier stage in the process—before the accounts become stale and uncollectible. PCAs have proven successful with over 40 states and have been used for many years with other federal programs. PCAs would hold no enforcement power and their employees would be subject to the same rules that apply to the IRS governing taxpayer rights and confidentiality. Consequently, taxpayer protections would be unaffected. The IRS would be required to closely monitor the activities and performance of the PCAs to ensure these rules are followed.

Reduce Inappropriate Payments in EITC Program (+\$100m and +650 FTE)

The EITC program benefits millions of low-income workers. The EITC lifts nearly 4 million people, especially single mothers, out of poverty each year. However, the current error rate for the EITC program is too high. In 1999, between 27 and 32 percent of EITC claims—or between \$8.5 billion and \$9.9 billion—were paid in error. EITC has been consistently listed among high-risk federal programs. Congress has recognized this by providing a separate appropriation that has been used for EITC compliance enforcement.

The FY 2004 Budget requests an additional \$100 million to begin a new strategy for improving the EITC program. This approach, suggested by the Department of Treasury EITC Task Force, concludes that the IRS must obtain additional information on certain EITC eligibility criteria before payment of the EITC-portion of refunds. A major portion of the request will be used to invest in suitable information technology and develop business processes.

The IRS will begin to use an integrated approach to address potential erroneous claims by identifying cases that have the highest likelihood of error before they are accepted for processing and before any EITC benefits are paid.

A key part of this strategy is to begin certifying taxpayers who claim qualifying children on the relationship and residency requirements. In addition, the IRS will use limited additional taxpayer information, in combination with taxpayer-specific IRS historical data, third party data and error detection systems to detect and freeze the EITC-portion of refunds that pose a high risk or filing status errors or income misreporting. The IRS will seek to minimize the burdens on taxpayers by using existing databases and other sources of information to verify eligibility in advance. This integrated approach is designed to provide far greater assurance that EITC payments go to the individuals who qualify for the credit, without sacrificing the goals of the EITC program.

Reinvestments

Resources Freed-Up within the Base Budget for Reinvestment (–\$166 million and –2,145 FTE)

The President's budget submission states, "In FY 2004, the IRS will improve performance primarily through better management and fundamental reengineering of business processes, and secondarily by increases in resources."

Through the IRS's Strategic Planning and Budget process, the agency's senior managers identified significant potential for the more effective and efficient use of current resources. A total of \$166 million and 2,145 FTE were identified for reallocation within the base budget in FY 2004. Examples of sources for reallocations include:

Submissions Processing/Electronic Filing (-\$13.5M and -366 FTE): IRS's continued success with electronic filing provides a great opportunity to reduce and reallocate resources from submission processing to strengthen compliance and improve customer service. The FY 2004 budget reflects the first-ever closing of a submissions processing pipeline (Brookhaven, NY) as the labor-intensive processing of paper filings decreases across the system.

Compliance Support Reengineering (-\$26M and -394 FTE): Reengineering of the compliance program in SB/SE will improve operational efficiency and workload selection, and reduce taxpayer burden. Business process improvements and centralization of the Compliance Support Organization will generate FTE that can be reapplied in front-line activities.

Remittance Transaction Research (-\$9M and -199 FTE): Creating a central data repository (taxpayer payment data and related images) for all individual taxpayer payment documents will increase efficiency, improve accuracy of posting payments, and reduce the time it takes to resolve payment issues.

Information Technology (-\$46M and -39 FTE): Efficiencies through re-engineering and other efforts will reduce expenditures in end-user support, computing center support, and network operations and maintenance.

Reinvestment of Reallocated Funds within the Base Budget (+\$166 million and +649 FTE):

Resources reallocated within the base budget would be used to improve Customer Service and strengthen Compliance programs. The specific initiatives include:

Reduce Compliance Staff Support of Filing Season (+\$13M and +154 FTE): Due to lower-than-needed staff levels in Field Assistance Programs for individual taxpayers, the IRS must detail compliance staff from SB/SE to field assistance during the filing season to meet taxpayer demand. Under this initiative, we would hire additional staff in field assistance so that the level of service in assistance is maintained while the number of compliance details can be reduced, and compliance staff can devote more time to compliance activities.

Improve Telephone Service to Small Business/Self Employed Taxpayers (+\$11M and +184 FTE): Additional resources are needed to assist SB/SE taxpayers in Accounts Management phone services. These staff members assist taxpayers with a broad range of issues concerning taxpayers' accounts.

Information Technology (+\$33M and 0 FTE): IT investments will expand web services to taxpayers, replace aging servers, purchase needed software, and expand high speed and secure access for revenue agents at remote sites.

**Continued Investment in Business Systems Modernization
(+65 million and 0 FTE)**

The BSM program request totals \$429 million, an increase of \$65 million over the current FY 2003 level. The BSM account provides for modernizing IRS-wide business practices and acquiring new technology.

We 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. The IRS Core Business System Executive Steering Committee, chaired by the Commissioner, approves investment decisions. This executive-level oversight ensures that products and projects delivered under the BSM program are fully integrated into IRS Business Units.

Highlights in BSM for FY 2004 include: (1) modernized e-File will provide electronic filing for large and small businesses; (2) implementation of the Integrated Financial System will replace the current antiquated administrative core accounting system; (3) the first release of the Custodial Accounting Project will put individual taxpayer data in a data warehouse for easier access and analysis; and (4) the Customer Account Data Engine and Internet Refund Fact of Filing will be revised for tax law changes to support the 2004 filing season. Given the changes in the FY 2003 and FY 2004 BSM funding totals, we are currently reviewing the FY 2004 allocation project-by-project to determine the optimum plan. They are discussed in greater detail below.

Achievements and Benefits

In FY 2002, the BSM Program provided real benefits, including a secure online system and system management capability and the aforementioned Internet Refund/Fact of Filing pilot program. In FY 2003 and FY 2004, additional supporting infrastructure services will be added, and an increasing number of business and internal

applications will be delivered, creating benefits for taxpayers and practitioners and enabling internal efficiencies.

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

- *Customer Account Data Engine (CADE) R1*. In July 2003, CADE will begin processing single 1040EZ filers (both electronic and paper). Taxpayers covered under CADE will receive their refunds about 40% faster than under Master File processing, if they use direct deposit. More importantly, we will have taken the first of many steps to replace the 40-year-old Master Files.
- *Custodial Accounting Project (CAP)*. We will continue development and testing of CAP Release 1 scheduled for deployment in the first quarter of FY 2004. CAP will create a repository for modernized Individual Master File data and will address documented financial material weaknesses.
- *Enterprise Architecture (EA) and Tax Administration Vision and Strategy (TAVS)*. TAVS focuses on creating a long-term vision of how the agency should work in the future. Delivery and acceptance of EA Release 2.0 was a significant achievement. We also conducted a planning effort called "TAVS Refresh" to identify gaps and outdated information in TAVS which we plan to address in FY 2003.
- *e-Services*. e-Services sub-releases will provide: registration of electronic return originators, Taxpayer Identification Number (TIN) matching, initial partner relationship management capabilities, electronic account resolution, transcript delivery, secure e-mail, and bulk TIN matching.
- *Infrastructure (STIR and Infrastructure Shared Services [ISS])*. This project provides the basic secure infrastructure necessary to support the modernization effort including e-Services R1, IR/FoF, Internet Employer Identification Number (EIN), and subsequent FY 2003 releases.
- *Integrated Tax Administration Business Solutions (ITABS)*. Projects to ensure we understand requirements and select COTS (commercial off-the-shelf) solutions that can effectively integrate business processes in IRS functions.
- *Internet EIN*. This application will automate Employer Identification Number (EIN) requests over the Internet. Currently, the EIN request process is cumbersome and people-intensive, often resulting in unacceptable delays for those starting new businesses.
- *Integrated Financial System (IFS)*. Although the first release of the new financial system will not go live until October 1, 2003 (therefore, an FY 2004 delivery project), it is likely to be our most work-intensive project during FY 2003.
- *Modernized e-file*. The Modernized e-file project will be in pre-deployment testing for all of FY 2003, with initial deployment in early CY 2004, with Forms 1120 and 990 e-file capabilities.

BSM benefits delivered in FY 2004 will include:

- *Modernized e-file* will provide electronic filing for large and medium-sized businesses (Forms 1120 and 990), as well as a new Tax Return Data Base, which will greatly improve customer service and issue resolution.
- *e-Services* will provide support for the 2004 Filing Season as well as implement support structures for modernized e-file planned for implementation later in the fiscal year.
- *IFS* will develop the detailed functional requirements to support internal management requirements for financial and management planning, execution and reporting.
- *CAP* will provide an integrated enterprise data warehouse to support organizational data needs, performance measurement, and tax operations process improvements.
- *CADE* will allow for electronic processing of selected Form 1040 Wage & Investment returns with additional taxpayer segments that have increasingly more complex tax returns and/or balance due returns.
- *ISS* will establish a program whose goal is to deliver a fully integrated shared information technology infrastructure to include hardware, software, shared applications and data, telecommunications, security and an enterprise approach to systems and operations management. This approach results in overall reductions in time and dollars to develop, deploy, and maintain the infrastructure and the business applications that use the infrastructure.

IMPACT OF UNFORESEEN COSTS ON STAFFING LEVELS

Although staffing increases were supported in recent budgets, they could not be realized because of unexpected cost increases. The IRS is labor intensive; salaries and benefits make up 71% of our Operations Budget. Therefore, any unexpected major cost that the agency must absorb will have a negative effect on staffing levels, despite efforts to reduce non-labor costs.

For FY 2003, the President proposed a budget for the IRS that included 98,727 FTE (less EITC). However, the total FTE for FY 2003 (less EITC) is currently expected to be 96,802, which is 1,925 FTE less than the President's request. The following are examples of what drove projected FY 2003 FTE down below the President's request by 1,925.

- The unfunded increase in the FY 2002 annual pay raise from the President's 3.6% request to the 4.6% enacted level (Cost: \$43 million).
- Postage increases above initial budget projections (Cost: \$22 million).
- Unfunded increase in security costs after 9/11 (Cost: \$20 million).

Let me put the staffing problem in even greater perspective. Over time, the current FY 2003 FTE projection is 1,249 FTE less than what was requested in the President's FY 2001 Budget. It is also important to note that the FY 2003 appropriation bill created a \$68 million unfunded pay increase and an across-the-board cut of \$64 million. These actions will further reduce our staffing levels and directly affect our ability to deliver on performance projections included in the FY 2003 budget request.

CONCLUSION

Mr. Chairman, in conclusion, we are making progress. Although there is great room for improvement, we are providing better service to taxpayers and are hitting more of our performance goals. The President's proposed FY 2004 budget for the IRS keeps us on track and will allow us to provide both the short-term and longer-term benefits to taxpayers, which has been the hallmark of our modernization program from its inception. Once again, I thank the President and his Administration for their continued support of our program and their confidence that we can get the job done, and at the least cost to America's taxpayers.

Chairman HOUGHTON. Thanks very much. Let me just ask a question or two, and then we will pass it along here. I think the 2007 year and 80 percent was sort of an arbitrary figure, as far as a goal. Are we anywhere near on track to reaching that figure or is this more of a generational problem?

Mr. WENZEL. As you mention, it was a goal that was set by Congress in the Internal Revenue Service Restructuring and Reform Act of 1998 (P.L. 105-206), that 80 percent of all individual and business returns would be filed electronically by the year 2007, and we set out to achieve that goal. As I mentioned, we have had considerable initial success in the individual income tax return area, but some additional progress needs to be made in the business tax returns area. Right now, it doesn't look like we will achieve the 80 percent goal.

We proposed new ideas to achieve this goal. For example, this year, the Free File that I mentioned was an example of trying to get us to the 80 percent goal. Free File fits in with the President's management agenda.

We also need to make sure that we come up with other incentives. The April 30 date is an example of an incentive that will encourage taxpayers to opt to use electronic filing. This is where we extend the filing date by 2 weeks, from April 15 to April 30, to offer to individuals to file their return electronically, so there will be a number of individuals that have used the paper form of filing in the past that will now opt to use the electronic filing date.

Chairman HOUGHTON. You have stated this before and Commissioner Rossotti stated it before also, that the 80 percent in 2007 is not particularly realistic. So, what do you do, keep pushing for this and just say, somehow, some way, we are going to make it? Do you reduce the percentage figure? Do you increase the year figure? What do you do in order for us to have some sort of a realistic guide?

Mr. WENZEL. Our goal is to keep pushing to try to achieve the 80 percent. While there is only—

Chairman HOUGHTON. So, are people going to be hung by the thumbs if you don't reach that?

Mr. WENZEL. I hope not. I hope that we will demonstrate along the way that we have tried everything we possibly could as an agency to reach that goal, because this is so critical in terms of moving the IRS forward. A substantial amount of our resources are required to process the paper returns in the 10, soon to be 9, processing centers that we have around the country. There is an enormous amount of full-time equivalent (FTE) positions, that need to go into processing that paper. We hope that every FTE position that we could save in that regard could be used somewhere else in our service and in our enforcement programs.

Chairman HOUGHTON. Thank you. Mr. Pomeroy?

Mr. POMEROY. Thank you, Mr. Chairman. I want to again begin my questioning by just saying I think that staff at the IRS is real top-flight professionals. They don't get the public acclaim that they probably ought to have, and I hope they understand how much we appreciate their dedicated and competent service.

I understand that the IRS has entered into discussions since our last hearing regarding the private sector partners on the Free File e-filing as to coming up with some evaluation or standards as to the products that they might be offering to taxpayers, is that correct?

Mr. WENZEL. Yes. Just to go back a little bit on the Free File, about a year or so ago, we entered discussions with the private sector about Free File, what we refer to as the Free File Alliance. We reached agreements with 17 different providers.

In terms of the agreement that we entered into to start the 2003 filing season, which is the first time effort, we entered into an agreement that they would be able to come into our site with the understanding that when they brought up their particular site, they would be able to have some pop-up screens to show the products and services that they have to offer.

As I mentioned, we have had considerable success. Over 2 million returns have been filed. We have our own survey for individuals who want to give us some feedback after they are done using these sites. To date, we have had a little over 9,000 responses back from the over 2 million returns that have been filed. We would be very happy to give you the specifics on that and share that with the Committee. We have also heard from external groups, particularly some of the consumer groups, that they have some concerns. We have already scheduled a session with the Free File Alliance for the end of this month, Congressman, just to review this first-time effort in terms of the results and to listen to the feedback from all sources that we received so that we can build on the first year's

experience and go forward and effect anything that needs to be done here in the way of improvements.

Mr. POMEROY. I commend you for that and think that your leadership, the IRS's participation in discussion with the private sector partners regarding the identification of the range of products and certain quality dimensions of them that are acceptable and others that may not be acceptable is important.

Now, for the trade association to do it on themselves, that might run afoul of their antitrust issues, and so as long as I believe the IRS is directing the discussion and participating in it, then there are State actions sufficient to make antitrust not apply. Therefore, your active leadership here is really important.

I believe that many of the well-known name brand partners don't want to be associated with an endeavor that has inferior products coming onto the marketplace. Your efforts there will, I think, preempt any necessary legislative effort that we would—you ought to take care of it, not us, and so I am happy that you are looking after it. The other point I would like—

Mr. WENZEL. Congressman, I just want to say you have my personal assurance, our personal assurance that that will be exact on how we would proceed on this.

Mr. POMEROY. Thank you very much. The issues of concern raised regarding the pre-certification don't go as to whether pre-certification of EITC claimants is appropriate, but rather has sufficient care been made in developing the format so that we are starting with a document that is appropriate, eliciting the material needed for purposes of determining whether they qualify or not but not imposing a hurdle or a barrier that would discourage people who are qualified and, frankly, need this credit but otherwise wouldn't be allowed to pursue it.

Just for an example, your third party verification that the children have lived for 6 months with the household is more stringent than that used for food stamps and places a barrier, again, on this population that may be difficult.

Second issue, for some claiming step-parent status, marriage certificates are required, and I don't know that you have checked or not, but some States, California is reporting on their web page a 2- and 3-year backlog in the issuance of marriage certificates.

Can you tell us that all care has been given to make certain that this does not represent a barrier, and would you be inclined to think it might be helpful to have the GAO look at the form to determine whether or not it will serve its intended role in the marketplace?

Mr. WENZEL. We would welcome GAO's involvement. They have, over the years, been very, very beneficial in providing this kind of oversight.

Let me just say, on the pre-certification issue, the last thing we want to do, is put additional burden on individuals. Our intent with pre-certification is that rather than examining the return on the back end, we are trying to go to the front end and resolve any concern that we might have so that once that individual is pre-certified, then it stays that way.

Over a period of many months, we put together what we thought was the best approach to this issue, and we invited external groups

into the IRS that have a very special interest and are well aware of the taxpayers that we would be working with in terms of the pre-certification.

There have been two meetings that have been called by our national Taxpayer Advocate. She took the lead on this and invited these groups in and is engaging people from the wage and investment organization. I am briefed on it regularly myself in terms of how those sessions have gone. As far as the input, we have received information from those groups that we are now looking at ourselves to make sure that we are not going to create this kind of burden.

It was interesting that you mentioned California. I was aware of that, and I think that is striking that it is going to take them that long. My understanding is it may be due to some budget problems they have. That is an unreasonably long period of time. This pre-certification effort should be done as quickly as possible.

In a situation like that, we have what we call Federal and State agreements between the States and the IRS. There may be some opportunities to work out arrangements with a State that those extended delays don't occur when we need information for the pre-certification program.

We are, as I mentioned, working with the groups, getting additional input, so all of this is being seriously considered right now to come up with the right answer that doesn't place undue burden on that whole process.

Mr. POMEROY. I appreciate your response. I may have some additional questions for you in writing, but I see that my time has expired. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much, Mr. Portman?

Mr. PORTMAN. Thank you, Mr. Chairman, and Mr. Wenzel, thank you for being here again. I want to commend you for your stewardship of the IRS during this interim period after Mr. Rossotti's departure and before the new Commissioner is confirmed. I understand Mr. Everson is on his way toward confirmation, having made it through the gauntlet of the Senate Finance Committee and maybe we will get a vote even as soon as this week in the full Senate. I know you are very eager for him to come on board.

Mr. WENZEL. We look forward to Mr. Everson joining us as our Commissioner.

Mr. PORTMAN. Well, again, your testimony today is an example of the kind of leadership you provided, and we appreciate it very much.

On e-filing, just if I could quickly, and then I want to talk about EITC. The enormous diversion of resources you talked about that could otherwise be used for taxpayer service or enforcement is obviously a huge concern of the IRS. Just one other point to make is that there is also an enormous cost to the taxpayer because of the error rate, both caused by the taxpayer and by the IRS. We are told it is as high as 10 or 11 percent on each side, so 20 to 22 percent error rate, which causes enormous downstream costs to you but also to the taxpayer, and a lot of that, I understand, is simply in transposing the numbers. That is why the Congress has been so determined to get that electronic filing number up, as you have,

and I think we need to do everything we can, even take some chances. That is why I commend you for what you are doing in terms of giving people access to e-filing on a low-cost or no-cost basis. Forty-one percent of individual returns are now filed, or will be this year, by electronic. What is the business number?

Mr. WENZEL. The business number, in terms of percentage?

Mr. PORTMAN. Yes.

Mr. WENZEL. It is about half that. I will get the exact figure for you.

Mr. PORTMAN. Roughly 20 percent?

Mr. WENZEL. Yes.

Mr. PORTMAN. This is why we are putting in the legislation, which will come to the floor this week, this IRS recommendation of extending the filing deadline for those who file electronically, just to try to do everything we can because it is good for the IRS and good for the taxpayer to encourage electronic filing, and based on your surveys, we know that particularly people who have amounts due very much appreciate having that additional time and that will be an incentive, is that accurate?

Mr. WENZEL. Yes.

Mr. PORTMAN. We have gotten some criticism on this proposal from Members of the Committee on both sides of the aisle and also from tax preparers. Could you respond just briefly to the criticism that has been raised by tax practitioners about the problems of moving away from the sacred date of April 15?

Mr. WENZEL. Certainly. April 15 has been there for, it seems like forever. I often commented to IRS and some practitioners along the way that if there was—if Congress ever wanted to establish another national holiday, maybe April 15 would be appropriate—but that is coming from a tax administrator. So, I can appreciate the practitioners' concern about that.

Our obvious intent there is to make sure that we have a very, very active awareness campaign, investing the right amount of resources so that individuals realize who qualifies for the April 30 date, and what it takes to qualify for that date.

Mr. PORTMAN. I think that is very important, to keep the April 15 date out there and encourage folks to electronically file by indicating this is an exception to the April 15 rule, not that the date has changed. Again, I am willing to take that risk and push it as hard as we can because I think that electronic filing goal is so important and appreciate the Chairman's support and Mr. Pomeroy's support, too. This Subcommittee has taken a lead on that, and we will continue to help you in every way we can.

Quickly, on the 10 deadly sins, are you happy with the way the legislation is drafted that is coming to the floor this week to reform the 10 deadly sins, so-called?

Mr. WENZEL. Yes.

Mr. PORTMAN. Okay. Any thoughts you have on that, we need to hear from you because after it passes this chamber, which I think it will, of course, we will be in negotiations with the Senate and trying to do something on the Senate side.

With regard to electronic filing, you have got a study from 2002, a U.S. Department of the Treasury study showing, again, a large improper payment rate. The study shows that as many as 31.7 per-

cent of claims amounting to \$9.9 billion are improper, and I think we have gotten to the point here where we once again need to look carefully at the EITC and come up with some better ways to encourage compliance. I commend you for doing that.

One of my questions, as you know, all along has been should the EITC be an IRS program? Is this an appropriate thing for the IRS to do? My experience with the IRS is that I am more for tax reform than ever because of the IRS problems it has administering this code, not because I believe the IRS is at fault, and I think the EITC is the classic example.

If you could just quickly tell us whether this program is supported by the Taxpayer Advocate, the compliance program you have come up with.

Mr. WENZEL. In terms of the program that we are proposing, the Taxpayer Advocate has been very much involved in all of the sessions and all of the procedures that we have now drafted to this point. She has provided us with valuable insight in terms of where we thought we might go in one direction, but she brought us back into another procedure that was, in terms of fairness and application.

So, I can't speak for Ms. Olson, but I do know that she has been actively engaged, and when she had some disagreement with the direction that we were headed in, she was right there and stayed with it and we listened to her and made the changes. So, at this point in time, I would think that she is fully with us in terms of where we are with the effort.

Mr. PORTMAN. I think it is important the person who is responsible for looking out for the taxpayer be involved in it, and my understanding is she is supporting it and I think that is an important point.

Mr. WENZEL. Again, I—

Mr. PORTMAN. I will ask additional questions in writing because my time is up, but if you could comment at some point today about the different error rates. Mr. Pomeroy raised a good question about whether what you are asking for in terms of certification is in addition to what we ask for in other programs, like the U.S. Department of Housing and Urban Development (HUD) programs or the food stamp program or Supplemental Security Income or other programs, and I think the compliance rate differences need to be pointed out at some point, as well. Thank you.

Chairman HOUGHTON. Mr. Foley.

Mr. FOLEY. Thank you very much, Mr. Chairman, and I do welcome you here today and I would echo in the comments of my colleague, Mr. Pomeroy, relative to the IRS and its employees taking an unusual burden of criticism due to the fact we here on this Committee oftentimes change the Code every other hour. So, it is difficult for you all to figure out all of the various rules and laws we are passing on you.

He did also open up another opportunity, though, when he mentioned our effort to pull the tax code up by its roots, something we have all talked about, and I wondered if you had a chance at all to do an analysis internally relative to the implementation of a flat tax or a sales tax, and what it would do to the IRS itself.

Mr. WENZEL. We have not done that, Mr. Foley. That kind of review would be something that would be done at the Department of the Treasury. The IRS on those two specific areas, the sales tax and flat tax, I am not aware of anything that we have done in the IRS.

Mr. FOLEY. Would it be fair to assume a simplification of that sort would be much easier to not only implement, but obviously to monitor?

Mr. WENZEL. We have heard about the need for simplification from taxpayers over the years. It is one of the critical issues. The issue is, keep it simple. Simplify the tax code. Make it more understandable, easier to prepare returns.

More and more, every year, there is an increase in third party preparers that need to help individuals and businesses prepare individual and business tax returns because of the complexity. The issue, of course, universally is simplification.

Mr. FOLEY. You raised another important point. I think complexity is probably the underlying word that bothers most Americans. It is not that they do not want to meet their obligations, but on our panel alone, my colleague from Florida, Representative E. Clay Shaw (R-FL), is a certified public accountant (CPA) and a lawyer. He is uniquely double-degreed, if you will, and he has a person prepare his return for fear of making a mistake. That seems to be, in his particular situation, somebody quite capable of doing a 1040 form.

You look at most Americans who are struggling just to work their 40-, 60-, or 80-hour week, then gather all the receipts necessary in order to make certain their return is properly filed. It is daunting and intimidating. How are we providing—

Mr. WENZEL. Congressman, if I could just say—

Mr. FOLEY. Please.

Mr. WENZEL. Our own employees have that issue, too, in terms of trying to provide the correct answers through a telephone or through one of our field assistance centers because they are dealing with the same tax code that is in two volumes already. So, we are always challenged in terms of our accuracy rate in trying to keep up with those changes.

Mr. FOLEY. It does beg the need for reform of some kind, and I think simplification, not necessarily just changing rates. I think it needs to be dramatically changed. How are we doing for your agency relative to technology funding and providing you the infrastructure necessary?

Mr. WENZEL. We feel that the funding that the Congress has given us to date has been fully supportive of our effort. During the current fiscal year, we actually slowed down our effort in terms of business systems modernization a little bit because we were evaluating where we were with our prime contractor and decided that we were taking a lot of projects on at once. We decided it is time for us just to pull back a little bit and do a reassessment.

This calendar year, before the end of December, there are a number of significant projects that should come online. Specifically to your question, the business assistance modernization funding has been adequate for us.

Mr. FOLEY. In conclusion, I did want to again compliment you. I visited some of your service centers in my area. I found the employees to be readily able to help people. The phone lines are being answered. They are very accommodating. Their assistance has been very, very good. So, I just want to take a moment to commend you, your agency and its employees.

Mr. WENZEL. Thank you, Congressman. We will share that with our people. I am sure you have done that already, but I will pass that back.

Chairman HOUGHTON. Thanks very much. Mr. Ryan?

Mr. RYAN. Thank you, Mr. Chairman. I am encouraged to hear from my colleague from Florida that he still has service centers up and running to help his constituents, and that is really what I want to direct my questioning to, Mr. Wenzel.

As you know, these service centers are very helpful, these Taxpayer Assistance Service Centers. People coming off the street, they get the forms they need. They get quick answers to some pretty simple questions they have.

Unfortunately, what happened in Wisconsin was every Taxpayer Assistance Service Center was shut down except for Milwaukee. We have a very large State, and so when you shut down the Appleton, Waukesha, Janesville, and Racine Service Centers, obviously, a lot of people are upset about that, and that is the decision that the agency made.

I would like to ask you for, and I don't know if you can give me this right now, but if you could do so in writing, for the justification of those decisions. It is also my understanding that the local IRS offices are still open. They still exist in those places, the same number of staff is still there, only that there can be no taxpayer assistance provided at those offices. No forms can be picked up at those offices. No questions can be answered at those offices. So, if a person wants to speak to a person, wants to go get a form, they will have to drive anywhere—like a couple hundred miles to Milwaukee to get that and stand in line at one office in our State.

So, our entire Congressional delegation has written you and Mr. Rossotti prior to this about this, and I would like to get your response on that. Are you saving money by doing this, because it doesn't seem like you are saving money by consolidating it into the Milwaukee office because you are not reducing any FTE numbers. So, it seems like it has brought forth a lot of frustration, it has reduced the service of the IRS to our constituents, and it doesn't seem like you gained much efficiency in doing so. So, if you could give me a good response to that, I don't know if you can do it fully here, but in writing, I would appreciate that.

Mr. WENZEL. Let me just comment, Congressman Ryan, and I will ask Mr. Dalrymple to respond to that. I don't know the specifics around the offices in Wisconsin, but I assure you we will respond to you in detail as to the rationale. We have 795 offices in the continental United States and just under 500 of them offer call assistance.

Mr. RYAN. Right.

Mr. WENZEL. To your point, the offices that you mentioned, we don't offer that assistance to date. We have applied a criteria across the country in terms of where an office would provide assist-

ance, and it sounds like the offices that you mentioned did not meet that criteria, but I would ask Mr. Dalrymple just to add to that.

Mr. RYAN. Just before he does, but what that criteria meant for the State of Wisconsin is only one office in the metropolitan center of the State has these services. No other office in the entire State has these services. So, what does that do to people in the rural areas? Nothing. Just not providing the forms that people need in these local offices doesn't seem to me to be an incredible expense, now that you are not providing that service, you all of a sudden save a lot of money. That decision, I have a hard time coming to grips with, but please, go ahead.

Mr. DALRYMPLE. I am not specifically familiar with Wisconsin, so we will definitely get you the written response that you have asked for. We have embarked on a strategy, actually, to make our telephone service tremendously better so that people who have the kinds of questions that you have talked about can get that service through our telephone services.

Also, forms and questions are available to be answered or downloaded through our Internet sites. We have had over, as Mr. Wenzel had mentioned earlier, 3 billion hits so far this year, hundreds of millions of forms and publications downloaded.

Fundamentally, we do expect to be able to serve rural areas, and in many instances where we have had to reduce service in some locations, we then had mobile units that have visited specific locations on a rotational basis, have specific places like senior centers where we go 2 days a week where we have had to close an office. So, we are trying to provide those kind of services in other ways. I will specifically look into Wisconsin to make sure that we haven't overlooked a need there, and we will get back with you.

Mr. RYAN. In your response, because obviously you identified the seniors as being part of the problem, what you do when you sort of bring the services into the metropolitan area and not into the rural area is it is really the retirees who don't download things from the web, who don't really know the right questions to ask on the phone, who are the people who have been disproportionately benefiting from the local offices. So, that is really who loses out on this. In your response, if you can give me more details about your mobile office plan, because that is something that we can coordinate to ship around, give me more details about that, if you could, in your response.

Mr. DALRYMPLE. We will do that.

Mr. RYAN. All right. Thank you.

[The information follows:]

The IRS currently operates several TAC offices in Wisconsin. We have offices in Milwaukee, Madison, Green Bay, Mosinee, Eau Claire, Appleton, and La Crosse. These offices are placed to provide taxpayer assistance to the majority of Wisconsin residents. The TAC offices continue to provide the needed services to the surrounding communities and we have no plans to suspend these important services.

Several convenient options are available for taxpayers to obtain the service they need, when they need it most, without visiting a local office. Taxpayers may contact IRS customer service representatives toll-free at 1-800-829-1040. Recorded tax information on hundreds of tax topics is available toll-free at 1-800-829-4477. Forms and publications can be ordered at 1-800-829-3676 or available over the Internet. The IRS Internet site can be accessed at www.irs.gov. Practitioners needing assistance have access to the Practitioner Priority Service toll-free by calling 1-866-860-

4259. This accounts-related service created exclusively for tax practitioners nationwide should be the practitioner's first point of contact for assistance regarding taxpayers' account-related issues. Employees answering these calls are specially trained in handling practitioner issues.

If preferred, taxpayers can schedule appointments in advance to resolve any tax problems, thereby ensuring that an employee will be available and ready to assist them at the TAC nearest to them. Local telephone numbers for Taxpayer Assistance Centers are available from directory assistance and will appear in all new telephone directories, and are also available on the IRS Web site. In addition to scheduling appointments, taxpayers can call the number for advance information about the nearest office location and hours of service.

With regard to your specific concern about the Racine office, I want to provide you with an update. This is a matter on which we corresponded with your office late last year. The IRS office in Racine remains open, but we have relocated the Field Assistance employee who worked in the TAC office there, on a part-time basis, to Milwaukee, which is less than 30 miles away.

In addition, we have closed the Waukesha and Janesville TACs, both of which were only open part time. There was no Field Assistance employee in the Janesville location. The services previously offered in the Janesville TAC were provided on a limited basis by employees assigned to Compliance activities. The Waukesha TAC, like Racine, had only one Field Assistance employee, who has been voluntarily re-assigned to Milwaukee, just 15 miles away.

We initiated these actions to provide quality customer service for taxpayers and practitioners within the commuting distance of Milwaukee and reduce the impact on compliance resources needed to support lesser TACs. These TACs, with few employees, place a burden on employees at other locations who are required to manage these centers when TAC employees are necessarily absent. The Milwaukee office has a much higher demand for service, yet is not staffed as fully as such service is required. The voluntary assignment of the Racine and Waukesha employees to Milwaukee will ensure much more efficient and effective use of our resources and allow us to better serve higher numbers of taxpayers. In addition, enhanced security will be provided for these employees.

I trust this information is helpful in responding to your concerns.

Chairman HOUGHTON. Thank you. Mr. Weller?

Mr. WELLER. Thank you, Mr. Chairman, and Mr. Wenzel, welcome. It is good to have you before the Committee, and thank you for this opportunity to spend some time with you and your staff today.

I would like to focus on the IRS collection programs, particularly the new initiative that the Administration has included in your budget here, and let me begin with sharing some what I consider to be pretty disturbing statistics, and that is regarding IRS collection programs.

It is estimated that the IRS collects approximately 9 percent of assessments, leaving 91 percent of tax assessments uncollected for the duration of the 10-year statute of limitations. Between 1996 and 2001, the number of tax liens fell 43 percent, tax levies on property fell 73 percent, and seizures fell 98 percent.

These statistics indicate that the IRS has not been very aggressive or very effective in collecting tax assessments. Of course, the Administration has decided to do something that other agencies have been doing for some time, and that is that there is a legislative proposal to allow the use of private collection agencies to collect outstanding tax obligations. Chairman Houghton of this Subcommittee has introduced legislation. I, like others, have joined with him as a cosponsor.

I would like to hear from you, of course, as the Acting Commissioner, what are the advantages of this proposal that you have in-

cluded in the Administration's budget request to assist you in collecting outstanding tax assessments.

Mr. WENZEL. We support the legislation and look forward to its passage. As you pointed out there is a significant amount of what we call potentially collectible inventory that we are not devoting any resources to, and we see the possibility of private collection agencies coming in. The proposal is that the compensation for the effort the private collection agencies would put into the effort would come out of the proceeds that they are able to collect through their efforts. So, there isn't any loss of positions inside the IRS for this effort.

Having been in the collection function in the IRS, as Assistant Commissioner of Collection at one time in my career, I advocated that we needed to do something to support the IRS's effort as relates to its collection initiatives by supplementing it with private collection agencies.

Right now, there is a significant number of dollars that go uncollected each year because the 10-year statute has expired. There is a significant number, it is well over \$200 billion, that is often pointed to as the amount of money sitting there that is currently uncollectible and no efforts are being made to collect it. A lot of that is corporations that have gone out of business, individuals that are deceased, individuals where there are hardships, where it is inappropriate to collect any additional taxes from them, and so forth.

After you eliminate all of that, you still have a significant amount of money left, and our own review of that inventory to date demonstrates that if private collection agencies were able to come in, there is at least \$13 billion that we feel is—

Mr. WELLER. Thirteen billion dollars?

Mr. WENZEL. At least \$13 billion, potentially even more, that through additional efforts on the part of these companies that would be collected that would go into the Department of the Treasury.

Mr. WELLER. Do you have some examples of States that have used private debt collection services?

Mr. WENZEL. Actually, it is a significant number of States. It is somewhere in the neighborhood of 40 States that have gone into this for a period of years, and even in the executive branch, the U.S. Department of Education has used these companies, and also Financial Management Services, which is part of the Department of the Treasury. One of their principal roles is to collect delinquent debt throughout the executive branch.

So, this is not a new effort in the executive branch. There is a lot of experience already in the executive branch, and particularly at the State level. Many of us in the IRS have actually traveled to some States and firsthand sat down with the State tax administrators to learn about their feedback as it relates to their satisfaction levels.

In one in particular, Michigan, I will give you an example, that I visited a number of years ago, they have been in that at least probably about 10 years already, and other States along the same line have used private collection agencies to their advantage in terms of going after tax debt, and—

Mr. WELLER. Commissioner, I realize my time is pretty well utilized. I was just going to, just in closing, I have been an advocate of this for some time and I appreciate your support for this initiative. The question I have is, we have had earlier proposals. How has this proposal been refined and improved upon from the earlier ones we have been looking at?

Mr. WENZEL. There was a pilot, as we call it, that was conducted in the 1996–1997 time frame, and there were different reports that were prepared as a result of that effort. What we learned from that is, and we have applied it to this particular effort, was that we turned over accounts to the private collection agencies for that effort that were really, really old accounts. They were in the period of time that 5 or 6 years. The best that we ever did at the IRS, maybe once a year, we would send out a notice, at best. So, there was a real challenge because of just the age of the accounts.

The obvious thing is that once a debt is incurred, you don't let it sit there for too long before you start to do your follow-up and make sure that it is collected in a reasonable period of time, and the longer it takes and the older it gets, the more difficult it becomes to collect.

So, what we have learned from that study, and that is just one example, is that we need to make sure that we give inventory—and we have it, believe me, at all stages as it relates to the age, from less than 1 year all the way out to the last year. If this proposal is passed, we intend to make sure we give a fair mix of inventory to these companies so they have an opportunity, and we have an opportunity.

There is an oversight role, by the way, of the IRS. We just don't let those companies go about doing their business. We actually will have an IRS employee on premise, I call it, kind of like quality assurance to make sure that everything they do is what we would expect of our own employees as far as their employees in terms of the effort at hand. So, that is one example that we benefited from that previous pilot.

Mr. WELLER. Thank you, Commissioner, and Mr. Chairman, thank you.

Chairman HOUGHTON. Thank you. Now we are going to have another fast round of second questions.

Mr. POMEROY. This will be so fast, Mr. Chairman, I will just basically tee it up, and you don't have to answer. I will ask for a written response.

I have been informed that www.irs.com is not the IRS site. That is a private site. We have had that problem with other government names that have—where the domain name has been purchased, especially on the dot-com one. Obviously, www.treas.irs.gov, a lot of people aren't ever going to find their way there.

Now, I understand also that the search engines that people might enlist to help get them there directs to the commercial site, and so I would be interested in learning from the IRS what activities you are doing, including outreach to the search engine firms, to make certain that inquiries for the IRS go to the more cumbersome www.treasury.irs.gov site, not www.irs.com. Thank you, Mr. Chairman. I yield back. I will write to you more about this.

[The information from Mr. Wenzel follows:]

At the time that IRS developed its own website, they were not allowed to have their own URL/Domain. IRS partnered with the Department of Treasury to use the following URLs/domain names:

www.irs.treas.gov
www.irs.ustreas.gov

Since then, IRS has been issued authority to establish their own URL and domain name. Taxpayers as well as search engines were provided with IRS new URL—www.irs.gov—that provides a direct linkage to the IRS's website. The old URLs automatically redirect the public to the current URL.

In a survey performed of the top search engines (according to our internal Web Trends reports), using different search terms as "IRS", "tax" and "tax forms", the IRS current URL was displayed as the number one or two search result in several searches, but in all but one search was always on the first page of search results. Based on these results, we do not believe that additional guidance to the search engines is needed.

In addition, IRS has also pursued the usage of IRS.com for private use. While we do not want a private company to use those URLs, we do not have the authority to enforce non-use.

Chairman HOUGHTON. Thanks very much. Mr. Portman?

Mr. PORTMAN. Thank you, Mr. Chairman. Just quickly on electronic filing, one idea that has been thought about, as you know, perhaps, is to insist on the April 15 date for all tax returns, but for those people who have an amount due who, based on your own surveys and common sense, are motivated by the idea of electronic filing, if they get a little more time to make their financial commitment, that those folks who electronically file would be able to send their check in late. In other words, the April 30 deadline, the 15 days later, would apply to the check but not to the return. How do you respond to that?

Mr. WENZEL. Do you want to answer that, John?

Mr. PORTMAN. Does that create administrative problems for you that are—

Mr. DALRYMPLE. Well, we have done some research and we feel that we would actually—if we could extend the due date of the tax return and the payment date, that we could increase filings in the first year by almost 2 million electronic filers, and it is an important group of filers, also, because it is the most difficult group that we have in terms of penetration. It is more complicated tax returns and it is people who owe tax generally who would take advantage of this, and that has been the place where we have had the most difficult time penetrating that market segment.

All of our marketing experts that we have used to help us with our marketing have told us that at a particular point, it is going to get more and more and more difficult to continue to grow at the rate we have grown electronic filing, and that we will have to have incentives if we are going to continue to make inroads. I actually believe that is one of the more important incentives.

Mr. PORTMAN. John, you think one of the incentives has to be the return itself, not just the check?

Mr. DALRYMPLE. I do, and I think the reason for that is that I think that there will be a tremendous amount of confusion if you separate the due date of the payment from the due date of the return.

Mr. PORTMAN. Another opportunity for an error.

Mr. DALRYMPLE. Exactly.

Mr. PORTMAN. Mr. Wenzel, this may be your last time before this Subcommittee as Acting Commissioner, and if you could sit back and be reflective and philosophical for a moment and be totally candid with the Subcommittee, I would love to hear your view on three things quickly. I know we are going to hear from GAO in a moment on the business systems modernization, but is it on track or not, and what should we be doing with regard to business systems modernization other than more money, which we are asking for?

Mr. WENZEL. This last year, we really have looked at business systems modernization, and did a serious critique as to where we are. As I mentioned earlier, we decided to slow down a number of the projects, eliminate some, and concentrate on a few. The expectation is here.

There are two critical projects that are due later this fall during the August-September time frame. One is what we call the Customer Account Data Engine, and that is the start—that is a critical project because even though it will only handle a 1040-EZ form, it is the really complete overhaul of our master file, which is every account for individuals and businesses. The other one is what we call our Integrated Financial System, which is a more in-house effort that is also due to come online.

We meet regularly with the prime contracts in terms of their leadership. For example, I have another meeting with them this afternoon again in terms of status reports. We have sat down with them and they have beefed up their leadership in terms of the key positions from the prime and brought some more experienced senior executives into their role and responsibility as it relates to their deliverables and our expectations of our deliverables. We have sat down with them and said, in terms of the cost of the projects to date, that the prime has to make sure that—and they have agreed to do this—that some of this would be as it relates to a fixed price to a specific project and other examples where that cost, once we agree on that, won't continue to increase.

Mr. PORTMAN. We are going to hear about some of the cost overruns and some of the delays from GAO, and again, my question to you would be—I appreciate that response, but are you leaving it in a situation where you think it can recover, get back on its feet, and do you think we are on track to get this done?

Mr. WENZEL. I really think that we really haven't gotten off track, Congressman. These efforts, and Commissioner Rossotti, with all his years of experience, and others have come in—

Mr. PORTMAN. Very complex.

Mr. WENZEL. It is a huge undertaking. You know that, and others know that. That is not a reason to say that we can't get this done.

Mr. PORTMAN. This will be a critical year, from what you have said. The two other things I would love to have you respond to in writing, if you could, to the Committee would be great, would be the Oversight Board, whether that is working, in your view or not. Again, as you depart, we would love to have your comments, and we are going to hear from the Oversight Board in a moment, and

finally, EITC, and I would love to know what you think about not just some of these reforms we have talked about, and the reasons for them, I think, are clear, but whether there is a way for the IRS to do this in an efficient way, or whether it should be a different kind of a program. I appreciate your leadership, and thank you, Mr. Chairman.

Mr. WENZEL. I look forward to providing my response, Congressman.

Chairman HOUGHTON. Mr. Foley?

Mr. FOLEY. No thank you, Mr. Chairman.

Chairman HOUGHTON. Mr. Ryan?

Mr. RYAN. No questions.

Chairman HOUGHTON. Mr. Weller?

Mr. WELLER. I just have one question here, Mr. Chairman, just to follow up on. Earlier in the hearing when we were talking about the EITC compliance, Mr. Commissioner, and it has been noted from IRS review and other review of the EITC program, there is about a 30 percent error rate, about \$8.5 to \$10 billion worth of fraud, according to the last estimate in 1999 is the figure I have. I was wondering, how does this error rate compare with the error rate for other types of low-income assistance programs?

Mr. DALRYMPLE. Actually, I have that data here, if I can find it in front of me. Basically, the error rates for things like HUD and other programs are in the 6 to 8 percent range. Our error claim rate, as you said, is just about 30 percent, so that is a fair comparison, I believe.

Mr. WENZEL. We can provide you the specifics of the comparisons, and we have that available, as Mr. Dalrymple mentioned. This 30 percent has continued to grow and grow, and that is why we needed to come in with this proposal for fiscal year 2004 to try to make sure we stem that, actually reverse it, bring it back down, and try to eliminate it.

Mr. WELLER. Well, Commissioner, if you could provide those statistics and similar means-tested programs and then also explain what you define as the error rate so that we are comparing apples to apples and not apples to oranges. Thank you, Mr. Chairman.

Mr. POMEROY. Would the gentlemen yield just for a moment?

Mr. WELLER. Sure.

Mr. POMEROY. The question that I would have in follow-up, we passed in 2001 some reforms and hope that this 30 percent figure would refer to the pre-2001 reforms in EITC. Are you telling us, Commissioner, that the reforms have had no effect and the problem continues to grow?

Mr. WENZEL. Yes. We have the breakdown by year, but truly, this is, in terms of the amount, where it is almost 30 percent or so, roughly \$9 billion, that that figure continues to grow each year, yes.

Mr. POMEROY. So, the reforms have had no effect, or have you measured the post-2001 reforms from the pre-2001 period?

Mr. DALRYMPLE. Actually, the latest data we have is from the 1999 research study, which we have projected out. So, in that sense, we have not done another research study. We are doing one now as part of our national research program which will allow us

to have some measurements here which we will be able to report back to the Committee on what that is.

Let me just say that we expect that the over-claim rate will be significant. Whether it has gone up or down at this point in time, because we haven't done a research study since 1999, I can't say with any specificity.

Mr. POMEROY. I certainly don't want to carry water for anybody that is abusing this very important program, but I think I would caution the IRS about using 1999 data when we have passed a law to tighten up the error rate and to try and reduce noncompliance if you haven't had any evaluation of whether or not the error rate is lower in light of the changed legislative landscape. I yield back.

Chairman HOUGHTON. Mr. Portman?

Mr. PORTMAN. Thanks, Mr. Chairman. If you could give us the timing on that new research that you are doing, what will that study timing—

Mr. DALRYMPLE. We are in the middle of our national research project right now. There is a bridge study that is being done in order for us to be able to measure the EITC compliance as part of that, as part of the national research project that is measuring compliance overall.

Mr. WELLER. When will that be available?

Mr. DALRYMPLE. I don't have a time frame right now Congressman, but we will get back to the Committee with that and tell you exactly when the data for the EITC portion will be available.

Chairman HOUGHTON. Well, I have got a couple of questions I won't ask you now, I will send them to you. I want to thank you so much. This will probably be the last time that you will be in front of us as the Acting Commissioner. You represent the finest in what civil service is, and we are enormously grateful, and thank you very much for it.

[Applause.]

[Additional written questions submitted by Chairman Houghton, Representative Pomeroy, Representative Weller, and Representative Portman to Mr. Wenzel, and his responses follow:]

1. The Administration's budget requests \$10.4 billion to fund the IRS for fiscal year 2004. This is about the same as last year. What would the IRS do with an additional \$287 million in resources in fiscal year 2004, as recommended by the IRS Oversight Board?

The President's FY 2004 budget request represents what the Agency has the capacity to manage. This request is a thoughtful representation of what the IRS requires to provide effective customer service and also maintain efficient tax administration.

Under the Oversight Board recommendations, additional funds would be placed in our system modernization efforts and would also be used to increase customer service.

The IRS has announced that it will request an independent review of the CADE project. Funding the system modernization effort to the Oversight Board recommended level would not be the most effective use of our appropriated funds. After the independent review is completed, the IRS will be better positioned to work with the Oversight Board to produce a budget that will cover our system requirements and our management capacity.

The IRS has just finished a successful filing season. It's shown improvement in all aspects of customer service. The President's budget request represents the right level of funding for the IRS to meet its mission without exceeding its capacity to manage.

What new benefits will taxpayers see this coming year?

Because of concerns in ensuring that all taxpayers pay their fair share of the tax burden, our budget request includes increased funding needs to enhance compliance particularly for high risk, high-income taxpayers, businesses, and abusive tax schemes.

The Service is also requesting funds for the Earned Income Tax Credit Compliance Initiative to ensure that only eligible applicants receive the credit. While the current initiative prevents \$1 billion in erroneous payments annually, it fails to reduce the EITC noncompliance rate to acceptable levels. A new approach, based on recommendations of the Treasury EITC Task Force, will require that further information be provided to the IRS by certain EITC claimants in order to validate eligibility before payment.

Also, in order to enhance compliance efforts, the President's FY 2004 Budget proposes legislation that would allow the IRS to use Private Collection Agencies (PCAs) to support IRS collection efforts in specific, limited areas. The use of PCAs would enable the Government to obtain payment from delinquent taxpayers while simultaneously allowing the IRS to focus its own limited enforcement resources on more complex cases.

2. What is the percentage of business returns filed electronically?

In Calendar Year 2002, 6,251,572 business returns were filed electronically. This represents 18% of those returns which could have been e-filed and 14% of all business returns filed. For reference, the term business returns includes:

- fiduciary returns (Form 1041);
- partnership returns (Form 1065);
- corporation returns (Form 1120 series);
- estate tax returns (Form 706 and 706NA);
- gift tax returns (Form 709);
- employment tax returns (Form 940 series, Form 941 series, Form 943 series, Form 945, and Form CT-1); and
- corporate extensions (Form 7004);
- exempt organization returns, Federal Tax Deposits, Form 1040 returns, with attached Schedules C, E, and F, excise tax returns, and Forms K-1 are not included.

3. The IRS compiles data on the "most common errors" identified on returns prepared by taxpayers and professional preparers. Generally, the error types have been the same for the past decade, and the errors made by taxpayers are the same as those made by tax professionals (e.g., math calculations, filing status, and Social Security numbers). What are the most common errors made by taxpayers?

1. Earned income tax credit was figured or entered incorrectly.
2. Taxpayer identification numbers or names for dependents did not match IRS or SSA records. We did not allow the exemptions.
3. Refund amount or the amount owed was figured incorrectly.
4. Tax amount was not the correct amount from the tax table for the taxable income.
5. Taxable amount of Social Security benefits for page 1 was figured incorrectly.
6. Tax was figured or entered incorrectly.
7. Child(ren)'s age exceeded the limit. Child tax credit was reduced or removed.
8. Taxpayer identification numbers or names for dependents did not match IRS or SSA records. All or part of Child Tax Credit not allowed.
9. Earned income credit was not allowed. Must be at least 25, but less than 65, years old within the tax year.
10. Child tax credit was figured incorrectly.

What are the most common errors made by tax professionals?

1. Taxpayer identification numbers or names for dependents did not match IRS or SSA records. We did not allow the exemptions.
2. Rate Reduction Credit was not claimed. We computed it.
3. Taxpayer identification numbers or names for dependents did not match IRS or SSA records. All or part of Child Tax Credit not allowed.
4. Earned income tax credit was figured or entered incorrectly.
5. SSN for child(ren) who qualify taxpayer for earned income credit did not match SSA records. Earned income credit was changed.
6. Child(ren)'s age exceeded the limit. Child tax credit was reduced or removed.

7. Spouse's SSN was either missing or did not match SSA records. Spouse's personal exemption was not allowed.
8. Additional child tax credit was figured incorrectly on Form 8812.
9. Based on information reported, we refigured the tax using the filing status for a single person.
10. Taxable amount of Social Security benefits for page 1 was figured incorrectly

How do these errors compare to earlier years?

Statistics show that the same types of errors occur each year. There may be a reorder of the top ten but basically the same type of errors occur each year. Filing seasons that occur after there is significant change in the tax code, may show a spike of errors relating to the new provision. An example of this is the computation of the Child care tax credit. These errors usually show a significant drop in succeeding years.

What needs to be done?

The number one cause of filing errors is the complexity of the tax code. Taxpayers are often confused and frustrated by the intricate calculations required to formulate the proper tax.

There is a significant drop in the volume of errors when returns are electronically filed. The IRS is dedicated to increasing taxpayers' use of electronic filing. Fewer errors, positive acknowledgement of receipt and faster refunds are the main reasons to file electronically. The Congress set a goal that 80% of all individual returns be file electronically by 2007. This will be a difficult goal to achieve but the IRS will continue to work towards having as many returns electronically filed as possible.

4. Describe the background for the EITC program and any conflicts or problems this program presents to the IRS. Does the IRS believe this type of program can be effectively administrated or should their objectives be achieved in a different kind of program?

The IRS TY 1999 EITC Compliance Study estimated that between 45% and 49% of all EITC returns contained an over claim (i.e., the claimant was either not entitled to EITC at all or was not entitled to EITC in the amount claimed). Thus, according to the study, in TY99 there were approximately 9 million EITC returns with over claims. Likewise, in TY 2000, the IRS detected over 13 million potentially erroneous EITC returns and estimated that approximately 9 million represented actual errors. Although the IRS already detects a high number of erroneous claims, it cannot actually prevent payment on those claims unless it can confirm or refute facts about a taxpayer's personal circumstances (e.g., residency of claimant and children, marital status or household composition) prior to payment. Under the current structure, the IRS can only verify such factual information after a return is filed. The IRS currently is able to work only about 4% of erroneous EITC returns. The task force recommendations attempt to address this structural flaw that is inherent in administering a social benefits program through the tax code. Although compliance objectives cannot be achieved using the current "tax administration" paradigm, the IRS believes that it can achieve those compliance objectives with minimal additional burden to claimants under the integrated approach recommended by the joint Treasury/IRS EITC task force, which represents a shift towards a "social benefits program administration" paradigm.

5. Concerning EITC errors:

Please provide the specific comparisons discussed at the hearing for error rates in HUD and other federal programs.

HUD Housing Assistance: 10%; USDA Food Stamps: 7%; SSA Supplement Security Income: 6%

Please provide the error rate for all non-EITC taxpayer groups (however small) that exceed 30%, such as for certain small businesses, self-employed, etc.

Based on the Tax Year 1988 Individual Income Tax TCMP (Taxpayer Compliance Measurement Program), we estimated that the Net Misreporting Percentage (basically the proportion of income not accurately reported) was between 31.3% and 32.3% for Nonfarm Proprietor Income, between 31.3% and 32.3% for Farm Income, and about 81% for Informal Supplier Income. The "Informal Supplier" category consists of sole proprietors who operate in an informal business style, i.e., cash basis with few or no books and records. Examples of Informal Suppliers are street vendors, door-to-door salesman, and individuals who moonlight to augment their wage

income. Please note that this data is 15 years old. Inferences should be drawn with considerable caution because much in the tax system and the economy has changed during that time. The ongoing National Research Program (NRP) should allow us to develop better estimates of non-compliance for specific subpopulations of individual taxpayers, but these will not be available until sometime late in 2004.

Please outline the legislative and administrative reforms put into place since the 1999 EITC compliance study, and describe its effectiveness in improving compliance.

The IRS will not have definitive answers about changes in the EITC non-compliance rate until the completion of the NRP in late 2004, which will provide data for the 2001 tax year. The joint Treasury/IRS EITC task force estimated that the cumulative impact of the legislative and administrative changes effective subsequent to TY 1999 would have reduced the TY99 over claims from between \$8.4–\$9.9 billion to between \$6.4–\$7.9 billion. The biggest legislative change since TY99 was the modification of rules relating to a claimant's Adjusted Gross Income contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107–16), and effective TYs beginning after 12/31/01. Previously, it was the TP with the higher modified AGI. Now the TPs can choose which of them will claim the credit using the child. This increases EITC claimants because some were prohibited from claiming the credit because the other TP had the higher modified AGI—often too high to claim the credit. This provision also includes tie-breaker rules, which are applied by the Service when two or more taxpayers actually claim the credit using the same child.

6. What are the plans at the IRS for beginning EITC pre-certifications?

Commissioner Everson is currently independently reviewing the EITC task force proposals. Once the Commissioner has completed his review, the IRS will issue an announcement seeking public comment on aspects of the verification initiative. Responses to this formal request for comments, in addition to the extensive comments the IRS has been receiving during the course of briefing stakeholders (see below) and feedback from focus groups will be used to refine the verification process and forms. During late summer, the IRS intends to contact 45,000 EITC claimants who will be randomly selected for processing using the verification proposal. The IRS will refine the verification program in response to information gained from the verification pilot.

Has the IRS done a “due diligence” assessment in planning to insure that the documents to be required of EITC beneficiaries can be feasibly obtained and will be useful to the IRS in enforcing the law?

The IRS has a team working on the documentation requirements for the pre-verification process. This team is carefully considering what documentation will be acceptable for verifying qualifying child relationship and residency eligibility to ensure that the requirements reduce erroneous claims. Taxpayer burden and the participation rate are key considerations. Outside stakeholder comments are being solicited.

Please provide a description and analysis of the existing EITC correspondence examination program and EITC re-certification program.

The correspondence examination program is primarily an automated process that operates in a pre-refund environment. Returns are selected based on a set of business rules, which are established using internal and external data. If a return is identified based on the selection process, the entire refund is frozen and the taxpayer is notified that his or her return is under review. The IRS may release the refund after this review without any further action by the taxpayer. If additional information is needed to validate the claim for the EITC, a letter and report are automatically generated and sent to the taxpayer requesting the information. A correspondence examination considers all issues related to dependency and support and requires documentation to support more than the EITC eligibility claim. After review of taxpayer documentation, or if taxpayers fail to provide requested documentation, returns determined not to meet eligibility requirements have EITC disallowed through Statutory Notice of Deficiency procedures. For returns where EITC is determined to be allowable and all questioned items are substantiated, the refunds are released and the examination closed “no change.” If disallowed, the taxpayer is provided information on their appeal rights to refute the IRS's determination.

In response to legislation passed in 1997, the IRS implemented the EITC Re-certification Program in January 1999. When the IRS denies the EITC during an ex-

amination, a re-certification indicator is placed on the taxpayer's account preventing the taxpayer from receiving EITC unless the IRS and/or the taxpayer take appropriate actions.

In a subsequent year, if taxpayers believe they are qualified to receive EITC, they attach Form 8862, Information to Claim Earned Income Credit after Disallowance, to that tax return. Upon receipt of this form, the IRS freezes the refund and then determines whether or not the return should be selected for audit. IRS examiners are to select the returns for examination unless the taxpayer is no longer claiming the EITC child or children previously disallowed and is not claiming a new EITC child. If the return is selected for audit, essentially the same examination procedures are followed for correspondence examinations to determine EITC eligibility. If not, the EITC is issued.

Please describe how the planned EITC pre-certification program would be similar to, and different, these two existing IRS programs both in terms of how the IRS will handle the cases and the information to be requested of taxpayers.

Each of the programs is similar in that claimants are required to submit certain documentation that demonstrates eligibility for the credit. But the programs differ in significant ways. Unlike the qualifying child verification program and the re-certification program, a correspondence examination requires documentation to support all issues included in the examination of a return and does not limit focus to the EITC qualifying child eligibility issue. The verification program also differs from the correspondence examination and re-certification programs in that taxpayers will be given the opportunity to show EITC eligibility prior to filing their returns to allow claimants to avoid any refund delays. Moreover, under the new verification approach, if a claimant's return is selected for further review, only the EITC-portion of the refund will be frozen and any remaining refund will be released to the claimant. In contrast, the current examination and re-certification programs require freezing the entire refund until a determination is made on the eligibility of the taxpayer to receive the EITC. Under the verification proposal, taxpayers with re-certification indicators would be instructed to participate in the pre-verification program. Additionally, under the verification proposal, a dedicated staff will specialize in qualifying child verification issues. This staff will review documentation, handle correspondence and answer phone inquiries about the verification process and acceptable documentation. This will help ensure equal application of rules, while at the same time providing greater assistance to those taxpayers having difficulty understanding or providing standard documentation. In addition, the qualifying child verification approach proposes a single-issue inquiry worked by these issue specialists and will be designed to move large volumes quickly by focusing only on qualifying child eligibility. In contrast, correspondence examination can include other issues and credits related to dependency and support, which add time and complexity to the process.

Please describe how various EITC pre-certification issues need to be resolved to prevent unnecessary barriers for EITC recipients (including obtaining birth/marriage certificates and third-party verification of household living arrangements).

The key issue surrounding the relationship verification is how to verify attenuated relationships without unduly burdening taxpayers for this one-time verification. Verification of household living arrangements is part of establishing the residency requirement. Under the qualifying child verification proposal, claimants will be given multiple ways and multiple sources to prove that they meet this requirement. The IRS is continuing to seek outside stakeholder feedback, including through taxpayer and practitioner focus groups to provide suggestions for other credible sources of verification. Moreover, the instructions to the verification forms include a dedicated toll-free number for claimants and preparers to call to receive assistance if they believe they cannot obtain the listed documentation. Thus, the IRS believes that legitimate claimants will be able to obtain necessary documentation. Finally, the IRS is continuing to review stakeholder input and compliance data to determine possible additional ways to minimize burden.

Please give us an estimate of the error rate and amount of EITC overpayments. How does the error rate for this program compare with the error rate for other types of low-income assistance programs?

The IRS TY 1999 EITC Compliance Study estimates an unrecovered overclaim rate of between 27% and 32% and between \$8.4 billion and \$9.9 billion, as set forth in the answer to question 5, the error rates for other programs are as follows: HUD

Housing Assistance—10%; USDA food stamps—7%; and SSA Supplement Security Income—6%.

What documentation is currently required for individuals to receive the EITC and are all forms that are used for verification finalized or are you still working out the details? Would you agree that we need to take some steps to verify eligibility for the EITC?

Currently, an EITC claimant is not required to file any documentation to receive the EITC (beyond filing a tax return that includes a schedule EIC). If an EITC claimant's return is selected for examination, the EITC issue is worked in conjunction with all related issues as explained above. Documentation is requested to establish all requirements for EITC and related issues using document request forms specifically for qualifying child, filing status and dependency issues. The documentation requirements and the forms for the qualifying child verification initiative are still in draft form pending additional stakeholder input and focus group testing.

The joint Treasury/IRS EITC task force concluded that the IRS cannot appreciably reduce the overclaim rate without verifying EITC qualifying child eligibility before payment of the refund. The IRS agrees with this assessment. The IRS will use all its available resources to establish a claimant's eligibility without action on the part of the claimant, but it must obtain documentation from selected claimants about their eligibility when the IRS data is insufficient.

Some are saying that the documentation requirements (both a birth and marriage certificate) will be too difficult to produce and that some states take 2-3 years to provide marriage certificates. Is this true?

The IRS generally believes that the documentation will not be too difficult to produce. The documents described in this question (birth certificate, marriage certificate) are associated with proving the EITC relationship requirement, which is a one-time requirement. A birth certificate and marriage certificate are not required in most situations. For example, the IRS can establish close relationships, such as parental, for about 80% of EITC claimants using available databases without requiring any documentation from a taxpayer. Other close relationships such as grandchild, niece, and nephew can be established if the taxpayer can provide just the SSN of the parent of the qualifying child so we can systemically verify the relationship. The birth certificate of the parent of the child is another choice that a claimant may use to substantiate their qualifying child relationship eligibility. Although there have been some claims that certain states may take 2-3 years to provide marriage certificates, we believe this claim overstates the difficulty in obtaining marriage certificates. (For example, while a State of California Web site states that "due to budgetary constraints, our processing time can take up to 2-3 years," that same site directs individuals to the California county recorder's offices, which generally issue marriage certificates in much shorter time periods.) Nonetheless, the IRS takes seriously concerns about claimant burden, and is currently working with its stakeholders to ensure that any documentation required is as minimally burdensome as possible.

Is the EITC compliance program supported by the Taxpayer Advocate?

Yes. The National Taxpayer Advocate was a Member of the EITC task force Executive Steering Committee that approved the task force administrative proposals, including the qualifying child verification proposal. In addition, a Member of her staff was on the EITC task force working group. The National Taxpayer Advocate has been extensively, personally involved in briefing and working with stakeholders to ensure that these proposals can be implemented with the least possible burden to eligible claimants.

Has the IRS met with stakeholders to get their views on this new compliance initiative?

The IRS and the National Taxpayer Advocate have been extensively briefing our stakeholders, including Low Income Taxpayer Clinics, other advocacy groups, practitioners, and the Internal Revenue Service Advisory Committee, since March. The IRS has been meeting with many of the groups on a regular basis to receive their input on the compliance initiatives and suggestions for improving both the process and the draft forms. In addition, the IRS is conducting focus groups in June to get additional feedback. Finally, as noted above, once Commissioner Everson has completed his review, the IRS will issue an announcement seeking public comment on certain aspects of the qualifying child verification initiative.

7. The IRS is developing a new audit program, the National Research Program, which will provide for an updated means of selecting tax returns for examination. When will this new audit selection process begin?

In April 2000, the Internal Revenue Service (IRS) established the National Research Program (NRP). The purpose of this effort is to address the shortfall in data about taxpayer compliance that is required to run the IRS effectively and efficiently. The NRP is a comprehensive effort to measure payment, filing, and reporting compliance for different types of taxes and taxpayers. NRP's current and most public effort is a study of reporting compliance with the Federal income tax by individuals.

One goal of this effort is to gather high-quality information about taxpayer compliance behavior that will allow the IRS to better allocate its resources to enforcement and other activities. A second goal recognizes the deterioration of the workload selection formulas in use today, due to the reliance on data generated for Tax Year 1988. In recent years the percentage of audits closed with no tax change has been increasing rather steadily. The rate means that the IRS is devoting resources to unproductive examinations and that compliant taxpayers are being unnecessarily burdened. A third goal of the reporting compliance study is to collect data that will provide insight into the causes of reporting errors that may aid in providing taxpayer service. If examinations turn up systemic compliance errors on particular items for otherwise compliant taxpayers, the IRS may be able to address the source of these errors through redesigned forms, better communications, improved taxpayer education, or perhaps through recommending legislative changes. A fourth goal is to develop data that can be used to update IRS estimates of the tax gap, since most of the estimates for individual tax gap components are based on old data and studies.

The program of examining 46,860 returns is well underway. The IRS has assembled case files for virtually all the returns in the sample, and we already reviewed more than 86% of them to identify issues for examination and the level of taxpayer contact to verify information on the returns (the returns are either accepted as filed—perhaps with adjustments made, sent to a correspondence examination facility, or sent to a field office for a face-to-face examination). These actions occurred in the first months of the current NRP reporting compliance study. The bulk of examinations will take place in fiscal years 2003 and 2004, with the more complicated returns generally being examined later in the process (since these often are filed after receiving an extension of the due date and often require extensive case-building).

Preliminary data from the NRP reporting compliance study should be available within the IRS late in fiscal year 2004 with more thorough analysis and use of the data occurring in 2005.

What will be the overall audit rate for individuals and for corporations as a result of the new program?

The current reporting compliance study does not include corporations so there will be no direct impact on their audit rate. In general, the NRP audits substitute for other examinations of individual tax returns, so there will be little effect on the overall audit rate for these taxpayers while the NRP examinations are taking place. As we are in the early examination phase, the current study cannot yet provide data to determine the levels of compliance among individual taxpayers and projections of what the audit rates for individuals should be.

Will large corporations and small businesses be selected for audit at the same rate as low-income individuals?

The current study focuses only on individual income tax returns (taxpayers filing Form 1040). As such, the current study will have no impact on the audit rates of large corporations. Individual taxpayers with high and low incomes, individuals with only wage and salary income, and individuals who file a Schedule C or Schedule F to account for their business operations all will be part of the NRP reporting compliance sample. In general, NRP audits substitute for other examinations of individual returns, so there should be little effect on the overall audit rate for these taxpayers while the NRP examinations are taking place. Changes in future audit rates for these groups of taxpayers may result from the levels of compliance discovered during this study.

8. The April 7, 2002 New York Times article titled “Affluent Avoid Scrutiny On Taxes Even As IRS Warns Of Cheating” raises many questions about IRS's ability to address non-compliance by high-income taxpayers and businesses. Is it true that 1 in 45 working poor will be subjected to an IRS audit while 1 in 145 high-income taxpayers will be audited?

No. Based on our FY 2001 accomplishments (cases closed in FY 2001), 1 in 120 taxpayers with income less than \$25K were audited (0.83% coverage), as compared to 1 in 145 with income over \$100K (0.70% coverage). However, the “income less than \$25K” coverage includes the EITC mandated returns which are not part of the examination plan targeted priorities. If the EITC cases are removed from the low income category, then only 1 in 565 taxpayers with income less than \$25K were audited in FY 2001 (0.18% coverage).

For FY 2002, only 1 in 130 taxpayers with income less than \$25K were audited (0.78% coverage) versus 1 in 120 for those with income over \$100K (0.86% coverage). After removing the mandated EITC cases, only 1 in 580 taxpayers with income less than \$25K were audited in FY 2002 (0.17% coverage).

Is it true that tax losses on partnership/K-1 income is in the range of \$9-\$64 billion annually?

The IRS is compiling the data for this answer. The response will be delivered to the Committee no later than June 1, 2004

What types of taxpayers are filing the “high-risk” returns that the Treasury Department announced IRS will focus on for audit this year?

In 1988 the Service changed the definition of a high income return to include those returns with Total Positive Income (TPI) of \$100,000 or more. At that time, these taxpayers accounted for approximately 2 percent of all individual returns filed. For examination workload planning, execution, and monitoring purposes this definition remains in effect today. However, the number of returns in this category has grown to approximately 10 percent of the individual filing population.

To ensure adequate examination coverage for high income returns, we created a new sub-category for FY 2003 and the future with emphasis on returns with TPI of \$1million or more. These returns represent 0.2 percent of all returns filed during processing year 2001.

For FY 2003 and 2004, we have realigned our compliance resources to focus on the areas of greatest compliance risk. To a large extent, much of the non-compliance in these areas involves the use of multi-tiered entities/K-1s (partnerships, 1120S, trusts) to improperly reduce income and tax liabilities. Taxpayers filing these high risk returns generally have incomes in excess of \$100K or more and they come from all walks of life. They include various types of professionals, business owners, executives, consultants, and so forth.

Our strategies to deal with these high risk taxpayers include the following:

- **Promoter Investigations** An initiative focused on identifying and investigating promoters (which may include return preparers, financial planners, professionals or others) who sell or distribute any plan, arrangement or transaction designed or structured for the purpose of circumventing tax laws or evading tax obligations.
- **Abusive Offshore Financial Transactions** An initiative aimed at bringing back into compliance with tax laws, taxpayers who used “offshore” payment cards or other offshore financial arrangements to mask or shelter their income.
- **Abusive Tax Avoidance Transactions** A program designed to bring taxpayers, who have used an abusive scheme to circumvent tax laws or evade tax obligations, back into compliance.
- **High Income Taxpayers (TPI > \$1Million)** A initiative directed at taxpayers with Total Positive Income (TPI) income of \$1million or more who are involved in structured financial transactions in order to lower their taxable income.
- **UI DIF (Returns with a high probability of unreported income)** A strategy to identify self-employed taxpayers filing Form 1040 returns with potential unreported income, especially those with Total Gross Receipts of \$100,000 or more and a Schedule C or F.
- **High Income Non-Filers (Income > \$100,000)** An initiative focused on those taxpayers with Information Reporting Program (IRP) income, i.e., income reported by third parties on Forms W-2, 1099, and so forth., of \$100,000 or more in 1 year who have not filed a return.

Is the IRS still focusing on wage earners’ returns because they are more non-compliant than other individual business filers or corporate filers because IRS computer systems are targeted to get audit wage earners (generally through correspondence audits—even for the most minor infractions) because they are “easy pickings?”

The IRS is not focusing its' audits or their enforcement resources on wage earners' returns. The IRS is focusing enforcement resources in each Operating Division on a variety of programs designed for the type of taxpayer they serve.

Correspondence audits are the primary enforcement tool of the Wage & Investment Business Division. These audits are quicker to complete, and far less complicated than the traditional face-to-face audits. Correspondence audits represent a valuable enforcement tool and were not put in place because the effected taxpayers were "easy pickings."

9. Concerning Free Filing, please provide the results of IRS's survey (9,000 + responses), feedback from external groups, results of April 2003 Free File Alliance session.

Since Free File was launched on January 16, 2003, Members of the Free File Alliance have prepared and transmitted to the IRS over 2.73 million returns (as of April 20, 2003). The overwhelming majority (95%) of the Free File comments received by the IRS were submitted through the IRS.gov Help Desk (See chart below). This volume represents a small fraction (.001%) of the total number of taxpayers (5.6 million) who visited the Free File homepage. E-mail was the dominant method of contacting IRS. Calls and chats were also used. It is important to note that 83% of the 5800 e-mails received during the weeks of January 27, February 3 and February 10, and almost 60% of the e-mails overall, were related to technical difficulties with the IRS.gov Web site—not issues related to Free File Alliance products. Immediately after the Web site issues were resolved (February 10), the number of emails received steadily declined. This correction had the same impact on the number of calls and chats received during the same period indicating that the types of comments submitted through these channels were similar to those submitted through e-mail.

Free File Comments

IRS.gov Help Desk

Week Starting	Number of Comments	% of Total
January 16, 2003	84	0.82%
January 20, 2003	310	3.04%
January 27, 2003	2,750	26.93%
February 3, 2003	3,100	30.36%
February 10, 2003	1,606	15.73%
February 17, 2003	806	7.89%
February 24, 2003	297	2.91%
March 3, 2003	207	2.03%
March 10, 2003	172	1.68%
March 17, 2003	185	1.81%
March 24, 2003	162	1.59%
March 31, 2003	172	1.68%
April 7, 2003	180	1.76%
April 14, 2003	180	1.76%
Total	10,211	100.00%
% of Total	100.00%	0.01%

The remaining 5% of comments were received through several other sources within IRS including e-mails submitted through the Electronic Tax Law Assistance (ETLA) system (the second most common vehicle for contacting IRS) and through

the IRS Customer Service Representatives (CSRs). Using the Inquiry Referral process, IRS's CSRs informed the responsible program office of the various taxpayer comments mostly relating to the following: level of company customer service and software design, site design problems that led taxpayers to believe they had to pay for something such as a state return, company web site operational problems, and error reject problems.

All Comments and concerns received through these vehicles were immediately addressed by IRS personnel (through the use of formatted responses where appropriate) or were reviewed by IRS staff for validation and/or resolution, if necessary. For example, when a number of comments were received regarding the performance of a particular Free File Alliance member's tax software program, the IRS provided constructive feedback to the representatives of the company for purposes of improving their program. In every instance, the feedback was received positively and was used to improve the company's product.

The success of the Free File program for its inaugural year cannot be overlooked. The IRS exceeded their original Free File volume projections. However, the IRS and the Free File Alliance recognize that based on the results and feedback of this past filing season, more improvements will be made to the program. In fact, discussions between the IRS and industry have already begun on plans for next year's release of the program.

10. Concerning private IRS debt collection:

Of the \$13 billion in potentially collectible tax debts, how does this number breakdown in terms of income level, amount of tax due, age of case, and type of taxpayer?

All the information in the following table relates to Forms 1040.

	Percentage Representation
% of balance due under 2 years old	26%
% of balance due 4 years old	21%
% of balance due 6 years old	22%
% of balance due 8 years old	17%
% of balance due more than 8 years old	14%
% of balance due with AGI less than \$20,000	15%
% of balance due with AGI between \$20,000 and \$40,000	14%
% of balance due with AGI between 40,000 and \$75,000	12%
% of balance due with AGI between 75,000 and \$100,000	4%
% of balance due with AGI between 100,000 and \$250,000	4%
% of balance due with AGI more than 250,000	1%
% of balance due with AGI of Blank	50%
Note: Blank means no AGI for Tax Year 2001	
% of balance due less than \$250	0.03%
% of balance due >\$250 to \$500	0.11%
% of balance due >\$500 to \$1,000	0.76%
% of balance due >\$1,000 to \$2,500	6.38%
% of balance due >\$2,500 to \$5,000	11.03%
% of balance due >\$5,000 to \$10,000	14.04%
% of balance due >\$10,000 to \$25,000	21.81%
% of balance due >\$25,000 to \$50,000	18.91%
% of balance due >\$50,000 to \$100,000	12.31%
% of balance due >\$100,000 to \$250,000	5.95%
% of balance due more than \$250,000	8.67%

How much of the \$13 billion is attributable to taxes less than 2 years old?

Of the \$13 billion, 26% (\$3.4 billion) is attributable to cases with eight or more years until statute expiration, i.e., less than 2 years has run on the statute.

How much does it cost the IRS to send the typical series of collection notices to a taxpayer?

The IRS is compiling the data for this answer. The response will be delivered to the Committee no later than June 1, 2004.

How much in the average telephone collection IRS employee get paid in salary and how much (as an estimate) does this employee collect in taxes?

The IRS is compiling the data for this answer. The response will be delivered to the Committee no later than June 1, 2004.

11. Is the Oversight Board providing an effective review of IRS activities? Does it perform the role expected by the 1998 Restructuring Act and is it giving useful feedback to the IRS?

Shortly after the Board was constituted, it began to establish its procedures for working with the IRS. As the Board continued to mature, it became a valuable part of the IRS oversight process. Along with the Taxpayer Advocate, General Accounting Office, and the Treasury Inspector General for Tax Administration, the Oversight Board provides another informed but independent view of the IRS's operations. Past history shows that the IRS needs strong, independent oversight.

We welcome James R. White, Director of Tax Issues, GAO, and the Honorable Karen Hastie Williams, Member of the IRS Oversight Board. Mr. White and Ms. Williams, thank you very much for being here. Mr. White, would you please give us your testimony.

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

Mr. WHITE. Mr. Chairman and Members of the Subcommittee, we are pleased to participate in the Subcommittee's annual hearing and provide our assessment of IRS's budget request and filing season performance to date.

This year, IRS expects to process about 130 million individual tax returns as we have heard, issue about 100 million refunds, and receive tens of millions of phone calls. Many of these contacts with Americans occur during the filing season.

Let me start with the budget. For fiscal year 2004, IRS is requesting \$10.4 billion and 100,000 FTE employees. In dollar terms, this is a 5.2-percent increase over last year's request. The 2004 budget request is one of a series that over the last several years have identified compliance as a top priority for receiving additional resources, that is, increased staffing. However, actual compliance staffing for these same years has declined. For example, between 2001 and 2003, it declined by over 7 percent. Thus, recent history raises questions about whether IRS will be able to satisfy the priority needs identified in the 2004 budget.

Let me explain. One reason for the inability to allocate more resources to compliance work is unfunded cost increases, costs, such as Federal salary increases larger than those anticipated in the budget. The IRS has dealt with such unbudgeted costs by cutting back on compliance rather than, for example, cutting staff issuing refunds or answering taxpayer questions.

A second reason is the difficulty of realizing internally generated savings. Like last year, this year's IRS budget includes investments in priority areas like compliance that would be funded in part out of a budget increase and in part out of internal savings. The graph on the easel, which is also shown on page 3 of my statement, helps illustrate. Of \$454 million in new priority spending, what IRS calls program enhancements, \$288 million would come from the budget increase. The rest, \$166 million, is funded from internal savings such as an initiative to improve the efficiency of handling payments and returns that would save over 200 staff years.

As we did last year, we commend IRS for identifying such savings opportunities. However, it now appears that IRS will not be able to realize all of the savings identified in last year's budget, in some cases, for example, because new computer systems have been delayed. This history raises the question of whether the 2004 budget is optimistic.

I will return to this issue, but want to make two other points first. One is that the budget justification for information technology, another IRS priority with over \$2 billion in the budget request, still needs improvement. Specifically, the information systems budget for operations and maintenance is not formulated using practices followed by leading organizations. The IRS is working to implement recommendations we made last year.

The request for capital funds, called business systems modernization, is adequate. We support it, and IRS has improved its ability to manage the funds. However, IRS has acknowledged some remaining weaknesses and has initiatives planned or underway to correct them, as well.

Now, I will discuss the filing season. The IRS's filing season performance to date has improved compared to recent years. For example, telephone access has improved while accuracy has remained generally stable and IRS's website has seen increased use, which decreases the number of labor-intensive phone calls.

Electronic filing continues to grow, and although more than half of returns are still filed on paper, the number of paper returns is declining. In fact, paper returns have decreased so much that IRS is closing one of the paper return processing centers, an action that is going smoothly.

Mr. Chairman, as the examples of improved telephone access and the processing center closing show, IRS is beginning to realize payoffs from the ongoing systems modernization investments and wider management improvements. Although IRS has not succeeded in reallocating staff to one of its priority needs, compliance, there will likely be increased potential for such reallocation as modernization proceeds.

This will present Congress, in both its oversight and appropriation roles, with significant opportunities to weigh in on IRS's overall strategy for better accomplishing its mission. Specifically, Congress will have opportunities to help IRS establish strategic priorities and make decisions about the resources needed for those priorities.

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

[The prepared statement of Mr. White follows:]

Statement of James R. White, Director of 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 Internal Revenue Service's (IRS) fiscal year 2004 budget request and 2003 tax filing season performance.

With its mission to "provide America's taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all," IRS is responsible for collecting most of the funds that pay for the Federal Government. To carry out its mission, IRS has a budget of about \$10 billion and staff of about 100,000 full time equivalents (FTE). For 2003,

IRS expects to process 130 million individual income tax returns, issue 99 million refunds, receive 100 million telephone calls, and assist 4 million taxpayers face-to-face at IRS and volunteer^[1] offices.

As you requested, our statement discusses both IRS's 2004 budget request and its 2003 filing season performance. With respect to the budget, we assessed the likelihood that IRS will be able to allocate more resources to one of its key priorities, compliance, and whether the proposed spending on some computer systems is justified. With respect to the filing season, we assessed IRS's performance in processing returns and providing assistance to taxpayers.

Our assessment of the budget request is based on a comparative analysis of IRS's fiscal year 2003 and 2004 budget requests, supporting documentation, and interviews with IRS officials. Our assessment of the filing season is based on a comparison of IRS's performance this year to last, site visits to IRS processing centers and walk-in sites, and interviews with IRS and Treasury Inspector General for Tax Administration (TIGTA) officials, tax preparers, and other external stakeholders. We also reviewed IRS's Web site for usability and accessibility.

In summary, our assessment of IRS's 2004 budget request shows that:

- IRS is requesting 100,043 FTEs and \$10.4 billion, an increase of about 5 percent over its fiscal year 2003 request. The 2004 budget request is one of many that have identified compliance activities as among IRS's top priorities for receiving additional resources. These additional resources were to be funded from budget increases, internally generated savings, or both. Savings projections have been revised downward since the 2004 budget request was prepared, which raises questions about IRS's ability to achieve all the savings and shift resources to compliance as planned. Further, IRS's recent history shows that it has been unable to increase resources in compliance, despite having made it a priority in budget requests. In fact, for the most recent three full fiscal years—2000, 2001 and 2002—compliance resources have declined slightly. Reasons for this include unfunded expenses consuming budget increases.
- Another priority area for IRS is Information Technology (IT). IRS is requesting about \$2.1 billion and 7,986 staff years in information technology resources for fiscal year 2004. This includes (1) \$429 million for the agency's multiyear capital account that funds contractor costs for the BSM program and (2) about \$1.67 billion and 7,735 staff years for information systems, of which \$1.62 billion is for operations and maintenance. In preparing its fiscal year 2004 budget request for the operations and maintenance of information systems, IRS began to implement an information technology portfolio management process patterned after the one used for the BSM program. However, until IRS fully implements planned process improvements, its ability to develop supportable information systems budget requests will remain limited.

Our assessment of the 2003 filing season to date shows that:

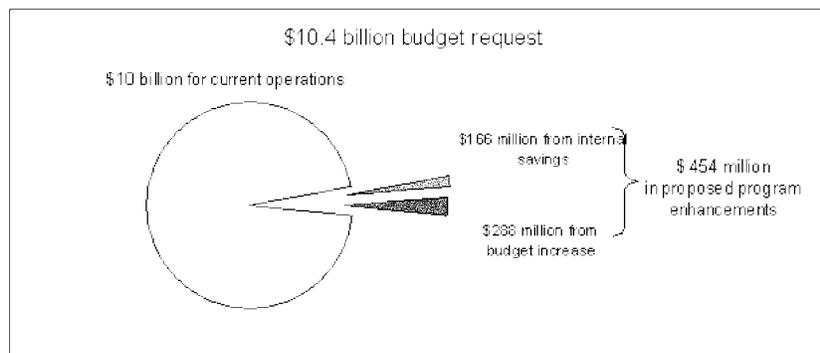
IRS's 2003 filing season performance has improved over last year, based on the data we reviewed in key filing season activities—paper and electronic processing, telephone assistance, IRS's Web site, and walk-in assistance. In particular, access to IRS's telephone assistors has improved and Web site usage has increased. While we cannot quantify the connection between these results and IRS's ongoing systems modernization efforts, the improvement in filing season performance, in part, represents a payoff from systems modernization.

IRS's Fiscal year 2004 Budget Request Includes Compliance, Taxpayer Service, and Information Systems as Priorities

For fiscal year 2004, IRS is requesting \$10.4 billion, an increase of 5.3 percent over fiscal year 2003 requested levels, and 100,043 FTEs. IRS's 2004 budget request is its second in a row to propose increased spending for higher priority areas that would be funded, in part, with internal savings redirected from other areas. Specifically, IRS proposes to devote an additional \$454 million and 3,033 more FTEs to enhance programs, primarily in compliance and some customer service areas. As shown in figure 1, \$166 million of the enhancements would be funded from internal savings with the remainder funded from the budget increase.

^[1]These offices use IRS-trained volunteers to help prepare basic tax returns for taxpayers with special needs.

Figure 1: IRS's Proposed Funding for Program Enhancements



Source: IRS data.

As we did in last year's testimony on IRS's 2003 budget request, we commend IRS for identifying savings to be reinvested in operations to improve IRS performance. This approach implements a key principal of IRS's long-term modernization effort. Under this approach, the reengineering of IRS's work processes—much of which is dependent on investments in computer modernization—would automate or eliminate work, improve productivity, and free staff time that could then be redirected to higher priority customer service and compliance activities.

We provide some context for understanding the 2004 budget request in figures 2 and 3 as shown in appendix I. In those figures, we illustrate how IRS allocated expenditures and staff resources in fiscal year 2002, the most recently completed year.

Current Projections and Recent History Raise Questions About Whether IRS Will Realize Some Priority Resource Reallocations

Revised projections developed since the 2004 budget request was prepared raise questions about IRS's ability to achieve all the savings projected and shift resources to compliance as planned. In addition, some projected savings are based on re-engineering efforts that are not well defined. Further, IRS's recent history also shows that it has been unable to increase resources in the compliance area despite having made it a priority in past budget requests. In fact, for the most recent 3 full fiscal years—2000, 2001, and 2002—compliance resources have declined slightly. Reasons for this decline include unfunded expenses consuming budget increases and workload increases in other essential operations.

IRS Has Revised Some Savings Shown in Its 2004 Budget Request

IRS has revised the savings associated with several reengineering efforts identified in the 2004 budget request. Revisions this far in advance of the start of the fiscal year are not a surprise. They do indicate that there is some uncertainty associated with the budget request's savings projections.

Four of the seven most significant reengineering efforts—in terms of FTEs and dollars to be saved—will not achieve all of their projected savings because the efforts were based on assumptions that will not be realized, according to IRS data and officials. IRS now projects that the seven most significant efforts will save 1,073 FTEs and \$60.5 million, down from original projections of 1,356 FTEs and \$77.7 million.

IRS provided different reasons for why all savings will not be achieved for the following individual efforts.

- IRS's effort to improve the efficiency of compliance support activities—the single most significant effort—was partially dependent on IRS implementing individual compliance savings projects in 2003. This effort was projected to save 394 FTEs and almost \$26 million. However, due in part to delays until 2004 to allow for additional testing, this effort is now expected to save about 30 percent of the original projections through the end of fiscal year 2004.
- IRS's effort to improve the efficiency of personnel services—the second most significant effort—depended in part on the functions of a new computer system to achieve most of its savings. This effort was originally projected to save 222 FTEs and \$14.6 million. According to IRS officials, these functions will not be

delivered on time due to schedule delays. IRS officials have not determined the impact of this delay and are currently assessing other potential approaches to achieve savings in this area.

IRS officials said the remaining three of the seven most significant efforts will achieve all or more of their projected savings. For example, the effort to improve the efficiency of handling payments and returns, originally projected to save 121 FTEs and \$4.6 million, is now expected to have more than double the savings, or 235 FTEs and \$11.9 million, due to greater than expected productivity. However, according to IRS officials, even when their savings are combined, these three efforts will not save enough to offset the reduced savings from the other four.

Reengineering efforts may not achieve all of their savings goals, in part, because of the long time lag between when IRS begins developing its budget request and when the fiscal year begins. As with most other federal agencies, IRS usually begins formulating its budget request about 18 months before the start of the fiscal year and about 10 months before the President submits his budget to Congress. With planning beginning so far ahead of the budget's actual execution, there are inevitably intervening events, such as implementation delays with computer systems, that make the assumptions upon which projections are based no longer realistic.

Some 2004 Reengineering Efforts Are Not Well Defined

Some of the reengineering efforts listed in the 2004 budget request are not well defined, thus raising questions about whether they will achieve their savings goals. For example:

- IRS still is reviewing its procedures to identify ways to make tax return processing more efficient. Although IRS projected this effort to save 203 FTEs and \$6.9 million, it has not yet identified the operational areas that will be reengineered. IRS officials said that the projected savings are based on a 2 percent efficiency increase, but they are currently determining how to achieve that goal.
- The effort to improve the efficiency of personnel services noted above also included numerous competitive outsourcing assessments affecting several program areas that, according to the budget request, would result in a significant reduction of staffing. However, in response to our request for more information, IRS was unable to provide details on the type or number of specific assessments, program areas that would be affected, how this effort would lead to reduced staffing, or the amount of net savings expected.

According to IRS budget officials, IRS uses its budget formulation process to establish productivity goals, although the responsible business units may not know specifically how savings will be achieved. Officials said that this approach encourages innovation in meeting performance goals while identifying ways to save FTEs and budget dollars.

In Recent Years, Compliance Staffing Declined

Since 2001, IRS's budget requests have made increasing compliance staff one of several key priorities. For example, in its 2001 budget request IRS asked for funding for the Staffing Tax Administration for Balance and Equity (STABLE) initiative, which was designed to provide additional staffing for examination, collections, and the new Tax Exempt and Government Entities Division. However, TIGTA recently reported data that showed an over 7 percent decline in compliance staff between 2000 and 2002.^[2]

There are several reasons for the decline, including increased workload and unfunded costs. In September 2002, the Commissioner attributed the decline in compliance staffing to increases in workload in other essential operations such as processing returns, issuing refunds, and answering taxpayer mail. In the most recently completed fiscal year, 2002, IRS faced unbudgeted cost increases, such as rent and pay increases, in the amount of about \$106 million. As a result, IRS had to delay hiring revenue agents and officers, tax compliance officers, and tax specialists. As shown in appendix I, in 2002 figure 2 shows about 69 percent of IRS's spending was for labor costs. IRS noted in its budget request that any major negative changes in the agency's financial posture, such as unfunded salary increases, will have a negative effect on staffing levels.

^[2]Treasury Inspector General for Tax Administration, *Trends in Compliance Activities through Fiscal Year 2002*, Reference No. 2003-30-078, Washington D.C.: March 2002. The compliance staff figures include revenue officers, revenue agents, and tax auditors.

IRS's Experience in 2003 Illustrates the Difficulty of Projecting Savings and Investments

IRS's experience with last year's budget request illustrates the difficulty of projecting and realizing savings and investing resources in higher priority areas. As part of its 2003 budget request, IRS identified internal savings of almost \$197 million and 2,287 FTEs to be accomplished through various reengineering efforts and workload decreases. IRS planned to reinvest those savings in higher priority areas—compliance and customer service program enhancements, including efforts to stabilize audit rates, improve telephone assistance level of service, and target highest priority collection cases. However, IRS now estimates that about \$75 million, or 38 percent, of the dollar savings and about 1,280, or 56 percent, of the FTE savings will be achieved by the specific reengineering efforts and workload decreases as identified in the 2003 budget request. IRS officials provided several reasons why some savings for these particular reengineering efforts will not be realized, including delays in modernization projects and less-than-anticipated workload decreases. For example, IRS received more innocent spouse cases than anticipated, and the cases received were more complex, causing the hours spent per case to increase.

While savings associated with a particular effort listed in the 2003 budget request may not materialize, IRS officials said that business unit managers have identified other ways to increase productivity and did more work with fewer staff—therefore achieving productivity increases through efforts not identified in the 2003 budget request. As an example, officials provided an analysis showing increased telephone collections cases closed with significantly fewer staff than in the previous year. While GAO did not verify these savings, however, IRS officials were confident that this and other similar productivity increases were being achieved. Furthermore, IRS budget officials said the results of productivity increases not listed in the 2003 budget request should be included in any tally of IRS's savings.

We agreed that productivity increases generate savings. IRS was unable to quantify the gains from productivity increases in time for this hearing. IRS officials also said that most of the savings generated by the productivity increases would be used to handle workload increases in the same area where savings were generated. They said the savings would not be available for reallocation to other areas.

As was the case in 2002, cost increases not included in the 2003 budget request are also limiting IRS's ability to fund new investments. According to IRS officials, IRS will need to fund a total of about \$388 million out of existing resources, including about \$128 million for pay increases.

Information Technology Budget Formulation

Process Still Needs Improvement

IRS is requesting about \$2.1 billion and 7,986 staff years in information technology (IT) resources for fiscal year 2004. This includes (1) \$429 million for the agency's multiyear capital account that funds contractor costs for the BSM program and (2) about \$1.67 billion and 7,735 staff years for information systems, of which \$1.62 billion is for operations and maintenance. In preparing its fiscal year 2004 budget request for the operations and maintenance of information systems, IRS began to implement an information technology portfolio management process patterned after the one used for the BSM program. However, until IRS fully implements planned process improvements, its ability to develop supportable information systems budget requests will remain limited.

Fiscal Year 2004 BSM Request Developed in Accordance with Federal Guidance

Consistent with the Clinger-Cohen Act of 1996,^[3] the Government Performance and Results Act of 1993,^[4] OMB guidance on budget preparation and submission^[5] 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 missions and operations, and provide positive business value in terms of expected costs, benefits, and risks.

^[3]P.L. 104–106.

^[4]P.L. 103–62.

^[5]See, for example, OMB Circular No. A–11: *Preparing, Submitting, and Executing the Budget* (Washington, D.C.: June 27, 2002).

Since the BSM appropriation was established in fiscal year 1998, we 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 road map for business and technological change from which agencies can logically and justifiably derive their budget requests and capital investment plans. In response to our recommendations, IRS developed an enterprise architecture. In March 2002, IRS approved a new version of this architecture (version 2.0), which describes IRS's current and target business and technology environments. In December 2002, IRS completed the associated high-level transition strategy 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's \$429 million request for the BSM account for fiscal year 2004 is based on its enterprise architecture as well as its related life cycle methodology and investment management process. Thus, this request is based on analyses that meet the statutory and regulatory requirements for requesting multiyear capital investment funding.

BSM Program Management Capability Improved, But Risks Remain

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 2002, IRS submitted an expenditure plan seeking approval to obligate funds from the BSM account for its planned fiscal year 2003 projects and program-level initiatives. In March 2003, IRS submitted a revised plan that reduced the initial request by shifting funding for two BSM projects to the information systems account and reducing the amount requested for the core infrastructure projects and program-level initiatives.

In briefings to the staff of the relevant appropriations subcommittees and IRS on the results of our review of IRS's November 2002 expenditure plan, we reported that IRS has progressed significantly in improving its modernization management controls and capabilities, and has taken steps to better balance the pace of the BSM program with its management capability. We also reported that, although important progress has been made, certain management controls and capabilities, related to configuration management, human capital management, and cost and schedule estimate validation, have not yet been fully implemented. Our analysis has shown that weaknesses in these controls and capabilities contributed to BSM project cost, schedule, and performance shortfalls during fiscal year 2002. In approving the release of a portion of the fiscal year 2003 BSM funding, the appropriations subcommittees directed IRS to, among other things, fully establish and implement all management processes and controls needed to effectively manage the BSM program. IRS has acknowledged these weaknesses and has initiatives planned or underway to address them.

Despite the progress made during the past year, IRS's BSM program faces heightened risks because (1) several key projects are entering their later stages of development and deployment, (2) some of these projects provide the foundational infrastructure upon which later projects depend, (3) an increasing number of project milestones are experiencing cost increases and schedule delays, and (4) IRS plans to start more projects. While IRS is better prepared to manage risk and meet the challenges ahead, sustained top management involvement, improved management capa-

^[6]See U.S. General Accounting Office, *Tax Administration: IRS's 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); *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 *Tax Administration: IRS's 2000 Tax Filing Season and Fiscal Year 2001 Budget Request*, GAO/T-GGD/AIMD-00-133 (Washington, D.C.: Mar. 28, 2000).

^[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 road map for transitioning between these environments.

^[8]Consolidated Appropriations Resolution, 2003 (P.L. 108-7).

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

bilities, and consistent oversight, are critical to the successful implementation of the BSM program.

Although Progress Made, Information Systems Budget Request Development Process Needs Additional Improvements

Leading private- and public-sector organizations have taken a project- or system-centric approach to managing not only new investments but also the 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 decision-making is incorporated in the IT investment management approach that is recommended by the OMB and GAO.^[10] By using these proven investment management approaches for budget formulation, agencies have a systematic method, on the basis of risk and return on investment, to justify what are typically very substantial budget requests for the operations and maintenance of information systems. 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.

In our assessment of IRS's fiscal year 2003 budget request, we reported^[11] that IRS did not develop its information systems operations and maintenance request in accordance with the investment management approach used by leading organizations. For example, in developing the request, IRS had not identified and assessed the relative costs, benefits, and risks of specific operations and maintenance systems and projects. Instead, according to IRS officials, they developed the request by beginning with the fiscal year 2002 expenditures and simply adding amounts to fund cost-of-living and salary increases. IRS officials attributed this gap between IRS's 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. We recommended^[12] that IRS prepare its fiscal year 2004 information systems budget request in accordance with the investment management approach used by leading organizations. IRS agreed and initiated actions to address our recommendation.

IRS has made progress in incorporating investment management practices into the formulation of its fiscal year 2004 information systems budget request. For example, IRS created information technology portfolios for its operations and maintenance systems in accordance with revised OMB budget guidance.^[13] According to IRS officials, these portfolios were used to assist managers and staff involved with information technology planning and investment decision-making to (1) assess initiatives in terms of their cost, risks, and expected returns and (2) determine and maintain the appropriate mix of investments. They also indicated that they are working with Treasury and OMB to improve the information technology investment portfolio development process. IRS's emphasis on portfolio development demonstrates an increased effort to ensure its information systems operations and maintenance requests are supported.

Despite this progress, IRS has not yet completed its planned actions to implement our recommendation. As of April 2003, IRS has not developed an activity-based cost accounting system 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 officials stated that they are developing an activity-based cost model in conjunction with the Integrated Financial System modernization project, but this model will not be fully implemented until December 2003. Furthermore, IRS officials stated that data from this model will not be available for use

^[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).

^[11] U.S. General Accounting Office, *Internal Revenue Service: Assessment of Budget Request for Fiscal Year 2003 and Interim Results of 2002 Tax Filing Season*, GAO-02-580T (Washington, D.C.: Apr. 9, 2002) and *Internal Revenue Service: Improving Adequacy of Information Systems Budget Justification*, GAO-02-704 (Washington, D.C.: June 28, 2002).

^[12] See GAO-02-580T and GAO-02-704.

^[13] Office of Management and Budget, OMB Circular No. A-11.

until the fiscal year 2006 budget formulation cycle. In addition, IRS has still not completed its capital planning guidance, and thus did not use it in preparing its fiscal year 2004 information systems budget submission. According to IRS officials, the agency has developed a draft Capital Planning and Investment Control guide that is undergoing internal review, but it will not be completed and implemented until late October 2003. Until IRS incorporates the cost model and capital planning and investment control guidance into the preparation of its information systems budget request, IRS will not be able to ensure that the information systems operations and maintenance request is adequately supported.

Interim Results of IRS's 2003 Filing Season Show Improvement Over Previous Years

IRS's filing season performance through mid-March has improved compared to recent years, based on data we reviewed in five key filing season activities—paper and electronic processing, telephone assistance, IRS's Web site, and walk-in assistance. For example, telephone access has improved, and IRS's Web site has seen increased use. While we cannot quantify the connection between these results and IRS's ongoing systems modernization efforts, the improvement in filing season performance, in part, represents a payoff from systems modernization.

IRS's Paper and Electronic Processing Operations Have Gone Smoothly This Year

Through March 28, IRS has smoothly processed about 67 million individual income tax returns. According to IRS data and to officials and tax preparers we spoke with, IRS has not experienced any significant processing or computer problems. IRS officials attribute this year's smooth processing, in part, to the relatively insignificant tax law changes compared to last year.

Electronic filing continues to grow, although at a slower rate than projected. Of the approximate 67 million returns, about 26 million individual income tax returns were filed on paper and 41 million returns were filed electronically, as of March 28, as shown in table 1. This represents an increase in electronic filing of 10.4 percent over the same time period last year. Whether IRS will achieve its goal of 54 million tax returns filed electronically in 2003 is uncertain. Last year at this time, IRS was also below its goal, but made up the difference late in the filing season.

Table 1: IRS Performance in the First Weeks of the 2003 and 2002 Filing Seasons

Volume in thousands	2002	2003
Actual returns processed^a		
Paper	29,014	26,289
Electronic	37,035	40,870
Telephone assistance		
Total calls ^b	60,674	38,213
Answered by assistors	9,540	9,938
Answered by automation	28,130	19,860
Not answered	23,004	8,415
Customer service representative level of service ^b	69%	84%
Average speed of answer ^b	216 seconds	155 seconds
Accounts customer accuracy rate ^c	88% +/- 1%	88% +/- 1%
Tax law customer accuracy rate ^c	84% +/- 1%	81% +/- 1%
Internet assistance		
Forms and publications downloaded ^d	213,000	283,000

**Table 1: IRS Performance in the First Weeks of the 2003 and 2002 Filing Seasons—
Continued**

Volume in thousands	2002	2003
Refund status inquiries ^e	N/A	10,200
Walk-in assistance		
Returns prepared at IRS walk-in sites ^f	436	291
Returns prepared at volunteer sites ^g	466	594

Source: IRS data.

^aFrom January 1 to March 29, 2002, and January 1 to March 28, 2003.

^bBased on actual counts from January 1 to March 23, 2002, and January 1 to March 22, 2003.

^cBased on a representative sample estimated at the 90 percent confidence level from January to February 2002 and 2003.

^dFrom January 1 to March, 31 2002 and 2003.

^eFrom January 1 to March 28, 2003.

^fFrom January 1 to March 16, 2002, and January 1 to March 15, 2003.

^gFrom January 1 to March 9, 2002, and January 1 to March 8, 2003.

Growth in electronic filing is a key part of IRS's modernization strategy. Electronic filing allows IRS to control costs and improve customer service, by reducing labor intensive processing of paper returns. This year, to help increase electronic filing, IRS entered into an agreement with the Free File Alliance, a consortium of 17 tax preparation companies, to offer free online tax preparation and filing services for at least 60 percent of all taxpayers via the IRS Web site. IRS data shows that as of March 26, about 2.1 million returns were filed through the consortium, close to the goal of 2.5 million. While there have been some complaints about pop-up ads, taxpayers reported in IRS surveys that they were generally pleased with the service.

Because of the growth in electronic filing, the number of paper returns has declined in recent years. As a result, IRS is closing processing operations at the Brookhaven Submission Processing Center, one of its eight processing centers for individual income tax returns filed on paper. This closing represents a significant consolidation of IRS's processing operations. Based on processing data to date, the consolidation has not disrupted the filing season.

Telephone Access Improved over Last Year, While Accuracy Generally Remained Stable

Access to IRS's toll-free telephone lines improved over last year. As table 1 shows, as of March 22, the percentage of taxpayers that attempted to reach an assistor and actually got through and received service—referred to as the Customer Service Representative level of service—increased 15 percentage points over the same period last year, for the approximately 10 million calls served. In addition, taxpayers have waited 61 seconds less, on average, to speak to an assistor so far this filing season as compared to last year. According to IRS officials, the increase in the level of service is largely due to lower than expected call demand and more effective routing of calls to qualified assistors. Part of the reason for the decrease in demand is that some taxpayers are using the new refund status check feature on IRS's Web site rather than calling.

Accuracy was relatively stable this year as compared to last year. As shown in table 1, taxpayers who called about their accounts received correct information an estimated 88 percent of the time. IRS officials said that accounts accuracy rates remained stable, because many simple refund inquiries were diverted to the new refund feature on IRS's Web site, leaving assistors to handle more complex calls. Table 1 also shows taxpayers who called with tax law questions received correct information an estimated 81 percent of the time, slightly down from last year. According to IRS officials, because many assistors had difficulty in adapting to a change in the guide used to query callers.

Web Site Is Seeing Increased Use and Has New Features, although Concerns About Usability Still Exist

IRS's Web site use has increased over last year. About 283 million forms and publications have been downloaded—a 29 percent increase over the same period last year. In addition, an independent study reported that IRS's Web site had ranked in the top 10 out of 40 government web sites and that users were able to access

IRS's site in less than one second during the January 20 through February 28 test period.

IRS added a new feature to its Web site for use this filing season: the refund status check, ("Where's My Refund?"). This feature enables taxpayers to find out if the IRS received their returns and whether their refunds were processed. IRS intended this feature to divert some simple telephone calls from assistors. Data shows that as of March 28, about 10.3 million taxpayers have used this feature to check the status of their refund.

While some of the problems we identified in previous years appear to have been remedied, we continue to have concerns about the search function on IRS's Web site. Our informal testing of IRS's Web site showed that it is more user friendly than last year. We found it to be more accessible, easier to navigate, and data was more current. However, the search functions still do not always make the most pertinent information readily available. For example, when we typed "earned income tax credit" into the forms and publication search function, Publication 596—the primary publication on the earned income tax credit—was the 70th item on the list, and we had to scroll through seven pages to find it. According to IRS officials, an independent contractor is currently looking at ways to improve the search functions, and the contractor expects to issue its report in mid-April of this year.

Walk-in Assistance Improved and Community Based Coalitions Expanded over Last Year

The quality of assistance at IRS's walk-in sites has improved this year over last, and service to taxpayers through community based coalitions has increased. At congressional direction, the TIGTA has been responsible for measuring the quality of assistance at IRS's walk-in sites. According to TIGTA officials, the accuracy of tax law assistance provided at IRS's walk-in sites increased as of February this year to about 73 percent—an increase of 27 percentage points over the same period last year. TIGTA also found that the rate at which IRS employees referred taxpayers to a publication instead of answering tax law questions—which had been an issue last year—declined by about 85 percent.

According to TIGTA officials, the increased accuracy rates resulted from various steps taken by IRS, including revising to the guidelines used by walk-in staff, certifying staff proficiency, conducting monthly reviews of tax law accuracy, and taking immediate action to address review information relating to any incorrect answers or improper referrals found during IRS or TIGTA quality reviews.

As table 1 shows, more taxpayers had their returns prepared by community-based coalitions and other organizations that provide free tax return-preparation assistance as part of IRS's Volunteer Income Tax Assistance and Tax Counseling for the Elderly programs. These programs use IRS-trained volunteers to help prepare basic tax returns for taxpayers with special needs—including those with a low to fixed income, non-English speaking people, and the elderly.

Concluding Observations

As the examples of improved telephone access and the Brookhaven Submission Processing Center closing show, IRS is beginning to realize payoffs from the ongoing systems modernization investments and wider management improvements. Although IRS has not succeeded in reallocating staff to one of its priority needs, compliance, there will likely be increased potential for such reallocation as modernization proceeds. This will present Congress, in its oversight and appropriations roles, with significant opportunities to weigh in on IRS's overall strategy for better accomplishing its mission. Specifically, Congress will have opportunities to help IRS establish strategic priorities and make decisions about the resources needed to meet those priorities.

Mr. Chairman, this concludes my prepared statement, and I would be pleased to respond to any questions.

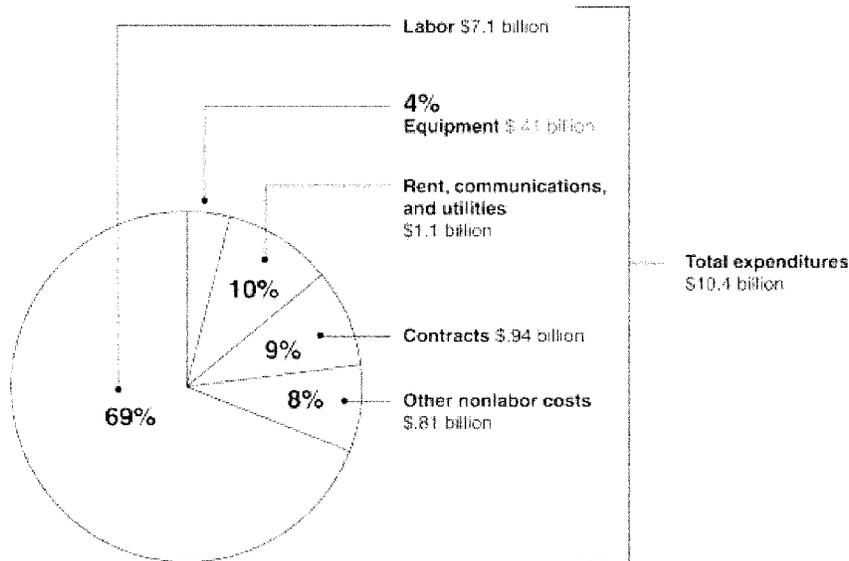
Appendix I

How IRS Allocated Expenditures and Staff Resources in Fiscal Year 2002

To provide some context for understanding the 2004 budget request, figures 2 and 3 illustrate how the Internal Revenue Service (IRS) allocated expenditures and staff resources in fiscal year 2002, the most recently completed year. Figure 2 shows IRS's fiscal year 2002 actual expenditures in several categories, including about 69

percent that was spent on labor. Figure 3 shows how IRS allocated its labor across functional areas, including ensuring compliance such as auditing and collecting delinquent taxes (45 percent), providing taxpayer services such as telephone assistance (21 percent), and processing tax returns (15 percent). However, the boundaries between categories may not be as well defined as the figures indicate. For example, in figure 3, staff categorized as maintaining information systems could also be considered under support for processing, taxpayer service or compliance. Therefore, the figures are meant to provide a summary of how IRS uses its resources and should be interpreted with caution.

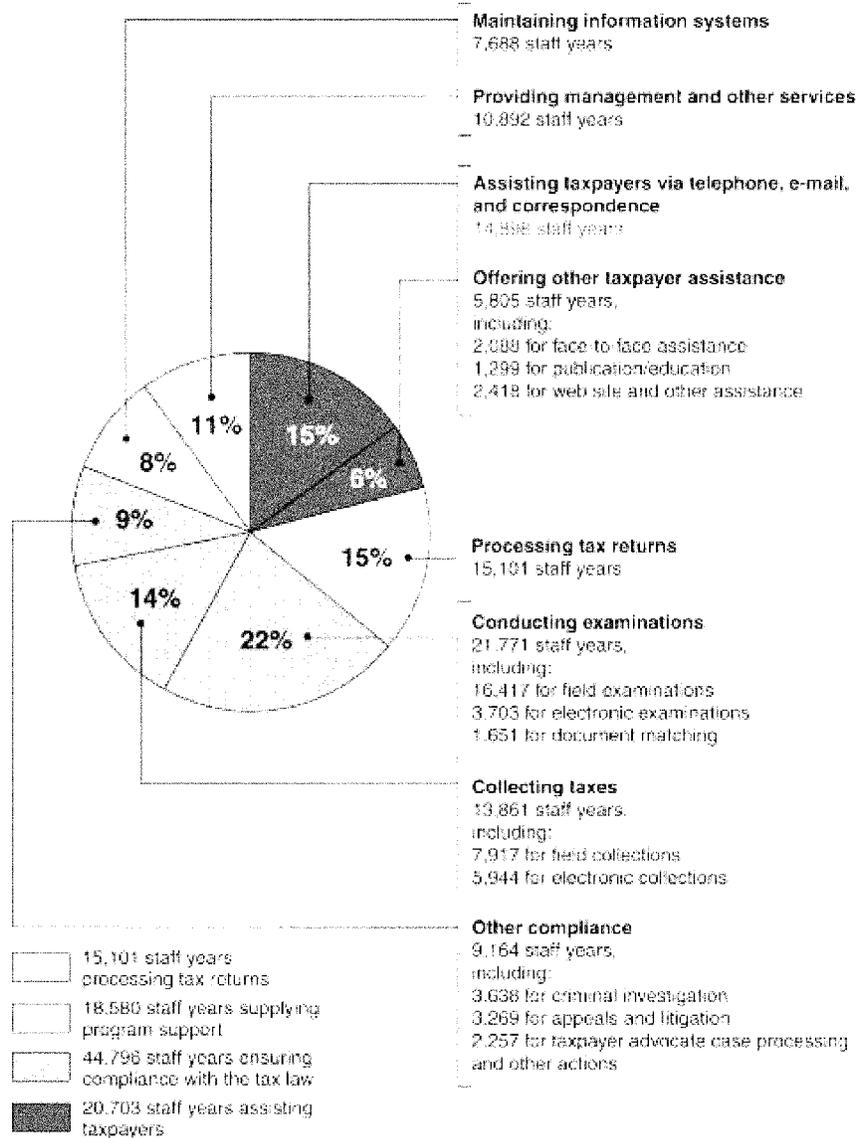
Figure 2: IRS's Expenditures in Fiscal Year 2002^[14]



Source: GAO's analysis of IRS data.

Figure 3: How IRS Spent Its 99,180 Staff Years in Fiscal Year 2002

^[14] IRS's annual expenditures may exceed its current year appropriations, because IRS has additional budgetary resources available to it and also incurs certain costs that were funded in prior years. During fiscal year 2002, IRS's total budgetary resources included its fiscal year 2002 appropriation of \$9.437 billion as well as unobligated balances available from prior years, spending authority from offsetting collections, and recoveries of prior year obligations.



Source: IRS Budget, FY 2010

Chairman HOUGHTON. Ms. Williams?

**STATEMENT OF THE HONORABLE KAREN HASTIE WILLIAMS,
MEMBER, INTERNAL REVENUE SERVICE OVERSIGHT BOARD**

Ms. WILLIAMS. Good morning, Mr. Chairman and Members of the Subcommittee. Thank you for holding this hearing and inviting me to testify. It is an honor for me to be here this morning and

appear before the Subcommittee on behalf of the IRS Oversight Board. I have submitted written remarks and ask that they be included within the record.

My remarks today will focus primarily on the Oversight Board's recommendation for the IRS fiscal year 2004 budget. I would like to address the Oversight Board's view of the IRS budget from two perspectives. First, I will discuss the challenge the IRS must face as it continues to modernize in accordance with its strategic plan. The IRS's ability to meet these challenges will be affected by resource availability. Second, I want to present the Oversight Board's fiscal year 2004 budget recommendations, and why we have made these recommendations.

The IRS is 5 years into a process that will transform it into a modern financial institution. During this period, the IRS has refocused, redefined, and rebuilt itself with dramatic changes in its mission, organization, management processes, and governance. It remains, however, the essential engine of finance in the Federal Government.

As the transformation continues, the IRS continues to face difficult challenges. Each will require an investment of resources over multiple years if the IRS is to continue the following transformation processes.

First, closing a compliance gap that is unfair to honest taxpayers. Second, continuing and implementing the business systems modernization program that will modernize its business processes and information technology. Third, replacing its human capital. Fourth, modernize its facilities. Let me highlight several specific issues.

On enforcement, the IRS faces many examination and collection issues, but the sheer number of identified cases that it cannot pursue because of the lack of resources seems to me like a serious failure to treat all taxpayers fairly. Our system of voluntary compliance is based on the premise the taxpayers believe that everyone is paying what they legally owe. While this situation cannot be fixed in a single year, the IRS Oversight Board believes that the IRS needs about a 2 percent real growth each year for the next 5 years. This is a practical and necessary approach to the problem. Moreover, if you look at the survey results on page 3 of my submitted testimony, taxpayers expect it.

With respect to business systems modernization, let me emphasize one simple fact. The IRS will never become modernized unless it replaces its current information systems. The Legacy systems, many of them over 40 years old, prevent the IRS employees from obtaining timely and accurate information about taxpayers' accounts and must be modernized.

Although the Oversight Board has been disappointed in the performance of this critical program, which is still plagued with delays and schedule and cost overruns, these facts remain. The modernization program is a major long-term investment that will require significant ongoing and growing investment. Modernization should be implemented as quickly as possible in order to lower the program's ultimate cost and serious risks. Funding reductions, while seemingly attractive in the short term, have long-range negative consequences which outweigh any short-term savings.

Human capital is a very important and vital element in modernizing the IRS. During the past 5 years, the IRS has devoted energy and resources toward its structural realignment in its business systems and technology modernization, but it has placed less attention on strategic human capital planning. This must change.

During the next 5 years, the IRS must cope with an aging work force that is increasingly retirement eligible, as is true in many government departments, build new skills for the more complex work in a modernized environment, develop an agency-wide approach to training, use modernized technology so it can deliver high-quality services to taxpayers, and improve internal communications.

The facilities of the IRS are aging and are no longer capable of supporting the modernized IRS. As it modernizes its processes and technologies, the facilities must be capable of supporting this modernized environment. Today's buildings do not provide the functionality needed to house modern office workers who use information technology extensively in their jobs. Upgrading facilities will challenge the budget in the next 5 years.

With respect to the IRS budget, the Oversight Board has looked carefully at issues of fiscal constraint. We have, in my view, however, indicated that the government, in order to collect the revenue that is due—and the taxpayers insist that this be done—needs additional resources. The Oversight Board's budget recommendations are detailed in my written statement.

We recommend a budget of \$10.724 billion. Our recommended budget is \$287 million higher than the Administration's. We believe this is necessary for several reasons. We believe that this additional funding is the first step in a 5-year plan to close the compliance gap. It provides for additional FTE levels for the IRS so that it can rebuild its human capital needs. It provides full funding for the IRS efforts to modernize its processes and information technology and it provides for increased level of telephone service to the taxpayers, additional taxpayer outreach and pre-filing assistance to help taxpayers file correctly, prevent problems before they occur. This budget will also provide funding for counterterrorism.

We believe that modernization still has a way to go. There are new systems that are scheduled to come online, including the customer account system that Acting Commissioner Wenzel referred to, and that will be critically important in providing services to taxpayers. If the IRS is not able to demonstrate in the year ahead that the modernization program is moving forward, then I think we will have to reconsider the additional funding.

In conclusion, Mr. Chairman, let me say that the Oversight Board supports the extension of the filing deadline to April 30, both with respect to filing the returns and making payments electronically. We believe this will help move toward the goal that the Congress has established to increase e-filing both for individual filers as well as for businesses.

With that, I will conclude my formal remarks and will be happy to entertain your questions.

[The prepared statement of Ms. Williams follows:]

Statement of The Honorable Karen Hastie Williams, Member, Internal Revenue Service Oversight Board

Mr. Chairman, and members of the Subcommittee, thank you for holding this hearing and inviting me to testify. It is an honor for me to appear before your committee today on behalf of the IRS Oversight Board. My remarks today will be focused primarily on the Oversight Board's recommendation for the IRS FY2004 budget.

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

I would like to address the Oversight Board's view of the IRS budget from two perspectives. First, I will discuss the challenges the IRS must face as it continues to modernize in accordance with its strategic plan. The IRS's ability to meet these challenges will be affected by resource availability. In a world of scarce resources, the Administration, Congress, and Oversight Board must be conscious of the competitive balance between resources and performance. The Oversight Board wants to alert IRS stakeholders, especially the Congress, of the strategic needs the IRS must face in the next five years, and the budgetary demands that meeting these needs will entail.

Secondly, I want to present the Oversight Board's FY2004 budget recommendations, and why we made these recommendations. Funding the IRS presents difficult choices, and these decisions should be made in full consideration of the performance levels that various funding alternatives deliver to the public.

Strategic Challenges Over the Next Five Years

RRA 98 set the IRS on a process to transform itself into a modern financial institution that could meet the needs of taxpayers. Five years into that process, the IRS finds itself at a crossroads. It has made enormous progress in setting the stage to provide better service and ensure fair treatment under the law for taxpayers. During this period, the IRS has refocused, redefined, and rebuilt itself, with dramatic changes in its mission, organization, management processes, and governance.

Yet the tax system is still plagued with two long-term conflicting trends: an increased demand on the tax administration system, and a steady decline in IRS resources due to budget constraints. In the past decade, the IRS workload has increased steadily. The number of tax returns continue to grow; particularly complex returns, such as those filed by individuals earning more than \$100,000 each year and small corporations.

As the transformation continues, the IRS continues to face challenges, some of which may be more difficult than the ones it has overcome in the last five years. The Oversight Board believes that the following issues present enormous challenges to the IRS, and each will require an investment of resources over multiple years if the IRS is to continue the transformation process:

- Closing a compliance gap that is unfair to honest taxpayers
- Continuing and implementing the Business Systems Modernization program that will modernize its business processes and information technology
- Replenishing its human capital
- Modernizing its facilities

Closing the Compliance Gap

There is mounting evidence that some taxpayers are not reporting and paying what they legally owe. The amount of assessed but uncollected taxes, analogous to receivables, is almost \$280 billion and growing. The Administration has asked Congress to authorize the IRS to use private collection agencies to help reduce uncollected taxes. The number of promoted abusive tax shelters also is on the rise, and the IRS has developed programs to do more to counter this problem. Both of these issues are serious, but particularly vexing to the Oversight Board is the number of potential examination and collection cases the IRS has identified but cannot pursue due to lack of resources. For many of these cases, the IRS is only assigning resources to approximately 20 to 30 percent of the cases it has identified. In the view of the Oversight Board, IRS's lack of resources to pursue this many known cases is a serious failure of the IRS to meet taxpayers' needs. Our system of voluntary

compliance is based on the premise that taxpayers believe that everyone is paying what they legally owe.

The Oversight Board recognizes the IRS cannot add the resources in a single year to work all identified cases. Adding this many new employees would be impractical, ineffective, and inappropriate. A more practical approach is to add a manageable number of new employees on a steady basis over a long period of time. This is the approach that former Commissioner Rossotti suggested to the Oversight Board in his End-of-Term Report, recommending a steady but slow growth in staff in the range of 2 percent per year for the next five years combined with a 3 percent increase in productivity. The Oversight Board believes that an investment of this scope is what is needed to close the compliance gap.

Not only does the large workload gap represent a significant revenue shortfall to the government, taxpayers expect the IRS to enforce the law. Honest taxpayers recognize that they bear the burden for under-enforcement by the IRS. The IRS Oversight Board conducted a public survey in July 2002, in which taxpayers' opinions about the IRS's role in enforcement was questioned. Ninety-three percent of taxpayers said that it was very important or somewhat important to them that the IRS ensures that high income taxpayers, corporations, and small business are honestly paying what they owe. More detailed survey results are in the table below.

How important is it to you, as a taxpayer, that the IRS does each of the following to ensure that all taxpayers honestly pay what they owe?					
	Very Important	Somewhat Important	Not Very Important	Not at All Important	Don't Know
1. Ensures low income taxpayers are reporting and paying their taxes honestly	56	28	8	5	3
2. Ensures small businesses are reporting and paying their taxes honestly	68	25	3	3	2
3. Ensures high income taxpayers are reporting and paying their taxes honestly	77	16	1	3	2
4. Ensures corporations are reporting and paying their taxes honestly	83	10	1	3	3

Continuing and Implementing the BSM Program

The Business Systems Modernization (BSM) program is a second strategic area that will require a long-term investment if the IRS is to become a modern financial institution. Much has been written about the state of the IRS's computers, but the sad fact is that no private sector company could remain competitive with computer systems similar to those used by the IRS. These systems prevent IRS employees from obtaining timely and accurate information about taxpayers' accounts and must be modernized.

The BSM program is essential to the transformation of the IRS. Without modern processes and information technology, the IRS cannot meet taxpayers' needs. The Oversight Board, however, has been disappointed in the performance of this critical program, which is still plagued with delays in schedule and cost overruns.

Not only does some of the most difficult development work lie ahead, but the approach to modernization requires that legacy and modernized systems operate in parallel for extended periods of time, possibly five years. These parallel operations will represent an additional cost to the IRS that it is not experiencing today in a major way. The Oversight Board estimates that the IRS has spent approximately \$60 million in FY2002 from its operational information systems budget to support the BSM program, and will spend \$75 million in FY2003 and approximately \$120 million in FY2004 supporting this program. Additionally, modernized systems will

have a major impact on business operations, and transitioning to modernized systems will require a major investment in developing modernized processes and training of IRS employees. Managing change must become a way of life for the IRS, and implementing change will present additional cost challenges.

The Oversight Board wants to emphasize two important points about the BSM program:

- The BSM program is a major long-term investment that will require significant ongoing and growing investment
- BSM should be implemented as quickly as possible in order to lower the program's ultimate cost and risk. Funding reductions, while seemingly attractive in the short term, have long-range consequences, which outweigh any short-term savings.

Replenishing Human Capital

As the IRS transforms itself by modernizing its organizational structure and its business and technology systems, it is also important for the IRS to assess its human capital needs. In a modernized environment, people will remain an important enabler of agency performance and will continue to be the IRS's most important asset. Both the Government Accounting Office (GAO) and Treasury Inspector General for Tax Administration (TIGTA) have identified human capital issues among the major challenges facing IRS management.

During the past five years, the IRS has devoted energy and resources towards its structural realignment and its business systems and technology modernization programs, but has placed less attention on strategic human capital planning. During the next five years, the IRS must cope with an aging workforce that is increasingly retirement eligible, build new skills for more complex work in a modernized environment, develop an agency-wide approach to training using modernized technology so it can deliver high quality services to taxpayers, and improve internal communications.

Ensuring that IRS employees are engaged in their new organizations and new positions still represents a major challenge for the IRS. Moreover, the reorganization is only the first of many changes the IRS must manage. The introduction of modernized technology has barely begun, and this change will require the IRS to address employees' needs in the modernized environment.

The investment needed to improve the IRS's human capital is not separately identified like the BSM program; it is embedded in all its budget accounts. Historically, budget for human capital improvements such as training are often cut first when the need to reduce expenditures occurs. It is important that human capital investments be given the attention they deserve, and be more explicitly identified so that decisions on human capital needs be made on an informed basis. Addressing these needs over the next five years will be critical to continuing IRS transformation to a modern financial institution.

Modernizing its facilities

Much like its information technology, the IRS is presently dependent on aging facilities to process paper returns. Commonly known as "pipelines", they are co-located with ten central sites referred to as campuses at which the IRS performs a multitude of centralized tax administration functions. With the level of electronic filing now rising, the IRS is planning to close its first pipeline, located at its Brookhaven campus.

The Brookhaven pipeline closing only represents the start of a program to re-align IRS campus facilities to its new workforce needs. In 2005, the IRS plans to close its pipeline at Kansas City, and in 2007 plans to close the pipeline at its Philadelphia campus.

The IRS has partnered with the General Services Administration to develop a long-term strategic plan to modernize all its campus facilities by the year 2017. The plan includes 83 buildings at 10 campuses, encompassing approximately 9.8 million square feet of space, at a capital cost estimated at \$2 billion.

Although one goal of the plan is to replace aging facilities with flexible, modern facilities that align with the IRS new organization, the plan will achieve other objectives as well. The existing facilities average over 35 years in age, and are generally in need of substantial repair. As the IRS modernizes its processes and technology, its facilities must be capable of supporting the modernized environment. Today's buildings do not provide the functionality needed to house modern office workers who use information technology extensively in their jobs.

The plan has not yet been approved, but the Oversight Board has no doubt that the need to upgrade IRS facilities over the next 15 years will add an additional

strain on already scarce budget resources. The plan's first step is to provide new facilities in Kansas City and Philadelphia. The IRS requested the Board's support to include \$72 million in FY2005 budget for these facilities. The Board recognizes the condition of some of the IRS's campuses, but noted that budget restraints will require trade-offs in the future, and that decisions must be placed in this context.

Oversight Board's FY2004 IRS Budget Recommendations

I would now like to present the Oversight Board's FY2004 budget recommendations in the context of the long-range budget challenges just discussed. The FY2004 budget is the first step. It provides for steady improvements in IRS performance, and establishes a level of investment necessary for addressing these challenges.

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

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

Table 1 shows the Oversight Board's FY2004 budget recommendations for each account compared to the FY2003 IRS budget and the Office of Management and Budget (OMB) recommendations.

Table 1. Comparison of IRS's FY2003 Budget with Administration Request and Oversight Board Recommendations for FY2004 (All \$ in 000s)

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

¹ FY2003 actual appropriation. Administration FY2003 request was \$9,916 million.

² The original FY2003 budget request was \$450 million, which was subsequently reduced to \$380 million.

Overall, the Oversight Board's recommendation is \$889 million higher than the FY2003 IRS appropriation, of which approximately \$273 million is due to inflation and \$616 million is attributed to growth. This growth includes approximately \$100 million for an expanded EITC program and \$35 million for the HITC program.

The Oversight Board's recommended budget is \$287 million higher than the Administration's recommended IRS budget of \$10,437 million. Without the 650 FTEs proposed for the EITC Reform Initiative, which is common to both budgets, the Oversight Board recommends an additional 2,120 FTEs over FY2003 levels compared with the Administration request of 238 additional FTEs.

The Oversight Board's budget recommendation provides for:

- A first step in a five year plan to close the compliance gap;

- An adequate FTE level for the IRS so it can rebuild its human capital to meet its future needs
- Full funding for the IRS's efforts to modernize its processes and information technology;
- Increased level of telephone service to taxpayers;
- Additional taxpayer outreach and pre-filing assistance to help taxpayers file correctly and prevent problems before they occur, and
- Additional funding for counterterrorism activities.

The Oversight Board has recommended this budget for several reasons. First, and most importantly, it is consistent with the Oversight Board's goal of achieving two percent in real growth for a five year period, which it believes is necessary for the IRS to close the workload gap in compliance. The IRS requires this level of funding if it is to successfully continue its transformation.

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

Third, it restores resources for customer service and enforcement that have been lost in recent years. Unexpected cost increases have caused the IRS to realize a number of Full Time Equivalents (FTEs) that was significantly below the Administration's request. For example, the Administration request for FTEs in FY2002 and FY2003, and the FTE level achieved by the IRS, are:

Fiscal Year	Administration FTE request (less EITC)	FTEs Achieved by the IRS	Difference
FY2002	99,116	96,714	- 2,402
FY2003	98,727	96,802 (projected)	- 1,925

The FY2003 FTE level will likely be lower when the effects of the \$64 million across the board cut in the FY2003 appropriation are calculated.

The Oversight Board is concerned that these same problems will be experienced in FY2004. In the FY2004 budget, the Administration proposed a 2 percent raise for civil service employees and a 4.1 percent raise for military personnel. If past years are any indication, Congress will again agree to provide pay parity to military and civilian personnel. Furthermore, both the House and Senate versions of the FY2004 budget resolution contain a 'sense of the Congress' provision supporting military-civilian pay parity for federal employees.

The Board's FY 2004 budget proposal, as does the Administration's, assumes a 2% pay increase. The Board urges that Congress provide the necessary funds to fully fund any pay raise it may pass in the coming year. Otherwise, as in previous years, the IRS will be forced to cut employee training programs, telephone service to taxpayers and freeze future hiring initiatives.

For three of the six IRS appropriation accounts, there is no difference between the Administration and the Oversight Board recommendations. For Tax Law Enforcement, the difference is small, only about 1 percent. Both the Administration and Oversight Board are recommending significant increases to this account. In two accounts, PAM and BSM, the differences are larger. I will only address the difference in these two accounts.

Processing, Assistance, and Management

The Oversight Board's recommendation for the Processing, Assistance, and Management Account is \$172 million higher than the Administration's proposed budget. A common feature of both recommendations is that this account should be the source of significant savings resulting from improvements in systems and work processes. Much of the work accomplished in this account relates to assisting taxpayers, processing of tax returns, and management, and the IRS has saved 1,427 FTEs through reengineering in this account.

Although enforcement issues have captured the public's attention, customer service issues are still important, and in many ways can prevent future non-compliance. The demand for customer service grows each year; so too does the complexity of the tax code. Yet only seven out of ten taxpayers can get help from the IRS over the telephone.

The Oversight Board's recommended budget also contains the savings resulting from reengineering, but also recommends an additional \$172 million for taxpayer assistance that the Board believes is needed to help taxpayers. For example, the

Oversight Board's budget provides an additional \$45.6 million to improve telephone services to small businesses as well as individual taxpayers who have questions or concerns regarding their taxes, as well as an additional \$38 million in pre-filing services to determine the needs and values of taxpayers, identifying whether current or innovative methods are working, and providing education and assistance to taxpayers. Overall, the Oversight Board's additional budget will provide for the following pre-filing and account services:

- Provide a higher level of assistor service (76 percent v. 73 percent), which will result in IRS assistants answering an additional 1,700,000 phone calls from small business owners and other taxpayers who have questions regarding their tax obligation;
- Provide face-to-face assistance to an additional 492,000 taxpayers through outreach programs and pre-filing compliance alternative treatment initiatives;
- Provide indirect assistance to an additional 138,000 taxpayers through established partnerships with practitioner groups as well as the Volunteer Income Tax Assistance program;
- Provide an additional 38 staff-years of education and out-reach services.

Business Systems Modernization

The Oversight Board's recommendation for the Business Systems Modernization account is \$136 million higher than the FY2003 appropriation of \$364 million and \$71 million higher than the Administration's proposed budget of \$429 million.

Considering the essential nature of the BSM program, the Oversight Board is concerned with the FY 2003 appropriation for the BSM account, and the implications of these actions for future appropriations. The Administration's original FY 2003 budget request included \$450 million for the BSM account, which was approved by both the House of Representatives and the Senate Appropriations Committee. However, in September 2002 the IRS was assigned responsibility for implementing a new tax credit, the Health Insurance Tax Credit (HITC), which was passed as part of the 2002 Trade Adjustment Act. In response to this new requirement, the Administration supported a transfer of \$70 million from the BSM account to implement the HITC program, creating a separate HITC account and reducing the BSM request to \$380 million. This transfer was in lieu of a request for additional funding to cover the costs of the HITC program.

Ultimately, the FY2003 appropriation for BSM was \$364 million, \$28 million less than the FY 2002 appropriation of \$392 million. The Oversight Board is disappointed that funds to meet the requirements of the new HITC requirement were taken from such an important strategic program as BSM. Admittedly the BSM program had disappointing results in FY2002, but underfunding the program in the long term only delays the delivery of benefits to taxpayers.

Clearly the program execution needs improvement, and the Oversight Board believes that approval of expenditures must be consistent with the IRS's ability to manage and implement the program. The Oversight Board believes that the current process of having Congress approve the BSM expenditure plan provides safeguards against spending funds on projects the IRS cannot manage.

The Board believes the IRS is beginning to improve its ability to manage the BSM program. If the IRS can demonstrate its ability to manage the program, the funding to move the program forward must be available. On the other hand, if the IRS cannot demonstrate its ability to manage the BSM program in an acceptable manner, additional changes must be made prior to starting any new projects. Poor performance is not acceptable.

Extension of Filing Deadline for Electronic Filers

One last topic that I would like to address is the proposed extension of the filing deadline to April 30th for taxpayers who file and pay electronically.

I commend this subcommittee for its strong interest in electronic filing. E-filing delivers benefits to taxpayers and is now starting to simplify IRS operations as well. The number of paper returns has now decreased to the point where the IRS is planning to close one of its ten paper processing pipelines in 2004, and is planning to close a second one in 2005.

Last year, in its electronic filing report to Congress, the Oversight Board supported the extension of the filing deadline to April 30th for taxpayers that file electronically. Recently, in response to questions raised at the Oversight Board's public meeting in January, the Board revisited this issue to ensure that this continues to be a sound recommendation. Based on surveys the IRS has made of taxpayers, the Board believes that the proposed due date change would be effective in attracting

additional electronically filed returns, and continues to support the proposed extension.

That concludes my statement. I will be pleased to answer any questions.

Chairman HOUGHTON. Thank you very much. I just have a quick question. I may be misidentifying the numbers here, but you were asking for \$200 million more than the original request, but my Lord, you are able to put the service back into compliance, you are able to upgrade the people, you are able to modernize the new technology and to institute a program for counterterrorism. That is all within that \$200 million?

Ms. WILLIAMS. Mr. Chairman, the \$200 million goes toward those objectives. We are not saying that it will complete that process. We are also mindful of the savings that the agency presumes that it will be able to make in terms of savings from their past budget. So, both of those elements are part of what we anticipate the higher budget can satisfy.

Chairman HOUGHTON. Thank you very much. Mr. Pomeroy?

Mr. POMEROY. I want to thank the panel, and especially Ms. Williams for participating in the Advisory Oversight Committee. I think that is a terrific additional resource that has come online to help us from a third party, credible vantage point evaluate whether the IRS has this capacity it needs.

As to Mr. White, the GAO, I would like, and I think the Chairman and I will get a formal request together, a GAO evaluation of this whole business of the preparation of the pre-certification on the EITC. I would like an evaluation in terms of whether or not sufficient care has been put into the process by which the proposed prototype certifications are going to be market friendly or would represent potentially a barrier to people that otherwise need those benefits.

We want screening. We want to get that error rate down. We want to stop cheating, but we don't want, on the other hand, to prevent some of the most vulnerable aspects of our population from accessing a benefit that we have determined they are entitled to have and, in fact, need.

So, there is substantial concern now in terms of whether or not this thing has been developed too quickly, with too little input, not sufficiently linked to other pre-certification processes other agencies might use that have substantial marketplace experience in terms of whether or not they are user friendly or not. So, that is one component of what we would like you to look at.

The second component involves basically an evaluation as this first set comes in. It is going to be 45,000 the first year, 2 million the second year, 5 million the third year, and there is a concern as to whether or not on this time line there is sufficient opportunity to really evaluate what we are seeing by way of results from the first year's experiment. I think the GAO evaluation, for example, the first 1,000 sent out and responded, or in any event, a very careful evaluation of this first 45,000 block would assist the IRS greatly in evaluating whether or not this is just prepared to ramp up to the next 2 million or whether or not we need to do some important form revision.

So, that is what I am interested in. Is this thing ready to go to the first 45,000 in your evaluation there, and then, second, what are we getting as returns start to come in? I think GAO could play a very important role for us in making certain that we have a market-appropriate product as we initiate pre-certification. Is GAO equipped to do something of that nature?

Mr. WHITE. Mr. Pomeroy, those are two very good questions. What I would like to do is talk to either you or your staff about the details of the proposed study.

Mr. POMEROY. I expect that the Chairman and I will be of one mind on this and be able to tee something up with a little more specificity than my utterances from the dais, but you get what I mean.

Mr. WHITE. Yes. Yes. We will work with you and your staff.

Mr. POMEROY. That is the kind of thing you can do?

Mr. WHITE. Yes, sir.

Mr. POMEROY. Thank you. I yield back.

Chairman HOUGHTON. Thanks very much. Mr. Portman?

Mr. PORTMAN. Thank you, Mr. Chairman, and Mr. White, thanks for staying on top of the business systems modernization program. We have had some cost overruns and delays, and as the Acting Commissioner said, it is a very difficult and complex project, but we depend on you to provide us with accurate third-party analysis and to keep everyone's feet to the fire because it is so important.

Ms. Williams, thank you very much for your service on the Oversight Board. I know this is sometimes a thankless task which you do in addition to your full-time job, and yet your expertise and the expertise of your colleagues has been, I think, very, very helpful. Commissioner Rossotti thought so, and I still believe the Oversight Board plays a very important function, partly on the budget side, and that is one question I want to ask you about.

You do ask for actually over \$200 million more than the IRS has asked for. I am not sure if it is that different than the IRS initial discussions with the Office of Management and Budget (OMB), but in terms of where we have ended up. As I look at it, what I really see is that you are asking for additional funding in the enforcement area, which is obviously very important, and we have talked about some of the problems with enforcement right now, but you are also asking for additional funding in other areas, too, including taxpayer service and, of course, including the modernization effort as we just talked about.

I guess my question to you is this. Traditionally, the IRS has been accused of kind of having a pendulum swing. It is either a focus on enforcement, and sometimes that enforcement mentality has dominated over the years, I would say particularly in the years prior to the Commission's work where there were a lot of concerns raised, and then perhaps the pendulum swings the other way toward focusing on service and having less focus on the enforcement side. We talked about the impact of the 10 deadly sins, for instance, on the enforcement attitude, and so on.

Are you fearful, looking at this with some perspective now, that we may be seeing that pendulum swinging again, in other words, now that we have identified this problem in terms of compliance

and enforcement, are we in danger of the pendulum swinging, or do we have more of a balance now where we are able to move forward, understanding that by providing service, in the end, we do get better enforcement?

Ms. WILLIAMS. Mr. Portman, our view is that enforcement and service are not opposite sides of the coin. We think both are critically important to the success of the IRS, and our budget recommendations are in both of those areas, as you observed, in customer service as well as in the enforcement area. Indeed, we feel that by providing additional services, we can accelerate the compliance process by providing accurate and complete information to taxpayer inquiries.

So, I think the two of them have to be looked at in tandem, and I don't think that we have a pendulum effect. I think we have sometimes in the past considered a stop and start in terms of emphasis. We hope to see both elements going forward, and that is a particular reason behind our recommendations for the budget.

Mr. PORTMAN. Well, thank you, and again, your job is in part to oversee that and make sure that we continue to have a balance, and I couldn't agree with you more. I think every service business in America has learned that almost in a revolution in the service industry, that by providing better information, by having better service, in a sense, you have better compliance and better enforcement and they are not inconsistent, and I hope you will continue to work on that.

The Oversight Board, as you know, has been the subject of some controversy since its establishment, and it was initially established in 1998. Then it took a while to get the Oversight Board Members there. With Steve Nichols' departure recently, we have heard again some questions about the independence of the Oversight Board.

I would appreciate it if you could comment on that. How independent is the Oversight Board? Is it continuing to serve the function envisioned by the Commission and by the Restructuring and Reform Act of 1998? How do you feel about the Oversight Board, and its relationship with the IRS?

Ms. WILLIAMS. I think the Oversight Board is clearly very independent. I think that the Oversight Board sees as its focus the concerns of taxpayers. Our concern is for the taxpayers, just as on a corporate board, a good board of directors is focused on its shareholders.

From this perspective, we look very closely at the IRS. We look at its budget. We look at its personnel. We have had a series of public hearings over the years to get public input. Members of the Oversight Board and staff have attended tax forums every year that we have been in existence where more than 2,000 practitioners are present. We make ourselves available in small groups to talk with them, to get their concerns and to put that into our thinking as we look at the budget.

So, I think that the Oversight Board as envisioned by this Committee and the Congress as a whole has served an important independent role. Certainly, we talk with the IRS management. The Commissioner and the Secretary of the Department of the Treasury, as you know, are statutory Members of the Oversight Board and have participated in our meetings on a regular basis.

We think that this combination of interaction with management, with the public, with the practitioners who work with the IRS, provide us with an independent basis to make recommendations with respect to budget as well as to management initiatives.

Mr. PORTMAN. Thank you, Ms. Williams.

Chairman HOUGHTON. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman, and Ms. Williams. Mr. White, thank you for participating today in today's panel. I would like to direct my question to GAO, if I could, this morning. Earlier, I had asked the Acting Commissioner regarding the Administration's proposal for use of private debt collection services to collect outstanding tax assessments, and I was wondering, Mr. White, the statistics that I shared at that time, less than a dime on the dollar was being collected between 1996 and the year 2001 in outstanding tax assessments. I was just wondering from the perspective of the GAO, from your analysis, what are the primary reasons why the IRS was unable or ineffective in collecting outstanding tax assessments?

Mr. WHITE. I would make a couple of points. One is not all of that debt, not all of those outstanding tax assessments are collectible. There is a significant proportion of that that is debt owed by bankrupt businesses, mainly small businesses, but bankrupt businesses, so there is no chance of collecting a significant portion of that debt.

At the same time, there is tax debt that has collection potential that IRS is unable to work. We have done work in the past. The IRS simply is unable to work all of the cases, so they will make an assessment. It goes into their collections queue and they are unable to work all of those cases.

Mr. WELLER. Why are they unable to work all of those cases?

Mr. WHITE. Well, part of it is due to staffing declines in the compliance area. Over the last—you can go back almost any number of years and what you see is a steady, but over years when you add it up, a fairly significant decline in compliance staff. We talked about it in our statement, that IRS has over the last several budgets proposed increasing resources devoted to compliance, and they have been unable to do that.

Mr. WELLER. Now, the Administration has proposed and Mr. Houghton has introduced legislation which would provide for the use of private debt collection agencies to help collect what is collectible for tax assessments. Have you reviewed that proposal? Has the GAO reviewed that proposal?

Mr. WHITE. We have not reviewed the current proposal. We reviewed the experience in 1996 and 1997 when IRS did their pilot then, and I guess there are kind of two levels of issues here. One is the policy judgment about whether this is a good approach to take in general, and I think because of the concern about the uncollected debt with collection potential that IRS is able to work, that there may be some benefits to this sort of approach.

Then a second level issue, though, is the IRS's capability to manage this sort of process. Back in 1996 and 1997, they did not have the capability in their information systems to identify the kinds of cases that the private debt collectors could most productively work. They had agreed with the contractors up front to deliver certain

kinds of cases to those contractors. They were unable, using the systems they had at that time, to actually pick those cases out and get them to the contractors. So, after the first pilot, the effort was stopped.

Mr. WELLER. The Commissioner noted that over 40 States use private collection services, and I was wondering, has the GAO ever studied how the States have utilized these services and see whether there have been successes or weaknesses in the State program?

Mr. WHITE. As I said, we have not looked at the current proposal. We have not looked at what the States have done since 1996 or 1997. We have not looked at whether IRS's systems now, with the improvements that they have been making as a result of the modernization investments, now give them improved capability for delivering cases to contractors.

Mr. WELLER. Thank you, Mr. White. Ms. Williams, do you have any thoughts from the Oversight Board's perspective on this?

Ms. WILLIAMS. Yes, Congressman Weller. I would be happy to respond. We believe that this is a very positive initiative. Over \$280 billion in uncollected funds stand on the books and, unfortunately, is growing. We think that the IRS has learned from the earlier pilot experience, has looked at the problems that arose there, and is prepared to launch a new effort with the support of the Congress.

The Oversight Board will stay on top of the situation. One of the things we have talked to the IRS about is being sure that as they initiate this process, there are good controls in place, there are performance measures that they can use to evaluate the performance, that the cases that are selected are cases that have a reasonably high degree of collection to avoid some of the problems that Mr. White identified, and that there is an appropriate fee structure.

As you are certainly aware, other agencies of the Federal Government, such as the Department of Education, already use outside collection agencies and have done that successfully. So, we think that this is an important initiative, and we fully support it.

Mr. WELLER. Thank you. Thank you, Mr. Chairman. I see my time is expired.

Chairman HOUGHTON. Thank you very much. I have just got one additional question, but I want to thank you very much, so much, Mr. White, for being here and we will be in touch with you on this evaluation of the pre-certification. Ms. Williams, thank you very much for your participation.

I would like to ask you both a broad question. We never seem to quite have the funds to do what we want, and everything is being squeezed. You have got the compliance issue, you have got the equipment issue for analysis and administration and electronic filing. You have got service. Then on top of that, Ms. Williams, you say that the facilities really are inadequate and also our human capital planning is not adequate. Those are going to take additional dollars. Are we going to be able to do all of that within the confines of these sort of projected budgets?

Ms. WILLIAMS. Mr. Chairman, I think we will be able to begin the process or to continue from where we are now. We are not going to have 100 percent success, but we think it is important that the IRS focus on all of these issues.

From the perspective of the Oversight Board, we represent the taxpayers. We think the taxpayers need service; they need modernization; they need enforcement. I think with the leadership of the Oversight Board, the IRS focused on these three key areas. I think we can make significant progress and use the dollars appropriated by the Congress effectively toward this end.

It is a long-term process. It is not going to happen on a 1-year basis. That is why in the past, the Oversight Board has recommended multi-year funding, particularly for the modernization program, because it is very difficult to have stop-and-start funding and have an effective, smooth delivery of these major system changes that are underway.

So, I think it is a long-term process. It is a multi-year process. We believe that the budget that has been recommended by the Oversight Board, which, as I think you recognized, was not that different from what the IRS originally recommended to the Department of the Treasury before it went through the OMB review process, is a number that will get us clearly down the path that we need to go.

Mr. WHITE. Mr. Chairman, one way to judge an agency's budget is by looking at the resources they are given and then comparing that to the results that the agency is able to achieve with those resources, and I think in the IRS case, there is some good news there.

Over the last several years, Congress has fully funded, or essentially fully funded IRS's budget request, and over that same period, IRS has had two priorities. One was to improve service to taxpayers. One was to improve their compliance processes.

On the service to taxpayers side of the coin, we are seeing some visible improvements now. Telephone service is considerably higher than it was several years ago when you look at access rates and accuracy rates.

The example of the paper return service center closing is another example of a payoff, where IRS is improving efficiency through increased electronic filing. This is enabling them to close a service center, which is a very labor intensive process for handling paper returns, and ultimately ought to be able to shift those resources then into other areas.

At the same time, on the compliance side, they have not been able to increase resources there the way that they have intended in the last several budgets, where they have made that a priority but have not been able to shift the resources into that area.

Chairman HOUGHTON. Thank you very much again. I certainly appreciate your time and all the information and wisdom you share with us. Thank you.

Now, I would like to call the next panel, which is Robert McKenzie, attorney, of Arnstein and Lehr from Chicago, on behalf of the American Bar Association (ABA); Timothy McCormally, Executive Director of Tax Executives Institute (TEI); William Stevenson, Chairman of the Federal Taxation Committee of the National Society of Accountants in Alexandria; and Claudia Hill, a Member of the National Association of Enrolled Agents (NAEA). If you would come to the desk, I would appreciate it. All right, ladies and

gentlemen. Thank you very much for being with us. Mr. McKenzie, would you start your testimony?

**STATEMENT OF ROBERT E. MCKENZIE, AMERICAN BAR
ASSOCIATION SECTION OF TAXATION**

Mr. MCKENZIE. Mr. Chairman, Ranking Member Pomeroy, and other Members of the Subcommittee, I am Bob McKenzie. I am from Chicago, Illinois. I am here on behalf of the ABA. One disclaimer. The testimony to be presented is on behalf of the section of Taxation and represents the views of our individual Members and does not represent the view of the entire ABA. With that disclaimer, let us move to a few points.

Chairman HOUGHTON. That lets you off the hook. You can say anything you want.

[Laughter.]

Mr. MCKENZIE. Let me move to just a few important points made in our written testimony, and I would submit that for your review, but I would like to first go to the problems with the collection due process (CDP). We found that it is a wonderful program. It adds protections for taxpayers, but the problem we have is that the tax protester community is using it to abuse and delay the system. We have serious reservations about the abuse of these new rights by this community, and we believe that there has to be legislation to reduce the impact of the tax protesters' abuse of the CDP system.

There is legislation currently pending which would permit the IRS to treat portions of the CDP hearing request based on frivolous positions without having a full hearing, and we believe that that is appropriate. We also believe that even though the courts have sanctioned some of these protesters when they have gone to Tax Court, that may not be sufficient.

For those people who continually abuse the system, we believe that consideration should be given to even more serious sanctions, including the right to enjoin further actions in Tax Court by the U.S. Tax Court, and perhaps criminal penalties for those who continually abuse the system, because some of the tax protesters aren't getting the word. They enjoy abusing the system, and our view is for those taxpayers we represent who are legitimately protesting through the CDP system, they are not getting their cases heard because of the abuses of the system by a minority whose only goal is to thwart the tax system.

So, we do hope, though, if there is any such penalty imposed, that consideration be given that this be based upon a reasonable basis test, which is a test that is already established within Internal Revenue Code 6662 in respect to penalties when we look to penalizing people abusing the CDP process.

The second issue I would like to speak to goes to Congressman Weller's question with respect to collection outsourcing, and we believe this is something that certainly deserves review, but we would like to have this panel look in balance to the issue of section 1204 of the Restructuring and Reform Act 1998, which specifically prevented the IRS from using collection statistics in evaluations.

One of the problems we have with outsourcing is how can we protect the taxpayer in the same manner, when in the past, we had

civil service employees being paid a salary and not being rewarded in a monetary bounty system for collection and we had abuses. Now, we are moving to a system proposed which would give a monetary reward to outside collection agencies for each collection. So, we would ask that any outsourcing look to balancing both the needs of the taxpayers for protection and the intent of this body with section 1204 in protecting those rights with the need to get the revenue. So, we certainly believe it is something that warrants looking at, but we have great reservations about the protection of taxpayer rights, and we would also note that many of our Members have noted that not all State agencies have fully protected people's rights with outside collection activities.

The last matter I would like to discuss is the failure of the IRS's new offer and compromise system. Congress passed new laws in 1998 to liberalize the offer and compromise process. The IRS has not effectively implemented it. They have not applied the individual facts and circumstances test that was required in addition to the IRS standards, and their new system adopted in 2001 in reaction to a large backlog has, in fact, resulted in a much lower acceptance rate of offers and compromise, and we have to consider that. Thank you.

[The prepared statement of Mr. McKenzie follows:]

Statement of Robert E. McKenzie, American Bar Association Section of Taxation

Good morning. My name is Robert E. McKenzie. I practice tax law in Chicago, and currently serve as the Division Coordinator for the American Bar Association Section of Taxation to the IRS Wage and Investment Division. This testimony is presented on behalf of the Section of Taxation. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, it should not be construed as representing the policy of the Association.

I. Introduction

The Section of Taxation is comprised of more than 20,000 tax lawyers. As the country's largest and broadest-based professional organization of tax lawyers, one of our primary goals is to make the tax system fairer, simpler and easier to administer. Our members include attorneys who work in law firms, corporations and other business entities, government, non-profit organizations, academia, accounting firms and other multidisciplinary organizations. We advise on virtually every substantive and procedural area of the tax laws, and interface regularly with the Internal Revenue Service ("IRS") and other government agencies and offices responsible for administering and enforcing such laws. Many of our members have served in staff and executive-level positions at the IRS, the Treasury Department, the Tax Division of the Department of Justice, and the congressional tax-writing committees.

We very much appreciate the opportunity to provide input to the Subcommittee regarding ways in which the IRS might more efficiently and effectively administer the internal revenue laws. There are, of course, numerous aspects to this enormous task. My testimony today focuses on what we believe to be an especially important administrative objective: effective collection of federal income taxes. In that regard I will focus my comments principally on the offer in compromise program and how it has been implemented. I will also address briefly a number of other issues affecting tax collection.

II. Offers in Compromise

Section 7122 of the Internal Revenue Code grants the IRS the authority to compromise tax obligations. The offer-in-compromise ("OIC") program is intended to bring taxpayers, who are sincerely trying to fulfill their obligations, back into compliance. In order to accomplish this objective more effectively Congress and the Treasury Department have gradually liberalized the OIC program in recent years—both by expanding the grounds on which compromise may be granted and by estab-

lishing allowable expense guidelines that permit taxpayers entering into compromises to provide for basic living expenses in light of their particular facts and circumstances. Notwithstanding Congressional and Treasury initiatives, we as tax practitioners have found that in practice the statutory and regulatory objectives of the OIC program are not being met. In fact, the effectiveness of the OIC program is being severely undermined in certain cases by the manner in which it is being implemented.

Traditionally, compromise was permitted on two grounds: doubt as to collectibility (*i.e.*, the taxpayer conceded the amount due, but was unable to pay it) or doubt as to liability (*i.e.*, the taxpayer contended that he or she did not owe the underlying liability and was able to show that the issue had not adequately been heard earlier in the administrative process). In 1998, Congress expanded the scope of the program by directing the IRS to implement a third ground for compromise: “effective tax administration.”

While the aim of the OIC program is to collect the maximum, reasonably collectable amount from the taxpayer, while still encouraging future compliance—both in terms of filing returns and paying tax—the IRS in recent years has tended to process OICs restrictively with the result that taxpayers are not only left with tax debts that they are not reasonably able to pay but also are strained to meet their current tax obligations.

How has this occurred? In the summer of 2001, the IRS created a new centralized processing system for offers in compromise. The centralized processing system was designed to reduce the backlog created by the increasing number of offers in compromise submitted each year. Unfortunately, in some cases, the backlog is being reduced simply by the return of offer packets that have only minor omissions in documentation. For example, documentation sometimes is simply lost. Lost documentation is treated the same as documentation that was never submitted. Failure by the taxpayer to provide the missing documentation in a short time-frame results in the offer not being processed at all. This strict “gatekeeper” approach is not consistent with recent Congressional efforts to liberalize the OIC program and to encourage reasonable collection alternatives.

Similarly, many IRS employees below the Appeals level who process offers in compromise refuse, in direct contravention of the amendments to IRC § 7122 enacted in the Restructuring and Reform Act of 1998, to consider individual facts and circumstances when applying allowable expense standards for offers in compromise. While Appeals generally observes the IRC § 7122 requirements, the OIC program is not benefiting all taxpayers it is intended to reach if fair consideration of an offer can only be obtained at the Appeals level.

In addition, the IRS has taken the position that if a taxpayer can pay the tax debt, based on his current monthly income and expense extrapolated over the entire remaining statute of limitations for collection, an OIC will not be available. In fact, as a condition of approving an offer, some Area offices have insisted that the statute of limitations be extended up to five additional years, both for purposes of determining the acceptable offer amount and the term for its payment. While it is obvious that some baseline period is necessary to determine collectibility, these are unrealistic measurement standards.

Finally, although compromise based upon effective tax administration (“ETA”) grounds is still relatively new, and final regulations on ETA were only issued in July of 2002, the ability of taxpayers to compromise on these grounds is being frustrated by a lack of clear policies concerning the processing of ETA offers. The final ETA regulations did not provide a meaningful indication of what kinds of cases have a chance of succeeding on ETA grounds.

In the long run, the desire to collect the maximum amount of tax possible must be weighed against disincentives to future compliance that are being created by current restrictive OIC policies. To realize the objectives of the OIC program more effectively, we recommend the following:

- Return to a local system of processing offers in compromise, or streamline centralized processing by permitting offers to be submitted for initial consideration with only the amount of documentation essential to make a reasoned decision.
- Direct IRS employees who are processing offers in compromise to exercise more discretion when evaluating the sufficiency of documentation submitted with an offer.
- Assign experienced Revenue Officers to review each incoming OIC.
- Ensure that IRS employees are properly trained to follow statutory directives to consider individual facts and circumstances when applying allowable expenses.

- Support legislative efforts to develop additional guidelines on processing ETA offers.

III. Allowable Expense Standards

A. Background

In August, 1995, the IRS adopted guidelines with respect to taxpayer expenses that would be taken into account when considering installment agreements and offers in compromise. The guidelines on national and local allowances published by the IRS are designed to enable taxpayers entering into offers in compromise to settle their tax liabilities while still providing for basic living expenses.

To introduce additional flexibility into the OIC program and, in particular, “make it easier for taxpayers to enter into OIC agreements,” Congress, in 1998, directed the IRS to continue the practice of prescribing guidelines for allowable expenses. In addition, Congress expressly directed that the allowable expense guidelines be expanded to provide that IRS employees consider the facts and circumstances of each individual taxpayer before ultimately determining the appropriate amount of allowable expenses for such taxpayer. In particular, the legislative history anticipates that the IRS would “take into account factors such as equity, hardship, and public policy” in making individual determinations. Unfortunately, practice has shown that IRS employees rarely deviate from the published expense tables. Additionally, allowable expense guidelines are often administered unfairly and inconsistently.

The IRS created two categories of expenses to guide examiners in their decision-making: Necessary Expenses and Conditional Expenses. The IRS has charts for national and local standards setting forth its view of necessary living expenses. Necessary Expenses are based on national and local standards tables, which are usually less than the taxpayer’s actual expenses. Conditional Expenses are those expenses that the IRS does not consider meeting the Necessary Expense tests, but which it might allow if the taxpayer can pay the outstanding taxes pursuant to an installment agreement within five years. If the taxpayer could not pay within five years, she is allowed one year to eliminate her Conditional Expenses.

B. Necessary Expenses

The IRS procedures provide that a Necessary Expense will be allowable if “it provide[s] for a taxpayer’s and his or her family’s health and welfare and/or the production of income.” The IRS requires that Necessary Expenses be in an amount that reflects the minimum on which the taxpayer and his or her family can live based on prescribed national, local or other applicable administrative standards:

1. National Standards: These provisions establish reasonable amounts standards for five types of Necessary Expenses: food, housekeeping supplies, apparel and services, and personal care products and services. The first four standards come from the Bureau of Labor Statistics (“BLS”) Consumer Expenditure Survey 1999–2000. The last standard has been established by the IRS. Any amount above the national standards may be considered excessive. Alaska and Hawaii have been allowed some upward adjustment because of their high cost of living. However, it is interesting to note that the IRS adjusts Hawaii expense upward by 10% yet its employees receive a 25% cost of living adjustment. It is also interesting to note that the same standards are applied everywhere in the continental United States despite the fact that personal living expenses vary widely. For example, contrast the personal living expenses of a New York City resident with those of a Des Moines resident. It is clear that the New Yorker would face significantly higher costs yet the tables do not reflect any differential.

2. Local Standards: Local standards have been established for housing and transportation. The IRS has established a housing category for each county in the United States. Housing standards, which include utilities, are extremely parsimonious. However, when applying the local housing standards, the IRS employee is allowed to consider other factors that might justify an expense in excess of the local housing standard including, for example:

1. The increased cost of transportation to work and school which would result from moving to lower cost housing;
2. The tax consequences that would result from selling a home;
3. The tax consequences which would result from moving from an owned home to a rented home, and
4. The cost of moving to a new residence.¹

¹ Internal Revenue Manual 5.15.1.3.2.2.2.

In practice, it is rare that IRS employees will deviate from the tables. The tables impose particular hardships on young families because they are based upon averages and include homeowners whose homes were acquired years ago and have low mortgage payments.

Transportation standards are established for regions with additional amounts allowed for particular metropolitan areas. The IRS Tables set the standards for amounts to be allowed for car purchase and lease, repairs, insurance, maintenance and fuel.² These amounts are inadequate. For example, in the Washington, D. C. area the IRS allows \$55 per month for a second vehicle. A family with teenage drivers would have insurance costs alone that would exceed \$55 per month.

3. Reasonableness Standards: IRS collection employees may allow other expenses if believed to be necessary and reasonable in amount. Because there are no national or locally established standards for determining reasonable amounts, the IRS employee is given discretion to determine whether an expense is necessary and the amount is reasonable.³

None of the standards provides properly for the economic needs of the average family. Taxpayers are essentially told to live below a subsistence level. Moreover, because the standards are based on data for periods a year or more before the time of negotiation, they invariably fail to reflect current average costs.

C. Conditional Expenses

Conditional Expenses, which include excessive Necessary Expenses, are taken into account if the taxpayer has the ability to pay the tax liability, including projected accruals, within five years. In addition, the taxpayer has up to one year to modify or eliminate unallowable Conditional Expenses if the tax liability, including projected accruals, cannot be fully paid within five years. By way of example, if a taxpayer's car payment exceeded the standards by \$100, that expense would have to be eliminated within one year. In practice, most taxpayers have many expenses that exceed the tables and reducing all of them is usually not possible.

D. Other Necessary Expenses

The IRS standards for Other Necessary Expenses are quite strict and lack flexibility.⁴

² Internal Revenue Manual 5.15.1.3.2.2.

³ Internal Revenue Manual 5.15.1.3.

⁴(1) In addition to those listed under the National and Local Standards, certain other expenses are usually considered to be necessary.

- (a) taxes,
- (b) health care,
- (c) court-ordered payments,
- (d) involuntary deductions,
- (e) accounting and legal fees for representing a taxpayer before the IRS,
- (f) secured or legally perfected debts (minimum payments), and
- (g) accounting and legal fees other than those for representing a taxpayer before the IRS

which meet the necessary expense test of health and welfare and/or production of income.

(2) Depending upon individual circumstances, other expenses may meet the necessary expense test: health and welfare and/or production of income.

(3) A taxpayer may be required to substantiate the amounts and justify these expenses as necessary. Unless the tax liability will be fully paid, including projected accruals, within five years, expenses must be reasonable in amount. Expenses include, but are not limited to:

- (a) childcare,
- (b) dependent care: elderly, invalid, or disabled,
- (c) secured or legally perfected debts,
- (d) life insurance,
- (e) charitable contributions,
- (f) education,
- (g) disability insurance for a self-employed individual,
- (h) union dues,
- (i) professional association dues;
- (j) accounting and legal fees other than those for representing a taxpayer before the IRS

which meet the necessary expense test of health and welfare and/or production of income, and

- (k) optional telephone services (call waiting, caller identification, etc.) or long distance calls, if they meet the necessary expense test of health and welfare and/or production of income.

(4) The last two listed expenses are frequently encountered: charitable contributions and education.

(a) Charitable contributions. These expenses include donations to tax exempt organizations such as civic organizations, religious organizations (tithing and educational), and medical services or associations. To be necessary, charitable contributions have to provide for a taxpayer's or his or her family's health and welfare or be a condition of employment. Otherwise, they are

E. Unsecured Debts

The taxpayer's payment of unsecured debts generally does not qualify as a Necessary Expense unless the expense is necessary for the production of income or is in settlement of a credit enforcement action. The IRS standards have forced many taxpayers to file for Chapter 13 bankruptcy protection in order to secure reasonable repayment terms.

F. Excessive Necessary and Conditional Expenses Incurred after Assessment of Tax Liability

The IRS takes the position that it will not take into account any Conditional Expense or Excessive Necessary Expense incurred after the assessment of a tax liability. IRS employees are instructed that in such instances consideration of enforcement against the post-assessment assets or not allowing the expenses in an installment agreement may be appropriate. The IRS employee has the authority, however, to make exceptions to the five-year rule⁵ and in unusual situations the IRS can choose to allow Conditional Expenses even if the liability, including projected accruals, cannot be paid within five years. In practice, very few IRS employees have seen fit to exercise this authority to vary from the five-year rule.⁶

G. Results of IRS Policies

As a result of the restrictive allowable expense standards and the inflexible application of these standards by the IRS, taxpayers are forced to make difficult decisions that undermine the effectiveness of the OIC program.

A clear indicator of the failure of the IRS to follow the legislative mandate to liberalize the offer program are the following statistics on accepted offers:

	2001	2002
Number of offers in compromise received (thousands)	125	124
Number of offers in compromise accepted (thousands)	39	29
Amount of offers in compromise accepted (thousand dollars)	340,778	7300,296

The IRS revised offer program introduced in 2001 has resulted in over a 25% reduction in accepted offers. Notwithstanding IRS denials to the contrary it has established a program which results in the denial of many appropriate offers.

The IRS should revisit its standards in order to have a more realistic approach to family needs. The standards for personal expenses should provide for regional variances in expenses. Taxpayers should be allowed to account for legal obligations in their budgets. IRS personnel should exhibit more flexibility in applying the standards.

In the case of offers in compromise, IRC § 7122(c)(2)(B) now provides that, in applying its standards, the IRS "shall determine, on the basis of the facts and circumstances of each taxpayer, whether the use of the schedules—is appropriate and shall not use the schedules to the extent such use would result in the taxpayer not having adequate means to provide for basic living expenses."⁸ In practice, the IRS

conditional and allowable only if the tax liability, including projected accruals, can be paid within three years.

(b) Education. To be a necessary expense, a taxpayer must demonstrate that:

1. the education is for a physically or mentally handicapped dependent and must demonstrate that such education is not otherwise provided by public schools; or
2. the education is a condition of employment. [IRM 5.15.1.3.2.3]

(5) The expenses listed in IRM 5.15.1.3 do not exhaust the category of necessary expenses. Other expenses may be considered if they meet the necessary expense test: health and welfare and/or the production of income.

(6) If other expenses are determined to be necessary and, therefore, allowable, the case history must be documented providing the reasons for the decision.

⁵ Internal Revenue Manual 5.15.1.3.2.2.
⁶ Internal Revenue Manual 5.15.1.3.3.1.4.

⁷ IRS 2002 Data Book

⁸ IRC § 7122(c) **Standards for evaluation of offers.**

(1) In general.

The Secretary shall prescribe guidelines for officers and employees of the Internal Revenue Service to determine whether an offer-in-compromise is adequate and should be accepted to resolve a dispute.

(2) Allowances for basic living expenses.

rarely deviates from its schedules. The IRS should be directed to comply with the provisions of IRC § 7122(c) and rely more extensively on the application of individual facts and circumstances. A more flexible policy in this regard would result in more successful offers in compromise and, thus, increase collection revenues.

We also propose that IRC § 6159 be amended to adopt language similar to § 7122(c) for installment agreements. The IRS should be required to review the facts and circumstances of each taxpayer when considering an installment agreement. The current application of the standards has caused adverse results, including forced bankruptcies, increased default rates on installment agreements and hardships to taxpayers attempting to pay their tax debts. We believe that greater IRS flexibility in this regard will increase collection rates for delinquent taxes.

V. Other Problem Areas

A. Abuse of Collection Due Process by Tax Protestors

The 1998 Reform Act granted new rights to taxpayers with respect to IRS collection procedures. Specifically, taxpayers now have the right to request a hearing before levy action is taken against the taxpayer.⁹ Taxpayers are also provided with a hearing after a federal tax lien is placed on their property. These collection due process (“CDP”) hearings are designed to ensure that the collection actions proposed to be taken against the taxpayer are reasonable, and that the IRS has fully complied with all statutory and procedural collection requirements.

While CDP hearings have helped to usher in a new era in IRS-taxpayer relations, and are designed to promote a higher quality of service, they have also contributed to a decline in collection expediency because (i) they have placed greater demands on decreased IRS staff, and (ii) some taxpayers have intentionally used them as tools to delay collection frivolously. Current statutory and/or administrative provisions should be amended to decrease the number of unnecessary and frivolous CDP hearings.

CDP hearings are conducted by the IRS Appeals Division. This past year, approximately 30,000 new CDP cases reached Appeals, and collection cases now account for half of Appeals’ workload.¹⁰ Under the existing statute, the IRS must grant a CDP hearing if the taxpayer submits a timely written request for a hearing.¹¹ This means that a taxpayer cannot be denied a hearing based on issues that he or she intends to raise—even frivolous arguments challenging the Federal Government’s authority to levy and collect income taxes (*i.e.*, “tax protestors”). The IRS currently instructs its Appeals employees that it is not appropriate to deny a CDP qualified taxpayer a hearing because the only issues they raise are frivolous or otherwise do not qualify for consideration.¹² Moreover, Appeals must grant a face-to-face hearing, even to a tax protestor, if one is requested.¹³

Because Appeals does not have any discretion to deny CDP hearings, it is forced to process tax protestor cases that serve only to frustrate IRS collection efforts and to delay other taxpayers’ cases. Invariably, tax protestors seek judicial review of Appeals’ determination of their case. Although courts have willingly upheld the imposition of penalties in response to such frivolous arguments, they have not been able to prevent tax protestors from misusing and bogging down the judicial process.¹⁴

Reducing the impact of the frivolous use of collection due process has been a strategic goal of the IRS for more than a year.¹⁵ Accordingly, legislation should be passed that would provide statutory authority to deny requests for CDP hearings that are based on frivolous arguments. Legislation is currently pending which would permit the IRS to treat portions of CDP hearing requests based on frivolous posi-

(A) In general. In prescribing guidelines under paragraph (1), the Secretary shall develop and publish schedules of national and local allowances designed to provide that taxpayers entering into a compromise have an adequate means to provide for basic living expenses.

⁹ I.R.C. §§ 6320 and 6330.

¹⁰ See “Bogged Down With Collection Cases, IRS Appeals Is Hot on Fast Track,” 2002 TNT 211-2 (Oct. 31, 2002) (summarizing comments of IRS Appeals Chief David S. Robison made at AICPA’s Fall Tax Division Meeting in Washington, D.C.).

¹¹ I.R.C. §§ 6320 and 6330; Treas. Reg. § 301.6330-1(d).

¹² I.R.M. § 8.7.2.3.3 (11-13-2001).

¹³ Treas. Reg. §§ 301.6330-1(d), Q-D7; I.R.M. § 8.7.2.3.3 (11-13-2001) (making an exception only for potentially dangerous taxpayers).

¹⁴ See, e.g., *Pierson v. Commissioner*, 115 T.C. 576 (2001); *Davidson v. Commissioner*, 84 TCM 156 (2002); *Lemieux v. United States*, 2002-2 USTC ¶ 50,220 (D.C. Nevada 2002).

¹⁵ See, e.g., JCS-2-02, Joint Review of the Strategic Plans and Budget of the Internal Revenue Service, as Required by the Internal Revenue Service Restructuring and Reform Act of 1998, (May 8, 2001) (containing a statement by Commissioner Charles O. Rossotti that he would like the collection provisions of RRA 1998 to be changed).

tions (to be defined and listed periodically by the IRS) as never having been submitted, and would deny administrative or judicial review of such portions.¹⁶ Additionally, this legislation would preclude a taxpayer from raising frivolous issues at a CDP hearing.¹⁷ The passage of such legislation would be a step toward ensuring that collection due process serves the purpose originally intended by the 1998 Reform Act. However, we have some concern about granting the IRS unfettered discretion to determine when a position is frivolous. Consideration should be given to requiring that a “reasonable basis” (as described in Treas. Reg. sec. 1.6662-3(b)(3)) support any taxpayer request for a CDP hearing.”

Short of legislation that denies CDP hearings based on frivolous positions, Treasury and the IRS should consider promoting legislative efforts that would amend the statute to deny further judicial or administrative review of Appeals determinations with respect to CDP hearings in which frivolous positions are advanced. Likewise, the Tax Court could be granted jurisdiction to enjoin further frivolous claims, and new criminal penalties could be enacted for application to taxpayers who have repeatedly requested CDP hearings based on frivolous positions and/or who have repeatedly advanced frivolous positions during CDP hearings. Additionally, legislation should be passed to specifically deny face-to-face hearings to tax protestors. Such a provision would still allow Appeals to process these types of cases more efficiently, and it would be consistent with Appeals’ practice of terminating CDP hearings in situations where a taxpayer persists in raising frivolous issues.¹⁸

Administrative measures might also be implemented in this area. For example, Treasury should consider amending the regulations to deny tax protestors the right to request an “equivalent hearing,” which is a hearing that is available to taxpayers who have failed to timely request a CDP hearing.¹⁹ Equivalent hearings are not required by statute and, therefore, administrative action alone may be taken to deny their availability to tax protestors. Furthermore, the IRS should develop a policy of prioritizing or fast-tracking frivolous CDP hearing requests. These claims should receive expedited consideration by Appeals and be promptly rejected using appropriate standard language.

B. Priorities on Collection: Trust Fund Taxes

The next issue is the priority being given to collection of trust fund taxes. This issue involves employers who fail to pay over to the IRS the employment taxes which they withhold from employees’ wages.

This is a critical enforcement priority but, in practice, we find that enforcement is frequently tardy and relatively ineffective. Perhaps more importantly, this is an area in which the announced, and often widely publicized, refusal of certain employers to withhold and pay over these taxes encourages tax non-compliance and disrespect for the tax system.

Our system of payroll taxes serves a double function: it supports the revenue needs of our government, while simultaneously funding health and welfare benefits for broad segments of our society under the Medicare and Social Security programs. While enforcement of individual income tax liabilities will always be important, in a practical world in which competing claims for enforcement resources must be weighed and reconciled, we believe that the continued failure by the IRS to enforce payroll tax obligations aggressively is fundamentally detrimental to our tax system. In aggressively seeking to enforce employment tax obligations, however, the IRS must ensure that it carefully determines which employees may be personally liable for the penalties associated with the enforcement action.

C. Treatment of Nonfilers

Another perennial problem is nonfilers, taxpayers who simply do not file tax returns. Since 1979, the General Accounting Office has issued at least three studies, and one report to Congress, dealing with the nonfiler problem.²⁰ The GAO studies provide the following recommendations to improve filing compliance:

¹⁶ See Tax Administration Reform Act of 2002, H.R. 5728, 107th Cong. § 307.

¹⁷ *Id.*

¹⁸ T.R.M. § 8.7.2.3.3 (11-13-2001).

¹⁹ Treas. Reg. § 301.6330-1(i).

²⁰ See “Internal Revenue Service—Results of Nonfiler Strategy and Opportunities to Improve Future Efforts,” GAO/GGD-96-72 (May, 1996); “Tax Administration—Improving IRS’s Business Nonfiler Program,” GAO/GGD-89-39 (March, 1989); “Tax Administration—IRS Could Reduce the Number of Unproduced Business Nonfiler Investigations,” GAO/GGD-88-77 (May, 1998); and “Report to the Congress—Who’s Not Filing Income Tax Returns? IRS Needs Better Ways To Find Them And Collect Their Taxes,” GGD-79-69 (July 11, 1979).

- The IRS should contact delinquent taxpayers as soon as possible to get returns filed and to prevent delinquency over a number of years.
- The IRS should consider using non-audit personnel to “man the phones” to follow up with delinquent taxpayers.
- The IRS should develop a better statistical model to identify nonfiling situations and to use information obtained from various state agencies and other information sources more effectively to identify and track nonfilers.
- The IRS should allocate sufficient funds and personnel to the nonfiler issue on an on-going basis.

About a decade ago, the IRS tried a new approach to this problem by instituting its “Nonfiler Initiative,” intended to get nonfilers back into compliance.²¹ The basic feature of the program was to allow taxpayers to file delinquent returns in exchange for the assurance that no criminal prosecutions would occur. In addition, the IRS told taxpayers that people who could not pay their outstanding liabilities would be allowed to enter into installment agreements, or that the liabilities might be reduced or eliminated under the offer-in-compromise program. The IRS was successful in obtaining the help of outside tax professionals who volunteered their time to help with the preparation of delinquent tax returns.

The Nonfiler Initiative ran from 1993 through mid-1995. The program was a success because it (1) reduced the size of the nonfiler inventory; (2) eliminated unproductive cases; and (3) increased the number of returns secured from individual nonfilers. The GAO, however, had concerns about the results of the program because (1) the IRS had not set a goal for the number of nonfilers it wanted to bring into compliance; (2) the IRS had not prepared a plan to prevent recidivism of nonfilers; and (3) the IRS had not prepared a cost-benefit analysis with respect to the results achieved.

Anecdotal evidence indicates that public perception of the program was mixed. Seriously delinquent taxpayers were brought into compliance, at least temporarily. In addition, a number of states instituted their own Nonfiler Initiative that helped increase state tax revenue. The Nonfiler Initiative did not provide, however, for a blanket waiver of either interest or penalties. As a result, a number of taxpayers decided not to enter into the program because of the significant tax bill that would clearly result.

Where are we today? In 2001, the IRS issued roughly 1.4 million notices to nonfilers,²² and it made assessments totaling roughly \$1.9 billion with respect to substitute returns prepared on account of nonfilers.²³ In addition, the IRS has once again identified nonfilers as a significant problem. The IRS website indicates that “IRS has implemented a ‘multifunctional, comprehensive effort called the National Nonfilers Strategy.’ The overall goal of the strategy is to bring taxpayers back into compliance and keep them there.”

To help preserve the integrity of our tax system, it is essential that the IRS undertake serious efforts to bring nonfilers into compliance. This is especially true considering that many taxpayers now believe that the IRS has become a “paper tiger,” and that failure to file one’s tax return will not bring serious repercussions. We strongly recommend that the Oversight Subcommittee indicate its full support for any Nonfiler Initiative that the IRS may undertake. Moreover, we fully support any legislative or administrative proposal that:

- Increases funding which directly supports the IRS’s Nonfiler Strategy.
- Increases trained personnel whose sole job is to identify and work with nonfilers.
- Develops statistical models and other information sources that will help to identify and track nonfilers.
- Develops methods to track and handle repeat nonfilers.
- Expands the “substitute-for-return” program, and institutes a “refund hold” program for habitual non-filers until all returns are brought current.
- Increases use of criminal prosecution with a dynamic publicity campaign. Considers another voluntary “Nonfiler Initiative” that will allow abatement of penalties and/or interest before implementing enforcement measures.

D. Repeat Abusers of the System

²¹ See “IRS Reaches Out To Bring Nonfilers Back Into The Tax System, IR–News Rel., 1992–94 (September 30, 1992); and “IRS Says Nonfilers Who Come Forward Are Not Prosecuted,” IR–News Rel., 1992–114 (December 7, 1992).

²² See “Internal Revenue Service—2001 Data Book” (September 30, 2001) at Table 25.

²³ *Id.*

Many repeat delinquent taxpayers create new tax debts after being allowed to repay prior obligations. The IRS uses a scoring system for field collection efforts, and we believe that more emphasis should be placed on aggressively pursuing collection from repeaters. In the case of trust fund repeat delinquencies, the IRS should place the highest priority on field contact. The IRS Automated Collection System is ill-equipped to deal with sophisticated delinquent trust fund liabilities whereas Revenues Officers have the skills to intervene to stop new liabilities. The IRS should also consider requiring repeaters to file returns monthly, not quarterly.²⁴

E. Collection Outsourcing

It is our understanding that the IRS is considering the use of private vendors to assist in the collection process. We believe that this idea warrants additional study and consideration. We would note however, that paying vendors a percentage of collections appears to be inconsistent with the prohibition of collection statistics in the 1998 Revenue Reconciliation Act.²⁵ That provision was passed by Congress to prevent abusive conduct by IRS employees. A private system that rewards and encourages aggressive collection activities by private collectors may only revive the abusive conduct which gave rise to the protections passed in 1998. Some of our members have related abuses by private collectors hired by state tax agencies. We therefore recommend that private collection agencies be hired if studies find that the bounty incentives inherent in private collection efforts can be reconciled with taxpayer protection and rights.

F. Inadequate Training of IRS Employees

Many of our members have expressed concern that collection employees are not being trained to the standards observed in prior decades. Controversies often arise merely because inadequately trained collection employees do not follow the Internal Revenue Manual. Greater resources should be dedicated to providing quality continuing professional education to IRS employees. As a related matter, we believe that the IRS should consider raising the standards for initial employment. Raising the hiring standard, over time, will raise the quality and efficiency of IRS collection efforts.

I hope that the foregoing observations and suggestions are helpful to the Oversight Subcommittee in discharging its important responsibilities. Other representatives of the ABA Tax Section and I would be happy to meet or otherwise communicate with Subcommittee members in order to further discuss these views or any other matter on which our input might be considered helpful.

Chairman HOUGHTON. Thank you very much, Mr. McKenzie. Mr. McCormally?

²⁴ IRC Sec. 7512

²⁵ Sec. 1204 Revenue Reconciliation Act, This section repeals an earlier statute which prohibited the Service from using records of tax enforcement results to (1) evaluate employees directly involved in collection activities or their immediate supervisors; and (2) impose or suggest production quotas or goals upon employees described in (1) above. The new section keeps those prohibitions but expands them to include "employees"—not just those directly involved in collection activities. Additionally, this section expands the certification requirements by requiring "appropriate" supervisors to certify compliance with the law. The earlier law required only the District Directors to certify compliance. Finally, this section requires that the Internal Revenue Service use the fair and equitable treatment of taxpayers by employees as one of the standards for evaluating employee performance. As described above, the new law expands the prohibitions on the use of records of tax enforcement results to "employees," no longer limiting the prohibitions to those directly involved in collection activities. Similarly, the new law imposes a certification of compliance requirement upon all "appropriate" supervisors, not just District Directors as in the earlier law. Finally, it requires that the fair and equitable treatment of taxpayers be a standard for evaluating employee performance.

STATEMENT OF J.A. (DREW) GLENNIE, INTERNATIONAL PRESIDENT, TAX EXECUTIVES INSTITUTE, INC., AS PRESENTED BY TIMOTHY MCCORMALLY, EXECUTIVE DIRECTOR, TAX EXECUTIVES INSTITUTE, INC.

Mr. MCCORMALLY. Thank you, Mr. Chairman, Members of the Subcommittee. I am Timothy McCormally, Executive Director of TEI. Our International President, Drew Glennie, had flown to Washington yesterday from Calgary to testify today, but is unable to be here due to illness.

The TEI is an international organization of 5,300 individuals who work in the tax departments of 2,800 companies in the United States, Canada, and Europe. I am accompanied today by our General Counsel, Fred Murray.

The TEI is pleased to be here today to speak on three general topics. First, efforts of the IRS to implement effective enforcement strategies. Second, the IRS's budget for fiscal year 2004. Finally, some tax administration issues that are present in the budget and in pending legislative bills.

Mr. Chairman, for enforcement to succeed, the law must be clear because the ability to understand the law and to comply with it in an efficient fashion is a critical component of our tax system. Current law is marked by many ambiguous provisions that often produce unintended consequences, and we urge Congress and the Department of the Treasury to continue their efforts to simplify and clarify the law, both statutorily and administratively.

In this regard, TEI commends the Department of the Treasury and the IRS for their efforts through the use of de minimis rules and safe harbors in recent regulations relating to the capitalization of expenditures. The consultative process that the government used in this case produced a good product and should be encouraged.

An effective enforcement strategy also depends on a committed, well trained, and stable workforce. It is not enough just to announce new procedures from the national office in Washington. There must be buy-in and training in the field, and as Ms. Williams pointed out, qualified individuals must be recruited to replace the many seasoned agents who will be retiring in a few years.

Both the IRS and taxpayers have a common goal in completing audits in a timely and efficient manner, and we commend the IRS and specifically the Large and Mid-Size Business (LMSB) Division for several innovative procedures, including fast-track settlement, accelerated issue resolution, and limited issue focused examinations. These programs will improve the examination process and promote currency. The increased attention on front-end activities can reduce contentious audits and expensive litigation.

As business executives, TEI Members know how critical it is to invest in and plan for the future, and it is important that there be adequate resources devoted to core functions such as customer service and employee training. We applauded the IRS's decision, Congress's decision, to have the IRS restructured along taxpayer oriented service lines. Much has been accomplished under the modernization effort, but as you already heard and you already knew, much remains to be done. If the IRS is to continue its efforts to improve its credibility and effectiveness, the agency must have adequate resources for its programs.

We believe the agency has made substantial progress in dealing with its management systems and other aspects of its operations, but this Subcommittee and Congress and all of us in the private sector must remain vigilant to monitor the progress. Critical systems, particularly those involving individual and business taxpayer master files, must be delivered successfully, on time, and within prescribed budget.

We are encouraged that the President has nominated Mark Everson to be Commissioner of the IRS and are hopeful that the modernization effort will continue to progress under his tenure.

Money and stability are also required for the agency to recruit, train, and retain qualified individuals. In the LMSB Division, which we are most familiar with, 46 percent of the workforce is eligible to retire or will be eligible to retire within the next 3 years. In 2001, 5.3 percent of the workforce did retire.

Mr. Chairman, you have heard today certain concerns expressed by Mr. McKenzie and others about proposals to use private firms to collect Federal taxes. The TEI recognizes that the IRS must move to effectively resolve collection issues, and we share the Administration, the Chairman, and other Members' concerns about the level of uncollected taxes. Moreover, we commend the sensitivity to privacy and confidentiality issues that has led to the presence in many proposals of sound safeguards.

Nevertheless, TEI believes that the better approach is to provide the IRS with sufficient resources to perform its core governmental duties in an efficient manner. Private collection agencies should generally not be used to perform core governmental functions. If, however, these proposals go forward, TEI believes it is imperative that the legislation adopt safeguards of taxpayer rights, particularly in respect of any lien and levy powers delegated to outside parties. Like Mr. McKenzie and the ABA, we have significant reservations about basing compensation on the amount of tax collected.

Mr. Chairman, last summer, Senator Grassley inquired whether consideration should be given to the disclosure of corporate tax returns, both to the public and to the Securities and Exchange Commission (SEC). The disclosure proposal engendered serious discussions within Congress, the business community, and the public at large, and we understand that the Department of the Treasury and the SEC have voiced concerns about the proposal.

For our part, TEI believes that the proposals go in the wrong direction. Confidentiality of tax return information is a key privacy right that should be vindicated because it is the cornerstone of voluntary compliance.

We similarly have questions about proposals to require the chief executive officer (CEO) of companies to sign corporate tax returns. In our view, this proposal would adversely affect tax administration. The tax affairs of major corporations are extraordinarily complicated and their management is routinely delegated to the chief tax officer, someone who has been specially trained. The proposal that has been recommended would force companies to devote substantial time and resources to educating CEOs about the intricacies of the company's tax affairs, which in our view would distract them from more important items, including company and strategic vision

and the overarching issues of corporate governance and accountability.

Finally, Mr. Chairman, I wish to reiterate TEI's support for and our appreciation to you and others on the Committee, including Mr. Portman, for your efforts to advance the goal of tax simplification. As I mentioned at the beginning, for the law to be effectively enforced, it must be understood. We understand that budget pressures and other concerns may impede progress on broad simplification proposals, but we remain eager to work with you and your staff to achieve whatever we can.

In this regard, I would note that TEI continues to believe that fundamental reform and simplification could occur by eliminating completely the individual and corporate alternative minimum tax.

I would be happy to answer any questions you have about any statements I made here or in the written testimony. Thank you.

[The prepared statement of Mr. Glennie follows:]

Statement of J.A. (Drew) Glennie, International President, Tax Executives Institute, Inc., as presented by Timothy McCormally, Executive Director, Tax Executives Institute, Inc.

Mr. Chairman, and distinguished Members of the Subcommittee:

Good morning. I am Drew Glennie, General Manager—Tax and Insurance for Shell Canada Limited. I appear today as the International President of Tax Executives Institute, the preeminent association of business tax professionals. I am accompanied by the Institute's Executive Director, Timothy McCormally, and by our General Counsel and Director of Tax Affairs, Fred Murray. The Institute is pleased to participate in this hearing.

Background

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today, the Institute has 53 chapters in the United States, Canada, and Europe. Our 5,300 members are accountants, attorneys, and other business professionals who work for 2,800 of the largest companies in North America and Europe; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. Hence, TEI represents the business community as a whole, and our members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily basis. TEI is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike.

The companies that employ TEI's members have almost without exception been assigned to the IRS's Large and Mid-Size Business (LMSB) Division. The largest 1,600 taxpayers within LMSB are subject to ongoing audits as part of the Coordinated Industry Case (CIC) program. The Institute's testimony is largely based upon our experience with this segment of IRS operations.

We are pleased to offer our views on the enforcement challenges within LMSB, the IRS Budget for Fiscal Year 2004, the use of private collection agencies for collection of federal taxes, proposals regarding disclosure of corporate tax returns and requiring CEOs to sign income tax returns, and simplification of the complex tax system and its effects on our system of tax administration.

The Components of an Effective Enforcement Strategy

A successful enforcement strategy has the following characteristics:

- **Clarity.** The ability to understand the tax law—and to comply with it in an efficient fashion—is a critical component of an effective tax system. Taxpayers must understand their responsibilities and commit resources to comply with the law in as efficient a manner as possible. Sadly, the current law—which is marked in many cases by complex, ambiguous provisions that often may produce unintended consequences—leaves much to be desired. We recognize that true simplification begins with the Internal Revenue Code which we ad-

dress below, but there are ways in which the law can be made simpler by the IRS. For example, the Treasury and IRS are to be commended for the inclusion of *de minimis* rules and safe harbors in the recent regulations on the capitalization of expenditures. We also believe the consultative process used by the government before issuing the proposed regulations—last year the government used an advance notice to invite comments on a broad range of issues—will produce.

- **Confidence.** Taxpayers must have confidence in the integrity of the tax system. The law must be applied evenhandedly, and taxpayers must believe that no one is getting a better “deal” upon audit. An effective enforcement strategy must be equitable and ensure that similarly situated taxpayers are being treated alike.
- **Competence and Continuity.** An effective enforcement strategy also depends upon a committed, well-trained, and stable workforce. It is not enough to announce new procedures and policies from the National Office; there must be buy-in from the field to make the policies work. In addition, field personnel must know and understand the tax law and how it relates to the businesses they audit. Qualified individuals must also be recruited to take the place of the many seasoned agents who will be retiring over the next few years.
- **Currency.** TEI’s members generally work for companies that are under continual audit by the IRS. Both the taxpayer and the IRS have a common goal of completing these audits in a fair, timely, and efficient manner. Several innovative procedures—such as Fast Track Mediation and Settlement, Accelerated Issue Resolution, Early Referral to Appeals, and Limited Issue Focused Examination—have been introduced in the last two years to improve the examination process and promote currency. An effective enforcement strategy must promote the efficient use of government and taxpayer resources during the course of an audit. The lack of currency in audits creates significant recordkeeping burdens for taxpayers. If taxable years are closed in a timely manner, there is less need to retain records relating to those years.

Implementing an Effective Enforcement Strategy

LMSB has shown a refreshing openness to trying new and different ways of doing business. More than a year ago, the division announced several “pre-filing” initiatives, emphasizing the need to resolve issues before a return is filed. This increased attention on “front-end” activities—by the use of pre-filing agreements and industry issue resolution techniques—potentially could reduce contentious audits and prolonged litigation.

In order to substantially complete its change in focus from post-filing to pre-filing activities, the IRS must improve the currency of its audits. Thus, we are pleased with LMSB’s recent announcement of its limited issue focused examination or “LIFE” initiative. It is an innovative process to focus government and taxpayer resources on the most significant issues on a taxpayer’s return. The new initiative requires the execution of a formal memorandum of understanding between the taxpayer and the IRS that will govern key aspects of the examination, including the imposition of a dollar threshold on a case-by-case basis below which issues will not be raised.

The use of materiality standards in examinations is an approach that TEI has long supported, and we commend LMSB for thinking outside the box to resolve the significant backlog of cases within the division. The LIFE initiative holds great promise for creating an atmosphere where the examination process is less time-consuming and more efficient for all parties.

As the IRS has acknowledged, the new approach represents a major culture shift for LMSB. Critical to its success is the involvement—and training—of IRS field personnel. Without a commitment from the examination team and their supervisors, the new procedure could well be viewed as the latest “flavor of the week,” *i.e.*, a mere reworking of other initiatives without an underlying change in philosophy. Reports from our members seem to indicate that not all specialists are yet on board with the new approach. However, we understand that LMSB has begun training its agents in the new process and remain hopeful that the LIFE process will succeed in institutionalizing “best practices” for IRS examinations and providing consistency in the treatment of taxpayers.

Other innovative approaches to resolving issues may be found in IRS’s use of new settlement initiatives. In October, the IRS announced proposed settlement options in three groups of tax shelter cases: corporate-owned life insurance (COLI), section 302/318 basis-shifting transactions, and contingent liability transactions. These cases have the potential for clogging the tax system, consuming undue resources, and preventing LMSB from making progress on other important issues.

The three initiatives offered taxpayers an opportunity to settle these issues in a timely manner and were intended to bring the cases to a comprehensive resolution, based on the IRS's assessment of the strength and weaknesses of its legal positions. Although some may disagree with that assessment, the process demonstrates a willingness to let taxpayers resolve a contentious issue and move on. We understand, for example, that the COLI initiative has resulted in the resolution of nearly all outstanding cases. We understand that the IRS is working on settlement options for several other transactions and we encourage the agency to continue its undertaking to resolve issues on a wholesale, rather than a "retail" or case-by-case, basis.

Possible Barriers to an Effective Enforcement Strategy

The IRS Budget for Fiscal Year 2004

One barrier to implementing an effective enforcement strategy is the lack of adequate and reliable funding. As the preeminent association of business tax executives, TEI knows how critical it is to invest in and plan for the future. Our members know the importance of sound business processes and strict internal controls. Equally important, the companies represented by TEI's membership know that to be successful, they must plan ahead and ensure that adequate resources are devoted to core functions such as customer service and employee training. As a group, they applauded the decision to restructure the IRS to operate more like a business and to adopt a more taxpayer-oriented service focus.

The IRS's previous attempts at major technological modernization have not been successful. As a consequence, American taxpayers have had to endure customer service that has been less effective than it should be, and significant amounts of taxes that could have been collected were not. This failure to modernize has operated as an indirect tax increase on compliant taxpayers. Taxpayers trying to pay their taxes and IRS personnel trying to do their jobs have had to work with systems that are inadequate and seriously out of date. The current modernization effort is the most far-reaching yet, and at the five-year mark is approximately one-half of the way through the original planning horizon.

If the IRS is to continue its efforts to improve the agency's credibility and effectiveness, the agency must be assured that the programs needed to implement its mission will be fully and consistently funded. Much has been accomplished under the IRS Restructuring and Reform Act, but much remains to be done. We recognize that the IRS has experienced problems in the past with its modernization programs, but we believe that the agency has made substantial progress in dealing with internal management systems. In addition, these concerns, while important, should not impede the IRS's efforts to deal with its broader mission. TEI respectfully suggests that reducing the IRS's funding is not the most efficient or effective way to address concerns about management of its modernization. OMB, the Treasury, and the IRS should directly address problems as they are encountered and find workable solutions to them. This subcommittee and others within the Congress should continue to assess and monitor the progress. It is imperative that we all work together, and that effective solutions to problems be found as soon as possible. Critical systems, particularly those involving the individual and business taxpayer master files, should be delivered successfully, on time, and within prescribed budgets. A failure of the current effort would have far-reaching effects on our government and American taxpayers. The current reorganization programs must be successful. If the IRS is to succeed as a modern, customer-focused agency, it must have adequate funding for its service initiatives. We are encouraged that the President has nominated Mark W. Everson to be Commissioner of Internal Revenue and are hopeful that the modernization effort undertaken by former Commissioner Charles O. Rossotti will continue to progress under his tenure.

Staffing and Training Concerns

Money and stability are also required for the agency to recruit, train, and retain qualified personnel. LMSB experienced a 5.3 percent attrition in 2001, and 46 percent of its workforce is eligible to retire within the next three years. With the additional emphasis on auditing tax shelter issues, the IRS will need to deploy its resources carefully. Modern technology is important, but the lack of qualified, experienced personnel will almost certainly hinder an effective enforcement strategy.

Stated simply, whether the promise of the reorganization can be realized depends in large measure on the IRS's securing sufficient funds to do its job. TEI has consistently supported both adequate funding for the Internal Revenue Service and adequate oversight by the IRS Oversight Board, the Treasury, and Congress. We know

the Subcommittee shares our concern and urge you to continue to support adequate funding of the IRS.

Use of Private Collection Agencies to Collect Taxes

The President's Budget proposes the use of private debt collection agencies to assist in the collection of delinquent taxes, and Chairman Houghton has recently introduced legislation to effect the same objective. Intended to reduce the number of deficiencies deemed uncollectible, the proposal would effect a significant and far-reaching change in the way federal taxes are collected in this country. While the intent of the proposals is laudable, TEI believes that the collection of taxes is a core governmental function, the outsourcing of which could potentially imperil taxpayer rights and erode taxpayer confidence in the fairness of the tax system.

In testimony before the House Government Reform Subcommittee last year regarding plans to implement a filing and payment compliance (FPC) initiative to resolve collection issues quickly and fairly, then Commissioner Rossotti emphasized that "[u]nlike private collection agencies, the IRS often takes inherently governmental actions involving judgment, such as discretionary decisions on liens and levies on delinquent accounts."

Because TEI's members are generally part of LMSB, they are not often involved with the IRS's collection function. Nevertheless, TEI is concerned about the effect of the proposal on tax policy and administration. Taxpayers' perception that the tax system is fair is essential to voluntary compliance. For the tax system to work, taxpayers need to know that, when they deal with their government, they will be treated in a fair and impartial manner. The use of private firms to perform a core function of government—the collection of taxes due—could undermine this goal. As a practical matter, collection agencies involved in performing ministerial functions might be unable to assist a taxpayer who questions the underlying tax liability. In addition, low-income taxpayers—who do not have access to representation—may be pressured to enter into unreasonable collection agreements.

Moreover, using outside, for-profit contractors could impede taxpayer privacy and undermine the perception of fairness. Employing private collection agents provokes all of the concerns raised by the sharing of sensitive taxpayer information with persons not employed by the Internal Revenue Service, and in fact not employed by the Federal Government or any governmental entity. Such concerns are even more acute if the companies are compensated on a contingency basis, which raises significant due process issues.

TEI recognizes that IRS must move to effectively resolve collection issues, and we share the Administration's and the Chairman's concern about the level of uncollected tax debts. Moreover, we commend the presence in the current proposals of sound safeguards. Nevertheless, TEI believes the better approach is to provide the IRS with sufficient resources to perform core governmental duties in an efficient manner. Private collection agencies should not be used to perform these governmental functions. If, however, the proposals are adopted, the legislation must also adopt safeguards of taxpayer rights, particularly with respect to any lien or levy powers delegated to outside parties, that are at least as protective as those applicable to federal employees. Further, contract fees should not be determined on a contingent basis.

Public Disclosure of Corporate Tax Returns

On July 8, 2002, Senator Charles Grassley wrote to the Treasury Department and the Securities and Exchange Commission (SEC), inquiring whether consideration should be given to requiring public companies to provide copies of their tax returns (or summaries thereof) to the SEC and to the public. The disclosure proposal has engendered important discussions within Congress, the business community, and the public at large, and we understand the Treasury Department and SEC have voiced concerns about the proposal. For our part, TEI believes that public disclosure of tax returns is wholly inappropriate. Confidentiality of tax return information is a key privacy right that should be vindicated not just for its own sake, but because it is the cornerstone of voluntary compliance.¹

¹In computing their annual tax liabilities, corporate taxpayers must disclose not only the nature, sources, and character of their revenues and expenses, but also all manner of information relating to their corporate legal structures as well as other proprietary data. For example, disclosure of sales, licensing, and leasing revenues by legal entity and jurisdiction may enable a competitor to more clearly understand the location and, potentially, the identity of a company's customers, as well as other key data such as product pricing and gross margins. Together with advertising and other key selling expenses disclosed on the return, competitors would have clear

As important, we do not believe that providing copies of the tax returns (or summaries thereof) as a matter of course to the public or the SEC will enhance the overarching goal of protecting public investors through the disclosure of full, fair, and meaningful information. Should it be determined that the SEC lacks sufficient authority under current law to obtain tax returns or tax return information and that such information is necessary and appropriate in the SEC's investigations or enforcement actions, TEI recommends that the SEC request a limited amendment to section 6103 of the Internal Revenue Code to clarify its authority to obtain expeditious access to confidential taxpayer information. Such limited authority, however, must be subject to appropriate privacy safeguards, including exemption from public disclosure under the Freedom of Information Act.

TEI members share the concerns expressed by the Administration, Congress, and the public about recent allegations of financial reporting involving fraud and malfeasance. Such lapses in behavior, once investigated and proven, rightly merit not only public reproach, but also vigorous enforcement of applicable civil and criminal laws and sanctions. Moreover, if current laws and penalties are inadequate to deter, prevent, or punish such misconduct, they should be appropriately enhanced. But public disclosure of corporate tax returns is a solution in search of a problem; it is neither cure nor palliative for financial reporting irregularities. Indeed, public disclosure of corporate tax returns is not only contrary to the longstanding policy of protecting the confidentiality of taxpayer returns, but is potentially counterproductive to the goal of providing shareholders with meaningful information.²

CEO Signatures on Tax Returns

Section 722 of the CARE Act of 2003, S. 476, as reported in the Senate by the Committee on Finance, would amend section 6062 of the Internal Revenue Code to require the chief executive officer (CEO) of a corporation to sign the corporation's income tax returns. Under the amendments, the Secretary of the Treasury would be authorized to designate other officers who may sign the income tax return where the corporation does not have a CEO. Because the provision misapprehends the CEO's role in the preparation of company tax returns and could adversely affect tax administration, TEI recommends that it be abandoned.

The tax affairs of major corporations are extraordinarily complicated and their management is routinely delegated to the Chief Tax Officer (or similarly titled individual) who has been specially trained. While the senior officers (including the CEO and CFO) remain ultimately responsible for the company's compliance with the tax laws—and all other laws—it would be rare that a CEO could be personally involved in, or knowledgeable about, the plethora of tax rules that apply to literally thousands of transactions that are reflected in the company's tax returns. Indeed, the level of detail and specialized knowledge demanded in the preparation and submis-

insights into a company's marketing strategies. Similarly, the disclosure of the nature and location of a company's manufacturing costs by functional type will, in many cases, enable competitors to understand the company's manufacturing cost structure and permit them to identify potentially more cost-effective suppliers and more efficient ways of doing business. In summary, the greater the detail of information that is publicly available, the more a competitor can discern about a company's business model. Indeed, if the confidentiality of taxpayer information is breached, U.S. public company taxpayers would be substantially impaired in the global competition for capital, labor, customers, and suppliers.

²Many provisions of the Code require companies to treat items of revenue or expense reported one way for financial accounting purposes in a vastly different fashion for tax purposes. By adhering to the different accounting treatments prescribed by Generally Accepted Accounting Principles (GAAP) and tax law in respect of the same item, companies are complying with legal requirements and business exigencies. For example, a major reason for differences between book and tax reporting lies in the determination of the reporting "entity." Consolidated financial statements are generally required to be prepared under GAAP where one entity has an effective economic controlling interest (i.e., more than 50-percent ownership) in another entity. For tax purposes, affiliated groups of corporation subject to control by a common parent corporation may elect to file a consolidated tax return only where 80 percent of the vote and value of a subsidiary is owned by the group. In addition to the different ownership control thresholds for consolidation, U.S. tax rules exclude foreign corporations from the consolidated return but foreign affiliates must be included in GAAP consolidated financial statements. Thus, consolidated financial statements report worldwide results whereas the U.S. consolidated tax return generally includes only U.S.-based legal entities (plus their foreign branches). Even before the determination of taxable income and tax liability can begin, the composition of the reporting "entities" for tax and financial reporting purposes can be so different, and the reconciliation between the amounts reported by the differing "entities" such a complex exercise, that significant confusion will be engendered by a side-by-side comparison of the tax returns and financial statements. Given the scope and degree of differences in tax and financial accounting requirements, public disclosure of corporate tax returns poses great potential for confusing rather than enlightening investors.

sion of complex corporate tax returns demands that the responsibility for signing the return—and affirming under penalties of perjury the completeness and accuracy of the return—be delegated to an employee with a significant level of professional tax expertise, training, and experience. In TEI's view, the senior tax official is the person in the best position to assess—and state affirmatively—that the return fulfills the company's legal obligations.

Although TEI has consistently supported efforts to enhance the disclosure of transactions justifying IRS scrutiny and supported IRS appropriations sufficient to adequately fund the IRS, the Institute believes the proposal to require a CEO to sign a corporate tax return is flawed. We regret that it misapprehends the role of the tax department as well as that of the CEO. And while we believe it unjustifiably impugns the integrity and professionalism of both CEOs and corporate tax professionals, our fundamental concern is that the proposal is misdirected: It would force companies to devote substantial time and resources to educating CEOs about the intricacies of the company's tax affairs, distracting them (and the company's tax personnel) from activities that put their respective professional expertise to their best uses—including, in the case of the CEO, overarching issues of corporate governance and accountability. Indeed, in a typical year, corporate tax officials will sign under penalties of perjury hundreds, sometimes thousands, of federal, state, and local income, excise, and property tax returns—and the penalties can be quite severe.³ Further, while recent reports unfortunately document that some corporations have engaged in improper conduct, there has been no showing that the noncompliance is due to the lack of sanctions.

The CEO signature proposal would impose undue burdens on compliant taxpayers. Since most CEOs are not experts in the complexities of the tax law, they will of necessity turn to others (specifically, corporate tax officials or outside tax advisers) to compile the necessary background documents and review the thousands of pages and multiple volumes that constitute a complex, multinational corporate consolidated income tax return. The CEO's review of the income tax return would be redundant to the review process currently undertaken by the chief corporate tax officer, and the added resources required to comply with the proposal, again without demonstrable need, should not be ignored, especially since it would distract both CEOs and tax department personnel, including (in the latter case) dealing with the IRS to resolve outstanding tax issues.

Moreover, Congress has recently undertaken steps to strengthen the accountability of CEOs and CFOs for corporate financial matters, as well as the audit committees of the boards of directors of such corporations, in the Sarbanes-Oxley Act of 2002.

In summary, the proposal to require CEOs to sign corporate tax returns would impose a burden on CEOs that most are ill-trained to bear, would unnecessarily saddle companies with additional compliance costs, and would represent a step backward for efficient tax administration since the person signing the return would not be the employee in the best position to ensure the accuracy or completeness of a complex multinational tax return. TEI urges that the proposal be abandoned.

Tax Simplification

It is often said that tax simplification has no constituency. TEI disagrees, and we know that many on this committee do, too. Complexities in the tax system have important ramifications for tax administration and tax compliance. A joint task force of the American Institute of Certified Public Accountants, the American Bar Association Section of Taxation, and Tax Executives Institute has worked over the past few years to sensitize the public, the Treasury, and the Congress to the urgent need for major simplification of the tax laws. We applaud the Chairman's ongoing efforts to make tax simplification a higher priority.

In February 2000, the three groups submitted to the Treasury Department a list of ten areas of the Code as a starting point for simplification efforts. Others have identified a number of other worthy candidates for consideration. For example, the

³At a minimum, the provision must be clarified to apply solely to the Federal income tax returns (Form 1120) filed by corporations. If this provision extends to other federal tax returns, or worse, is copied by other jurisdictions, CEOs will have little time to properly perform their other substantial duties. Moreover, depending on the size and scope of the company's Form 1120, chief tax officers currently devote considerable time to the ministerial act of signing dozens, if not hundreds, of different forms, schedules, statements, and elections within the return that are subject to a signature requirement. Presumably, regulations would clarify whether the CEO signing on page one of Form 1120 would also be required to sign each form or statement subject to a separate attestation, but the sheer number of such attestations reinforces our concern about the demands the proposal would impose on the CEO's limited time.

staff of the Joint Committee on Taxation produced a comprehensive study in April 2001 that contained numerous recommendations, and the National Taxpayer Advocate has also pressed for change. In addition, tax simplification legislation was recently introduced by Chairman Houghton, as H.R. 22 and H.R. 285. In addition, recent bills introduced by Chairman Thomas, Representative Portman, and Representative Levin also include a number of simplification proposals worthy of consideration.

The three groups in the joint task force of which we are a part continue to support the original proposals, but have more recently sought to emphasize three areas of reform in which modifications to present law would yield substantial and beneficial simplification: providing a uniform definition of a qualifying child; elimination of the many phase-outs for tax incentives, including child and education credits, personal exemptions, and itemized deductions; and, repeal of the individual and corporate alternative minimum taxes. We recognize that budget pressures and other concerns may impede progress on such wide reforms, but are eager to work with you and your staff in order to achieve them to the greatest extent possible and as soon as possible.

We wish to stress today proposals relating to repeal of the alternative minimum taxes. When the alternative minimum tax was originally enacted in 1969, it was targeted at high-income individuals who paid no income taxes. It now hits middle-class taxpayers.⁴ Recent adjustments have provided some relief for those middle-class taxpayers seeking to take advantage of credits intended to benefit them, but soon millions will face the mind-numbing complexity of the AMT rules and find, to their great surprise, that they are subject to an extra tax that erodes the benefit of tax rates, deductions, and credits that Congress has specifically granted.

No less complex is the corporate alternative minimum tax, which requires companies to keep two separate sets of books for tax purposes, and has the perverse effect of taxing struggling companies at a time when they can least afford it. These provisions no longer serve their intended purposes, and changes in the law in recent tax years have also changed the tax base in ways that address the concerns that originally gave rise to these taxes.⁵ The AMT creates enormous administrative burdens and undermines the policies underlying substantive provisions of the Code. Taxpayers should not be required to compute their taxes twice and to keep two sets of books. In addition, the AMT is counterproductive: It takes in more revenues during recessions and reduced revenues during periods of expansion. Thus, the AMT taxes corporations when they can least afford it—when they are struggling to survive in a downturn economy. Moreover, because the calculation and payment of AMT is driven in large measure by a slower depreciation schedule for capital investments, the AMT is a substantial drag on one of the potential engines of economic recovery: capital investment in plant and equipment.⁶ The AMT represented poor public policy when it was enacted and time has not tempered its lack of appeal.

We reiterate our recommendation that both the individual and corporate alternative minimum taxes be eliminated.

Congress is currently considering steps to provide an economic stimulus to offset the current economic downturn. In one stroke—repeal of the corporate AMT—Congress can eliminate a flawed tax policy that can only serve to exacerbate the down-

⁴The JCT Study indicates that more than 11 percent of all individual taxpayers will be subject to the individual alternative minimum tax by 2011. *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*, Staff of the Joint Committee on Taxation, JCS-3-01, April 26, 2001, v. II at 10 (JCT Study).

⁵Initially enacted in 1969 and substantially modified to its present form in 1986, the corporate AMT today has little effect on its original target—companies with significant economic income that were paying little or no federal taxes. In its recent study on ways to simplify the Internal Revenue Code, the staff of the Joint Committee on Taxation concluded that the original purpose of the corporate alternative minimum tax is no longer served in any meaningful way. The AMT does not necessarily produce a more accurate measurement of income than the regular corporate income tax, especially after the provisions of the Tax Reform Act of 1986, and subsequent legislation, became fully effective. JCT Study, v. II at 16.

⁶The principal tax preference that contributes to taxpayers paying the corporate AMT is accelerated depreciation. Capital assets tend to produce a schedule of depreciation deductions that does not vary with economic conditions. As the economy enters a recession, business receipts fall. Consequently, corporate income as measured under the regular tax declines, but depreciation deductions generally remain the same. Because, in simple terms, a taxpayer becomes subject to the AMT when its AMT tax preferences and adjustments become large relative to its regular taxable income, a recession increases the likelihood that a business will become an AMT taxpayer.

turn and simultaneously effect a major simplification of the Internal Revenue Code.⁷ In addition, to provide further economic stimulus and investment, corporate taxpayers with accumulated AMT credits—amounts that represent a prepayment of a company's regular corporate tax liability—should be afforded the opportunity to recover those credits.

We recognize that AMT repeal would likely be an expensive fiscal step, but that cost will only continue to increase the longer the AMT remains in effect, and the cost to the tax system of retaining such a complicated regime is simply too great to bear. In the end, there can be little disagreement that the provisions must be repealed.

At the very least, as an interim step toward full repeal, the temporary increase in the exemption amount enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 should be made permanent immediately. The Budget submitted by the President also contains modest incremental change.

The international provisions of the Internal Revenue Code are among the most complicated provisions in the tax law. The last several years have seen several small steps taken to reduce tax law complexity for multinational corporations. For example, several years ago, Congress repealed section 956A of the Internal Revenue Code, which in our view was ill-conceived when it was enacted in 1993. And in 1997, Congress rectified an inequity that has existed for the past decade when it eliminated the overlap between the controlled foreign corporation and passive foreign investment company rules. Although laudable, these actions represent only a small step on the journey of simplifying the international tax provisions of the Code.

TEI believes that the Code's foreign provisions need fundamental reform and simplification, and for this reason we support efforts like those in Chairman Houghton's bill to reform various complex provisions of the Code including reforms to subpart F, in particular the elimination of the foreign base company sales and service income rules, and the reforms of the foreign tax credit, in particular the reduction of the number of baskets under section 904(d) to three. These reforms will not only reduce compliance costs—thereby enhancing the country's competitiveness—but they will also signal Congress's continued commitment to the simplification of the tax law generally.

We believe that implementation of simplification measures in each of these areas would significantly reduce complexity for large numbers of both individual and business taxpayers, and have the concomitant effect of making the tax laws far more administrable.

In Conclusion

We will continue to work with you to refine them and to develop additional proposals for simplification of the system. We appreciate the opportunity to submit these recommendations and stand ready to provide whatever assistance may be necessary to bring them to fruition.

Tax Executives Institute commends the Subcommittee for holding this public hearing. TEI looks forward to working with the Subcommittee to improve tax administration.

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Chairman HOUGHTON. Thank you, Mr. McCormally. Mr. Stevenson?

⁷In addition to ameliorating the counter-productive nature of the tax, the repeal of the corporate AMT would have a salutary effect in reducing administrative burdens and costs comparable or greater in value than the foregone revenues. Many taxpayers must undertake the AMT calculation to determine whether, in fact, they are liable. For example, the GAO reported that while only 28,000 corporations actually paid corporate AMT in 1992, 400,000 corporations filed the AMT form. See General Accounting Office, *Experience with the Corporate Alternative Minimum Tax*, GAO/GGD-95-88 (April 3, 1995), at 3. The 400,000 figure would understate the number of corporations that did the necessary calculations to determine whether they had an AMT liability.

STATEMENT OF WILLIAM STEVENSON, PRESIDENT, NATIONAL TAX CONSULTANTS, AND CHAIRMAN, FEDERAL TAXATION COMMITTEE, NATIONAL SOCIETY OF ACCOUNTANTS, ALEXANDRIA, VIRGINIA

Mr. STEVENSON. Good morning. In 1995, when you invited me to this table, Mr. Portman was sitting back there and I can remember you had asked me a question during the question and answer, and I am not exactly sure how we got into it, but my observation was that this Committee needed to provide more oversight to the IRS. That was 1995. Little did I know what would happen with the Commission and all the things that followed.

Since then, the National Society of Accountants has been intimately involved with Mr. Portman and this Committee, and I do want to tell you how impressed I am with the staff that you have. They have a lot of perspective and they are very concerned people who work very hard, and I think we communicate probably once a week to stay connected about what is going on out in the field.

I come to you today from the front lines of tax administration. Just like most other tax practitioners, we don't just deal with filing tax returns. We deal with every aspect of the IRS, and some of us even have to go into U.S. Tax Court to get relief.

My goal here today is to make you guys feel connected with the American taxpayer, and so what I am going to try to do is just laser focus on one concept and give you a handful of cases that are actually live cases now, that are not closed, to show you the kind of problems that we are facing.

First off, filing season has ultimately been excellent, and we compliment the IRS and tip our hat. They are really doing a fine job. There are some nitpicking things that we can talk about, but by and large, our Members have not complained about it. We have done surveys and we are very satisfied with it.

The problem that we have is with post-season, post-filing problems. What we have discovered is, first of all, there is a lack of access to the IRS. You heard it discussed earlier today. Offices have closed. The reorganization has made it impossible for us to deal with people face-to-face. All the relationships that we used to have, where we had credibility as a practitioner to solve many taxpayer problems, are gone. We are dealing with people across the country, well-meaning, perhaps, but the situation is different and we are very unhappy about not only our relationship but their ability to solve problems.

What we have discovered is that middle management has not bought into the service concept of the IRS. When this Committee went along with the Senate Finance Committee and adopted my recommendation to change the mission of the IRS to service, I had made another recommendation that you had adopted and that had to do with education. Training programs are critical to the success of delivering service to the American public.

I am talking to you as a person who has a doctorate in the educational process, and I am here to tell you that the IRS's educational system is totally flawed. It is being run by middle management, middle managers who know nothing or very little about the educational process. In addition to that, many middle managers haven't bought into the service mission. So, you have well-meaning

people at the top thinking they are doing a great job, but it is not being translated at the lower level.

I think the educational process needs to be brought back into Washington. Experts in the field of education, people knowledgeable about tax administration need to develop a sounder education program and then put it out to the rest of the country.

The IRS agents on the phone, from my perspective and the perspective of many of our Members, are not willing to solve problems. They don't want to take on cases. They just want to move the cases. Let me give you just a few examples just to show you.

We have a woman by the name of Pat T. I won't give you her last name. Eight years ago, an IRS agent prepared seven tax returns for her. She was entitled to the EITC. He didn't give it to her. She had a tax debt for those 7 years hanging over her head—this woman makes less than \$10,000, has a kid, on welfare—she had a \$5,000 debt that is now over \$20,000. Eight years later, the IRS is now doing enforced collections to try to get the money from her, and I am trying to work with the Taxpayer Advocate Service to get them to realize they made a mistake to begin with.

Another person, Larry C., his company failed. He owed taxes as a responsible party. Another one of his partners paid off all of the taxes, but there is interest remaining that accidentally wasn't wiped off the books. I can't fix that problem. I talked to an IRS agent who said, on the phone, they knew what the problem was, they knew how much money had been paid, they told me that I had to file a Form 843 with the service center and close the case, which means this person could have solved the problem, and now I have to go to a service center to some unknown person who may or may not want to move the case.

There's another case where a salary is levied. I called the Practitioner Priority Service. Please lift the levy. Lo and behold, they lifted the levy for me to allow me some time to work out the case, gave me 2 months. Two weeks later, the levy is back on. The man is in my office crying. He is going to lose his job because his boss doesn't want to deal with the IRS and the levy. I called the IRS. "Oh, my God, we don't know how this levy got on. It was an accident."

I just wanted to make you feel connected. I will be happy to respond to many of those other questions. Incidentally, on your way back to Corning, if you want to make a right-hand turn and come out to Long Island, I would love for you to come and see what a battlefield really looks like.

[Laughter.]

[The prepared statement of Mr. Stevenson follows:]

Statement of William Stevenson, President, National Tax Consultants, and Chairman, Federal Taxation Committee, National Society of Accountants, Alexandria, Virginia

Good morning, Mr. Chairman and members of the Committee. My name is William Stevenson. I am the chairman of the National Society of Accountants Federal Taxation Committee. I am an Enrolled Agent and President of National Tax Consultants, based in Merrick, New York.

NSA and its affiliated state organizations represent approximately 30,000 accountants, tax practitioners, business advisors and financial planners providing services to more than 19 million individuals and small businesses. Most NSA members are sole practitioners or partners in small- to mid-sized firms. NSA members

agree to adhere to a code of ethics and professional conduct. NSA members are the champions of small business as we represent 20–25% of the small businesses in the United States.

We appreciate the opportunity to testify before the Committee to share our views on the 2003 filing season and on tax administration issues of importance to practitioners.

THE 2003 FILING SEASON

I am pleased to report that we have had a smooth filing season in 2003. E-filing went well with no significant delays in processing returns and issuing refunds. The service campuses performed well. Indeed, the NSA national office received few complaints of any kind regarding the filing and processing of returns this season. On behalf of NSA members and the tax practitioner community at large, I congratulate the IRS for a job well done. The Congress did its part too and I wish to express our gratitude for not passing any tax legislation with effective dates retroactive to 2002 during the tax-filing season!

Although the filing season went well, that does not mean all is well in the area of tax administration. The IRS does a very good job in processing millions of routine forms and documents. Where NSA encounters significant problems is in the post-filing environment—dealing with small business and individual taxpayer problems such as IRS notices, levies, and audit issues, to name a few. Tax practitioners repeatedly cite the current difficulty in accessing IRS decision makers who are willing to take responsibility for a case in order to solve it in an expeditious manner. We also see a critical need for additional training for IRS personnel to improve their ability to serve the American taxpayer and administer the tax system. These problems are not insurmountable but they must be addressed expeditiously if the IRS is to become the world-class agency Congress envisioned when it passed the IRS Restructuring Act of 1998.

LACK OF ACCESS TO THE IRS

Part of the current access problem stems from the IRS reorganization. The need for the IRS to organize along business lines is not at issue. However, it appears that IRS senior management has yet to obtain the necessary buy-in from middle managers in the operating divisions to make the reorganization an actual success.

One unfortunate consequence of the reorganization was to break up longstanding relationships between practitioners and IRS managerial employees. Before, practitioners knew whom to call to solve a problem. This is no longer the case and building new working relationships is proving to be difficult.

We hear complaints by many IRS employees that they do not know how much authority they have, what their role is, or who they can turn to within the IRS to solve a taxpayer's problem. Many employees fear that they will be criticized for making decisions and accepting responsibility. We continue to see a disconnect between the national office and field offices in the communication of new policies and procedures. Under the new structure, solving all but the easiest of taxpayer problems is becoming increasingly difficult.

The results of inadequate access and poor communications are chaos and confusion. Here is a real life example. A taxpayer received a collection notice (CP 504) for a tax year that was part of an offer-in-compromise accepted by the IRS two years ago. An IRS employee working in the Automated Collection System (ACS) advised the practitioner handling the case that the Taxpayer Advocate Service (TAS) will need to resolve the problem. The practitioner contacted TAS and was informed that one of the two centralized offer processing centers will handle the case. The practitioner informed the TAS employee that the offer was accepted by the IRS before the creation of the centralized sites. The TAS employee responded that it might be necessary for the original revenue officer handling the case to resolve the problem. The practitioner asked what if that revenue officer is no longer with the IRS? The practitioner was placed on hold until the TAS employee found someone who might be available to handle the case. The TAS employee returned to the line and gave the practitioner the name of someone who could help, but unfortunately, that person was out of the office until the following week. The TAS employee opened a case file so no accidental levy would take place.

Later, the ACS worker's supervisor contacted the practitioner and said that this erroneous notice case would not be handled by the TAS after all but would go to one of the centralized offer centers. The practitioner explained, once again, that the offer was accepted prior to the formation of the centralized sites and that the original revenue officer may not be able to handle the case. The supervisor stated that the practitioner should not worry because a hold is placed on the account and no levy will occur. The practitioner responded that no account could exist because the

accepted offer wiped the slate clean. After all of this activity and wasted time, the practitioner was no closer to getting the problem solved than at the outset. More importantly, the resolution of the problem—an erroneous account making wrongful enforcement measures possible—has not occurred and the practitioner is not being informed by any IRS or TAS personnel of any steps being taken to resolve the problem.

Chaos and confusion will continue until IRS senior management clearly defines the duties and responsibilities of field personnel and IRS employees are trained and empowered to resolve cases at the lowest possible level as envisioned by then Commissioner Rossotti.

We were encouraged by the remarks of Mark Everson, nominee for Commissioner of Internal Revenue, at his confirmation hearing before the Senate Committee on Finance on March 18, 2003. Mr. Everson stated:

“In order to realize the full benefits of the '98 Reform Act, line managers and employees at all levels must fully embrace the changes which began under Commissioner Rossotti.”

We hope that improving internal IRS communications, developing clear lines of authority and responsibility and employee empowerment will be top priorities of the next commissioner.

TRAINING

We see a widening training gap at the IRS. NSA members deal with IRS personnel on a daily basis. Increasingly, we experience instances where IRS employees lack the expertise and skills to handle difficult, problem cases. Complex problems are shoved to the side. Often, the only way to get action on a case is to take it to the Taxpayer Advocate Service. This bogs down the TAS system and is a source of aggravation and concern to both taxpayers and practitioners who have hardship cases that should receive the undivided attention of TAS personnel. The resulting confusion erodes confidence in the tax system.

Unfortunately, over the years, IRS training budgets have been slashed to deal with other funding problems. We ask that Congress reverse this trend and provide adequate funding to support critical training programs. Without adequate training, all the funds invested in systems modernization will be wasted.

Also, NSA has grave concerns over the manner in which the IRS program of employee training has evolved. The IRS should introduce a concentrated training program, developed by experienced educators and implemented by individuals who understand and embrace the new IRS structure. The program must be supported, coordinated and directed from the highest levels of IRS.

IMPROVING ACCESS

Many access issues would be resolved if IRS would publish an on-line directory of IRS phone numbers for use by practitioners. The IRS has promised an on-line service for sometime now, but has yet to deliver. The need and importance of this directory information was well documented by the National Taxpayer Advocate in her 2002 report to Congress. We understand that IRS is working on this application and we encourage this effort. But it needs to come on-line quickly.

FIRST CALL PROBLEM RESOLUTION

Another opportunity is for the Service to empower its employees and adopt a policy of “First Call Resolution.” Such a program would lead to more timely problem resolution, improve IRS employee job satisfaction and lessen practitioner reliance on other tools, such as collection due process hearings. The IRS could model its program after any number of systems operated by complex organizations in the private sector.

Here is a real life example of how a “First Call Resolution” program could resolve a problem. One of my clients, a responsible party in a failed business, received a notice of taxes, penalties and interest now personally owed. After contacting the ACS, I learned that one of the other responsible parties in that failed business had previously paid the debt in full. The problem was that IRS records were not properly updated and between \$10,000 and \$15,000 of interest remained on the IRS books, hence the notice to my client. The ACS worker informed me that this was an unusual situation and that I needed to file a claim (Form 843) with the appropriate service campus to resolve the problem.

In this situation the ACS worker recognized the problem, understood the problem, knew how to fix the problem, but did not have either the authority or willingness to do so. A “First Call Resolution” program would have enabled the ACS worker to fix the problem. Now, I am at the mercy of an anonymous service campus employee

who must start at square one to understand the problem and then, hopefully, will take appropriate action to resolve the issue. Under present practice, accountability for problem resolution is non-existent.

CONCLUSION

We commend the IRS for a successful 2003 tax-filing season. However, much work remains to be done in the post-filing tax administration environment. To improve this stage of tax administration, NSA recommends the following:

1. Senior IRS management needs to secure the buy-in of middle management and rank-and-file employees on the need for and benefits of IRS restructuring.
2. IRS must revamp its employee training process. Programs should be developed by trained educators and taught by IRS staff dedicated to the new structure.
3. Congress should provide adequate funding to support state-of-the-art training for IRS personnel.
4. IRS should complete work on the directory for practitioners as soon as possible.
5. IRS should empower its employees and give them the tools and responsibility to resolve problems as early in the process as practical and adopt a policy of "First Call Resolution" to expedite problem resolution.

NSA believes that these steps will start the IRS toward a post-filing tax administration system that will meet with the same success as its filing season administration.

This concludes my remarks. Thank you, Mister Chairman.

Chairman HOUGHTON. Well, thank you very much. I might just do that. Thank you. We will get to the questions afterward. Ms. Hill?

STATEMENT OF CLAUDIA HILL, GOVERNMENT RELATIONS COMMITTEE, NATIONAL ASSOCIATION OF ENROLLED AGENTS, GAITHERSBURG, MARYLAND

Ms. HILL. Mr. Chairman and Members, I am representing the NAEA. I am Claudia Hill from Cupertino, California. I am an enrolled agent, and I am a return preparer. My firm will prepare over 1,100 returns this filing season for individuals, small businesses, estates, trusts, gift tax returns. Almost half of those, we filed electronically. We work directly with taxpayers wishing to voluntarily comply with their annual filing rituals.

Overall, this filing season has gone very smoothly, but every year as filing season approaches, I get prepared to hear my clients' annual litany of commentary on the fairness of the tax system and what other people get away with.

Last filing season, for example, a client called to let us know that she wouldn't be needing the return we prepared for her, and she asked if we would discount our fee. She complained to her brother-in-law about how much taxes she was having to pay and he volunteered to prepare her return for her using software he had purchased, and he assured her that when he finished, she wouldn't owe any taxes.

Although this is just one obvious example of a client choosing not to volunteer last year, it was not the only challenge to our role as preparers in a voluntary compliance system. I am asked by my clients constantly, how will IRS know about this money? Is it true IRS isn't doing audits anymore? These situations are played out in tax preparation offices throughout this country this time of year, and to me, they bring home quite vividly the meaning of declining enforcement statistics.

It is a good thing most taxpayers aren't aware of the significant areas of noncompliance in reporting income that exists or the significant and growing backlog of collection cases involving individual taxpayers who know their tax liabilities and simply do not pay them. Currently, over \$13 billion in delinquent tax liabilities are going uncollected because IRS cannot continuously pursue every taxpayer with an outstanding liability.

The NAEA strongly supports the efforts that focus attention on serious compliance issues such as these and promotion of abusive shelters, misuse of devices such as trusts and offshore accounts, and corporate tax avoidance schemes, underreporting of income, and failure of employers to file and pay over employment taxes. While such activities go unchecked, honest taxpayers wonder whether they are being chumps for paying more than their fair share.

There are three key proposals in the budget proposed that are aimed at improving the fairness of the tax system and addressing compliance and collection issues. The first proposal focuses resources on high-income taxpayers and businesses in areas where noncompliance is likely to be greatest. The second proposal permits private collection agencies to support IRS collection efforts, and the third proposal strives to improve the effectiveness of EITC.

Generally, we applaud these new proposals. We believe to ensure fair and effective enforcement of the laws is essential to the perception of fairness in the system. Stable funding for the IRS is essential to permit them to focus their attention on the most serious compliance problems. However, we have reservations about the proposal to permit private collection agencies to collect tax debt. We encourage efforts to focus on those taxpayers who choose not to file returns.

About a decade ago, IRS promoted a non-filer initiative with strong threats of consequences for those that didn't come forward. Although many were brought into the system at that time, we have once again seen IRS become lax in following up on taxpayers who they know have not filed taxes and/or who have vastly under-reported their income.

As an active observer of our tax system for almost 30 years, I cannot understand why IRS would turn their backs on the highly cost-effective document matching programs and non-filer substitute for return programs. In efforts to reallocate resources to other customer services, IRS has done a disservice to those who consistently file and pay their taxes. The IRS must be given the budget to support continuing and consistent enforcement of tax laws. Honest taxpayers need to know there are consequences to noncompliance.

I have additional comments on IRS communications with taxpayers and tax professionals. Acting Commissioner Wenzel reported just recently that for fiscal year 2002, IRS compliance work involved more than 11 million contacts with taxpayers. When it comes to IRS contacts with taxpayers, many of them result in requests for tax practitioners to intervene. The IRS Practitioner Priority Support Services is an essential tool in that intervention effort. It is cost effective and it allows us to resolve problems at the lowest administrative level. However, recent tinkering with that system is causing us to have problems.

Recently, the system switched from a regional routing to a national routing. Our Members' experience has not been good to date on this. There are many instances where, on a national basis, a phone call can lead to several different locations. In resolving one problem recently, I contacted Ogden, Philadelphia, and Memphis all in one attempt to resolve one issue because none of them could get back to the center that started and needed additional information.

Our Members have a similar complaint when it comes to national routing of the automated collection system. If the IRS is concerned by national routing as the most efficient way to use their toll-free telephone resources, I can assure them that practitioners would be glad to pay for the telephone calls if it would actually be routed to the center where they had previous contact and needed to provide additional information that would resolve the account.

It also seems incongruous to me that the IRS Internal Investigation Division would focus on return preparer fraud deterrence and enhancing compliance in the preparation return industry, at the same time the IRS electronic tax administration is rushing to offer what could be access to information that would be an identity thief's dream come true.

In its zeal to meet the Congressionally mandated e-filing returns by 2007, IRS again has let the ends justify the means. The history of IRS e-filing has been replete with this. At this point we are much concerned with the proposal to offer e-filing services to any electronic return originator (ERO) that would give them access to taxpayer accounts that indicate bank accounts and brokerage account numbers on them.

Thank you for your concerns. I would be glad to address any further questions.

[The prepared statement of Ms. Hill follows:]

Statement of Claudia Hill, Government Relations Committee, 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 Claudia Hill, EA from Cupertino, California and I am a member of NAEA's Government Relations Committee. I am a tax return preparer. My firm will prepare over 1,100 individual, small business, estate, trust and gift tax returns during this filing season. As one who works directly with taxpayers wishing to comply with their annual filing rituals, I know it is important that hearings such as this take place so that concerns and frustrations of America's taxpayers can be heard.

Today, I am representing the National Association of Enrolled Agents whose 10,000 members are tax professionals licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the Internal Revenue Service.

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. Like attorneys and Certified Public Accountants, Treasury Circular 230 governs us in our practice before the Internal Revenue Service. We are the only tax professionals who are tested by the IRS on our knowledge of tax law. 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.

IRS Filing Season Readiness

Filing season began even earlier this year than last year. We had reports of members starting the process as early as January 3. We attribute this phenomenon to a couple of factors: taxpayers seeking early refunds and increased use of electronically generated W-2s by businesses.

Overall, tax season has run very smoothly. We are particularly pleased with the wealth of information and resources made available to the public through the IRS Internet web site, www.irs.gov. This season IRS has also been pro-active in release of news alerts to practitioner groups in a way that leverages the efforts of those of us in the preparer community.

For example, publicity has been given to tax frauds and schemes via coordination information from the Department of Justice about prosecutions of tax evaders as well as fraudulent preparers. Publicizing the convictions of promoters has been very helpful to practitioners who find they are dealing with clients considering inappropriate or abusive techniques to avoid their tax responsibilities. This information is vital to maintaining taxpayer confidence in our system of tax administration and we strongly encourage the continuation of this effort.

There have been very few glitches. Among those few were:

- (1) Problems with the automated refund hotline and refund inquiry web site indicating when refunds would be deposited in bank accounts. Although this enhancement in availability of refund information is much welcome, it was very troubling to taxpayers and practitioners who relied on the technology. IRS managed to get things stabilized by March 1.
- (2) Many tax preparers, public libraries and volunteer tax clinics rely on IRS provided forms reference books annually (Package X) to assist them during filing season. Volume 1 of Package X came out January 3 but Volume 2 did not appear in mailboxes until mid to late March. Reports are that some forms, like the new Form 8880, Retirement Savers Credit, were missing. The IRS CD-ROM was also late. We attribute both the delay in Package X and the CD-ROM to the possibility of late tax legislation.
- (3) The paper IRS E-file Handbook (Pub 1345), a required reference for electronic filers, did not arrive until as late as March 27th. E-filing demand peaks by the second week of February. This did not inspire confidence in tax practitioners new to e-filing.
- (4) We had reports that clients whose returns were e-filed and had scheduled automatic payment withdrawn for their IRS tax bills were sent letters stating that they owed the amount that was supposed to be withdrawn automatically. This could have been merely a confirmation letter. However, it was confusing to taxpayers who misread the letter and paid. The IRS still withdrew the automatic payments, so taxpayers paid twice. This will need to be straightened out after filing season.

IRS Budget Request

We are aware that Congress is considering the President's budget proposals requesting \$133 million in new funding for audits and other law enforcement work. Over all, the IRS would receive \$10.4 billion, a 5.25 percent increase, but still less per tax return, after adjusting for inflation, than it got five years ago.

The IRS has identified the following as some of the most serious compliance problem areas:

- (1) the promotion of abusive tax schemes;
- (2) the misuse of devices such as trusts and offshore accounts to hide or improperly reduce income;
- (3) the use of abusive corporate tax avoidance transactions;
- (4) the underreporting of income by higher-income individuals; and
- (5) the failure by employers to file employment tax returns and pay large amounts of employment taxes.

NAEA strongly supports efforts that focus attention on these areas of noncompliance. While such activities go unchecked, honest taxpayers wonder whether they are being chumps for paying more than their share.

There are three key proposals in the budget aimed at improving the fairness of tax administration and addressing the compliance and collection issues. The first proposal focuses resources on high-income taxpayers and businesses in areas where noncompliance is likely to be greatest. The second proposal permits private collection agencies to support the IRS's collection efforts while affording full protection of taxpayer rights, allowing the IRS to devote resources to more complex enforcement and collection issues. The third proposal strives to improve the effectiveness

of the Earned Income Tax Credit (EITC) program by ensuring that benefits go to those who qualify for them.^[i]

Generally, we applaud these new proposals, because we believe a comprehensive strategy to ensure fair and effective enforcement of the tax laws on the part of the Treasury is essential to the perception of fairness in the tax system. Stable funding for the IRS is essential to permit them to refocus their attention on the most serious compliance problems, aggressively combat abusive tax avoidance transactions and schemes, and better detect new areas of non-compliance.

However, we have strong reservations about the proposal to permit private collection agencies to collect tax debts. The opportunities for disclosure of taxpayer information combined with the potential for aggressive collection approaches inherent in a bounty-incentive approach runs counter to the protection of taxpayer rights.

We encourage efforts to refocus on those taxpayers who choose not to file returns. About a decade ago, the IRS promoted a non-filer initiative, with strong threats of consequences for those that did not come forward. Although many were brought into the system at that time, we have once again seen IRS become lax in following up on taxpayers they know have not filed or have vastly under reported their income.

As an active observer of our tax system for almost 30 years, I cannot understand why IRS would turn their backs on the highly cost efficient document matching programs and non-filer/substitute for return programs. In efforts to re-allocate resources to other customer services, IRS has done a dis-service to those who consistently file and pay their taxes. IRS must have the budget support to make their tax compliance activities once again have a presence in people's lives.

Honest taxpayers need to know there are consequences to non-compliance.

The Offer in Compromise program

Since the adoption of Policy Statement P-5-100 in 1992, the IRS has struggled with the design and administration of the offers-in-compromise program. In recent years, the volume of applications for offers in compromise has increased enormously, as have the frustrations of practitioners representing taxpayers in the process. This year it ranked as one of the "Most Serious Problems" encountered by taxpayers in the FY 2002 Annual Report of the Taxpayer Advocate Service.

Pursuant to the IRS Restructuring and Reform Act of 1998 (P.L. 105-206), the IRS is required to develop employee guidelines for determining whether a proposed offer in compromise is adequate and should be accepted to resolve a dispute. The guidelines must include national and local allowances (standards) under which the IRS must determine basic living expenses of the taxpayer. However, the IRS must determine, based on the facts and circumstances of each taxpayer, whether use of the standard allowance is appropriate.

The standards are not to be used if they would deprive a taxpayer of adequate means to provide for basic living expenses.^[ii] Temporary Reg. § 301.7122-0T and Temporary Reg. § 301.7122-1T were issued by the IRS to comply with these requirements. Temporary Reg. § 301.7701-1T(a) provides that the grounds for compromise may be based on doubt as to collectibility or doubt as to liability.

The effectiveness of the OIC program is being severely undermined in certain cases by the manner in which it is being implemented.^[iii] Although compromise based upon effective tax administration ("ETA") grounds is still relatively new, and final regulations on ETA were only issued in July of 2002, the ability of taxpayers to compromise on these grounds is being frustrated by a lack of clear policies concerning the processing of ETA offers. The final ETA regulations did not provide a meaningful indication of what kinds of cases have a chance of succeeding on ETA grounds. The continuing lack of guidance in this area has brought an already slow and cumbersome process to a standstill, with little willingness to even consider making a pro-taxpayer decision by IRS personnel.

For over a year, the IRS has worked to develop an OIC user fee proposal. The purpose of the OIC user fee would be the same as the purpose of the installment agreement user fee: to defray the administrative costs associated with providing a specialized service to a limited segment of taxpayers. The Office of Management and Budget (OMB) and the Department of Treasury have approved the IRS's proposed user fee regulations for offers.

^[i] Id.

^[ii] Code Sec. 7122.

^[iii] Statement of Robert E. McKenzie on behalf of the American Bar Association Section of Taxation, IRS Oversight Board Hearing, Washington, DC January 27, 2003. Panel 3: Effective Collection Strategies. The complete testimony can be found at www.abanet/tax.org.

The proposed fee is \$150^[iv] Most taxpayers who submit an offer would pay the proposed fee. However, when a taxpayer is at the poverty level or is applying under doubt as to liability the fee will not be charged, or will be refunded to the taxpayer if their case successfully meets effective tax administration criteria. NAEA continues to oppose such user fees generally, and is not able to reconcile the reasoning behind imposing an additional fee on taxpayers who are currently in such financial straits they are not able to pay the tax. It seems to simply compound the problem, not contribute to a solution.

IRS communications with taxpayers & tax professionals

On March 21, 2003, Acting IRS Commissioner Bob Wenzel issued a statement on compliance results and activities for Fiscal 2002. In terms of compliance activity, fiscal 2002 may be a sign of changing times at IRS. Revenue from IRS collection activity increased to more than \$32 billion, reaching the highest level in eight years.^[v] Overall, Wenzel observed that IRS compliance work involved more than 11 million contacts with taxpayers in 2002.

When it comes to IRS contacts with taxpayers, many of them result in requests for practitioners to intervene. Those practitioners who have used the former Practitioner Hotlines and the new Practitioner Priority Service (PPS), know that it has been an essential tool in resolving taxpayer issues at the least expense to the taxpayer, quickly, and at the lowest administrative level. However, just as we are learning to work with the new system, IRS has started “tinkering” with the process.

Recently the PPS system switched from “regional” routing of calls to “national” routing. Our members’ experiences with national routing to date have not been positive. It seems that all the technology and training is not in place to allow access to the full variety of account inquiries that come in on a National basis, nor is the ability to transfer calls to the sites that are able to handle site-specific issues. The change from regional to national was expected to reduce hold times, but having a phone answered quickly is not always the same as resolving an issue quickly. Let us hope IRS reconsiders how this one should be administered.

With IRS attempting to collect more unpaid taxes, we are seeing an erosion of the kinder, gentler IRS we have been hearing about in recent years. To cite just one example, several members have told us that when they have contacted the Practitioner Priority Service (PPS) about a client with a balance due, the PPS Customer Service Representatives (CSRs) appear to be taking on the role of collection officers seeking levy sources if the taxpayer’s account shows a balance due. In fact, most account related issues practitioners call about do involve a balance due; often an incorrect one, and that is why they make the call. This line of questioning is a significant departure from the friendly, information-providing, problem-solving approach we have come to appreciate.

Although practitioners often see their role as being a buffer between the taxpayer and the Service, that role still focuses on assisting the taxpayer in resolving their tax obligations. This new policy will hinder case resolution if practitioners become reluctant to call PPS, fearing it will speed up enforced collection efforts or otherwise cause harm to their clients.

Practitioner Priority Service is a program IRS benefits from as well, leveraging the resources of practitioners who are able to assist taxpayers with account resolutions or in coming back into the tax system and confronting their tax deficiencies. Practitioners are able to obtain needed information and chart a plan to remedy their clients account discrepancies or work out payment arrangements without fear of creating more imminent problems for the client. However, if the “levy source” line of questioning continues, practitioners will not utilize this resource, and both IRS and taxpayers will suffer.

While on the subject of the Practitioner Priority Service, let me say that many members have expressed the view that IRS employees continue to strive to provide excellent service but run into systemic roadblocks. For example, since PPS is primarily a “call in” site, accommodations are not routinely made to allow CSRs to “call out” to follow-up on accounts that need that additional level of service. To circumvent this problem, IRS employees are giving up their lunch hours and breaks to call us back so we can close the loop and resolve issues more quickly. There really needs to be some kind of call back mechanism built into the system.

Our members have a similar complaint when it comes to national routing and the Automated Collection System. Those cases, even more frequently, require more than one contact. If IRS is concerned that national routing is most efficient utilization

^[iv] News Release IR-2002-118—IRS Proposes User Fee For Certain Offer-In-Compromise Request and Frequently Asked Questions

^[v] IRS Data Book for Fiscal Year 2002 (IR-2003-38; Publication 55-A)

of their toll-free telephone access system, I can assure them that practitioners would be glad to pay for the telephone call if it would actually be routed to the center where they had previous contact and needed to provide additional information that would resolve the account.

Third Party Authorization & E-Services for Tax Professionals

NAEA supports increasing the number of tax returns filed electronically and understands that incentives to those in the tax industry, particularly tax return preparers, are needed to achieve the electronic filing goals established by Congress. The “e-services” program for practitioners fosters this goal and has, within its scope, many opportunities beneficial to practitioners in serving their clients.

Over the last two years IRS has expanded the types of access they offer well beyond that afforded with the traditional Form 2848 Power of Attorney and Form 8821 Taxpayer Information Authorization. Electronic return filers are provided limited authorization with the Form 8453, 1040 returns now have “third-party designees” and Oral Tax Information Authorization^[vi] (OTIA) can be used to allow a taxpayer to call IRS and establish disclosure authority for all types of tax accounts.

The issue of limitations of practice, access to taxpayer information and expansion of third party authorizations should be of concern to those who place a high priority on protection of taxpayer information as well as those who have studied, taken tests and earned designations recognized by IRS and the public as qualified to represent taxpayers. While IRS is charged with protecting the confidentiality of taxpayer information, they are also expected to make whatever accommodations they legally can to reduce taxpayer burden in allowing for assistance in resolving tax related matters. NAEA is concerned that the trade-off to rapidly expand access be tempered by imagining the field day identity thieves would have if given access to the third-party information reports IRS provides by social security number and account number listing.

It seems incongruous that while the IRS Criminal Investigation Division focuses on return preparer fraud deterrence and enhancing compliance in the return preparer community, the IRS Electronic Tax Administration will rush to offer what could be access to information that would be an identity thief’s dream come true. In its zeal to meet the congressionally mandated 80% e-filed returns by 2007, IRS has once again let the ends justify the means. The history of IRS e-filing is replete with shortsightedness in this regard. If one goes back to the origination of the program in the late 1980’s, we find that refund anticipation loans were seen as the draw that would create the market demand for electronic services. They certainly did, and today we view these extremely high interest rate loans, as an onerous mechanism to take entitlement money out of the pockets of low-income, working taxpayers.

Our current concern: In an effort to reward electronic filers, IRS has announced an intention to expand “*e services for the third-party community*” defined as “web-based products that allow practitioners to interact with the IRS electronically.” “*e-services*” are expected to include, “disclosure authorization, electronic account resolution, transcript delivery system, and TIN matching.”

The system is envisioned to allow authorized practitioners to electronically submit Power of Attorney and Tax Information Authorization forms over the Internet. The user may also review, revoke and modify authorization records online. It would allow authorized practitioners to submit account related inquiries for their clients’ individual and business accounts and support payment tracing, complex refund analysis, installment agreements, notice resolution and account problem resolution. It would provide request and delivery of the following information items: account transcripts; return transcripts, records of account, wage and income statements, and verifications of non-filing.

Access to such information and ability to more quickly resolve client problems sounds like a beneficial service to all practitioners admitted to practice before IRS. However, IRS intends to “authorize” this service initially to a very select group of return preparers—those that are enrolled in the electronic filing program and who file a minimum number of returns online. This leaves out most attorneys, CPAs, and many Enrolled Agents. Yet, makes such services available to return preparers least likely to be qualified to represent taxpayers in the first place. Unless those return preparers are also “authorized to practice before IRS,” this suite of “e-services” will see very limited usage. Moreover, those who would use it most will not be able to access it.

^[vi] Disclosure of returns and return information to designee or taxpayer and oral tax information authorization is discussed in Temp. Regs. Sec. 301-6103(c)-1T.

To qualify for this enhanced level of access to account information would only require the preparer to be an Electronic Return Originator who has filed 100 returns. According to a report by the Treasury Inspector General for Tax Administration, "E-File Providers Are Not Adequately Screened" in June 2002:

"Our review identified that the IRS does not have effective screening procedures to adequately determine who should be allowed to participate or to continue to participate in the e-file program. Specifically, we found that the IRS does not independently validate age and citizenship requirements. Our analysis of IRS data identified e-file providers who were not United States citizens, were under the age of 21, or were identified as deceased. In addition, screening checks publicized to the taxpaying public as being extensive were found to be limited primarily to whether an individual filed tax returns and paid taxes due. For those individuals that file electronic tax returns as part of IRS's volunteer income tax preparation program, no checks are performed. We also identified that for those limited number of individuals selected for a criminal background check, 60 percent of the individuals received authorization to participate in the e-file program before results from the Federal Bureau of Investigation (FBI) were received and analyzed by the IRS. Finally, testing found that once individuals are authorized to participate in the e-file program, no subsequent non-tax related screening checks are performed to ensure these individuals continue to maintain a high degree of integrity and adhere to the highest professional and ethical standards."

NAEA is concerned about unauthorized disclosure of taxpayer information and the disclosure of tax account information to persons not authorized to represent taxpayers before the IRS. In this regard, many EROs' activities are limited to return preparation; a great number engage in this endeavor during the filing season only. They have no training or education equipping them for tax practice and are not eligible to so practice. Hence, much of the information that would be made available to them would serve no valid purpose, would not be helpful to taxpayers, and/or would be counterproductive to effective and efficient tax administration.

We believe adequate safeguards have not been placed into this program. In view of this, we recommend that this aspect of e-services be broken into two sections: Section One would allow all participating EROs (1) to apply for EINs for taxpayers who have executed the third party authorization on Form SS-4 and (2) to resolve processing issues on returns where the "check-box" authorization has been executed. Section Two would allow access to all other account information only to EROs who meet the eligibility to practice requirements and who have been authorized by the taxpayer to receive such information.

As a result and in view of the sensitivity of the information that would be made available, it is our belief that access to Section Two information documents should be limited to credentialed practitioners, i.e. attorneys, Certified Public Accountants, and Enrolled Agents.

We are particularly distressed that many Circular 230 practitioners who do not engage in tax preparation work will be denied access to e-services because they only do representation work. This strikes us as inherently unfair and counter productive to what should be a mechanism to assist *all* taxpayers in resolving account related problems at the least expense.

The Impact of Tax Law Complexity on IRS Employees

As we have told you in past years, we believe that tax law complexity is an area that requires your attention as it affects IRS employees and we respectfully urge you to press for simplification of the tax code. As we have reviewed proposals currently under consideration, our great fear is that you will fail to consider the administrative difficulties of implementing the changes before you pass on the legislation. If taxpayers (and their preparers) cannot understand the law, they are not likely to comply with it.

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, we believe Congress could provide significant relief and make the job of IRS employees easier by making immediate changes in three areas. First, Congress needs to repeal or dramatically restructure the alternative minimum tax (AMT) for individuals. Second, phase-outs and phase-ins (such as those for IRA contributions, education incentives, child credit, itemized deductions and personal exemptions) need to be standardized. Finally, the rules for qualifying for the Earned Income Tax Credit need to be streamlined.

Once again, the Alternative Minimum Tax is providing nightmares to taxpayers and practitioners. Here is a representative sampling of what our members say:

- From a California EA: I am seeing so many people with small/large AMT taxes due to the disallowance of state income, real and personal property taxes. Since there have been almost no changes to the AMT exemptions or rules since 1986, could something be done to alleviate this problem before next year?
- AMT is hitting quite a few of my clients this year—middle class taxpayers it was never intended to hit: senior citizens with a once in a lifetime bonanza of selling property that they've sat on for 45 years, low income folks with inherited stock, and middle class managers with bonuses. Not only are they hit with AMT, they lose Schedule A deductions and personal exemptions. They don't get to take their rental losses. AMT should be abolished or adjusted for the times. "Stealth taxes" should be abolished in favor of honest tax rates.
- I personally prepare over 1200 tax returns per year and I am seeing an increasing incidence of the AMT being applied to the workforce and adversely affecting them in a way that I do not believe was the intent of the law. Employee business expenses are NECESSARY expenses incurred for conducting one's employment. Outside sales persons are particularly hard hit when their expenses for travel already take a significant portion of their income. The employee is required to incur job related expenses to earn the income yet they are forced to absorb the equivalent of 2% of their AGI before any deduction can be claimed, and then the amount claimed cannot be taken for AMT purposes so often they lose the benefit completely.
- More families with children are seeing the AMT this year since the personal exemption amount of \$3000 per person is not allowed against AMT. Even with "normal" amounts of state & local property taxes itemized on Schedule A, we are seeing a much higher percentage of middle-income filers with AMT.

Since most self-prepared returns do not calculate the AMT, IRS ends up sending change notices to affected taxpayers. On the more complex cases, IRS does not have the information on the return to calculate the correct AMT, so those taxpayers benefit from the complexity. Changes to these three areas would provide significant relief to taxpayers as well as allow the IRS to free up compliance resources within the agency for other purposes.

Conclusion

Mr. Chairman and members of the subcommittee, I am pleased to have been able to share with you our members' views of 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. Thank you very much. I just have a series of questions. The first one, I think, is Mr. McKenzie and Ms. Hill have talked about the outside collection systems and they worry about it. Could you add a few additional comments about that?

Also, as far as Mr. McCormally is concerned, it is pretty frightening, isn't it, to think that half the employees in the IRS are eligible to retire in 3 years. Then, also, Mr. Stevenson, in terms of the training, what do you suggest we do, just bring it back to Washington or what? So, maybe each of you would like to comment on those. Do you want to start, Mr. McKenzie?

Mr. MCKENZIE. Yes. The outsourcing, again, we think it could work, but we have noted to State agencies, and myself in particular, I have dealt with agencies all over the country. I have written a book on how to represent people in collection matters and I do it every day, and I found that not all the private collection agencies are very concerned about individual rights. On many occasions, I have had to invoke the procedures of the Fair Debt Collection

Practices Act (P.L. 90-321) to protect my clients from overly aggressive State collection agencies.

So, again, we think we need more efforts to collect. It is unfair that many people file their returns and don't pay them, and I applaud the efforts to look to outside collection. If we are going to do it, let us make sure that all the protections are in place before we allow an outside collector to call and abuse an American taxpayer.

Chairman HOUGHTON. Is that possible, all the collection procedures are in place? Obviously, there are going to be some glitches along the line here. What are the fundamental things that you worry about most?

Mr. MCKENZIE. Well, somebody calling and demanding the money repeatedly from the taxpayer without telling them their rights under the Fair Debt Collection Practices Act. We have the requirement that the IRS give each taxpayer a Publication 1 and tell them of their rights. If we are going to have private collectors calling on the phone, they should, before they even begin any interview with the taxpayer, have to give a full range of rights to the taxpayer, including the right to decline to discuss the matter with that collection agency as required by the Fair Debt Collection Practices Act.

If we are going to have phone collection efforts and we are going to use private collectors, we have to assure that they go to the same high standards we hold the IRS collection agents to, and I want to assure that all those protections are within any legislation authorizing this.

Chairman HOUGHTON. Mr. McCormally?

Mr. MCCORMALLY. Mr. Chairman, I think actually there is a connection between the concerns that some of us have about the use of private collection agencies and the point that was made earlier during the hearing and in my testimony about training and education efforts with respect to agents. The tax law is not a simple thing. Tax administration is not a simple thing.

I know that the Taxpayer Advocate has expressed some concerns, especially with respect to one of her core constituencies, low-income taxpayers who don't have the wherewithal to understand fully their rights and what they can request when contacted by an IRS employee. The IRS employee currently has an obligation to know the processes and to make assistance available. I think what Mr. McKenzie was saying is that those same rights and that same knowledge don't necessarily follow naturally from the IRS to a private debt collector.

More generally, with respect to the concerns of TEI Members and large businesses in general, we believe it is essential that the IRS have adequate funding to hire new agents and really to stay the course with respect to training those agents. The LMSB Commissioner Langdon has testified before that it is a minimum of a 3- to 5-year process to create a good international agent, a good revenue agent that can understand and audit the complicated transactions that TEI Members engage in. So, funding on an ongoing basis to secure adequate personnel and to train them, I think are essential for the agency to address the challenges that lie ahead.

Chairman HOUGHTON. Thank you very much. Mr. Stevenson?

Mr. STEVENSON. First off, the Restructuring and Reform Act 1998 places a very high priority on education, and the IRS is really required by that bill to provide you with a multi-year layered plan of an educational process.

I don't know if this is quality time to discuss a whole educational mode, but off the top of my head, I suppose what I would consider doing is I would set up—I would formalize the educational process in such a way that I would have an academy inside the IRS, that this academy would be staffed by people who understand the mission, understand the educational process and also understand that they are working to change the culture of the IRS. If the plan stays the way it is, with middle management who haven't bought into it, you are never going to change the culture of the IRS unless those 43 percent retire and you get all new people in place.

Chairman HOUGHTON. Thank you very much. Ms. Hill, any other comments?

Ms. HILL. On this specific subject?

Chairman HOUGHTON. Any subject you want, particularly the privatization issue which you talked about.

Ms. HILL. The NAEA concern about the privatization is will taxpayers' rights be protected. That is our primary concern.

Chairman HOUGHTON. Right.

Ms. HILL. Our other concerns have to do with the confidentiality of information that the IRS seems to be making available through its programs to encourage electronic filing by offering e-services, and that is where they would make available through the Internet access to taxpayer accounts and charts of accounts, as well as listings of accounts for those people who are electronic filers rather than those people who are prepared to represent taxpayers.

Chairman HOUGHTON. Okay. Thanks very much. Mr. Pomeroy?

Mr. POMEROY. It is a very difficult line, trying to put in place protections that are meaningful for taxpayers without creating inadvertently shelters for those who want to avoid their tax obligations.

I was very interested in the comments of your testimony, Mr. McKenzie, but let me ask you a little more broadly something referenced by Ms. Hill, that there is almost a—let me put it this way. There was some publicity a year ago that there was a public attitude that audit functions were not as aggressively pursued by the IRS anymore and cheating, especially with more affluent filers, was increasing. I would like to just run across the panel and have your thoughts in terms of whether or not you sense in the areas where you work any changed public attitude about the IRS and its rigor relative to collections.

Mr. MCKENZIE. As someone on the frontlines every day with the taxpayers, I certainly have seen a view that the IRS is not as aggressive, and many of my clients take the attitude when they first arrive in my office, perhaps, of who is to know, and the numbers bear them out. When the IRS is only doing about a third of the face-to-face audits it was doing 6 years ago, there is good reason for the taxpayers to believe that they can get away with more. More people are getting away with more.

When in fiscal year 2001, we audited more poor people than we did wealthy people, something is wrong. I know Congress gave a mandate to come after EITC, but there are all types of inefficiencies. When I audit somebody poor in the 10 percent tax bracket and I find \$1,000 wrong with their return, that is \$100 into the Department of the Treasury. I audit a wealthy person in a 37.6 percent tax bracket and find \$1,000 wrong with that return, I get \$376 into the Department of the Treasury. So, there are huge inefficiencies.

Going to Mr. McCormally's comment, the IRS is the only profit center in the Federal Government. Why don't we devote the resources to hire adequate people to go out and collect the money, because many taxpayers think it is unfair that a lot of people are not paying their fair share. Until we give the IRS adequate enforcement means to come after the tax cheats, the system is always going to be perceived as unfair.

Mr. POMEROY. In your substantial practice, you see it deteriorating at present?

Mr. MCKENZIE. Yes. I do not prepare returns. I only represent people who have come face-to-face with the IRS for some misconduct. Either they haven't paid their taxes or they may not have reported everything or they may even face potential criminal prosecution. The attitude of those people I represent who do finally essentially get caught is, "Why me? Everybody else is getting away with it. Why am I caught?"

Mr. POMEROY. Very interesting. Mr. McCormally?

Mr. MCCORMALLY. Mr. Pomeroy, the Members of TEI don't have the luxury of engaging in the audit lottery for the most part. They are part of this coordinated industry case program that the IRS runs. They have IRS agents living with them in their offices on a year-round basis.

That doesn't mean, however, that there aren't ways that the IRS can do its job better and can bring efficiency. I think the question here, as in all things, is the appropriate balance to be struck between how aggressive the IRS is in pursuing certain issues and how helpful their employees are in helping taxpayers find better ways of doing things. As my written testimony elaborates, there are a number of initiatives that the LMSB Division, in particular, has instituted in the last few years that have really brought a lot of efficiency to the audits and, I think, have opened up a realm of possibilities to getting issues and cases resolved earlier.

Certainly, the attention that this Committee and Congress as a whole has shown on questionable activities by some corporations in recent years has resonated throughout not only the IRS, but the entire business community. I do not think that the sense that Mr. McKenzie has with respect to the individual taxpayers at all obtains in respect to the large business community whose members make up TEI.

Chairman HOUGHTON. Thank you.

Mr. STEVENSON. Let me take a little different approach. I think the lack of enforcement plays a role in noncompliance. The behavior is manifest in a cadre of new tax preparers who have come into the business and never had to face an audit of a tax return that they have prepared. I think these people tend to be more cavalier. I think some of the people who have been around the barn

a few times who know what it is like to have to face an audit of something you have done are less inclined to push the envelope beyond what they feel is reasonable.

The practitioner community prepares about 50 or 60 percent of the tax returns in this country and I think if there were some education, not education, but enforcement where the younger people started getting a taste of the action, I think they would probably tighten up their practice, too.

By the way, I will give you three ways to increase money flowing into the Department of the Treasury without having to go to outside third parties. Consider interest and penalty amnesty, not tax amnesty, but interest and penalty amnesty. Improve the offer and compromise program, not the administration of it, but the program, and adopt less than full pay installment agreements and you will probably get that \$12 billion you were talking about a little while ago.

Mr. POMEROY. Thank you I know my time is up, but Ms. Hill, if you could just briefly respond.

Ms. HILL. I see a tremendous drop. Wage and investment sector examinations have almost totally disappeared in the area that I live in in the last 3 years. Small business examinations, I had two last year out of a client base that is primarily individual small businesses. This is an extremely low number.

What amazes me that has dropped has been the follow-up on known non-filers, where IRS has third party information and has not contacted them with substitute for returns and instances where people who have underreported their income and that has not been followed up on. Now, those kind of contacts are cost effective. It is very inexpensive for IRS to make these kind of contacts, but they do indicate an IRS presence when those contacts go out. That lack of IRS presence is what makes my job difficult in working with clients when they sit there and ask, how do they know?

Mr. POMEROY. You have professional exposure for not doing it right, dealing with a clientele that no longer thinks there is a penalty for doing it wrong.

Ms. HILL. Mr. Pomeroy, when I have people who say, well, you don't have to put that income down because I don't think it got reported, I have to put that income down. We prepare returns competently and professionally knowing that we have standards to meet.

Mr. POMEROY. Thank you very much.

Mr. PORTMAN. Thank you, Mr. Pomeroy. I thank the panel. First, I hope the IRS is here and listening, because there continue to be major concerns, and yet I do think we are beginning to address some of them. Certainly, the IRS is focused more on the audit side as well as compliance in general.

I would say to Mr. McKenzie, I agree with what you are saying, but remember with regard to going after wealthy taxpayers versus poor taxpayers, this is in specific response to the huge concerns we have with EITC and all audits are not equal. The amount of time the IRS puts into these EITC audits, as you know, is far less than they would put into, say, a small businessperson's audit, which might result in a larger return to the Department of the Treasury.

Sometimes these audits on the EITC side are minimal in terms of the IRS involvement, but that is all we can do right now.

We talked about \$12 billion being out there. We also talked about \$9 million in missed payments every year, or erroneous payments under the EITC system. Again, as I said at the outset, I am not sure the IRS is equipped, nor would any entity that is always looking at taxpayers in terms of whether they are underreporting income, to deal with the EITC problem, which is often over-reporting in order to get EITC. I think it is a very different mindset, and I think there are some real concerns about whether the IRS and their employees, even trained up better, Mr. Stevenson, than they are now, are trained to go after the EITC problem and go to a person's home and possess a rented television set or whatever assets are there. It is a very different kind of approach.

So, I just throw that out and I don't particularly expect a response, but if you had any great ideas as to how to change EITC so it could work better, we would appreciate it.

With regard to some of the input you have given us, all of which is excellent, and I appreciate your comment on training in particular, Mr. Stevenson, and it concerns me that you think middle management is not accepting the reforms, my sense is that, over time, we have begun to see some movement down not just to middle management, but people on the line, or maybe you are saying on the line they are getting it and at the top they are getting it, but middle management isn't yet understanding this lack of exclusivity between service and enforcement, which is what Ms. Williams talked about.

Could you comment on that for a second, and then I would love to follow up with Ms. Hill on some of her comments, in terms of middle management and their acceptance of the new attitudes at the IRS.

Mr. STEVENSON. My comments are pretty much supported, by the way, by people across the country in my organization, and so it is not just my own observation. It just seems to us that in the IRS's current culture, there is no profit in the lower-level people resolving problems. The only profit they have is closing a case. It doesn't make a difference whether the problem is resolved. Well, that is really poor training. They are not empowered, and even if they were empowered, they are afraid to make a decision. So, what they will do is move the case or push it aside or bury it.

This is the fault of middle management, who have not bought into what it means to be a service organization. It is like buying a car. Everything is great, it is nice and shiny, and what happens when there is a problem? If you go back to try to fix the problem and you can't fix it, then that says something about the agency.

The quality of an organization is not how well it performs its function, it is how well it solves problems. The IRS does a very good job at pro forma stuff, but when it starts getting into people problems, where you have to make decisions and you have to have perspective, this agency is not doing very well, from my perspective.

Mr. PORTMAN. Well, thank you, and "empowerment" is probably a good word to use because that is part of the vision here, is to empower people at that level to be able to make decisions to

solve problems and to close cases in that way, not just to move the cases along. Thank you for your help. Since 1995, we have made a lot of progress, but we have got a long way to go.

I was just following up, Ms. Hill, on your written testimony as well as your oral testimony. You didn't have a chance to get into this as much in your oral statement, but you talked a lot about this confidentiality issue, and in response to Mr. Houghton, you talked about it again. You mentioned access to bank account and brokerage information being a problem. In your testimony, you talk about the Circular 230 practitioners and the EROs. Can you tell the Committee, what is the difference between the EROs and the Circular 230 practitioners?

Ms. HILL. Circular 230 practitioners includes enrolled agents, CPAs, and attorneys. They have established, and are held accountable to, standards of practice and professional responsibility. They are regulated by the Department of the Treasury and they have required continuing professional education (CPE) requirements.

An ERO makes an application to IRS to file returns electronically. There are no standards, no CPE requirements, no level of expertise required, and it includes Mailboxes USA, used car dealers, anyone who is wishing to set up shop offering refund anticipation loans, as well as a number of very well-qualified practitioners. I am an ERO, but there is a difference.

Mr. PORTMAN. What is the significance of that difference in terms of your recommendation to the IRS on electronic filing and confidentiality?

Ms. HILL. The IRS is offering, as an incentive to become an electronic filer, a program called e-services. It is a suite of services that would authorize products electronically to practitioners who would be able to obtain disclosure authorization, that is, power of attorney, electronic account resolution, taxpayer identification number matching and transcript delivery over the Internet. These are items that are very, very useful to a person who practices tax. However, the people that IRS is going to authorize this access to are EROs who file more than 100 returns. This leaves out most attorneys, most CPAs, and many enrolled agents, people who could take advantage and use this service.

What is of most concern to me is that in my review of the program so far, it appears that IRS has not built the safeguards into it to protect client information that is available when they offer electronic account services, including transcripts of accounts. There is a variety of transcripts. They go from the point of just proving that a person has filed to showing account status, but I have along with me today an example of one that gives actual bank account names and account numbers for each taxpayer.

Now, a person who is looking at the access that they would be able to obtain without talking to an individual, electronically over the Internet, is going to receive this kind of information. They are people that IRS does not hold to standards of practice, that are difficult to control in terms of their practice before them, have no CPE requirements, no other kind of requirements. This is of real concern to us, that there are not safeguards being built in this program at the front end to prevent this kind of access.

Mr. PORTMAN. My time is more than expired. I appreciate your indulgence, Mr. Chairman, and thank you for raising that point again. I hope that is something that we will take a very serious look at as we put together the final e-file proposal that Acting Commissioner Wenzel talked about. Thank you, gentlemen and ladies.

Chairman HOUGHTON. Thank you very much, Ms. Hill, Mr. Stevenson, Mr. McCormally, Mr. McKenzie. We certainly appreciate your testimony. The hearing is adjourned.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]

[Submissions for the record follow:]

American Institute of Certified Public Accountants
Washington, DC 20004
April 21, 2003

The Honorable Amo Houghton
Chairman
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
1136 Longworth House Office Building
Washington, DC 20515

RE: Hearing on the 2003 Tax Filing Season and the IRS Budget for Fiscal Year 2004

Dear Chairman Houghton:

The American Institute of Certified Public Accountants appreciates the opportunity to submit this statement for the Subcommittee on Oversight's April 8, 2003 hearing record on the 2003 tax filing season and the IRS budget for fiscal year 2004. 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.

The AICPA is pleased to report that the 2003 filing season is progressing largely without any significant problems. American taxpayers and practitioners are reasonably pleased with the Service's performance during the 2003 tax filing season.

Our comments herein focus on the IRS budget for fiscal year 2004 and a number of critical programs administered by the Service. Specifically, we are pleased to address (1) the IRS budget, (2) Electronic Tax Administration, (3) enforcement, (4) collection strategies, and (5) the IRS workforce.

1. THE IRS Budget

The AICPA urges Congress to support full funding of the Internal Revenue Service's fiscal year 2004 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.

The IRS performs an essential 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 are encouraged by the remarks of Mark W. Everson, President Bush's nominee for IRS Commissioner, at his March 18, 2003 confirmation hearing before the Senate Finance Committee. Mr. Everson testified that (as Commissioner) he is committed to (1) staying the course on the reorganization, (2) continuing the emphasis on modernization, and (3) enhanced enforcement activities. By providing the IRS with full funding for the agency's fiscal 2004 budget, the Congress would be going a long way towards helping Mr. Everson meet these commitments, commitments that we believe the Congress and the nation's taxpayers expect.

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 be provided the necessary resources 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's 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.

2. Electronic Tax Administration

The AICPA supports the IRS's long-range goals for electronic tax administration in general, and electronic filing (ELF) in particular. Last year, the IRS implemented a number of improvements in the electronic filing program that we believe practitioners who file returns electronically should find positive. We especially appreciate 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 continues to expand the electronic filing options for business taxpayers.

The AICPA has been frustrated in recent years 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.

We appreciate the many hurdles on the road to achieving the goals established for the electronic filing program by Congress. And to this end, we look forward to being a positive partner in the ELF system.

3. ENFORCEMENT CHALLENGES

A. The IRS's Enforcement Agenda

The AICPA appreciates public concerns regarding how non-compliance and aggressive taxpayer behavior threatens to overwhelm IRS resources. To counteract these tax administration trends, the IRS has announced a number of major compliance initiatives. Tax shelters are the primary focus for the Large and Mid-Sized Business (LMSB) Division. The Small Business/Self-Employed Division is emphasizing offshore credit cards, the unreported income and underreporting of income by high-income taxpayers, and promoter investigations and abusive schemes.

These LMSB and SB/SE initiatives are resource intensive, and will change the allocation of resources which would otherwise fund enforcement initiatives targeting traditional and mainstream taxpayers. In order for the IRS to maintain a high level focus on compliance areas like tax shelters and abusive schemes, the IRS is forced to focus its remaining resources on mainstream taxpayers by principally basing their examination and collection efforts towards these taxpayers on the concept of materiality; that is, by emphasizing the more material issues under investigation. This materiality focus underlies the IRS's efforts to reengineer the examination and collection efforts.

B. Reengineering of Examination

The AICPA supports the goals behind the reengineering of the examination function. These goals include: (1) streamlining the examination process, by reducing the taxpayer's time and expense in responding to an IRS examination, (2) increasing SB/SE's effectiveness and timeliness in examining returns, and (3) enabling the Service to reduce and redirect resources to major compliance initiatives.

At the beginning of the "reengineered examination" audit, the examiner and taxpayer will conduct an audit engagement meeting; it is expected that the examiner and the taxpayer will discuss the audit issues, the information needed for resolution of the examination, and the time estimated to complete the audit. The IRS expects to establish materiality guidelines for examining critical audit issues, and for man-

ager involvement in the early stages of the audit to facilitate quick and effective problem resolution.

Like SB/SE's examination reengineering initiative, LMSB has announced its Limited Issue Focus Examination (LIFE) program. LMSB Commissioner Larry Langdon recently stated that this program is the Service's "gold-card" treatment for taxpayers "who want to be cooperative and professional in sharing documents." Under LIFE, the IRS will start building its case before referral to a Revenue Agent by identifying the material issues for review. LMSB expects to conduct a periodic review to ensure that Revenue Agents are not routinely extending the scope of the audit beyond the material issues that have been identified during the case building stage. The IRS and taxpayer would sign a memorandum of understanding at the start of the audit outlining the examination's focus.

We support the IRS's quest to reengineer the examination function. These efforts are constructive ways to better target the overall scope of examinations; and practitioners believe the reengineered process offers significant opportunities to reduce taxpayer burden in terms of the time and cost of an examination.

4. EFFECTIVE COLLECTION STRATEGIES

The AICPA strongly supports IRS implementation of effective collection strategies designed to improve taxpayer compliance. Two particular collections areas that we believe warrant careful consideration are the Offer in Compromise program and the frivolous filing penalty.

A. Offer in Compromise User Fee

The IRS issued proposed regulations on November 5, 2002 that would impose a \$150 user fee for Offer in Compromise filings. However, the user fee would not be imposed on Offers: (1) filed by "low income" taxpayers; (2) based on doubt as to liability; (3) based on doubt as to collectibility due to economic hardship; or (4) which promote effective tax administration.

The AICPA commends the Service for seeking to alleviate its workload in processing Offers in Compromise, a burden that often results in taking more than a year to process, evaluate, or reach a final determination on an Offer. Nevertheless, we are concerned that the proposed regulations do not address the dire need to improve customer service in the Offers in Compromise program. We fear that taxpayers will pay a new fee without receiving improved customer service or reduced processing time in return.

We generally do not support the IRS's proposal because the user fee would place additional administrative and financial hardships on taxpayers. Instead, we suggest that consideration be given to a broadening in the scope of the frivolous filing penalty to cover frivolous Offers. We view this penalty proposal as potentially a more effective means of addressing problems with administering the Offer program. (See subsection B below, "Frivolous Tax Returns and Submissions.")

(1) The Concept of Imposing a User Fee

Based on our review of user fees in other IRS programs, the AICPA believes that the proposed Offer in Compromise user fee is not consistent with the use of such fees in other administrative programs. Most user fees routinely involve voluntary requests for advice from the Service, such as private letter rulings and determination letters. Moreover, we do not agree with those who suggest that an Offer user fee is similar to the current \$43 fee assessed to set up an Installment Agreement. This Installment Agreement fee reimburses the IRS for the costs associated with monitoring and administering the Installment Agreement program over an extended period of time. In contrast, filing an Offer in Compromise is not a voluntary request for IRS administrative guidance. Rather, an Offer is a request of last-resort for administrative relief; one that provides the taxpayer with a possibility of making a fresh start financially.

(2) Taxpayers' Inability to Pay the User Fee

To the extent a taxpayer does not qualify for an exemption from payment of the user fee, section 300.3(b)(3) of the proposed regulations states that "the fee will not be refunded to the taxpayer if the offer is accepted, rejected, withdrawn, or returned as nonprocessable after acceptance for processing."

Many practitioners feel that the IRS uses overly rigid criteria in processing and evaluating Offers. As a result, they fear that clients will be forced to pay multiple user fees, because clients must often submit Offers two or three times before reaching final resolution of their tax problem. These practitioners believe the user fee is being proposed solely to discourage taxpayers from filing Offers in Compromise, par-

ticularly since persons who file Offers typically have insufficient funds or lacks financial resources.

Under certain circumstances, the AICPA respects the need to establish user fees that are fair and reasonably approximate governmental costs for administering a program. Although we don't agree with the suggestion that the user fee is being imposed solely to discourage Offer filings, we doubt that this user fee will result in any meaningful revenue increases for the IRS's administrative budget or even for the U.S. Treasury.

(3) Cost of Administering the User Fee Program

Administering a new user fee program is not cost-free. Systems must be created to determine who is required to pay, and when refunds or exemptions from payment are appropriate. As previously stated, there will be a waiver (or in some cases, a refund) of a user fee for taxpayers filing Offers involving doubt as to liability, low income status, or Offers based on effective tax administration or economic hardship grounds. In all likelihood, a specific form, accompanied by potentially complex instructions, will be needed to apply for, and explain the grounds for waiver of, the fee. These costs will further reduce any revenues the Service hopes to collect from the fee.

(4) The Definition of Low-Income

The proposed regulations would exempt low-income persons from paying the user fee. A low-income person is defined under the regulations as a taxpayer falling at or below the Department of Health and Human Services' annual poverty guidelines—for 2002, \$18,100 for a family of four.

This definition of "low income" is too low and would force many taxpayers of limited means, who happen to earn more than the HHS poverty guidelines, to pay the user fee. A more equitable—and consistent—definition for low-income can be found in IRC section 7525(b)(1)(B). This Code section defines a low-income taxpayer clinic (among other criteria) as a facility that represents taxpayers who generally do not have incomes exceeding 250 percent of the poverty level. If \$18,100 represents 100 percent of the poverty level for a family of four, then 250 percent of the poverty level amounts to \$45,250. Few, if any families of four with incomes of \$18,100 or less pay any tax at all, and are unlikely to use the Offer in Compromise program.

B. Frivolous Tax Returns and Submissions

Under current law, the IRS has the authority to impose a \$500 civil penalty against individuals who file frivolous original or amended returns. Section 107 of H.R. 1528 addresses submissions raising frivolous positions or intending to delay or impede tax administration. This proposal would modify present law by (1) increasing the frivolous filing penalty to \$5,000 and (2) expanding the penalty's scope to cover collection due process hearings, installment agreements, offers-in-compromise, and taxpayer assistance orders. The bill would also require the IRS to publish a list of positions, arguments, requests, and proposals that the Service has determined to be frivolous.

The AICPA supports increasing the frivolous filing penalty to \$5,000 and the proposed expansions in its application. However, we would not want the frivolous penalty proposal to be used to stifle—overtly or inadvertently—legitimate taxpayer submissions involving collection due process hearings, installment agreements, offers in compromise, and taxpayer assistance orders.

Although we are pleased that the proposal would require the IRS to publish guidance regarding what constitutes a frivolous position, we recommend expanding this requirement to also provide guidance regarding the meaning of the language of section 107 involving "a desire to delay or impede the administration of Federal tax laws." It is particularly critical that the guidance regarding what constitutes "a desire to delay or impede the administration of Federal tax laws" be restricted to truly frivolous positions or actions. Such guidance would go a long way to ameliorate concerns about the potential misuse of the expanded penalty's application, especially if the IRS consults with the practitioner community in the development of such guidance.

5. Workforce Empowerment

A. IRS Employee Training

There are many practitioners and IRS personnel who do not have a good grasp on how the overall IRS reorganization is supposed to work. When an IRS employee in the field is unsure how it implements a new program or procedure, that person

will invariably fall back on his or her old ways of doing things. Nevertheless, the old way of doing things is not an option for the IRS or its employees in 2003.

Some of the most frustrating experiences realized by taxpayers and tax practitioners in dealing with the IRS occur because of a lack of training on the part of the IRS employees. It is much easier to work out a solution that is fair to both the tax system and the taxpayer if the individuals resolving the issue are knowledgeable and well trained. Given the “taxpayer segmented” nature of the new IRS organization, it is more important than ever that IRS employees acquire the technical skills and insights that correspond to the needs and issues of their different taxpayer constituencies.

The IRS needs to target meaningful resources toward the training of Service employees, particularly with the need to overcome any cultural inertia of mid-level and rank-and-file personnel toward the reorganization overall. The AICPA strongly supports such efforts. IRS executives must continue their resolve to hire and train new employees and replace its aging workforce.

We believe we can be of immense help to the Service with the training of its employees. First, whenever the IRS seeks to implement a new program, we suggest that the Service seek input from key stakeholders on the details and development of any new program. Second, the Service could benefit from the constructive suggestions of the AICPA and other stakeholders regarding materials that will be used in the training program for the new IRS initiative. Third, we recommend that the IRS utilize CPAs and other stakeholders in teaching part of the training curriculum for IRS personnel involved with any new program.

An excellent example of how this process can work and benefit the overall tax administration process is the IRS’s roll-out of the National Research Program. In fact, the IRS did share the initial NRP program details and the training materials with critical stakeholders. Also, the IRS successfully utilized CPAs in the training of IRS personnel for the NRP program. We firmly believe private sector involvement in the training process helps sensitize IRS employees to the need to conduct new programs in a way that proves effective for the tax administration process, but which remains non-intrusive and minimizes taxpayer burden. By including taxpayer representatives in the training of IRS personnel, the Service will help the public learn about a new compliance program, thereby potentially mitigating the emotional, and sometimes political, reactions of the public to a new IRS program.

B. Coordination Between Divisions

One of the greatest challenges for the IRS is to implement a strategy that promotes positive communications and coordination between the Large and Mid-sized Business, Small Business and Self-Employed, Wage and Investment, and the Tax Exempt and Government Entities Divisions. Such coordination is necessary to avoid confusion among the public regarding how to respond to an inquiry from one of the four operating divisions. Some early commentators on the reorganization were concerned that instead of one IRS, taxpayers might now face responding to four IRSs as represented by the operating divisions. During the last several years, IRS senior executives have done an excellent job of setting the tone for the overall organization, and the tone for proper coordination and cooperation among the operating divisions. At this juncture the IRS national office has successfully steered the organization in the direction of a united structure, overseeing its critical (but integral) components.

We encourage the Service to stay the course with respect to the reorganization. While the AICPA recognizes that the reorganization effort remains in transition, with further work to be done, we believe that the general rationale underlying the formation of the four operating divisions—focusing on specific taxpayers and their needs—is the right one. Furthermore, we believe that any more significant changes to the IRS’s organizational structure would only serve to confuse taxpayers and practitioners who only now are beginning to become comfortable with the new organization.

Sincerely,

Robert A. Zarzar
Chair, Tax Executive Committee

Statement of Gerald E. Scorse, New York, New York

I wish to make a written statement regarding the Subcommittee’s April 8th hearing on the 2003 tax return filing season and the IRS budget for fiscal 2004.

My statement takes the form of the article which appears immediately below. Pursuant to formatting requirement No. 3, a supplemental sheet also follows.

The Sweet Math of Capital Gains Taxes

My name is Peter Privilege. Along with millions of other Americans, I'll be filing my Form 1040 with the Internal Revenue Service by April 15th. Unlike wage earners, however, the income that I report can be whatever I want it to be. I'm a capital gains taxpayer, which gives me a loophole so big you could drive a Hummer through it.

Really, you say? Yes, really.

And it's ever so simple.

Every year, I get a statement that lists my stock and bond sales. The IRS gets the same information: it tells them what I sold, when, and how much the proceeds were.

But the statement doesn't say what I paid in the first place. I could put down whatever I please, and the IRS would never know.

Let's say I bought 500 shares of IBM at \$50 and sold them at \$100. Commissions aside, that's a capital gain of \$25,000. But I could wipe it out entirely, or even claim a loss, by simply reporting that I paid \$100 or more for the stock. Remember, the IRS receives no information on how much I paid in the beginning.

And there's almost no way it could find out.

As long as my tax return jibes with the information the IRS has (in this case, a sale of 500 shares of IBM at \$100 a share), why would they ever question me?

The answer is, they wouldn't.

It's the same with short-term gains, which incur higher taxes, and long-term gains, on which the taxes are lower. The IRS has only the sell date, which essentially tells them nothing. It's left to me to report the gains as short-term or long-term.

Didn't I tell you it was simple?

On my good days, when I feel virtuous, I'm inclined to report the real numbers and let my taxes fall where they may.

But there are other days, I have to admit, when I'm tempted big-time.

On those days I feel like jumping right through that loophole, and maybe buying myself a Hummer.

I'm no angel, you know.

(Author's Note: If this gets your Irish up, do something. Contact your Congressman and demand third-party reporting of capital gains income by brokerage houses and mutual funds. Be sure to carbon Bill Thomas (R-CA), chairman of the Ways and Means Committee of the House, where all tax legislation originates. Why should capital gains *not* be reported, anyway?)

