OVERSIGHT OF THE INTERNAL REVENUE SERVICE FINANCIAL MANAGEMNT

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT HOUSE OF REPRESENTATIVES

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OVERSIGHT OF INTERNAL REVENUE SERVICE FINANCIAL MANAGEMENT

WEDNESDAY, MARCH 6, 1996

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 1:35 p.m., in room 311, Cannon House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Fox, Peterson, Spratt, and Maloney.

Staff present: J. Russell George, staff director and chief counsel; Anna Miller, and Mark Brasher, professional staff members; Andrew Richardson, clerk; David McMillen, Mark Stephenson, and Lisa Mientus, minority professional staff members.

Mr. HORN. We have some Members that are coming. We just had a vote, so I apologize for their lateness. We will have a quorum by the end of this statement, since it is a little long.

The Subcommittee on Government Management, Information, and Technology is holding this hearing on the oversight of Internal Revenue Service's financial management so that we can examine the Internal Revenue Service's ability to produce financial statements, have them audited and get a clean opinion, that is, a verification of the IRS, that it has accurately reported its financial position and the results of its activities.

In 1990, the Chief Financial Officers Act became law. Pursuant to the Act, the IRS was required to prepare and have audited agency-wide financial statements for fiscal year 1992 and each year thereafter. The General Accounting Office was given the responsibility to audit the statements.

The GAO discovered that it could not express an opinion on the reliability of the IRS's 1992 Principal Financial Statements and it gave two reasons for this. First, critical supporting information was not available and, second, where information was available, it was found to be generally unreliable. The result was the same with the 1993 statements.

The GAO noted seven areas of weakness: the processing of cash receipts; the processing of refund payments; the reporting of tax accounts receivable; the protection of property and equipment; the reconciliation of IRS accounts with Treasury funds amounts; the adequacy of computer general controls; and the setting of an inventory of seized assets.

In August 1995, the GAO issued its report on the IRS's fiscal year 1994 audit. Once again, it was unable to express an opinion. The reasons for this were: that $1.3 trillion of total revenues could not be verified or reconciled to the accounting records; amounts reported for various types of tax collections could not be substantiated; and the amounts of gross and net accounts receivable reported on the financial statements and estimates were a problem. The GAO could not determine from the IRS records whether the estimates were accurate. In addition, the IRS fund balance could not be reconciled with the accounts at the Department of the Treasury, and supporting documentation was lacking for total operating expenses. As a result, nearly 30 percent of the expenses in this category were questioned.

The only category of expense that the GAO could verify that the IRS properly accounted for and reported was the $5.1 billion in payroll expenses. It is noteworthy, however, that the Department of Agriculture's National Finance Center administers the IRS payroll.

Between May 1993 and August 1995, the GAO issued a series of reports on the IRS, the titles of which speak volumes.

And, as I say, some of this goes back to 1992, so this is not a partisan thing. All administrations have had some of this problem:

"IRS Significantly Overstated Its Accounts Receivable Balance" (May 1993);

"IRS Lacks Accountability Over Its Automated Data Processing Resources" (August 1993);

"IRS Information Systems: Weaknesses Increase Risk of Fraud and Impair Reliability of Management Information" (September 1993);

"IRS Self-Assessment of Its Internal Control Accounting System is Inadequate" (October 1993);

"Important IRS Revenue Information is Unavailable or Unreliable" (December 1993);

"IRS Does Not Adequately Manage Its Operating Funds" (February 1994); and

"Tax System Modernization: Management and Technical Weaknesses Must Be Corrected if Modernization is to Succeed" (July 1995).

This is, of course, on top of the financial statement audit. These are reports for fiscal years 1992, 1993 and 1994.

Each of these reports resulted in recommendations for changes to the IRS financial management system, a total of 59 recommendations. The IRS has completed corrective action on only 13 of the 59.

The GAO report on the IRS self-assessment of its internal controls causes grave concern. It found that the IRS misrepresented the state of its internal control system, the system that controls errors, including fraud, by preventing or detecting them. The IRS concluded that it had reasonable assurance that the objectives of internal control had been achieved, a requirement of the Federal Financial Managers Integrity Act. The General Accounting Office, however, disagreed with that.

According to the GAO, it appears Congress could be getting inaccurate information from these IRS reports, unreliable information, information that cannot be independently verified. The amounts re-

ported in the financial statements may not be representative of the IRS's actual operations.

One of the primary missions of the Internal Revenue Service is to know how much revenue should be coming in and to make determined efforts to collect all the revenue that is due the Federal Government. With a voluntary compliance system, and I know the IRS is correctly very proud of their work on the voluntary compliance system, but with that system such as ours, it is extremely important that the American taxpayer has confidence in the IRS's ability to be aware of the revenue owed, how do they contact delinquent taxpayers and to followup on the delinquent taxpayers once it has identified them.

If taxpayers were to think that "the other guy" is getting out of paying his or her taxes, it would seriously reduce compliance levels and the revenue generated.

The Chief Financial Officers Act audits first brought to light the fact that the IRS cannot reconcile its fund balance with Treasury accounts. It was reported by the GAO that in the 3 years before August 1995, hundreds of millions of dollars had been written off when the causes of the unreconciled amounts cannot be identified.

As of May 1995, amounts continue to be unreconciled and are not being identified and resolved promptly.

The GAO has requested the IRS give it a detailed plan for improvement, with clear accountability for failure to meet deadlines. We hope to learn today whether the IRS has done so.

In the August 1995 GAO report, the IRS claimed that its revenue general ledger system would be operational by fiscal year 1996. That is the year we are in. However, the IRS is currently redesigning it. The system will not be fully operational until the new software program developed as a part of the Tax System Modernization is completed and that will be some time in 1997.

What are we to expect until then? No improvement in the IRS's ability to effectively manage its operations and to reliably measure its performance?

Furthermore, there are questions on the reliability of the information the IRS supplies to Congress on taxes collected and uncollected, and on the cost of the IRS operations. I am concerned that the IRS has decided, and this is not something recent, this is since 1990, that $100 billion of tax debt is not collectible. I understand that another $60 billion is considered to be collectible.

The subcommittee needs to know the process and the criteria that were used in each case as to what is uncollectible and what is collectible. A total of $160 billion involved in the two categories. It will not solve the deficit, but it might help for 1 year if we ever got it.

Congress must have accurate information to properly oversee and evaluate the IRS's performance. The GAO cannot ensure that the Congress is getting such information now from the IRS.

In H.R. 2234, I have offered a bill which is bipartisan in sponsorship and designed to improve debt collection efforts in the Federal Government. Included in this legislation are provisions related to the IRS use of private debt collection agencies.

We will hear today from several witnesses whether the IRS is doing enough to collect its delinquent debt, whether it can do more

and, whether it should consider contracting out the responsibility for recovering those debts to which it is unable to give its attention.

In today's hearing, we are going to explore the reasons underlying the disclaimer of opinion by the GAO on the IRS's fiscal year 1994 financial statements.

We will review the IRS's plan for improvement in developing accurate financial information and adequate internal controls that will ensure that errors are either prevented or detected quickly.

Our examination will include the adequacy of the IRS procedures for processing delinquent tax inventory, collecting debts owed and writing off uncollectible debts.

We will also assess the ability of the IRS's information system to produce reliable information. This includes the weaknesses in general controls over the IRS computer system that have increased the risk of fraud and diminished the reliability of the information provided to Congress and others.

Today's hearing includes several witnesses commenting on the IRS financial management problems. Appearing today are: Gene L. Dodaro, Assistant Comptroller General, Accounting and Information Management Division, General Accounting Office.

The Honorable Margaret M. Richardson, Commissioner of the Internal Revenue Service.

The Honorable Donald C. Alexander, former Commissioner of the Internal Revenue Service during the Nixon, Ford and Carter administrations, and now with Akin, Gump, Strauss, Hauer, & Feld law firm. Mr. Alexander will provide a historical perspective on IRS collection efforts since President Nixon's administration.

The fourth panel will consist of Donald L. Korb, former Assistant to the Commissioner under President Reagan and now with Thompson Hine & Flory, and Ms. Shannon O'Toole, a former Resolution Trust Corporation Department Head and Section Chief of Real Estate Disposition Group.

Mr. Korb will be discussing IRS's processing of its delinquent tax inventory and other possible approaches to collecting tax dollars.

Ms. O'Toole will describe a proposal she has developed to improve IRS tax lien recovery efforts.

We thank you all for joining us and look forward to your testimony.

Subcommittees of the House Government Reform and Oversight Committee have a tradition of swearing in all witnesses for hearings, so, if I might, I would like each of you who will be testifying to stand and raise your right hand for the oath.

[Witnesses sworn.]

Mr. HORN. The clerk will note that all the witnesses have affirmed.

Our practice is also to put the written testimony you have in the record immediately after we introduce you and then generally we limit most of the people to 5 minutes. I do not mind stretching it this time because I think we can get through this in a few hours. So if it takes you 10, OK, but do not read me your testimony.

I want you to look us in the eye and summarize it. And, you know, I have said that in hearings and people get in there and they sort of read like I was reading that statement and what you need to do is get down to the basic points and then we have time for

the Members to ask questions. And we will limit ourselves to 5 minutes per round, but we might have a number of rounds. It is not meant to shut off a Member, it is just meant to give other Members a chance to ask questions.

So we are delighted to hear from you, Mr. Dodaro, and it is always a pleasure to see you. You are the principal witness from GAO, so proceed as you wish.

STATEMENTS OF GENE L. DODARO, ASSISTANT COMPTROLLER GENERAL, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY GREGORY M. HOLLOWAY, DIRECTOR, GOVERNMENTWIDE AUDITS, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, GENERAL ACCOUNTING OFFICE; RONA B. STILLMAN, CHIEF SCIENTIST FOR COMPUTERS, AND COMMUNICATIONS, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, GENERAL ACCOUNTING OFFICE; AND LYNDA D. WILLIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL ACCOUNTING OFFICE

Mr. DODARO. Good afternoon, Mr. Chairman, Congresswoman Maloney, Congressman Spratt. I would like to introduce my colleagues first.

On my far left is Lynda Willis. Linda is in charge of tax administration work and monitors IRS activities as it relates to collection programs and enforcement activities.

On my immediate left is Dr. Rona Stillman, our chief scientist for computers and telecommunications. Rona has been in charge of our efforts to evaluate IRS's tax system modernization effort. On my right is Mr. Greg Holloway. Greg has been in charge of the financial audits that we have done of IRS from fiscal years 1992 through 1994.

We are pleased to be here today to talk about the significant challenges facing IRS in improving its financial management and carrying out its tax system modernization activities. Both of these areas are ones that we have closely examined. They are both on GAO's high-risk list and, as a consequence, we have continuing activities underway to monitor IRS's progress.

As you noted in your opening statement, the IRS was one of the original pilot agencies under the CFO Act and, as a result, we have been auditing their financial statements since fiscal year 1992. Those statements cover both IRS's responsibility as a custodian of collecting tax revenues which, as you pointed out, exceed $1 trillion a year and also financial statements that account for their $7 billion in appropriated funds which are used to carry out their activities.

As you have noted, we have been unable so far to render an opinion on IRS's financial statements due to some longstanding and pervasive financial management problems. In the revenue area, this includes, as you mentioned in your opening statement, the inability to reconcile or verify the total amount of tax collections on the financial statements. In 1994, it was $1.3 trillion with the accounting records of individual taxpayers in the aggregate.

We have also been unable to substantiate the balances for individual taxes such as income, Social Security and excise taxes; and

we have had difficulty attesting to the reliability of the accounts receivable information both in terms of the valid accounts receivable and those that are deemed to be collectible due to data integrity problems.

In the administrative side, we have had difficulties in a number of areas. In 1992, we were unable to perform an audit of the administrative financial statements. Since then, some improvements have been made, and last year we had two outstanding issues, reconciling IRS's cash balances with Treasury and providing documentation for about $2.1 billion in non-payroll expenditures on the part of the IRS.

Now, I want to stress to the committee that these are not just bookkeeping problems. First, this provides, in my opinion and those of others, an adequate public scorecard on IRS's stewardship over taxpayer revenues.

Second, it goes to the very heart of the Congress' ability to assess IRS's performance and to have a good basis for judging their requests for budgetary resources. Without adequate underlying data, efforts to look at the performance measures and the cost effectiveness of IRS's programs and activities is very limited. So improvements in this area are important to not only achieve the objectives of the Chief Financial Officers Act, but are also really very much intertwined with the ability of IRS to successfully implement the Government Performance and Results Act, which I understand this committee sponsored a joint hearing this morning on. So these problems are serious and ones that impede Congress' ability to make informed decisions about IRS.

Now, there have been a number of areas where there has been progress on the part of IRS since we have done the audits and I want to highlight those.

Regarding their payroll expenses, which are $5 billion back in fiscal year 1994, we were able to say that those had been adequately accounted for. This was due to the IRS, as you mentioned in your opening statement, transferring its payroll operations to the National Finance Center run by the Department of Agriculture in New Orleans. So we are pretty satisfied with that effort.

We are also satisfied that IRS has put in a new financial management system to keep better track of its appropriated funds for running its operations. That has enhanced its ability to track its expenditures and was also a good move.

Additionally, we believe that IRS has been learning more about the depth and nature and scope of its financial management problems through the audit process. This has helped them both to develop more insights into what is needed to fix these problems, but it is really proven to be a good learning process about how pervasive some of these problems are and how serious they are.

To help IRS in this area, we have made over 59 recommendations as a result of our audits. As you pointed out in your opening statement, only 13 of those were implemented as of our last financial audit. We are currently in the process of monitoring IRS's progress in implementing the other 46 recommendations and will be reporting on that soon.

Now, in addition to our work in auditing the financial management statements, we have also had an extensive effort underway

to review IRS's efforts to implement its tax system modernization effort. That effort is a laudable undertaking to move toward electronic filing. IRS is drowning in paper and really needs to move into the new information age and toward electronic filing. They have spent about $2.5 billion on this activity so far and plan to spend another $5 to $6 billion between now and the year 2001.

While IRS has made progress in implementing the tax system modernization program over the past few years, we believe there are still fundamental managerial and technical problems with the program that they have underway. Last year, what we did was to perform a comprehensive evaluation of IRS against several different criteria. One of which are best practices that we have done research on regarding what type of management actions are taken by successful organizations to implement successful information technology initiatives.

We have testified before this committee, myself and Chris Hoenig, on our research in this best practices area, but what we did was compare IRS's tax system modernization management to these best practice criteria.

We also compared IRS to industry standards. For example, we looked at the maturity of their ability to develop software to implement the tax system modernization effort. In doing that, we used the computer maturity model criteria developed by the Software Engineering Institute at Carnegie-Mellon and this is recognized throughout the world as the best criteria.

What we found as we compared IRS against all these criteria is that they had made efforts in many of the areas to make improvements, but there were still pervasive, serious problems in each of the major categories that we compared them to using this criteria. Again, as in the financial area, we made a number of recommendations, over a dozen recommendations, to help IRS strengthen its tax system modernization effort. It covered a wide range of activities. For example, we suggested they revamp their business strategy for tax system modernization.

In this area, we suggested they look to a broader range of the taxpaying population to move toward electronic filing, that their current plan at that time by the year 2001 under the current estimates would only reach about 18 percent of the taxpaying population. They had set a goal for about 36 percent but they were falling short of that goal.

We thought through redoing and relooking at their business strategy they could reach a larger segment of the estimated 224 million returns that are filed each year. They agree.

We also suggested that IRS put in place a more disciplined process to look at the investments that they were making, the multibillion dollar investments in the tax system modernization. This is really the heart of many successful organizations. They put in discipline process to select, control and evaluate their investments in technology. They do it in modular, incremental pieces, not long-term, multi-year activities, and we find criteria for making investment decisions and doing cost benefit analysis in the tax system modernization effort needed to be greatly strengthened.

Third, we recommended that the IRS put in place an intensive program to increase its software development capability. What we

found in our evaluation and, indeed, IRS had rated itself at a level one organization in the computer maturity scale, which is the initial scale of one to five used by the Software Engineering Institute.

Level one means that IRS's practices were ad hoc, chaotic and that basically they needed to have much more disciplined processes to put it on a level where they could on a repeatable basis make cost estimates, schedule estimates, control the functionality of the systems requirements to make sure that their processes were going to produce the right results within costs and within schedule.

So we recommended that IRS put a detailed plan together to move from level one up to level two. We also suggested that any contractors that IRS hired should be at a level two maturity level as well.

So under that criteria, there were a number of other recommendations which are submitted in our statement for the record.

We think in both of these areas it is clear IRS is facing some formidable challenges to produce auditable financial statements where we can get a clean opinion and also to put their tax system modernization effort on a good track.

We are pleased that IRS has made a commitment in these areas, and that they have agreed with all of our recommendations in the financial audit reports, as well as the recommendations in the tax system modernization effort.

We believe, however, that successful implementation of these recommendations, moving beyond agreement to actually implementing the practices, is the real key to success in both of these areas.

That concludes my summary remarks. I would be glad to answer any questions.

[The prepared statement of Mr. Dodaro follows:]

Statement of Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division

Mr. Chairman and Members of the Subcommittee, I am pleased to be here today to discuss the results of our fiscal year 1994 financial audit of the Internal Revenue Service (IRS)--our most recently completed audit--and our reports evaluating IRS' Tax System Modernization (TSM) effort. Last year, we issued two major assessments concerning IRS' guardianship of federal revenues and its ability to function efficiently in an increasingly high technology environment. I am submitting these reports for the record: Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995) and Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected if Modernization Is To Succeed (AIMD-95-156, July 26, 1995).

These reports

(1) highlighted a number of serious technical and managerial problems that IRS must directly address to make greater progress in both of these areas,

(2) discussed actions being taken by IRS to strengthen its operations, and

(3) presented numerous specific GAO recommendations for needed additional improvements.

IRS agreed with all our recommendations and committed itself to taking the corrective measures necessary to improve its financial management and information technology capability and operations. We currently are in the process of auditing IRS' fiscal year 1995 financial statements and evaluating IRS' response to the

recommendations we made regarding its TSM program. We discuss each of these areas in the following sections.

FINANCIAL MANAGEMENT WEAKNESSES PERSIST

For the last 3 fiscal years,[1] we have been unable to express an opinion on IRS' financial statements because of the pervasive nature of its financial management problems. We were unable to express an opinion on IRS' financial statements for fiscal year 1994 for the following five primary reasons.

-- One, the amount of total revenue of $1.3 trillion reported in the financial statements could not be verified or reconciled to accounting records maintained for individual taxpayers in the aggregate.

-- Two, amounts reported for various types of taxes collected, for example, social security, income, and excise taxes, could also not be substantiated.

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[1]Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993); Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994); and Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995).

-- Three, we could not determine from our testing of IRS' gross and net accounts receivable estimates of over $69 billion and $35 billion, respectively, which include delinquent taxes, whether those estimates were reliable.

-- Four, IRS continued to be unable to reconcile its Fund Balance With Treasury accounts.

-- Five, we could not substantiate a significant portion of IRS' $2.1 billion in nonpayroll expenses included in its total operating expenses of $7.2 billion, primarily because of lack of documentation. However, we could verify that IRS properly accounted for and reported its $5.1 billion of payroll expenses.

To help IRS resolve these issues, we have made dozens of recommendations in our financial audit reports dating back to fiscal year 1992. In total, we have made 59 recommendations on issues covering such areas as tax revenue, administrative costs, and accounts receivable. While IRS has begun to take action on many of our recommendations, as of the date of our last report--August 4, 1995--it had fully implemented only 13 of our 59 recommendations.

IRS has made some progress in responding to the problems we identified in our previous audits. However, IRS needs to intensify its efforts in this area. IRS needs to develop a detailed plan with explicit, measurable goals and a set timetable for

action, to attain the level of financial reporting and controls needed to effectively manage its massive operations and to reliably measure its performance.

The sections below discuss these issues in greater detail.

Issues with Revenue

IRS' financial statement amounts for revenue, in total and by type of tax, were not derived from its revenue general ledger accounting system (RACS) or its master files of detailed individual taxpayer records. This is because RACS did not contain detailed information by type of tax, such as individual income tax or corporate tax, and the master file cannot summarize the taxpayer information needed to support the amounts identified in RACS. As a result, IRS relied on alternative sources, such as Treasury schedules, to obtain the summary total by type of tax needed for its financial statement presentation.

IRS asserts that the Treasury amounts were derived from IRS records; however, neither IRS nor Treasury's records maintained any detailed information that we could test to verify the accuracy of these figures. As a result, to substantiate the Treasury figures, we attempted to reconcile IRS' master files--the only detailed records available of tax revenue collected--with the Treasury records. We found that IRS' reported total of $1.3 trillion for revenue collections, which was taken from

Treasury schedules, was $10.4 billion more than what was recorded in IRS' master files. Because IRS was unable to satisfactorily explain, and we could not determine the reasons for this difference, the full magnitude of the discrepancy remains uncertain.

In addition to the difference in total revenues collected, we also found large discrepancies between information in IRS' master files and the Treasury data used for the various types of taxes reported in IRS' financial statements. Some of the larger reported amounts for which IRS had insufficient support were $615 billion in individual taxes collected--this amount was $10.8 billion more than what was recorded in IRS' master files; $433 billion in social insurance taxes (FICA) collected--this amount was $5 billion less than what was recorded in IRS' master files; and $148 billion in corporate income taxes--this amount was $6.6 billion more than what was recorded in IRS' master files. Thus, IRS did not know and we could not determine if the reported amounts were correct. These discrepancies also further reduce our confidence in the accuracy of the amount of total revenues collected.

Despite these problems, we were able to verify that IRS' reported total revenue collections of $1.3 trillion agreed with tax collection amounts deposited at the Department of the Treasury. However, we did find $239 million of tax collections recorded in IRS' RACS general ledger that were not included in reported tax collections derived from Treasury data.

In addition to these problems, we could not determine from our testing the reliability of IRS' projected estimate for accounts receivable. As of September 30, 1994, IRS reported an estimate of valid receivables of $69.2 billion,[2] of which $35 billion[3] was deemed collectible. However, in our random statistical sample of accounts receivable items IRS tested, we disagreed with IRS on the validity of 19 percent[4] of the accounts receivable and the collectibility of 17 percent[5] of them. Accordingly, we cannot verify the reasonableness of the accuracy of the reported accounts receivable.

Inadequate internal controls, especially the lack of proper documentation of transactions, resulted in IRS continuing to report unsupported revenue information. In some cases, IRS did not maintain documentation to support reported balances. In other cases, it did not perform adequate analysis, such as reconciling taxpayer transactions to the general ledger, to ensure that reported information was reliable.

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[2]The range of IRS' confidence interval, at a 95 percent confidence level, is that the actual amount of valid accounts receivable as of September 30, 1994, was between $66.1 billion and $72.3 billion.

[3]The range of IRS' confidence interval, at a 95 percent confidence level, is that the actual amount of collectible accounts receivable as of September 30, 1994, was between $34 billion and $36 billion.

[4]The range for our confidence interval, at a 95 percent confidence level, is that the actual amount of the validity exceptions as of September 30, 1994, was between 14.5 percent and 24.2 percent.

[5]The range for our confidence interval, at a 95 percent confidence level, is that the actual amount of the collectibility exceptions as of September 30, 1994, was between 13.1 percent and 22.5 percent.

We found several internal control problems that contributed to our inability to express an opinion on IRS' financial statements. To illustrate,

-- IRS was unable to provide adequate documentation for 111 items, or 68 percent, in our random sample of 163 transactions from IRS' nonmaster file. The nonmaster file is a database of taxpayer transactions that cannot be processed by the two main master files or are in need of close scrutiny by IRS personnel. These transactions relate to tax years dating as far back as the 1960s. During fiscal year 1994, approximately 438,000 transactions valued at $7.3 billion were processed through the nonmaster file. Because of the age of many of these cases, the documentation is believed to have been destroyed or lost.

-- We sampled 4,374 statistically projectable transactions posted to taxpayer accounts. However, IRS was unable to provide adequate documentation, such as a tax return, for 524 transactions, or 12 percent. Because the documentation was lost, physically destroyed or, by IRS policy, not maintained, some of the transactions supporting reported financial balances could not be substantiated, impairing IRS' ability to research any discrepancies that occur.

-- IRS is authorized to offset taxpayer refunds with certain debts due to IRS and other government agencies. Before refunds are generated, IRS policy requires

that reviews be performed to determine if the taxpayer has any outstanding debts to be satisfied. For expedited refunds, IRS must manually review various master files to identify outstanding debts. However, out of 358 expedited refunds tested, we identified 10 expedited refunds totaling $173 million where there were outstanding tax debts of $10 million, but IRS did not offset the funds. Thus, funds owed could have been collected but were not.

-- IRS could not provide documentation to support $6.5 billion in contingent liabilities reported as of September 30, 1994. Contingent liabilities represent taxpayer claims for refunds of assessed taxes which IRS management considers probable to be paid. These balances are generated from stand-alone systems, other than the master file, that are located in two separate IRS divisions. Because these divisions could not provide a listing of transactions for appropriate analysis, IRS did not know, and we could not determine, the reliability of these balances.

-- An area that we identified where the lack of controls could increase the likelihood of loss of assets and possible fraud was in the reversal of refunds. Refunds are reversed when a check is undelivered to a taxpayer, an error is identified, or IRS stops the refund for further review. In many cases, these refunds are subsequently reissued. If the refund was not actually stopped by Treasury, the taxpayer may receive two refunds. In fiscal year 1994, IRS

stopped 1.2 million refunds totaling $3.2 billion. For 183 of 244, or 75 percent of our sample of refund reversals, IRS was unable to provide support for who canceled the refund, why it was canceled, and whether Treasury stopped the refund check. Service center personnel informed us that they could determine by a code whether the refund was canceled by an internal IRS process or by the taxpayer, but, as a policy, no authorization support was required, nor did procedures exist requiring verification and documentation that the related refund was not paid.

With regard to controls over the processing of returns, we also found weaknesses. During fiscal year 1994, IRS processed almost 1 billion information documents and 200 million returns. In most cases, IRS processed these returns correctly. However, we found instances where IRS' mishandling of taxpayer information caused additional burden on the taxpayer and decreased IRS' productivity. In many cases, the additional taxpayer burden resulted from IRS' implementation of certain enforcement programs it uses to ensure taxpayer compliance, one of which is the matching program. This program's problems in timely processing cause additional burden when taxpayers discover 15 months to almost 3 years after the fact that they have misreported their income and must pay additional taxes plus interest and penalties.

Issues with Administrative Operations

IRS has made progress in accounting for its appropriated funds, but there were factors in this area that prevented us from being able to render an opinion. Specifically, IRS was unable to fully reconcile its Fund Balance with Treasury accounts, nor could it substantiate a significant portion of its $2.1 billion in nonpayroll expenses--included in its $7.2 billion of operating expenses--primarily because of lack of documentation.

With regard to its Fund Balance With Treasury, we found that, at the end of fiscal year 1994, unreconciled cash differences netted to $76 million. After we brought this difference to the CFO's attention, an additional $89 million in adjustments were made. These adjustments were attributed to accounting errors dating back as far as 1987 on which no significant action had been taken until our inquiry. IRS was researching the remaining $13 million in net differences to determine the reasons for them. These net differences, which span an 8-year period, although a large portion date from 1994, consisted of $661 million of increases and $674 million of decreases. IRS did not know and we could not determine the financial statement impact or what other problems may become evident if these accounts were properly reconciled.

To deal with its long-standing problems in reconciling its Fund Balance with Treasury accounts, during fiscal year 1994, IRS made over $1.5 billion in unsupported

adjustments (it wrote off these amounts) that increased cash by $784 million and decreased cash by $754 million, netting to $30 million. In addition, $44 million of unidentified cash transactions were cleared from cash suspense accounts[6] and included in current year expense accounts because IRS could not determine the cause of the cash differences. These differences suggest that IRS did not have proper controls over cash disbursements as well as cash receipts.

In addition to its reconciliation problems, we found numerous unsubstantiated amounts. These unsubstantiated amounts occurred because IRS did not have support for when and if certain goods or services were received and, in other instances, IRS had no support at all for the reported expense amount. These unsubstantiated amounts represented about 18 percent of IRS' $2.1 billion in total nonpayroll expenses and about 5 percent of IRS' $7.2 billion in total operating expenses.

Most of IRS' $2.1 billion in nonpayroll related expenses are derived from interagency agreements with other federal agencies to provide goods and services in support of IRS' operations. For example, IRS purchases printing services from the Government Printing Office; phone services, rental space, and motor vehicles from the General

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[6]Suspense accounts include those transactions awaiting posting to the appropriate account or those transactions awaiting resolution of unresolved questions.

Services Administration; and photocopying and records storage from the National Archives and Records Administration.

Not having proper support for if and when goods and services are received made IRS vulnerable to receiving inappropriate interagency charges and other misstatements of its reported operating expenses, without detection. Not knowing if and/or when these items were purchased seriously undermines any effort to provide reliable, consistent cost or performance information on IRS' operations. As a result of these unsubstantiated amounts, IRS has no idea and we could not determine, when and, in some instances, if the goods or services included in its reported operating expenses were correct or received.

Some Improvements Made but Overall
Computer Systems Security Remained Weak

In our prior year reports, we stated that IRS' computer security environment was inadequate. Our fiscal year 1994 audit found that IRS had made some progress in addressing and initiating actions to resolve prior years' computer security issues; however, some of the fundamental security weaknesses we previously identified continued to exist in fiscal year 1994.

These weaknesses were primarily IRS' employees' capacity to make unauthorized transactions and activities without detection. IRS has taken some actions to restrict account access, review and monitor user profiles, provide an automated tool to analyze computer usage, and install security resources. However, we found that IRS still lacked sufficient safeguards to prevent or detect unauthorized browsing of taxpayer information and to prevent staff from changing certain computer programs to make unauthorized transactions without detection.

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The deficiencies in financial management and internal controls that I have discussed throughout this testimony demonstrate the long-standing, pervasive nature of the weaknesses in IRS' systems and operations--weaknesses which contributed to our inability to express a more positive opinion on IRS' financial statements. The erroneous amounts discussed would not likely have been identified if IRS' financial statements had not been subject to audit. Further, the errors and unsubstantiated amounts highlighted throughout this testimony suggest that information IRS provides during the year is vulnerable to errors and uncertainties as to its completeness and that reported amounts may not be representative of IRS' actual operations.

IRS HAS TAKEN STEPS TO IMPROVE ITS OPERATIONS

IRS has made some progress in responding to the problems we have identified in previous reports. It has acknowledged these problems, and the Commissioner has

committed to resolving them. These actions represent a good start in IRS' efforts to more fully account for its operating expenses. For example, IRS has

-- successfully implemented a financial management system for its appropriated funds to account for its day-to-day operations, which should help IRS to correct some of its past transaction processing problems that diminished the accuracy and reliability of its cost information; and

-- successfully transferred its payroll processing to the Department of Agriculture's National Finance Center and, as a result, properly accounted for and reported its $5.1 billion of payroll expenses for fiscal year 1994.

IRS is working on improving the process of reconciling and monitoring its funds. In this regard, it has created a unit whose sole responsibility is to resolve all cash reconciliation issues and retained a contractor to help with this process. In the area of receipt and acceptance, IRS stated that it is more fully integrating its budgetary and management control systems. Also, IRS has developed a methodology to differentiate between financial receivables and compliance assessments and has modified current systems to provide financial management information. Finally, IRS is in the process of identifying methods to ensure the accuracy of balances reported in its custodial receipt accounts. We are currently reviewing these actions.

MANAGEMENT AND TECHNICAL WEAKNESSES MUST BE CORRECTED IF MODERNIZATION IS TO SUCCEED

Over the past decade, GAO has issued several reports and testified before congressional committees on IRS' costs and difficulties in modernizing its information systems. As a critical information systems project that is vulnerable to schedule delays, cost over-runs, and potential failure to meet mission goals, in February 1995, tax systems modernization (TSM) was added to our list of high-risk areas.[7]

In July 1995,[8] we reported that one of IRS' most pressing problems is efficiently and effectively processing the over 200 million tax returns it receives annually; handling about 1 billion information documents, such as W2s and 1099s; and, when needed, retrieving tax returns from the over 1.2 billion tax returns in storage. IRS' labor-intensive tax return processing, which uses concepts instituted in the late 1950s, intensifies the need to meet this enormous information processing demand by reengineering processes and using modern technology effectively.

Since 1986, IRS has invested over $2.5 billion in TSM. It plans to spend an additional $695 million in fiscal year 1996 for this effort, and through 2001, it is

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[7]High-Risk Series: An Overview (GAO/HR-95-1, February 1995).

[8]Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected if Modernization Is To Succeed (GAO/AIMD-95-156, July 26, 1995).

expected to spend up to $8 billion on TSM. By any measure, this is a world-class information systems development effort, much larger than most other organizations will ever undertake. TSM is key to IRS' vision of a virtually paper-free work environment where taxpayer account updates are rapid, and taxpayer information is readily available to IRS employees to respond to taxpayer inquiries.

IRS recognizes the criticality to future efficient and effective operations of attaining its vision of modernized tax processing, and has worked for almost a decade, with substantial investment, to reach this goal. In doing so, IRS has progressed in many actions that were initiated to improve management of information systems; enhance its software development capability; and better define, perform, and manage TSM's technical activities.

However, our July report noted that the government's investment and IRS' efforts to modernize tax processing were at serious risk due to pervasive management and technical weaknesses that were impeding modernization efforts. In this regard, IRS did not have a comprehensive business strategy to cost-effectively reduce paper submissions, and it had not yet fully developed and put in place the requisite management, software development, and technical infrastructures necessary to successfully implement an ambitious world-class modernization effort like TSM. Many management and technical issues were unresolved, and promptly addressing

them was crucial to mitigate risks and better position IRS to achieve a successful information systems modernization.

First, IRS' business strategy did not maximize electronic filings because it primarily targeted taxpayers who use a third party to prepare and/or transmit simple returns, were willing to pay a fee to file their returns electronically, and were expecting refunds. Focusing on this limited taxpaying population overlooked most taxpayers, including those who prepared their own tax returns using personal computers, had more complicated returns, owed tax balances, and/or were not willing to pay a fee to a third party to file a return electronically. Without having a strategy that also targeted these taxpayers, we reported that IRS would not meet its electronic filing goals or realize its paperless tax processing vision. In addition, if, in the future, taxpayers file more paper returns than IRS expects, added stress will be placed on IRS' paper-based systems.

Next, IRS did not have the full range of management and technical foundations in place to realize TSM objectives. In analyzing IRS' strategic information management practices, we drew heavily from our research on the best practices of private and public sector organizations that have been successful in improving their performance through strategic information management and technology. These fundamental best practices are discussed in our report, Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology

(GAO/AIMD-94-115, May 1994), and our Strategic Information Management (SIM) Self-Assessment Toolkit (GAO/Version 1.0, October 28, 1994, exposure draft.) To evaluate IRS' software development capability, we validated IRS' August 1993 assessment of its software development maturity based on the Capability Maturity Model (CMM) developed in 1984 by the Software Engineering Institute at Carnegie Mellon University. CMM establishes standards in key software development processing areas and provides a framework to evaluate a software organization's capability to consistently and predictably produce high-quality products.

To its credit, IRS had (1) developed several types of plans to carry out its current and future operations, (2) drafted criteria to review TSM projects, (3) assessed its software development capability and initiated projects to improve its ability to effectively develop software, and (4) started to develop an integrated systems architecture[9] and made progress in defining its security requirements and identifying current systems data weaknesses. However, despite activities such as these, pervasive weaknesses remained to be addressed:

-- IRS' strategic information management practices were not fully in place to guide systems modernization. For example, (1) strategic planning was neither complete

[9]A system architecture is an evolving description of an approach to achieving a desired mission. It describes (1) all functional activities to be performed to achieve the desired mission, (2) the system elements needed to perform the functions, (3) the designation of performance levels of those system elements, and (4) the technologic interfaces and location of functions.

nor consistent, (2) information systems were not managed as investments, (3) cost and benefit analyses were inadequate, and (4) reengineering efforts were not tied to systems development projects.

-- IRS' software development capability was immature and weak in key process areas. For instance, (1) a disciplined process to manage system requirements was not applied to TSM systems, (2) a software tool for planning and tracking development projects was inconsistently used, (3) software quality assurance functions were not well-defined or consistently implemented, (4) systems and acceptance testing were neither well-defined nor required, and (5) software configuration management[10] was incomplete.

-- IRS' systems architecture (including its security architecture and data architecture), integration planning, and system testing and test planning were incomplete. For example, (1) effective systems configuration management practices were not established, (2) integration plans were not developed and systems testing was uncoordinated, and (3) standard software interfaces were not defined.

[10]Configuration management involves selecting project baseline items (for example, specifications), systematically controlling these items and changes to them, and recording their status and changes.

Finally, IRS had not established an effective organizational structure to consistently manage and control system modernization organizationwide. The accountability and responsibility for IRS' systems development was spread among IRS' Modernization Executive, Chief Information Officer, and research and development division. To help address this concern, in May 1995, the Modernization Executive was named Associate Commissioner. The Associate Commissioner was assigned responsibility to manage and control modernization efforts previously conducted by the Modernization Executive and the Chief Information Officer, but not those of the research and development division. However, the research and development division still did not report to the Associate Commissioner.

We made over a dozen specific recommendations to the IRS Commissioner in our report to enable IRS to overcome its management and technical weaknesses by December 1995. Our recommendations were intended to improve IRS' ability to successfully develop and implement TSM efforts in fiscal year 1996. The House Conference Report on IRS' fiscal year 1996 appropriation notes that legislative language "fences" $100 million in TSM funding and requires that the Secretary of the Treasury report to the Senate and House Appropriations Committees on the progress IRS has made in responding to our recommendations with a schedule for successfully mitigating deficiencies we reported.[11] As of March 4, 1996, the Secretary of the

[11]House of Representatives Report 104-291, October 25, 1995.

Treasury had not reported to the Committees on TSM. We are assessing IRS' actions and will provide a status report to the Committees by March 14, 1996.

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Mr. Chairman, that concludes my statement. I would be happy to answer any questions you or Members of the Subcommittee might have.

Mr. HORN. Majority members will get 5 minutes a round. The minority, since they made the quorum and I am an educator and believe in Skinnerian rewards, get 6 minutes a round.

Welcome, colleagues. Glad you are here.

Let me just say the quorum was established in the last paragraph of my opening remarks, for the record.

Let me just ask you a few questions and I will yield to the ranking minority member.

One of the things that concerns me, as I mentioned in the opening statement, is the criterion by which we write off tax debt which is at $100 billion now. And I am interested in the criteria that then makes the other $60 billion collectible.

Did GAO look at any of this particular situation?

Mr. DODARO. Yes. In fact, one of the other areas we have made a little bit of progress in, was developing a methodology by which IRS could sort through its accounts receivable population and decide what is valid and collectible and what is not and also in terms of a valid receivable and what is not and also from a collectibility standpoint.

Part of the problem is a lack of detailed subsidiary records by which you can accumulate that information. In lieu of that for a financial reporting purpose, we decided to do statistical sampling to come up with some valid estimates, so we have worked with IRS to develop a methodology for doing that. The results showed that a lot of the accounts receivable that were carried on the books were actually not valid receivables, but had been put in for enforcement purposes. And so we are working through that and the detailed criteria, but it is a very difficult area.

I am going to ask Mr. Holloway to comment additionally on that because he has been working very closely in that area.

Mr. HORN. I am particularly interested in your comment that they were not valid receivables. Does that mean they had added interest, interest, interest and the real original debt was buried somewhere down there?

Mr. HOLLOWAY. Let me try to clarify a couple of things because the $100 billion write-off, I am not familiar with that number. I would offer to you that IRS technically does not write off anything until the statute runs, which currently is 10 years. They do not do the conventional write-off that you would see for financial reporting purposes.

I think what is at issue is being able to differentiate, of the purported $160-something billion of outstanding assessments, how much of that is cases where people legitimately owe money versus how much of that is the result of a compliance effort, where it is not so much a question of will we collect it, but rather to provoke taxpayer compliance by either filing a return or taking some other action.

And I think that is part of the deception and one of the problems when you talk about IRS receivables in that larger context is that what we found is a whole lot of that is not even accounts receivable. A lot of that are the results of compliance initiatives where they are trying to provoke a taxpayer action and that is part of the problem, is the inability to differentiate readily on a comprehensive basis how much of it is really what is owed so that you can evalu-

ate collection efforts against it versus how much of it is in there for the purposes of trying to provoke a taxpayer action.

So I guess I would just leave you with that I do not believe that there has been $100 billion written off. I think there is possibly that portion that may have been identified by some sources as believed to be not collectible, but I think there is a mistake in looking at $160-some billion because that is not a real number.

Mr. DODARO. The other point, Mr. Chairman, on your question is the basic problem we have had, and we have had this for years, the IRS accounts receivable area is a discrete area also on our high-risk list and part of the problem is just the underlying data is not accurate and until we can get the underlying data accurate and we have a good methodology on a routine basis that sorts through all the enforcement activities that IRS levies, to get down to have that account receivable information so we know what the number is, what is collectible and what is the most effective way to go about it. And that is really at the heart of the issue and that is one of the reasons we have been focusing a lot on this activity as part of the financial statement audit.

It is a classic case of where good accounting can enhance your program activities and your program efforts, and that is really the heart of what we are trying to work with IRS on.

Mr. HORN. In your written testimony, you mentioned one situation where the IRS was getting ready to pay 10 refunds totaling $173 million. The recipients of those refunds owed the Federal Government $10 million, but the IRS went ahead and sent the refunds anyway. I am curious how common that occurrence is, because that is what our debt collection bill is all about. Let the left and the right hand know where the benefits are going and when the obligations are there and either deduct one from the other or do not grant the benefits until the Government gets its money.

What is your view on that? Is that a common occurrence and could you estimate how much is unnecessarily lost each year by that processing or lack of processing?

Mr. HOLLOWAY. I think the concern there, and it is one that we certainly are concerned about, is that a minimum a threshold needs to be established. What is occurring for the most part or what provokes that is, I believe it is 45 days, that if it is not refunded in that time period interest begins to accrue. And what happens, and this is one of our overriding concerns about receivables is the timelineness with which we determine who owes us what and what is happening these refunds go out in an effort not to hit the penalty period as a result they would not have been subjected necessarily to review in the fullness of an exam or whatever step IRS might take and then it is out there. And then what happens is 1 year or 2, 3 years later an examination occurs and they determine that it should have been disallowed, but it is already gone and by the time we get back to them, it is often found that they are bankrupt, unfindable or whatever the issue may be.

So what is occurring in those cases, I think, is a definite need to establish thresholds of when you allow that to happen because sometimes I believe we may find that it is cost beneficial to absorb the interest, if we have to, rather than letting the moneys go and then have to try to recoup them. But I think it really goes to the

fundamental problem with collections, which is not so much who is collecting, but it is how timely we identify that it is owed.

Mr. HORN. Very good.

I now yield to the ranking minority member.

Since you both came in, if you have an opening statement, I would like to either put it in the record or whatever. We will put it in as read.

Ms. MALONEY. Very well. If you would put it in as read, I would appreciate it very much.

Mr. HORN. Yes. As read.

[The prepared statement of Hon. Carolyn B. Maloney follows:]

CAROLYN B. MALONEY
14TH DISTRICT, NEW YORK

1504 LONGWORTH BUILDING
WASHINGTON, DC 20515-3214
(202) 225-7944

COMMITTEE ON BANKING AND FINANCIAL SERVICES

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

DISTRICT OFFICES:

- 110 EAST 59TH STREET
  2ND FLOOR
  NEW YORK, NY 10022
  (212) 832-6531
- 28-11 ASTORIA BLVD.
  ASTORIA, NY 11102
  (718) 932-1804
- 678 LORIMER STREET
  BROOKLYN, NY 11211
  (718) 349-1260

Congress of the United States
House of Representatives
Washington, DC 20515–3214

Rep. Carolyn B. Maloney -- Opening Statement
Hearing on Oversight of Internal Revenue Service Financial Management

March 6, 1996

Thank you Mr. Chairman for holding this important hearing. I share your concern with the financial management of the federal government. It is a fundamental issue which must be addressed in these times of ever-greater budgetary restraint. The Chief Financial Officer Act of 1990 was a major initiative designed to help improve financial management in the federal government and it is important that we continue vigorous oversight to ensure its implementation.

One of the requirements of the 1990 CFO Act is that the General Accounting Office audit the Principal Financial Statements of the IRS. That report for fiscal year 1994 is very troubling, and I look forward to both the GAO's presentation of it and IRS Commissioner Richardson's response. The GAO reports that it was unable to complete its audit for FY 1994 because of shortcomings in the accounting practices at the IRS. Perhaps most worrying is the fact that the total revenue collected, $1.3 trillion, could not be reconciled to the accounts maintained in IRS master file. For instance, the totals by type of tax for the financial statement came from Treasury sources, rather than internal accounting systems; the IRS could not substantiate $2.1 billion in non-payroll expenses because of a lack of documentation; and, the GAO could not account for $6.5 billion in contingent liabilities claimed by the IRS. The IRS claims to have made significant improvement on these and other accounting deficiencies since 1994. I look forward to hearing about those improvements.

I am also concerned with problems the GAO found with the IRS's Accounts Receivable. These represent money owed to the federal government -- namely to the taxpayer -- which have not been collected. I have a longstanding interest in this issue, and have work with Chairman Horn on the collection of non-tax delinquencies. The IRS estimates that the total uncollected debt is $69 billion, but of that only $35 billion is collectable. The IRS is required to keep these accounts open for 10 years and this debt often becomes uncollectible through bankruptcy or death. The GAO found problems both in the estimates of this debt and in identifying whether or not individual accounts were collectable.

Other issues to be examined today should include "browsing," unauthorized examination of taxpayer returns, and the progress of the IRS's Tax Modernization System. I look forward to hearing from our distinguished witnesses on these and other issues at today's hearing. Thank you Mr. Chairman.

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Mr. HORN. Did the gentleman from South Carolina have an opening statement?

Mr. SPRATT. No, I do not.

Mr. HORN. OK.

Six minutes to the ranking minority member.

Ms. MALONEY. First, I would like to thank the chairman for calling this hearing and really for his hard work on the debt collection bill. In probably the most partisan Congress in history, certainly the most partisan one I can remember, we have found one area in which we could agree and we have worked very strongly and hard to enact it. I think it will be very positive to improve management in Government and ensure more revenues coming in to pay for more teachers, police officers, and other things that we need.

This report is extremely troubling and I would like to refer first to page 3 where you talk about your results in brief and say that the Government's investment of what could be more than $8 billion and IRS's effort to modernize tax processing are at serious risk due to remaining pervasive management and technical weaknesses that impede modernization efforts.

And it goes on. In this regard, IRS does not have a comprehensive business strategy to cost-effectively reduce paper submissions and it has not yet fully developed and put in place the requisite management, software development and technical infrastructure necessary to successfully implement an ambitious world-class modernization effort like TSM.

That is probably one of the most damning results I have ever read in a GAO report. It goes on and says in so many words that the success rate or modernization or improvement is not moving forward and, in fact, the problems that you identified in the 1994 report are not substantially different from those in previous audits. I would just like to ask you why has so little progress been made and based on what you say here, you say the Government is wasting $8 billion because they do not have the management in place to make this happen.

Am I reading it correctly? I mean, it is a very strong statement and is it a fair statement that not much progress has been made since the 1994 report to this report?

Mr. DODARO. We think that the statement that we said, that you just read, is very accurate and at the time IRS agreed with that assessment. We met with them very frequently during the course of that evaluation.

We think that the Government as a whole has had a lot of difficulty implementing successful information technology instances. The case of IRS, however, is that we are spending large amounts of money without having the necessary management and technical infrastructure in place.

Ms. MALONEY. Well, do they now have it in place?

Mr. DODARO. We are in the process of responding to the committee report on IRS's appropriation, the Treasury appropriation last year, which asked us to evaluate IRS's response to those recommendations and report back to the committee.

The Secretary of Treasury was due to issue a report responding to the recommendations. That report has not yet been issued. We have been reviewing IRS's plans and activities. We find that they

are making efforts in all the areas to address the recommendations, putting in some new processes and procedures, but they have not progressed far enough in implementing many of those areas for us to conclude that they are in any more appreciable different position today than they were when we issued that report.

Ms. MALONEY. What do they need to do to get into that position?

Mr. DODARO. Let me ask Dr. Stillman to respond to that.

Ms. STILLMAN. What they really need to do is commit to instituting disciplined processes for controlling their systems investments and for building their systems.

By doing that, they can justify to themselves, and to you why an investment in a given system is worth making and, having made that investment, they will have half a chance at delivering the system.

What they have to do is implement discipline processes which exist. There are software development organizations today that implement processes like this and they do substantially better at building big software than organizations like IRS.

It is not a change that requires scientific genius. As they say, this is not brain surgery. What this is is good management and enforced discipline.

Mr. DODARO. And we believe the recommendations we have made in this latest report provide a good blueprint for IRS if they can successfully implement them and put them into practice.

Part of the difficulty here, and the same thing exists in the financial management area, is ingraining these processes in your day-to-day management activities. That has not happened yet. That is what needs to be put in place.

And I might also add here is that we are not the only organization that has made this assessment. The IRS has had the National Research Council employed for the past 5 years tracking their progress in tax system modernization. They have just recently issued their report and that report mirrors the recommendations that we have made and also adds some additional areas and recommends further that IRS set up an independent group to keep monitoring this as they go forward.

It is just a matter of execution of the different management techniques. We have had a number of discussions, continuing dialog with IRS on this issue. I think they hear our concerns. I think they are trying to move forward, but they need to do so more aggressively in all these areas, given the amount of money that they are spending.

Ms. MALONEY. OK. On page 22, you have a graph on how this $8 billion is going to be spent and out of roughly, 224 million filings at the end of 2001 they estimate that only 17 percent is going to be electronically handled.

Is that correct? Am I reading it correctly?

Mr. DODARO. Yes.

Ms. STILLMAN. You are reading it correctly.

Ms. MALONEY. I am reading it correctly?

Mr. DODARO. Right.

Ms. MALONEY. For $8 billion, just to have 17 percent electronically handled seems very low to me. I would like a comment on what is happening. And then further down you talk about how they

are not taking advantage of home PCs for electronic filings from individuals. That would take out a step for IRS and a step for the individual, saving a lot of money.

So I would like a comment on the 17 percent electronically handled. If the goal which you set is to have your paperwork electronically handled, why is the percentage so low after $8 billion?

Mr. DODARO. Right. That was the essence of the concern that we brought to the IRS at that point in time. That if they went forward with their existing business strategy, we did not think they would achieve their goal that they had set out in terms of bringing the vast majority of the taxpaying population into an electronic transmission mode.

And they agreed with us and they have since then started to do some additional market research. A lot of these figures were based upon IRS using third-party tax preparers and other services to process some of the tax returns. And we felt, as you have pointed out in the report, the large number of people who develop and use tax preparation packages on their home PCs. What these people were doing was developing it using software, printing it out on paper form, mailing it to IRS and then it was transcribed, and not all of the information was ever collected off the form, but it would have to be transcribed again by IRS keypunch operators and put into electronic format. And it did not make sense to us.

IRS has agreed. They have committed to move toward a broader strategy, but we have yet to see what that revised strategy is going to be. But this is where the big payoff is, if we can get most of the information in electronic format and put in place. But you need to have your business goals directed toward getting there. This is one of the areas where we found leading organizations really excelled by making sure you have a good business plan in place first and then your information technology supports that business plan and business goals.

And our recommendations are intended to move IRS in that direction.

Ms. MALONEY. My time is up.

Mr. HORN. I now yield 6 minutes to the gentleman from South Carolina.

As I recall, my distinguished colleague held a hearing on this subject in the 103d Congress.

Mr. SPRATT. Well, about more than the Internal Revenue Service, so reconciling all of the departments of the Government to something like generally accepted accounting principles is a chore and it has still proved to be one.

I am finding myself a little hard to follow this because I do not understand the process. When I send a check on April 15th to the Internal Revenue Service, is it bundled with other checks and immediately deposited in the Treasury of the United States? Or does the IRS maintain an account and then transfer the funds from it periodically to the Treasury?

Mr. HOLLOWAY. There are a variety of ways that money comes in to the IRS. About 60 percent of it, I am going to come back to the individual, but about 60 percent of it, which is the FTD coupons that most businesses file, come through what is known as the

TT&L process which is usually electronically transmitted through the Federal Reserve and so on and so forth.

There are lock box arrangements where it is sent to commercial banks and packaged and sent to the Federal Reserve and there are instances like you describe where it comes directly to a service center at IRS and they deposit it. I believe their policy is to deposit it every day and send it to the Federal Reserve.

Mr. SPRATT. To the Treasury account at the Federal Reserve?

Mr. HOLLOWAY. Right. They send it to the Federal Reserve. That is correct.

Mr. SPRATT. Now, when you say that—and at the same time, then, what is the data entry made for accounting purposes? Is there a ledger, John M. Spratt, there that——

Mr. HOLLOWAY. Basically, what they do, is a process. I will call it pre-journalization. I believe that is the correct phrase. But essentially when those deposits are made, and I am going to cut through some corners just to simplify the basic way it works, they identify all the cash that was purportedly deposited and sent to the bank, they pre-journalize that, and then the processing of your receipt through their system begins through the RACS system ultimately going to master file, which is the detailed record of your tax account.

Mr. SPRATT. Now, they journalize it? There is an entry there?

Mr. HOLLOWAY. There is an actual journal entry made to their accounting system for the receipts that came in for the most on a daily basis.

Mr. SPRATT. Now, is there then a transfer from the journal to ledger cards, to a ledger account or a ledger for each individual taxpayer?

Mr. HOLLOWAY. Say that one more time.

Mr. SPRATT. All right. You have got a journal entry. Then does somebody post the journal to a ledger?

Mr. HOLLOWAY. Not to your independent account. No. The receipt processing goes through the entire process of the keypunching and the other things that happen to move it to master file.

There is an overall journal entry that takes the aggregate receipts that came in that day on Fed Wire or whatever and they say this is how much we got, write a journal entry to book all of cash, essentially putting in cash and putting it in quote-unquote a suspense account, to say that this is how much we got in.

The challenge then becomes to verify to your individual record that the thing ultimately posts and there is a period of time that it takes for it to move through the IRS's processing stream before it hits what is known as the master file which is where your individual account is and it is posted.

Mr. SPRATT. Well, that is where I was trying to get, from the receipt of the check where it is a check transaction, the individual taxpayer to the Internal Revenue Service Service Center. Once it is journalized upon receipt, is a data entry made in a journal?

Mr. HOLLOWAY. Yes, but not to your account at that point.

Mr. SPRATT. Not to my account. But it is cash received and then something, something is debited and something is credited.

Mr. HOLLOWAY. That is right. A suspense account.

Mr. SPRATT. OK. And then just that aggregate amount is then booked on some kind of deposit slip, I am converting this to terms I can understand, for purposes of that day's deposit.

Mr. HOLLOWAY. Right. I mean, the deposit slip is what goes to the bank, the deposit—just like you send the deposit to the bank—goes to the bank with the money. And then they run those through their system, and that system is basically a batch processing system, where your return and the other things that go with it will go and get processed. And if everything checks out over—I forget what the period of time is—ultimately it will post to the master file to your specific account, but initially on the recording of the receipt of the cash, your account is not hit.

Mr. SPRATT. All right. How do you get from the journal to the master file? Is it electronically derived from the batch processing or does it require another step internally by the Internal Revenue Service to post the journal to a master file?

Mr. HOLLOWAY. There are a couple of things that happen. The return goes down one track, the receipt goes down another track, and basically what happens is that stuff gets keypunched in, it is usually batched in groups of 100. If the batch that yours happened to be in is successfully posted, then you are on the way to master file. If it does not and something kicks out, then you are probably going to be held up somewhere in the process until they cure the issue to perfect that batch and then you go to master file.

Mr. SPRATT. Well, now, to what extent is this problem a problem of unreconciled accumulated rejects? In a banking business they used to call that rolling rejects.

Mr. HOLLOWAY. Oh, I think there is no question that that is the inherent problem that IRS has when we talk about the inability to reconcile the total receipts collected to the master file, is that there is an in process stream where moneys have been journalized to be recorded basically as having been received based on we got the money, but for whatever reason the individual tax receipt has not posted to the master file for any number of reasons.

Mr. SPRATT. But for the most part it is because they got kicked out in the process.

Mr. HOLLOWAY. That is right. It was in a bad batch that got kicked out, that somehow got delayed. There is a multitude of things that could happen. It could get misposted. There is a variety of things that could occur that create problems and that is the difficulty, is trying to figure out the total receipts number does not equal what hit the master file for the period in question.

Mr. SPRATT. My light is on, but let me ask you, is this a manpower problem? Is it usually it requires some human attention to work these rejects. Somebody has got to sit down and cognitively think through this.

Mr. HOLLOWAY. Oh, they have people that work them. I think the fundamental problem with the revenue accounting system as we see it, and this is where we have made a concerted effort to try to help out is that IRS does not have that whole process documented to where they know the entire flow and one of the things we have been working with them on since the last audit was to try to get that process mapped out so we can figure exactly where through that process the check could get stuck, in an effort to try

to go back and retrieve it to reconcile to the overall receipts, and that is the inherent dilemma.

The problem is, and it goes counter to what Gene says, which is the fortitude to stick with it. It is an arduous process, but somebody has got to do it. I think it is important that you do understand how your system works. And what we found is there are a lot of people in IRS that have a lot of knowledge about that system, but the problem is putting it all together, to get it down and document it so that you know how it works. And when you have experts on different pieces and you get conflicting information on how it works, you have to reconcile those things and resolve it. So, I mean, there are people that understand the system but we just do not have it documented as to exactly how it works to go back and get the information.

That is why there is so much trouble trying to reconcile it.

Mr. DODARO. And I think one of the things in our recommendations directed to put this in place is to put more checks and balances and reconciliations into the individual aspects of the process. Many are there, they have many of those, but they need some additional ones so that you can then find where the differences are to be able to reconcile and satisfactorily explain that your system has captured everything.

Mr. HOLLOWAY. I will offer to you, Congressman Spratt, that while the RACS system, probably when it was initially developed, was not designed with CFO in mind. The capacity to generate the information is there because all of the information is there. It is just mapping out the process and knowing where everything is and then developing programs to go get the information to identify it.

Mr. SPRATT. Thank you, Mr. Chairman.

Thank you.

Mr. HORN. I thank the gentleman.

And I now yield a minute to my ranking colleague. She has to leave for a meeting.

Ms. MALONEY. Yes. We have a Democratic caucus meeting and I will be right back, but following up on my colleague's question, this is not about missing money, is it? The $1.3 trillion is there, it is in the Treasury, correct?

Mr. DODARO. Well, yes.

Ms. MALONEY. It is not about missing money, it is just about bookkeeping.

Mr. DODARO. Well, let me answer that a different way. We have been able to each year satisfy ourselves that what was in the bank was what was reported, but in terms of whether or not anything was missing or misappropriated or whatever, because you cannot satisfactorily reconcile everything, you really do not know.

You do not have as much confidence as you should. You are hoping nothing is wrong, but you cannot really know for sure until you can adequately reconcile all these issues that we have brought up.

Mr. HOLLOWAY. Let me amplify on that a little bit. The bottom line is what he concluded, which is you do not know. You would like to believe that is the case, but you really do not know and that is why it is important to reconcile.

The second issue, though, is that what we have been able to say is that what is in IRS's records at a summary level essentially

equals what they told Treasury was collected. That does not necessarily mean that it equals what was at the Federal Reserve, which is where the actual money is, which is what we are trying to do in this year's audit, is to try to ascertain whether or not we can agree the transactions that they have in their master file.

They are making an effort to try to develop all of the transactions in the master file that I talked about that should have gotten through the process during the fiscal year. We are in the process of trying to secure directly from the Federal Reserve how much came in through those accounts in an effort to see if they do agree and that will at least in part go to your question in trying to do that.

But that is the problem when you do not reconcile something. It is just like your own personal bank account. You do not know if something is missing. You would like to believe it is not, it could not be, but then again it could be.

Mr. DODARO. But that lack of assurance and our comfort level with that process is really at the heart of the reason we have not been able to render an opinion on the statements.

Mr. HORN. Now, remind me, Mr. Dodaro. Were you involved in our hearing with the Pentagon as to whatever happened to $15 plus billion and they said, "Gee, we do not think anybody stole it and we think we have the equipment, but we cannot reconcile anything because we have 49 different accounting systems." Were you involved with that?

Mr. DODARO. Yes, I was.

Mr. HORN. Is this worse?

Mr. DODARO. I have also the honor of auditing the Defense Department as well.

Mr. HORN. Right. I thought you were one of the more popular people in the executive branch as you go round to round.

I am curious, how would you compare these two situations?

Mr. DODARO. I think there are some similarities in terms of the need for discipline into the process and procedures, but the problems are very different. They are more easily solvable at the IRS because of the reasons that Greg mentioned in terms of the revenue accounting system actually being—in comparison to DOD's systems, it is in relatively better shape. With some effort we can get there quicker on the IRS than we are going to do at the Defense Department.

Additionally, in the Defense Department, when we tracked down some of the control problems, we actually found some fraudulent activities. I think you have a different problem. There you have a bigger problem controlling your disbursements in the process and you are spending a lot of money on a lot of different things and a lot of different people are spending the money and you do not know whether you have spent more than you are supposed to have spent, there is no assurance of that at Defense. Making sure you do not overpay contractors. We know they overpay contractors routinely. So you have different problems there with their systems.

At IRS, it is more collecting the money and there are various checks and balances in the system but we cannot get them all to reconcile yet. And I think we can get there. I think they are both

serious problems, they are both on our high-risk list, but I think in the IRS's case we can get there faster.

Mr. HOLLOWAY. I think clearly on the administrative side, if I were to do a quick analogy, it would be at IRS you can see the light at the end of the tunnel. In DOD, I do not think you even know if you are in the tunnel and I think that is the difference because clearly the things at IRS are fixable and there are clear cures for those things and a lot of it is just determination and putting good controls in place and follow through to make sure people do their jobs right and holding them accountable when they do not.

Mr. HORN. Let me ask you, on the famous 59 recommendations we have been talking about, last year you found 13 had been implemented and you were satisfied with that and you are in the middle of the process to see how many more are implemented. I am curious if you have a sense that the most significant of your 59 recommendations were implemented first or are they simply being implemented in chronological order or are they simply being implemented in the easiest ones first and they are not tackling the big stuff that might have a greater effect?

What is your reading on that?

Mr. DODARO. I think clearly the more difficult recommendations to address and to fix are the ones that are still outstanding. Many of the 13 involve putting in place policies and procedures which they were able to quickly move and we noted their progress for doing that. But I think the outstanding items are the more knotty problems that need to be resolved.

Mr. HOLLOWAY. But I think the real important thing to note here, and it goes back to our premiere recommendation which is the need for a clear plan with clear time tables, with clear deliverables, with clear accountability, and then hold people accountable if they do not get it done. I mean, the best example is the reconciliation issue. I mean, that issue dates back to the first audit. Last year, we were told that it was done and we went and looked, it was not. This year, they have made progress but the problem is it is, I do not want to use the word ad hoc, but they are doing some necessary steps, but there still is not a clear plan and timetable for deliverables to finish it and I think the importance of that is it creates focus, it creates determination, and it gives Congress the opportunity to look at it and say did they do what they said they were going to do.

And I think it is imperative that that be done because clearly they have made strides, they brought in a contractor on the reconciliation issue, they took a first step to fix part of the problem but they still have not resolved the reconciliation. And at least they have not offered to us a firm time table for at what point that will be resolved.

Mr. HORN. We mentioned the electronic filing and it did not quite meet expectations, but you feel confident that they are getting there. What was the main problem with the first plan? It seems to me, as I remember, one of the incentives was you would get your refund much more rapidly. Did that seem to work or did you even examine that?

Mr. DODARO. In terms of? I am not——

Mr. HORN. Using electronic filing.

Ms. STILLMAN. The issue on electronic filing is that for IRS to succeed at its own vision of processing electronically rather than processing paper, they have to get most of their returns submitted electronically rather than on paper. They have to get most of their returns submitted electronically.

They themselves had a goal of about 35 percent by 2001. By their own estimates, they were only going to reach 18 percent. The reason for that was that they had not targeted segments of the population, large segments of the population that would be willing to file electronically or they had not planned to give them the incentives to do so.

For example, the only people who would find any advantage to filing electronically were those who were expecting a refund, those who were filing relatively simple returns, those who were willing to pay a fee for the privilege of submitting their tax returns.

For people like me, I use Turbo Tax. My tax return is a little more complicated. I usually have a balance due. I do not have any incentive at all for filing electronically. We saw no business plan for getting people like me on board and that is exactly what we were asking for, a comprehensive business plan to get the bulk of the population on board with incentives to do so.

Mr. HORN. Did they use any public service ads, anything like that?

Ms. STILLMAN. They had targeted a narrow segment of the population. They targeted, for example, tele-file, people like students filing very simple returns who could punch in their returns over the phone; people who went to third-party providers and wanted a refund and those especially who wanted a loan against that refund in order to use the money more quickly.

They really had no strategy at all or no incentives for anyone else.

Mr. HORN. It seems to me one logical place to deal with are the taxpayers that are in it professionally, have the appropriate equipment, this kind of thing.

Ms. STILLMAN. And that is who they have used primarily, but all of them charge a fee to do so. And so for that portion of the population that does not want to pay more than the cost of the stamp, that option is not very attractive.

Mr. HOLLOWAY. Which is most of us.

Mr. HORN. Yes. I understand that.

Mr. DODARO. Part of the issue here, too, was in addition to doing a market research and targeting that population, you need to have the systems in place in order to receive the information electronically. And unless you have both in place, and we found neither in place and they have agreed to move in that direction and we think that is the right way to go.

The other concern that we have that we brought up in the report is if you fall short on your goals to have electronic information submitted by 2001, that means you are going to have much more paper still coming in than your old systems can handle during that period of time. We were concerned that you needed a plan to accommodate that as well because that would put additional stress and strain on the paper systems that they may not be prepared for.

Mr. HORN. One last question just to round this thing out. What do you think of the status of the electronic equipment that the IRS is using? Are they lagging behind in this?

Ms. STILLMAN. I do not think the primary problem with IRS is equipment. The primary problem is business planning and management.

Mr. HORN. And that would solve most of the missing recommendations in terms of implementation? Or are you just talking electronic filing?

Ms. STILLMAN. In terms of the recommendations on the computer systems, they need a good business plan, they need a good investment strategy and they need good technical procedures in place to build systems. They need a way to determine what to build from an investment point of view and from a business point of view and then they need the infrastructure in place to enable them to build it. They had neither of those things when we looked at those reports.

Mr. HORN. I see.

The gentleman from South Carolina?

Mr. SPRATT. No questions.

Mr. HORN. The gentleman from Minnesota, Mr. Peterson?

Mr. PETERSON. Thank you, Mr. Chairman. I apologize. I got tied up.

I think it was a discussion I had with you about some of these similar issues a couple of years ago and at that time, I think it was you, maybe it was somebody I was talking with, you said that these returns were coming in to some of these centers and they were literally putting them in carts and trucking them over to the other side of the thing and that the big problem was that there was no plan to get them into the computers.

Mr. DODARO. Right. We had a discussion at a hearing on revisions to the Paperwork Reduction Act.

Mr. PETERSON. Right. Right. And apparently they have not made a whole lot of progress in getting a system in place to deal with all the paper and get the input without errors and so forth. Is that what you are saying?

Mr. DODARO. Yes. We basically concluded that the plan to modernize and move in that direction and have more things submitted electronically was not good. The business plan needed revamping to move more in that direction and IRS' ability to actually develop the software and put the systems in place within costs and within schedule needed major enhancement.

We had mentioned earlier that their software development capability was at the lowest level in the ranking by the Software Engineering Institute and unless they could move up their level of software development capability, they were not going to be able to produce the systems in order to receive the information electronically.

Mr. PETERSON. This is just for the receiving of the electronic information?

Ms. STILLMAN. It is for all of their processing of data electronically: when they receive paper, they convert that paper or some of the data on that paper to electronic format and then from there on it is electronic.

Mr. PETERSON. And how do they convert it?

Ms. STILLMAN. Manually. Some manually. They have some optical character reading equipment.

Mr. PETERSON. That was my question.

Ms. STILLMAN. It is mix and match.

Mr. PETERSON. Are they using optical scanning?

Ms. STILLMAN. They do do some of that, yes.

Mr. HOLLOWAY. Certain parts of the operation are done that way, yes. But certain parts of it are not.

Mr. PETERSON. Well, when a tax return comes in, I mean, I agree with Ms. Stillman here. I just did my tax return on Turbo Tax and I am not going to send it in electronically because it costs me money and I think most people are going to take that position.

So the question becomes it is going to be, I think, hard to change that so you need to have some kind of a system there to deal with this paper that comes in and not have the errors and not have the inefficiencies that are going on, but that is what we are talking about, right?

Mr. PETERSON. Right.

Mr. DODARO. That is exactly correct.

Ms. STILLMAN. Actually, there are some alternatives. It ought not to be that hard to take it via a modem from your PC.

Mr. PETERSON. It should be easy to do.

Ms. STILLMAN. It ought to be not too bad. It is already in the format they want it. You have it electronically and complete in your machine. If you have a modem, all you have to do is send it out on the phone.

Mr. PETERSON. They have no way to accept it. In an easy way.

Ms. STILLMAN. At the moment they do not do that. That is correct.

Mr. PETERSON. It would not be that hard to do.

Ms. STILLMAN. It does not seem to be, does it?

Mr. PETERSON. They could do it with off-the-shelf software, probably.

Ms. STILLMAN. It ain't rocket science.

Mr. PETERSON. Right. And have they not been moving toward the paper that comes in just trying to do all of that just by optical scanning rather than have people manually inputting it?

Mr. HOLLOWAY. I think it is a mixture. I mean, certain parts of their operation, like when the returns come in, for the most part, a lot of that is still being keypunched in but I would defer to——

Mr. PETERSON. But my question, why are they doing that? It just seems to me it would be a lot more accurate and inexpensive if——

Ms. STILLMAN. Congressman, if I could interrupt you here, it depends on the type of return that is coming in. If it is a fairly simple return, they have optical character reading capability to scan those returns and to process them and a more complex return similar to what you and I would probably file they do manual data entry.

Mr. PETERSON. But my question is why.

Ms. STILLMAN. Because they do not have the capability with the scanners right now.

Mr. PETERSON. Why? The scanner is there, the software is there. I mean, they could do this if they wanted to, right?

Mr. DODARO. Well, a lot of this gets back to what our first recommendation was in the report. You need to set clear business goals in terms of what you want to do, that you are going to go after that segment of the population. We felt there was too much emphasis in going through third-party tax preparers. I can understand why originally IRS wanted to go in that direction, you would have more confidence in the information being submitted and that was a pilot program that they had for years and we were endorsing it. It was a good move to go in that direction. But with the proliferation of personal computers and software packages, and things of that nature, we felt the business strategy had not been modified to keep pace with the potential opportunities that IRS would have to receive more types of tax returns, more types of information put in place.

And they have agreed with us, and they are relooking at that and trying to put that vision in place. Part of the problem, though, is that you are building systems that were designed to accomplish one business strategy and now you have to sort of segue into a different type of strategy. They are struggling to do that and it is complicated further by the fact that their ability to develop some of these systems and to provide adequate security and to have the right type of architecture for taxpayer information is not as reliable as it needs to be.

Mr. PETERSON. What happens with all of this if we decide next year to scrap the income tax system and go to a sales tax? Then we do not have all these problems, right?

Mr. HOLLOWAY. But you may have another whole set of problems.

Mr. PETERSON. No, I know, but we do not have this particular set any more.

Mr. DODARO. As long as you are in the business of collecting revenue, you are going to have accounting problems and you need good financial management systems, and depending on what type of tax it is and how it is collected and whether it is withheld at the source or whatever, you are still going to have those problems.

The technology problems would need to be revisited if there are major changes in the tax code, I think. And probably we would also have a transition period, I would imagine, and we will have to figure out what implications there are. But if you have in place a good managerial and technical foundation, you could make adjustments like that easier than you can if you do not have that infrastructure in place. And that is our basic message, to get that in place.

Mr. PETERSON. Thank you.

Thank you, Mr. Chairman.

Mr. HORN. Let me ask about the electronic filing in this way. As I understand it, they took various tests, they found that high percentages of fraud were among the initial electronic filers and last year the electronic filers were targeted, either before or after that finding, for extra reviews and more audits. And the question would be to what degree, if any, did that discourage any further electronic filing or at least lower the number of people that might otherwise have filed? Did you run into that problem at all?

Ms. WILLIS. The number of people who filed electronically was down last year and we believe it was in part due to the additional

controls that were in that did not allow people to file returns electronically that they would have been able to file in previous years.

Mr. HORN. Now, was electronic filing going the preceding year to that?

Ms. WILLIS. Yes.

Mr. HORN. When did they start with the electronic filing, roughly?

Ms. WILLIS. I do not know the answer.

Mr. HORN. Well, we obviously can ask the IRS that, but I was just curious if you had run into that problem?

Mr. DODARO. Well, one of the issues, that is an interesting example, Mr. Chairman, of what we are talking about, about having the right infrastructure in place because some of the security controls to prevent the filing fraud had to be retrofitted after the system was in place and that is why we have been harking on the fact that as you move toward new systems and new systems being put in place that security features be built in up front. In the private sector, it has proven to be much more cheaper to build them in up front rather than retrofit them at the end.

Mr. HOLLOWAY. I think the mystery, too, when you look at any kind of performance measure is I do not know that the fact that it went down was necessarily a bad thing. You might recall that when they started asking for Social Security numbers, the number of dependents went down quite a bit, too. So it may not always be a bad thing.

Mr. HORN. OK. Any further questions over here?

[No response.]

Mr. HORN. If not, we thank you very much for coming. We appreciated all of your comments.

Mr. DODARO. Thank you very much, Mr. Chairman.

Mr. HORN. The next panel is Commissioner Margaret Richardson of the Internal Revenue Service; accompanied by Mr. Michael Dolan, the Deputy Commissioner; Mr. Anthony Musick, the Chief Financial Officer; and Mr. James Donelson, the Chief of the Taxpayer Service.

[Witnesses sworn.]

Mr. HORN. The clerk will note all four witnesses have affirmed. And we will ask Commissioner Richardson to begin and we are conscious that you have to leave at 4. We might have you stay over a little bit, but anyhow, please proceed.

STATEMENTS OF MARGARET MILNER RICHARDSON, COMMISSIONER, INTERNAL REVENUE SERVICE, ACCOMPANIED BY MICHAEL P. DOLAN, DEPUTY, COMMISSION OF INTERNAL REVENUE SERVICE; ANTHONY MUSICK, CHIEF FINANCIAL OFFICER, INTERNAL REVENUE SERVICE; AND JAMES E. DONELSON, CHIEF, TAXPAYER SERVICE, INTERNAL REVENUE SERVICE

Ms. RICHARDSON. Thank you, Mr. Chairman, and distinguished members of the subcommittee.

I am pleased to be able to be here today to talk about two of IRS's critical responsibilities: the implementation of the Chief Financial Officers' Act of 1990 as well as the collection of tax receiv-

ables. There were several other issues that came up in the course of the GAO testimony which we would like to touch on as well.

As you noted, Mike Dolan, the Deputy Commissioner is with me, as well as Jim Donelson, who is the Chief of Taxpayer Service and the Acting Chief Compliance Officer. The collection activities are in his bailiwick. And then Tony Musick, who is our new Chief Financial Officer and our principal advisor on financial management issues.

I do appreciate the opportunity to talk about the CFO Act of 1990 and the contribution that we think it has made to financial management at the IRS. We also wanted to talk to you a little bit about the actions we are taking to implement the objectives of the act.

As the collector of over 90 percent of the Nation's revenues, we do fully understand that we have a special obligation to taxpayers to be accountable for each tax dollar we collect and spend and I wanted to talk to you today about what we are doing to meet this obligation.

As the head of the Government's primary revenue collection agency, I do want to assure you, Mr. Chairman, as well as the other members of the subcommittee and the taxpayers that the IRS does have strong systems and controls to ensure that their individual accounts are accurate and I think we can tell you that these systems work.

Each year, and again today, the GAO has certified that the more than $1 trillion that we collect has been properly deposited in the Treasury. It is no small accomplishment for an organization that handles over a billion information documents a year, processes more than 200 million returns and issues more than 90 million refunds. Any complex system will produce some errors and ours does, but I want to assure you we make and will continue to make great efforts to detect and correct errors promptly.

While I said at the start of my testimony that I was pleased to be here, I am frankly less than pleased with the results of the GAO financial statement audits for the past 3 years. It is disturbing to hear that the IRS has not passed its financial audit and all of us are quite concerned as well.

But it is important for us, I think, to understand what is meant and what is not meant by that statement. It certainly does not mean, as I said before, that the money we are supposed to be collecting or spending has simply disappeared or somehow been misappropriated.

When we had our first financial statement audit in 1992, I had just become Commissioner. The 1994 statement which was issued just last August reported that we had made considerable progress since 1992 in implementing a new administrative accounting system and transferring our payroll processing to the Department of Agriculture's National Finance Center and improving the accounting for Federal revenues.

In fact, in testimony before the Senate Committee on Governmental Affairs in November 1995, Comptroller General Bauzer stated, "To its credit, IRS has made a commitment to institute changes. Through the strong support of the Commissioner, the

Agency has made important strides to address far-reaching financial management problems."

While this kind of praise is nice to hear, especially from the GAO, we also know for our financial audit that we have more work to do to get a clean financial opinion.

Shortly after I met with Comptroller Bowsher or shortly after I became Commissioner I met with him to talk about the 1992 audit because I was concerned and he assured me that his experience had been that some of the problems while very correctable would take several years before we would be able to get a clean financial opinion and he felt that we should be looking realistically at fiscal year 1996 as the first year that we could expect to get such an opinion.

He also, I think, noted that he hoped that the same standards would someday be applied to the legislative and the judicial branches as well.

I think it is important to understand that we do have two separate financial processes to track funds: the administrative system that handles our appropriated funds and our revenue system that tracks the tax collections. And I think it is also important to understand what these two different systems do in order to understand the GAO's audit findings and what we are doing to improve both systems to comply with the CFO Act.

We have taken some significant improvements which I think the GAO recognized today to our administrative accounting system. In 1992, they were unable to audit that system. In 1993, it was auditable but we were not able to provide them with all the information they wanted. In 1994, the audit report focused on just two administrative accounting issues: the failure to reconcile the accounts with Treasury and the lack of the receipt and acceptance documentation for the non-payroll payments such as rent to GSA and printing payments to the Government Printing Office.

Regarding the two issues, we are reconciling our cash balances to Treasury's records in fiscal year 1995 and we are going to ensure that these balances are reconciled on a monthly basis. On the non-payroll payments, the concern of the GAO was that we were not adequately verifying the payments being made for us by the General Services Administration and the Government Printing Office. We are reviewing those processes and working to improve them, but the solution requires the assistance of GSA and GPO as well.

One significant example of the effectiveness of our improved administrative financial systems has been our ability to track one of our major programs.

In 1995, you may remember we received funding for a compliance initiative, a 5-year plan with the moneys raised going directly to deficit reduction. Ironically, it was not refunded because of reduced funding for 1996, but the results of that initiative have been impressive and because of the information produced by our tracking system, I can tell you that our compliance initiative did yield over $800 million in revenue in fiscal year 1995 which far exceeded the $331 million we promised.

Now, that system is the very kind of thing the GAO was talking about that enables us to make good management decisions as well as Congress to evaluate whether its money has been spent wisely.

But along with improving our administrative accounting systems, we are working to improve how we account for the revenue we collect.

Our current system, which was implemented during 1994, was not designed to provide the detailed information that is required by the CFO Act for financial statement presentations. While we can and do reconcile the gross amounts corrected, as discussed earlier, we have not been able to give the General Accounting Office the information they would like to have to tie individual transactions to their sources.

To immediately address this issue for the fiscal year 1995 audit, the Service is providing detailed revenue receipt information from the individual taxpayer accounts that we have on our master file. Also, we are installing a short-term system solution which we call our interim revenue accounting control system.

In July of this year, it should be implemented nationwide so that the network will connect our data base located in our Detroit computing center with our 10 service centers.

These improvements hopefully will bring us closer to achieving our goal of a clean financial audit opinion and we hope, as I said, by 1996 to be able to do it on both sides.

But I would also like to talk to you for a minute about our accounts receivable inventory. As early as 1988, we determined that the accounts receivable was a growing concern, an assessment that OMB and GAO agreed with. Since that time, we have continued to take steps to improve the management of the receivables inventory.

We have focused on four specific areas: making sure that the composition of the accounts receivable is correct, ensuring the accuracy of the assessments that were included in that inventory, improving the currency of the inventory, and increasing the collection of the amounts in the inventory.

In 1990, Congress extended the time that IRS would be required to keep accounts receivable on the books from 6 years to 10. Thus, unlike accounts receivable in the private sector, what we call our accounts receivable dollar inventory, also called ARDI by some, is not a reflection of the annual underpayment of taxes, but it does include current receivables plus a 10-year carryover of unpaid taxes along with accrued interest and penalties.

At the end of 1995, our gross accounts receivable inventory equalled about $200 billion, of which 28.5 percent or $56.9 billion reflected accrued interest and penalties.

The gross accounts receivable inventory is divided into two components: those considered currently not collectible as well as the active accounts receivable. Our currently not collectible accounts are accounts that a collection employee has determined a taxpayer cannot currently pay. That accounts for about $87.4 billion or nearly half of the gross receivable inventory. Accounts in this category are periodically monitored and if a taxpayer is able to pay within that statutory 10-year period, the account will be collected, so it can move out of the currently not collectible inventory back into the active accounts receivable.

Active accounts receivable are accounts that are potentially collectible and continue to be pursued through activities ranging from notices and telephone contacts to installment agreements and of-

fers and compromise and ultimately liens, levies and seizures. These accounts total $88.8 billion.

Correctly accounting for taxpayers' payments is an important way to prevent the creation of a receivable and through the expansion of our electronic filing and our electronic payment options we are lowering that error rate. As more deposits are received electronically and more returns are filed that way, errors in posting and assessments will continue to decline. We are also working to make that receivables inventory as current as possible.

Unlike in the private sector where liability is established when goods or services are purchased, we must establish a tax liability frequently through the audit process and taxpayers can then use the administrative appeals process and litigation before tax liability is ultimately determined.

Thus, several years can elapse between a tax return as due and filed and the time that the liability is actually finally established. Once that final determination is made, however, we are moving to contact taxpayers more promptly. A number of specifics about what we have done are covered in our written testimony and we will be happy to respond to any questions you may have about that.

But we are also stepping up our efforts to increase our collection yield and I think the results from that are quite promising.

For 3 years prior to 1994, collection yield had declined between 4 and 6 percent. Now, some of that decline was attributable to a decline in staffing. It was also quite frankly a result of a decline in productivity.

In 1994, our collection yield increased 3 percent, despite a 9.5 percent decrease in our collection staffing.

In 1995, we continued to increase our collection yield by over 7 percent. While we are making progress, I will say the loss of our compliance money last year may make it difficult for us to continue to increase the yield in our productivity.

Before I conclude, Mr. Chairman, I would like to touch on two things very briefly. One, I wanted to tell you about our efforts regarding contracting out of collection, of our activities as provided in our appropriations budget for this year. Yesterday, we issued requests for proposals and we intend to award up to five contracts and to initially deliver about 125,000 cases relating to taxpayers who are delinquent in paying their tax obligations. Based on an evaluation of the contractors' performance, additional cases may be provided throughout the contract period.

Payments under the contract will be performance based. However, they will not be on a contingency fee. Contractors and their employees will be subject to the disclosure laws, the Privacy Act, as well as the Taxpayer Bill of Rights and the applicable sections of the Fair Debt Collection Practices Act.

The startup date we hope will be 45 days from the contract award and we are looking forward to seeing how this pilot compares to the kinds of collection productivity initiatives we have undertaken.

The other issue I would like to touch on very briefly relates to the tax systems modernization discussion, particularly the electronic filing discussion that was had with the GAO. I think there was a bit of a misunderstanding or perhaps maybe I misunder-

stood, but I had the sense that someone felt we were spending $8 billion just to have an electronic filing program. That is not at all true.

We are in the process of trying to modernize the administration of the tax system and we are doing it in three ways: one, by looking at our business processes and really trying to re-engineer how we do our tax processes and that would include perhaps getting rid of returns all together, looking at trying to increase the number that are filed electronically and looking at a range of alternatives for trying to re-engineer exactly how we do our business today.

We have also looked at our organizational structure. This past year, last May, we announced that in October we would reduce the number of regions from seven to four and that was completed in October 1995 and we have moved from 63 districts to 33 and that should be completed within the next couple of months.

Mr. HORN. Commissioner, I will let you give us your last formal paragraph. Right now, we have to break for a vote and we will be in recess for 15 minutes.

Ms. RICHARDSON. Great.

[Recess.]

Mr. HORN. Commissioner Richardson, if you'd like to get to your final paragraph, we'll begin the questioning.

Ms. RICHARDSON. Thank you, Mr. Chairman. I really wanted to just close the loop on the electronic filing for one moment.

We, as you may recall, last year did make a concerted effort to assure that the fraud that had been reported in prior years was addressed, and we did slow down the process of electronic filing.

And we are developing and have developed a very different kind of electronic filing strategy, and it really does relate to looking at the various markets that are out there and trying to address those needs, as opposed to relying on the rapid refund.

I think the fact that we lost about a million and a half dependents last year indicates that it was well worth the effort, and if it caused a temporary setback, frankly, we thought that it was important enough to protect the integrity of the tax system to do it.

I have tried to demonstrate today to you and members of the subcommittee the priority and the significance we attach to both our financial management responsibilities under the CFO Act and the importance of collecting revenue through the effective management of our accounts receivable inventory.

It is my hope that the IRS, in the near future, will be looked upon as an example of how the CFO Act has improved the credibility of Government in the eyes of the public.

That, Mr. Chairman, concludes my remarks, and my colleagues and I would be delighted to answer any questions you have.

[The prepared statement of Ms. Richardson follows:]

STATEMENT OF
MARGARET MILNER RICHARDSON
COMMISSIONER OF INTERNAL REVENUE

BEFORE THE
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION AND TECHNOLOGY

MARCH 6, 1996

Mr. Chairman and Distinguished Members of the Subcommittee:

Good afternoon. I am pleased to be here today to discuss two of the IRS's critical responsibilities -- implementation of the Chief Financial Officers' Act (CFO) of 1990 and the collection of tax receivables. With me are Mike Dolan, Deputy Commissioner, Jim Donelson, Chief Taxpayer Service and Acting Chief Compliance Officer, and Tony Musick, our new Chief Financial Officer, who is my principal advisor on financial management issues.

Tony is a certified public accountant with a master's degree in business administration from George Washington University with a concentration in Finance. From 1972 to 1983, Tony was an auditor with the public accounting firm of Ernst and Ernst, the General Accounting Office (GAO) and the Environmental Protection Agency. Tony also served as budget director for Virginia Commonwealth University in Richmond. Tony began working for the Internal Revenue Service in 1991 as our National Director for Systems and Accounting Standards and served on Vice President Gore's National Performance Review participating in the "Improving Financial Management Team." He served as Acting CFO for six months before his selection.

One of Tony's priorities -- as well as mine -- is to continue our progress toward a clean financial statement opinion from GAO by improving financial management in

the Service. I have assured Tony that I am committed to ensuring that he and his staff have all of the necessary resources to accomplish this and to achieve any requisite changes within the Service.

Chief Financial Officers' Act of 1990

I appreciate the opportunity to discuss the Chief Financial Officers' Act of 1990, its contribution to improved financial management in IRS, and the actions we are taking to implement the objectives of the Act. The expectations of the Act include:

- the deployment of modern systems to replace outdated ones;
- the development of better performance and cost measures; and
- the design of results-oriented reports that integrate budget, accounting, and program information.

The passage of the Act, and the designation of IRS as a pilot agency, gave us a unique opportunity over the last four years to improve financial management to meet these expectations and provide full accountability to all our constituencies. The IRS, as with virtually all other agencies privileged to be CFO Act pilots, has both made progress and faced unexpected challenges in meeting financial audit requirements. We at IRS are using the CFO Act and the financial statement audit as our blueprint for financial management improvements. The process of preparing financial statements and having them audited imposes a critically important discipline on us -- a discipline which can only benefit the taxpayers of the United States. It is only appropriate that we be held to the same standards to which we hold taxpayers.

As the collector of over 90% of the nation's revenues, we fully understand that we have a special obligation to taxpayers to be accountable for each tax dollar we

collect and spend. My testimony today will focus on the two systems we have installed that allow us to meet this obligation.

Financial Statement Audits

As the head of the government's primary revenue collection agency, I want to assure taxpayers that the IRS has strong systems and controls to ensure that their individual accounts are accurate. These systems work. Each year, the GAO has certified the more than $1 trillion we collect has been properly deposited in the Treasury. This is no small accomplishment for an organization that handles over 1 billion information documents per year, processes more than 200 million returns, and issues more than 90 million refunds. Any complex system will produce some errors, and ours does, but we make great efforts to detect and correct them promptly.

While I said at the start of my testimony that I was pleased to be here, I am frankly less than pleased with the results of the GAO financial statement audits in the past three years. It is disturbing to hear that the IRS "has not passed its financial audit." And, we are quite concerned as well. But it is important that we all understand what is not meant and what is meant by that remark. It does not mean that the money the IRS is supposed to be collecting or spending has simply disappeared -- or somehow been misappropriated. This has not occurred.

The Service has two separate financial processes to track funds: the administrative system that handles our appropriated funds and our revenue system that tracks tax collections. It is important to understand these two different systems in order to understand the GAO's audit findings and what we are doing to improve both systems to comply with the CFO Act.

Results of FY 1994 Audit

The IRS' first financial statement audit by the GAO was for FY 1992. In the 1994 financial statement audit, GAO recognized the progress we had made since 1992 in implementing a new administrative accounting system, in transferring our payroll processing to the Department of Agriculture's National Finance Center, and in improving the accounting for federal revenues. But GAO also listed five primary reasons why they were unable to express an opinion on the financial statements:

1. They could not reconcile the amount of total revenue of $1.3 trillion reported in the financial statements to accounting records maintained for individual taxpayers.

2. They could not substantiate amounts reported for various types of taxes collected, for example, social security, income and excise taxes.

3. They could not determine the reliability of our estimates of accounts receivable.

4. They could not substantiate a significant portion of our $2.1 billion in non-payroll expenses, primarily due to lack of documentation, and

5. IRS could not reconcile its fund balances with Treasury accounts.

While our goal is a clean financial statement audit opinion at the earliest possible time, and I reaffirm that commitment today, I would also like to highlight some of the progress we have made since FY 1994 in addressing some of the GAO's concerns. The FY 1995 financial statement audit is currently underway but GAO has not given us any indication when it will be completed.

Accounting for the Appropriated Funds that the IRS Spends

We are very proud of the significant improvements we have made in our Administrative Accounting System. Just five years ago, we had eight separate systems. Now we have a single corporate data base for our over $7 billion in

appropriated funds. In addition, in the last two years we have made measurable improvements. For instance,

- We implemented our integrated financial system, transferred payroll to the National Finance Center, and integrated other administrative systems to capture data at the source and transmit this data electronically to our corporate financial database.

- Our travel vouchers and payments to contractors have been automated nationwide. The traveler keys the travel information into the system, certifies the electronic voucher, and sends it to the supervisor. Once the supervisor approves, the traveler will receive payment in 5 to 7 days. Over 80% of our travel vouchers were processed this way in FY 1995.

- We implemented commitment accounting procedures, so that we will have timely information about how money is being spent and so that we can manage our expenditures more carefully.

- We linked the procurement system with the administrative accounting system to enable obligations to be transferred electronically.

To show the progress we have made in improving our administrative finance operations, the GAO was unable to audit our administrative accounting systems for FY 1992. In FY 1993, our system was auditable, but we were unable to provide supporting information for among other things the reconciliation of budgeted amounts to actual expenditures. For FY 1994, the GAO audit report focused on just two administrative accounting issues in this area -- failure to reconcile our accounts with Treasury and the lack of receipt and acceptance documentation for non-payroll payments, such as rent payments to GSA and printing payments to GPO.

Regarding these two issues, we are reconciling our cash balances to Treasury's records through FY 1995 and will ensure these balances are reconciled on a monthly basis. On the non-payroll payments, the concern of GAO was that we were not adequately verifying the payments being made for us by GSA and GPO. We are

reviewing the processes involved and working to improve them, but the solution requires the assistance of GSA and GPO.

Improving Financial Information Systems

A significant example of the effectiveness of our improved administrative financial systems was our ability to track one of our major programs. In FY 1995, we received funding for a Compliance Initiative, a five-year plan with the monies raised going directly to deficit reduction. (Ironically, because of budget cuts, it was not funded for FY 1996.

In order to meet our commitment to Congress to account for the Initiative so that we could verify the money raised by the FTEs hired under the Initiative, we developed comprehensive tracking procedures that enabled us to provide a clear and verifiable picture of the results. Using our Enforcement Revenue Information System (ERIS), we were able to produce reports showing resource and revenue plans and results in far greater detail than ever before.

The results have been impressive. Because of the information produced by our tracking system, I can tell you that our Compliance Initiative yielded over $800 million in revenue in FY 1995, far exceeding the $331 million we promised. Regrettably, much of the progress we have made in improving our collection efforts that I will be discussing with you today, is because of the Compliance Initiative and may be jeopardized by its abandonment.

Accounting for the Revenue that the IRS Collects

The Revenue Accounting and Control System (RACS), which was implemented during 1984, was not designed to provide the detailed information required by the

CFO Act for financial statement presentations. Most of the problems with the revenue accounting procedures that have been raised by GAO concern summary data produced by RACS that is difficult to reconcile on a transaction by transaction basis with our Masterfile.

While we can and do reconcile gross amounts collected, we have been unable to give GAO auditors the information that they would like to have to tie individual transactions to their sources. Because the revenue systems were not designed to meet the CFO Act audit requirements, our real challenge is to alter our revenue accounting system to provide the necessary data to meet the new standards, so that our revenue accounting systems can also get a clean audit opinion.

To immediately address this issue, for the FY 1995 audit, the Service is providing detailed revenue receipt information from the individual taxpayer accounts contained in the Masterfile. Also, we are installing a short-term system solution, the Interim Revenue Accounting Control System or IRACS. By July, IRACS should be implemented nationwide so that the network will connect the database located at our Detroit Computing Center with our 10 service centers. The system will:

- improve balancing routines and validity checks,
- provide additional information on-line,
- retain three years worth of data instead of the one month that we currently retain, and
- interact electronically with and extract data from other tax processing systems.

Accounts Receivable

Generally, accounts receivable represent the credit sales of a business. How to handle accounts receivable is an important question for all businesses. One of the most effective tools is to investigate the credit-worthiness of customers before extending them credit. Private businesses formalize the precise amount and terms of debt repayment when the debt accrues, and they manage their receivables by writing off those accounts that are uncollectible. Businesses do not continue to carry debt on their books when it becomes apparent, after attempting to collect, that it will not be paid.

Like businesses, the IRS has accounts receivable. Unlike private businesses, however, our customers are not purchasing products with their debt, and their credit-worthiness is not determined prior to a transaction. In short, we do not choose our customers.

It is important to understand what makes up the total amount of receivables. When taxpayers either do not file returns or file inaccurate returns, we make assessments based on the tax laws irrespective of collection potential. We record these unpaid assessments as accounts receivable and keep them on our books for as long as they are legally collectible. While we attempt to collect these debts, some accounts are obviously uncollectible for various reasons, for example: the taxpayer has died or is insolvent. In other words, we know at the outset that some of these assessments will not be collected. But our gross accounts receivable do not include just unpaid taxes, it also includes the ever-increasing interest and penalties related to those unpaid taxes. In addition, the law prescribes how long we must keep accounts

receivable on the books -- 10 years. Thus, unlike private sector businesses, the IRS' accounts receivable cannot be written off even when we know that they are not collectible.

As early as 1988, the IRS determined that accounts receivable was a growing concern, an assessment both OMB and GAO agreed with. Since 1988, we have continued to take steps to improve the management of the receivables inventory, but key to that has been our efforts to develop a systemic approach to provide timely, accurate information about the accounts receivable. Having a reliable estimate of delinquent taxes that are truly collectible is essential in enabling us to better manage our collection efforts.[1]

Today, I would like to discuss with you our efforts to:

1. Determine the correct composition of the accounts receivable inventory;
2. Ensure the accuracy of assessments that are included in the inventory;
3. Improve the currency of the inventory; and
4. Increase the collection of accounts in the inventory.

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[1] The GAO has reported and we agree that financial receivables are those that the taxpayer has agreed to or the courts have set, and that from this amount we should estimate a net realizable value of accounts that are potentially collectible. To accomplish this, we have been working with GAO on a better way to represent these amounts on our financial statements. Starting with the FY 1995 statements, we will classify amounts as financial receivables (the amounts that taxpayers have agreed to pay or courts have set), financial write-offs (financial receivables that have subsequently been determined to have no further collection potential), and compliance assessments (those amounts that taxpayers have not agreed to or on which the courts have not acted). These amounts will be audited by GAO.

1. Correct Composition of Accounts Receivable Inventory

In 1990, Congress extended the time the IRS would be required to keep accounts receivable on the books from 6 to 10 years. Thus, unlike accounts receivable in the private sector, the IRS's Accounts Receivable Dollar Inventory ("ARDI") is not a reflection of an annual underpayment of taxes, but includes current receivables, plus a ten year carryover of unpaid taxes, along with accrued interest and penalties.

At the end of FY 1995, IRS gross accounts receivable inventory equaled $200 billion of which 28.5% or $56.9 billion reflected accrued interest and penalties. This is a $29 billion increase over the FY 1994 balance. A significant portion of this growth was due to additional accruals of interest and penalties, the extension of time we must keep the receivables on the books from 6 to 10 years[2], and to our non-filer program. The non-filer initiative was started in 1992 to encourage taxpayers who were not filing returns to get back into the system. While we realized the non-filer program would increase our accounts receivable since many were not filing because of an inability to pay their tax obligations in full, we believed it was more important to get taxpayers filing again and then assist them with ways to meet their obligations by expanding our installment agreement and offer in compromise programs.

The IRS gross accounts receivable inventory for compliance purposes is divided into two components: Currently Not Collectible and Active Accounts Receivable.

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[2] FY 1995 was the last year in which the ARDI would automatically increase because of the extension of time we must keep accounts on the books from 6 to 10 years.

- Currently Not Collectible (CNC) are accounts that a collection employee has determined a taxpayer cannot currently pay. Accounts in this category are periodically monitored, and if a taxpayer is able to pay within the statutory 10-year period, the account will be collected. At the end of FY 1995, $87.4 billion[3] -- or nearly half the gross receivable total -- is classified CNC. Of this amount:
  - 37.6% ($32.8 billion) is accrued penalties and interest.
  - Over 85% ($75 billion) is not collectible because it is owed by defunct corporations; taxpayers adjudicated bankrupt; hardships; or our inability to locate taxpayers.
- Active Accounts Receivable -- are accounts that are potentially collectible and that continue to be pursued through activities ranging from notices and telephone contacts, to installment agreements and offers-in-compromise, and, ultimately, liens, levies and seizures. At the end of FY 1995, $88.8 billion[4] is classified in the Active Accounts Receivable category. Of this amount:
  - 41% ($36.6 billion) the largest portion of the active account, has been assigned for enforcement action;
  - 22% ($19.1 billion) of the inventory is either awaiting adjudication by a court or acceptance of an offer-in-compromise;
  - 13% ($11.7 billion) is currently being collected by sending notices to taxpayers;
  - 13% ($11.2 billion) is being collected through installment agreements;

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[3] Not included in this balance are Trust Fund Recovery Penalty assessments of $6.3 billion that are potentially duplicative.

[4] Not included in this balance are Trust Fund Recovery Penalty assessments of $8.7 billion that are potentially duplicative and Resolution Trust Corporation assessments of $9.0 billion that have not yet moved to Currently Not Collectible.

- 2% ($1.6 billion) is lower value cases that will be collected through systemic monitoring, such as refund offsets and yearly notices to taxpayers.

Included in these numbers is $18.5 billion of accrued penalties and interest.

2. Ensuring the Accuracy of Assessments Included in Accounts Receivable

There are several ways an account can be put in the accounts receivable inventory. For example, a taxpayer may file a tax return but not pay what is due, and the unpaid tax will be included in accounts receivable inventory. In addition, accounts receivable are created as a result of any number of compliance initiatives. Examinations and secured delinquent returns frequently result in an assessment which is not fully paid, and therefore becomes part of accounts receivable inventory. Tax payments that are erroneously posted may increase the accounts receivable, and we are actively seeking to minimize the erroneous assessments. Finally, the accounts receivable inventory is increased by accrued interest and penalties.

Between FY 1992 and FY 1995, the IRS has --

- Through rigorous pre- and post-assessment reviews eliminated $276 billion of erroneous assessments, preventing these assessments from becoming part of the accounts receivable inventory.
- Created a new computer match that detects discrepancies between the amount taxpayers claimed were deposited and the amount in their accounts, an action which has prevented $22 billion from becoming part of accounts receivable inventory.

Correctly accounting for taxpayers' payments is an important way to prevent the creation of a receivable and the expansion of electronic filing and electronic payments is a significant way to lower our error rate. For example, in FY 1995 taxpayers deposited $232 billion using the TaxLink/Electronic Funds Transfer Payment System. This was a substantial increase over the $6.2 billion deposited this way in FY 1994.

Electronic transfer of funds not only means that federal tax deposits are deposited into the Treasury a day earlier than under the paper deposit system, but the errors by taxpayers and us are significantly fewer. As more deposits are received electronically and more returns are filed electronically errors in posting and assessments will continue to decline.

3. Improving the Currency of the Inventory

The earlier a debtor receives a request for payment, the better the likelihood that it will be paid. Recognizing this, we have been working to make the receivables inventory as current as possible. Unlike in the private sector, where liability is established when goods or services are purchased, the IRS often must establish a tax liability through audit. To protect their rights, taxpayers who do not agree with an audit finding may use the administrative appeals process and litigation. Thus, several years may elapse between the time a tax return is due or filed and the time a liability is finally established.

During FY 1995, for example, more than $17 billion in recommended additional taxes and penalties were not resolved with taxpayers during the examination process. The IRS could not take any collection action until the final liability is determined. Thus, when the FY 1995 recommended assessments finally become eligible for

collection and are included in the accounts receivable inventory, several years will have passed.

Once a final determination is made, however, we are moving to contact taxpayers promptly. We are moving to collect tax at the earliest possible time -- by the Taxpayer Service function after account questions are resolved over the telephone or at the close of an agreed audit. During the past 3 years, we have shortened the time between when the delinquency arises and the first telephone contact with the taxpayer is made. Examples of our efforts and the results are:

- Decreasing the number of notices, shortening the notice period, and instituting earlier intervention by telephone. (During FY 1994, the IRS tested "early intervention" in two Automated Collection System (ACS) sites with positive results. In January 1995, using 770 staff years of the FY 1995 Compliance Initiative in ACS sites (raising ACS staffing from 2300 to about 3100) early intervention was implemented nationwide. Although the loss of Compliance Initiative funding in FY 1996 will have an impact, the early results of this increase in ACS staffing resulted in additional collection of $111.2 million.

- In FY 1992, examination secured payment of 8.1% of agreed tax assessments. As a result of increasing emphasis on payment of agreed tax assessments at the conclusion of an examination, in FY 1994, examination secured payment of 31.7% of agreed tax assessments and in FY 1995 it secured 64.2%.

- Accelerating the collection of the largest corporate assessments by having the resolution of an issue in one year carried forward to later years without further examination. Under this procedure, taxpayers have agreed to about $1.1 billion (tax and penalties) for the period FY 1993 through FY 1995.

- Under the FY 1995 Compliance Initiative, we placed 1727 collection personnel in parts of the country with the most significant workload. Through this targeted placement, in FY 1995 we collected an additional $545 million in unpaid taxes.

- Expanding installment agreement authority. Installment agreements offer the IRS an opportunity to keep taxpayers in the system who would otherwise not be able to meet their full tax obligations. Expanding the authority increased the dollars secured through installment agreements from $2.28 billion in FY 1992 to $5.4 billion in FY 1995.

- Expediting field enforcement action on taxpayers who have repeatedly been delinquent, with emphasis on those who are delinquent in their payroll tax payments. A test in one site in 1994 resulted in a reduction to the receivables inventory by almost $15 million. Nationwide implementation began in FY 1995.

- Expansion of the Integrated Collection System (ICS) (the full automation of the IRS field collection activity) to 2 districts in 1995 and to 7 additional districts in FY 1996. In the two districts with ICS, productivity increased by more than 30% last year.

A longer-term initiative that will continue the efforts to improve currency is the integration of our telephone resources by combining the ACS and the Toll-Free Service Center telephone operations. (In FY 1993 we had 70 sites, we currently have 34 sites and our goal is to reduce to 23 sites.) Combining the ACS and Toll-Free sites will give taxpayers "one stop" resolution of their accounts. It will also provide uniform handling of account issues and allow the IRS to balance outgoing and incoming calls in a way that maximizes the collection of delinquent accounts.

4. Increasing the Collection of Accounts in the Inventory

The initiatives I have just described are designed to ensure the correctness of assessments and accelerate contact with taxpayers so that we can avoid the use of enforcement actions such as liens, levies, and seizures. I also want to describe our efforts to improve our effectiveness in collection enforcement.

We are changing our business practices, our technology, and our organizational structure. Our actions have focused on improving the use of existing collection tools coupled with increased productivity of our field operation. The results are quite promising. For the three years prior to FY 1994, collection yield had declined between 4% and 6%. Although some of this decline was attributable to a decrease in collection

staffing, it was also the result of a decline in productivity. In FY 1994, IRS' collection yield increased 3% despite a 9.5% decrease in collection staffing. In FY 1995, collection yield continued to increase by over 7%. While we are making progress, the loss of the Compliance Initiative funding will make it difficult to sustain our increasing collection yield.

Our accounting systems will also significantly improve our ability to collect accounts receivable. We are developing an ARDI expert system. A prototype we'll begin using this year will allow us to predict collectibility based on case characteristics.

This system will complement the Inventory Delivery System (IDS) which will be tested in FY 1996. IDS ensures cases are routed to the most effective point in the collection processing stream. These systems prioritize work so it is assigned to the point of most likely resolution as early in the process as possible.

Some additional changes to improve collection already under way include:

- Enhanced cooperation with state taxing authorities. The State Income Tax Levy Program involves agreements with states whereby they accept our levies on state income tax refunds. This resulted in collections of $108 million from FY 1992 through FY 1994. Another example involves joint collection of delinquent employment taxes which includes joint installment agreements, levies, and seizures.
- Proper use of certain collection tools, including installment agreements, offers in compromise, levies and seizures.
  - In FY 1992, we modified the Offer in Compromise policy and streamlined procedures to enable field personnel to resolve accounts that previously

would have languished in the receivables inventory. This resulted in additional collections of $281 million in FY 1994 and $295 million in FY 1995.

- Effective use of levies resulted in over $2.7 billion for FY 1994 and FY 1995.
- Dollars collected from installment agreements increased from $4.75 billion in FY 1994 to $5.38 billion in FY 1995.

Conclusion

I have tried to demonstrate to you and the members of the Subcommittee the priority and significance that we attach to both our financial management responsibilities under the Chief Financial Officers' Act and to the collection of revenue through the effective management of the accounts receivable inventory. It is my hope that the IRS in the near future will be looked upon as an example of how the CFO Act has improved the credibility of government in the eyes of the public.

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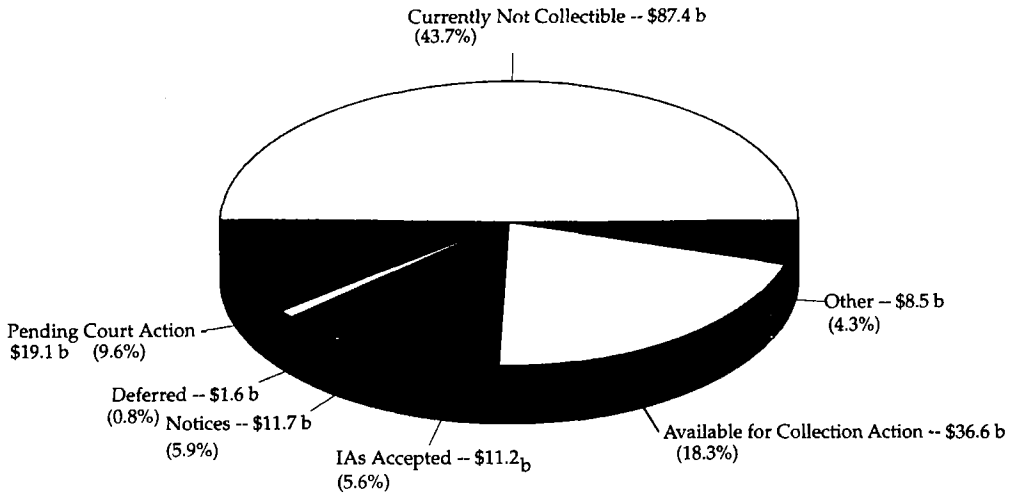
Mr. Chairman, that concludes my remarks. My colleagues and I would be happy to answer any questions.

Gross ARDI

FY 95 -- $200 billion



Internal Revenue Service
Chief Compliance Officer
March 6, 1996

Mr. HORN. OK.

Ms. RICHARDSON. I did provide at the recess a pie chart.

Mr. HORN. We have that pie chart, and I will be asking you a question about it, but let me first pursue the problem of collectible and uncollectible.

Can you give the committee an idea as to by what criteria do we decide that $100 billion since 1990—I realize this predates you—is uncollectible? What are our standards, our criteria?

Ms. RICHARDSON. May I ask Mr. Musick, our CFO, to address that?

Mr. MUSICK. First of all, Mr. Chairman, the $100 billion is not a write-off, and contrary to what GAO said, this is a bookkeeping exercise.

What we have to do on the financial statements to get them in compliance with generally accepted accounting principles is to report as receivables a number called net realizable value.

The offset to that is an amount that's called due to the Treasury. We do not have a profit and loss or an income statement.

The write-offs take place only after 10 years, which is a statutory requirement, but to get down to that number and to put a number on the statements that would be in accordance with generally accepted accounting principles, we go through this exercise of identifying this.

The other problem is that we're not talking about just accounts receivable. The last two parts of the ARDI name is left off. It's called a dollar inventory.

So our approach is to take that inventory and to try to break it down, as the GAO said, working with them in the two pieces, what we call financial receivables and compliance assessments, but there is not $100 billion written off.

The difference that is noticed there is between net realizable value on the statements and the gross ARDI.

Mr. HORN. Well, as I understand it, there is $100 billion that the IRS has decided is not collectible. Is that correct?

Mr. DONELSON. Congressman, if I could answer that?

Mr. HORN. Sure. Please.

Mr. DONELSON. There are various categories of situations that result in the taxpayer's account becoming currently not collectible. I think that's what Mr. Musick was trying to explain.

The cases that are processed in our collections systems, be it on the telephone or in person by revenue officers interviewing taxpayers are classified as they're closed currently not collectible. And currently, there are nearly $100 billion worth of those kind of accounts.

Mr. HORN. OK. There are $100 billion of the accounts that somebody in the IRS has said are not collectible?

Mr. DONELSON. Yes, sir.

Ms. RICHARDSON. I think what we need to underscore is the term "currently," not "collectible." That does not mean that at some later point in time they may not become collectible.

Mr. HORN. Unless the 10-year period is elapsed?

Mr. DONELSON. Yes. And during that 10-year period——

Mr. HORN. Do we know how much of that $100 billion has already gone beyond the 10-year period, or are there no 10-year obligations in there?

Mr. DONELSON. The extension of the 10-year statute includes this year, and starting next year there will be expirations of that statute, and some of those currently not collectible cases would expire without any extensions either by a waiver being granted by the taxpayer or the judicial or administrative action by us. There will be some expiring, yes.

Mr. HORN. What is the extension that's going to be made? I mean, did I misunderstand you?

Mr. DONELSON. Yes. The statute was extended in 1990 from 6 to 10 years.

Mr. HORN. From 6 to 10 years? It was six in 1990?

Mr. DONELSON. Yes, sir.

Mr. HORN. It's 10 years now?

Mr. DONELSON. Yes.

Mr. HORN. And how long does that statute run?

Mr. DONELSON. Ten years.

Mr. HORN. Ten years from now, 10 years from 1990. So the year 2000?

Mr. DONELSON. No. Excuse me, sir. What happened was we had a 6-year statute, and Congress extended the statute to 10 years. So all the cases that were on the books in 1990 were extended. Cases that were 3, 4 or 5 years old were also extended.

Mr. HORN. When was the extension to 10 years, what year?

Mr. DONELSON. 1990.

Mr. HORN. 1990. OK. So everybody that was on the books then, that still had time to go to meet the 6-year test now has to go and meet the 10-year test?

Mr. DONELSON. Yes, sir.

Mr. HORN. Well, if they were 6 years in 1990, they met it in 1994, didn't they, because you counted the 6 years, or did the clock start running again?

Ms. RICHARDSON. The first year that it became effective, I think, was in fiscal year 1991.

Mr. DONELSON. Congress passed it in late 1990, I believe.

Ms. RICHARDSON. But fiscal year 1996 is the first year that the 10th year is no—we should see a decline from just the mere retention for the additional 4 years.

Mr. HORN. Well, of the $100 billion, which includes what was declared uncollectible in 1990, 1991, 1992, 1993, 1994, 1995, now 1996, what I'm trying to get at is has anybody analyzed what in that debt—I mean, there must be in your computer somewhere a target date when that expires and you can't take any further action.

Do we know what the spread is of that debt over the future? You're telling me there is still some collectible. That's news to me, because no one else in the IRS has told me that.

Mr. DONELSON. Well, each year the money that's residing in a currently not collectible status—and it was put there for various reasons, and I'll be glad to go through some of those categories for you—we have money applied from future refunds.

Taxpayers' circumstances change, and then they're able to pay their taxes. Taxpayers who have liens on their property have to sell a home, and the money that's there, their equity, is applied to a formerly currently not collectible account.

Mr. HORN. OK. So you're telling me if suddenly the taxpayer who you thought was uncollectible as a period 1990 through 1996 now that we're into suddenly wins the Maryland State Lottery or something and declares that, that your equipment, are you telling me will cross-check that?

Mr. DONELSON. Yes.

Mr. HORN. So you have everybody that's in the $100 billion list, you can check them against what's coming in?

Mr. DONELSON. Yes.

Mr. HORN. OK. Well, that's good news, first good news I've heard on that subject.

Mr. DONELSON. Well, let give you some categories and maybe explain.

Mr. HORN. OK.

Mr. DONELSON. About 28 percent of our accounts are in what we call hardship categories. We've gone out, taken a financial statement, analyzed the taxpayers' situation and come to the decision that further enforcement action, taking the taxpayers' assets and so forth to collect the tax would be a hardship on the taxpayer.

We can go into all kinds of definitions of that for you for the record.

Mr. HORN. We'll put them in the record at this point without objection.

[The information referred to follows:]

Definition of Hardship—A hardship is where a taxpayer's *necessary* expenses exceed expected annual income. Thus, further enforcement action would be a hardship on the taxpayer.

Mr. DONELSON. About 10 percent of the accounts are results of bankruptcies, but 36 percent are as a result of defunct corporations, no assets corporations.

Mr. HORN. Now, what do you mean by that?

Mr. DONELSON. Corporations go out of business after accruing tax liabilities.

Mr. HORN. Are these, essentially, Americans that have done a, say, Bahama-type operation?

Mr. DONELSON. No. These are——

Mr. HORN. These are U.S.——

Mr. DONELSON. Start-up businesses that didn't make it.

Mr. HORN. OK. This is the person that's running the small sandwich shop, and he's had it.

Mr. DONELSON. That's a good example.

Mr. HORN. And he's not paid the last year of payroll taxes.

Mr. DONELSON. That's a good example.

Mr. HORN. Right. OK.

Mr. DONELSON. Unable to locate taxpayers, approximately 5.6 percent of the currently noncollectible are unlocatable. We've done everything we can within our jurisdiction and with the information that we have available to us to find the taxpayer.

Mr. HORN. OK. Let me ask you about that. Have you checked with the post office tapes?

Mr. DONELSON. Yes.

Mr. HORN. Have you checked with the Social Security tapes?

Mr. DONELSON. Yes.

Mr. HORN. And you've had cooperation from both groups?

Mr. DONELSON. Absolutely.

Mr. HORN. OK. Is there anything else that should be done, like a private——

Mr. DONELSON. We check credit bureau records, and we use that data to update our information to get a better telephone number, better information on an employee.

We also use our own records, because if a taxpayer all of a sudden gets a job and we match our records and we find out they're in a new location with a new employment situation, we will reactivate those cases that were formerly unlocatable.

Mr. HORN. Now, for a small company that we talked about that went bankrupt, you've got an identification number for that entity?

Mr. DONELSON. Yes.

Mr. HORN. OK. But do you have the Social Security number of the owner of that entity so you can check both of them?

Mr. DONELSON. We have cross-checking ability. We take those small corporations, and if they have a liability, we institute what we call a trust fund recovery penalty.

We'll apply that to any officers of that corporation that we believe are responsible for those trust fund taxes. One of our difficulties in the financial audit is we have the original assessment, and we have additional assessments for each of the officers we think are responsible for the trust fund portion of the tax.

Mr. HORN. OK. Do you check the Social Security number for these people that were officers of the corporation to find out where they are?

Mr. DONELSON. Yes.

Mr. HORN. OK. Because I had understood you didn't do that. You're telling me under oath you do do it?

Mr. DONELSON. Part of our investigation to establish the trust fund recovery penalty is to identify who the taxpayers are, who the officers are, and one of our first steps is to get their Social Security number.

Mr. HORN. Because they have a whole series of phony corporations, some of them.

Mr. DONELSON. That's right.

Mr. HORN. And then the question is who is behind all this, and let's stick him.

Mr. DONELSON. And that doesn't happen automatically. It happens with hard work from our folks to uncover that. There are a few more categories, and they're very brief. I'll go through them quickly.

Deceased taxpayers represent 2.5 percent of our——

Mr. HORN. This is the what tax?

Mr. DONELSON. Deceased.

Mr. HORN. Deceased. OK.

Mr. DONELSON. People passed away.

Mr. HORN. That includes the city of Chicago, I guess, from election returns. The vice chairman is not here. I can get away with saying that.

Mr. DONELSON. And the final large category is Resolution Trust Corporation accounts where we withhold collection. Nine and a half percent of the accounts there are currently not collectible because of the overlapping situation.

Mr. HORN. OK. So that's constituency or constituent parts of that debt, and then do you have the figures as to how that debt is aging at all? In other words, the $100 billion, how much hits the 10-year mark?

Well, they won't hit it until the year 2000 if they started in 1990, but if they started in 1985 and had 5 years under the old law, did you grandfather in the time?

Mr. DONELSON. Congressman, I have the cumulative number. I can get you the——

Mr. HORN. Yeah. Well, why don't we put it at this point in the record so we got the total picture. OK? Now, then, you've got $60 billion that is deemed to be collectible, and at that point we get into the IRS collection processes.

[The information referred to follows:]

The chart below ages the Accounts Receivable Inventory of $200 billion at the end of FY 1995.

Aging of Accounts Receivable Inventory of $200 Billion

Age [1]	Active Accounts Receivable	Currently Not Collectible
0–30 days	$7.99 BN	$4.7 MN
31–60 days	2.8 BN	14.8 MN
61–90 days	2.5 BN	69.6 MN
91–120 days	5.2 BN	57.3 MN
121–180 days	4.9 BN	251 MN
181–360 days	8.8 BN	2.0 BN
361–720 days	14.8 BN	6.8 BN
721–1080 days	10.1 BN	9.9 BN
1081–1440 days	7.3 BN	9.8 BN
1441–1800 days	6.1 BN	9.1 BN
1801–2160 days	3.95 BN	8.3 BN
2161 days +	11.2 BN	38.0 BN
Total	85.64 BN [2]	84.3 BN [3]

[1] Age is the time that has elapsed since the date the additional tax was assessed.
[2] The difference of $3.16 bn ($88.8 bn in Active Accounts Receivable less $85.64 bn) is assessments that are NonMaster File. NonMaster File assessments cannot be aged in this manner.
[3] The difference is again due to NonMaster File assessments which cannot be aged in this manner.

Mr. DONELSON. Yes, sir.

Mr. HORN. And the degree to which we collect the debt when we say it's a debt and you've made that determination, within the first 30 days, the next 30 days, in other words, 2 months, and 6 months, et cetera.

Now, does the IRS keep any figures as to how that debt is collected? My theory being, based on dealing with debt as a university president and student debt, alumni debt, the sooner you ask, the more likely you are to get the funds.

And if you just let that sit there, pretty soon everybody forgets they even have a debt that they owe you. Now, as I understand it, you then out about four or five letters that first month or so, I gather, or the first couple of months. How does that work?

And only the last one is registered to my understanding. What is the process to collect?

Mr. DONELSON. Mr. Chairman, after an assessment arises and we agree with the taxpayer or we assess the tax without the taxpayer's agreement, we issue to individuals up to three notices.

I say "up to" because we can skip ahead if we see it's an egregious situation, but these three notices are issued over a 16-week period.

Mr. HORN. Over what period?

Mr. DONELSON. Sixteen weeks.

Mr. HORN. Sixteen weeks.

Mr. DONELSON. Yes.

Mr. HORN. So one goes out on week one and then another one on, what, week seven or something, and the third one is on the 16th week? How does it work?

Mr. DONELSON. It's within a 16-week window. My hesitation is because we get correspondence from a taxpayer, and that may satisfy our first inquiry.

On the other hand, it may require us to cycle that taxpayer through another cycle of notices. So it isn't a set period for every taxpayer in order. It's not a lockstep-type situation.

Mr. HORN. How many reply with the first notice? Do you have any figures on the success of the first notice? I mean, do you get a 20 percent return where it says, "Yeah. Sure. I'll settle and send you the check"?

Mr. DONELSON. To be honest, I'd be guessing, in terms of giving you a percentage off the top of my head. We have a very good success rate on reaction to our notices.

Mr. HORN. Well, that's only three notices. In other words, when do they start facing up to it? Is it the registered mail one? Do they turn down the registered mail, refuse to go to the post office?

The first two were not registered, so you don't even know if they received them.

Mr. DONELSON. The best response is from the last notices. Those are the most harshly and aggressively worded notice as well. But the first notice is a statutory notice that we have to issue to explain to the taxpayer why the assessment arose.

We generally expect that most taxpayers are going to pay, and they will respond to a notice that isn't necessarily harshly worded.

Mr. HORN. Why don't you send them a registered notice to start with?

Mr. DONELSON. There is an expense involved.

Mr. HORN. Well, there is an expense on the first two letters, too.

Mr. DONELSON. Yes, but it gets prohibitively expensive when you use certified mail or registered mail.

Mr. HORN. And you've worked out those figures based on how much you get in on the first notice which is not certified, not registered?

Mr. DONELSON. Yes. We have all those figures in terms of how much we get off of the first, second and third notices——

Mr. HORN. Let's put them at this point in the record, then, if you don't mind, without objection. All those exhibits will appear where we've had the discussion.

[The information referred to follows:]

In FY 1995, the IRS' collection yield was $25.2 billion. Almost 47 percent ($11.8 billion) of this yield was collected through the notice process. Dollars collected by the various notices are as follows: A) First notice—$7.7 billion, B) Second Notice thru Final Notice—$4.1 billion.

Mr. HORN. So go ahead. Tell me, then, your first notice, is it only certified at the end, or is it registered?

Mr. DONELSON. It's certified.

Mr. HORN. It's certified. You don't register it. OK. It's certified, but you do get a slip back?

Mr. DONELSON. It requires the taxpayer's signature, yes, sir.

Mr. HORN. OK.

Mr. DONELSON. That series of notices is to individuals.

Mr. HORN. Yes.

Mr. DONELSON. There is another situation for businesses, and we send two notices to businesses in an 11-week period. So we have fewer notices, and we limit the time to 11 weeks.

Mr. HORN. Now, as I understand it, it varies by the IRS district, and maybe "district" is the wrong word. Maybe it's even a smaller subdivision, but let's take California.

I'm familiar with the Fresno processing center. I'm familiar with Los Angeles, and I'm familiar with Laguna Niguel.

My understanding is that management in all three districts have different policies as to when enforcement action is triggered against a taxpayer, after the letters are sent out, in terms of the revenue agent actually going out, knocking on the door, and trying to track the person down.

What's the experience on that policy, and maybe others, maybe the Commissioner can answer. I assume she knows. Nationwide do we have a tremendous variety of what triggers enforcement human response, as opposed to mail and certified mail? How do we do that?

Mr. DONELSON. Well, when a case reaches the point where it reaches the revenue officer in Laguna Niguel or Los Angeles, the case is examined and analyzed on a case-by-case basis.

Depending on the circumstances, depending on the taxpayer's history, depending on the amount of money owed and the type of tax that is owed, the analysis will result in a decision as to what type of enforcement action to take.

It could be as simple as a visit to the taxpayer's business or residence to ask for the money because telephone calls haven't worked, or it could be that because of the history of the taxpayer a seizure may be warranted.

And depending on the circumstance of a business, where it looks like it's a precarious situation, we might move in and make a seizure on an original assessment of the situation.

But seizures account for only about 10,000 of our cases over the course of a year. There are only 10,000 seizures made. So it's a very small percentage of our activity.

We have millions of levies that we use, which are, basically, attaching bank accounts or salaries or other assets. That's one of our most productive tools, in terms of bringing in revenue.

Mr. HORN. I forgot. You reminded me with your word "telephone" there. You go from the paper notice, a couple of notices not cer-

tified, the certified notice. Then, you go to, what, an automated telephone system? And what do you mean by "automated?"

Is there a human being there, or is it like campaigns where they drive you nuts and get their message over, and you can't use your phone until they're done?

Mr. DONELSON. We have human beings there, let me assure you, and we have two basic activities that occur. We call out, and we receive calls.

Most of the calls that we receive are driven by either the notices that were sent out and they call us at the telephone site, or we have used a levy authority and levied a source to attach wages or a bank account.

That will usually generate a telephone call to our call sites. After we talk to the taxpayer on the telephone, we make a determination whether to levy again, keep the levy in place, release the levy, give the taxpayer an installment agreement, or even transfer the case immediately to the field because it looks like a really difficult situation that requires face-to-face handling.

Mr. HORN. So going from the paper notice to the telephone call to the field agent actually knocking on the door, how much time does that usually take?

Mr. DONELSON. Well, every case isn't handled the same way. There are some cases that bypass the entire telephone——

Mr. HORN. And go immediately to the agent.

Mr. DONELSON. That's exactly——

Mr. HORN. I understand that, if you think the guy is going to flee to Panama or someplace.

Mr. DONELSON. Well, even if the case is the second or a third case in a taxpayer's situation, if the first case is in the hands of a revenue officer in, your example, Los Angeles or Laguna, we will have all subsequent cases sent directly to that revenue officer, too, so they don't have to stop off and get all of the series of notices and the telephone calls. We expedite the cases to the person who has the original case.

Mr. HORN. Do you have a ballpark figure about what percent return you get with the paper effort, the telephone effort and the revenue agent effort?

Mr. DONELSON. We have those numbers. We can give those to you for the record, as well.

[The information referred to follows:]

The precise information requested in not available. In FY 1995, $11.8 billion was collected through the notice process. The notice process does not require any resources; only printing and postage costs. In FY 1995, employees in the telephone Automated Collection Process collected $1.124 million per staffyear and revenue offices in the field collection process collected $413,000 per staffyear.

Mr. HORN. Well, off the top of your head do you have one? I'm just trying to get a feel for success here at this point.

If you have the chart with you, maybe we can go to another question. Let's get it out, though, before we leave today, because I'd like to understand the process.

Part of my concern is the next one goes to human resources applied to the job. What is your feeling based on the number of agents you have knocking on people's doors?

And are we lacking those resources so we could have collected more of that $100 billion that's sitting there and might or might not be collected over the 10-year period? Commissioner, do you have any thoughts on that?

Ms. RICHARDSON. Well, I think Mr. Donelson can give you some more specifics, but I think it's clear that in the proper cases where we do need the face-to-face contact that we could use more people.

But what we chose to do with the additional compliance money we got in 1995 was try to put people in places such as our automated collection system, our telephone site, where we do have a very high yield and can reach a large number of taxpayers.

But in the proper cases, having some more people to have the face-to-face contact is also important. And yes, we do think that we can collect more money if we had more people.

Mr. HORN. Now, some of us here think that there is a problem of intensity here, I guess, on collection, and that while people might do a good job in the early months, and those are your people, what is not collected, if it lags, people are just going to say, "Hey, sorry. I don't owe anything. I forgot about you. You're not doing anything."

Why shouldn't the uncollectible $100 billion be assigned to private debt collectors? I understand the IRS has resisted this. I know the unions resisted this, but I understand management resisted this.

What is the rationale for resisting, turning an uncollectible debt that amounts to $100 billion over to private debt collectors or commercial law league tax attorneys?

There are a whole series of debt collectors out there. They have success. Corporations turn it over to them. Universities turn it over to them.

Ms. RICHARDSON. As I mentioned in my earlier testimony, we are in the process of piloting a private debt collection effort, and I think we'll have a lot more information as to how effective people in the private sector can be.

Mr. HORN. Now, that's a pilot project of the Appropriations Committee?

Ms. RICHARDSON. Yes. As a general rule, people in the private sector are compensated out of the proceeds they collect. It's, I think, generally about 30 percent, typically 30 percent, something we don't do, as you know.

If we kept 30 percent of what we collected, we could probably have our modernization in place and a number of other things as well.

We have an ongoing relationship with taxpayers, or at least we would like to have, and frequently people in the private sector don't have to be concerned about that.

So if you have a bill from a department store or a telephone company or whatever, they want that debt collected. They really don't typically want that customer back. We have an ongoing relationship, as I say. So frequently we can offset a tax debt from 1 year against a refund for a later year.

We are driven by the concerns about taxpayers' rights. We do try to adhere very scrupulously to the Taxpayer Bill of Rights provisions. So we take frequently more time and more care.

And when we're on the telephone with people explaining to them what the collection process is and what their rights are, it takes longer on that phone call than it might if I were a private debt collector and could call and say, "Pay up, or else."

So there are a number of ways——

Mr. HORN. Well, you certainly can say pay up or else.

Ms. RICHARDSON. We could, but we also——

Mr. HORN. You don't put it quite that way?

Ms. RICHARDSON. We also are in the position where we're required to describe to taxpayers what their appeal rights are and what our obligations are and what our limits are in pursuing the collection activities.

I think we feel that our efforts, and certainly, as we've examined our practices of late and are working more effectively and more productively that we feel that it's going to be interesting to see whether or not people in the private sector who adhere to the same rules and practices are more effective and more efficient.

I think we're all very anxious to see whether that works.

Mr. HORN. Well, how are you framing that pilot project? Do you have a competitive group of debt that was picked on a random sample that you can give some to the private collectors and some to your own people?

I mean, is this really an experiment, or has the fox decided I'm going to win this one?

Ms. RICHARDSON. No. I think I'll let Mr. Donelson talk more specifically about it, and we're somewhat limited because the request for proposal is out there as of yesterday and fairly specific.

But no, we've tried to decide a program that would really give us a fair opportunity to assess what the private sector can do for us and how they compare to what we do.

We've also taken to heart concerns that you and others have expressed over the years about being more effective in using private sector methods, and that's one of the reasons we shortened up the notice process.

We've moved more people back to the automated collection system sites rather than have them knock on doors. So we know that we can learn a lot from the private sector, but we also understand that we have a different relationship with our customers, and we have concerns about privacy and about taxpayers' rights.

Jim, would you like to give just a little bit more information, to the extent you can, about how we designed the program?

Mr. DONELSON. Mr. Chairman, on February 12, 1996, we issued a CBD announcement, a Commerce Business Daily announcement, outlining what we would be providing in this sample.

It is, I think, a very level playing field in terms of the type of cases we're putting to this. They will be currently not collectible cases. It will be a variety of work that's offered.

It will be in a region that includes the States of Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, New Mexico, Nevada, Oregon, Utah, Washington and Wyoming. It will be work coming out of our Ogden and Fresno service centers.

Mr. HORN. And is that work, as I say, is there any way we can compare by a random sample of just going into that file of getting

this batch, which would be comparable to the batch the IRS does, so you have some basis of comparison?

Mr. DONELSON. There will be 125,000 cases, 25,000 to 40,000 in each batch given up to five successful bidders, and we will have the cases categorized, and we'll transfer the cases from ourselves to the private contractor.

And we'll be able to make a comparison on the type of case we transfer, but obviously, they'll have one case, and we'll have a different case. They will be of the same type, but it would be difficult to——

Mr. HORN. Well, I can understand that you can compare among types of cases and you can compare among competitive private collectors.

My interest is the timing of when they get it compared to when the IRS handles it. Does the IRS stop after—well, let me put it this way.

A lot of people you go through the paper and the telephone call. It's my understanding that you simply don't have the agents to follow through on everything because either it's too small an amount—and that's what concerns me—is there a national policy on when you do or you don't follow through?

My understanding is this is a decision of management at the local level, and there is not a national policy. Are we wrong on that?

Mr. DONELSON. Well, actually, it's a national decision. It's covered in our law enforcement manual, and we make a determination based on a combination of inventory and the staffing available to work that inventory.

One of the things the Commissioner mentioned in her remarks was concern about the compliance initiative that ended after 1 year, and that does impact us in terms of how we assign work.

We've had to look at our tolerance levels in terms of what we are able to put into the case creation stream because of the size of our work force, yes.

Mr. HORN. OK. Now, I understand that the IRS pilot does not allow collectors to interview debtors if the debtor says that they can't pay. Is that true?

Mr. DONELSON. That they can pay?

Mr. HORN. If they cannot pay. I mean, in other words, let's say the private collector has used the letters and the phone, more likely the phone, I would think, and then they say, "Sorry. I can't pay."

Is it true that the pilot does not allow the collectors to interview debtors if the debtor says they cannot pay?

Mr. DOLAN. Congressman, we're just a little antsy about pursuing in the open session an explanation of the request for proposals that went to the street yesterday, because what the procurement process requires us to do is be sure that any kind of public utterances we have on what's in that proposal or what's not get documented in a way that all prospective bidders hear all the answers.

I guess if it would meet your needs, we'd be happy to brief you maybe in a concentrated way——

Mr. HORN. Well, it seems to me if it was on the street it's public, or some have the requirement that you don't followup if they say they can't pay, and others have the requirement that you do follow-

up? If that's part of the batch as one way and part of the other, I can understand that.

You can try to see if it makes any difference, and I'm not quarreling over that. I guess what I'm quarreling over is the revenue agent would go—it wouldn't matter if they said they couldn't pay, I assume, on the telephone. They would followup, I would think. Everybody would be saying you can't pay.

Mr. DOLAN. One of the things that's presumed in your question, I want to make sure we don't mislead you, because the nature of the commitment, the nature of the request made of us by the Appropriations Committee and therefore the nature of the design of this test that's on the street is to take work that we don't otherwise get to.

So by definition, there is a difference right there in terms of what we're working and——

Mr. HORN. You can be creaming off the easy ones.

Mr. DOLAN. Or said differently, we could be dealing with the most egregious, the most in need of our immediate attention.

And indeed, what we were asked to do was see if contractors could help in those cases where we had declared them currently noncollectible or if they were below the threshold of the prudent application on a resource.

So that really is the way this test is conceived and put to the market, and it's because that's the way the appropriators asked us to attack the problem.

Mr. HORN. See, I don't have a problem with the IRS doing the initial debt collection. I'd say spend a couple of months on that.

But after that, it seems to me, given a world of limited resources, I think it ought to go out to the private sector and let them take their crack at it.

And as you know, in our bill, I think, we give a percent back to agencies who participate which the Appropriations Committee might not like, but then we'd have to work that out up here.

I mean, it's a pretty good investment. It's the first time anybody has got a reward in this Government for doing good deeds. So the agency, as you say, Commissioner, might well have paid for the computing situation that you face.

And by the way, on that point, I understand you're pretty much still mainframe oriented, are you?

Ms. RICHARDSON. Yes.

Mr. HORN. On the computing?

Ms. RICHARDSON. Yes.

Mr. HORN. Has anybody ever looked at the fact that most people don't really care much about mainframes anymore? Is that an octopus you're carrying?

Mr. DOLAN. Congressman, all the dialog that has gone on about TSM today may have missed the point you're making now.

We are coming out of a 1960's design infrastructure. We got newer boxes, but that infrastructure is around mainframes. We are desperately trying to abandon that structure and get to the distributed computing power, get to the on-line data bases as opposed to the batch updated weekly like we do today. That is the heart and soul of what we're trying to do in our modernization effort.

Mr. HORN. Now, is the Appropriations Committee supportive of this?

Mr. DOLAN. I think my answer would be yes, in the context that I think we've all agreed that there are plenty of places where we need to improve on our ability to deliver that program.

We're working desperately hard to do that. In that context, I think the appropriators are very conscious of the need and want to be supportive of the effort.

Mr. HORN. OK. Let me just say on this chart, the Accounts Receivable Dollar Inventory, which for fiscal year 1995 lists $200 billion, and it says, "Currently noncollectible $87.4 billion or 43.7 percent of the debt," and then the next largest here would be the, "Pending court actions, $19.1 billion, 9.6 percent part of the debt."

And then we go down to "Available for collection action" which is the next big one, "18.3 percent."

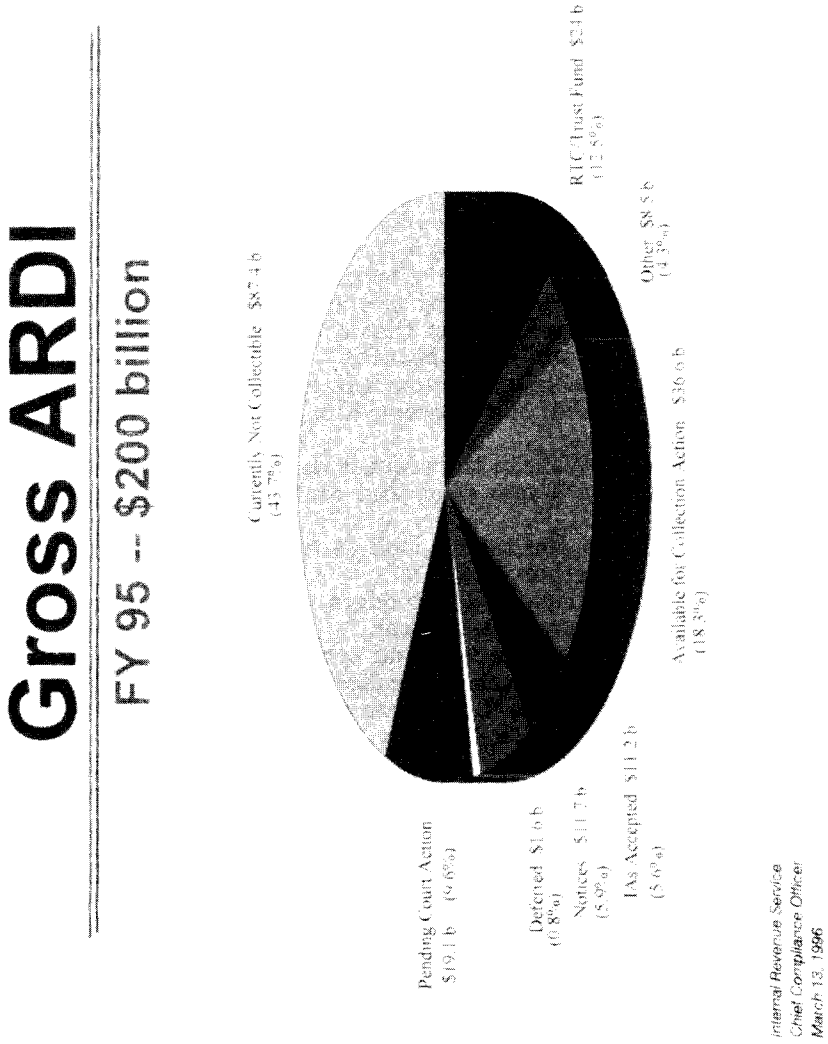
Now, I'm told by staff that the chart doesn't quite add up, that it really adds up to about $176 billion, and I guess we need to find out. We're going to put it in the record, but you might want to correct it before we print it.

What's missing, since it looks like $24 billion—well, more than that. It's $176 billion apparently that is totals, and the chart is titled "$200 billion."

And I realize Senator Dirksen had his famous comment, "A billion here and a billion there, and pretty soon it's real money." You're dealing with the real money, and I'm just curious if we can straighten that one out.

[The information referred to follows:]

Corrected chart for the Gross Accounts Receivable Delinquent Inventory (ARDI) is attached.



Ms. RICHARDSON. In the statement for the record, we have included footnotes which explain the difference, and if I can get to the right page here, I can tell you exactly.

Not included were the trust fund recovery penalty assessments of $6.3 billion which were put——

Mr. HORN. What page are you on?

Ms. RICHARDSON. I'm sorry, page 11, I apologize, of my written statement.

Mr. HORN. And this is in your statement itself or in a footnote?

Ms. RICHARDSON. Yes, Mr. Chairman.

Mr. HORN. At the top of the page? Where are you?

Ms. RICHARDSON. It's page 11.

Mr. HORN. OK.

Ms. RICHARDSON. At the bottom there is the footnote.

Mr. HORN. OK. "Not included in this balance are trust fund recovery penalty assessments of $8.7 billion, and that's potentially duplicative in Resolution Trust Corporation assessments of $9.0 billion. They have not yet moved to the currently not collectible."

It still means we're still off on that chart somewhere. Don't ask me where, but I'll let you worry about it.

OK. Let me now get to a few other things here. So when will this experiment be over that the Appropriations Committee has funded as a pilot project?

Ms. RICHARDSON. Well, in the request that's on the street, we indicated it would be a 1-year pilot that could be renewed for a second year.

Mr. HORN. OK. So you take a look at the results the first year, and you might do another year of it?

Ms. RICHARDSON. Correct. The bidders would be given an opportunity to participate for a second year.

Mr. HORN. Now, your concern and comments about private collectors, and I realize some private collectors have violated basic civility, and there are a lot of State laws concerning that, but so have some IRS violated the rules of civility.

And while the ones I know are all nice people, I don't know what they do to customers, and you're dealing with the taxpayers as a customer.

And I guess what you're saying is right now your position is that the IRS has greater charisma and joviality than private bill collectors. I hope you're right, but I don't know if it's true.

So the question is I just simply want to see $200 billion, $100 billion, whatever figure you're going to land on, I just want to see some of that collected if we can possibly collect it.

And I must say I think the average taxpayer is outraged when they say, "What? They're not collecting those debts which are clear, and I'm getting beat over the head? I got a problem, too."

Now, I realize a hearing like this might make more people resistant, and I know that's your worry, but I think you've done a very good job, on the whole.

But here we have suddenly $100 billion hanging out there, and this chart says $200 billion and in varying grades of collectibility.

Now, we also talked about $60 billion that is deemed collectible. Maybe you could explain what the plans are for that. Does this

seem to be a growing situation, or is it declining based on the efficiency of collecting?

Do you have more problems where people can't pay? Is it just due to a recession in some areas? What is it? What's your theory on that?

Ms. RICHARDSON. Our collection yield in 1995 was $25.15, which was up from $23.5 billion the preceding year. I mentioned in my opening statement I think we are working more productively, more efficiently, and I think the results are starting to pay off.

We are in the process, as described in more detail in my written testimony, of implementing technology in more and more districts so that we can have our revenue officers working for productively.

I guess we feel that it's a combination of factors that is causing the collection yield to go up, including the ability to have the right funding for the people who can be out there engaging in the collection activities.

Our plans, and I'll let Jim talk about more specific plans, and I think we're probably more concerned than almost anyone around about making sure that each and every taxpayer pays his or her proper share of taxes.

The thing I probably hear most about from taxpayers is, "I pay my proper share. I want to make sure my neighbors and my in-laws and everybody else are doing the same thing."

Mr. HORN. Absolutely.

Ms. RICHARDSON. When I visit with our people, collection people, particularly in the field, many of them are frustrated because they can see situations where taxpayers are, perhaps, not paying what they owe.

One of the things we have done and technology has allowed us to do and one of the very impressive gains we've made through our modernization efforts are in what we call our integrated collection system.

They were fully operational in two districts in 1995. It's being rolled out to nine more this year, I believe, and the productivity increase just from automating many of the processes that our field agents or field officers, revenue officers do has resulted in about a 30 percent productivity increase. That's a good investment. That investment in technology is paying off very, very well.

Mr. HORN. Let me just ask a couple of more questions, and then I know you have to leave. We might continue on with your staff.

On page 3 of your testimony, you said that the General Accounting Office has certified that more than $1 trillion collected by the IRS has been properly deposited in the Treasury.

My question, is this an estimated amount or an actual amount that can be verified by recalculating from the records? What type of estimate is that?

Ms. RICHARDSON. Well, I would quote from Mr. Dodaro's written testimony which was on page 5 of his statement, and he said, despite the problems, the ones he described, "We were able to verify that IRS's reported total revenue collections, the $1.3 trillion, agreed with tax collection amounts deposited at the Department of the Treasury."

Mr. HORN. My understanding is, and we will ask Mr. Dodaro to file something for the record on this comment, that it's an esti-

mated amount, and of course, I'm wondering how GAO can say it's accurate.

Mr. HORN. Tony.

Mr. MUSICK. No. I don't believe it's an estimated amount, sir. I think the difficulty that GAO has is that they can't take that total amount and tie it back to individual transactions in the master file, and that has been their problem, and to our revenue accounting and control system.

Mr. HORN. You also state in your written testimony, "The money the IRS is supposed to be collecting or spending has not simply disappeared or has not been misappropriated."

And I guess the query there, I'm going to ask for the record is can you be 100 percent sure of this, given that there are pervasive weaknesses in the IRS internal control system, which is the system that detects or prevents such misappropriations?

I mean, how sure and confident are we of this?

Ms. RICHARDSON. Well, not having seen every dollar go in myself, I guess I have to rely on others, but I think the GAO has also reported each year that despite their inability to audit the revenue system the way they would like to and to track every transaction from an individual taxpayer who pays the check all the way to the master file and then back, I guess, to the Federal Reserve Bank ultimately.

Mr. HORN. So the totals add up?

Ms. RICHARDSON. The totals add up.

Mr. HORN. OK. Very good. Now, I guess my last query is this, since we have the Chief Financial Officer here—do we not?

Ms. RICHARDSON. We do. And I might add he is the Chief Financial Officer as of just 2 months ago, sir.

Mr. HORN. Well, congratulations. You always wanted to attend a congressional hearing, I'm sure. You're doing a lot of good folks. I appreciate all the hard work the CFOs have done.

The Chief Financial Officer Act requires agencies to prepare auditable financial statements. If an auditor cannot give an opinion on the financial statements, they are not auditable.

The GAO has been unable to give an opinion on the IRS financial statements for the last 3 years. It would seem that the IRS is not in compliance with the law.

Do you agree with this interpretation, and what does the IRS intend to do to remedy this situation, and can you remedy it in time for the balance sheet required under the law, which is, what, the end of this fiscal year, essentially?

Mr. MUSICK. 1996, I believe it is.

Mr. HORN. What's your feeling on that?

Mr. MUSICK. Let me answer that in a couple of ways. We have several things going on. No. 1, we've already taken significant action in the administrative side of the House to put in a new finance system that is compliant with the Government standards.

As in previous audits, GAO could not be provided accounts payable transactions or other transactions in order to do the audit.

Last year they found two items, really, the cash reconciliations, which is inexcusable, and we're trying to correct that right now, and the issue with lack of receipt and acceptance on some of the intergovernmental payments, namely, to GSA and to GPO.

So from that standpoint, we feel fairly comfortable on the administrative side that if we can resolve those two issues we're in pretty good shape.

One of the things, if I could, I'd like to just take a minute and correct something. Folks talk about the 5.1 billion that NFC processes for us.

Really, all NFC is acting as is as a utility. We have people all across the country that have to issue though time sheets. They sign those things. They file them.

It goes to the National Finance Center. They cut the checks. They bring all that data back and post it into our finance system, and that's a large task.

That's not just passing off information and saying cut checks and then walking away from it.

Mr. HORN. Is that electronically filed?

Mr. MUSICK. Yes, sir. It's electronically passed. At the time it's entered in, it's electronically passed after the payments are made back to us.

Mr. HORN. Very good. One last one. In the previous years, the IRS has had a problem with its employees improperly accessing tax information of friends, neighbors, even celebrities, and, on occasion, even changing information in the records.

What actions have you taken to lessen the chance of this happening, and what penalties were the browsers who were identified subjected to?

Ms. RICHARDSON. Mr. Chairman, I'd be happy to submit for the record a whole chronology of activities that we have engaged in since it first—well, since we first discovered it and reported it to ourselves and then it was picked up by the GAO. I want to underscore——

Mr. HORN. So you have taken action, No. 1?

Ms. RICHARDSON. Absolutely.

Mr. HORN. No. 2, what was the severest action you took?

Ms. RICHARDSON. There are several people who are under indictment.

Mr. HORN. I couldn't hear you.

Ms. RICHARDSON. Several people have been indicted.

Mr. HORN. Indicted.

Ms. RICHARDSON. And being prosecuted for violating the statute. What we have done, though, are a series of things, raise the bar. You can't sign onto the system without reading a host of what the penalties are for not using the system properly, as you're authorized.

We have also supported changes to Title XVIII and to Title XXVI that would make it very clear that any kind of browsing activity would be a misdemeanor and automatic dismissal, and we continue to support those measures.

Because I really do believe, as I've said before and said to you that the confidence that taxpayers have in our system and their willingness to comply voluntarily, although some may not view it quite as voluntarily as others, is the confidence that they have that we keep the information secure for tax administration purposes. So it's very important to us.

[The information referred to follows:]

Protecting IDRS Privacy - Chronology of Actions

Date	Action
10/92	Internal Audit Report - Southeast Region
8/93	Commissioner's Testimony on browsing before Governmental Affairs Committee of the Senate
9/93	IDRS Privacy & Security Action Plan approved by the Deputy Commissioner
10/20/93	Memorandum announcing the Taxpayer Privacy Rights Policy to all employees from the Commissioner
11/29/93	Memorandum on EARL System to All IDRS Users from Chief, Management and Administration
12/93	Leaders Digest Article - Problem Solving: Stopping the Invasion of Privacy
2/94	Guide for Penalty Determinations
2/94	Commissioner's Task Force on Privacy, Security and Disclosure Report
4/94	Managers Toolkit Article - Privacy, Security and Disclosure
5/94	Supplemental Guidance for Penalty Determinations (Computer Security and Taxpayer Privacy) - Sent to Heads of Office
5/9/94	Memorandum announcing the Declaration of Privacy Principles to all employees from the Commissioner
7/94	Commissioner testifies before Senate Committee on Governmental Affairs - update on browsing - actions taken.
7/94	Privacy Advocate Hired by IRS
8/94	IDRS Security Training Modules for Employees and Managers: "IDRS Security: A Public Trust"
9/30/94	All IRS employees complete privacy awareness training, including viewing the videotape on privacy and browsing, "Protecting Privacy."
10/94	Managers Toolkit Article - Ethics: IDRS Security

11/16/94	Memorandum on Privacy and Security of Taxpayer Information to all employees from the Commissioner and President, NTEU
12/28/94	Memorandum on Taxpayer Privacy and Browsing to Regional Commissioners and Chief, Taxpayer Services from Chief, Management and Administration
1/3/95	Memorandum on IRS Information Security Policy to all employees from the Commissioner
3/12/95	Privacy Advocate's Memorandum to Chief, Management and Administration suggesting that use of The Electronic Audit Report Log (EARL) System for purposes other than detecting browsing be curtailed.
5/31/95	Response from Chief, Management and Administration that EARL will only be used for IDRS security purposes
7/31/95	IDRS Security Files Systems of Records Notice amended to fully implement EARL
8/95	Managers Toolkit article - IDRS browsing
9/95	Initiation of use of Automated Information System User Registration/Change Request Form - lists IDRS security rules
11/95	Manager's Toolkit articles - Ethics: EARL Privacy Computer Security

Mr. HORN. We thank you, Commissioner. If you don't mind, there might be a few followup questions. We'd appreciate answers in writing we can put at this place in the record. We thank you for taking the time.

Ms. RICHARDSON. I will be happy to. There were two things, though, I did want to touch on real quickly, if I could.

Mr. HORN. OK.

Ms. RICHARDSON. And that was that I think there was an occasion from the GAO they had made 59 recommendations and only 13 of which had been fully satisfied.

Mr. HORN. Right.

Ms. RICHARDSON. We're in the process of really trying to ascertain—because we felt we had complied with many more, I think maybe 43.

Mr. MUSICK. Something over 40.

Ms. RICHARDSON. Something over 40. So we are actually working with them to try to ascertain where that list is, because clearly, we want to make sure that we are following their recommendations and meeting their expectations.

And the other is the detailed plan that they requested I've been assured will be available next week, and we will make a copy of that available to you for the record as well.

Mr. HORN. Well, we thank you very much and appreciate all of you coming. We now have one of your predecessors who also knows what it is to be in a tough job.

Ms. RICHARDSON. That's right. He was also my boss.

Mr. HORN. Will Donald C. Alexander, now attorney, former Commissioner, come forward? Mr. Alexander, if you'd raise your hand.

[Witness sworn.]

Mr. HORN. The ex-Commissioner affirmed, and we welcome you here. We know you have a time problem, too, and we'll try to get you out of here on time.

STATEMENT OF DONALD C. ALEXANDER, FORMER COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. ALEXANDER. Thank you, Mr. Chairman. I'll try to speed it up. Mr. Chairman, listening to GAO brought back some memories, a few of them happy.

If you think things are bad now, you should have seen them then, Mr. Chairman. They were much worse. We were fighting GAO. We wouldn't let them in the house.

As I recall, it was at the request of Treasury that we were fighting. So finally, we concluded, why fight them? Let's call them in and see if they can do something constructive.

And they do, and they have, and they're a very fine agency. However, one tiny little point. If they found that everything was perfect, they would be out of business.

Mr. HORN. Right. That's the nature of auditors.

Mr. ALEXANDER. Yes, sir.

Mr. HORN. And every other human being I know.

Mr. ALEXANDER. That is correct. And Internal Revenue people are, unfortunately, human beings. Back in those days when I was around the shop, we had a worse problem of unevenness than Internal Revenue has now and that was discussed this afternoon.

Part of the problem was grade structure. Part of it was organizational structure. In order to try to get high grades and therefore high pay for revenue officers, you had to delegate apparently under then Civil Service rules.

Immense discretion to individuals to decide whether to seize a taxpayer's business, therefore putting the taxpayer out of business, to decide whether to let the taxpayer work along with you or to decide whether to, say, levy on bank account, thereby telling the world that the taxpayer was in deep troubling and calling down other creditors who could take action before Internal Revenue was able to act.

You went through that long period with the chief collection this afternoon, Mr. Chairman, of those three letters followed by a friendly trip from a revenue officer.

By the time the revenue officer gets there, the other creditors have pretty well plucked things bare. So I'm not sure that unless we can speed up the process and do more on the telephone, learn more of the private sector—and Internal Revenue has learned a great deal from the private sector and can learn more, work with the private sector—you could make much of a dent in future bills of that $100 billion that is of such concern to you and rightfully concerned to you.

Back about 20 years ago, people were not concerned about Internal Revenue being too lenient. They were concerned about it being too harsh.

I was constantly called to hearings, properly, of course, for Internal Revenue actions which were far, far tougher, as you've pointed out still are in certain areas of the country than in other areas dependent upon the particular district director's views toward collection.

And in order to somehow prevent Internal Revenue being politicized, Internal Revenue is divided into a series of 58 little kingdoms by the district director, basically—and most of the time the district director was a he; we brought in some shes, thank goodness—as to how tough collection policy would be.

So if you lived on one side of town, you could expect a lenient rule. If you lived on the other side of town, you could expect a harsh rule.

Luckily, that has changed. Congress has helped quite a bit through the Taxpayer Bill of Rights that was enacted in the 1980's, and Congress can help more by keeping a watchful eye on Internal Revenue to try to make sure that it does its job carefully, courteously but effectively.

The hearing this afternoon has demonstrated some of the concerns, and rightly so, about the effectiveness of the process.

Private bill collection, private tax collection is being tried this year, as you've pointed out, and perhaps there are benefits that outweigh some of the detriments, at least those sent by aged people like me.

The detriments are concerns about taxpayer privacy, concerns about taxpayer security, and concerns about taxpayer rights.

If you put people on a commission, you're telling them that they'll be rewarded if they produce a particular result. The same is true in a law firm.

If you tell people they have to bill 2,100 hours, they'll bill 2,100 hours if they possibly can. Sure, you need to motivate Internal Revenue people.

You need to learn from the private sector, but if you're going to move into private tax collection, Mr. Chairman, I hope you move very carefully and take a look at what happened this year to see if next year can be an improvement both for the taxpayers of this country and for the revenues. Thank you, Mr. Chairman.

[The prepared statement of Mr. Alexander follows:]

The Subcommittee is to be commended for its interest in reducing delinquencies and improving debt-collection activities of the government and, in particular, the Internal Revenue Service.

In its vitally important role as the Nation's chief debt collector, the Internal Revenue Service has come a long way--in the right direction--in the last 20 years. IRS has long possessed very powerful tools (some say weapons) to carry out its heavy responsibilities. IRS could levy on a taxpayer's bank account or even put a delinquent taxpayer out of business by seizing the taxpayer's property. IRS was accused, not without justification, of uneven enforcement, of doing too little for too long and then coming on too strong. In certain areas of the country, collection enforcement was much stricter than in others. Grade structure considerations called for delegation of responsibility and discretion to bag-carrying revenue officers, and it is not surprising that different revenue officers applied different standards in similar circumstances. Clearly IRS had a duty to re-examine its collection activities, to learn from the private sector, to use the telephone, to work with rather than against taxpayers who were delinquent in their tax obligations and to act early rather than late. On the other hand, IRS had a clear duty not to permit the use of withheld taxes as working capital, and this is a frequent and recurring problem for small business.

Congress has done much to enhance and protect taxpayers' rights in the last decade. Also, the IRS has made great strides in developing more uniform and reasonable treatment of taxpayers and in substituting installment agreements (working with the taxpayer) for seizures (working against the taxpayer). Similarly, levies against wages of delinquent individuals have been legislatively and administratively altered, to the benefit of the system.

To collect the Nation's taxes, the IRS must be given the resources to do the job. Recent curtailment in IRS's compliance budget threatens to undermine the strides that have been made in recent years to see to it that our Nation's tax debts are collected, but collected in a reasonable, as well as an effective, way.

Mr. HORN. Well, I think your perspective has greatly helped the committee. Have you had any chance to look at the RFP they're putting on the street on their experiment under the Appropriation's Committees auspices? Have you seen that at all?

Mr. ALEXANDER. I'm aware of the RFPs and the write-ups about the RFPs.

Mr. HORN. Do you have any feeling on that as the right way to go about it?

Mr. ALEXANDER. I think they've done a good job in complying with the Appropriations Committee's mandate, in complying with it in a way that should come close in meeting the concerns that some of us have.

And by the way, I think our concerns are shared by taxpayers around the country who seem to be more concerned than we are about privatizing tax collection, not without some cause, I suppose.

Mr. HORN. What, in your judgment, does an IRS collector or a private collector need to know? Do they need any information other than the name, the address, the telephone number and the obligation?

Mr. ALEXANDER. Oh, certainly. It varies, of course, depending on the particular case, because some matters are very simple.

Mention was made of the 7 million dependents that disappeared when their Social Security numbers were required. That's an easy situation. Some are quite difficult.

In many cases, the taxpayer doesn't agree that he, she or it owes anything at all. In many cases, the taxpayer could demonstrate that by the time Internal Revenue seeks to collect a tax the taxpayer had an operating loss carry-back that wiped out the tax. So no tax is owing.

If you simply give the name, the address, the telephone number and the amount of a tax and, perhaps, the type of tax purportedly due, you may be able to collect some taxes, but some of that $100 billion is not going to wind its way into the Nation's coffers without a fight and without the tax collector, whether a revenue officer or a private collector, having to obtain much more information.

And one of the risks in giving information to private collectors is that information is very valuable and can be misused.

That's not to say that private collectors are all going to misuse information. I'm not saying that at all. But I'm saying that private collectors, like Internal Revenue officers, are human beings, and human beings are sometimes fallible and sometimes possessed by self-interest.

Mr. HORN. Under the existing law, what are the problems? Would they have to secure an amendment to the law if they went to private collectors? What are the problems of getting more than the obligation that's owed?

Mr. ALEXANDER. Well, what they've done in the RFP is subject private collectors to the same rules under Section 6103 and 7213 of the Internal Revenue Code as Internal Revenue employees are subjected to as to the misuse of taxpayer information.

Exactly how they did it I don't know, because I haven't had a chance to go back and read 6103 to find out under what subsection of that provision they can subject private citizens to the rather

stringent rules that Commissioner Richardson mentioned as to the use of taxpayer information.

There is a criminal penalty that runs along with that, and it's sort of hard for me to see how you can subject a private collector to a criminal penalty applicable primarily to the misuse of taxpayer information by an Internal Revenue employee. Maybe you can.

So that's what they've tried to do, on the one hand. On the other hand, they've tried to limit the amount of information going to the private collectors.

Now, that will impede the collection process, as I attempted to explain earlier.

Mr. HORN. Well, should they just, then, separate out those debts that they are not contesting versus those debts that, the example you gave, they have real problems and say, "IRS has the wrong interpretation here," so when it goes to the private collector, presumably, it's a debt where most of those questions have been resolved, and it just isn't collected?

Mr. ALEXANDER. It will go to the private collectors if the system recently discussed here at this table of assigning the old ones, the stale ones, the ones about to go bad to private collectors, it will be those that IRS has been unable to collect.

Mr. HORN. That's correct.

Mr. ALEXANDER. And that worries me for two reasons. First, is if IRS can't collect it, can a private collector do better? Well, it would be interesting to find out.

Second, if IRS can't collect it and a private collector does better, what methods are the private collector using? Is that an invitation to a private collector to apply lower standards that otherwise the private collector would not apply.

I realize, of course, there are State statutes and various other rules dealing with private collectors and regulating private collectors and that private collectors are not subject to the old stereotype of Bruno of Jersey City that we used to hear about and that I think I may have mentioned in the recent past.

Sure, they're better than that. But still, is this a good idea and in the national interest? If Internal Revenue is looking into it now, your bill, H.R. 2238, which I commend you for bringing out, which I think is very good, and I'm delighted to see has brought us some support, would go a long way toward meeting the Nation's needs to try to collect overdue revenues without impairing rights.

Mr. HORN. Well, I appreciate that. Do we have any more questions from staff? Commissioner, it's marvelous to see you again and glad that you could make it to the hearing, and I wish you well.

Mr. ALEXANDER. Thank you, Mr. Chairman.

Mr. HORN. You did a wonderful job when you were Commissioner.

Mr. ALEXANDER. I tried.

Mr. HORN. We now have the next panel, which is panel 4, Donald Korb, partner and chair of the Taxation Practice Group Thompson, Hine and Flory and former assistant to the Commissioner of Internal Revenue in the marvelous period when they were trying to simplify taxes on Capitol Hill, 1984 to 1986; and Ms. Shannon O'Toole, the consultant for the county of Orange, CA, Bankruptcy on Real

Estate Disposition, former Resolution Trust Corporation department head, section chief of the Real Estate Disposition.

If you don't mind, both stand, and we'll swear you in.

[Witnesses sworn.]

Mr. HORN. Why don't we just take them in alphabetical order. Mr. Korb, would you like to begin?

STATEMENTS OF DONALD L. KORB, THOMPSON HINE & FLORY, P.L.L.; AND SHANNON O'TOOLE, EXPERT CONSULTANT FOR COUNTY OF ORANGE, CA, BANKRUPTCY ON REAL ESTATE DISPOSITION

Mr. KORB. Congressman, I appreciate your reference back to the tax reform days of 1985 and 1986. You should know that while I was the assistant to the Commissioner, I was the person who was responsible for working on that on behalf of the Commissioner and spent many a day, evening, weekend, whatever, up here. It was a very exciting time. I look forward to going through that again, actually.

Mr. HORN. Was Gucci Gulch the book written on that?

Mr. KORB. That's right. Remember, I was working for the IRS at the time.

Mr. HORN. Yeah, I know. But I was wondering. Is that pretty accurate?

Mr. KORB. That's right.

Mr. HORN. OK.

Mr. KORB. There was the lobby outside the Ways and Means Committee room where it was full of lobbyists. You're exactly right.

I appreciate the opportunity to appear today. A lot of what I was going to talk about has already been covered, and it is covered in my written statement, but I would like to summarize some of the main points for you.

I would like to say at the outset that I'm not here to criticize the collection function of the IRS. I'm not here to suggest that the IRS collection function be replaced by private debt collection agencies.

But I am here to talk about the recent experience of the IRS collection function, which demonstrates quite clearly the IRS simply does not possess the resources to adequately deal with all of the taxpayers' accounts that are in delinquent status.

What I'm going to do today is focus on the collection pipeline and point out those places where accounts, if you will, fall out of the pipeline and are not being worked by the IRS. It seems to me, those are the accounts that should be focused on.

I believe the IRS collection function is properly concentrating its efforts on the highest yield cases and those cases that present the gravest threat to voluntary compliance.

On the other hand, the IRS does not have sufficient resources, due to budget constraints, to adequately deal with the relatively small dollar amount cases and the cases that require a greater effort to contact the taxpayer or locate the taxpayer assets or sources of income or otherwise collect the amount owed.

I think the best way to look at this is to describe the process which has been discussed already; that is the three-stage collection process.

You have the notice process with a computer. The service centers generate computer notices, which are really bills sent out to the taxpayers.

You have ACS, where the telephone contacts are made, and then you have the revenue officer investigations and personal visits.

In the first stage, when the delinquent notices are sent out, as has been discussed, once that now third notice goes out by certified mail, if an account falls below a certain dollar threshold, it becomes what is called a deferred account.

This account is, basically, put aside and will be collected should another credit show up, like a refund, or another return filed that, when that amount is added to the amount that's in deferred status, they go over the threshold, and it moves on through the system.

So there is the first place in the system where you have a group of accounts sitting there, no work being done.

The accounts then move on to the second stage, which is the ACS level, and this is where the Service attempts to collect the tax by using telephone to demand full payment of the tax.

They search for taxpayers and for their assets. They make contacts with third persons as well. At that stage, if the accounts are not collected, they then move on to the third stage, and that is the revenue officer stage.

At that stage they are put in a computerized holding file called a queue. I think it was referenced earlier, q-u-e-u-e.

And what happens is accounts are put in the queue, and they're given priority for assignment by something called the Resource and Workload Management System, RWMS.

What this does, is to allow each district to look at its resources and concentrate the available revenue officer resources on the most productive cases, and that's where the revenue officers go out and make the personal contacts.

Now, how do they determine what the score is? Well, they look at the expected collectability. That's what they're trying to determine.

They look at factors such as information from prior returns, information matching program documentation, payment history, whether it's a first time delinquent. They also factor in the anticipated cost of collection.

So a score is assigned to the account. The account then goes into this queue, the computerized holding period. The chief of collection for each of the districts—and there will be 30 districts by the end of this fiscal year, end of September—then makes a judgment for that particular district what resources they have available to determine what the cutoff score will be before cases come out of the queue.

And that's where you get your variance across the country that you alluded to earlier, when you were talking about California, for example. This is where it happens.

So the account stays in the queue until it exceeds the cutoff score. What this means, of course, is that higher-scored accounts are worked before lower-scored accounts even if the lower-scored accounts sit in the queue for months or even years, for some cases.

Now, also keep in mind that this isn't a static group of accounts. New accounts are being added all the time. So an account won't

necessarily move up. As long as other accounts come in with a higher score, they move ahead of it.

So that's the third stage. Now we've identified a second place where accounts come to rest and remain unworked for some period of time. That's the queue.

In addition, we talked about currently noncollectible. At any stage of the process, the IRS can determine that an account is currently noncollectible, and that could be done for a variety of reasons.

Three of the most common are: the taxpayer is unable to pay the delinquent tax without undue hardship that was talked about; the IRS is unable to locate the taxpayer or the taxpayer's assets; or they have an address for the taxpayer, but they just can't contact them. The taxpayer isn't responding, not answering the phone.

So those accounts are put into the currently noncollectible status, and once a year a balance due notice is sent out. So that's the only followup at that point in time.

So again, we have three places now we've identified, the deferred accounts at the notice stage. We have the accounts in the queue. Now, we have these currently noncollectible accounts.

These are the accounts that are sitting there unworked, and that is, in my view, where the emphasis ought to be placed.

As we all know, the Federal Government's resources are increasingly limited. Realistically, the Congress cannot authorize a large number enough of slots at IRS to collect these types of accounts.

And as any private sector business would do, the IRS must necessarily deploy its scarce resources to go after the highest field cases.

Unfortunately, there are a lot more cases entering into the collection process than resources will allow to be worked in a timely fashion.

One way to address this pressing problem is to use private collection agencies to help collect a portion of these delinquent tax accounts.

So, what I'm suggesting is that the collection function be supplemented. It's very important. I'm talking about supplementing the current efforts of the IRS to enable the Federal Government to collect these accounts which the IRS, rightfully so, considers a lower priority and, reasonably, will not use its resources to work.

It is known that the private collection firms do work on a contingent fee basis, and therefore, if you use that approach, that's going to make sense from the Government's perspective, since there will be no cost to the Government.

There is no training, no startup costs. They've been incurred. It's a win-win situation.

In conclusion, I'm proud of my past service with the IRS, and I believe the Service does a good job overall. In recent years, the Service has made progress in accelerating the collection process, but the reality that we have to face is the IRS cannot work all of the cases the way they need to be worked in order to collect taxes that should be collected. One thing people ought to keep in mind is we are talking about collecting tax dollars that taxpayers by and large admit they owe.

We're not talking about the audit process. We're talking about collection after assessment. The IRS is beleaguered. Its funds are being cut, and it just doesn't have the resources to do the job it needs to do to collect the deferred accounts, the accounts in the queue and the CNCs we've talked about.

And I think given the current efforts to cut Government spending, it's really unrealistic to think this is going to change in the near term.

So it makes sense to me to supplement, again, supplement the IRS's collection efforts by contracting out certain activities to get the job done.

The IRS cannot collect these accounts, but let's let private collection agencies supplement the Government's efforts.

With over 1 million private businesses, 32 State tax collection agencies, and numerous Federal agencies availing themselves of these private collectors, why not the IRS? Those who pay their taxes shouldn't have to carry the additional burden for those who do not.

That concludes my prepared remarks, and I'll be pleased to answer any questions.

[The prepared statement of Mr. Korb follows:]

HOUSE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION AND TECHNOLOGY

MARCH 6, 1996

STATEMENT OF DONALD L. KORB
THOMPSON HINE & FLORY P.L.L.
CLEVELAND, OHIO

Mr. Chairman and Distinguished Members of the Subcommittee on Government Management, Information and Technology:

Thank you for the opportunity to appear here today to explain how the Internal Revenue Service processes its delinquent tax inventory. I am a partner in the Cleveland office of the law firm of Thompson Hine & Flory P.L.L. and the Chair of the firm's taxation group. From 1984 through 1986, I served as Assistant to the Commissioner of Internal Revenue, and in that capacity, among other things, I was the overall coordinator of the IRS's participation in the legislative process that resulted in the Tax Reform Act of 1986. Since last year, I have represented Diversified Collection Services, Inc., which is a national collection agency specializing in the collection of defaulted Federal student loan debt. More recently, I have been retained by a coalition of private debt collection firms to advise them on ways to improve Federal debt collection.

Let me say at the outset that I am not here to criticize the Collection function of the IRS. I am also not here to suggest that the IRS Collection function be replaced by private debt collection agencies. However, I am here to talk about the experience of the past 10 years of the IRS Collection function which demonstrates quite clearly that the IRS simply does not possess the systems and resources to adequately deal with all of the taxpayers' accounts that are in delinquent status.

In my view, the IRS Collection function is properly concentrating its efforts on the highest yield cases and those cases that present the gravest threat to voluntary compliance. On the other hand, the IRS does not have sufficient resources due to budget constraints to adequately deal with (1) the relatively small dollar amount cases and (2) the cases that require a greater effort to contact the taxpayer, locate the taxpayer's assets or sources of income, or otherwise collect the amount owed. Today, I am going to suggest that serious consideration be given to the concept of contracting with private collection agencies to collect these types of accounts. Contracting out the collection of these types of accounts would merely supplement the existing IRS collection efforts.

Attached to my statement as Exhibit A is an outline which explains how the IRS processes it delinquent tax inventory. Although there are always unusual cases that receive unique

treatment, generally the IRS uses a three-stage process to collect delinquent taxes: Service Center computer-generated notices and bills, Automated Collection System telephone contacts, and investigations and personal visits by revenue officers in the field.

In the first stage, IRS Service Centers mail delinquent taxpayers a series of computer-generated notices--really bills--demanding payment. In most cases, there are between three and five notices sent to the taxpayer. Before sending the final notice, the Service Center searches IRS computer records for levy sources--a levy is the seizure of a taxpayer's property, including assets in the possession of employers and financial institutions, such as wages and bank deposits. The final notice is sent by certified mail and informs the taxpayer that failure to satisfactorily respond to the IRS may lead to the filing of a notice of federal tax lien and/or a levy on the assets of the taxpayer in the possession of third parties.

If the efforts of the Service Center do not secure payment, accounts which exceed certain dollar thresholds are transferred to the second stage, which is called the Automated Collection System or ACS. Note that I said that it is only accounts which exceed the dollar threshold which are sent on to ACS. The accounts that fall below the dollar threshold have tax liabilities that the IRS believes are so small that it is not economical to pursue them

further. The IRS does not publicly disclose its criteria for determining the cutoff point for such so-called "tolerance cases," but I can tell you that the amount is not de minimis and it has been increasing over the past several years as the number of cases in delinquent status has risen.

The accounts that fall below the dollar threshold go into what is called "deferred status." What this means is that no further action will be taken with respect to these accounts until some other credit (such as a refund) shows up in the system and the credit is offset against the deferred amount. If the taxpayer should file a tax return for a subsequent tax period which reflects additional taxes due and those additional taxes plus the deferred amount exceed the dollar threshold, then the account is reactivated and moved on to ACS.

At the ACS level, the IRS attempts to collect the tax liability by contacting taxpayers by telephone to demand full payment of the delinquent tax. It also searches for taxpayers and their assets by telephoning third parties and other techniques. During this stage, IRS collection employees attempt to collect the tax delinquencies through payment arrangements or levies.

If the delinquency is not resolved in ACS, the account moves to the third stage. At this stage, the account is placed in a computerized holding file called the "Queue." Accounts in the

Queue are given priority for assignment to IRS revenue officers according to each case's collection potential. The priority is determined by the Resources and Workload Management System (RWMS), which enables each IRS District Office's management to concentrate available revenue officer resources on the most productive cases. In the third stage, revenue officers attempt personal contact with taxpayers; search internal and external sources for taxpayers' assets; initiate levies; file notices of federal tax lien; and seize taxpayers' physical property such as automobiles and homes, to satisfy the tax delinquencies.

Each account in the Queue is assigned a RWMS score based on its expected collectibility, which in turn depends on such factors as information from prior returns, information matching program data, payment history on delinquency modules (i.e., tax periods), business type, dollar amount of tax liability, whether the taxpayer is a first time delinquent or has been delinquent in the past, etc. It also ensures cost-effective use of revenue officers by factoring into each RWMS score the anticipated cost of collecting the debt in question.

The RWMS score for an account is computed for each module at the time the account becomes delinquent. The module scores are added together for the entity score (the entity is the taxpayer, either an individual or another taxpaying entity such as a corporation). The entity score changes as delinquent modules are

satisfied or additional modules become delinquent for the particular taxpayer.

Once the account is transferred to the Queue of the appropriate IRS district, if the RWMS score for the case equals or exceeds the cutoff score established for that district by the Chief of its Collection function, the account is assigned to a revenue officer for pursuit. Those cases which fall below the cutoff score for the district, however, remain in the Queue until the cutoff score is revised (i.e., adjusted to satisfy current inventory requirements) or the account is specifically called out of the Queue. Therefore, at the third or revenue officer stage, accounts are basically worked in order of RWMS score. This means that the higher scored accounts are worked before the lower scored accounts, even if the lower scored accounts have been in the Queue for months, or even years.

The number of accounts in the Queue that is worked in any particular IRS district is dependent upon the resources available to the Collection function in that district. In a district such as Manhattan where there are a significant number of accounts with high RWMS scores but limited collection resources, an account would have to score a high RWMS score before it leaves the Queue and is assigned to a revenue officer, while in other parts of the country with greater collection resources, accounts with lower RWMS scores would be assigned immediately to a revenue officer because the

cutoff score in that particular district is lower.

Accounts that do not score high enough to be assigned to a revenue officer remain in the Queue until they move "up" in line as a result of the disposition of higher scoring accounts. Keep in mind that new accounts are being constantly added to the Queue and, if a new account has a higher RWMS score, it will be worked before a lower scoring account that is already in the Queue. Also the Chief of Collection can adjust the cutoff score as resources available to him or her decline.

At any stage of the collection process, the IRS may determine that collection of a particular account is not currently possible. At that time, the case is closed from the active inventory and placed in "Currently Not Collectible" or "CNC" status. The IRS classifies accounts as CNC for a variety of reasons. The most common reasons for individual taxpayers are that (1) based on information available to the IRS, the taxpayer is unable to pay the delinquent tax without undue financial hardship; (2) the IRS is unable to locate the taxpayer or the taxpayer's assets; or (3) the IRS is unable to contact the taxpayer (although it has a current address) and is unable to locate any of the taxpayer's assets. Once a year (approximately October) a balance-due notice is sent to taxpayers whose accounts have been classified CNC for at least a year.

Because the situation for which the account was classified as CNC could change--making the account potentially collectible--the IRS has established mechanisms to reactivate these accounts. If a CNC account is reactivated, the account enters the collection process at the first (i.e., notice) stage. The account then follows the normal collection process through the next two stages.

As you can see, tax delinquent accounts not actively being worked by the IRS fall into three categories.

- Accounts in deferred status. These are the accounts that went through the first stage (Service Center notices) but fell below the dollar threshold for transfer to the second stage (ACS). Accounts remain in this status until (1) there are additional delinquencies for the same taxpayer in later tax periods which result in the total tax liability exceeding the dollar threshold or (2) the accounts are ultimately collected by virtue of refund offsets and/or by operation of the federal tax lien when the taxpayer attempts to sell property.

- Accounts in the Queue. These are the accounts that went through the second stage (ACS) but did not have a high enough RWMS score in the particular IRS

district to be assigned to a revenue officer in the third stage. Accounts remain in this status until (1) the cutoff score is reduced so that the account now has a high enough RWMS score to be assigned to a revenue officer, (2) there are additional delinquencies in later periods which cause the taxpayer's RWMS score to rise above the cutoff score so that the account will be assigned to a revenue officer, (3) the accounts are ultimately collected by virtue of refund offsets and/or by operation of the federal tax lien when the taxpayer attempts to sell property, or (4) the imminence of the expiration of the 10-year statute of limitations causes the account to be assigned to a revenue officer.

- Accounts classified as CNC. These are the accounts for which the IRS has concluded collection is not currently possible. Accounts remain in this status until (1) they are reactivated, (2) they are ultimately collected by virtue of refund offsets and/or by the operation of the federal tax lien when the taxpayer attempts to sell property, or (3) the expiration of the 10-year statute of limitations, at which time they are written off.

As we all know, the Federal government's resources are increasingly limited. Realistically, the Congress cannot authorize a large enough number of slots at IRS to collect these type of accounts. As would any private sector business, the IRS must necessarily deploy its scarce resources to attempt to work the highest yield cases. Unfortunately, there are a lot more cases entering into the collection process than resources will allow to be worked in a timely fashion.

The IRS is experiencing not only growth in delinquent tax debt, but also the parallel growth of the "tax gap" of unreported income. The growing demand for resources to combat the underground economy further reduces the resources available to the IRS for debt collection--and this comes at a time when the resources of the IRS are strained by its efforts to accomplish a massive computer update. One way to address these pressing problems would be to use private collection agencies to help collect a portion of the delinquent tax accounts.

Therefore, I am suggesting that the current efforts of the IRS Collection function be supplemented to enable the federal government to collect those accounts which the IRS considers a lower priority and thus reasonably does not use its resources to work. Private collection firms typically work on a contingent fee basis. Contracting out these accounts would therefore make sense from the government's perspective. There would be no cost to the

government since nothing would be paid to the private collection agency unless the debtor pays. It is truly a win-win situation.

In a 1993 study assessing the use of private collection companies, the GAO declared, "[f]or IRS to be a successful competitor, it will have to adopt collection strategies that are more effective than its current approaches . . . . The use of private collection companies could prove to be an effective strategy . . . ." The GAO continued, "[s]ince IRS does not work all its delinquency cases and many of the cases that are eventually worked are delayed because collection staff work higher priority cases first, we believe that private collection companies should be allowed to supplement IRS's collection . . ."

There is another plus for the government in contracting out certain collection activities on dormant accounts. That plus would come from the expectation that voluntary compliance would also increase. At the present time, the IRS sends at least three notices, the last one of which threatens as follows:

> If you do not take the requested action within 30 days from the date of this notice, we may, without further notice to you, levy upon and seize your property and rights to property. Section 6331 of the Internal Revenue Code allows us to seize wages, bank accounts, commissions, and other income. Real estate and personal property such as business assets and automobiles may also be seized. (A copy of IRS Notice of Intent to Levy--Form 504 is attached as Exhibit B.)

The IRS cannot possibly be helping voluntary compliance when it sends a notice with this language and then--on a deferred account--

does absolutely nothing to follow up. Taxpayers quickly learn that if their delinquent amount is below a certain dollar threshold, the IRS will do nothing more than send out a notice once year. The long term cost to the integrity of the voluntary compliance system when the IRS sends out notices and then does not follow up should not be underestimated.

In conclusion, I am proud of my past service with the IRS and I believe that the Service does a good job overall. In recent years, the IRS has made some progress in accelerating the collection process. But the reality is that the IRS cannot work all of the cases in the way they need to be worked in order to collect taxes that should be collected--and remember here that we are talking about collecting tax dollars that taxpayers by and large will admit they owe.

The IRS is beleaguered, its funds are being cut, and it just does not have the resources to do the job it needs to do to collect the deferred accounts, the accounts that sit unworked in the Queue, and the CNCs. Given the current efforts to cut government spending, it is unrealistic to think that this will change in the near term. Consequently, it makes sense to supplement the IRS's collection efforts by contracting out certain activities on the tax debts I have described to private collection agencies to get the job done. If the IRS cannot collect these accounts, let the private collection agencies supplement the government's efforts.

With over one million private businesses, 32 state tax collection agencies, and numerous Federal agencies availing themselves of these private collectors, why not the IRS? Those of us who pay our taxes should not have to carry the additional burden for those who do not.

That concludes my prepared remarks. If you have any questions about my statement, I would be pleased to answer them.

INTERNAL REVENUE SERVICE
THREE-STAGE PROCESS TO COLLECT DELINQUENT TAXES

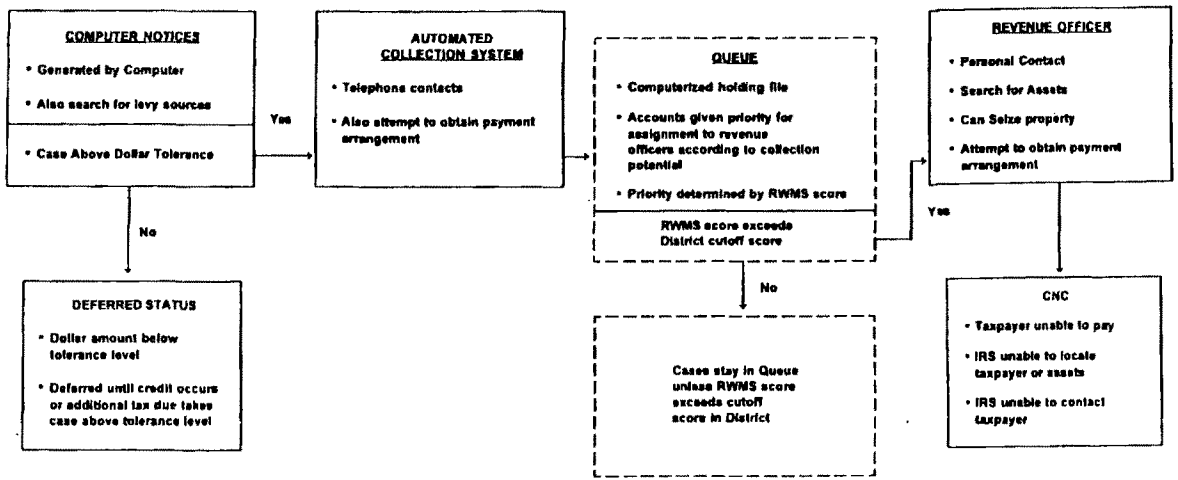


EXHIBIT A

HOW IRS PROCESSES ITS
DELINQUENT TAX INVENTORY

I. The IRS uses a three-stage process to collect delinquent taxes: Service Center notices and correspondence, Automated Collection System contacts, and Revenue Officer field investigations.

A. In the first stage, Service Centers mail delinquent taxpayers a series of computer-generated notices (bills) demanding payment. In most cases there are between three and five notices sent to the taxpayer. Prior to sending the final notice, the Service Center Collection Branch searches IRS computer records for levy sources (a levy is the seizure of a taxpayer's property, including assets in the possession of employers and financial institutions, such as wages and bank deposits). The final notice is sent by certified mail and informs the taxpayer that failure to satisfactorily respond to the IRS may lead to the filing of a Notice of a Federal Tax Lien and/or a levy on assets of the taxpayer in the possession of third parties. During the notice process, IRS responds to any taxpayer replies.

B. If the efforts of the Service Center do not secure payment, accounts which exceed certain dollar thresholds are transferred to the second stage, called the Automated Collection System (ACS).[1]

1. The accounts that fall below the dollar threshold have tax liabilities that the IRS believes are so small that it is not economical to pursue collection. The IRS does not publicly disclose the current criteria for such so-called "tolerance cases."

2. The accounts that fall below the dollar threshold go into "deferred status." This means that no further action will be taken with respect to these accounts until some other credit (such as a refund) shows up in the system and that credit is offset against the deferred amount. However, if the

[1] Note that there are certain cases that bypass the ACS stage and are sent directly to the districts for assignment to Revenue Officers.

taxpayer files a return for a subsequent tax period reflecting additional taxes due and those additional taxes plus the deferred amount exceed the dollar threshold, the account is reactivated and moved to ACS.

3. At the ACS level, the IRS attempts to collect the tax liability (a) by contacting taxpayers by telephone to demand full payment of the delinquent tax and (b) among other means, by searching for taxpayers and their assets by telephoning third parties. During this stage, IRS collection employees attempt to collect the delinquencies through payment arrangements or levies.

C. If delinquencies are not resolved in ACS, collection efforts move to the third stage. At this stage, the accounts are placed in a computerized holding file called the "Queue." Accounts in the Queue are assigned to IRS Revenue Officers according to the cases' collection potential. The priority is determined by the Resources and Workload Management System (RWMS) which is supposed to enable IRS district management to limit Revenue Officer assignments to the most productive cases based upon current collection staffing in the district. In the third stage, Revenue Officers attempt personal contact with taxpayers; search internal and external sources for taxpayers' assets; initiate levies; file Notices of Federal Tax Lien; and seize taxpayers physical property such as automobiles and homes, to satisfy the tax delinquencies.[2]

1. Each account in the Queue is assigned a RWMS score which is based on such factors as information from prior returns, infomration matching program data, payment history on delinquent modules,[3] business type, dollar

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[2] Note that there are certain cases that are not placed in the Queue, but instead are assigned directly to Revenue Officers.

[3] A "module" is a tax period. For example, for individual taxpayers, each calendar year is a module. This is to be distinguished from an "entity" which is the taxpayer, either an individual or another taxpaying entity such as a corporation. Thus, for example, one entity is delinquent for more than one module if the taxpayer (the entity) is delinquent for two or more tax years (each tax year being a module).

amount of tax liability, whether the taxpayer is a first time delinquent or has been delinquent in the past, anticipated cost of collection, etc.

a. The RWMS score is computed for each module at the time the account becomes delinquent. The module scores are added together for the entity score. The entity score changes as delinquent modules are satisfied or additional modules become delinquent for the particular taxpayer.

2. Once the account is transferred to the Queue of the appropriate IRS district, if the case equals or exceeds the cutoff score established for that district by its Chief, Collection function, it will be assigned to a Revenue Officer for contact. Those cases which fall below the cutoff score for the district will remain in the Queue until the cutoff score is revised (i.e., adjusted to satisfy current inventory requirements) or the account is specifically called out of the Queue.

a. Therefore at the Revenue Officer stage, accounts are basically worked in order of RWMS score. Thus, the higher scored accounts are worked before the lower scored accounts.

3. The number of accounts in the Queue that are worked in any particular IRS district (there are 63 districts today, but that number will be reduced to 33 on October 1, 1996) is dependent upon the resources available to the Collection function in that district. In districts such as Manhattan where there are a significant number of accounts with high RWMS scores but limited collection resources, an account would have to score a high RWMS score before it leaves the Queue and is assigned to a Revenue Officer, while in other parts of the country, accounts with lower RWMS scores could be assigned to a Revenue Officer because the cutoff score in the particular district is lower since more collection resources are available in that district.

4. Accounts that do not score high enough to be assigned to a Revenue Officer remain in the Queue until they move "up" in the line as

the result of the disposition of higher scoring accounts. Keep in mind that new accounts are being constantly added to the Queue and if a new account has a higher RWMS score, it will be worked before a lower scoring account already in the Queue.

II. At any stage of the collection process, the IRS may determine that collection is not currently possible. At that time, the case is closed from the active inventory and placed in "Currently Not Collectible" or "CNC" status.

A. IRS can classify accounts as CNC for a variety of reasons. The most common reasons for individual taxpayers are that (a) the taxpayer is unable to pay the delinquent tax (this includes instances when the delinquent taxpayer does not have the resources to pay as well as when the taxpayer has resources but collection of the tax would cause the taxpayer undue financial hardship); (b) the IRS is unable to locate the taxpayer or the taxpayer's assets; or (c) the IRS is unable to contact the taxpayer (although it has a current address) and is unable to locate any of the taxpayer's assets.

B. Because the situation for which the account was classified CNC could change -- making the account potentially collectible -- the IRS has established mechanisms to reactivate these accounts.[4] If a CNC account is reactivated, the account will enter the collection process at the first stage. Note that it may enter the collection process at different points in first stage depending upon why it was reactivated. The account then follows the normal collection process through the next two stages.

C. Once a year (approximately October) a balance-due notice is sent to taxpayers whose accounts have been classified CNC for at least a year.

III. In summary, tax delinquent accounts not actively being worked by the IRS fall into three categories.

A. Accounts in deferred status (described in Item I.B.1. above). These are the accounts that went through the first stage (Service Center) but fell below the dollar threshold for transfer to the

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[4] Note that once an account is classified as a CNC, in general it will remain a CNC for at least 15 months before it can be reactivated.

second stage (ACS). Accounts remain in this status until (1) there are additional delinquencies in later tax periods which result in the total tax liability exceeding the dollar threshold or (2) they are ultimately collected by virtue of refund offsets and/or by operation of the Federal Tax Lien when the taxpayer attempts to sell property.

B. Accounts in the Queue (described in Item I.C. above). These are the accounts that went through the second stage (ACS) but did not have a high enough RWMS score in the particular IRS district to be assigned to a Revenue Officer in the third stage. Accounts remain in this status until either (1) the cutoff score is reduced so that the account now has a high enough RWMS score to be assigned to a Revenue Officer, (2) there are additional delinquencies in later periods which result in the taxpayer's RWMS score to rise above the cutoff score so that the account will be assigned to a Revenue Officer, (3) they are ultimately collected by virtue of refund offsets and/or by operation of the Federal Tax Lien when the taxpayer attempts to sell property, or (4) the imminence of the expiration of the 10-year statute of limitations causes the account to be assigned to a Revenue Officer.

C. Accounts classified as CNC (described in Item II. above). These are the accounts for which the IRS has concluded that collection is not currently possible. Accounts remain in this status until either (1) they are reactivated, (2) they are ultimately collected by virtue of refund offsets and/or by the operation of the Federal Tax Lien when the taxpayer attempts to sell property, or (3) the expiration of the 10-year statute of limitations.

Donald L. Korb
Thompson Hine & Flory P.L.L.
March 6, 1996

EXHIBIT B

Internal Revenue Service
AUSTIN TX 73301

DATE OF NOTICE: [illegible]
TAXPAYER IDENTIFYING NUMBER:
FORM CIV PEN TAX PERIOD 03-31-86

FOR ASSISTANCE YOU MAY CALL US AT:

742-2440 LOCAL DALLAS
263-9229 LOCAL FT. WORTH
1-800-829-1040 OTHER TX

OR YOU MAY WRITE TO US AT THE ADDRESS SHOWN AT THE LEFT. IF YOU WRITE, BE SURE TO ATTACH THE BOTTOM PART OF THIS NOTICE.

NOTICE OF INTENT TO LEVY

OUR RECORDS SHOW THAT WE HAVE PREVIOUSLY SENT YOU NOTICES BUT WE HAVE NOT RECEIVED FULL PAYMENT OF THE FEDERAL TAX LIABILITY SHOWN BELOW. THIS IS YOUR FINAL NOTICE.

A NOTICE OF FEDERAL TAX LIEN, WHICH IS A PUBLIC NOTICE THAT THERE IS A TAX LIEN AGAINST YOUR PROPERTY, MAY BE FILED AT ANY TIME TO PROTECT THE INTEREST OF THE GOVERNMENT. IF YOU DO NOT TAKE THE REQUESTED ACTION WITHIN 30 DAYS FROM THE DATE OF THIS NOTICE, WE MAY, WITHOUT FURTHER NOTICE TO YOU, LEVY UPON AND SEIZE YOUR PROPERTY AND RIGHTS TO PROPERTY. SECTION 6331 OF THE INTERNAL REVENUE CODE ALLOWS US TO SEIZE WAGES, BANK ACCOUNTS, COMMISSIONS, AND OTHER INCOME. REAL ESTATE AND PERSONAL PROPERTY SUCH AS BUSINESS ASSETS AND AUTOMOBILES MAY ALSO BE SEIZED. THE ENCLOSED PUBLICATION CONTAINS AN EXPLANATION OF THE ACTIONS WE MAY TAKE.

TO PREVENT ACTION FROM BEING TAKEN, SEND FULL PAYMENT TODAY BY CHECK OR MONEY ORDER PAYABLE TO THE INTERNAL REVENUE SERVICE. WRITE YOUR SOCIAL SECURITY NUMBER OR EMPLOYER IDENTIFICATION NUMBER ON YOUR PAYMENT. INCLUDE THE BOTTOM PART OF THIS NOTICE WITH YOUR PAYMENT SO WE CAN QUICKLY CREDIT YOUR ACCOUNT.

WE HAVE CALCULATED PENALTY AND INTEREST AMOUNTS TO THE DATE OF THIS NOTICE. IF FULL PAYMENT IS NOT RECEIVED WITHIN 10 DAYS FROM THE DATE OF THIS NOTICE, ADDITIONAL INTEREST AND PENALTIES WILL BE CHARGED AND WILL CONTINUE UNTIL THE ACCOUNT IS FULL PAID. THE FAILURE TO PAY PENALTY INCREASES FROM ONE-HALF TO ONE PERCENT.

IF YOU RECENTLY PAID THE AMOUNT DUE, OR IF YOU CANNOT PAY THIS AMOUNT IN FULL, CONTACT THE OFFICE SHOWN ABOVE TODAY.

Mr. HORN. Well, those are very well done. If you don't mind, we will also take Ms. O'Toole's testimony, and then we'll question both of you.

Ms. O'Toole, we're glad you could make it here. You've done, I know, a terrific amount of work in developing your tax lien recovery plan, and we deeply appreciate those efforts and your willingness, frankly, to take the time to come here and testify. So thank you very much.

Ms. O'TOOLE. Thank you kindly for having me here today. I sincerely appreciate it, and I'm also honored to be here and for the committee setting aside the time to hear this issue. It's very important that we address it now while there is still time to correct it.

My name is Shannon O'Toole, and I am not appearing here today in my official capacity. I am here as an individual. I am going to express some points of view that come from my own experience, my own professional background.

I've done independent research for this, and I've prepared studies that I'm going to be presenting to you today.

I have over 15 years' experience as a Government real estate expert. I have been managing assets from institution- and Government-owned properties as well as private investments prior to my joining other agencies.

For the last 11 years, I have overseen over $7 billion worth of Government-owned properties. I am formerly from the Federal Deposit Insurance Corporation, from the Division of Liquidations and most presently from the Resolution Trust Corporation as department head and section chief for the Real Estate Disposition Division.

But again, I'm here today as an individual not representing my agencies.

I've also been an expert consultant to the county of Orange during their bankruptcy sessions to give them advice on disposing of real estate to bring in revenue for the county as well.

I have written and published Government manuals, policies and procedures for the disposition of real estate. I've been deeply involved in trying to find the best practices from other agencies and trying to make disposition efforts bring in the most recovery at the least amount of expense.

I'm going to talk about something we have not addressed yet today. I'm going to focus on another portion of IRS recoveries. It was not addressed specifically on the floor today or in any of the reports that I have read previously to appearing here today.

That area is the property tax lien recovery plan that I'm putting before you, because all the laws and all the statutes and all the rules are in place. They're already in place to be activated.

Unfortunately, they're not being activated or used to bring in the Treasury recoveries that we're here to discuss today.

The IRS has the rules, the statutes, the codes to place liens against property, both real tangible and intangible property when a debtor does not pay his taxes that are due.

From our earlier testimony today, you can see that that's generally happening in the IRS' third stage of collection, after the letters, after the phone calls. This is where they take more direct action.

Now, these liens, as you've heard today, are placed against the property, and they are generally valid for 10 years—you've heard that—and they are renewable as well.

In my last 4 years, I have tried to find out exactly how many IRS liens there are, where they're located, and I have not been able to find out how many liens there are in, say, New York or in any county of California, say Los Angeles County or Orange County.

I am not able to and I don't believe the information is available to tell you what kinds of properties those liens are against. I don't believe they can tell you there is X-amount of dollars against commercial or X-amount of dollars against residential or land.

We need to know this. We need to know where those liens are. We need to do the research to go out and find out and identify those IRS liens.

And capture them. Capture them in a data base. We've heard a lot of testimony about the IRS data base not being adequate at this time. We have to commit resources, whatever they may be, to capture these liens.

Congress deserves to know. Congress deserves to know how many liens there are in this category and where they are. Then, we can go about taking the appropriate action to redeem them.

Now, there are several ways that these liens can be redeemed. We know it's a 10-year lien that's placed against property. We can sit back and we can wait for the taxpayer to come forward and pay. We can also wait until he attempts to sell his property, and at that point he would be compelled to pay the amount of his lien or a negotiated amount.

There is a third action that can be taken, and that's where the IRS actually seizes his property. They actually take the property themselves so that they can get the equity from the property.

But what is most interesting is that the liens are against the property and at a time a senior lien holder, say a mortgager, an investor, a bank or a savings and loan, forecloses against a property, that IRS lien is going to go away. It's going to evaporate, dissolve, expire, go away, be wiped off the books in 120 days.

This is called the redemption period, and this is something that has not been discussed. This has not been specifically identified as another very significant area that we need to examine.

When a piece of property is foreclosed on, my experience has shown in about 19 States that the property will simply go to the lienholder, the mortgagor, the bank, the savings and loan, and they will take the property back.

They will see the IRS lien against the title to the property, and they know that that lien is going to go away in 120 days.

We are creating a windfall profit for these institutions because they not only keep their money, but they keep all of the equity in the property that should have been going to the IRS to satisfy these liens.

The rules are there to do this. They're simply not being implemented. They're simply not being paid attention to, and that needs to happen right away.

In doing additional research, let's see if I can get my numbers to you clearly, there are over 12,112 institutions still today in the

United States after all the banking problems, the savings and loan problems that have been going on.

And, of course, they sometimes have hundreds and hundreds of branches or sometimes none at all. Of these 112,000 branches that are FDIC insured—and, of course, we know there are other credit unions, other mortgage houses that are not insured at all, so we are focusing now just on the insured institutions—there are over $5,254 trillion in assets in those institutions of which more than a third is secured by real estate.

That's a lot of real estate that's out there with mortgages against it. Now, we don't know how many of those loans are going to perform and how many are not.

Historically, it's public record, that for the institutions that the Resolution Trust Corporation managed 13 percent, perhaps, sometimes 15 percent of the assets from the failed institutions were real estate. That's a very large portion.

I don't believe that portion is going to be in effect in these thriving institutions, but I do understand from the quarterly banker profile that perhaps up to 6 percent of the real estate loans are in trouble.

They're overdue, up to 89, 90 days overdue and/or it already includes real estate that has been foreclosed on.

What we don't know, ladies and gentlemen, is how many liens there are against these properties. We do not know if there are IRS liens out against any of these assets that could immediately become assessable and be collected upon.

I have attached a 10-step plan to this program, and it is a step-by-step mini manual, if you will, as to how you go about collecting on these liens.

For one, it is separating the duties and responsibilities from the auditor agent at the IRS and no longer having what is known in the industry as cradle-to-grave responsibilities whereby the auditor not only examines the tax return but pursues the taxpayer debtor and also is responsible for trying to place a lien on his property and follow it and collect on it.

In this day and age of specialization, that simply does not make good business sense. So a check and balance is to separate the duties of the auditor, let them do their job, but once it is determined that a lien needs to be placed, let's put that into another set of hands, whether that's another section, another department or any other entity, but let's make that a separate entity so that they can check and balance.

If the auditor did not record the lien as he should have done so that it's reportable, now we have a check and balance immediately to go back and put the correct records into place so that we can always go back and track those liens.

I've given you a strategic plan. It's to implement this lien recovery plan, and it's really so simple, because not another rule or law has to be passed. It's all there.

We simply have to prioritize this area. We have to bring it forward, and we have to implement it, commit resources and dedicate ourselves to going after these recoverable liens.

I've issued a vision-mission statement included in this proposal, again to take all the lawful steps available to this agency, the IRS

agency or other new entities to go forward and get these funds back into the Treasury, where they should be.

New expertise and experience is going to be needed simply based upon past performance and the lack of IRS collections that we've looked at all day long.

The 10 steps are here. I won't take your time to go through the lengthy 10 steps. I'll give you a quick summary so that you can review them later at your leisure.

Also, on page 7, I've given you a very basic flow chart. For those of us that learn more easily by visual means, rather than testimony, it gives you a very simplified flow chart as to how it should work, the step by step plan that has to be followed to bring this new plan about.

The very first step, of course, is simple on its face. Find the liens. Research the liens. Right now, again, I don't believe that they could tell you what is in New York, California, Nevada.

They could tell you some of the uncollectibles, which would be from tax returns, but not these liens against real property, and they certainly could not detail it for you by State, county or by product type, residential/commercial.

We need to know this so that we can go and dispose of the property and collect the revenues.

So we're going to go do research. We're going to find these properties. We're also going to have to simultaneously commit resources, create, perhaps, new policies and procedures that will then take this program in the forefront, bring it forward so that all of the liens are tracked accordingly, which goes hand-in-hand with step two, and that is what you've heard today, create or borrow a data base.

Create a resource to capture and identify and track and report to Congress what is in this area of Treasury recoverable dollars.

It's essential that there be an open line of communication. It's essential for Congress to do its job. It's essential that we find out what's in there and that this is a retrievable system to tell you at all times where the liens are, how much the liens are, to date what has been collected, what is going to expire, all of the questions we've been asking and also to track the status of these properties.

We can tell you, perhaps, later down the road that we have 10 new liens against the properties. We need to watch every single property to see if it's going to go into foreclosure where one of these institutions does the foreclosure and that equity that belongs to IRS is not even being looked at.

It's being passed straight over to another foreclosing entity. IRS is walking away from all of these funds. We need to track every one of those and know what status each one of those liens is in.

Also, you heard today that the liens expire after 10 years. Those liens could be extended. That needs to be watched very carefully so that never is that ball dropped and never is that lien allowed to expire on its own means.

We have the tools to do this. We don't have to make another law or rule to do any of this. We do need to improve the system for determining equity.

So now we have the liens. We have 10-year liens against the property. We know they're going into foreclosure, but we have to know if there is equity.

If there is no equity, then it makes a good business sense, in most instances, to pass. Why spend more resources on something that's not going to bring in Treasury recovery?

But when it is determined that there is equity, then we should take action, appropriate action to go and recover our lien moneys.

This would require some in-house or some special circumstance for appraising equity. There are on-line systems right now, there is Data base, Dataquick. All of these systems are already there.

They don't need to be developed. They just need to be brought forward and implemented to determine that the equity is in the assets and to go and take appropriate steps.

Fourth task you'll see is to develop policies and procedures for lien attachment. "Redemption" is your key word here. That has not been discussed until just now.

Redemption is that very, very small 120-day window that is open after a property is foreclosed on. IRS has 120 days to act, and that's short.

And if IRS has not reported the lien, if they have not tracked the lien, if they do not know the status of the lien, if they don't know that it's in foreclosure, then 120 days is a very short window.

But if they have tracked that lien and they do know that it's about to go into foreclosure and they have ascertained equity, then 120 days is a very easy amount of time to move in and redeem, if it's determined that equity is there, and get the money back for the Treasury.

Again, in my 11 years with the Government and 15 years overall looking at Government-owned real estate, I have never once had an IRS lien redeemed in my entire career.

IRS will redeem occassionally. I have seen, on highly visible assets but not on the every day property liens that rank up to be billions and billions of dollars.

We need to, again, get a logging and tracking data-system. We've discussed that. By identifying the properties, we're able to release liens as necessary, when the debtor sells his property. By having a strong marketing arm come into effect, if these properties are redeemed, if they are going to be redeemed by the IRS, then there should immediately be a marketing vehicle ready for these properties.

It's my experience that the public is ready, willing and able to step in and repurchase these properties. It has been done many times by many other agencies.

You announce that there is a quarterly sales initiative to put forth these properties, and you have a built-in buying base ready to step in, pick up these properties, and every dollar goes back into the Treasury.

It is not an expensive system. My experience has been to bring in the liquidation and disposition of real estate owned by the Government, at one of the lowest cost of sales in the Nation.

It is not difficult, but it takes organization, and it takes planning, and it takes commitment. We need to get the resources in here, both financial and operational, and we need to get internal

controls so that this program can go forward so that we can report to Congress at any time at any moment how many dollars are out there in this lien category, what status they're in, not allow another 10-year lien to ever expire and to step into the redemption period when there is adequate equity to go after it.

This 10-step plan is just a blueprint. It's just a beginning. It's just an outline of what needs to be done but is really so simple.

With our population growing, this lien problem is not going to decrease. This problem is going to increase. As we heard earlier today, as the efforts go from step 1, 2 to 3 for the IRS recovery, normal steps, we're increasing the cost of collections, the time.

The cost of money, today's cost of money is being extended out years and years. That money could be in your hand today. It is a bird in the hand today.

Instead of stretching it out over years and years where the value of that money decreases but your collection efforts go on and on and increase, that can be stopped in this area of property tax liens.

I would like to see the attached IRS Property Tax Lien Recovery Plan strongly recommended by this committee to the IRS to be adopted. This plan should be made a major priority in restructuring the IRS programs or other entities in deficiency to ensure that no other IRS property tax liens are permitted to ever expire again and increase the unnecessary losses for the national Treasury.

This plan is before you now. It can be implemented immediately without another rule or law, and it is here for your consideration. Thank you.

[The prepared statement of Ms. O'Toole follows:]

Testimony
of
Shannon O'Toole
before the
House Subcommittee
on
Government Management, Information and Technology

March 6, 1996

Mr. Chairman, members of the Committee, I am honored to have this opportunity to present my views and findings to the Committee as they pertain to the Hearings on IRS Financial Management, with a **special focus on Internal Revenue Property Tax Lien Recoveries.**

My name is Shannon O'Toole: I am not appearing here today in any official capacity, the views I present here today are my own personal views from my own independent research and studies and my 15 years experience as an expert in real estate, government and institution owned properties and the IRS lien process. The last 11 years I have overseen over $7 billion dollars in real estate with the Federal Deposit Insurance Corporation, formerly Division of Liquidations, and the Resolution Trust Corporation Real Estate Sales Division as Department Head and Section Chief, in addition to $20 million in private investments. I have also been an expert consultant for the County of Orange, California bankruptcy in real property disposition.

I have written published real estate training materials and have developed government programs, policies and procedures for the management, reporting and disposition of government owned real estate and other assets for the Federal Deposit Insurance Corporation and the Resolution Trust Corporation.

In managing these properties from failed banks and savings and loans, I have observed millions of dollars in IRS liens go unredeemed.

I would first like to commend the Committee in their diligent efforts to examine the extremely complex financial management of the Internal Revenue Service.

While I concur with the GAO Financial Audit for IRS' fiscal year 1994 which addressed significant IRS practices in need of improvement, I intend to **focus on an area that was NOT addressed in the GAO audit, an area that was omitted, and the billions of dollars the Treasury is loosing. We will be discussing IRS real property tax liens.**

THE GAO REPORT: EXAMINATION OF IRS' FISCAL YEAR 1994

The recently released Government Accounting Office (GAO) IRS Financial Audit report for 1994 dated August 4, 1995 consistently sets forth inefficiencies, inaccuracies, errors and omissions in present IRS accounting practices and procedures, as well as in the actual collections efforts of the IRS to account for IRS recovery dollars and assets.

GAO's introductory letter to the President of the Senate and the Speaker of the House of Representatives states that "We are unable to express an opinion on the reliability of IRS' fiscal year 1994 Principal Financial Statements. Our report discusses the **scope and severity of IRS' financial management and control problems, the adverse impact of these problems on IRS' ability to effectively carry out its mission, and IRS' actions to remedy the problems".**

While the entire IRS GAO report outlines and details extensive errors and omissions, there is **ONE AREA THAT IS COMPLETELY OVERLOOKED.**

THAT AREA IS IN THE IRS PROPERTY TAX LIENS THAT ARE ALLOWABLE UNDER CURRENT IRS RULES AND REGULATIONS THAT ARE NOT BEING EXERCISED. PROPERTY LIENS ARE NOT BEING REDEEMED OR ARE BEING ALLOWED TO EXPIRE, THAT COULD PROVIDE HUNDREDS OF BILLIONS OF ADDITIONAL TREASURY RECOVERY REVENUES.

IRS REAL PROPERTY TAX LIENS

The GAO report discusses seized property and uncollectible receivables, however, it does NOT discuss those IRS property tax liens that were allowed to "expire" or to be "abandoned". These liens never showed up in the IRS files or records, because they are not reported, logged into a retrievable data system, or tracked, and they amount to estimated billions of potential treasury revenue.

In order to collect taxes from non-paying debtors, the IRS is empowered to place liens against the debtor's real property. If the debtor sells his property, the IRS is paid the amount of the lien or a negotiated amount. If the debtor's property is foreclosed upon by a bank, savings and loan, mortgage holder or investor, the IRS lien transfers with the property and remains a lien against the real property for 120 days from the date of the foreclosure. IRS has 120 days to "redeem" or buy back the property for the amount the foreclosing entity paid at the foreclosure sale, plus certain expenses. IRS then can re-sell the real property and retain the equity to credit towards the debtors tax debt, pay IRS operating expenses for the property tax lien recovery program, and to provide additional funds to "redeem" more property liens.

If the IRS does not "redeem" the foreclosed property within 120 days, the lien expires, or "drops off", is considered "abandoned" and the IRS looses the tax lien forever.

Other lien holders, such banks or savings and loans, have been receiving WINDFALL PROFITS when they foreclose on real properties that have IRS liens levied against them. The IRS has not been redeeming properties with IRS tax liens against them, the IRS tax lien expires after approximately 120 days and the other lien holders re-sell the properties and retain all of the equity, including the equity interest of the IRS, and IRS writes off another lien as a loss.

BRIEF DISCUSSION ON EXISTING IRS RULES AND CODES FOR REAL PROPERTY LIENS

The GOOD NEWS is that the IRS rules to place liens for non-payment of taxes and to recover or redeem the real properties are already in place. Present IRS rules, regulations and codes provide for the procedures for placing liens, and the rights for IRS to "redeem" a real property and other tangible and intangible properties to recover treasury revenue. No new rules, laws or codes will need to be drawn, approved or passed to implement this Plan. These rules, codes and statutes are listed later in this text.

The Bad News is that the Internal Revenue Service is not logging, tracking or able to report the number, location, or dollar value of the liens they may have placed, and they are not redeeming those properties with IRS liens against them when they are foreclosed on by a bank, savings and loan or investor. It is estimated that over $100 billion dollars in these liens have been written off, additionally another $60 billion dollars is estimated to be ready to be abandoned.

My experience is that IRS does NOT redeem approximately 99% of these properties and resell them to recover billions of dollars in treasury tax dollars. Instead, the IRS property tax liens are simply allowed to "expire" and "disappear".

The IRS is letting go of a **bird in the hand,** by allowing these liens to expire; instead IRS pursues the debtor's wages over the next several years, with limited success. This INCREASES collection costs over time, and DECREASES net present value of collection dollars.

The OTHER GOOD NEWS is that even though these IRS codes, rules and regulations are in place, new policies, procedures and guidelines for **implementing** and **improving** the real property lien recovery program are needed, and have been developed herein.

INABILITY TO TRACK OR REPORT ON IRS PROPERTY LIENS

The GAO report states ..."For fiscal year 1994 IRS systems could not provide reliable information on (1) the expenses incurred from the seizure activity (2) revenue realized from the sale of seized assets, or (3) the potential revenue that could be realized from the sale of seized assets reported in its ending balance. IRS systems were unable to provide such information because IRS has NO tracking or inventory system to monitor the progression of seized assets from seizure to final disposition"...."**The extent of errors noted during our preliminary review of the reconciliations precluded us from auditing the seized asset balance. Out of a judgmental sample of 143 assets, we found that 57 assets should not have been included in the ending balance because of double counting errors, the assets had been disposed of, or IRS did not have actual or constructive control over the assets...."**

Additionally, Note 4 pertaining to Custodial assets states that..."As of September 30, 1994 and 1993, IRS held seized property and collateral valued at $773 million and $761 million respectively. These amounts are based on estimated values assigned at the time of seizure and are not reduced for liens and other encumbrances."

In this example, actual EQUITY or RECOVERY potential is not accurately reported, it is **GROSSLY OVERSTATED.** For Custodial real estate assets, prior liens such as property taxes, other lienholders, mortgages, judgements and claims could encumber the majority of equity value in these custodial properties.

PROJECTED NATIONAL VOLUME OF UNCOLLECTED LIENS

My experience has been in reviewing the title of foreclosed properties from failed banks and savings and loans in over 19 states, primarily within Arizona, California, Colorado, Florida, Kansas and Texas. The number of FDIC insured banks throughout the United States is 10,054 and the number of insured Savings Banks and Savings and Loans throughout the nation is 2,058, for a total of 12,112 institutions, of which the Office of Thrift Supervision (OTS) is monitoring 1,459. The assets from these institutions total over five trillion two hundred fifty-four billion dollars.

The Quarterly Banking Profile states that over one trillion, six hundred and three billion of these assets are loans secured by real estate.

The majority of these thriving and OTS monitored institutions will also have foreclosed real estate on their books, some of which will have IRS liens against them. Additionally, uninsured credit unions, thrifts and other mortgage and investor houses hold foreclosed real estate with IRS liens that total more losses for the IRS and the Treasury.

IRS REVOLVING FUND

The IRS has a revolving fund from which money can be taken to redeem a very small number of IRS liens. Page 110 under Note 5 of the GAO report notes that the ending balance in this revolving fund was $ 10 million in 1993 and $ 12 million in 1994 of **Unexpended Appropriations** for the redemption of IRS liens.

The appropriated money should have been used to redeem IRS liened assets and then to resell the properties to recover treasury revenue, paying back the revolving fund, paying for expenses to run the lien recovery program, and providing going forward funds to redeem more properties.

CHECKS AND BALANCES, INTERNAL CONTROLS

The GAO audit sorely points out the lack of internal controls and checks and balances throughout the IRS....."because key staff knowingly and consistently did not follow established procedures....".(p.49). The attached Ten Step plan sets forth new checks and balances between IRS sections and extensive internal controls to ensure all future liens will be recorded, tracked, and reported in an accurate and timely manner.

It is not reasonable to expect an IRS tax auditor to also be an expert in real property appraisal, equity determination, title examination and re-sale marketing. The IRS has expected its' staff to handle a tax debt "from cradle to grave", from the tax audit through tax lien collection. This is not customary in today's environment of specialty work, to provide the most experienced and highest quality performance in each specialty area.

The attached Ten Step IRS Property Tax Lien Recovery Plan separates the duties of auditors and lien monitoring through resale of the liened property. This provides a check and balance/ internal control for the audit department, in the event the audit department does not log the new lien into the Central Database system, the resale section will log it in and include the amount of the lien, location and description of the property, market value and personal responsible for monitoring the asset. 4

THE STRATEGIC PLAN

It is essential to initiative the IRS Property Lien Recovery Plan to locate IRS liens levied against real properties by utilizing county title companies and document recording systems to identify and quantify those liens that are still collectible, and not recorded in the IRS records.

New, expanded technology, better techniques, policies and procedures need to be developed as outlined in the attached Plan, for identifying, tracking and reporting secured liens.

Increased efforts are needed to reshape the IRS workforce to meet the needs for specialization skills and experience, to replace the "cradle to grave" present system.

THE VISION AND MISSION STATEMENT

Focus must be made by the IRS to take all lawful steps to enforce IRS lien statutes, rules and regulations on a timely basis, to avoid allowing these lawful liens to expire and to be written off as a loss to the Treasury.

Resources must be committee to develop new, expanded technologies and a database system for tracking, monitoring, accounting for and reporting on all IRS property liens and recoveries.

Increase the expertise and experience of IRS staff, who have historically been trained in accounting techniques, to include those with technological and real property asset based disposition knowledge and expertise.

THE TEN STEP PROGRAM TO IMPLEMENT THE IRS PROPERTY TAX LIEN RECOVERY

The attached Ten Step Plan sets forth the outline of **Tasks, Policies and Procedures** that would turn around the present IRS lien program into one that provides <u>billions of dollars of recovered revenue for the Treasury.</u> The Ten Steps are summarized below:

1. Prioritize, strengthen and develop IRS Policy to exercise lien authority for all unpaid taxes, when equity is sufficient to recovery all or a portion of debtor's unpaid tax. RESEARCH and LOCATE IRS PROPERTY LIENS THROUGH County Tax Recorder's Office or other local authorities.

2. Develop policies, procedures and <u>CENTRAL DATABASE</u> for reporting and collecting data for all IRS tax liens.

3. Improve and expand policies and procedures for determination of asset equity.

4. Develop policies and procedures for determination and approval process for lien attachment/foreclosure/redemption action.

5. IRS determination that tax lien is appropriate action, or pass.

6. Notice is sent to central document control unit/CENTRAL DATABASE to <u>log in the real property lien.</u>

7. **Develop new policies and procedures to release files from IRS audit/tax examination unit and transfer to marketing disposition unit for tracking, marketing and recovery of treasury revenue.**

Note: The marketing disposition unit will create an internal control check and balance for the tax audit and examination unit. The "cradle to grave" system prevented internal controls to go unchecked.

8. Expand and improve marketing/disposition section and program for exposing assets to the public for sale.

9. Develop training materials for IRS staff and contractors in implementing new policies and procedures for the implementation of the **IRS PROPERTY TAX LIEN RECOVERY PLAN and CENTRAL DATABASE SYSTEMS.**

10. **Develop, improve and maintain effective financial and operational internal controls.**

The GAO report states....."**Because of these problems, in testimony before the House Subcommittee on Oversight, Committee on Ways and Means, we stated that IRS should seek another agency or contractor to handle the property management functions that it now carries out in disposing of seized property.....we believe that the management function should be handled outside of IRS....**".

RECOMMENDATION TO ADOPT THE IRS PROPERTY TAX LIEN RECOVERY PLAN

Honorable members of the Committee, I would like to see the attached IRS Property Tax Lien Recovery Program strongly recommended by the Committee to the IRS to be adopted. This Plan should be made a major priority in restructuring IRS programs and efficiency to ensure no further IRS property tax liens are permitted to expire and increase the unnecessary losses for the National Treasury. I would like to be part of this historical restructuring, and participate in guiding and implementing this Plan to provide a new source of funds and billions of dollars towards the balancing of the national budget.

FLOW CHART

Present IRS System		IRS Property Tax Lien Recovery Plan
	IRS Files Property Tax Lien	
IRS does not track liens	↓	New Procedures to report liens and new Database to record and track liens needed
	Notice of Default is filed	
IRS not notifed	↓	Notice to IRS is made a requirement IRS determines equity, pass or take action
	Bank or S&L Forecloses	
IRS does not act	↓	IRS still has 120 days to act, pass or redeem
	IRS has 120 days to redeem property	
IRS does not act	↓	IRS redeems property, begins remarketing
	After 120 days the lien expires or drops off if IRS does not act	
IRS WRITES OFF LOSS	↓	IRS resells property, applies recovery to treasury collections, repays revolving fund
	Bank or S&L retains all equity including IRS'	
		IRS uses portion of recovery to redeem additional property tax liens

IRS PROPERTY TAX LIEN RECOVERY PLAN

10 STEP PLAN

A PLAN TO INCREASE TREASURY RECOVERIES

Presented by Shannon O'Toole

Former Resolution Trust Corporation

Department Head and Section Chief of Real Estate Disposition

PRESENTED TO THE HOUSE SUBCOMMITTEE

on

GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY

HOUSE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

HEARINGS ON IRS FINANCIAL MANAGEMENT

March 6, 1996

STRATEGIC PLAN

Changes in the national economy have created the need for changes in the IRS systems for revenue recovery. New demands will be made upon the IRS workforce to accept challenges to develop broader expertise and experience to respond to an increasing and changing economic environment.

Reassessment of policies, codes, regulations, practices and procedures to assure their currency and effectiveness as the economy and circumstances change is needed.

The Internal Revenue Service (IRS) must focus on going forward systems to examine new forms of business operations and to recover those revenues secured by IRS liens which are rightfully and legally owed the United States Treasury.

New, expanded technology, better techniques, policies and procedures need to be developed for identifying, monitoring and reporting secured liens to assure the soundness and effectiveness of an expanded IRS property lien division.

Increased efforts to reshape the IRS workforce will be needed to meet these changing needs, which no longer expects an employee to be an expert in all areas from "cradle to grave", from taxpayer review analyst to asset disposition and recovery expert.

A system of specialization with a new mix of experience, special skills and technologies will enable the Internal Revenue Service to expand its efforts and effectiveness in performing its responsibilities, services and duties, to examine taxpayers and collect treasury revenue.

Improve IRS services, operating and reporting capabilities, within limits of statutory authority, to develop new efficiencies and revenue recovery programs to create added value and increased recovery for the treasury.

Locate abandoned IRS liens levied against real properties by utilizing county title companies document recording systems, evaluate equity, track and implement IRS statutory recovery systems.

TASKS, POLICIES & PROCEDURES OUTLINE

First Task: Prioritize, Strengthen and Develop IRS Policy to exercise lien authority for all unpaid taxes, when equity is sufficient to recover all or a portion of debtor's unpaid tax.

1. Exercise IRS authority to place liens and to redeem property for unpaid taxes.

2. Review existing IRS policies and procedures for determination/approval process for lien attachment/redemption action, and make recommendations for improvement as needed.

3. Develop strong policy for directing IRS staff to use lien codes when making demand for payment of IRS unpaid taxes.

4. **Prepare Scope of Work and Commit resources to RESEARCH COUNTY TAX RECORDS TO LOCATE IRS LIENS.**

5. Develop improved policies and procedures for reporting lien activity.

6. **Reduce amount of IRS uncollected and written-off liens and claims.**

Second Task: Develop policies, procedures and CENTRAL DATABASE for reporting and collecting data for all IRS tax liens.

* **Note: At the present time, IRS cannot accurately report the number, value, location, property type or amount of liens that are outstanding today, and they can only estimate the amount IRS has written off or abandoned.**

At all times, the proposed CENTRAL DATABASE will provide accurate and up to data information to IRS mangers, directors and congress on the status amount of liens redeemed and funds brought back into the treasury.

This CENTRAL DATABASE will log in all liens placed against real, personal, tangible or intangible property placed by the IRS, and will provide the primary source of information for tracking and accounting for IRS liens and inventory.

1. Develop CENTRAL DATABASE for reporting all IRS liened, redeemed or sold assets.

a. Commit resources to creating new computer database to:

collect
retain
inventory
sort
track
report
and account for all IRS lien data

2. Develop polices and procedures for reporting each IRS liened, written off or redeemed assets, and their re-sale/revenue recovery into the DATABASE by IRS staff for asset control and management review.

a. Develop policy and procedures with internal controls for logging lien information into a timely and accurate system.

b. Identify organizational point person(s) at both the local office and national IRS level through whom all lien information must be reported for logging into CENTRAL DATABASE as a check and balance for total data control.

c. Develop policy and procedures for accounting systems for revenue recovery.

d. Develop policy and procedures for detailing physical and geographical description into DATABASE for use in re-sale marketing.

e. Develop policy and procedures for tracking all liened, redeemed or re-sold assets to provide accurate information to interested purchasers, management and Congress.

f. Develop policy and procedure for entering redemption period into Central Database for real estate properties and other assets to ensure IRS liens are not "**wiped out, or expire**".

g. Develop relationships with national Title Companies to be required to send notice to lien point person/section in each local IRS office with confirmation when an IRS lien has been recorded at county recorder's office.

h. Develop "failsafe" disaster recovery plan to determine system sensitivity and vulnerability and to insure risk management is complete.

Third Task: Improve and expand existing IRS **policies, procedures and guidelines for determination of asset equity.**

1. Develop new, expanded policy and procedures for evaluation of equity, prior to lien attachment including the following:

   a. Resources for in-house and contracting appraisal determination.

   b. On-line/subscription resources for determining comparable sales data.

   c. Create policies and procedures for obtaining brokers opinions for re-sale. value in addition to appraisals.

   d. Develop policies and procedures for equity tracking.

2. Develop policy and procedures for Examination of title, prior liens, mortgages or other attachments as follows:

   a. Review and improve policy and procedures for ordering preliminary title reports.

   b. Correct policy and procedures for title exception expirations, work-outs and clearance.

   c. Create policy and procedures for clearing title.

   d. Create policy and procedures for UCC filings.

Fourth Task: Develop policies and procedures as follows for determination/approval process for lien attachment/foreclosure/redemption action

1. Expand policies and procedures for determination of acceptable equity.

2. Improve policies and procedures for determination title is acceptable.

3. Correct policies and procedures for IRS staff recommendation process to management to proceed with lien/foreclosure/redemption action.

4. Develop policies and procedures for appropriate management approval level for authority to proceed with recommended action.

Fifth Task: IRS determines tax lien is appropriate action.

If determination is positive that sufficient equity is available to satisfy some or all of the unpaid taxes, and title is acceptable, IRS follows existing rules to place lien against the real or other property for unpaid taxes.

Sixth Task: Notice is sent to central document control unit/ CENTRAL DATABASE to log in the property lien.

including property address, if any
market value of property
brief description of property
amount of tax lien, debtor identification
type of property
responsible IRS staff person, contractor or broker,

Seventh Task: Develop policies and procedures to release files from IRS tax examination unit and transfer to marketing disposition unit for tracking, marketing and recovery of treasury revenue.

Note: The marketing disposition unit will create an internal control check and balance for the tax examination unit. If the asset lien is not entered into the CENTRAL DATABASE by the examination unit, the marketing unit will note the omission and take corrective action.

1. Develop policies and procedures to release the examiner's file to the expert marketing disposition section.

Note: This will be a change from the current IRS method of using the same staff from "cradle to grave", wherein the same staff person performs the accounting examination and marketing functions.

IRS accounting personnel do not have expertise, training or experience in evaluating real property tax lien equity or skills necessary to efficiently market and dispose of real property assets as evidenced in the large estimated volume of over $100 billion dollars in written off IRS lien assets and additional estimated $69 billion in liens pending future write-off.

2. Policy statement development that it is recognized that these two functions require separate and different expertise, and that they will be performed by separate staff, to provide the best experienced staff in each area.

Eighth Task: Develop a marketing/disposition section and program for exposing assets to public for sale.

1. Develop policies and procedures for marketing IRS liened/foreclosed/seized or redeemed assets.

2. Develop appropriate levels of delegated authority and Power of Attorney to approve re-sale offers and to execute transfer and sale documents.

3. Expand policies and procedures to **market and accelerate the resale of these redeemed assets.**

4. Create a list of available properties and/or assets is generated from the CENTRAL DATABASE to send to buyers, investors and brokers to promote the sale of the assets.

5. A quarterly list of properties can be promoted, auctioned, or put out for bid to create public interest in quarterly sales events and participation in the sale of IRS assets.

6. Develop a system to retain buyers names for future sales.

7. **Develop Marketing Programs for the orderly, timely and efficient disposition** and sale of IRS owned assets.

   Develop disposal strategies including:

   - **pre-sale of real properties with IRS liens**
   - **promotional listing of all IRS liened or owned properties and other assets**
   - **listing broker strategy**
   - **auctions**
   - **sealed bids**
   - **portfolio sales**
   - **structured transactions**
   - **quarterly disposition sales initiatives**
   - **InterNet listings of IRS available assets**

2. **Solicit and have ready "bucket initiatives", such as auctions or brokerage houses ready to place newly acquired assets into to expedite their marketing and sale.**

Ninth Task: Develop training materials for IRS staff in implementing new polices and procedures for the implementation of the IRS RECOVERY Plan and CENTRAL DATABASE.

Tenth Task: Develop, maintain and improve effective financial and operational internal controls.

1. Develop **timeline check points** in lien reporting procedures.
2. Monitor internal control check and balance of examination unit to marketing unit.
3. Develop balancing of lien assets to recoveries and write-offs.
4. Develop balancing of sold lien assets to accounting reports.
5. Measure cost effectiveness of disposition methods used.
6. Develop lien release procedures.
7. Install Quality Assurance programs in effect.
8. Continue to monitor IRS lien program for updating and modifications as the national, geographical and local economy and markets change.
9. Create a liaison between IRS and Congressional leaders for continuous information exchange
10. Provide IRS management, Executive branch and Legislative branch with timely, complete and accurate reports of IRS property tax lien recoveries.

The development of this **IRS TAX LIEN RECOVERY PLAN** can be implemented immediately with existing IRS rules, statutes and codes, with the addition of a new IRS section with new, experienced, expert staffing in the area of real property liens and disposition of government owned assets, that will provide the **necessary check and balance for the tax examination unit.**

The proposed program will fully sustain itself after the seized, redeemed or liened assets are re-sold, creating sufficient recovery to repay the IRS Revolving Fund, credit the taxpayer with recovered monies, and provide going forward operating capital for the on going collection of IRS REAL PROPERTY TAX LIENS.

FINAL DISCUSSION

Final discussion items are ones in which IRS rules and codes would require a change to increase IRS tax lien recoveries and reduce other foreclosing entity windfalls.

A change in the expiration date on IRS liens against real property could be lengthened from 120 to a longer period of time. However, it appears that the intent of the 120 expiration period was to allow foreclosing entities the go forward with recovering their losses without a protracted holding time. The IRS lien must expire to allow the property title to be free of the IRS lien and marketable for re-sell. If the IRS redemption period was extended, it would hinder the foreclosing entities in re-selling the assets and their recovery efforts.

A change in the expiration process is a recommendation to be considered, whereby the IRS lien never expires. The foreclosing entity would be allowed to foreclose and re-sell the asset and recover all of their own lien, costs and expenses, AND THEN FORWARD ANY REMAINING EQUITY NOT TO EXCEED THE AMOUNT OF IRS LIEN AMOUNT TO THE IRS.
IRS will still need to develope a method of tracking the property liens in order to credit the debtor's account.

This would, however, require a change IRS codes, policies and new procedures for foreclosing entities to send notice to the IRS of each asset they are re-selling that is encumbered with an IRS lien, and receive IRS concurrence and release of the IRS lien to provide marketable title. This would extend the holding time, processing time and re-sell closing time for the foreclosing entity, and the IRS presently does not have an efficient method of tracking IRS liens to verify the IRS lien to be reconveyed or removed.

The Internal Revenue Service Revolving Fund requires sufficient resources to implement the Ten Step IRS Lien Recovery Plan. Presently approximately $10 million dollars is available in the Revolving Fund, which is not sufficient to redeem one medium sized commercial property. No new laws need to be passed to increase the initial Revolving Fund committment to implement this Plan. The Fund will be replenished and additional operating capital will be created for further treasury recoveries through lien collections.

The **Proposed IRS Property Tax Lien Recovery Plan** can be commenced immediately under current IRS rules and codes, and the proposed program will be fully self-sustaining through the recovery of IRS lien redemptions.

Mr. HORN. Well, thank you. Let me ask you on the lien question, you're including all property the taxpayer might have that is both industrial, business, home, et cetera. Is that correct?

Ms. O'TOOLE. Those are available assets. That's correct.

Mr. HORN. Right. OK. The one problem I saw in a lien case recently that, as you know, congressional offices have hundreds of cases involving the IRS that come in in the course of a year, in this one case, one part of the IRS was negotiating, and the other part of the IRS was issuing a lien.

And the person couldn't make the payment if his business had a complete lien on it, because he needed the cash-flow that was coming in, if his bank accounts were frozen and everything else.

And all that would do is put him out of business and being unable to pay the tax bill, which he was quite willing to pay, but it was a mistake when they put a lien on it.

Now, part of that is just organization, that the left and the right hand know what each other is doing in any human agency, but do you have any reaction to that, or have you ever seen those situations?

Ms. O'TOOLE. Certainly, I have a reaction. It's very simple. If they had a data base to capture these liens and track them, they could look into the system and see credit notation notes that simply said the lien has been attached or we have come to an agreement with the taxpayer to pay X-amount of dollars by this date. Do not take lien action.

It could be there by a push of a button, total communication, full reporting.

Mr. HORN. OK. Let me ask you another question on this. By the way, what I'm going to do on this is take your proposal, send it to Commissioner Richardson, ask her for the response of the Internal Revenue Service to that.

So staff and you can work out the transmittal letter of what particular questions, but I just want their reaction on the record to that proposal.

Now, in your testimony, you suggested that the IRS should be more aggressive in the property redemption marketing activities, and I guess my query is on the staffing.

What is your assessment of the staffing level needed to carry out your proposal, and could this activity be contracted out? And if it were to remain an in-house activity, what additional training would current staff need?

Those are three questions. We can take them one at a time. What is your assessment of the staffing level needed to carry out your proposal?

Ms. O'TOOLE. All right. First portion, of course, I do not have that information as to what IRS staffing has at this time or how they consider this a priority.

My experience tells me it is not a priority, since, in 11 years and working in 19 States, I haven't seen one IRS tax lien redeemed. So that should tell you that.

As far as what staffing would be needed, you could have in-house staff, and certainly it could be contracted out, since that has been a topic today.

It is not a difficult process, but you have to recognize that you have to lay the tracks for this. You have to first research, find, recover.

You have to be able to grasp and report and track these liens. That's where it starts, and I know for a fact that's not done.

We know it's not a priority, and we know they're not tracked. Yes, it could be done outside.

Mr. HORN. You have many years' of experience in this area. If a revenue agent or staff of the IRS had no experience, what type of additional training do they really need to deal with the lien problem?

Ms. O'TOOLE. Since I've written training manuals, since I've had my training manuals published for basic real estate owned, how to do real estate for the FDIC and RTC in multiple asset sales, it is not difficult to train staff.

It would probably take a 2-week training class intensive, perhaps one, if they already have a lot of background.

It's the policies and procedures that I'm most concerned about. Are they in place, and are they thorough? I'm sure there is a whole manual on this, but it will need to be revised and refocused.

Mr. HORN. Well, are there any other costs besides staff and training the staff that is associated with implementing your proposal?

As I say, the IRS is putting liens on various types of property, but is there advertising? Are there marketing costs and distribution of training material which we agree they would need, such as manuals, bringing in interactions with people that have experience in this and all that? Where is the rest of the cost in this process?

Ms. O'TOOLE. The IRS does have, by law, the IRS revolving fund. Those are moneys that are already set aside for the redemption of properties, but I will say that at the present time that money is inadequate.

The money only begins to open up the Pandora's box on these liens. You need to have this revolving fund sufficient to have the seed money to go out and redeem these liens.

Through the sale of the asset, through the resale of the real estate, you will repay the resolving fund. You will repay the marketing, the advertising. You will repay the cost of running the program, and you will have the Treasury recoveries in addition to that to satisfy part of this national debt.

Mr. HORN. Let me move to Mr. Korb for a minute. According to your testimony, there are three types of accounts that are not subject to active collection efforts by the IRS, and I just wonder if you could elaborate further on these types of accounts and why they're not pursued.

Mr. KORB. The first type of account are the deferred accounts. These are the ones that are at the service center where the notices have been sent out and they fall below the tolerance levels that have been set.

I think the IRS believes that it's not cost-effective to pursue them any further. They might be a good candidate for using private collection agencies.

With respect to the second group, it's the accounts that are in the queue. These are the ones—and these are going to become very significant, I think, as IRS staffing would, for example, go down.

It's my understanding that the collection staffing—I'm talking about revenue officers, ACS and service center collection branch employer—are going to decrease by about 1,000 positions in the next fiscal year.

What that means, of course, is that the chiefs of collection in the various districts will have less resources at their disposal, and they will set the cutoff scores higher. That's how that works. It's a flexible system.

So there could be an increase in the accounts in the queue as a result of that. Keep in mind that time is here in the collection business.

Mr. HORN. Sure.

Mr. KORB. Time value of money is very important, as you indicated earlier. The longer these accounts sit out there, the less likely they are going to be collected.

The third group are the currently noncollectible accounts. The two groups in there that seem susceptible to be worked by outside collectors would be the inability to locate taxpayers.

The IRS is trying to emulate—as I read the Commissioner's testimony—a number of the procedures and practices the private collection industry has used for many years and using some of the new technology.

The problem with that, once they go through the requisition process and once they get all that in place, the technology will move that much further ahead.

So it will probably be never-ending—they'll never be able to catch up. But that would be one group.

Another would be the hardship cases, to try to determine what assets are really out there that some individuals might have, if the time were spent to try to locate the assets. So those are the three areas.

Mr. HORN. Mr. Korb, you've heard Ms. O'Toole's suggestion. What do you think of it?

Mr. KORB. This is the first time I've heard of it, and I find it very interesting, but it seems to me that it makes sense. It's something that should be pursued, no question about it. I was intrigued by it.

Mr. HORN. Do you recall much use of the lien when you were serving with the IRS?

Mr. KORB. Oh, absolutely. Sure. It's used all the time.

Mr. HORN. Right.

Mr. KORB. Federal tax lien is used quite a bit. It's a statutory lien.

Mr. HORN. Conceivably, you'd need an appraisal very rapidly on some of these properties if they're going to put them up for auction or sale or whatever, wouldn't you?

Mr. KORB. Sure.

Ms. O'TOOLE. You can do the appraisal through Dataquick, an automated on-line service. It would probably take less than a half an hour to write one up on residential property with an experi-

enced person. I could do it. I could teach you to do it. You look at comparable sales in the neighborhood.

Mr. HORN. After the November election comes. You never know.

Ms. O'TOOLE. You look at comparable data, square footage, similar type of house, recorded sales. It's right there. It's not a difficult maneuver at all. You don't need a formal appraisal. You could do that, perhaps, on 20 percent as a check and balance, though.

Mr. HORN. Mr. Korb, back to you. As I understand it, if the private collection agencies were authorized to work only the three types of accounts that you're discussing, the collection agencies would merely supplement the collection work of the IRS.

In other words, the private collection agencies would merely perform collection activities with regard to accounts lying dormant at the IRS, and thus there would be no displacement of IRS collection staff. Do you think that's correct?

Mr. KORB. Yes. That's clearly my suggestion. Let the IRS focus its efforts on the higher-yielding accounts.

Mr. HORN. Right, and get them early.

Mr. KORB. That's right.

Mr. HORN. The first month or two.

Mr. KORB. That's right. And let the contractor supplement these efforts on the accounts that aren't going to be worked.

What I think it does, Congressman, it provides more flexibility. It helps smooth out the peaks and valleys of resource allocations. It's also going to provide for uniform treatment nationwide, too, when you think of it.

As I mentioned, in the collection business, time is important. The sooner an account is referred, the more likely it will be collected.

And by its nature, as we've learned today, the IRS pipeline takes a long time, and therefore, by the time these accounts reach this dormant status, quite a bit of time has gone by.

So think about it for a moment. The deferred accounts there is no further contact. A telephone call might turn up some of that money right there.

On the CNCs, one thing that's forgotten, I think, although was mentioned by Mr. Donelson, as time passes, a debtor's ability to pay could improve.

An unemployed person can find a job. A failed business owner can recover. A telephone call at the right time could make the difference instead of having the accounts sit there unworked.

So I really do view it as really a supplement that can fit in with what the IRS is already doing.

Mr. HORN. With your experience, is there a minimal level of funding that is necessary to launch a successful private collection program?

It seems to me it would take an individual, a telephone, a good pair of shoe leathers and maybe a car. Then, you could have an individual out there, if they have State licensure or whatever.

Mr. KORB. Right. You don't even have to launch it. There is a whole business out there. Thirty-two States out there now use this. So, there is a whole industry that does this kind of thing. A good portion of the Federal Government uses these people.

Mr. HORN. Yeah, certainly the Department of Education.

Mr. KORB. That's a very good example.

Mr. HORN. Which has $15 billion in uncollected debt.

Mr. KORB. But they had 15 years of experience with outside collectors to try to help on that. Again, that's a point that should be kept in mind.

There is no training. There is no cost of equipment. I'm talking about the Government. It's a matter of contracting with somebody who already has that already at their disposal.

Mr. HORN. Is there a direct correlation between the amount of the debt collected and the amount of funding provided to support increased efforts to collect, or would a point be reached at which the additional funding wouldn't really produce any more bang for the buck?

Mr. KORB. That's a very interesting question, because based on some numbers that I've just had a chance to look at, I really question whether additional funding will do much.

What I'm referring to is in fiscal year 1990 the collection yield was $25 billion, roughly, $25.4 billion. In 1995, fiscal year 1995, it was $25.15 billion. So it has been stagnant for 6 years.

When you look at the number of employees the Service had in their revenue officers, ACS staffing and service center collection branch functions, there was an increase of 1,000 employees over that period.

Mr. HORN. Now, do we know that they went into the enforcement side?

Mr. KORB. Into these three functions.

Mr. HORN. OK.

Mr. KORB. I'm just looking at these three functions, and these are the functions—not enforcement. This is collection.

Mr. HORN. Yes. OK. Collection.

Mr. KORB. These are the people doing the kind of things we're talking about. So what you had was a 1,000 employee increase. The collection yield was stagnant, but the departments in CNC, notice status, deferred status and in that ACS queue revenue officer group went from $64.8 billion to $137.2 billion. So you really have to wonder.

Mr. HORN. Now, you heard a discussion we had a little earlier on the Privacy Act implications. What's your feeling on that with the private bill collectors?

That was one argument the IRS, apparently, gave a year or so ago as to why they weren't keen on private collection.

Mr. KORB. Well, as I understand your bill, it limits the information provided. It gives just enough information to the private collection agencies—and I want to disagree a little bit with Mr. Alexander on that point—to do their job.

But it also provides severe legal sanctions against the private collection agencies who violate the taxpayers' rights or violate the disclosure.

So we have Section 6103, which Mr. Alexander mentioned. There is a provision 6103(M) is the legal authority. He was wondering what the legal authority was.

If you look at 6103(M), that is the legal authority for providing taxpayer information to the contractors so they can do their job.

But you have those rules that will restrict. You have the Privacy Act, of course, of 1974. In addition, you have something which the

IRS isn't subject to, and that's the Fair Debt Collection Practices Act.

There is a code provision that permits civil lawsuits against the IRS for unauthorized collection activities. There is a $100,000 ceiling on that.

The Fair Debt Collection Practices Act has no ceiling, none whatsoever. So the liability exposure to private collection agencies is much, much higher than it would be to the IRS.

So I think there is clearly within the law and in the RFP they clearly recognize that and put the private collection agencies under or will put them under these requirements.

With respect to the information that needs to be provided, the name, Social Security number, address, phone number, employer address and phone number, amount of debt, that's really about it for the types of accounts that I envision.

Mr. Alexander was talking, I think, about turning over accounts, for example, where the amount of the debt would be in dispute. That's not what I'm talking about here. You would not have to provide any additional information to collect these kind of accounts.

Mr. HORN. Some people have expressed concern about private bill collectors just as they have expressed concern about IRS bill collectors.

What do you think is the best way to handle that, in terms of the average American citizen? Do you think they would have a more negative attitude against the private groups or the IRS, or would they just be, sort of, generally negative with anybody that's trying to get some money out of them? And is that a problem in public relations for the Government?

There seems to be that implication in the IRS group that they've trained their people so forth, so on. If they trained all of them, I wouldn't be hearing my colleague, Mr. Traficant, on the floor citing the latest horror of IRS collection or enforcement, as the case may be. Do you have any feeling on that?

Mr. KORB. Yes. I think the best answer to that is that a professional, skilled contingency fee collector is not going to waste their time or money going after an account that's going to end up being a dry hole.

These people are trained to know, to sense who has the money and who doesn't. So I don't think they're going to be wasting their time and be hard on somebody who just doesn't have the money. I think that's probably the best answer to this.

Also, I guess this is a little off the question, but when you look at the CNCs, just because the IRS doesn't know that there are assets there doesn't mean that the debtor still doesn't have them.

The decision to classify something as a CNC may have come without full knowledge of what assets the taxpayer actually had or, as I said, the taxpayer may have come into some assets subsequent to that time.

Again, I think professional collectors have a way, of experience of finding that money.

Back to the broader question, I have a feeling that no matter who does this the individuals being called is not going to be terribly excited about receiving the call.

Mr. HORN. Right.

Mr. KORB. Again, this is money that's owed. This is different, in my view, than the examination process, for example, where they're trying to determine if the taxpayer owes money or if there is unreported income or whatever.

Here it could be a situation where somebody filed their 1040 April 15th and didn't send in a check, and the way the process works now, with all the notices and all the time, it's quite some time before that's resolved.

Mr. HORN. Let me ask you. Do either one of you want to make a closing point that we haven't covered that you think is important, or have we pretty much covered it?

I think we understand what you're both advocating. I think you've both given excellent testimony, and we appreciate it.

Ms. O'TOOLE. I've covered it all, thank you.

Mr. HORN. OK.

Mr. KORB. I guess I'd just like to—you asked a question of Mr. Alexander if he had any problems with the pilot, the RFP, and it's quite lengthy.

Mr. HORN. I see. So you've had a chance to look at it.

Mr. KORB. Not the whole thing.

Mr. HORN. Has this congressional committee had a chance to look at it? You have it. Anybody read it?

Mr. KORB. But I do have a couple of points that I'd like to say for the record. No. 1, no employer data is being provided on individual debtors, and that's going to be a hinderance. That is not a good fact.

Second, there is no authority to actually enter into installment agreements with the debtors. That will have to be turned back to the IRS. That will result in a delay.

Remember I went through the different categories. The unable to pay category is not included in the sense that, if a taxpayer, as I read this, tells the private debt collector that he can't pay, that's the end of it. He has to turn it back over to the IRS.

Well, that shouldn't be the end of it. That's what that person is trained to figure out, whether or not he really can pay.

Maybe they don't realize it, but they're actually losing some of the benefit that they could gain from private collection.

In addition, in the items that are being referred out, the deferred accounts are not. So there is a group that are being left behind, and the hardships are not.

That's just a fact. It looks like what they've done is they've focused on the queue, and they've focused on unable to locate in the CNC. And there is also no authority to do asset location.

If you would like, we could provide you a more complete analysis at some point, if that would be helpful to you.

Mr. HORN. I'd be glad to include it at this point in the record without objection. Well, again, we thank you, and let me just acknowledge the staff that has spent a lot of time on this hearing headed by J. Russell George, the staff director and chief counsel; Anna Miller, who is on my left, the professional staff member, who is the expert in financial statements; Mark Brasher, who was here, professional staff member, expert on the Debt Collection Act; Christine Carpino, who we're delighted to have as a Senior Executive Service Candidate from the U.S. Department of Agriculture; and

our faithful clerk, Andrew Richardson, who keeps this place rolling and is sitting there saying, "When are these people going to go home?"

And I don't want to forget the minority staff. There is even some long contenders there. We've had David McMillen, professional staff member; Mark Stephenson, professional staff member; and Lisa Miontes, professional staff member, and we have our official reporter, Amy Rose. So thank you all. And with that, the hearing is adjourned.

[Whereupon, at 5:10 p.m., the subcommittee was adjourned.]