DEPARTMENTS OF TRANSPORTATION, TREASURY AND GENERAL GOVERNMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2004

WEDNESDAY, APRIL 9, 2003

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 2:02 p.m., in room SD–124, Dirksen Senate Office Building, Hon. Richard C. Shelby (chairman) presiding.

Present: Senators Shelby and Murray.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENT OF ROBERT E. WENZEL, ACTING COMMISSIONER

ACCOMPANIED BY TODD GRAMS, CHIEF FINANCIAL OFFICER

OPENING STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. The Committee will come to order. With the April 15th tax filing deadline less than a week away I believe it is appropriate that we review the Internal Revenue Service's (IRS) fiscal year 2004 budget request. Since the newly nominated Commissioner of the Internal Revenue Service has not been confirmed we will hear from Bob Wenzel, the Acting Commissioner of the IRS today. I would also like to thank you for appearing before the committee this morning.

Although I am the Chairman of the newly created Transportation, Treasury and General Government Subcommittee, these are not necessarily new issues for me. Many of you may recall that I was the Chairman of the Treasury and General Government Subcommittee several years ago when the reorganization and modernization of the IRS was in its infant stage. Since those days, the IRS has improved its service to the taxpayers, but there's still a great deal more to be achieved.

I am relieved to know that today, unlike the last time I chaired a hearing on these issues, taxpayers are receiving courteous service, refunds are being processed in a timely manner, and more individuals are filing their taxes electronically. The Offer in Compromise program is working efficiently to help the taxpayers eliminate tax debts, and the Innocent Spouse program, I am told, is also

making progress because only the guilty party is now being assessed the tax liability.

Even with the success of all these programs, the IRS still has a long way to go to provide the service that taxpayers deserve and expect. I believe that the IRS should provide top quality service to America's taxpayers by helping them to understand and to meet their tax obligations, and by applying the tax laws with integrity and fairness. Americans deserve and expect no less from the Service.

Turning now to the IRS budget request, I would like to point out that your fiscal year 2004 request is $10.4 billion, an amount that comprises over 90 percent of the overall budget for the Department of the Treasury. The IRS' ongoing business systems modernization efforts will require $429 million in the year 2004. The Subcommittee appreciates the efforts that continue to go into this massive upgrade that we hope will improve the speed, timeliness, and accuracy of IRS' administration of the tax system.

I am aware that last year's efforts encountered some setbacks and I am interested to learn how the Service has gotten back on track and will ensure that such issues will not occur again because I expect positive results from such an investment.

While the IRS' traditional role is to implement and enforce our tax laws, it has also been charged with administering the earned income tax credit. The earned income tax credit has expanded since its enactment in 1975 and at the same time has become politically controversial. This budget proposes a number of changes to that program because of the high level of fraud associated with the program's administration. Each year the IRS makes approximately $9 billion in erroneous earned income tax credit payments. This is a direct and permanent cost to the American taxpayer because it is virtually impossible to recapture these payments once they have been made.

You are requesting $251.2 million in 2004 for the EITC program, and of that amount, $100 million is requested to implement the earned income tax credit task force recommendations to address the problems associated with current program administration that results in these overpayments. Eliminating erroneous payments and ensuring the proper administration of this program are certainly goals with which I completely agree.

Compliance is a problem and you are requesting an additional $133 million for staff to strengthen compliance. I am interested in hearing of the abusive tax schemes you will be targeting and how you will deal with them.

With the IRS' progression into the information age, I am keenly interested in how the electronic filing system is working, who is using the system, under what conditions, and finally, what kinds of systemic cost savings are being realized.

The IRS promotes electronic filing as "free" but I have been made aware that most, if not all, of the programs or services that are requested do charge a fee. I do not know anyone that would agree that is free. I am interested in exploring this more.

Along those lines, the IRS has initiated a new program called Free File, which is a public-private partnership between the IRS and a consortium of tax software companies that offer free filing

services to qualifying taxpayers. I applaud this effort and the assistance that it provides low income taxpayers. It is my understanding that savings identified because of electronic filing and increases in productivity will enable the IRS to close one of its processing sites. I would think that the closure of this processing site will realize some savings. Additionally, I am interested in how you think continued increases in electronic filing will change the nature of the IRS and its workforce.

Another significant change is this budget proposes to employ private collection agencies to track down taxpayers that owe billions of dollars in delinquent taxes. I do support the effort of collecting delinquent debt, but this is of serious concern because in addition to having a responsibility to protect taxpayers' privacy, I cannot imagine IRS as having the resources to administer and oversee such an undertaking.

While this is a fairly straightforward budget, the IRS proposes a significant number of changes in the way that it does business. As I mentioned, I am very interested in these changes and look forward to your explanation of the proposal that is included in the budget.

Senator Murray.

STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Thank you, Mr. Chairman. We are now less than a week away from tax day, and 2002 was a very rough year for America's working families. The economy has continued to decline, hundreds of thousands of Americans were put out of work, and many of them still have not found jobs. Even those who have found jobs have had to take big pay cuts. Six days from now many of those families will be hard-pressed to cover their check to the IRS. At a time when our national economy is struggling and when individual families are hurting, the President is pushing for tax cuts that overwhelmingly favor our wealthiest citizens. That has got to be pretty disheartening to the many families who are struggling through no fault of their own.

Today I want to shine a light on a similarly, I believe, unfair proposal in the President's budget that could mean less help for low income families. An initiative in the President's 2004 IRS Budget seems to be targeted at throwing working families off of the rolls for receiving the earned income tax credit or EITC. This is a tax credit that is targeted at the working poor. The EITC is probably the most targeted means-tested tax benefit in the entire Federal Code. It was started by President Gerald Ford and it was greatly expanded under President Reagan.

While many working families are eligible to receive it, as many as 25 percent or more of those families do not even apply for it. We should be taking steps to allow more eligible families to get the help they need, but I believe the President's proposal goes the other away. It would require many of these working poor families to basically pre-certify that they are eligible to receive the EITC. This proposal is designed, we are told, to minimize fraud in the earned income tax credit program.

Mr. Chairman, you will not find one Senator on this committee or anywhere in the U.S. Senate that supports citizens perpetuating

fraud on the IRS. Tax fraud by any taxpayer should never be tolerated. It is a disservice to every other family that works hard and pays its share.

As we work to eliminate fraud we need to be careful that we do not penalize the families who rely on this credit. As I understand it, under the Administration's proposal, within a couple of months, tens of thousands of families will receive Federal forms requiring a great deal of documentation in order to qualify them to take the Earned Income Tax Credit later in the year. Much of this required documentation will be hard to get, and the Federal tax assistance centers for the poor will not be up and running during the summer months. By this time next year more than 2 million families are expected to be subject to this procedure. The average earned income tax is roughly $1,660. That makes a pretty big difference for families that are struggling.

I will repeat, I believe each and every case of tax fraud should be prosecuted. Given the fact that the IRS never has and never will have enough resources to audit every return, I am mystified by its decision that $100 million in scarce funds should be committed to going after the working poor. No amount of fraud should be allowed for any taxpayer at any income level and I think we need to be very cautious of proposals that could have an adverse effect on families getting the benefits that they deserve.

The IRS should go after people that are cheating the system to receive the EITC when they are not eligible. But I believe the IRS also carries the responsibility to make sure that these enforcement efforts do not undermine the whole purpose of that the EITC program and the families that rely on it.

I hope that we will pursue this critical issue of fairness in our tax collection system today, Mr. Chairman. Thank you.

Senator SHELBY. Mr. Wenzel, your written statement will be made part of the record in its entirety. Proceed and sum it up, if you would.

STATEMENT OF ROBERT E. WENZEL

Mr. WENZEL. Mr. Chairman and distinguished members of the Subcommittee, thank you for this opportunity to discuss the President's fiscal year 2004 budget for the IRS. Accompanying me today is Mr. Todd Grams, the IRS' chief financial officer.

The President's overall fiscal year 2004 budget request increases discretionary spending by 4 percent. Seen in this context, the proposed 5 percent funding increase over the fiscal year 2003 request for the IRS is greatly appreciated. We will work hard to justify this confidence and investment.

Mr. Chairman, we also share your commitment to make the most efficient and productive use of the taxpayers' dollars. Indeed, beginning with the fiscal year 2004 budget, strategic planning, budgeting, resource allocation and performance goals, are much better aligned at the IRS.

Moreover, we are now integrating the development of our budget with the establishment of performance measures, a key part of the President's management agenda, and we believe we are on the right track.

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

The principal strategic focus of the budget is strengthening enforcement activities. Last October we realigned our audit resources to focus on key areas of noncompliance, such as offshore credit card users and promoters of abusive schemes and scams.

To strengthen enforcement programs across the board, the IRS budget request includes $133 million to fund numerous initiatives. For example, new revenue agents and revenue officers will be added to address offshore credit cards, abusive trusts and shelters, high risk high income taxpayers, and other priority work. We also will increase staff devoted to frivolous returns and refund claims to counteract recent growth and aggressiveness by promoters in this area.

A legislative proposal is also in the budget that would authorize us to contract with private sector collection agencies to supplement current IRS tax collection efforts. By using these private collection agencies we expect to be able to handle more collection cases at an earlier stage, before the accounts become stale and uncollectible. Moreover, we can then concentrate our resources on more complex cases and issues.

The second focus of the proposed budget is reinvestments. Through the IRS' strategic planning and budgeting process, the agency's senior managers identified a significant potential for more effective and efficient use of current resources. A total of $166 million and 2,145 FTEs were identified for reallocation within the base budget for fiscal year 2004. By reinvesting $166 million, primarily from increased productivity, we will be able to increase performance in key tax administration areas.

For example, electronic filing success provides a great opportunity to reduce and reallocate resources from submission processing. The fiscal year 2004 budget reflects the first-ever closing of a submissions processing pipeline as paper filings decrease. We can use these reinvestments to strengthen enforcement and improve customer service.

The third and final focus is business systems modernization. The BSM program requests a total of $429 million, an increase of $65 million over the current fiscal year 2003 budget level. Over the course of the BSM program, these investments will benefit the IRS and taxpayers by reducing operating costs, increasing cost avoidance, reducing taxpayer burden, and boosting tax receipts.

PREPARED STATEMENT

Mr. Chairman, in conclusion, current trends in customer service and enforcement are pointing in the right direction. The President's budget will help us to maintain this upward course and to succeed in achieving our mission.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF ROBERT E. WENZEL

INTRODUCTION

Mr. Chairman, and distinguished Members of the Subcommittee, thank you for this opportunity to discuss the President's proposed fiscal year 2004 budget for the Internal Revenue Service. Accompanying me today is Mr. Todd Grams, IRS Chief Financial Officer.

I also want to thank the President and Treasury Secretary Snow for their strong and visible support of the IRS and our critical mission during these challenging times. The President's overall fiscal year 2004 budget request increases discretionary spending by 4 percent. Seen in this context, the proposed 5 percent funding increase over the fiscal year 2003 request for the IRS is greatly appreciated and we will work hard to justify their confidence and this investment.

The funding provided in the President's budget will help us to build on the improvements we have made in compliance, service and productivity while continuing to make longer-term investments in our Business Systems Modernization (BSM) program.

Mr. Chairman, I also welcome the opportunity to work closely with you and we share your commitment to make the most efficient and productive use of the taxpayers' dollars. Indeed, beginning with the fiscal year 2004 budget, strategic planning, budgeting, resource allocation and performance goals are better aligned. Moreover, we are now integrating development of our budget with the establishment of performance measures—a key part of the President's Management Agenda. We believe we are on the right track.

BUILDING ON A GOOD FOUNDATION

Mr. Chairman, the IRS continues to make steady progress on the mandates and new direction set forth by the IRS Restructuring and Reform Act of 1998 (RRA 98). We continue to make gains on our three strategic goals: top quality service to each taxpayer in every interaction; top quality service to all taxpayers through fair and uniform application of the law; and productivity through a quality work environment.

Although still unacceptable in some areas, service to taxpayers has improved. Returns, payments and refunds are better processed. Taxpayers are getting better service over the telephone, in person and over the Internet. Most are getting the right answers to their tax law and account questions. New incentives, such as the innovative Free File program, are breaking down the last barriers to e-file.

After careful study, we are redirecting our resources to the key areas of noncompliance, such as offshore tax avoidance schemes. New programs such as the Offshore Voluntary Compliance Initiative are producing promising results.

The four customer-focused operating divisions are also meeting the varying needs of their taxpayer segments. After years of planning, the BSM program is entering a new, challenging but risky phase: producing the flexible systems, technology and tools needed to provide service to taxpayers on a par with the best private sector financial services companies and to administer an increasingly complex tax system.

Clearly, we are doing a better job than when RRA 98 was enacted into law although we are far short of providing the level of service envisaged in the legislation. We still have a long way to go, but if we stay the course we began almost five years ago, we can still succeed.

Customer Service

The IRS has made steady gains in better serving America's taxpayers. Each filing season and year is appreciably better than the previous one and we are building on those successes. With only one week left in the filing season, we can detect some very positive trends.

For the 2002 filing season, the agency processed over 128.7 million individual returns, and issued over 99.5 million refunds totaling $191.2 billion. We believe we will exceed these numbers by the end of this filing season.

In 2002, web site usage smashed all records with 2.7 billion hits and 336 million files downloaded. For the 2003 filing season, usage on our newly designed web site is already running almost 25 percent ahead of last year's torrid pace.

IRS representatives also answered 25.9 million telephone calls during fiscal year 2002; the automated telephone system handled about 62.4 million calls. For the 2003 filing season, total assistor calls answered are running about level with last year, with automated calls down dramatically. This drop can be most likely traced to the high volume of calls we received last year related to the advance refund checks.

The big news is assistor level of service. It is up 20 percent over last year. This can be attributed to the implementation of new telephone lines, less complicated scripts and lower demand. Time spent waiting, while still below private sector standards, improved substantially. Average wait time is down 26 percent from the previous year.

Quality of service is as important as access to service. Taxpayers expect not only to get through on our toll-free telephone lines but to get the correct answer to their tax law or account question. For the 2002 filing season, taxpayers were receiving correct responses to 82.76 percent of tax law questions and 88.89 percent of account questions. So far this filing season, the numbers stand at 82.02 percent and 86.42 percent respectively.

In 2002, more than 46.7 million taxpayers (36 percent) filed electronically—a 16.4 percent rise from last year. This filing season, all e-file is up by almost 9.23 percent and e-filing on line has grown by 29.28 percent. Much of this surge can be attributed to the Free File program that will help us reach the RRA 98 mandated goal of 80 percent of individual returns filed electronically by 2007.

On January 16, 2003, the Treasury Department, the Office of Management and Budget (OMB) and the IRS launched the free online tax preparation and filing service called Free File. It was made possible through a partnership agreement between the IRS and the Free File Alliance, LLC—a private sector consortium of tax software companies.

The partnership agreement requires that the Alliance as a whole provide free tax preparation and filing to at least 60 percent, or approximately 78 million American taxpayers. The primary candidates for Free File are those taxpayers who prepare their own taxes and still file paper returns.

Initial Free File reports are most encouraging. As of March 19, Alliance members have processed and transmitted more than 2.0 million tax returns. This represents approximately 25 percent of the total 8 million online e-filed returns.

Improved service to taxpayers has not gone unnoticed. On the 2001 American Customer Satisfaction Index Survey (ACSI), taxpayers gave the IRS an overall score of 62, an 11 percent increase among individual tax filers over 2000, and a 22 percent increase over 1999. This was the largest favorable gain of the 30 federal agencies surveyed by the ACSI. The 2002 annual rating for IRS in the Roper Starch customer satisfaction survey was 44 percent—a 38 percent increase over its 32 percent nadir in 1998. However, it reflects a small decrease from 2001.

Compliance

The IRS does not have the resources to attack every case of noncompliance. Therefore, it must apply its resources to areas where noncompliance is greatest while still maintaining adequate coverage in other areas. After careful study, the IRS identified some of the most serious compliance problem areas. These include: (1) promoters of tax schemes of all varieties; (2) the misuse of devices such as trusts and offshore accounts to hide or improperly reduce income; (3) abusive corporate tax shelters; (4) underreporting of tax by higher-income individuals; (5) accumulation and failure to file and pay large amounts of employment taxes by some employers; and (6) the high rate of erroneous earned income tax credit (EITC) payments.

Our goal was to stop the long-term decline in compliance while beginning to focus effectively and efficiently on the key areas of noncompliance. In most areas, the IRS achieved this goal. For example, in fiscal year 2002, the IRS closed 140,737 Tax Delinquent Investigation cases. It also examined 60,894 individual returns for taxpayers with incomes exceeding $100,000 and 528 Large Cases (corporate). All of these show gains over the previous fiscal year and the audits of individuals with incomes over $100,000 represented a 22 percent increase. However, the 724,430 Tax Delinquent Account closures represent a small drop over the same period last year.

Our new emphasis against promoters of abusive tax devices has also shown results. As of March 19, 2003, the IRS had 25 promoter injunctions granted, 17 promoter injunctions pending in District Court and 17 pending at the Department of Justice, 216 promoter exams and information requests underway, and 464 ongoing criminal investigations of promoters of various tax schemes. The Offshore Voluntary Compliance Initiative, which ends April 15, is also producing promising leads on promoters and is bringing back taxpayers into compliance.

In addition, an abusive tax shelter disclosure initiative was launched in 2002. The IRS processed 1,664 disclosures from 1,206 taxpayers who came forward. The disclosures cover 2,264 tax returns and involved more than $30 billion in claimed losses or deductions.

Also, key to successfully executing a compliance program is better data. The IRS failed to detect new areas of noncompliance in part because of a reliance on increasingly obsolete data from the old Taxpayer Compliance Measurement Program.

(TCMP was last conducted in 1988.) The agency designed and is implementing a National Research Program that will obtain the essential information with far less burden on the taxpayer. New scoring models are being developed using 21st century techniques, with interim models already deployed.

Technology and Modernization

Critical to our success is better managing our massive technology and Business Systems Modernization program. From 15 separate information systems operations, we created one MITS (Modernization and Information Technology Services) organization that has the job of serving all of our operating units and managing our modernization program.

As part of this major transition, standards were established and largely implemented for hardware and software. We consolidated mainframes from 12 centers to three and established one standard for desktop and laptop hardware and software. We implemented nationwide e-mail and voice messaging systems, standard office automation software, and security certifications and standards. We deployed important interim applications systems, including Intelligent Call Routing, Integrated Case Processing and the Integrated Collection System.

Business Systems Modernization laid the foundation for success of this massive program. Both the long-term vision and enterprise architecture were established and embedded as a living blueprint for all business and technology improvement programs.

BSM has finally begun delivering the first projects with tangible benefits to taxpayers, such as moving the first set of taxpayers to a modern, reliable database in 2003. This year, taxpayers also began using the new Internet Refund/Fact of Filing (IR/FoF) application that allows them to check on the status of their return and refund 24 hours a day, 7 days a week. Of paramount importance, we implemented the first project on our new security system, which provides one standard for ensuring the security of all IRS data and systems. IR/FoF usage has already exceeded our expectations. So far this filing season, there have been more than 8.7 million uses of "Where's My Refund?"; we project that number will rise to 15 million by the end of the year.

Over the next five years, all individual taxpayers will be moved to the new database, cutting times for refunds on e-filed returns to less than a week and allowing us to provide taxpayer and employees with up-to-the-minute accuracy on their accounts.

All major management processes, which are needed to manage this program on a continuing basis, were improved. Indeed, we are only the second agency in the federal government to obtain Level Two certification in the Software Engineering Institutions Capability Maturity Model.

FISCAL YEAR 2004 RESOURCE REQUEST

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

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

First is Compliance.—The principal strategic focus of the President's fiscal year 2004 IRS budget is strengthening compliance activities, especially in the area of high-income, high-risk taxpayers and businesses, and abusive tax avoidance schemes and offshore trusts. A legislative proposal would also authorize the IRS to contract with private-sector collection agencies to supplement current IRS tax collection efforts. The budget further includes a major initiative to reduce erroneous payments in the Earned Income Tax Credit (EITC) Program.

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

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

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

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

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

COMPLIANCE

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

The Internal Revenue Service is realigning its audit resources to focus on key areas of noncompliance with the tax laws. The strategy represents a new direction for the agency's compliance effort.

Following months of research and planning, the new approach is focusing on high-risk areas of noncompliance. Our effort will generally focus first on promoters and then on participants in these various schemes. The initiative will feature new and enhanced efforts on the most serious compliance problem areas described earlier in my testimony.

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

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

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

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

Counterterrorism (+$6M and 24 FTE).—The IRS is heavily involved in the fight against both global and domestic terrorism. Demand for the financial investigative skills of Criminal Investigation (CI) special agents remains high. After September 11, 2001, over 273 FTE in fiscal year 2002 and 206 FTE projected in fiscal year 2003 were redirected from CI tax enforcement activities to counterterrorism related activities. CI is working on counterterrorism with the Treasury Executive Office of Terrorism Financing and Financial Crimes and is an integral part of the nation's war on terrorism.

Use of Private Sector Contractors for Collection of Taxes Due

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

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

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

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

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

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

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

REINVESTMENTS

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

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

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

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

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

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

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

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

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

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

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

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

CONTINUED INVESTMENT IN BUSINESS SYSTEMS MODERNIZATION (+65 MILLION AND 0 FTE)

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

We use a formal methodology to prioritize, approve, fund and evaluate our portfolio of BSM investments. This methodology enforces a documented, repeatable and measurable process for managing investments throughout their life cycle. The IRS Core Business System Executive Steering Committee, chaired by the Commissioner, approves investment decisions. This executive-level oversight ensures that products and projects delivered under the BSM program are fully integrated into IRS Business Units.

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

Achievements and Benefits

In fiscal year 2002, the BSM Program provided real benefits, including a secure online system and system management capability and the aforementioned Internet Refund/Fact of Filing pilot program. In fiscal year 2003 and fiscal year 2004, additional supporting infrastructure services will be added, and an increasing number of business and internal applications will be delivered, creating benefits for taxpayers and practitioners and enabling internal efficiencies.

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

—*Customer Account Data Engine (CADE) R1.*—In July 2003, CADE will begin processing single 1040EZ filers (both electronic and paper). Taxpayers covered under CADE will receive their refunds about 40 percent faster than under Master File processing, if they use direct deposit. More importantly, we will have taken the first of many steps to replace the 40-year old Master Files.

—*Custodial Accounting Project (CAP).*—We will continue development and testing of CAP Release 1 scheduled for deployment in the first quarter of fiscal year 2004. CAP will create a repository for modernized Individual Master File data and will address documented financial material weaknesses.

—*Enterprise Architecture (EA) and Tax Administration Vision and Strategy (TAVS).*—TAVS focuses on creating a long-term vision of how the agency should work in the future. Delivery and acceptance of EA Release 2.0 was a significant achievement. We also conducted a planning effort called "TAVS Refresh" to

identify gaps and outdated information in TAVS which we plan to address in fiscal year 2003.

—*e-Services.*—e-Services sub-releases will provide: registration of electronic return originators, Taxpayer Identification Number (TIN) matching, initial partner relationship management capabilities, electronic account resolution, transcript delivery, secure e-mail, and bulk TIN matching.

—*Infrastructure (STIR and Infrastructure Shared Services [ISS]).*—This project provides the basic secure infrastructure necessary to support the modernization effort including e-Services R1, IR/FoF, Internet Employer Identification Number (EIN), and subsequent fiscal year 2003 releases.

—*Integrated Tax Administration Business Solutions (ITABS).*—Projects to ensure we understand requirements and select COTS (commercial off-the-shelf) solutions that can effectively integrate business processes in IRS functions.

—*Internet EIN.*—This application will automate Employer Identification Number (EIN) requests over the Internet. Currently, the EIN request process is cumbersome and people-intensive, often resulting in unacceptable delays for those starting new businesses.

—*Integrated Financial System (IFS).*—Although the first release of the new financial system will not go live until October 1, 2003 (therefore, an fiscal year 2004 delivery project), it is likely to be our most work-intensive project during fiscal year 2003.

—*Modernized e-file.*—The Modernized e-file project will be in pre-deployment testing for all of fiscal year 2003, with initial deployment in early calendar year 2004, with Forms 1120 and 990 e-file capabilities.

BSM benefits delivered in fiscal year 2004 will include:

—Modernized e-file will provide electronic filing for large and medium-sized businesses (Forms 1120 and 990), as well as a new Tax Return Data Base, which will greatly improve customer service and issue resolution.

—e-Services will provide support for the 2004 Filing Season as well as implement support structures for modernized e-file planned for implementation later in the fiscal year.

—IFS will develop the detailed functional requirements to support internal management requirements for financial and management planning, execution and reporting.

—CAP will provide an integrated enterprise data warehouse to support organizational data needs, performance measurement, and tax operations process improvements.

—CADE will allow for electronic processing of selected Form 1040 Wage & Investment returns with additional taxpayer segments that have increasingly more complex tax returns and/or balance due returns.

—ISS will establish a program whose goal is to deliver a fully integrated shared information technology infrastructure to include hardware, software, shared applications and data, telecommunications, security and an enterprise approach to systems and operations management. This approach results in overall reductions in time and dollars to develop, deploy, and maintain the infrastructure and the business applications that use the infrastructure.

IMPACT OF UNFORESEEN COSTS ON STAFFING LEVELS

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

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

—The unfunded increase in the fiscal year 2002 annual pay raise from the President's 3.6 percent request to the 4.6 percent enacted level (Cost: $43 million).

—Postage increases above initial budget projections (Cost: $22 million).

—Unfunded increase in security costs after 9/11 (Cost: $20 million).

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

levels and directly affect our ability to deliver on performance projections included in the fiscal year 2003 budget request.

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

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

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

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

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

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

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

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

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

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

CONCLUSION

Mr. Chairman, in conclusion, the President's proposed fiscal year 2004 budget for the IRS keeps us on track and will allow us to provide both the short-term and longer-term benefits to taxpayers, which has been the hallmark of our modernization program from its inception. Once again, I thank the President and his Administration for their continued support of our program and their confidence that we can get the job done, and at the least cost to America's taxpayers.

ELECTRONIC FILING

Senator SHELBY. I want to talk to you a little about electronic filing. This process clearly makes your job easier and maximizes efficiency within the Service, but there are serious concerns about the inability of the average American to fill out his or her own tax return and press a button on the IRS's web site and file their return electronically. I understand that there are a number of reasons floating out there but I would like to hear from you, why can't I or somebody else go to the IRS' web site, fill out my tax return and file it unless, of course, I print it out and put it in the mail?

Mr. WENZEL. This year, for the first time, we do offer the opportunity to have individuals come into the IRS.gov site and avail themselves of a program we refer to as Free File. There are 17

commercial software firms that make up the consortium. I need to back up and explain that a little bit.

The electronic filing program started from very humble beginnings in 1996 at the IRS. The first year we had 26,000 returns filed. This year we expect about 53 million returns filed electronically of the 132 million individual income tax returns that will be filed this calendar year. So there is a significant increase.

As you are aware, the Congress in 1998, as a result of the Restructuring and Reform Act of the Internal Revenue Service set a goal for the IRS that by the year 2007, 80 percent of individual and business tax returns will be filed electronically. While we have had, as I mentioned, some significant success, attracting 53 million electronically filed individual returns this year, we still have quite a ways to go for not only individual returns, but also business returns, to reach that goal in 2007.

FREE FILE INITIATIVE

Senator SHELBY. Can you file an electronic return from your home if you had the software?

Mr. WENZEL. You can file, beginning this year, with the consortium that we entered into, this agreement with the private sector. One of the efforts that we are—as I mentioned, it is the first year—trying to increase the number of returns filed electronically. We have a long-standing position at the IRS, that we were not going to compete with the private sector software vendors, to offer free software. That was a position that the IRS took, Treasury took.

As a result of that position we contacted the private sector to form this consortium. As a result of it, this Free File initiative has come up on the IRS.gov web site. Over 68 percent of individuals required to file a return are able to use that right now, at no cost to them. Because all they have to do is pick one of the 17 sites, go into it and have the opportunity to file a return at no cost.

Senator SHELBY. They would have to have the proper software to do this, would they not?

Mr. WENZEL. No, it is there. It is on our system. So far this year over 2.1 million individuals have opted to use one of those 17 software products. Since it is still a week to go——

Senator SHELBY. How much does that cost?

Mr. WENZEL. There is no cost.

Senator SHELBY. No cost to it?

Mr. WENZEL. No cost.

Senator SHELBY. Free?

Mr. WENZEL. Maybe the confusion here——

Senator SHELBY. There is some confusion.

Mr. WENZEL [continuing]. Because you can go in and use the programs at no cost, but what we agreed to with these 17 vendors is they would have the opportunity to use what is called pop-up screens. So if an individual went in, there is a screen that pops up and says, "Would you be interested in getting some additional information, some products and services that we offer?" If you said no, the pop-up screen would go away and you can continue to file your return. But if you said yes, that screen will open up and there are other products and services there.

That is where the confusion may be, Mr. Chairman, because some individuals have availed themselves to take advantage of the additional services offered where there is a cost. But to file a return, there is no charge for that.

Senator SHELBY. The system that I understand is currently in place requires, for example, me to seek an IRS-approved e-file partner to file my return electronically; is that right? Do you want me to repeat that?

In other words, the system I understand that is currently in place would require me to seek an IRS-approved e-file partner to file my tax return electronically. Is that what you were talking about?

Mr. WENZEL. Yes, the partner——

Senator SHELBY. That is what I thought.

Mr. WENZEL [continuing]. Would be one of these 17——

Senator SHELBY. Seventeen of them?

Mr. WENZEL. Yes, for this first-year effort.

Senator SHELBY. Now that costs some money, does it not? It cost something. I do not know how much.

Mr. WENZEL. Not for the taxpayer to go in and file their return.

Senator SHELBY. But as I understand, my staff did a quick search on your web site and found a few examples I want to share with you. There is a $6.95 senior special, the number one tax forms for beginners is $9.95, and finally, there is the complete tax package for $24.95 and when you are finished you can e-file them for free. In other words, you have got to do that first, is my understanding. Am I wrong?

Mr. WENZEL. Mr. Chairman, I have received e-mail, I have received correspondence——

Senator SHELBY. I do not know if I am wrong or not. I am just asking the question.

Mr. WENZEL [continuing]. From individuals of the 2-million-plus that have used this that have said, this is great because it has been free. It was no cost to me in terms of filing.

Senator SHELBY. In other words, they did not have to pay that other money?

Mr. WENZEL. No. I need to check on the examples given here because——

Senator SHELBY. We will furnish those for you, because we would be interested——

Mr. WENZEL [continuing]. I would really need to look into that immediately.

BUSINESS SYSTEMS MODERNIZATION

Senator SHELBY. Business systems modernization, something we have been working with a long time. The Service has informed the staff that the IRS' current IT infrastructure is not equipped to receive and process electronic transactions directly from individual taxpayers. Given our discussion here, I am interested to know if, in fact, the Service's massive business systems modernization project includes an upgraded capability to receive and process electronic transactions directly from individual taxpayers. And if not, why not.

Mr. WENZEL. One of our initiatives and programs in the future, as it relates to the business systems modernization, is to make that a reality in terms of account information.

Senator SHELBY. Would that not help a lot and move a lot of people into electronic filing?

Mr. WENZEL. Absolutely.

Senator SHELBY. And that is what you really want.

Mr. WENZEL. That is one of our e-services that we have been trying to make a reality because it is done so much already in the private sector. The timeliness improves significantly, less cost.

PRIVATE COLLECTION AGENCIES

Senator SHELBY. I want to move into debt collection. It is my understanding you are planning to use private collection agencies to collect some of the $280 billion owed in taxes. I remember Senator Kerry and I were involved in this committee at one time and we tried that. But actually it did not work very well at that time. Maybe it will work now.

But what will IRS do to ensure that this will be a worthwhile project and cost effective this time?

Mr. WENZEL. As you mentioned, there was a pilot in 1996–1997. We learned from that experience, in terms of benefiting from that limited pilot. We also, in getting ready for this proposal, in terms of the budget request, included three private sector companies; a large organization, medium-size, and a small business organization to get their input.

You are right in the sense that the total number of accounts receivable, what we call now potentially collectible inventory, is well over $200 billion. A lot of that, as you know, is corporations out of business or deceased taxpayers. The reality is that we know for a fact there are at least $13 billion right now just waiting for a contact to be made that has an opportunity to potentially be collectible. The reality is that the best we can do at the present time is, once a year, send out a notice to remind that taxpayer they still owe that money.

There is a 10-year statute period which we have to collect the potentially collectible inventory. Every year there is a significant amount of money dropping off because we have not attempted a telephone call, for example.

Senator SHELBY. How do you plan to ensure the protection of taxpayers' rights and the confidentiality of taxpayers to taxpayer information when you contract this out to private contractors?

Mr. WENZEL. This is a very important area for us, Mr. Chairman, in terms of——

Senator SHELBY. Very sensitive too.

Mr. WENZEL. Absolutely. We expect the private sector collection agencies, when they go out and hire people, the people they are hiring will have to meet the same kind of requirements that we expect of IRS employees in terms of background checks and so forth.

We have included our National Taxpayer Advocate in the development of this whole proposal for this very—for obvious reasons, but particularly for this reason, to ensure that taxpayer rights are not violated.

Senator SHELBY. It is very important.

What will be the cost of these contracts compared to the cost of collecting the same debts using IRS employees? Have you done any comparisons there?

Mr. WENZEL. Mr. Chairman, we are finalizing what the projected cost would be. This is not the first time this kind of effort has been done. Forty-two States currently use collection agencies as do the Department of Education and also Financial Management Services, which is part of the Treasury Department. We are having discussions with them about the cost for this, but our proposal is basically that the costs would be recaptured in the proceeds that are collected by these agencies or companies.

Senator SHELBY. So that leads me to the compensation of the contractors, the people you contract out with. Is their compensation a percentage of what they collect?

Mr. WENZEL. Yes, that is generally what the States and the two Federal agencies that I mentioned that have entered into these kinds of agreements do, and there is a certain percentage of the receipts that are collected.

Senator SHELBY. Okay.

Senator Murray?

EARNED INCOME TAX CREDIT

Senator MURRAY. Thank you, Mr. Chairman. In the fiscal year 2004 President's budget, the IRS is proposing a so-called pre-certification initiative for the EITC program, and while you are asking for the money for this in the next fiscal year, you are planning to send verification documents as soon as this July, I understand, to about 45,000 individuals requiring them to provide additional documents to ensure their EITC eligibility. These taxpayers, I understand, will have until this December to submit verification documents and your agency intends to delay the EITC portion of their refund until IRS can review that documentation.

Can you tell me how quickly IRS expects to review that documentation?

Mr. WENZEL. The proposal, in terms of the $100 million, is that we would send out letters to 45,000 taxpayers to ask them to pre-certify things like what we call a "qualifying child." The intent is not to put more burden on the taxpayers as it relates to how we are doing business today. As you are aware, the EITC program for some time has been determined to be a high risk program because it is a tax credit. For a number of years now we have been funded additional monies, not only to do the outreach, the informing and educating to make sure that individuals who are eligible for EITC are in the program, but also there was certain direction given to us to make sure we minimized the amount of fraud that goes into the program.

Senator MURRAY. I was not actually asking about your rationale. I was asking, because you are sending 45,000 questionnaires out and you are telling taxpayers that it may delay their refund, how long can we tell these people that it is going be, that it will take you to review this documentation?

Mr. WENZEL. We would try to make sure that we keep that time span to the absolute minimum. Right now, Senator, we are still talking with some interest groups on the outside. We have not even

finalized the form that would be used. We have had two meetings that have been coordinated by our National Taxpayer Advocate to make sure that the form and what we are requiring for the documentation is kept to the absolute minimum, so that once the information comes in to us, we can immediately review it, turn it around and issue the refund.

Senator MURRAY. Do you expect a lot of EITC payments to be delayed this year?

Mr. WENZEL. Delayed in the sense of, in the past that—yes, that would be a correct statement. There would be a delay and we hope to keep it to an absolute minimum.

Senator MURRAY. Can you give us any kind of time line on that?

Mr. WENZEL. I think what is key here, Senator, is to really finalize—as I mentioned, we are still finalizing some of those decisions, working with considered outside stakeholders. That would be key. I would be happy, once we get that—it should be done——

Senator MURRAY. If you could let us know. We will be hearing from our constituents and we need to give them a response on that.

Then I understand that you expect to expand this project next year and require pre-certification by two million EITC recipients. I am curious if before you expand it from the 45,000 to the two million, are you going to do any kind of evaluation?

Mr. WENZEL. Absolutely. That is why we are starting out with a much smaller number; that is correct.

Senator MURRAY. And you will have the results of that evaluation before you send out pre-certification documents to two million people?

Mr. WENZEL. We will carefully track that and make sure that we completely analyze what has occurred here, and then make a decision in terms of what is the correct number. We think the two million is a fair estimate, but that does not mean that that would not be modified based on what we see.

Senator MURRAY. But you are going to take a look at what happens with the 45,000, and if we are seeing tons of delay and a lot of problems then you will relook at that?

Mr. WENZEL. We will try to make sure that we do this right the first time, and not incur any delay, even with the 45,000. But if that is the case, we will make sure we modify our process and carry that into the next year and the year after that.

Senator MURRAY. GAO estimates that in 1999 25 percent of eligible households, or about 4.3 million households, did not know even how to claim this credit. The Government Performance and Results Act requires you to set quantifiable goals for your agency's objective. Does your fiscal year 2004 performance plan set a numerical goal to increase the participation rate for EITC?

Mr. WENZEL. We have not quite finalized that goal yet, but it is important, based on the feedback we received from GAO, to make sure that we have an appropriate performance measurement in that area.

Senator MURRAY. Why has it not been done yet?

Mr. WENZEL. We are still working through what the right percentage should be in terms of first time effort and setting the right goal.

Senator MURRAY. So you have not set a numerical goal. When do you expect to do that?

Mr. WENZEL. We should be able to do that within, probably within the next 45 days.

Senator MURRAY. The IRS has identified other high risk compliance areas such as promoters of tax schemes, misusers of trusts and offshore accounts, and under-reporting of tax by higher income individuals. The average EITC credit is estimated to be only $1,660 while the average dollar-level fraud by those upper income individual is obviously much higher. Do you really believe that focusing $100 million on EITC is how the taxpayer gets the biggest bang for their buck?

Mr. WENZEL. Our intent is to make sure that we continue to devote a significant amount of our resources, as I mentioned in our budget proposal for 2004, to address the other areas that you just mentioned. But I also would say that we feel that the $100 million is appropriate because almost one-third of the program right now, $9 billion, is going out to individuals that are not entitled to the EITC. Based on trending, that percent may continue to increase unless we try to do something like the pre-certification. That is a real concern on our part as far as how a significant tax credit program like the EITC where already a large proportion, the money is going to the wrong individuals.

Senator MURRAY. You have estimated that almost one-third of the EITC claims in tax year 1999 should not have been paid due to taxpayer errors. But that percentage does not take into account the changes that were made in the 2001 tax act. Shouldn't that figure be lower now?

Mr. WENZEL. We have not been able to validate that. We should, based on this national research program that we just recently have gone out and done, a random audit, receive information to verify what you just mentioned; however, the information will not be available until next year, about this time, to see what the results were.

Senator MURRAY. So we will not know whether it is still that high until a year from now?

Mr. WENZEL. It is true, we are——

Senator MURRAY. We made changes in the 2001 tax act that should have reduced that. But you are basing what you want to do now back on what happened before we did that act.

Mr. WENZEL. That is correct. That is the latest information that we have that we cited. And despite our efforts in terms of how we approached this in the past, we have not been successful to reverse this trend.

Senator MURRAY. But shouldn't we wait until we get a more accurate estimate of what occurred with the 2001 tax act before implementing this kind of regime that could cause a lot of disruption among many taxpayers?

Mr. WENZEL. Senator, our assessment of this is that we really need it—we could not wait any longer. We needed to go ahead and try this pre-certification as a better way to identify and stop the 30 percent and reduce it significantly.

Senator MURRAY. Your documentation actually indicates that one reason that we have a high error rate is because taxpayers are con-

fused about many of the complex EITC rules. What steps have you taken to simplify these rules so that we can avoid taxpayer confusion?

Mr. WENZEL. We continue to get the input from our National Taxpayer Advocate and her advocates around the country. We ourselves at the IRS are always trying to learn from interested outside groups that give us input, to try to make sure that—the example I gave, in terms of this current effort, is to come up with a form that is easily understood, simplified, as much as possible, including the instructions, so people are not confused.

Senator MURRAY. Mr. Chairman, I would just say that if we do pre-certification and confuse people even more, then we are doing a real disservice to people who actually should be getting the EITC for very good reasons that we have set out before. So I think we have to be very careful. If we have confusing rules now and we add more confusing rules, I do not think it is very fair to low income taxpayers.

Mr. WENZEL. Senator, just in terms of the $100 million I just—and I am sure you are aware of this, but I just wanted to point out that of the $100 million, we asked for about 650 FTEs. About 20 percent of the 650 FTEs will be spent on educating and informing again, trying to reach out and make sure that people know they are entitled to the EITC and trying to clarify for them any misunderstanding. So it is not all totally devoted towards the enforcement side.

Senator MURRAY. Thank you, Mr. Chairman.

IRS FREE FILE INITIATIVE

Senator SHELBY. I want to go back to the free filing and so forth. Are there two separate systems here? One, the free file alliance is free for qualifying taxpayers.

Mr. WENZEL. Yes.

Senator SHELBY. And by that, do you have to have a certain income to qualify?

Mr. WENZEL. Yes, what is referred to as the adjusted gross income, Mr. Chairman. But what these different sites offer in the way of——

Senator SHELBY. What would that be before they could——

Mr. WENZEL. It varies by site. But when you add them all up, at least 68 percent of all taxpayers that would want to avail themselves of one of the 17 sites will have the opportunity to free file. It is not 100 percent.

Senator SHELBY. In other words, you have to have a certain income before you can go to these sites. So it is not for all taxpayers.

Mr. WENZEL. Not right now.

Senator SHELBY. Do you expect it to be for all taxpayers?

Mr. WENZEL. This is a first-year effort.

Senator SHELBY. So you are trying.

Mr. WENZEL. We are trying. It is truly a pilot. The response has been tremendous; 2.1 million people to date have used this option that would not have otherwise. They have had the opportunity to come in and file a return at no cost.

Senator SHELBY. Now the e-file partners are the only entities that the IRS allows to file tax returns; is that correct?

Mr. WENZEL. Through that site, yes. Through IRS.gov, yes.

Senator SHELBY. I wanted to clear that up.

CUSTOMER SERVICE

The IRS' budget request proposes to reduce the individual call service workforce. Some of us are concerned about the implications of the workforce reduction in the individual call service area. The IRS has come a long way in terms of customer service in the years since I chaired this committee last, and we are concerned that a reduction of this size will have a negative impact on the provision of customer service to individual taxpayers.

Mr. WENZEL. We fully agree with you in that regard, Mr. Chairman. We do not want to step back and reduce the service, what we have been able to achieve. Just to give you one measurement——

Senator SHELBY. Because, in a sense, if you reduce the service it will reduce your efficiency, will it not?

Mr. WENZEL. We have a responsibility to provide the best products and services to citizens of the United States, and one of the ways we do that is through our telephone call centers. We want to make sure we maintain and continue to improve the way we do business. We have been successful in improving the efficiency of the telephone operations, particularly in the last 12 months, but our performance goals, as you would review them, would continue to show that we want to improve in all areas, including the quality of the responses we give and also the level of service that we offer on our telephones. We do not intend to step back.

CAMPUS CONSOLIDATION

Senator SHELBY. Electronic filing again. We do not want to get away from that, I think. As more returns are filed electronically, what is the impact on IRS staffing in facilities? It has to go down.

Mr. WENZEL. Absolutely. Because of the 53 million that I mentioned earlier, as a result of that, we are closing one of what we call our submission processing centers.

Senator SHELBY. Brookhaven service center?

Mr. WENZEL. That is the Brookhaven service center, yes. We have eight, what we call individual tax return submission processing centers, and two for just business returns. As of September 30th of this year, not too many months from now, the submission processing operation in Brookhaven will shut down completely and we will go to seven, with plans as electronic filing continue——

Senator SHELBY. What savings will you realize by closing this facility?

Mr. WENZEL. Significant savings.

Senator SHELBY. How will the savings be used?

Mr. WENZEL. We hope in terms of reinvesting back into the IRS to put the savings into our customer service, into enforcement.

Senator SHELBY. What formula or criteria did you use to determine which centers to close and the order in which to close the centers?

Mr. WENZEL. I would be happy to share that with you and your staff, Mr. Chairman, but things like labor and rent savings, the impact on——

Senator SHELBY. Just management positions basically?

Mr. WENZEL. Yes. A whole list of criteria that we came up with.

Senator SHELBY. Okay, we would be interested in seeing it.

Since all taxpayers are still not filing their taxes electronically, are there plans to upgrade the paper returns processing system?

Mr. WENZEL. We are always looking for ways to continue to improve every part of the IRS' operation. The submission processing paper side has been in business for a long time, and even though it has been around for a long time, we have made substantial improvements, and we continue to realize efficiency savings. We will continue to look for additional efficiency savings.

BUSINESS SYSTEMS MODERNIZATION

Senator SHELBY. The IRS has developed an expenditure plan for Congressional approval detailing how funds are to be spent before the funds can be released. The key component of systems modernization is the customer account data engine (CADE), and it is scheduled to be released in June or July of this year. It has experienced numerous delays. Will CADE be rolled out as scheduled, and will it offer improved service to taxpayers?

Mr. WENZEL. This is, of any major business systems modernization project that we have, the most significant project because what it does is completely overhaul our master file. Right now we expect that the first iteration of CADE will be available to us later this year, around July and August. What that is, basically as I mentioned, is the first phase of——

Senator SHELBY. Master file, tell me what you mean.

Mr. WENZEL. Master file is every individual, business, exempt organization, employee plans——

Senator SHELBY. The whole matrix?

Mr. WENZEL. Everything, in terms of individuals and businesses that are housed, currently, on a very outdated system. So it is very sophisticated, very difficult. The PRIME contractors that we have, some of the best companies in the world, realize the challenges here. They are the ones that are doing this work for us, as you know. Right now we have regular meetings and the goal is to stay with the schedule of July or August to have the first version of CADE delivered.

Senator SHELBY. What steps are you taking at IRS to ensure that the business operating divisions are adequately prepared to accept and operate and support these modernize systems?

Mr. WENZEL. That is a very essential part because all of this modernization, when you talk about modernization——

Senator SHELBY. It means nothing without that, doesn't it?

Mr. WENZEL. It means nothing without having your people come along and understand what the new systems offer. So there is a training part, awareness part, all of that is so important, and it is integral to this whole effort.

Senator SHELBY. You do not want to purchase software and no one knows how to operate it.

Mr. WENZEL. That is exactly right. We have seen that happen in some other agencies, and we are not going to let that happen here at the IRS.

Senator SHELBY. GAO has reported that IRS has made progress in implementing modernization management controls and capabili-

ties, certain BSM management capabilities have not been fully implemented they say. GAO reiterated prior recommendations that the IRS correct modernization management weaknesses. We know you have made progress from when I used to benchmark it.

What is IRS's plan and schedule for addressing the GAO's recommendations, including implementing effective procedures for validating contractor development, cost and schedule estimates?

Mr. WENZEL. We have done a number of things based on the input from the GAO's oversight of the IRS, and also our inspector general's oversight of the BSM program. One of the things that we have done is this year, fiscal year 2003, we have slowed down or eliminated some of the projects that we thought we were going to undertake, and really focused on CADE and some of the other critical programs, which has helped us immeasurably.

We have also met with the PRIME contractor and entered into an understanding that a lot of the programs in the future will be cost performance-based type of compensation, rather than just continuing to write a check. That's the expectation; the work will be based on a set cost price or possibly a performance-based price, so there is accountability going back to the PRIME contractor.

The third thing that the PRIME contractor has done, based on their further awareness of the challenges that these efforts offer, is beefed up their experts, their expertise, particularly their senior leadership of the contract, and have brought in some individuals that really understand this better and know how to manage it better, and to work with the IRS leadership in terms of making sure we deliver on BSM this time.

OFFERS IN COMPROMISE

Senator SHELBY. The Offer in Compromise, this initiative has allowed the IRS to reduce the backlog of cases and all new cases are to be processed at one of two centralized sites, and only those offers that cannot be completed there are sent to field offices for resolution. Concerns exist because the program has been costly to operate in comparison to the return on the investment. Have the new initiatives enabled IRS to make the program more cost efficient? What measures are used to make your assessment?

Mr. WENZEL. What we have done is, in two sites, as you mention, one in Brookhaven and one in Memphis, added a total of 600 employees, roughly 300 in each of the locations. They are lower-graded employees. Obviously, to start this up we had to go through an extensive training program for the 600 employees. Now their skill level has really reached the point where they have become quite productive, and we are able to screen out and work in those sites some of the real easy offer in compromises where we do not have to make a one-on-one contact with a revenue officer who is much higher-graded, where there is travel time involved and so forth.

So our key measurement is what you might expect in terms of the quality of the work performed, the efficiency of the work performed. We feel, at this point in time, that now that we have gone through this learning curve, that our decision to go to that kind of an operation is going to really pay the overall benefits that we initially expected.

SECURITY

Senator SHELBY. Information security. News reports that the IRS has not done a good job in making sure that contractors receive appropriate background checks. There have been problems with lock box employee guards and even bomb-sniffing dogs that really could not detect explosives. What is the IRS doing to address these problems? Can these problems have an impact on the safety of IRS employees as well as on the security of the taxpayer data? It is important to have a safe place to work.

Mr. WENZEL. Mr. Chairman, if there is a number one priority at the Internal Revenue Service, it is to ensure the safety of our 100,000 employees around the country. We take seriously and welcome the reviews that have been conducted by the GAO and the inspector general for the IRS, who has also provided us ongoing feedback on things like you just mentioned, in terms of the contract employees. We have responded to those and taken the necessary actions to correct that problem, so that the background checks are done of contract employees, and do the follow-up reviews and make sure it does not recur again.

Ever since September 11th of 2001, we have an ongoing site here in Washington, D.C. with the Inspector General, where cooperatively we are looking at every aspect of physical security in every one of our 795 offices around the country to try to ensure the safety of our employees.

ADDITIONAL COMMITTEE QUESTIONS

Senator SHELBY. That is good to hear.

We appreciate your appearance here today. We will continue to work with you and we believe that we have to measure the expenditures of the taxpayer and you are in a position to set the ground rules.

Mr. WENZEL. Mr. Chairman, thank you for your oversight and support that you provide to the Internal Revenue Service.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD C. SHELBY

GENERAL

Question. Why is IRS requesting additional staffing in fiscal year 2004, when the positions granted in fiscal year 2003 have not been filled?

Answer. The IRS requested additional funding in fiscal year 2003 for 1,179 FTE to improve customer service and compliance and meet workload increases. However, before we published the fiscal year 2004 budget, a number of unfunded and unanticipated costs arose that reduced the funding available for hiring these additional staff. Since over 70 percent of the IRS Operating budget consists of salaries and benefits, any unanticipated costs we must pay requires the reduction of labor costs (i.e., FTE).

For example, the fiscal year 2002 annual pay raise of 4.6 percent cost an additional $43 million above the 3.6 percent budgeted amount. The IRS had also expected savings resulting from legislative proposals for postage and the Financial Management Service (FMS) levy that Congress did not pass that required us to fund an additional $23 million. The unfunded postage increase raised our postage costs by $22 million. Moreover, an unfunded increase in security costs resulting from the 9/11 tragedy cost the agency an additional $20 million. These changes and others

amounted to $170 million in unexpected, unfunded costs mandatory to meet our mission.

In addition, the extended Continuing Resolution for fiscal year 2003 limited our funding to the fiscal year 2002 level until the appropriation was passed in early 2003. That restriction forced the IRS to concentrate available funds on ensuring a good filing season and prevented the execution of hiring plans. Despite these setbacks, the IRS needs the additional funding in fiscal year 2004 to continue to build the staff necessary to address the enforcement problems that ensure that all taxpayers pay their fair share of taxes.

Question. What formula did IRS use to determine which Service Center to close and what cost savings if any, are derived from this action?

Answer. In the past, all ten IRS submissions processing centers processed returns from both the Individual Taxpayers (IMF) and Business Taxpayers (BMF). Prior to our reorganization the ten centers were identical to each other. Each center processed IMF and BMF returns. Each center also handled Taxpayer Accounts (correspondence/telephones) and Compliance programs for both IMF and BMF. While this was successful, we felt we could improve our Business results, and be more responsive to the Customer/Taxpayers by specializing our organization structure based on our customers. We based the initial IMF Consolidation Strategy of these centers around Wage and Investment (W&I), Small Business/Self Employed (SB/SE), Large and Mid-Size Business (LMSB) and Tax Exempt and Government Entities (TE/GE) customer segments. As a result of this reorganization, we reorganized the ten Processing Campuses into eight W&I and two SB/SE Submission (Return) Processing Centers.

With the increased emphasis on Electronic Filing we have designed a detailed business plan to reduce the number of Processing Centers from eight W&I sites to, eventually, two. This is several years in the future, but this plan will reduce the number of centers every couple of years, providing the public continues to switch from filing paper to electronic returns.

We used economies of scale, labor market factors and real estate costs, as well as the criteria listed below, to determine the order of consolidation of the sites:

—A Program Optimization Model using site specific volumetric and production rates,

—Campus specific Return on Investment for real estate expenditures associated with Submission Processing,

—Detailed potential severance costs associated with a Submission Processing consolidation,

—Qualitative factors such as, operational feasibility, infrastructure and work force impacts.

As Electronic Filing increases and paper returns decrease, consolidation of Submission Processing campuses will result in savings. The IRS' intent is to reinvest these savings to maximize program opportunities in other areas. While there is not a final figure for the Brookhaven Submission Processing consolidation, the initial cost savings projection was approximately $50 million. The projected savings at the Memphis Service Center consist of both Real Estate and Salary costs and are currently projected to be $12.5 million dollars for the period 2004 through 2006. We project an annual cost avoidance of $9.5 million dollars a year starting in 2007. It is too soon to project the cost savings for each center beyond Memphis at this time.

ELECTRONIC FILING

Question. Reports state that the 2002 filing season has been successful with the implementation of e-filing. There should be some cost savings from this program; can you identify savings generated because of this initiative?

Answer. During fiscal year 2002, IRS estimates that the savings generated from e-file were $9.995 million. Savings for fiscal year 2003 are estimated to be $10.369 million. Savings are computed as the costs that would have been incurred for processing the decreased number of paper returns, reduced by the costs of processing them as e-file returns.

Question. The IRS contracted with the Free File Alliance, to provide free online tax preparation and filing services for at least 60 percent of all taxpayers through the IRS Website. Since the 2002 filing date has passed, do you think the Free File Alliance was a success? What changes if any, would you make to this process for the next filing season?

Answer. We did not contract, but rather established and are executing a public-private partnership agreement with the Free File Alliance, LLC.

As of May 31, 2003, the IRS has received over 2.77 million returns through the 17 companies participating with the Free File Alliance. This figure represents over

23 percent of all returns filed online with the IRS (11.7 million). These free tax preparation and e-filing services will continue to be available to taxpayers through October 15, 2003 on the irs.gov web site. Deemed a tremendous success by Treasury, OMB and IRS, the Free File initiative exceeded expectations for the program. Based on the volume of returns received through Alliance members and the relatively small number of comments/concerns sent to the IRS, the Free File initiative was very well received by taxpayers.

The IRS and the Free File Alliance are assessing all feedback and impact of the program on both industry and the IRS. Completion of this process will determine appropriate refinements for the 2004 filing season.

Question. Electronic filing has a number of discrepancies pertaining to e-filing. Explain how free e-filing works? How can an individual qualify for free e-filing?

Answer. In November of 2001, the Office of Management Budget's (OMB) Quicksilver Task Force established 24 e-government initiatives as part of the President's Management Agenda. The task force designed these initiatives to improve government to government, government to business, and government to citizen electronic capabilities. One initiative, EZ Tax Filing (now known as Free File) instructed the IRS to provide free online tax return preparation and electronic filing services to taxpayers. To accomplish this objective, the IRS began working in partnership with the tax software industry to develop a solution. The result was a precedent-setting agreement between the government (IRS) and private sector (Free File Alliance, LLC, a group of tax software companies, managed by the Council for the Electronic Revenue Communication Advancement (CERCA)), that requires tax software companies to provide free online tax preparation and electronic filing services to eligible taxpayers. This agreement requires Alliance members to provide free tax return preparation and electronic filing services to a significant portion of the taxpaying population (at least 60 percent or 78 million taxpayers) through April 15, 2003. Many of these free services will be available for taxpayers with extensions through October 15, 2003. These free services were launched to the public on January 16, 2003 and are being promoted by the IRS and are accessible at www.irs.gov.

The following describes how a taxpayer can participate with Free File:

Determine eligibility.—Upon arrival to the Free File page within irs.gov, the taxpayer must determine his or her eligibility for using a particular company's free service. This eligibility can be determined by two methods: the taxpayer may browse the complete listing of Alliance members and their free services; or the taxpayer can use a "questionnaire" application (i.e., Free File Wizard) designed to help identify those free services for which they may qualify. Each Alliance member's company name is identified and a simple description of the criteria for using their free service is provided. For interested taxpayers, each Alliance member's company or product name is linked to additional information about the company and/or services.

Link to free services.—Upon determining eligibility, the taxpayer can link directly to that Alliance member's free service by clicking on the Alliance member's "Start Now" link. Upon doing so, taxpayers are notified they are leaving the irs.gov web site and are entering the Alliance member's web site.

Prepare and File Income Tax Return.—At the Alliance member's web site, the taxpayer can use the member's online software to prepare and e-file his or her income tax return using proprietary processes and systems. Once complete, the member transmits the taxpayer's return information to the IRS through the established e-file system. Upon receipt, IRS computers check the return information for errors or missing information and send the taxpayer notification of return acceptance or rejection through the Alliance member. Taxpayers will receive notification from the Alliance member.

[NOTE.—Each Alliance member has specific qualifying criteria for its free service. For the 2003 filing season, the members based these requirements on factors such as age, adjusted gross income, State residency, military status, or eligibility to file a Form 1040EZ or claim the Earned Income Tax Credit. Taxpayers who met these requirements can use that member's online software to prepare and e-file their Federal tax return for free. An Alliance member's qualifying criteria may change for the 2004 filing season.]

Question. When the business system modernization of IRS is complete, will all taxpayers be able to file their taxes by e-filing or file on-line from the privacy of one's own home? If not, why not?

Answer. Currently, over 99 percent of all tax returns can be e-filed from home computers or by using an authorized provider. The IRS is systematically removing the last few barriers to e-file to open eligibility to the remaining taxpaying population. However, IRS' Business Systems Modernization program does not have plans to offer direct on-line filing. RRA 98 directed the IRS to work cooperatively with the industry to promote electronic filing. Additionally, the IRS believes that private in-

dustry, given its established expertise and experience in electronic tax preparation, has a proven track record in providing the best technology and services available. As such, the IRS entered into an agreement with the private industry (Free File Alliance), to provide free online tax filing and preparation services to at least 60 percent of the taxpaying population. These free services were offered, during the 2003 filing season, by 17 different companies and were accessible through IRS' web site (irs.gov). The IRS is continuing to work with industry partners to provide opportunities and solutions that will encourage taxpayers to file their tax returns electronically.

MODERNIZATION

Question. What contributed to the delays in the projects in the Business Systems Modernization spending plan submitted to Congress?

Answer. The IRS is modernizing one of the largest and most complex information systems in the world. Since the creation of the IRS in its current form in the 1950s, our mission has evolved, and the volume and complexity of our operations have mushroomed. Our tax system modernization initiative faces several challenges:

—Complex, ever-changing tax laws,
—Extremely high volumes,
  —Over 130 million individual taxpayers,
  —Over 6 million business taxpayers,
  —200 million returns,
  —$2.1 trillion in receipts, $1.5 trillion in electronic payments,
  —Tax refunds totaling over $190 billion,
  —1.5 billion information documents,
  —52 million electronically filed returns,
  —19.2 million combined Federal/State returns,
—Inputs with wide-variation in content ranging from few to many fields of various lengths,
—Seasonal processing with extreme variations in processing loads,
—Hundreds of legacy applications,
—Transaction rates on the order of billions per year and storage measured in the tens of terabytes (trillions of bytes).

Since the Business System Modernization (BSM) effort began, the BSM program office and PRIME contractor have struggled to implement defined and repeatable processes that are necessary for effective and efficient systems development. Due to the complexity of the BSM projects, these management processes have required time to become established. Once all management processes are in place, and as they mature, the program will run closer to cost and schedule estimates and our capacity to initiate additional deliverables will also increase. Also, we have addressed many of the recommendations made by GAO, such as prudently slowing some projects and deferring new ones when management capacity is inadequate, to proceed with an acceptable risk level.

The IRS' systems are woefully obsolete and inefficient for an organization so critically dependent on technology. We are saddled with a collection of computer systems developed over a 35-year period. The most important systems that maintain all taxpayer records were developed in the 1960s. Additional cost and schedule delays arise from the challenge of programming interfaces with these historical systems, which cannot easily share information with the modernized systems.

Initial project budgets and delivery timelines are based on long term plans and strategy and may be developed years before the project start date. As the projects move through the lifecycle and as requirements become fully understood, we have adjusted most project estimates and schedules to reflect the enormous complexity of the systems. Legislative changes in the tax code also impact costs and schedules.

Both the IRS and the PRIME contractor have underestimated the enormous size and complexity of the BSM effort. We are engaged in a comprehensive process improvement initiative to enhance our effectiveness in validating cost and schedule estimates. This includes working with the PRIME contractor to develop and deploy best practice estimating capabilities consistent with Carnegie Mellon University's Software Engineering Institute (SEI), as recommended by GAO. Once all management processes are in place and as they mature, the program will run closer to cost and schedule estimates and our capacity to initiate additional deliverables will also increase.

In addition, given the important juncture we've reached with the first important deliverable for CADE, we have decided to have an outside group of experts take an independent look at the program and report back to us by the end of this summer. We have not yet identified who will conduct this study but expect to do so in the

next few weeks. No work will stop while the review is underway, but this is a good time to assess progress, project risk and whether any midcourse corrections are needed.

Question. Customer Account Data Engine (CADE) is the most critical of the components in the modernization process. When CADE goes live this year will it be able to process all individual and business accounts?

Answer. The first release of CADE will go live later this summer. CADE will begin to process individual returns this year. The system will not, however, process business returns this year. The individual tax returns that CADE will begin to process will only be 1040EZ returns, paper and electronic, for single filers who either fully paid or have a refund due. CADE's first release will not include EITC filers and filers with prior issues. The number of returns included in this first release will be approximately 6 million. Although this is a relatively modest beginning, this first release of CADE contains much of the highly complex infrastructure to support later releases.

CADE will be deployed over 6 years in five releases, each related to a specific taxpayer segment. Each release will deliver functionality to support increasingly complex filing scenarios. At the conclusion of Release 5, CADE will have replaced the Individual Master Files. Subsequent releases of CADE will eventually replace the Business Master Files and Non-Master Files.

Because CADE is one of the most complex projects in the world, we are moving forward carefully based upon positive results from the rigorous testing process, as well as cost and capacity considerations.

PRIVATE COLLECTION AGENCIES

Question. What guidelines does the IRS have in place to protect taxpayer's privacy, when and if the tax collection process is contracted to private collection agencies?

Answer. Under the Administration's proposal, taxpayer protections provided by the Internal Revenue Code (Code), IRS procedures, and other applicable laws, including those relating to taxpayer privacy, would be fully applicable to private collection agencies (PCAs). The taxpayer protections incorporated in the Administration's proposal have been reviewed thoroughly, including consultations with the National Taxpayer Advocate. The National Taxpayer Advocate would have a continuing role in ensuring that taxpayer protections are maintained under this program.

Sections 6103(n) and 7431(a)(2) of the Internal Revenue Code currently permit a taxpayer to pursue legal action against any person who is permitted to receive tax returns and return information for purposes of assisting in tax administration, but who unlawfully inspects or discloses that information. Criminal penalties also may be imposed under I.R.C. §§ 7213, 7213A. These provisions would apply to PCAs. The Administration's proposal would require annual reports outlining the safeguards in place at the PCAs to protect taxpayer confidentiality and PCA compliance with the taxpayer confidentiality provisions.

PCA employees would receive extensive training on taxpayer rights and privacy protections. The IRS' oversight processes, which would include an on-site presence, live and tape monitoring of communications with taxpayers, periodic audits, and performance evaluations, would ensure that taxpayer rights and privacy are fully protected.

PCAs would be required to maintain a dedicated secure physical space with approved access controls to ensure protection of taxpayer data. The IRS would evaluate the integrity of a PCA's computer system to ensure that appropriate access controls are in place to protect taxpayer data. To protect against browsing of taxpayer information, PCAs' systems would be required to maintain a log of accesses to taxpayer information, which would be audited periodically by the IRS. On-site security reviews would be performed to ensure that PCAs implement appropriate access controls to segregated areas where IRS work would be performed. Periodic security audits would be performed to ensure the PCAs maintain ongoing data and physical security.

Question. A pilot project was tried previously, using private collection agencies and it was not a success; what new information do you have that would indicate that this process will work now?

Answer. The Administration's proposal reflects the lessons learned from the pilot program. The primary issues affecting the success of the pilot program, and the manner in which those issues are addressed by this proposal, are set out below.

—*Implementation Period.*—The IRS was required to implement, almost from scratch, the pilot program within the year of the appropriation legislation—i.e.,

within 10 months of enactment. In contrast, planning for this proposal was begun well over a year ago and has involved discussions between the IRS, the Treasury Department, the Office of the National Taxpayer Advocate, the Department of Justice, and prospective contractors. Moreover, even once authorizing legislation is enacted, this proposal contemplates that additional time would be required before the PCA program could begin. This additional time allows the IRS to ensure that the business processes, security and oversight measures, and taxpayer protections are brought on-line and fully tested before the program begins.

—*Funding*.—The pilot program effectively was funded out of IRS appropriations and involved the assignment to PCAs of a range of cases. IRS employees can exercise discretion and enforcement authority which cannot be delegated to a PCA. IRS employees, therefore, should be more effective, compared to a PCA employee, at collecting a range of outstanding tax obligations. Thus, PCAs in the pilot program were destined to be judged as inferior to IRS employees over such a range of cases. In contrast, however, this proposal would involve the careful screening of cases to ensure that only the most appropriate ones are assigned to PCAs so that PCAs can act effectively and efficiently with respect to these liabilities. The Administration's proposal also involves PCAs supplementing, and not displacing, existing IRS resources. Accordingly, the program would add to the net revenue collected.

—*Processing and Communications*.—At the time of the pilot program, IRS computer and communication systems were not adequate for the processing, delivery, and updating of liabilities being handled by the PCAs. These processing and communications issues already are being addressed to ensure that all functions are performed timely in support of the program.

—*Selection of Accounts*.—The pilot program required the IRS to place accounts where the IRS had previously made attempts to collect the monies owed. Consequently, the pilot program involved the referral of many outstanding liabilities to PCAs that did not have realistic collection potential. This resulted in wasted effort by both the PCA and the IRS. Under the Administration's proposal, the IRS would focus on ensuring that the outstanding liabilities that are referred to PCAs are those that not only are within the authority of the PCA to resolve but also represent cases with a sufficient likelihood of payment if a PCA, in fact, were to handle the liability.

—*Taxpayer Information*.—The pilot program overly restricted the amount of information that could be provided to PCAs for purposes of collecting outstanding liabilities. As a result, many cases had to be returned by the PCAs to the IRS due to the PCAs' inability to respond to often straightforward questions about a taxpayer's liability. Under the Administration's proposal, PCAs would have access to specific information regarding an outstanding tax liability (e.g., type of tax, tax years affected, dates of assessment, whether the assessment is based on a taxpayer's own balance due return or an IRS notice, prior payments, and application of prior payments) in order to answer basic, but important, questions that a taxpayer may have regarding the liability. The taxpayer information that would be provided to PCAs would be strictly limited to the information required for the collection of the specific tax liability at issue. PCAs would not receive, for instance, information regarding a taxpayer's total or adjusted income, sources of income, results of IRS examinations, delinquency history for liabilities not being handled by the PCA, or employer information. All existing restrictions imposed by section 6103 of the Code would apply to the PCAs, and taxpayers would have the right to assert a claim against PCA employees who violate those protections.

—*Contract Structure*.—The pilot program involved a fixed-price contract with incentive payments. The Administration's proposal would involve a competitive, fee-for-service, performance-based, incentive contract structure. The performance evaluation would be based on a balanced scorecard that would look to quality of service, taxpayer satisfaction, and case resolution, in addition to collection results. The allocation of accounts among the PCAs participating in the program would be based on this performance evaluation, thereby providing a further incentive for PCAs to respect all taxpayer rights and protections. This compensation structure is modeled on the successful FMS and Department of Education contracts.

—*Oversight*.—The Administration's proposal would involve extensive oversight of the PCAs participating in the program, including direct, on-site monitoring. This oversight would ensure that procedures are followed, and that any issues are identified and resolved early.

QUESTIONS SUBMITTED BY SENATOR TED STEVENS

PUBLIC EMPLOYEES RETIREMENT SYSTEMS RULING

Question. In 2001, the Alaska State legislature passed a bill sponsored by Senator Rick Halsford (S.B. 145) which created the Village Public Safety Officer Program. The bill mandates Village Public Safety Officers are eligible to become a member of the Public Employees' Retirement Systems (PERS) under as 39.35. The IRS is considering the inclusion of Village Public Safety Officers in PERS, however they have not yet rendered a decision. Until the IRS makes a decision, S.B. 145 can't be implemented. In March, I wrote a letter to the IRS requesting a response regarding the status of the IRS' ruling on the inclusion of Village Public Safety Officers in PERS. No response has been received to this date. When can I expect to receive a written response regarding the inclusion of Village Public Safety Officers in PERS, or can you address this question right now?

Answer. The ruling request is under active consideration. Because positions taken by the Pension Benefit Guaranty Corporation and the Department of Labor can be affected by IRS rulings concerning the status of a plan as a governmental plan, we informally coordinate these rulings with those agencies on a taxpayer anonymous basis. We cannot disclose or otherwise make a draft taxpayer ruling available while we are deliberating on a ruling, whether redacted or not. Once the ruling is issued, with the taxpayer's permission we can make a redacted copy available to you.

We plan to forward a redacted copy of our ruling to the aforementioned agencies for their comments in mid-June. We expect their response within 30 days, and, assuming they concur with our proposed ruling or have no concerns or comments that require follow-up, we will issue our decision within a week of receipt.

EXCISE TAX CALCULATION

Question. You have stated one of the goals of the IRS is to ensure that top quality service is provided to each taxpayer through fair and uniform application of the law. It has come to my attention that an Alaskan company called Hawaiian Vacation has been using a handbook published by the Airlines Reporting Corporation to calculate its excise tax for flights from Alaska to Hawaii. According to the handbook, the route from Anchorage to Honolulu is subject to a 4.9 percent tax. The tax table has been used in the airline industry for over 30 years, and during this time, the IRS has not taken issue with the ARC handbook tables.

Recently, the IRS has disputes the use of the ARC handbook and has proposed the tax calculation for the flight between Anchorage and Honolulu is 10.45 percent. Obviously, the IRS' calculation affects Alaskans because this is a tax paid by passengers. In the past, has the IRS rejected the use of the ARC handbook to determine tax rates? If so, name the circumstances in which the use of the ARC handbook was rejected. Will you provide the code section that prohibits the use of the ARC handbook when computing excise taxes?

Answer. Industry tables are useful tools in the calculation of the taxable and excludable mileage for air transportation and are normally published by an entity having no Form 720 filing requirement. Neither the Internal Revenue Code nor Treasury Regulations prohibit or authorize the specific use of industry tables when calculating the excise tax due on taxable air transportation to or from Alaska or Hawaii. However, the underlying formulas and calculations to generate these industry tables must be in compliance with IRC section 4262(b) and applicable regulations.

The Airline Reporting Corporation (ARC) has published tables used in the airline reservation industry for over 30 years. Based on historical files, it appears that the IRS had reviewed tables revised by the Air Transport Association of America (ATA) in 1969. The tables concerned tax rate ratios for 29 TRANSPAC gateway cities. Although the specific mileages were not authenticated, the IRS stated the formula appeared reasonable, with an understanding that the computations were made using the method set forth in Reg, Sec. 49.4262(b)–1(c).

Recently, we determined that the airline reservation industry tables currently include tax rate ratios for over 700 cities to Alaska and Hawaii. It appears they may not conform to the method set forth in the regulations and revenue rulings. For example, all cities in Alaska have the same rate to Hawaii, as well as all cities in an area east from Vermont to Nova Scotia, regardless of the miles involved. In addition, established flight patterns over Kodiak Island in Alaska and Catalina Island in southern California, which are within the United States and taxable, are possibly not considered in the rate tables.

Although IRC Sec. 6103 prevents the discussion of specific taxpayers and their returns, we are able to provide general tax information in response to these questions. The industry table calculates the taxable mileage portion of a trip from Anchorage

to Hawaii to be 4.9 percent of the total miles. The 7.5 percent Federal Excise Tax rate would then be applicable to 4.9 percent of the amount paid for the ticket. Computing the specific mileage when normal flight patterns to Hawaii are over Kodiak Island, the taxable portion of the mileage is more closely reflected at 10.45 percent of the total mileage, because the flight passes over a point that is U.S. territory.

This is a broad-based issue that impacts airlines, charter companies, and travel agencies who have a Form 720 filing requirement, as well as all taxpayers who travel to and from Alaska and Hawaii. In an effort to treat all taxpayers fairly and equally, we hope to resolve the issue with a uniform application of the law. We have agreed to meet with the industry and determine whether this issue can be addressed on a broad scale. We will be including excise, industry and Counsel specialists in this matter to come to a final determination as to the Service's position. There are several options open to pursue this, including Industry Issue Resolution, Tax Advisory Memorandum, or Field Technical Guidance. We will determine the appropriate format and a path of resolution after a review of the underlying information and a discussion with industry.

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

WILL THE IRS TRY TO INCREASE EARNED INCOME TAX CREDIT (EITC) PARTICIPATION?

Question. Mr. Wenzel, you stated that you intend to develop your numerical performance goal in no more than 45 days.

Please forward to me your goal and an accompanying detailed description of how you intend to achieve this goal no later than May 26th.

Answer. We are currently developing a methodology to identify the EITC participation rate to allow us to establish a targeted goal. We will provide this goal and accompanying detail by the end of June, as we discussed with your staff.

Question. Some Federal agencies have used paid television advertising in English and Spanish as a method of publicizing their message. For example, the National Highway Traffic Safety Administration spent $10 million to buy primetime advertising utilizing volunteer celebrities to get out its enforcement message on seat belts with great success.

How much does the IRS plan to spend on paid advertising on radio and television in order to boost participation in the EITC program?

Answer. The IRS does not normally use paid advertising for EITC. EITC is promoted primarily through free Public Service Announcements (PSA). In 2003, IRS spent approximately $1.5 million for development and distribution of PSAs (TV, radio, and print media) in both Spanish and English and other related outreach materials. For 2004, we are beginning to plan an EITC awareness and understanding promotion strategy that will focus on encouraging workers eligible for EITC to claim it, while reducing erroneous payments. We have budgeted approximately $1.5 million for this effort.

Question. Will you be using volunteer celebrities to get people's attention?

Answer. In years past, celebrities have appeared in IRS PSAs from time to time. However, we do not actively seek celebrity participation. Celebrities can pose a public relations risk if the celebrity's positive image changes in the future.

Question. You are asking for an additional $100 million for the EITC program. We are told that this funding will go both for your pre-certification effort and to enhance participation.

Precisely what percentage of the $100 million will go toward pre-certification versus outreach efforts?

Answer. Of the $100.2 million:

—$16.2 million is allocated to the Qualifying Child Verification initiative,
—$13.0 million is allocated for Communications and Outreach,
—$11.1 million is allocated to the Filing Status and Income Misreporting initiatives,
—$7.1 million is for operations management,
—$9.9 million is allocated to phone support, and
—$4.5 million is allocated for support from a variety of areas, including Field Assistance, Taxpayer Advocate Service and Appeals.

The vast majority of the remainder ($38.4 million) is allocated to developing business and technological infrastructure. A description of the technology infrastructure that we are developing or acquiring is provided in Appendix I.

SHOULD THE IRS BE ALLOWED TO USE PRIVATE COLLECTION AGENCIES (PCAS) TO HELP COLLECT DELINQUENT TAX DEBTS?

Question. Mr. Wenzel, your agency is seeking legislative authority to use private collection agencies to help collect delinquent tax debts. IRS documentation states that the IRS would be required to closely monitor private collection agencies' activities and performance, including the protection of taxpayer rights. This is particularly important because PCAs would be compensated out of the revenue collected through their activities.

Please explain in detail the precise steps that would be in place to ensure that vigilant oversight would be conducted on PCA activities?

Answer. The IRS would establish an oversight group with responsibility for managing case referrals, monitoring and evaluating PCA performance, monitoring interactions with taxpayers, and reviewing and approving PCA invoices. The oversight group would be required to monitor a statistically valid number of taxpayer contacts by each PCA to evaluate taxpayer treatment and adherence to IRS approved procedures. A manual review of PCA activity on taxpayer accounts would be performed to ensure compliance with approved IRS procedures and overall quality of case handling. A full on-site audit of each PCA by the IRS oversight group would be performed on a regular basis and would be in addition to ongoing quality-control and taxpayer protection monitoring.

The PCA would be responsible for ensuring that each employee who has access to taxpayer account information has completed the appropriate background investigation and non-disclosure forms. The PCA would be required to submit verification of the required background investigation and copies of the non-disclosure forms to the IRS at least 20 days before the employee is permitted to access taxpayer information. In addition, the IRS would adopt tracking procedures developed during the 1996–97 pilot program to ensure that no PCA employee would be granted access to the IRS work site or taxpayer data until he/she successfully completed a satisfactory background determination. These procedures were very successful during the pilot.

The IRS' oversight of PCAs would be similar in many respects to the IRS' oversight of its own employees. For example, the IRS audit system logs for indications of improper accesses to taxpayer information. The IRS also performs oversight of employee work for quality and appropriateness of taxpayer interactions.

PCAs would be required to provide a large amount of information to the IRS, as well as access to various systems, to facilitate IRS oversight. This would include:

—detailed Operational Management Information Systems (MIS) reports,
—telephone Service Level reports,
—audits of employee access to IRS taxpayer data,
—access to PCA collection system for auditing purposes,
—remote telephone monitoring access to authorized IRS personnel,
—PCA employee tracking information,
—PCA employee quality review monitoring evaluations,
—PCA Operational Plans, and
—PCA Business Continuation Plans.

To make certain the IRS promptly hears, evaluates and addresses taxpayer complaints, a PCA would be required to provide to taxpayers, orally and in writing, information on how to report a complaint with the IRS. Any complaint received by the IRS from a taxpayer would immediately be provided to the PCA. If a PCA were to receive a complaint directly from the taxpayer, the PCA would be required to immediately forward the complaint to the IRS.

Upon receipt of a complaint from the IRS or directly from a taxpayer, a PCA would be required to immediately cease collection activity on the account in question and provide to the IRS, by the close of business on the following business day, a copy of its records on the account and any other information relevant to the complaint. The PCA would not be permitted to resume collection activity on the account until IRS resolved the problem and provided the PCA written authorization to resume work. Failure by the PCA to cease collection activity on the account would result in IRS recalling the account from the PCA and, if appropriate, the termination of the PCA's contract.

A PCA also would be required to investigate the complaint and provide a complete report to the IRS within 10 business days of receiving the complaint. The report would include a description of all actions taken to resolve the situation and steps put in place to ensure there are no future occurrences of similar situations.

If a complaint is validated, the PCA would be required to remove the offending employee from the IRS account and take all necessary steps to ensure the employee no longer has any access to taxpayer information. In addition, the PCA's bonus and inventory would be reduced, and the PCA would be subject to a penalty. The IRS

could choose to suspend all contract activity for the PCA either permanently or until the IRS has determined, at its discretion, that the PCA had taken appropriate corrective actions to prevent further complaints.[1] The IRS' determination that a complaint was valid would not be subject to review.

If a potential statutory violation is identified, the IRS also would notify the Treasury Inspector General for Tax Administration (TIGTA). TIGTA may investigate the complaint, depending on the circumstances and seriousness of the complaint. If TIGTA initiates a formal investigation of the complaint, the PCA would be required to cooperate fully with the investigation and coordinate its own management efforts with the IRS and TIGTA. TIGTA would provide a report of its investigation to the IRS Contracting Officer after concluding the investigation.

Question. What mechanisms would be in place to ensure that taxpayer rights are protected and private data is accurately secured in the use of private collection agencies?

Answer. Under the Administration's proposal, taxpayer protections provided by the Internal Revenue Code (Code), IRS procedures, and other applicable laws, including those relating to taxpayer privacy, would be fully applicable to private collection agencies (PCAs). The taxpayer protections incorporated in the Administration's proposal have been reviewed thoroughly, including consultations with the National Taxpayer Advocate. The National Taxpayer Advocate would have a continuing role in ensuring that taxpayer protections are maintained under this program.

Sections 6103(n) and 7431(a)(2) of the Internal Revenue Code currently permit a taxpayer to pursue legal action against any person who is permitted to receive tax returns and return information for purposes of assisting in tax administration, but who unlawfully inspects or discloses that information. Criminal penalties also may be imposed under I.R.C. §§ 7213, 7213A. These provisions would apply to PCAs. The Administration's proposal would require annual reports outlining the safeguards in place at the PCAs to protect taxpayer confidentiality and PCA compliance with the taxpayer confidentiality provisions.

PCA employees would receive extensive training on taxpayer rights and privacy protections. The IRS' oversight processes, which would include an on-site presence, live and tape monitoring of communications with taxpayers, periodic audits, and performance evaluations, would ensure that taxpayer rights and privacy are fully protected.

PCAs would be required to maintain a dedicated secure physical space with approved access controls to ensure protection of taxpayer data. The IRS would evaluate the integrity of a PCA's computer system to ensure that appropriate access controls are in place to protect taxpayer data. To protect against browsing of taxpayer information, PCAs' systems would be required to maintain a log of accesses to taxpayer information, which would be audited periodically by the IRS. On-site security reviews would be performed to ensure that PCAs implement appropriate access controls to segregated areas where IRS work would be performed. Periodic security audits would be performed to ensure the PCAs maintain ongoing data and physical security.

Question. To what degree will the backgrounds of contractor employees be investigated?

Answer. The IRS, following Internal Revenue Manual (IRM) procedures and using input from the National Background Investigations Center (NBIC) would determine the degree of background investigation required in accordance with the risk associated with the job function performed and the taxpayer information being provided to the PCAs. We anticipate PCA employees would undergo a moderate level of background investigation, which includes a criminal activity check, a tax compliance check and verification of personal references.

Question. The Administration is supporting legislation to allow private collection agencies to collect tax debt and be paid out of the proceeds of their collection efforts.

Isn't this in conflict with the 1998 IRS reform legislation that specifically prohibits IRS employees or managers from being evaluated on the amount of taxes they collect?

Answer. Fully consistent with Section 1204 of the IRS Reform and Restructuring Act, the IRS' contracts with PCAs would prohibit a PCA from evaluating a PCA employee based on quotas or collection results with respect to Federal tax debts serviced for the IRS. Moreover, these contracts would require that PCA employee evaluations include taxpayer service as a factor.

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[1] In determining whether to suspend a contract, the IRS would consider the severity and frequency of valid complaints for a PCA (whether related to one or more employees).

The PCAs themselves would be evaluated based on a balanced measure scorecard that would reflect quality of service, taxpayer satisfaction, employee satisfaction and case resolution, in addition to collection results. A PCA therefore will be judged at its, and its employees' effectiveness, at resolving outstanding accounts and, where appropriate, effecting payment of outstanding tax liabilities.

PCAs would have a very strong incentive to fully respect taxpayer rights and protections, including privacy rights. Validated taxpayer complaints and deficiencies identified during the IRS' monitoring and audit of a PCAs would result in significant monetary penalties for the PCA. In addition, the PCA's future allocation of cases would be significantly impacted. Simply put, a PCA that does not fully respect taxpayer rights and protections would soon find itself with a small to nonexistent role in the program.

Question. Congress was concerned that evaluating employees on tax collection success could promote overly aggressive collection techniques. Even if the individual contract employees are not evaluated on how much they bring in, they may be concerned that they won't have a job unless they are bringing in money.

Doesn't this conflict with the provisions of the 1998 IRS reform legislation?

Answer. The Administration's proposal combines carefully restricted PCA activities, careful and continuous oversight, and significant short and long-term penalties and incentives to ensure PCAs and their employees will fully respect taxpayer rights and protections.

PCAs would focus on taxpayers who are likely to pay their outstanding tax liabilities, either in full or in installments, if they were located and contacted. These are functions that do not require the exercise of discretion and which would not involve enforcement actions. PCAs may be provided by the IRS with a specific statement that can either be sent or delivered verbally to taxpayers regarding the benefits of paying an outstanding tax liability, and the potential consequences of failing to do so. PCAs would be prohibited from threatening or intimidating taxpayers, or otherwise suggesting that enforcement action will or may be taken if a taxpayer does not pay the liability. In no case would a PCA be permitted to take enforcement action against a taxpayer.

As described in previous responses, PCAs and their employees would be subject to extensive oversight and audit. A violation by a PCA of a taxpayer protection provided by the Internal Revenue Code (Code), IRS procedures, or other applicable laws, including those relating to taxpayer privacy, would have real short-term and long-term consequences to the PCA and its employee, including, where appropriate, contract termination.

Question. I understand that under current law, if an IRS employee misuses taxpayer information, the injured taxpayer can recover damages from the U.S. government.

Would that be the case with private contractors?

Answer. The existing protections against unauthorized disclosure of returns or return information would apply to PCAs and their employees. Sections 6103(n) and 7431(a)(2) of the Internal Revenue Code permit a taxpayer to pursue legal action against any person who is permitted to receive tax returns and return information for purposes of assisting with tax administration, but who unlawfully inspects or discloses that information. Criminal penalties also may be imposed under I.R.C. 7213 and 7231A.

Question. IRS employees are routinely charged with frivolous claims of misconduct by noncompliant taxpayers. These charges are investigated by IRS or the Treasury Inspector General for Tax Administration.

Who would do the investigating and who would pay the cost of investigations of charges against contract employees?

Answer. The process generally would be similar. The IRS would establish an oversight group with responsibility for managing case referrals, monitoring and evaluating PCA performance, monitoring interactions with taxpayers, and reviewing and approving PCA invoices. The oversight group would be required to monitor a statistically valid number of taxpayer contacts by each PCA to evaluate taxpayer treatment and adherence to IRS approved procedures. A manual review of PCA activity on taxpayer accounts would be performed to ensure compliance with approved IRS procedures and overall quality of case handling. A full on-site audit of each PCA by the IRS oversight group would be performed on a regular basis and would be in addition to ongoing quality-control and taxpayer protection monitoring.

The PCA would be responsible for ensuring that each employee who has access to taxpayer account information has completed the appropriate background investigation and non-disclosure forms. The PCA would be required to submit verification of the required background investigation and copies of the non-disclosure forms to the IRS at least 20 days before the employee is permitted to access taxpayer infor-

mation. In addition, the IRS would adopt tracking procedures developed during the 1996–97 pilot program to ensure that no PCA employee would be granted access to the IRS work site or taxpayer data until he/she successfully completed a satisfactory background determination. These procedures were very successful during the pilot.

The IRS' oversight of PCAs would be similar in many respects to the IRS' oversight of its own employees. For example, the IRS audit system logs for indications of improper accesses to taxpayer information. The IRS also performs oversight of employee work for quality and appropriateness of taxpayer interactions.

PCAs would be required to provide a large amount of information to the IRS, as well as access to various systems, to facilitate IRS oversight. This would include:

—detailed Operational Management Information Systems (MIS) reports,
—telephone Service Level reports,
—audits of employee access to IRS taxpayer data,
—access to PCA collection system for auditing purposes,
—remote telephone monitoring access to authorized IRS personnel,
—PCA employee tracking information,
—PCA employee quality review monitoring evaluations,
—PCA Operational Plans, and
—PCA Business Continuation Plans.

To make certain the IRS promptly hears, evaluates and addresses taxpayer complaints, a PCA would be required to provide to taxpayers, orally and in writing, information on how to report a complaint with the IRS. Any complaint received by the IRS from a taxpayer would immediately be provided to the PCA. If a PCA were to receive a complaint directly from the taxpayer, the PCA would be required to immediately forward the complaint to the IRS.

Upon receipt of a complaint from the IRS or directly from a taxpayer, a PCA would be required to immediately cease collection activity on the account in question and provide to the IRS, by the close of business on the following business day, a copy of its records on the account and any other information relevant to the complaint. The PCA would not be permitted to resume collection activity on the account until IRS resolved the problem and provided the PCA written authorization to resume work. Failure by the PCA to cease collection activity on the account would result in IRS recalling the account from the PCA and, if appropriate, the termination of the PCA's contract.

A PCA also would be required to investigate the complaint and provide a complete report to the IRS within 10 business days of receiving the complaint. The report would include a description of all actions taken to resolve the situation and steps put in place to ensure there are no future occurrences of similar situations.

If a complaint is validated, the PCA would be required to remove the offending employee from the IRS account and take all necessary steps to ensure the employee no longer has any access to taxpayer information. In addition, the PCA's bonus and inventory would be reduced, and the PCA would be subject to a penalty. The IRS could choose to suspend all contract activity for the PCA either permanently or until the IRS has determined, at its discretion, that the PCA had taken appropriate corrective actions to prevent further complaints.[2] The IRS' determination that a complaint was valid would not be subject to review.

If a potential statutory violation is identified, the IRS also would notify the Treasury Inspector General for Tax Administration (TIGTA). TIGTA may investigate the complaint, depending on the circumstances and seriousness of the complaint. If TIGTA initiates a formal investigation of the complaint, the PCA would be required to cooperate fully with the investigation and coordinate its own management efforts with the IRS and TIGTA. TIGTA would provide a report of its investigation to the IRS Contracting Officer after concluding the investigation.

The IRS would pay for an initial number of the background investigations (75), and the PCA would bear the cost for any additional background investigations after the first 75.

Question. How would IRS decide which cases to give to contractors?

Answer. The IRS is currently evaluating the cases that would be referred to PCAs. In general, the cases the IRS would refer to PCAs are cases where the taxpayer has a reasonable likelihood of paying the outstanding tax liability if contacted by telephone. These cases would include situations where a taxpayer has filed a return indicating an amount of tax due but has not sent in full payment of that amount (so-called "balance-due" taxpayers). These cases also would include situations where the taxpayer has made three or more voluntary payments of tax that the IRS has assessed (e.g., after having failed to file a return or report all income

[2] In determining whether to suspend a contract, the IRS would consider the severity and frequency of valid complaints for a PCA (whether related to one or more employees).

received). The IRS would not refer cases for which there is any indication that enforcement action would be required to collect the tax liabilities or cases in which the taxpayer disputes the amount of the liability or the existence of the liability.

The IRS anticipates that it initially would refer only cases relating to the Form 1040 series of returns, i.e., individual taxpayers. These cases also would include tax liabilities of Small Business/Self-Employed (SB/SE) taxpayers and sole proprietors who file a Form 1040 with a Schedule C, E, or F. Although the IRS would use PCAs to help address both new cases as well as those cases that currently are not to be addressed due to resource and collection priorities, the IRS does not intend to refer cases that are over 6 years old.

The IRS is currently evaluating the potential inventory of cases that may be appropriate for referral. The IRS is developing more detailed screening criteria to eliminate cases likely to result in a referral back to the IRS or that otherwise would have a low probability of collection by the PCA. In addition, the IRS is examining whether commercially available credit data could assist in identifying and prioritizing the potential inventory for PCA placement.

Question. Wasn't funding to analyze which cases could be given to contractors cut in this year's budget?

Answer. Collection Contract Support (CCS) was initially part of the Filing & Payment Compliance (F&PC) Modernization project. Although this project is now on hold, the IRS has identified fiscal year 2003 funding for critical needs, including analysis and development of predictive models that will place the appropriate accounts with PCAs should legislation be enacted. We have engaged an industry leader in the credit and risk management scoring process to develop these models for use with CCS.

While the empirical models that are envisioned for F&PC are ultimately desirable for the modernized IRS, the commercially available models presently planned for use in CCS will provide valuable insight to the IRS on which accounts can be best resolved in the PCA environment.

HAS THE IRS IMPROVED ITS CUSTOMER SERVICE?

Question. For the 2002 filing season and so far in this year's filing season, taxpayers have received correct responses to questions approximately 85 percent of the time.

What is the IRS doing to improve this rate?

Answer. The IRS utilizes several methods to continually address quality issues.

—The IRS monitors error data from the Centralized Quality Review System on a daily basis and provides ongoing feedback about top errors to frontline employees. The Centralized Quality Review system is conducting in-depth analysis of fiscal year 2003 Filing Season data to make recommendations on correcting problem areas.

—Frontline managers and local review staffs continually listen to the responses given to customers on the toll free telephone lines to ensure responses are correct and complete and to provide performance feedback to frontline employees.

—The IRS is working continually to improve tools used by frontline employees to respond to customer inquiries. These tools include the Service Wide Electronic Research Program, the Electronic Accounts Resolution Guide, and the Tax Law Probe and Response Guide.

—Employees responding to tax law inquiries are specialized in their respective topics and tested before being permitted to take live calls.

The IRS has accumulated data from each toll-free site on challenges faced during the fiscal year 2003 filing season and actions taken to overcome these challenges. This information is being used to plan for fiscal year 2004 and beyond to eliminate barriers to providing world-class customer service.

Field Assistance initiated several actions to improve the accuracy of responses given to taxpayers who visit Taxpayer Assistance Centers (TAC). Some of the actions are:

—*Monitor Employee Performance*.—TAC managers are monitoring 12 tax law counter contacts for each technical employee during the year. At least six of the contacts will be monitored during the filing season. To place the monitoring commitment into the proper context, Field Assistance had 1521 permanent and 335 seasonal and permanent part time employees as of March 2003. Considering that tax law represents only 10 percent of the total workload and the geographic dispersion of our TACs this is a significant number of reviews.

—*Employee Counseling*.—Counseling is provided when we identify an improper referral to a publication. We follow up with education and role playing to demonstrate proper use of the Publication Method. The Publication Method is a

technique to "walk" a taxpayer through a publication to cover all appropriate probing questions and illustrates the correct answer to his/her question.

—*Training Assessment Battery (TAB)*.—TAB will be administered to all employees and managers to identify skill levels and training needs. The TAB includes four modules that align directly with the four-stage training curriculum for Tax Resolution Representatives (TRRs).

—*Employee Certification Process*.—We have completed the first round of employee certifications. The certification process requires employees to correctly answer three out of three questions on four tax law topics (social security benefits, education credit, earned income tax credit and dependents). Employees will only be allowed to answer taxpayers' questions on topics for which they have been certified.

—*Anonymous Managerial Visits*.—The sample plan requires 30 anonymous visits monthly per Area. Results of the visits are provided to the employee's manager within one business day for follow-up for potential quality improvement.

—*Anonymous Headquarters Quality Assurance Visits*.—Our Headquarters Quality Assurance staff is required to make monthly anonymous visits to the TACs. Results of the visits are also provided to the employees' managers.

—*Error Trend Reports*.—Issued by Headquarters Quality Assurance staff when we identify errors. Areas are required to follow up on the errors identified and take appropriate actions to improve the accuracy of responses given to taxpayers who visit the TACs.

Question. How accurate are the answers supplied by employees using the IRS toll-free help phone lines?

Answer. Using fiscal year 2003 cumulative as of May 23rd, for the 2003 filing season the accuracy rate for tax law is 82.25 percent and accuracy rate for accounts is 88.11 percent.

Question. What is the result of reviews of the quality of walk-in service to taxpayers at IRS Taxpayer Assistance Centers?

Answer. The results of Field Assistance quality reviews and Treasury Inspector General for Tax Administration (TIGTA) reviews of the quality of walk-in service at TAC's during fiscal year 2003 are:

Field Assistance Quality Review Results.—The cumulative accuracy rate through April 2003 is 87 percent based on 840 questions asked nationwide.

TIGTA Results.—The cumulative accuracy rate through April 2003 is 68 percent based on 445 questions asked. We disagree with including referrals to publications and service denied responses in computing the accuracy rate. When recomputed to reflect only answers that are technically correct or incorrect, the cumulative accuracy rate is 73 percent. [NOTE.—The term "service denied" includes situations where the IRS employee did not answer the taxpayer's question, did not refer the taxpayer to a publication, another employee, the toll-free telephone number or offer to prepare a written referral for the question. The IRS employee may have told the taxpayer that no one was available to answer their question and that they should come back the next day.]

Question. Is there separate data available regarding the accuracy of information given in response to inquiries pertaining to EITC?

Answer. Yes. Cumulative through April 2003, IRS has achieved an 81.4 percent accuracy on Earned Income Tax Credit (Tax Law) for inquiries to our telephone assistors.

The accuracy results for EITC questions for our walk-in offices are as follows:

Field Assistance Quality Review Results.—The cumulative accuracy rate through April 2003 for EITC questions is 96 percent based on 69 questions asked nationwide.

TIGTA Results.—The cumulative accuracy rate through April 2003 for EITC questions is 70 percent based on 96 EITC questions asked. As stated above, we disagree with including referrals to publications and service denied in computing the accuracy rate. When recomputed to reflect only answers to EITC questions that are technically correct or incorrect, the cumulative accuracy rate for EITC questions is 79 percent.

IRS MODERNIZATION

Question. It seems that for more than a decade, IRS has been modernizing its computer systems. Obviously, this has been a challenge.

Why has it taken so long and why is it not completed? Despite improvements, the major modernization projects continue to experience significant delays, cost increases, management difficulties, and reductions in deliverables.

Answer. The IRS is modernizing one of the largest and most complex information systems in the world. Since the creation of Internal Revenue Service (IRS) in its current form in the 1950s, our mission has evolved, and the volume and complexity of our operations have mushroomed. Comparable to no other in the world today, our tax system modernization initiative faces several challenges:

—Complex, ever-changing tax codes,
—Extremely high volumes,
  —Over 130 million individual taxpayers,
  —Over 6 million business taxpayers,
  —200 million returns,
  —$2.1 trillion receipts, $1.5 trillion in electronic payments,
  —Tax refunds totaling over $190 billion,
  —1.5 billion information documents,
  —52 million electronically filed returns,
  —19.2 million combined Federal/State returns,
—Input with wide-variation in content ranging from few to many fields of various lengths,
—Seasonal processing with extreme variations in processing loads,
—Hundreds of legacy applications, and
—Transaction rates on the order of billions per year and storage measured in the tens of terabytes (trillions of bytes).

As you know, past modernization attempts have yielded small improvements, but have been largely unsuccessful. A critical question moving forward was whether or not the IRS could learn from these failures to become more successful at managing modernization. At the direction of Congress and to maximize the likelihood of success, the IRS awarded the PRIME contract to provide leadership in the development of the IRS long-term vision of tax administration including; systems integration and engineering, best practices in business process reengineering and business solution, software acquisition/development and program/project management capability.

Notwithstanding the complexity of our modernization effort, we are experiencing the same challenges faced by private industry in developing and deploying technology projects. The CHAOS report, published by the Standish Group, evaluated the causes for success and failure of technology projects. The Standish Group research shows a staggering 31.1 percent of projects will be canceled before they ever get completed. Further results indicate 52.7 percent of projects will cost 189 percent of their original estimates. The Modernization projects are realizing a success rate equal to or greater than the success rate experienced by private industry.

The Modernization program is delivering real benefits for taxpayers, tax practitioners and the IRS, and we are supporting an aggressive deliverable schedule. In addition to the accomplishments realized by project releases in fiscal year 2001 and 2002 discussed in the response to question 39d, planned deliverables for fiscal year 2003 include functionality for Internet Employer Identification Number (EIN), Customer Account Data Engine (CADE), Human Resources (HR) Connect and e-Services.

Initial project budgets and delivery timelines are based upon the long term visioning and strategy and sometimes developed several years before the project start date. As the projects move through the lifecycle and requirements become fully understood, most project estimates and schedules have been adjusted to reflect the enormous complexity of the systems. Additional costs and schedule delays also arise from legislative changes and the need for the modernized systems to interface with the existing legacy systems.

We are engaged in a comprehensive process improvement initiative to enhance our effectiveness in validating cost and schedule estimates. This includes working with the PRIME contractor to develop and deploy best practice estimating capabilities consistent with Carnegie Mellon University's Software Engineering Institute (SEI), as recommended by GAO. Following the present rollout of cost and schedule estimating enhancements our focus will transition to ensuring increased accuracy and reliability of estimates. Once all management processes are in place, and as these mature, the program will run closer to cost and schedule estimates and our capacity to initiate additional deliverables will also increase.

The modernization effort is a major challenge. As the GAO noted in its January assessment, modernization remains a high risk area. It stated, "The scope and complexity of the program are growing—the challenge for the IRS is to make sure the pace of systems acquisition projects does not exceed the agency's ability to manage them effectively." Given the important juncture we have reached with the first important deliverable for CADE, and the need to ensure future success of the program, we have decided to have an outside group of experts take an independent look at the program and report back to us by the end of this summer. We have not yet iden-

tified who will conduct this study but expect to do so in the next few weeks. No work will stop while the review is underway, but this is a good time to assess progress, project risk and whether any midcourse corrections are needed.

Finally, because of the importance of successfully achieving modernization, the new Commissioner recently appointed a new position, the Deputy Commissioner for Operations Support, who will supervise the Chief Financial Officer, Chief Information Officer, the Chief Human Capital Officer, Agency Wide Shared Services and the Service's IT and physical security operations. The Deputy Commissioner for Operations Support will own the modernization program and drive productivity across the organization in order to improve service to taxpayers.

IRS FINANCIAL MANAGEMENT

Question. The Acting Inspector General has found that IRS lacks, on an ongoing basis, the timely, accurate, and useful information needed to make informed management decisions.

How do you respond to this charge?

Answer. The IRS is in the process of implementing the Integrated Financial System, a Joint Financial Management Improvement Program (JFMIP)-certified, commercial off-the-shelf software application that addresses the legislative requirements for the IRS in support of the financial and revenue accounting, property and procurement processes. Release 1 is scheduled for agency-wide deployment in October 1, 2003.

This release will:

—Improve the capability to meet internal/external requirements related to management controls and financial reporting, including cost accounting;

—Improve the timeliness, quality, and utility of administrative activity data provided to IRS managers, as well as to central agencies, so they can make effective business decisions; and

—Address several Remediation Plan action items, and address GAO concerns regarding lack of integrated financial management systems at IRS.

With the implementation of IFS Release 1, the IRS expects to dramatically improve the timeliness, accuracy, and usability of the information required to make informed management decisions.

QUESTIONS SUBMITTED BY SENATOR BARBARA A. MIKULSKI

IRS ON PRIVATIZING TAX COLLECTION

Question. The Administration is supporting legislation to allow private collection agencies to collect tax debt and be paid out of the proceeds of their collection efforts. This seems to me to be in conflict with the 1998 IRS reform legislation that specifically prohibits IRS employees or managers from being evaluated on the amount of taxes they collect. Congress felt that evaluating employees on tax collection success promoted overly aggressive collection techniques. Even if the individual contract employees are not evaluated on how much they bring in, they will know that they won't have a job unless they are bringing in money. Isn't that in conflict with the provisions of the 1998 IRS reform legislation?

Answer. The Administration's proposal combines carefully restricted PCA activities, careful and continuous oversight, and significant short and long-term penalties to ensure PCAs and their employees will fully respect taxpayer rights and protections. Fully consistent with Section 1204 of the IRS Reform and Restructuring Act, the IRS' contracts with PCAs would prohibit a PCA from evaluating a PCA employee based on quotas or collection results with respect to Federal tax debts serviced for the IRS. Moreover, these contracts would require that PCA employee evaluations include taxpayer service as a factor.

PCAs would focus on taxpayers who are likely to pay their outstanding tax liabilities, either in full or in installments, if they were located and contacted. These are functions that do not require the exercise of discretion and which would not involve enforcement actions. PCAs may be provided by the IRS with a specific statement that can either be sent or delivered verbally to taxpayers regarding the benefits of paying an outstanding tax liability, and the potential consequences of failing to do so. PCAs would be prohibited from threatening or intimidating taxpayers, or otherwise suggesting that enforcement action will or may be taken if a taxpayer does not pay the liability. In no case would a PCA be permitted to take enforcement action against a taxpayer.

A violation by a PCA of a taxpayer protection provided by the Internal Revenue Code (Code), IRS procedures, or other applicable laws, including those relating to

taxpayer privacy, would have real short-term and long-term consequences to the PCA and its employee, including, where appropriate, contract termination.

Question. It's my understanding that under current law if an IRS employee misuses taxpayer information the injured taxpayer can recover damages from the U.S. government? Would that be the case with private contractors?

Answer. The existing protections against unauthorized disclosure of returns or return information in would apply to PCAs and their employees. Sections 6103(n) and 7431(a)(2) of the Internal Revenue Code permit a taxpayer to pursue legal action against any person who is permitted to receive tax returns and return information for purposes of assisting with tax administration, but who unlawfully inspects or discloses that information. Criminal penalties also may be imposed under I.R.C. 7213 and 7231A.

Question. IRS employees are routinely charged with frivolous claims of misconduct by noncompliant taxpayers. These charges are investigated by IRS or the Treasury Inspector General for Tax Administration. Who would do the investigating and who would pay the cost of investigations of charges against contract employees?

Answer. The process generally would be similar. The IRS would establish an oversight group with responsibility for managing case referrals, monitoring and evaluating PCA performance, monitoring interactions with taxpayers, and reviewing and approving PCA invoices. The oversight group would be required to monitor a statistically valid number of taxpayer contacts by each PCA to evaluate taxpayer treatment and adherence to IRS approved procedures. A manual review of PCA activity on taxpayer accounts would be performed to ensure compliance with approved IRS procedures and overall quality of case handling. A full on-site audit of each PCA by the IRS oversight group would be performed on a regular basis and would be in addition to ongoing quality-control and taxpayer protection monitoring.

The PCA would be responsible for ensuring that each employee who has access to taxpayer account information has completed the appropriate background investigation and non-disclosure forms. The PCA would be required to submit verification of the required background investigation and copies of the non-disclosure forms to the IRS at least 20 days before the employee is permitted to access taxpayer information. In addition, the IRS would adopt tracking procedures developed during the 1996–97 pilot program to ensure that no PCA employee would be granted access to the IRS work site or taxpayer data, and even then only limited access, until he/she successfully completed a satisfactory background determination. These procedures were very successful during the pilot.

The IRS' oversight of PCAs would be similar in many respects to the IRS' oversight of its own employees. For example, the IRS audit system logs for indications of improper accesses to taxpayer information. The IRS also performs oversight of employee work for quality and appropriateness of taxpayer interactions.

PCAs would be required to provide a large amount of information to the IRS, as well as access to various systems, to facilitate IRS oversight. This would include:

—detailed Operational Management Information Systems (MIS) reports,
—telephone Service Level reports,
—audits of employee access to IRS taxpayer data,
—access to PCA collection system for auditing purposes,
—remote telephone monitoring access to authorized IRS personnel,
—PCA employee tracking information,
—PCA employee quality review monitoring evaluations,
—PCA Operational Plans, and
—PCA Business Continuation Plans.

To make certain the IRS promptly hears, evaluates and addresses taxpayer complaints, a PCA would be required to provide to taxpayers, orally and in writing, information on how to report a complaint with the IRS. Any complaint received by the IRS from a taxpayer would immediately be provided to the PCA. If a PCA were to receive a complaint directly from the taxpayer, the PCA would be required to immediately forward the complaint to the IRS.

Upon receipt of a complaint from the IRS or directly from a taxpayer, a PCA would be required to immediately cease collection activity on the account in question and provide to the IRS, by the close of business on the following business day, a copy of its records on the account and any other information relevant to the complaint. The PCA would not be permitted to resume collection activity on the account until IRS resolved the problem and provided the PCA written authorization to resume work. Failure by the PCA to cease collection activity on the account would result in IRS recalling the account from the PCA and, if appropriate, the termination of the PCAs contract.

A PCA also would be required to investigate the complaint and provide a complete report to the IRS within 10 business days of receiving the complaint. The report

would include a description of all actions taken to resolve the situation and steps put in place to ensure there are no future occurrences of similar situations.

If a complaint is validated, the PCA would be required to remove the offending employee from the IRS account and take all necessary steps to ensure the employee no longer has any access to taxpayer information. In addition, the PCA's bonus and inventory would be reduced, and the PCA would be subject to a penalty. The IRS could choose to suspend all contract activity for the PCA either permanently or until the IRS has determined, at its discretion, that the PCA had taken appropriate corrective actions to prevent further complaints.[3] The IRS' determination that a complaint was valid would not be subject to review.

If a potential statutory violation is identified, the IRS also would notify the Treasury Inspector General for Tax Administration (TIGTA). TIGTA may investigate the complaint, depending on the circumstances and seriousness of the complaint. If TIGTA initiates a formal investigation of the complaint, the PCA would be required to cooperate fully with the investigation and coordinate its own management efforts with the IRS and TIGTA. TIGTA would provide a report of its investigation to the IRS Contracting Officer after concluding the investigation.

The IRS would pay for an initial number of the background investigations (75), and the PCA would bear the cost for any additional background investigations after the first 75.

Question. How would the IRS decide which cases to give to contractors? Wasn't funding to analyze which cases could be given to contractors cut in this year's budget?

Answer. The IRS is currently evaluating the cases that would be referred to PCAs. In general, the cases the IRS would refer to PCAs are cases where the taxpayer has a reasonable likelihood of paying the outstanding tax liability if contacted by telephone. These cases would include situations where a taxpayer has filed a return indicating an amount of tax due but has not sent in full payment of that amount (so-called "balance-due" taxpayers). These cases also would include situations where the taxpayer has made three or more voluntary payments of tax that the IRS has assessed (e.g., after having failed to file a return or report all income received). The IRS would not refer cases for which there is any indication that enforcement action would be required to collect the tax liabilities or cases in which the taxpayer disputes the amount of the liability or the existence of the liability.

The IRS anticipates that it initially would refer only cases relating to the Form 1040 series of returns, i.e., individual taxpayers. These cases also would include tax liabilities of Small Business/Self-Employed (SB/SE) taxpayers and sole proprietors who file a Form 1040 with a Schedule C, E, or F. Although the IRS would use PCAs to help address both new cases as well as those cases that currently are not to be addressed due to resource and collection priorities, the IRS does not intend to refer cases that are over 6 years old.

Collection Contract Support (CCS) was initially part of the Filing & Payment Compliance (F&PC) Modernization project. Although this project is now on hold, the IRS has identified fiscal year 2003 funding for critical needs, including analysis and development of predictive models that will place the appropriate accounts with PCAs should legislation be enacted. We have engaged an industry leader in the credit and risk management scoring process to develop these models for use with CCS.

While the empirical models that are envisioned for F&PC are ultimately desirable for the modernized IRS, the commercially available models presently planned for use in CCS will provide valuable insight to the IRS on which accounts can be best resolved in the PCA environment.

BUSINESS SYSTEMS MODERNIZATION

Question. I am concerned about the requested funding levels for the IRS business systems modernization program. The budget request for this year is just $429 million, about $21 million or 5 percent below the initial fiscal year 2003 request and $79 million or 14 percent below the level recommended by the IRS Oversight Board.

a. Are you committed to a robust Federal investment to continue the business systems modernization program at IRS?

Answer. Yes. We firmly believe we are making progress on our commitments, are leveraging our precious resources, and are managing the considerable risk inherent in a program of the enormous size, complexity, and sensitivity. The current BSM program funding level for fiscal year 2003 is $407 million (including available appro-

[3] In determining whether to suspend a contract, the IRS would consider the severity and frequency of valid complaints for a PCA (whether related to one or more employees).

priations from previous years). The President's Budget proposes an increase to $429 million in fiscal year 2004.

The $429 million enables us to provide a balanced program that builds out essential infrastructure, delivers taxpayer value, improves internal operations and is within our ability to manage and implement.

The BSM program has been steadily implementing management processes based on best practices in cost and scheduling planning, configuration management, risk management, management progress reporting, acquisition management and others. We feel the management processes coupled with our governance process will strike the proper balance between delivering business value, building critical infrastructure, and ensuring control and effectiveness. As the management processes mature, the program will run closer to cost and schedule estimates.

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

Given this assessment and the important juncture we have reached with the first important deliverable for CADE, we have decided to have an outside group of experts take an independent look at the program and report back to us by the end of this summer. We have not yet identified who will conduct this study but expect to do so in the next few weeks. No work will stop while the review is underway. But this is a good time to assess progress, project risk and whether any midcourse corrections are needed.

Question. b. What is the Administration's five-year run out for the business systems modernization—both in the annual appropriations request and the annual BSM program (expenditure plan) level?

Answer. In fiscal year 2001 we developed a Tax Administration Vision and Strategy (TAVS) and an Internal Management Vision and Strategy (IMVS) to guide the BSM program. TAVS and IMVS reflected our priorities (the sequencing plan). Some critical projects like CADE were already started, but future projects are generally chartered from the sequencing plan that we developed as part of TAVS and IMVS. We also developed an Enterprise Architecture (EA) that added significant functional and technical detail to TAVS and IMVS. The EA includes an Enterprise Transition Plan that further details the TAVS and IMVS sequencing plan.

The request for $429 million was determined after extensive analysis of: (1) the requirements for in-progress projects begun prior to fiscal year 2004; (2) the TAVS and IMVS sequencing plan; (3) funding the Custodial Accounting Project and Integrated Financial System to correct material weaknesses in financial management; (4) improving IRS e-gov functionality with e-Services and Modernized e-file; (5) maintaining adequate management reserve; (6) the Business Systems Management Office (BSMO) capacity to manage the program and projects; and finally, (7) the ability of the business units to absorb new software vis-à-vis training and implementation impacts. In requesting the $429 million, we believe we have set a realistic funding level that will allow us to continue the investments begun prior to fiscal year 2004 and initiate critically needed systems software and hardware for business operations.

As the IRS moves forward in its modernization efforts, funding requests will be developed after careful consideration of our long-term strategy, the sequencing plan and the priorities in the President's Management Agenda, as well as our ability to manage and absorb new functionality and business processes.

Question. c. The program's development growth has generally been sustained through a combination of annual appropriations and carryover from prior year appropriations so that this year's (2003) program level is $450 million (the $370 million appropriation + carryover from prior years). I am concerned that prior year carryover funding will pretty much be exhausted after 2003. So how can the BSM program—as it enters into a critical period next year for a series of major projects—maintain its momentum if the program level in 2004 actually drops below the anticipated level for 2003?

Answer. The current BSM program funding level for fiscal year 2003 is $407 million, including carryover from prior years. The President's Budget proposes an increase to $429 million in fiscal year 2004. The requested funding level of $429 million will allow us to continue the investments begun prior to fiscal year 2004 and initiate critically needed systems software and hardware for business operations.

Question. d. OMB seems to be pushing expenditure of funds for this program into more internal IRS information technology applications rather than robustly funding the development of major activities that benefit the four major IRS business units.

Can you explain what you are doing to guarantee that the products developed by the BSM are going to be used by the IRS' business units?

Answer. Guiding the BSM Program is our Tax Administration Vision and Strategy and Internal Management Vision and Strategy, both of which are reflected in the BSM Enterprise Architecture. The business units developed these during late 2002 and early 2001 and keep them current.

As we develop products based on the business priorities reflected in our sequencing plan, we have management processes that deeply invest the business units in leadership and ownership positions across the life cycle. One example is our Executive Steering Committees (ESC), which are chaired by the business unit. The Deputy Commissioner for Large and Mid-Size Business LMSB heads the Filing and Processing Management Sub-ESC and the Deputy CFO heads the Internal Management Sub-ESC, for example.

Our integrated project teams have representation from all the relevant affected business areas, including information technology, and all key designated roles, such as the Requirements Director, are always from the business units. There are many other examples of how bonded the systems people and the business people are in this process, but hopefully the examples above convey the flavor of what we are doing to ensure deep business engagement and ownership from the outset.

Our programs to date have addressed improved tax administration, internal management, and building technical infrastructure. Establishing a new secure online infrastructure to support tax administration applications like the very popular "Where's My Refund?" is one achievement we cite with pride. We have delivered several other tax administration applications (a new customer communications system, a new system for tax computations for use by LMSB revenue agents, and a new Internet Employer Identification Number system) and one major internal management system (human resources).

This summer we will implement a new Internet-based system to enable streamlined communications with tax practitioners, and the first release of CADE, which will be the first step in replacing the old master files with a modernized taxpayer account data system. This fall we will implement two new internal management applications, a new core financial system, replacing our current financial system, and a new custodial accounting system. Next January, we will launch electronic filing for large businesses and tax-exempt organizations.

As you can see, this represents an ambitious, but balanced (across tax administration and internal management) portfolio.

Question. I am very supportive—as have the House and Senate Appropriations Committees—of the efforts made to advance Business Systems Modernization (BSM) by its systems integrator—the PRIME Alliance. In fact, it was this Subcommittee in the fiscal year 1997 Treasury Appropriations bill that set the whole BSM/PRIME concept in motion. I am concerned, however, about a couple of items and would like your review of several matters.

a. Currently, about $50 million are spent each year on Tier B projects that are designed to be the next generation of applications for certain IRS business units, yet these funds are not controlled by either BSM or the PRIME. I am concerned about the failure to make sure that the right hand and the left hand are not only coordinated, but marching in lock step with each other—something only settled by putting these funds under the control of BSM and the PRIME. Can you apprise the Subcommittee of your position on this concept and provide for us a detailed idea of how we guarantee the kind of program integration on IRS IT activities that are necessary for BSM to succeed?

Answer. The BSM Business Integration Office is responsible for ensuring that strategically linked Tier B projects are under the BSM governance structure. In this case the Sub-Executive Steering Committees have oversight responsibility for Strategic Tier B projects along with Tier A projects, thus insuring project integration. In addition each modernization project contains a Transition to Support Plan, which details Operations & Maintenance activities after the modernized system is deployed.

These investments are not as large, dramatic or far reaching as the BSM program. They are small-scale investments that provide bridge systems until modernization arrives or, in some cases, are the modernized end-state solutions. All investments or projects within this portfolio are selected through the IRS' integrated prioritization process. A major component of this prioritization and selection process is a thorough engineering analysis to ensure that the proposed systems are compliant with the modernized enterprise architecture and do not duplicate what is being developed by the BSM program. This engineering analysis also ensures that these projects will run on the modernized or BSM infrastructure. And, finally, the engineering analysis checks for duplication with legacy system enhancements.

In order to support continuation of modernization efforts the newly appointed Deputy Commissioner for Operations Support will supervise the CFO, CIO, the Chief Human Capital Officer, Agency Wide Shared Services and the Service's IT and physical security operations. The Deputy Commissioner for Operations Support will own the modernization program and drive productivity across the organization in order to improve service to taxpayers.

Question. b. I am also concerned that an increasing amount of the funds appropriated for BSM are not flowing through the PRIME Alliance. When Congress directed the IRS to initiate BSM in fiscal year 1997, we were emphatic that a private sector integrator needed to be brought in to do the job. Yet by bypassing the PRIME, and splintering BSM funds in multiple directions, it appears the IRS—in the wake of Commissioner Rossotti's departure—is trying to return to a position of itself being the systems integrator. That is at odds with the original Congressional intent for the program and President Bush's Management Agenda. What can you do to make sure that we let the private sector serve as the systems integrator for this program as was intended?

Answer. The table below was recently prepared for House Congressional testimony. It shows the total amount of obligated funds since we awarded the PRIME contract. Over the life of the contract the PRIME has received approximately 75 percent of all obligated BSM funds. During the last two full fiscal years, 2001 and 2002, the PRIME has received approximately 76 percent of the obligations each year. Because of the long Continuing Resolution and the recent approval of the revised fiscal year 2003 Business Systems Modernization Expenditure Plan, we do not yet have comparable fiscal year 2003 numbers available.

We do not believe that the numbers indicate that the share of funds going to PRIME has decreased significantly. It is not the intention of the IRS to move away from the Congressional intent of having the private sector serve as systems integrator for the BSM program.

PRIME CONTRACTOR AND OTHER IRS SUPPORT CONTRACTORS

	BSM	
	Obligated	Expended
PRIME	$771,031,696	$634,725,415
MITRE	52,801,406	49,440,693
Other	202,236,866	171,071,729
Total	1,026,069,968	855,237,837

APPENDIX I.—TECHNOLOGY REQUIREMENTS FOR EITC CAN BE CATEGORIZED BY PRE-FILING, FILING, AND POST-FILING ACTIVITIES [1]

System Component	Description
PRE-FILING TECHNOLOGY COMPONENTS	
CERTIFICATION DATABASE	Database containing certification status (entered during Filing); Database may contained imaged documents.
AUTOMATED INFORMATION SYSTEM	System for taxpayers to check certification status through multiple channels, including Internet, Phone (ACD/IVR), E-File terminal, etc.
FILING STATUS SYSTEM	System to build taxpayer profiles from historical data to identify Filing Status errors in post-filing in batch.
CHOICEPOINT SYSTEM	System to import and store third-party data (Choicepoint).
EITC UNDER REPORTER SYSTEM	System to analyze and access historical AUR information and identify taxpayer fitting certain criteria (i.e. repeater offenders).
EITC CONTACT CENTER/ACCTS MANAGEMENT.	Complete call center solution that allows CSRs to access all EITC information; DSTs; Ability to transfer calls to external contractor; Includes application to access imaged documents.
FILING TECHNOLOGY COMPONENTS	
EITC E-FILING SYSTEM	System that enables taxpayers to electronically submit certification documentation.
CERTIFICATION SYSTEM	System to capture certification information during processing; Includes OTA-like Decision Support Tools to aid in decisions; Provides certification status to end-users; allows for scanning, sending, and viewing of documents (16 M) to central location.

APPENDIX I.—TECHNOLOGY REQUIREMENTS FOR EITC CAN BE CATEGORIZED BY PRE-FILING, FILING, AND POST-FILING ACTIVITIES [1]—Continued

System Component	Description
FILING STATUS SYSTEM	System to capture new Filing Status information at time of processing.
MATCHING SYSTEM	System to match taxpayer reported information against information stored in databases to determine if filing requirements have been met.
TECHNOLOGY MODIFICATIONS	Master File and other systems modifications to separate and freeze only EITC portion of return (instead of freezing the entire return).
POST-FILING TECHNOLOGY COMPONENTS	
RISK-BASED COMPLIANCE SYSTEM	System to analyze and identify trends in non-compliance; This system will aid in compliance strategies and case selection (can leverage F&PC RBSS).
COMPLIANCE DATA SYSTEM	System that allows Tax Examiners to access multiple databases containing EITC information.
FILING STATUS COMPLIANCE SYSTEM	System to access and analyze filing status information (internal and third-party) and identify errors in batch at the time of filing; Includes automated case building and issue-based notice generation; Provides all relevant Filing Status information to Tax Examiner; Includes OTA-like Decision Support Tools.
AUR MODIFICATIONS	Systems changes to AUR that would allow EITC cases to be identified, analyzed, and worked separately from other AUR cases; Includes changes to AUR to include the expected change in EITC in the AUR dollar discrepancy.
SUPPORT SYSTEMS	
MIS	System that provides all management information requirements, including pre-filing, filing, and post-filing activities; Includes OTA-like Decision Support Tools.
WORKFORCE/INVENTORY MANAGEMENT SYSTEM.	System to predict and manage workload and inventory in pre-filing, filing, and post-filing activities; Includes OTA-like Decision Support Tools.

[1] System includes applications, database, infrastructure, maintenance, etc.; DST—Decision Support Tools.

SUBCOMMITTEE RECESS

Senator SHELBY. Thank you. Thanks for your appearance.

The subcommittee is in recess.

[Whereupon, at 2:50 p.m., Wednesday, April 9, the subcommittee was recessed, to reconvene subject to the call of the Chair.]