

DEPARTMENTS OF TRANSPORTATION, TREASURY AND GENERAL GOVERNMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2005

WEDNESDAY, APRIL 7, 2004

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

The subcommittee met at 10:17 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Richard C. Shelby (chairman) presiding.

Present: Senators Shelby and Reid.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENTS OF:

MARK O. EVERSON, COMMISSIONER

**PAMELA J. GARDINER, ACTING TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION, DEPARTMENT OF THE TREASURY**

Senator SHELBY. The subcommittee will come to order.

Good morning. I would like to welcome Internal Revenue Service (IRS) Commissioner Mark Everson and Pamela Gardiner, the Acting Treasury Inspector General for Tax Administration (TIGTA) to this morning's hearing. I look forward to hearing each of your views on the IRS's administration and enforcement of our Nation's tax code.

As we all know, the April 15th tax filing season deadline is rapidly approaching. Each year the subcommittee requests that the IRS Commissioner appear before it in order to provide an update on how the Service is responding to the influx of questions and assistance that taxpayers need to correctly file their tax returns. This year we have also asked TIGTA to participate in order to provide a different perspective on the IRS's performance.

I have taken note of the IRS's stated mission to provide America's taxpayers with top quality service by helping them to understand and meet their tax responsibilities, and by applying the tax law with integrity and fairness to all. This mission statement is appropriate, but some might question whether we are making progress toward achieving that goal.

The IRS continues to face numerous challenges in tax law enforcement, customer service, and the modernization of its computer systems. While some strides have been made in some areas, much

work remains to be completed. Each one of these tasks would prove difficult to undertake individually and to tackle all three at once is daunting indeed.

I look forward to discussing each of these areas with both of you. The strength and weakness of our Nation's Federal income tax system is its reliance on the voluntary compliance of American taxpayers. Most Americans make every effort to comply with the law and pay their taxes. But as with any law, some intentionally seek to avoid compliance or engage in outright fraud. That is why effective enforcement of our tax laws is so important. If enforcement is lax, ineffective, or uneven, it encourages more people to commit fraud.

IRS ENFORCEMENT FUNDING

While it is uncertain whether tax fraud is on the rise, I am certain that funding for the IRS tax enforcement has been and will continue to be an important priority for the administration and for the Congress. Over the past several years Congress has consistently increased funding for tax law enforcement, including a \$265 million increase this past year.

In each fiscal year since 2000, Congress provided the IRS with additional funding to increase its enforcement staff. Inexplicably, these staffing needs were not filled and the funds were instead used for other budgeted expenses. The use of these additional dollars to cover other funding shortfalls rather than increase staffing belies the priority the Service claims to place on enforcement. This diversion of funds is in direct contravention to your own statements, Mr. Commissioner, and is simply unacceptable.

The first and foremost mission of the IRS must be to ensure the full and fair compliance of all U.S. taxpayers with their tax obligations. Yet, how can we ensure that the IRS is taking its enforcement responsibilities seriously if we continue to allow the Service to spend its funding for purposes other than that for which they have been requested and for which Congress has provided them?

If there are administrative shortfalls caused by absorbing pay increases or diverting funds to other priorities and other unbudgeted items, then the IRS should ask for funding for these expenses and not hide behind claims of underfunding of initiatives such as customer service and enforcement. With 100,000 employees and an annual budget that exceeds \$10 billion, I find it hard to believe that the IRS lacks the resources it needs to get the job done.

I look forward to hearing both your comments and any update on how the IRS is utilizing the additional \$265 million in enforcement and compliance funding appropriated recently. In the long term, a strong enforcement capability supported by necessary funding will continue to be a key part of combating tax non-compliance. But enforcement alone will never be enough. The IRS must provide high-quality customer service to assist taxpayers. I believe that many people who fail to comply with the code do so unintentionally because of its difficulty and complexity. Accurate and timely guidance from the Service is imperative to ensuring taxpayer compliance.

The IRS is to be commended for the improvements it has made in customer service over the past few years. Helpful guidance is

now much more accessible by way of the Internet, telephone, and in-person assistance. The accessibility of e-file options has eased the burden of filing tax returns for both the Government and the taxpayer.

While the IRS has improved its responsiveness to taxpayer questions, the troubling fact remains that nearly one in four callers to its toll-free helpline receive inaccurate guidance. The numbers are only slightly better for online questioners and considerably worse for those taxpayers who seek in-person assistance in an IRS-operated taxpayer assistance center.

I was even more alarmed, Mr. Commissioner, after learning of TIGTA spot audit visits to 26 different assistance centers throughout the country that uncovered, "IRS employees incorrectly prepared 19 of 23 tax returns that they prepared," during the audits. How can we expect taxpayers to understand and comply with the complexities of the tax code when IRS's employees themselves have so much trouble understanding and explaining it?

Our Federal tax code is a large part of the problem. The code and accompanying regulations are more than 54,000 pages long, and are too complex, too confusing and costly to comply with. Comprehensive reform of the tax code itself would go a long way towards reducing tax fraud by making the process simpler and the system fairer for all taxpayers. Additionally, a less complex tax code would provide fewer opportunities for cheaters and reduce the paperwork burden for all taxpaying Americans.

I continue to believe that a simple and transparent tax structure would promote taxpayer compliance and lead to increased collections for the Treasury, while also markedly reducing the huge cost of administration and enforcement of our current tax system.

BUSINESS SYSTEMS MODERNIZATION

Now I would like to focus for just a few minutes on an area of particular concern to me, the ongoing effort to modernize the IRS computer systems, known as Business Systems Modernization (BSM). This effort has been ongoing for a number of years, and it has consistently run over schedule and over budget while also failing to achieve meaningful milestones for its development.

Mr. Commissioner, your budget request wisely seeks a decrease of \$102 million for BSM. I agree that now is an appropriate time to focus on reengineering efforts to achieve the goals set for the BSM initiative. This initiative was supposed to be completed in 10 years. However, I do not believe that anyone expects this schedule to be achievable as schedule delays continue to be the rule, not the exception, to this ongoing effort.

By way of example, the Customer Account Data Engine (CADE), the centerpiece of the entire BSM effort, was originally scheduled to roll-out in January of 2002, 2 years ago. Former Acting Commissioner Wenzel last year testified that CADE would be ready in August of 2003. It is now April 2004, and there is still no sign of CADE. True to form, CADE is not only late but significantly over budget. These schedule slippages and cost overruns have been epidemic. In fact, the IRS is running late and is over budget on all seven core projects related to BSM.

I am very concerned that BSM is becoming the 21st-century version of the Tax Systems Modernization (TSM) program which was abandoned after consuming \$4 billion of Federal tax dollars. That prior modernization effort was a complete loss. The current BSM effort began in 1998 and has already cost \$1.7 billion. This program, like TSM before it, raises more questions than it answers. As you noted, Commissioner Everson, in February of 2002, "good intentions and good beginnings are not the measure of success. What matters in the end is completion, performance, and results." Applying your own standard, Commissioner Everson, I think you will agree that the BSM effort has woefully under-performed.

I look forward to hearing the thoughts of both witnesses as to the best approach to take to keep this all-important modernization program on track. Again, I welcome you to the committee. Your written testimony will be made part of the record in its entirety, and Mr. Commissioner, we will start with you.

STATEMENT OF SENATOR HARRY REID

Senator REID. Excuse me, can I make a statement?

Senator SHELBY. Senator Reid. Excuse me.

Senator REID. I also feel at somewhat of a disadvantage. You are 6 foot 4 and I am just a small guy, and you have got a pad under your chair and I am here in this hole. It does not seem fair to me, Mr. Chairman.

Senator SHELBY. I do not think you would be at a disadvantage to anybody, Senator Reid.

Senator REID. I briefly want to just say this. I have a statement that is prepared and I do not want to take the time of the committee, but I would ask your permission that it be made part of the record.

Senator SHELBY. It will be made part of the record in its entirety and you may proceed as you wish.

Senator REID. Mr. Chairman, let me just say this. I hope that we can give the Commissioner of the Internal Revenue Service (IRS) the money that has been requested. I hope we do not have to cut that. I say that because we in Nevada have been faced with someone who has been indicted, and I think that is good, but he has promulgated falsehoods around the country saying you do not have to pay your taxes, and thousands of people have followed his lead. As a result of that, it is just one indication of why we have to have an Internal Revenue Service that has the manpower to collect the money that is due the government, because it places an unfair burden on those of us who pay their taxes fairly, if others are not.

PREPARED STATEMENT

Nobody likes to pay their taxes, but I would hope that we would give the Internal Revenue Service the tools they need to collect the taxes, and especially the tools to go after those people who are, like the person in Nevada, openly cheating. They do not have the manpower to do this adequately and I hope we can help them in that regard.

[The statement follows:]

PREPARED STATEMENT OF SENATOR HARRY REID

Mr. Chairman, I want to thank you for calling this important meeting to talk about one of the most serious challenges facing the Internal Revenue Service today—the mismatch between the resources devoted to the Service’s enforcement activities and the results that we in Congress and the public at large expect of it.

Back in his 1996 State of the Union address, President Clinton declared that the “era of big government is over.” Generally speaking, with the exception of homeland security and defense, that has continued to be the case. It’s a positive step to demand a more efficient, effective, and accountable government. Bloated and wasteful government is dangerous.

But there is also danger in not having enough government to perform critical services in a responsible fashion. Take the S&L Crisis as an example. Back in the 1980s and early 1990s, the pool of Federal bank regulators shrank dramatically in size, training, and experience. That was a material contributing factor in the savings and loan crisis that saw over a thousand S&Ls with over \$500 billion in assets fail. The Federal bailout of S&Ls eventually cost us \$124 billion. If we had employed a better-trained, more experienced, and larger team of examiners, we could have prevented that crisis at a miniscule fraction of what it eventually cost us.

I view the IRS’s enforcement budget in much the same way. It’s not that we’re attempting to avert a crisis here—it’s just that we have to make sure that the IRS has the tools it needs to conduct its important work effectively.

Nobody likes to pay their taxes, but taxes are necessary for our society to function. And the collection of those taxes should be efficient, accurate, and fair. Without an adequate staff and budget, the IRS can’t collect taxes efficiently, it can’t collect them accurately, and it can’t collect them fairly.

Since 1996, the number of IRS agents has fallen from just under 23,000 to 16,750, which is a decline of nearly a third. The number of taxpayers audited fell from 1.9 million to 849,000. Criminal cases against alleged tax offenders have fallen by about half, and civil cases have fallen by more than 60 percent.

Those numbers indicate that the IRS is experiencing difficulty carrying out its mission—collecting revenue. Last year, the IRS chose not to pursue \$16.5 billion of taxes owed on 2 million tax returns, mainly because of short-staffing. That represents 1.8 percent of the total individual and corporate income taxes expected for 2003. According to officials of the Service, many of these taxpayers would pay their bills if an agent simply called them.

The problem extends beyond the delinquent accounts. As was noted in yesterday’s USA Today, the Service estimates that it loses \$250 billion every year from taxpayers who cheat, fail to file, or abuse tax shelters. The lost revenue constitutes 10 percent of the Federal budget. That amounts to almost as much as we spend on Medicare!

When the IRS has a limited organizational capacity to go after this money—which is fairly owed—it means that the tax burden just got a little bit heavier on everyone who pays their taxes honestly. That’s not right.

Furthermore, especially at a time when the Federal budget deficit is \$500 billion, we should be ensuring that everyone pays in full.

Sometimes in our haste to create a smaller government, we settle for a considerably less efficient and productive government. That is unacceptable when it comes to the enforcement activities of the IRS, and I look forward to working with Commissioner Everson and his talented associates to ensure that they are equipped with the resources necessary to do their vital enforcement work.

Senator SHELBY. Thank you.

Senator REID. I am sorry to be here late.

PREPARED STATEMENT OF SENATOR PATTY MURRAY

Senator SHELBY. That is okay, Senator Reid.

Senator Murray has submitted a prepared statement which will also be included in the record.

[The statement follows:]

PREPARED STATEMENT OF SENATOR PATTY MURRAY

Thank you, Mr. Chairman. Over the past 3 years, our country has pursued a destructive and inequitable economic policy centered on providing tax cuts to the wealthiest Americans while restricting spending on programs that help all Americans. As a result, our Federal budget has gone from one of the greatest surpluses

in its history to the highest deficit ever known in the history of our country—\$478 billion—close to half a trillion dollars in the current fiscal year.

But if that sea of red ink is not bad enough, it is even more disturbing when you consider that a growing percentage of Americans believe that it is okay to avoid the taxes that they do owe the Federal Government.

Our IRS Commissioner, Mark Everson, is before the subcommittee today to report that the estimated tax gap, the difference between what the Nation's taxpayers actually owe versus the amount of actual tax receipts paid has grown to the level of \$255 billion.

In about 1 week from today, millions of American families who work hard every day and play by the rules will struggle to write a check to the Internal Revenue Service to cover their Federal tax liability while the rich and the super-rich in this country will pay an increasingly smaller percent of their income in taxes. If that isn't galling enough, the situation is made worse when you recognize that the Internal Revenue Service is very ill-equipped to catch and penalize those crooked Americans that do cheat on their taxes, especially the most wealthy and sophisticated of tax cheats.

Indeed, the IRS's own methods of prosecuting tax cheats and collecting old debts is so troubled that the Treasury Inspector General for Tax Administration recently reported that the IRS has failed to collect the taxes due even from dozens of individuals who have been convicted in court for tax evasion. This is an appalling situation where the government goes through the effort and expense of dragging these individuals into court and convicting them of cheating on their taxes. Even then, the IRS fails to collect the debts owed by these convicted criminals. This situation is unacceptable and it has got to change. The IRS must turn a corner and cease to be the laughing stock of the wealthy and super-wealthy tax cheaters in this country.

I am pleased to say that, today, the IRS Commissioner Mark Everson is here to testify on behalf of a budget that seeks to do something about the problem. He is asking for a 9.4 percent boost in funding for tax law enforcement, including funding for 2,942 additional enforcement agents. However, there are several questions that surround the Commissioner's request in this area that must be addressed in today's hearing.

The first question is: are the resources that the Commissioner is seeking enough to do the job? Recently, an oversight board appointed by the President said that the answer is "no." That oversight board pointed out that, absent even more resources beyond the level requested by the administration, the IRS will actually have to curtail some of its most critical enforcement and collection efforts.

A second question of equal importance is "will this subcommittee be in a position to fund the increased resources sought by the IRS?" Here, I believe that the Republican budget resolution adopted by the thinnest majority in the U.S. Senate indicates that the answer is "no."

At a time when the IRS is seeking a budget increase for tax law enforcement of 9.4 percent, the budget resolution adopted by the Senate, which I voted against, allows for an overall funding increase in discretionary spending of less than 1 percent. This is precisely one of the reasons that I voted against the budget resolution. That budget calls for continuing tax cuts to the wealthiest Americans while forcing difficult and illogical choices when it comes to Federal spending.

We know that when we provide for increased spending for the education of our young, we avoid even greater expenses down the road in job training, welfare payments, even the construction of new prisons. Similarly, if we can't fund enhanced enforcement in the Internal Revenue Service, our Federal budget will not gain the tax revenue that it is due and our deficit will be far worse. It is estimated that an increase in IRS enforcement efforts of several hundred million of dollars could yield billions in additional revenue that is owed to the government.

A third question that must be asked is whether the IRS can really do the job when it comes to hunting down and prosecuting tax cheats. The agency is working with very antiquated computer systems, and its efforts to modernize those computer systems have failed to produce promised results. Moreover, the President's Budget singles out these modernization efforts for a 26.5 percent funding cut for the coming fiscal year.

We have to recognize that it takes upwards of half a dozen years or longer for the IRS to finally pursue and prosecute individuals cheating on their taxes. We regularly have underpaid and overworked government lawyers going to court against handsomely paid private lawyers. Often times, those private lawyers are the very same lawyers that concocted the very complicated tax avoidance schemes that landed their client in court.

So, I hope our hearing will, at a minimum, pursue these three central questions that surround the Commissioner's request. I am glad that he is here to testify before

us. I should say that I believe his commitment to reversing the growing trend in tax avoidance and tax cheating is a sincere one and I look forward to hearing his testimony this morning.

Thank you, Mr. Chairman.

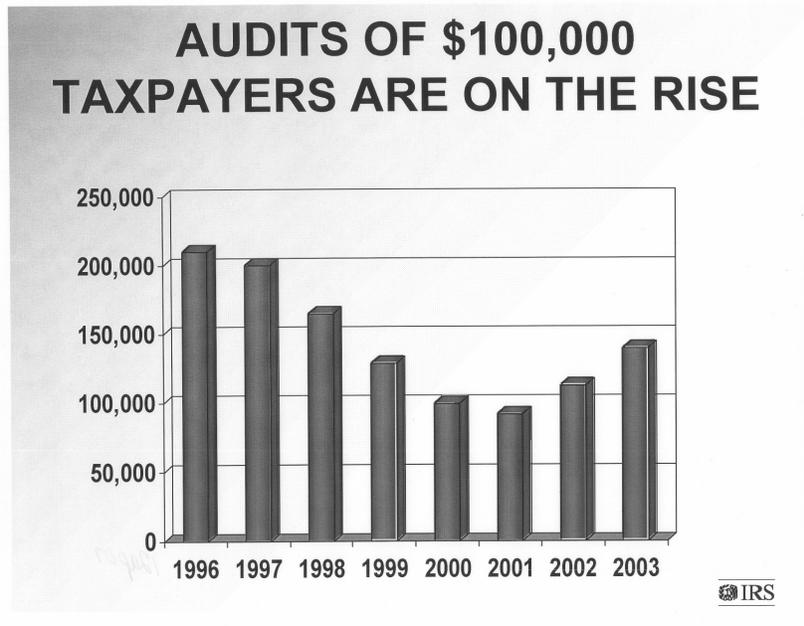
Senator SHELBY. Mr. Commissioner.

STATEMENT OF MARK W. EVERSON

Mr. EVERSON. Thank you, Mr. Chairman, Senator Reid. Nice to see you again. Thank you very much for your opening remarks. I am pleased to be here before the subcommittee today to speak about the President's 2005 budget request for the IRS. I would also like to welcome the future taxpayers behind me to this hearing.

Our working equation for the IRS is service plus enforcement equals compliance, not service or enforcement. The IRS must do both. We must run a balanced system of tax administration based on a foundation of taxpayer rights.

Last month we released our enforcement statistics for fiscal year 2003. They demonstrate that we have arrested the enforcement decline which began in the 1990s and worsened with the implementation of RRA 1998. Audits, criminal investigations and monies collected were all up. In particular, when compared with the fiscal year which started October 1, 2000, audits of taxpayers with incomes over \$100,000 were up by over 50 percent. That is taxpayer's income over \$100,000. You can see how badly over a period of years this declined, as did a lot of our audit rates. But you can see we have turned that around and we have given great prominence to this category in particular.



IRS ENFORCEMENT ACTIVITIES

The President's 2005 budget request for the IRS will continue to rebuild our enforcement activities. I would note that two-thirds of the new monies requested will be devoted to enforcing our compliance efforts in the areas of high income individuals, corporations, and criminal activities. The extra \$300 million in new monies that we seek will carry out our four objectives in enforcement. They are, discourage cheating and non-compliance, particularly by corporations, high income individuals and tax-exempt groups; help attorneys, accountants, and other professionals adhere to professional standards and obey the law; detect and deter domestic and offshore tax and financial criminal activity; and discourage and deter non-compliance within tax-exempt and government entities, and misuse of such entities by third parties for tax avoidance and other purposes.

ADDRESSING NON-COMPLIANCE

These incremental resources will help us address the tax gap, the difference between what is owed and what is paid due to non-filing, underreporting and underpayment, and secure billions of dollars for the Treasury. Furthermore, over a 4-year period we have seen an increase in the percentage of Americans who think it is okay to cheat on their taxes; an increase from 11 percent to 17 percent. I find this alarming, as I am sure do you. I believe, however, that enhanced enforcement efforts will improve attitudes concerning compliance by reassuring the average American who pays his or her taxes that when he or she pays neighbors and competitors will do the same.

Once we have hired and trained the new enforcement personnel as requested in the President's budget, this direct return on investment would be 6 to 1. That is the dollars we would get back directly. Beyond the incremental revenues associated with the increased audits, investigations, and collection activities there will also be a favorable spillover effect. Other taxpayers will be discouraged from cheating when they observe that those who play fast and loose with the tax code are being held accountable. Behaviors at the margin will change.

I am convinced we can augment our enforcement activities without diminishing our commitment to service. Our filing season results thus far in 2004 show that we can. Through last Friday, total returns filed have increased more than 1 percent. Our electronically filed returns are up 12 percent from last year. Electronic filing is more reliable both for the taxpayer and Service, and it is faster, allowing the IRS to issue refunds in half the time. Also noteworthy is that the Free File initiative, which helps low and middle-income taxpayers, has grown in volume by 23 percent from last year.

Our other service indicators for the most part also show improvement. We have handled increased call volumes with stable resources and bettered our level of service. There is increased usage of automated services both on the phone and the Internet. While we made some changes to improve tax law accuracy and had some

startup problems earlier in the season, in recent weeks our results in this area have recovered.

I want to assure you that should the Congress approve our budget request we will spend these resources wisely. I am aware of the problems in the past, particularly in the efforts to modernize information technology at the IRS. We are addressing our challenges in IT modernization and our plans in the 2005 budget take into account the necessity to improve as you indicated.

PREPARED STATEMENT

In conclusion, let me note with gratitude the strong bipartisan support the President's IRS budget request is getting here in the Senate. I was pleased by the letters of support from the leaders of the Governmental Affairs Committee to the Appropriations Committee as well as the letter from the Finance Committee to the Budget Committee. I think the tax administration can and should be a matter of broad bipartisan agreement.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF MARK W. EVERSON

INTRODUCTION

Chairman Shelby, Ranking Member Murray, and Members of the subcommittee, thank you for the opportunity to testify today on the fiscal year 2005 budget request for the Internal Revenue Service.

Our working equation at the IRS is service plus enforcement equals compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he or she owes.

This is not an issue of service OR enforcement, but service AND enforcement. As you know, IRS service lagged in the 1990's. In response, we took important and necessary steps to upgrade service—we significantly improved the answering of taxpayer telephone inquiries and electronic filing to name just a couple areas.

Unfortunately, improvement in service coincided with a drop in enforcement of the tax law. After 1996, the number of IRS revenue agents, officers, and criminal investigators dropped by over 25 percent.

We currently have a serious tax gap—the difference between what taxpayers are supposed to pay and what is actually paid—in this country. By our best estimates, we lose a quarter trillion dollars each year due to non-filing, under-reporting, and underpayment. (This is a rough estimate based largely upon data from our old Taxpayer Compliance Measurement Program, most of which was collected in the 1980's. Our estimates have been updated to reflect changes in the economy during the intervening years, but a key assumption is that compliance behavior has remained largely unchanged. If taxpayer compliance has changed in the last 15 years, the tax gap could well be much different than our estimate suggests.)

In addition, over the last 4 years, the number of Americans saying it is OK to cheat on taxes rose from 11 to 17 percent. Sixty percent of Americans believe that people are more likely to cheat on taxes and take a chance on being audited.

We must restore the balance between service and enforcement, but that will not come at the expense of continued improvements to taxpayer service. In recent years, we have begun to attack these declines by revitalizing our investigations, audits and prosecutions against those who do not pay their taxes. The President's fiscal year 2005 budget—if approved by Congress—will help with our efforts to boost enforcement while maintaining our levels of service. The submission requests an additional \$300 million for enforcement activities over the fiscal year 2004 consolidated appropriations level.

PRESIDENT'S FISCAL YEAR 2005 BUDGET SEEKS INCREASE IN ENFORCEMENT

The President has asked for an IRS fiscal year 2005 budget of \$10.674 billion, a 4.8 percent increase over the fiscal year 2004 consolidated appropriations level for the IRS.

This budget includes the goals of customer service, infrastructure/modernization and enforcement. After a period of declining enforcement resources, the IRS has stabilized and increased the amount of resources dedicated to enforcement.

This budget has an increase of \$300 million for a more vigorous enforcement of the tax laws. This strong commitment to tax administration will provide a significant augmentation of our enforcement resources.

The additional \$300 million will increase enforcement in several key ways:

- Discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individual taxpayers and other contributors to the tax gap;
- Assure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law;
- Detect and deter domestic and off-shored based tax and financial criminal activity;
- Discourage and deter non-compliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance or other unintended purposes.

Let me now provide more details on the broad categories of the budget request for the IRS.

PROCESSING, ASSISTANCE, AND MANAGEMENT

We are seeking \$4,148,403,000 for processing, assistance and management. This includes necessary expenses for pre-filing taxpayer assistance and education, filing and account services, shared services support, and general management and administration. Up to \$4.1 million of the \$4.1 billion total will be for the Tax Counseling for the Elderly Program and \$7.5 million of the total will be available for low-income taxpayer clinic grants.

The Processing, Assistance, and Management (PAM) appropriation handles all functions related to processing tax returns, including both manual and electronic submissions, and provides assistance and education to taxpayers to enable them to file accurate returns. The PAM appropriation issues refunds, maintains taxpayer accounts, and provides tax law assistance that includes tax law interpretation and rulings and agreements related to tax law issues. This appropriation is responsible for IRS personnel, facilities, and procurement services.

The IRS will continue to focus on pre-filing services and is requesting funding for taxpayer communication and education to help all taxpayers comply with tax laws and assume their fair share of the tax burden. Funding is being requested for resources to warn taxpayers of abusive tax schemes and improve compliance by preventing fraud and abuse. The IRS is redirecting funding to enhance customer service by reengineering processes to complement new technology and to develop an outreach strategy for the Child Tax Credit.

The IRS is reinvesting resources for filing and account services by providing funding for field assistance to reduce filing season details of compliance staff, funding the Business Master File workload increase, improving the level of telephone service to taxpayers, and updating processes to complement technology.

As part of the shared services program, the IRS will reinvest resources in new training and training delivery methods to develop and to improve expert consultative skills. This effort will significantly improve administrative and resource management decisions that will enhance delivery of compliance initiatives. Additional resource reinvestments will be used to defer rent annualization costs (based on partial year costs extrapolated annually for approved fiscal year 2003 space expansion projects) to fulfill the IRS's operational mission objectives. Shared services will implement HR Connect, the integrated Human Resources Management System over the next 2 years. This system will seamlessly link multiple Human Resource applications that should result in significant program efficiencies.

The OMB Program Assessment Rating Tool (PART) review of Submissions Processing recommends that IRS successfully implement the Modernized E-File IT projects. IRS is enabling e-file growth by increasing the numbers of returns eligible to be electronically filed. In fiscal year 2005, the IRS plans to complete the architecture and engineering analysis required to develop and deploy functionality, allowing taxpayers to electronically file Forms 1065, 990T, and 1041.

TAX LAW ENFORCEMENT

For enforcement, we are requesting \$4,564,350,000. This appropriation ensures IRS's ability to: provide equitable and appropriate enforcement of the tax laws, identify possible non-filers for examination, investigate violations of criminal statutes, support the Statistics of Income program, conduct research to identify compliance

issues and support the national effort to combat domestic and international terrorism.

The resources in the Tax Law Enforcement (TLE) Appropriation provide service to taxpayers after a return is filed and support activities such as research to identify compliance and tax administration problems, as well as tabulation and publication of statistics related to tax filing. In fiscal year 2001, Tax Law Enforcement was realigned and redefined as mandated by the Internal Revenue Restructuring and Reform Act of 1998 (RRA 98) to better serve the needs of taxpayers. The modernized IRS structure is similar to those widely used in the private sector: organized around customers' needs, in this case taxpayers. The IRS has set up four operating divisions to service the four major categories of taxpayers; Wage and Investment Income (W&I), Small Business and Self-Employed (SBSE), Tax Exempt and Government Entities (TEGE) and Large and Mid-Sized Business (LMSB). Each of these business units has substantial operations within the Tax Law Enforcement appropriation. The Criminal Investigation (CI) business unit investigates criminal violations of the Internal Revenue Code and also supports the national effort to combat terrorist financing by integrating CI special agents into the Joint Terrorism Task Forces and other anti-terrorism task forces. CI has the largest part of its operation within the Tax Law Enforcement appropriation.

The TLE appropriation is the primary source of funding for the compliance functions of the IRS, including: (1) automated, in-person and correspondence collection of delinquent taxpayer liabilities, (2) the matching of reporting documents with taxpayer returns, to insure reporting compliance, (3) face-to-face examination to determine taxpayers' correct income levels and corresponding tax liabilities, (4) service center support of the field examination function and correspondence with taxpayers regarding tax issues, (5) investigation of criminal violations of the tax laws, (6) processing of currency transaction reports over \$10,000, (7) tax litigation, (8) acting as an advocate to provide prompt resolution of taxpayer problems and (9) a general counsel function to offer legal advice and guidance to all components of the IRS.

I would specifically like to emphasize our continuing commitment to the administration's efforts to combat terrorism. The funding provided in the President's budget request will allow us to continue to make a significant contribution to this effort.

The functions in TLE are essential to accomplishing the primary goals of the Fiscal Year 2005 Budget Request. To accomplish this goal, the IRS must restore the strength of the compliance function. Staffing devoted to compliance and enforcement operations has declined in recent years. Annual growth in return filings and additional work related to RRA 98 have contributed to a steady decline in enforcement presence, audit coverage and case closures in front-line compliance programs.

The Fiscal Year 2004 Appropriations Act merged the Earned Income Tax Credit (EITC) Appropriation with the TLE Appropriation. The merge of EITC into the TLE appropriation will provide for customer service and public outreach programs, strengthened enforcement activities and enhanced research efforts to reduce over claims and erroneous filings associated with the Earned Income Tax Credit (EITC) compliance initiative.

Customer service for the EITC initiative includes dedicated toll-free telephone assistance, community-based tax preparation sites and a coordinated marketing and educational effort (including paid advertising and direct mailings) to assist low-income taxpayers in determining their eligibility for EITC. Improved compliance activities include increased staff and systemic improvements in submission processing, examination, and criminal investigation programs. Increased examination coverage, prior to issuance of refunds, reduces overpayments and encourages compliance in subsequent filing periods; in addition, post-refund correspondence audits by service center staff aid in the recovery of erroneous refunds. Criminal investigation activities target individuals and practitioners involved in fraudulent refund schemes and generate referrals of suspicious returns for follow-up examination. Examination staff assigned to district offices audit return preparers and may apply penalties for non-compliance with "due diligence requirements."

OMB Program Assessment Rating Tool (PART) observations concluded that the IRS does not work enough collection cases with its current resources, work processes and technology to ensure fair tax enforcement. Each year IRS fails to work billions of dollars worth of collection cases. Consequently, the Budget includes a legislative proposal to allow IRS to hire private collection contractors to assist the IRS in addressing a significant number of cases. In addition to the increased resources requested, the IRS is making internal process improvements, including: developing models to better identify high priority work, better use of the predictive dialer, realigning the workforce to core hours and creating a performance support tool to provide employees with technical guidance while handling calls. The PART review also determined that IRS financial management systems remain weak. In response, the

IRS plans to modernize its collection technology to improve effectiveness. New technology tools will be developed for collection employees (e.g., electronic Automated Collection System, contact recording, and desktop integration), which will improve program efficiency.

HEALTH INSURANCE TAX CREDIT ADMINISTRATION

We are requesting \$34,841,000 for expenses necessary to implement the health insurance tax credit included in the Trade Act of 2002. This appropriation provides operating funding to administer the advance payment feature of the Trade Adjustment Assistance health insurance tax credit program to assist dislocated workers with their health insurance premiums. The Trade Act of 2002 created the tax credit program and it became effective in August of 2003.

INFORMATION SYSTEMS

We are requesting \$1,641,768,000 for information systems. This appropriation is for necessary expenses of the Internal Revenue Service for information systems and telecommunications support, including developmental information systems and operational information systems.

It provides for IRS information systems operations and maintenance, investments to enhance or develop business applications for the IRS Business Units and staff support for the Service's Modernization program.

The appropriation includes staffing, telecommunications, hardware and software (including commercial-off-the-shelf), and contractual services. It also provides for Servicewide Information Systems (IS) operations, IRS staff costs for support and management of the Business Systems Modernization effort, and investments to support the information systems requirements of the IRS business units. It includes staffing, telecommunications, hardware and software (including commercial-off-the-shelf software), and contractual services.

Staffing in this activity develops and maintains the millions of lines of programming code supporting all aspects of the tax-processing pipeline as well as operating and administering the Service's hardware infrastructure mainframes, minicomputers, personal computers, networks, and a variety of management information systems.

In addition, the Information Systems "Tier B" modernization initiatives fund projects that modify or enhance existing IRS systems or processes, provide changes in systemic functionality, and establish bridges between current production systems and the new modernization architecture being developed as part of the Servicewide Business Systems Modernization efforts. Investment activities also include improvements or enhancements to business applications that support requirements unique to one of the IRS business units. These Tier B projects yield increased efficiency and allow the Service to progressively improve the quality of its interactions with the taxpaying public and its many other internal and external customers.

BUSINESS SYSTEMS MODERNIZATION

We are seeking \$285,000,000, for our Business Systems Modernization (BSM) efforts. This request is based upon the resizing efforts we began following the various internal and external reviews of BSM.

This appropriation provides for the planning and capital asset acquisition of information technology systems, including related contractual costs of such acquisition and contractual costs associated with operations authorized by 5 U.S.C. 3109, to modernize IRS's antiquated business systems.

The IRS collects \$1.7 trillion in revenues annually through an assortment of computer systems developed over a 40-year period. The IRS developed the most important systems that maintain all taxpayer records in the 1960's and 1970's. These outdated systems do not allow the IRS to meet today's taxpayer and business needs. Failure to modernize IRS's tax administration business systems will result in a significant increase in resources required to maintain legacy systems—systems that no longer efficiently or effectively serve America's taxpayers.

The BSM Appropriation provides for revamping business practices and acquiring new technology. The IRS is using a formal methodology to prioritize, approve, fund and evaluate its portfolio of BSM investments across the IRS Business Units and Modernization and Information Technology Services (MITS). This methodology enforces a documented, repeatable and measurable process for managing investments throughout their life cycle. The MITS Enterprise Governance (MEG) Committee, which includes the Chief Information Officer and other senior MITS executives, the Chief Financial Officer, and the heads of the Business Operating Divisions, approves investment decisions. This executive-level oversight ensures that products

and projects delivered under the Business Systems Modernization program are fully integrated into IRS Business Units. The Department of the Treasury Investment Review Board also reviews the BSM expenditure Plan once the IRS executive-level oversight board approves the investment decisions. The plan is then cleared through OMB and submitted through the Appropriations Committees.

The IRS has undergone an intensive servicewide portfolio prioritization effort, leading to a long-term modernization plan identifying selected modernization projects, a release sequence for each project, and estimated costs for each project. The effort is based on vision and strategy initiatives that created an enterprise-wide view, which unified the needs of the IRS Business Units. Fiscal year 2005 resources will fund the infrastructure, program management, and releases of business applications to support the successful delivery of a modernized tax administration system. More complete details are provided in the BSM Expenditure Plan.

A partial Fiscal Year 2004 BSM Expenditure Plan was submitted by the Department of Treasury for Congressional approval in January 2004, and the full-year revision incorporating current project information should be completed by this spring.

PROGRAM PERFORMANCE

The IRS expects to achieve the following levels of performance after attaining full performance of the requested fiscal year 2005 initiatives:

- Examine an additional 30,000 investor returns in the Small Business and Self-Employed (SB/SE) business unit and increase coverage of high-income taxpayers, generating an additional \$170 million in fiscal year 2006. SB/SE also anticipates closing an additional 50,000 taxpayer delinquent accounts, resulting in an estimated \$215 million in additional revenue.
- Hire and train over 2,000 new staff in the Examination, Collection and Document Matching programs. These increases will generate some \$2.8 billion in direct enforcement revenue through fiscal year 2007. Additional audits of investor returns and high-income taxpayers, together with 55,000 correspondence examinations, will yield more than \$1.0 billion during that same period. Collection closures will increase by 240,000 and taxpayer contacts through the Automated Underreporter Program by some 300,000 through fiscal year 2007—generating an additional \$1.8 billion.
- Increase the overall audit coverage rate in the Large and Mid-Sized (LMSB) business unit from 5.1 percent in fiscal year 2004 to 9.6 percent in fiscal year 2007 and increase projected return closures by 63 percent from 16,067 returns in fiscal year 2004 to 26,193 returns in fiscal year 2007. Enforcement revenue recommended for the 3 years fiscal year 2005 through fiscal year 2007 should increase by over \$3 billion.
- Complete 229 significant Corporate Fraud investigations through fiscal year 2007. Tax-related completed investigations will increase by approximately 20 percent over the fiscal year 2003 level by fiscal year 2007. In addition, CI is striving to reduce elapsed time on completed investigations by 30 percent from fiscal year 2002 levels.

IMPROVING SERVICE

We are improving service to the taxpayer. Let me give a broader picture of service and compliance, and how the President's budget will lead to more effective and fair collection of taxes.

It was not long ago that IRS service was not all that it should be—some would even say it was poor. In many areas the service level we provided, or more accurately stated, failed to provide, frustrated taxpayers in their effort to understand and comply with the tax law.

Regardless of the merits of some of the allegations directed against the IRS in the mid-1990's, there was a significant gap between the quality of service that the IRS was providing taxpayers and the quality of service that the public had a right to expect. This shortfall in services clearly warranted the fundamental improvements and reorganization established under RRA 98.

The reorganization of the IRS along customer lines of business and the other changes brought about by RRA 98 were, taken as a whole, sound reforms. The twin themes of the legislation were improvement of service and protection of taxpayer rights.

Through an almost single-minded focus on RRA 98 implementation, the IRS has demonstrated unmistakable progress in improving customer service and increasing its recognition of, and respect for, taxpayer rights. While we still aim to reach a higher level of customer service, our improvement and commitment with respect to these core goals is measurable.

Last year 53 million individuals filed their returns electronically. Thus far this year, nearly 1 week away from “tax day”, electronic filing is up again, by about 12 percent. Electronic filing is more reliable, both for the taxpayer and the IRS. And it is faster. Over three-quarters of Americans get refunds, and we issue the refund in about half the time when a taxpayer files electronically.

Another challenge in the 1990’s was getting through to the IRS at all. We now have a world-class telephone call routing system. A call is directed to the right person, someone who knows something about charitable contributions or IRA’s—whatever the subject may be—and the system balances workforce planning against predictable workload patterns to reduce waiting time. By 2003, overflows to the telephone system, such as busy signals—the crudest indication of service failure—decreased 99 percent from its worst performance of 400 million. We also reduced taxpayer call-waiting time by half since 2001, reduced the number of abandoned calls by half since 2002, and doubled the number of refund inquiries from our Spanish-speaking taxpayers.

Meanwhile, we have delivered other applications that provide tangible benefits to taxpayers and improve the efficiency and effectiveness of our tax administration system. They include:

- Where’s My Refund?/Where’s My Advance Child Tax Credit?, which gives taxpayers instant updates on the status of their tax refunds and advance child tax credits. Where’s My Refund? has provided almost 11 millions services and Where’s My Advance Child Tax Credit? has provided another 20 million services. By shifting a significant volume of customer demand to the Internet and automated telephone services, we have seen a measurable improvement in service for taxpayers who still need to talk with an IRS assistant.
- e-Services, which includes preparer tax identification number (TIN) applications with instant delivery, individual TIN matching for third party payers, on-line registration for electronic e-Services, and on-line initiation of the electronic originator application (currently released to a controlled segment of external users). I am pleased to announce that we recently made the first part of e-Services available on our public website. The remaining parts will come out over the next several months.
- Internet EIN, which permits small businesses to apply for, and receive, an Employer Identification Number on-line.
- HR Connect, which allows IRS users to perform many personnel actions on-line. This technological advance will enable the Service to redirect hundreds of positions to enforcement activities by the time it is fully deployed, which we have planned for October 2005.

Are we where we need to be on service? Not yet. As you know, I have been emphasizing enforcement, but I do not want this subcommittee or anyone to think the IRS will walk away from service. We still continue to maintain and improve service.

Our objectives for improved taxpayer service are three-fold:

- First, to improve and increase service options for the tax-paying public;
- Second, to facilitate participation in the tax system by all sectors of the public; and
- Third, to simplify the tax process.

These are service objectives that recognize the dynamics of a rapidly changing world, one in which the Internet will be the dominant communications tool. Yet we realize there will remain a wide range of computer and technological literacy among individual taxpayers, and we must not fail to provide the same level of service to all taxpayers regardless of their technological sophistication. Our objectives also recognize an America with an increasingly diverse population, and that diversity will create challenges for us as tax administrators. Nevertheless, we are confident that we can and will serve all American effectively.

Continued changes in traditional media will make it harder to cover the waterfront as we seek to educate taxpayers. Moreover, the complexity of our tax laws, along with the frequency of changes to these laws, is not only a challenge to taxpayers trying to comply with the tax laws, but a basis of cynicism about complying with the tax laws. The administration is committed to addressing this complexity. While it remains, we have an obligation to help taxpayers navigate these laws and make it as easy as possible for them to comply.

In a world increasingly impatient for prompt and reliable information and transaction processing, all of these factors pose significant challenges to the IRS as it strives to improve the level of service provided to the American taxpayer.

A good example of the challenges we will face is reconciling our desire to standardize our processes through electronic filing with the reality that some groups, such as immigrants and the elderly, will need different, targeted services. Electronic filing is important to the IRS and to taxpayers, but we cannot overemphasize it to

the detriment of services to taxpayer groups who will not utilize it. Addressing competing priorities on the service side of the IRS will not be easy, but we will work diligently to provide a balanced, effective program.

EFFECTIVE ENFORCEMENT

Our focus on the strong mandate of RRA 98 to improve IRS services to the tax-paying public made it difficult for us to balance both the service and enforcement elements that are so necessary to the success of our tax system. Improved taxpayer service enhances compliance and respect for our laws among the vast majority of Americans who do their best to pay their fair share. Improved taxpayer service also may help discourage those who might not otherwise do what is necessary to comply with our tax laws. Taxpayer service, however, does not address those who actively seek to avoid paying their fair share. I believe most people would agree that we achieved improvement of IRS taxpayer services in large part at the expense of needed enforcement activities.

Over a 5-year period beginning in 1997, the IRS refocused its enforcement resources significantly. The number of revenue agents (those who conduct audits), the number of revenue officers (those who collect monies due), and the number of criminal investigators (those who prepare cases for possible prosecution by the Justice Department) each declined by over a quarter.

In essence, we did not observe the wise admonition of President John F. Kennedy that "Large continued avoidance of tax on the part of some has a steadily demoralizing effect on the compliance of others."

We are correcting our course and re-centering the agency. We are strengthening the IRS enforcement of the tax laws in a balanced, responsible fashion. And we will do so without compromising taxpayer rights. As the IRS enhances enforcement, we have four priorities:

First, we are working to discourage and deter non-compliance, with emphasis on corrosive activity by corporations and high-income individuals. Attacking abusive tax shelters is the centerpiece of this effort. What is at stake is greater than many billions of dollars of lost tax revenues. Our surveys indicate that 80 percent of Americans believe it is very important for the IRS to enforce the law as applied to corporations and high-income individuals. Enforcing compliance in these sectors is critical to maintaining Americans' faith that our system is fair. The abuses of recent years have to a very real degree strained the credibility of our tax administration system.

The IRS is moving aggressively to attack these transactions. Working with our partners in the Treasury Department, we have accelerated the issuance of guidance identifying abusive and potentially abusive transactions and improved disclosure requirements to provide greater transparency—sorely needed in today's complex world. And we have over 100 promoter audits underway, not to mention thousands of audits of high-income individuals and corporations who have entered into potentially abusive transactions. Where necessary, the Treasury Department, on behalf of the administration, has proposed legislation that would stop abusive transactions that we may not be able to fully or quickly address under existing law.

However, we need to do better. We need to do more, and we particularly need to do it faster. The length of time it takes us to complete the audit of a large, complex corporation is 5 years from the date the return is filed, which in most cases is already 8½ months after year end. And these figures don't include the appeals process, which runs another 2 years before the matter is settled or goes to court. That means that half of our current inventory of large cases is from the mid 1990's or the early 1990's. In today's rapidly changing world, we might as well be looking at transactions from the Civil War.

Simply stated, the IRS did not detect and deter the abusive transactions that spread during the 1990's on an adequate or timely basis because we did not have an informed view of current taxpayer behavior, only an historical understanding of events long past. And the challenge is becoming greater every day, as promoters of abusive tax transactions operate globally, without regard to national boundaries.

The lessons we have learned make it imperative to get current in our audits, to identify transactions and shorten the feedback loop so that abusive transactions can be shut down promptly. I am convinced we can do it. Technology will help. Right now it takes 2 years on average before complicated corporate returns find their way into the hands of the assigned examiner. We are addressing this issue. Electronic filing by corporations will facilitate our analysis of data and help us calibrate risk. Through speedier audits we will provide better service to the compliant taxpayer by resolving ambiguity earlier, and hold accountable those who seek to game the sys-

tem. And we are creating a web of disclosure, registration and maintenance of investor lists that will provide information about abusive transactions.

Second, we are working to ensure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law. In recent decades, with an accelerated slide in the 1990's, the model for accountants and attorneys changed. The focus shifted from independent audit and tax functions, premised on keeping the client out of trouble, to value creation and risk management. The tax shelter industry had a corrupting influence. It got so bad that in some instances blue-chip professionals actually treated compliance with the law—in this case IRS registration and list maintenance requirements—as a business decision. They weighed potential fees for promoting shelters but not following the law against the risk of IRS detection and the size of our penalties.

Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are honest and scrupulous, but even they suffered from the erosion of ethics by being subjected to untoward competitive pressures. The IRS is acting. We have augmented our Office of Professional Responsibility by doubling its size and appointing as its director a tough, no-nonsense, former prosecutor; we are tightening the regulatory scheme; and we are receiving excellent support from the Justice Department in our promoter and associated investigations. But we need the Congress to enact the tougher penalties proposed by the administration for those promoters who have not yet gotten the message.

Third, we must detect and deter domestic and offshore-based criminal tax activity, our traditional area of emphasis, and financial criminal activity. Our Criminal Investigation Division is a storied and proud law enforcement agency. Their expertise comprises not just criminal tax matters but other financial crimes. Our investigators are the best in law enforcement at tracking and documenting the flow of funds. In addition to our tax investigations, the IRS has over 100 agents assigned on an ongoing basis to support the President's Corporate Fraud Task Force. We will continue and intensify these important efforts.

Two factors account in significant part for America's great economic vigor and success. They are our pervasive culture of entrepreneurship, on the one hand, and the stability and transparency of our markets on the other. The reputation and attractiveness of our markets have been compromised by the scandals of recent years. The President's Corporate Fraud Task Force and the President and Congress with Sarbanes-Oxley have taken important steps to restore confidence. Through these three enforcement initiatives, the IRS will do its part so that sound tax administration contributes to public confidence in our economic system.

We have one more enforcement priority. The stakes for America in this area are also important. We will discourage and deter non-compliance within tax exempt and government entities, and the misuse of such entities by third parties for tax avoidance or other unintended purposes. Non-compliance involving tax-exempt entities is especially disturbing because it involves organizations that are supposed to be carrying out some special or beneficial public purpose. Enforcement in this area has suffered as IRS staffing in the exempt organizations area fell from 1996 through 2003. Enactment of the President's budget would allow us to gradually build up staffing in this important area and step up enforcement.

If we do not act to guarantee the integrity of our charities, there is a risk that Americans will lose faith in and reduce their support more broadly for charitable organizations, damaging a unique and vital part of our Nation's social fabric.

A case in point is credit-counseling agencies. These organizations have been granted tax-exempt status because they are supposed to be educating and assisting people who are experiencing credit or cash flow problems. Based on the information we have reviewed, we believe that a troubling number of these organizations, however, instead are operating for the benefit of insiders or in league with profit-making companies, such as loan companies, to generate income from lending to these distressed individuals and families. We are taking a close look at these organizations to ensure that they are operating within the bounds of the law.

It is, of course, imperative as we reinvigorate the enforcement program that IRS employees maintain their respect for and diligence to all taxpayer due process rights and protections.

We are making progress in our effort to reduce the annual tax gap. Our enforcement statistics for Fiscal 2003, released in early March, demonstrate that we have arrested the enforcement decline that began in the 1990's and worsened with the implementation of RRA 98. Audits, criminal investigations and monies collected were all up. In particular, the number of high-income taxpayer audits again increased by 24 percent. Moreover, audits of taxpayers with income over \$100,000 were up over 50 percent from 2 years ago. Overall audits of all taxpayers increased to 849,296, an increase of 14 percent from 2002.

BUSINESS SYSTEMS MODERNIZATION AT THE IRS

While not as publicly visible as service or enforcement, modernization of IRS information technology is also a high priority. This effort is often referred to as Business Systems Modernization or BSM. Most of our tax administration systems are very old and difficult to keep current with today's fast paced environment—they must be modernized.

We are committed to resizing our modernization efforts to allow greater management capacity and to focus on the most critical projects and initiatives. Last summer, we used comprehensive studies to help us identify opportunities to improve management, re-engineer business processes and implement some new systems and technology.

As I have noted, the IRS has made progress on applications such as improved telephone service, electronic filing, and a suite of e-services to tax practitioners. But we have failed thus far to deliver several important projects with which taxpayers are not directly involved.

The projects include replacing our master file system, implementing the on-line security features, and building the modernized technological infrastructure on which all of our future modernization applications will depend.

Four studies completed last year consistently identified the following problems in delivering the large information technology efforts:

- Insufficient participation in the technology program by IRS business units;
- An overly ambitious portfolio;
- Inadequate performance by the contractor.

The IRS is responding by to this challenge by:

- Increasing business unit ownership of projects;
- Resizing the project portfolio and reducing the modernization program from \$388 million this year to \$285 million in the President's fiscal year 2005 request;
- And revising our relationships with the contractor and ensuring joint accountability.

While we have much work to do on modernization, I can assure you that it is one of my top priorities as Commissioner. We need to put in place the foundation upon which the tax system will build and rely for decades to come.

Before I conclude my testimony, let me give you an update on the 2004 filing season and what we are doing to make the tax season easier and more convenient for the American taxpayer.

2004 FILING SEASON

Mr. Chairman, I have been on the job for not quite a year so I am still going through my first filing season. Each year at the IRS, we process billions of tax-related documents. We process well over 100 million taxpayer returns. We send out about 100 million refunds. And we do a lot of other things as well.

It all peaks, of course, on April 15, a little more than 1 week away.

Here are some highlights as of March 26th (unless otherwise indicated):

Return Receipts

The IRS has received 74 million total individual returns. Twenty-nine million returns (39 percent) are paper and 45 million (61 percent) are e-file.

—The number of online returns is at 10.5 million, a 22.9 percent increase from last year.

—Through March 24th, 2.6 million Free File returns have been accepted, an increase of 24 percent from last year (2.1 million).

Refunds

Refund measures continue to show an increase over 2003. Total refunds are up from 2003 by 3.9 percent. Total dollars paid are 9.26 percent higher than last year, with an average refund of \$2,113 paid.

Telephone Measures

As of March 28, assistor level of service, at 84.9 percent, is up 1.9 percent compared to last year. Assistors have answered approximately 729,000 more calls than they did during the same period in 2003.

Automated calls completed are 183,000 more than the same period in 2003. A major contributor to this increase is Advanced Child Tax Credit (ACTC) related calls.

We created automated ACTC applications for use in providing taxpayers the correct amount of ACTC to report on their 2003 tax return. These applications are available through telephone automation and interactive web applications.

Telephone Quality Rates

We measure telephone quality two ways: (1) customer account accuracy and (2) tax law accuracy. While our customer account accuracy estimates, as of February 29th are 89.76 percent, up 1.32 percent over the past year, our tax law accuracy has declined to 75.79 percent thus far in 2004 (down 6.69 percent from last year.)

Fiscal Year 2004 Quality Review results indicate that two of our most frequent tax law defects are: incomplete research and applying tax law incorrectly.

We are undertaking the following efforts to improve performance:

- Identifying root cause of performance deficiencies and implementing corrective initiatives through analysis;
- Establishing Quality Review Improvement Teams to determine the drivers of Customer Accuracy rates and to establish resolution priorities as needed; and
- Strengthening accountability to the frontline managerial level to facilitate improvement in services provided.

Taxpayer Assistance Centers (TAC's)

The number of taxpayers walking into a TAC for assistance has decreased as a result of streamlined services in the TAC's and initiatives to educate taxpayers on alternate methods of obtaining services generally requiring a face-to-face contact. The advent of technological advances in irs.gov services such as "Free File" and "Where's My Refund", and the accessibility of forms online have all contributed to the decline in the number of customers walking into a TAC.

CONCLUSION

The IRS has lagged behind, for reasons that are understandable, in tax enforcement. But that is changing. We will continue to improve service and respect taxpayer rights. But we will also enforce the law. We won't relax until taxpayers who are unwilling to pay their fair share see that that is not a worthwhile course to follow.

Mr. Chairman, the great majority of Americans honestly and accurately pay their taxes. Average Americans deserve to feel confident that, when they pay their taxes, their neighbors and competitors are doing the same.

The President's budget request will help us enforce the tax law more fairly and efficiently. I am most grateful for your support of increased enforcement, and I look forward to working with you on this important budget request.

Thank you very much. I'd be happy to take your questions.

Senator SHELBY. Ms. Gardiner.

STATEMENT OF PAMELA J. GARDINER

Ms. GARDINER. Chairman Shelby, I appreciate the opportunity to appear before you today to discuss the Internal Revenue Service's budget and the related tax administration challenges.

The IRS is critical to the functioning of our government. Each year the IRS collects over \$2 trillion, processes over 200 million tax returns, and issues nearly 100 million tax refunds. It provides service to millions of taxpayers by telephone, Internet and in person. Since the enactment of the IRS Restructuring and Reform Act of 1998, the IRS has made significant progress in identifying opportunities to improve its operations.

For example, this filing season the IRS indicated it had received 43 million e-filed returns as of March 19, 2004, an increase of over 11 percent. The IRS has also made progress in providing information to taxpayers via its website, IRS.gov. Taxpayers have visited this website billions of times to obtain information. Just this tax season, the IRS stated taxpayers had made nearly 10 million visits by the end of February to obtain refund information from the "Where's My Refund?" section on this site.

Even with this progress, the IRS faces significant challenges to meeting its mission. I will focus my remarks on two of these key challenges: systems modernization and customer service.

The IRS's systems modernization program is in the sixth year of its effort to upgrade and modernize IRS information technology and business systems. This is an extremely complex effort and is expected to take up to 15 years at a cost of at least \$7 billion. This program must be successful for IRS to reach its goals in customer service and tax compliance.

Since 1999 about \$1.5 billion has been appropriated and released for modernization. The Treasury Inspector General for Tax Administration (TIGTA) agrees with the IRS's recent moves to scale back its systems modernization efforts to focus on ensuring that the most critical systems are implemented. In fact TIGTA has recommended such reductions in the modernization projects in the past. Our concerns are based on the cost and schedule overruns in the modernization program, including significant delays in the most critical project, the Customer Account Data Engine (CADE). CADE will eventually replace the existing Master File of taxpayer accounts and will enable the implementation of other modernized systems.

We believe the IRS and the PRIME contractor must address the following modernization challenges to be successful: implement planned improvements in key management processes; manage the increasing complexity and risks of the modernization program; maintain continuity with experienced leadership; and ensure PRIME contractor performance and accountability.

Improving customer service has been a key focus at the IRS for the last few years. Taxpayers have several options from which to choose when they need assistance from the IRS. These options include toll-free telephone assistance, walk-in service at the taxpayer assistance centers, or TACs, and the IRS Internet website. Each of these systems potentially effects the taxpayer's ability and desire to voluntarily comply with the tax laws.

The IRS's toll-free telephone system is the contact method most taxpayers choose when seeking answers to tax law questions or trying to resolve tax account issues. Taxpayers called the IRS toll-free telephone system over 50 million times during the 2003 filing season. Access to the IRS's toll-free telephone system has significantly improved. In comparison to the prior filing season, for example, the level of service increased, more calls were answered, and fewer taxpayers abandoned their calls. We evaluated the toll-free system and found that 78 percent of taxpayers received accurate answers to their account questions, and 73 percent of taxpayers received accurate answers to their tax law questions.

The next most popular contact method is the taxpayer assistance centers which provide face-to-face assistance to taxpayers in meeting their filing and payment responsibilities. Significant improvements have occurred in the percentage of accurate answers to tax law questions that TAC employees provided to TIGTA auditors anonymously conducting visits during the past 2 years. IRS employees correctly answered 69 percent of the questions asked from July through December 2003, compared to only 57 percent during the same period in 2002.

Although the IRS website has received billions of visits from taxpayers, most do not submit questions. Early statistics indicated approximately 75,000 questions had been received this year. Our past

audit work indicated that over 80 percent of Internet questions were answered correctly.

PREPARED STATEMENT

In conclusion, I believe the improvements in the levels of service the IRS has provided to taxpayers are impressive. However, challenges continue in the modernization effort. It must succeed if IRS is going to operate at a level that taxpayers expect and are entitled to receive from their government.

I would be happy to answer any questions.
[The statement follows:]

PREPARED STATEMENT OF PAMELA J. GARDINER

Chairman Shelby, Ranking Member Murray, and distinguished Members of the subcommittee, I appreciate the opportunity to appear before you today to discuss the Internal Revenue Service's (IRS) budget, and the challenges the IRS continues to face in using its funds to improve the economy, efficiency, and effectiveness of tax administration.

The mission of the IRS is critical to the functioning of our government. Each year, the IRS processes over 200 million tax returns and collects over \$2 trillion. The IRS also issues nearly 100 million tax refunds, provides service to millions of taxpayers in person and via telephone calls and the internet, and applies complex tax laws to help ensure taxpayers meet their tax obligations.

E-filing provides significant benefits to both taxpayers and the IRS including quick acknowledgement to taxpayers that the IRS received their tax returns, more accurately processed tax returns, and faster refunds. In addition, the IRS estimates that the processing of an e-filed tax return compared to that of a paper tax return results in cost savings of approximately \$2.30¹ per tax return. Since the enactment of the IRS Restructuring and Reform Act of 1998 (RRA 98), the IRS has made significant progress in attracting taxpayers to e-file and continues to identify opportunities and create incentives for taxpayers to e-file. These efforts have resulted in individual taxpayers being able to electronically sign their tax returns, e-file their State tax returns with their Federal tax returns, pay their taxes using a credit card, e-file 99 percent of all tax forms, and e-file at no cost.² Furthermore, in an attempt to encourage paid preparers to submit tax returns electronically, the IRS offers specific support services and is in the process of providing incentives exclusive to e-file providers.³ These incentives include the ability to apply to become an e-file provider online, interact with the IRS by email, and obtain client transcripts online. This filing season, the IRS indicated it had received 43 million e-filed returns as of March 19—an increase of over 11 percent.

The IRS has also made progress in providing information to taxpayers via its internet website IRS.gov. Taxpayers have visited this website billions of times to obtain information. Just this tax season, the IRS stated taxpayers had made nearly 10 million visits by the end of February to obtain refund information from the "Where's My Refund?" application which is featured on this site. This is almost double the number received last year at this time.

Even with much progress, the IRS still faces significant challenges to meeting its mission. TIGTA has identified major management challenges in the following areas that could affect the IRS's ability to help taxpayers address their tax responsibilities:

- Systems Modernization.
- Tax Compliance Initiatives.
- Security of Employees, Facilities, and Information Systems.
- Integrating Performance and Financial Management.
- Complexity of the Tax Law.
- Providing Quality Customer Service Operations.
- Erroneous and Improper Payments.

¹ Cost savings relate to the costs saved to process a tax return and do not include Information Technology and Customer Service costs as the IRS is still in the process of computing these costs.

² This no cost e-filing option is the result of the IRS entering into an agreement with tax preparation software companies and is available for taxpayers that meet certain requirements.

³ E-file providers may be electronic return originators, transmitters, software developers, tax practitioners, and States.

- Processing Returns and Implementing Tax Law Changes During the Tax Filing Season.
- Taxpayer Protection and Rights.
- Human Capital.

Although each of these areas presents its own unique challenges, I have chosen to focus the remainder of my remarks on two of these key areas, Systems Modernization and Providing Quality Customer Service Operations.

SYSTEMS MODERNIZATION

The IRS's systems modernization program is in the sixth year of its effort to upgrade and modernize IRS information technology and business systems. It is expected that this program will take up to 15 years and cost at least \$7 billion to complete. The modernization program is an extremely complex effort, since many of the IRS's current business systems are a mixture of technologies that date back to the 1960's. While difficult, the program must nevertheless be successful if the IRS is to meet its goals and commitments of improving its customer service and tax compliance activities. To facilitate the success of its modernization efforts, the IRS hired the Computer Sciences Corporation as the PRIME contractor and integrator for the modernization program, and created the Business Systems Modernization Office to guide and oversee the work of the PRIME contractor. Through March 2004, the IRS has received approximately \$1.59 billion to support the systems modernization program, and the IRS plans to request an additional \$142 million for fiscal year 2004. Approximately \$285 million has been included in the fiscal year 2005 budget to further fund systems modernization efforts.

The Treasury Inspector General for Tax Administration (TIGTA) agrees with the IRS's recent moves to resize and scale back its systems modernization efforts to place additional focus on ensuring the most critical systems are implemented. In fact, TIGTA has been recommending such a reduction in the modernization projects based on the concerns we have raised with cost and schedule overruns in the modernization program. The IRS Commissioner recently launched a comprehensive review of the modernization program resulting in 21 recommendations for improvement. Many of those recommendations were similar to those made in TIGTA reports issued during the past 4 years.

Over the last 2 fiscal years,⁴ TIGTA cited four challenges that the IRS and the PRIME contractor must overcome to be successful:

- Implement planned improvements in key management processes and commit necessary resources to enable success.
- Manage the increasing complexity and risks of the modernization program.
- Maintain the continuity of strategic direction with experienced leadership.
- Ensure PRIME contractor performance and accountability are effectively managed.

The fourth challenge has recently become critical as oversight groups are starting to lose confidence in the PRIME contractor's ability to meet its commitments in modernizing the IRS's business systems and have raised concerns about future funding. In light of this concern, effective contract management, always difficult on a project of this magnitude, is becoming an increasingly important challenge that needs to be overcome.

The IRS has made progress in defining the management processes and capabilities needed to effectively acquire and implement information technology systems. For example, it has deployed the infrastructure system on which future modernized applications will run. Establishing this infrastructure is a necessary prerequisite to introducing the business applications that are intended to provide benefits to taxpayers and the IRS. The IRS also deployed several applications that have immediately produced taxpayer benefits. The "Where's My Refund" application, as described earlier, has assisted taxpayers with millions of online inquiries to obtain refund information. Other applications that have been implemented allow businesses and taxpayers to obtain employer identification numbers online, tax preparers to apply to become an electronic filer and obtain an identification number for use in filing clients' returns, and businesses to electronically file certain tax returns.

In response to concerns of TIGTA and others, the revised fiscal year 2003 modernization spending plan submitted in March 2003 focused the program on a smaller portfolio of existing key projects. Although the IRS expressed high confidence in

⁴Annual Assessment of the Business Systems Modernization Program (Reference Number 2003-20-208, dated September 2003). Annual Assessment of the Internal Revenue Service's Business Systems Modernization Program (Reference Number 2002-20-189, dated September 2002).

the practicality of the revised plan and assured the Congress that it could timely deliver the revised fiscal year 2003 project portfolio, all of the projects experienced schedule delays and most incurred significant cost increases from fiscal year 2002 estimates. Also, management decisions were made to delay some of the functionality that was originally planned for these systems until sometime in the future.

These schedule delays, cost increases, and delayed functionality occurred, in part, because modernization project teams did not always follow defined management and project development processes. The IRS and the PRIME contractor have particularly struggled to develop adequate cost and schedule estimation techniques. As a result, delivery schedules and cost estimates were very aggressive and overly optimistic.

Additionally, the IRS and the PRIME contractor had not fully implemented disciplined project testing processes and procedures. Testing processes have been substantially revised and refined based on lessons learned during the early testing efforts for modernization projects. However, TIGTA analyzed several key projects and found the project teams were not consistently following the established testing processes. We believe the inadequate implementation of the testing processes was the result of the modernization project teams attempting to meet overly optimistic project schedules.

While progress has been made in the IRS's modernization efforts, it did not achieve its goals for fiscal year 2003. This underachievement is disappointing considering that the expectations for the year were scaled back in hopes of being able to successfully deliver several key modernization projects.

The delays in implementing projects can clearly be seen in the most critical modernization project, the Customer Account Data Engine (CADE). CADE will eventually replace the existing Master File⁵ of taxpayer accounts, and will enable the implementation of other modernized systems that will improve customer service and compliance and allow the on-line posting and updating of taxpayer account and return data. Therefore, CADE will be the foundation for managing taxpayer accounts in the modernized IRS. The portion of CADE related to individual tax accounts will be incrementally deployed in five releases, each related to a specific taxpayer segment, over several years, as shown in the revised CADE release schedule below.

⁵The Master File is the IRS's database that stores various types of taxpayer account information and includes individual, business, and employee plans and exempt organizations data.

CADE RELEASE SCHEDULE

	Release One	Release Two	Release Three	Release Four	Release Five
Tax Return Types	1040EZ, Refund or Even balance.	1040EZ, 1040 Sch A, B, D, 1040A Sch 1, 3, with Refund or Even Balance. 1040, 1040A 1040EZ, Full Paid.	All 1040 Family and supporting forms, Refund or Full Paid, 1040A Sch 2, Refund or Balance Due. 1040ES Pmts.	All 1040 Family and supporting forms, Refund, Full Paid, and Balance Due. 941, 940, 720 Forms—Payroll, unemployment, and Excise returns for 1040 taxpayers.	All remaining individual tax returns.
Filing Status	Single	(Single, Married—Married once and no dependents). No open account issues	All (including Head of Household). No open account issues EITC	All	All.
Account Characteristics	No account issues (Open or Closed).	No open account issues	No open account issues EITC	No open account issues	All accounts not included in previous releases.
Est. Returns: ¹					
Original estimate	6 Million	29 Million	41 Million	34 Million	12 Million.
Revised June 2003	5 Million	33 Million	57 Million	20 Million	15 Million.
Est. Delivery:					
As of April 2000	January 2002	August 2002	July 2003	July 2004	July 2005.
As of March 2001	January 2002	January 2003	January 2004	January 2005	January 2006.
As of April 2003	August 2003	January 2005	TBD	TBD	TBD.
As of Jan. 2004	Rel 1.1 ² —August 2004	TBD	TBD	TBD	TBD.
	Rel 1.2/1.3—January 2005/January 2006.				

¹ Estimated tax returns (electronic and paper) are based on 1999 statistics.

² Release 1 has been divided up into three separate releases—1.1, 1.2, and 1.3.

CUSTOMER SERVICE

One of the Congress' principal objectives in enacting the RRA 98 was to mandate that the IRS do a better job of meeting the needs of its customers. In the RRA 98, the Congress directed the IRS to achieve a better balance between its post-filing enforcement efforts and pre-filing taxpayer assistance through education and service. To comply with this Congressional mandate, the IRS revised its mission statement to refocus its emphasis on helping taxpayers understand and meet their tax responsibilities. Additionally, the IRS has enhanced its focus on increasing the levels of electronic filing.

Taxpayers have several options from which to choose when they need assistance from the IRS. These options include toll-free telephone assistance, walk-in service at the Taxpayer Assistance Centers (TAC), and the IRS internet website IRS.gov. The effectiveness of each of these services potentially affects a taxpayer's ability and desire to voluntarily comply with the tax laws.

Toll-Free Telephone Assistance

The IRS's toll-free telephone system is the contact method most taxpayers choose when seeking answers to tax law questions or trying to resolve tax account-related issues. Taxpayers called the IRS toll-free telephone system over 50 million times during the 2003 Filing Season. The IRS's strategy for handling this significant customer demand is to direct those taxpayers with less complicated issues to its automated services (i.e., recorded information and interactive applications) and allow its Customer Service Representatives (CSR) to assist taxpayers with more difficult issues. However, during fiscal year 2003, over 26 million of the calls were from taxpayers who had questions about their accounts and who chose to speak with a CSR.

The TIGTA and others have raised continuing concerns about the IRS's ability to effectively meet the significant annual taxpayer demand for access to its toll-free telephone system. Over the past several years, the IRS has made many technological changes, as well as organizational and process changes, to its toll-free telephone system in an effort to provide taxpayers with better access and improve the quality of its service.

Many aspects of the taxpayer experience in accessing the IRS toll-free telephone system were significantly improved during the 2003 Filing Season. This improvement was reflected in the measures the IRS uses to gauge the performance of its toll-free telephone system. In comparison to the prior filing season, for example, the level of service increased, more calls were answered, and fewer taxpayers abandoned (i.e., hung up) their calls before receiving assistance. Further, taxpayers that called with account- or refund-related questions had shorter wait times to receive service, and taxpayers that called with account-related questions were more likely to receive assistance when they reached a CSR assigned to an account application.

Although taxpayer access to its toll-free telephone services improved, the IRS has opportunities to further enhance the taxpayer experience and reduce the costs of providing toll-free telephone services. A major improvement opportunity involves implementing enhancements to automated call routing solutions so that much of the need for call screeners can be reduced or eliminated. For the 2003 Filing Season, using screeners to manually route calls cost the IRS almost \$3.6 million in salaries and benefits that would not have been needed if the previously developed call routing solution had worked as planned. Another improvement opportunity involves reducing the high Assistor Availability levels⁶ that have existed for at least the past two filing seasons. The IRS had planned for a level of 5.5 percent in fiscal year 2003, but during the 2003 Filing Season, the rate was 11.2 percent, and had further increased to 12.15 percent through the end of June. We estimate that this cost the IRS nearly \$6.4 million in CSR salaries and benefits. Finally, the IRS needs a financial system that will accurately track its cost-per-call for various toll-free telephone services to provide management and key stakeholders sufficient information to make critical decisions.

The IRS receives calls from taxpayers with account issues and questions about various aspects of the tax law. During the 2003 Filing Season, we reviewed both account assistance and tax law assistance calls for professionalism, accuracy, and timeliness.

Account Assistance.—TIGTA evaluated the professionalism, accuracy, and timeliness of account assistance obtained through the Toll-Free program. From a judgmental sample of 191 calls monitored between April 21 and May 16, 2003, we

⁶Assistor Availability is the measure the IRS uses to calculate how long its CSR's are available to take calls when none are coming in for their specific applications. Achieving the optimum Assistor Availability level is critical for effective and efficient call site operations.

determined that CSR's treated taxpayers professionally for 99 percent of the calls and provided timely service for 83 percent of the calls. In addition, 78 percent of taxpayers received accurate answers to their account questions. Using a statistical sample during the same period we reviewed, the IRS reported rates of 100 and 97 percent, respectively, for professionalism and timeliness, and 88 percent for customer accuracy.

Tax Law Assistance.—TIGTA monitored a judgmental sample of 294 toll-free tax law calls between January 27 and March 13, 2003, and compared the results to records from an IRS statistically valid sample of 6,011 calls monitored during the same period. The 2 samples showed that CSR performance was professional and timely in 98 percent or more of the total number of calls monitored. Although our sample showed a customer accuracy rate of 73 percent as compared to the IRS' measured rate of 81 percent, the need for CSR's to fully probe the taxpayer for information was clearly evident as an ongoing issue requiring improvement in both of the samples taken. The primary reason incorrect responses were given was because CSR's were not effectively using the appropriate guidance. Without effective use of this guidance, CSR's are unable to fully understand the taxpayer's situation and may provide information that is incorrect or incomplete.

Taxpayer Assistance Centers

The primary emphasis of the TAC's is to provide face-to-face assistance to taxpayers in meeting their filing and payment responsibilities, including educating taxpayers, providing self-help, interpreting tax laws and regulations, securing forms, resolving notices, and providing needs-based complimentary tax return preparation. The IRS has over 400 TAC's that served over 8.5 million taxpayers in fiscal year 2003.

Significant improvements have occurred in the percentage of accurate answers to tax law questions TIGTA auditors asked when anonymously conducting site visits to TAC's during the past 2 years. IRS employees correctly answered 69 percent of the questions asked and incorrectly referred only 2 percent to publications from July through December 2003, compared to correctly answering only 57 percent of the questions asked and incorrectly referring 12 percent to publications from July through December 2002. TIGTA commends the IRS for the improvements it has made in this level of accuracy.

Auditors also had positive experiences when they visited the TAC's. IRS employees were professional and courteous in 97 percent of the 194 TIGTA site visits to 105 TAC's. Wait time for service was 1 hour or less for 99 percent of the visits. In addition, 85 (81 percent) of the TAC's visited by our auditors had office hours listed on the IRS internet website IRS.gov, which matched the hours posted at the TAC's.

Although improvements have occurred in accuracy of responses to taxpayer questions, the accuracy of tax return preparation at the TAC's needs improvement. Complimentary tax return preparation and electronic filing is provided to those taxpayers whose returns meet certain requirements and limitations. For Tax Year 2002, IRS employees at the TAC's prepared 293,242 tax returns that involved refunds and tax liabilities totaling approximately \$330 million and \$6 million, respectively.

Returns prepared at the TAC sites, however, are often inaccurate. From February through April 2003, TIGTA auditors made 34 anonymous visits to 26 TAC's nationwide in an attempt to have a tax return prepared. IRS employees incorrectly prepared 19 of the 23 tax returns prepared during our visits. If these returns had been filed, the IRS would have inappropriately refunded \$32,000 and inappropriately withheld \$2,400 in tax refunds. IRS management has taken action to improve the accuracy of the tax returns prepared, and TIGTA has recommended additional actions to ensure taxpayers receive proper and accurate customer service when requesting assistance with tax return preparation.

Service to Taxpayers via the Internet

The use of the internet has increased dramatically. The latest statistics indicate that nearly 70 percent of the United States population are internet users. Since 1995, the IRS has administered a program to answer taxpayer questions submitted through its internet website IRS.gov. This program offers individual and business taxpayers an accessible and convenient alternative to using the telephone or visiting an IRS office to obtain answers to tax law questions. Taxpayers have the ability to submit tax law questions 24 hours a day, 7 days a week. The IRS provides responses to taxpayer questions via an e-mail message.

Past TIGTA testing indicated that the accuracy rate for the answers to the submitted questions was over 80 percent, which is higher than that received in TAC's or via the toll-free assistance telephone program. However, the IRS did not respond

to several of the questions TIGTA submitted anonymously to the program. Additionally, the number of questions submitted dropped from over 200,000 questions in the 2000 Filing Season to about 120,000 in the 2002 Filing Season. TIGTA encouraged management to provide clear instructions to taxpayers to help them locate the area to input tax questions on the internet website.

Statistics obtained from the IRS indicated that for the 2003 Filing Season, 146,369 questions were received from taxpayers (a 23 percent increase over the prior year). However, the average response time for each question increased from 2.4 days to 4.2 days. Thus far, for the 2004 Filing Season (through March 15, 2004), statistics indicate a reduction in the number of questions received—76,156 questions have been received (76 percent of the number received in the prior year during the same period) with an average response time of 3.6 days.

In closing, I would like to reiterate that the improvements in the levels of service the IRS has provided to taxpayers are impressive. The IRS has made great strides in enhancing the level of electronic filing, providing information via its internet website, and improving the accuracy and availability of toll-free telephone service. The early IRS filing season statistics indicate a rise in electronic filing and an increase in the use of some of the services available via the internet. However, significant challenges remain to be addressed as the IRS strives to modernize its systems and provide world-class customer service to America's taxpayers.

ACCURACY OF TAX RETURN PREPARATION

Senator SHELBY. I have a number of questions. The Treasury Inspector General for Tax Administration (TIGTA) reported that the IRS employees incorrectly prepared 19 of 23 tax returns during a spot check of 26 taxpayer assistance centers around the country. Ms. Gardiner, what recommendations do you have to ensure taxpayers receive proper and accurate customer service when requesting assistance in the preparation of a tax return?

Ms. GARDINER. The biggest problem that we see when mistakes are made, whether it is preparing tax returns or answering questions on the toll-free line or walk-in assistance, is that the IRS employees do not ask appropriate probing questions. For example, the earned income tax credit is a complicated law and there are so many different little pieces that make a difference in whether you qualify or not.

Senator SHELBY. I certainly would not be qualified—

Ms. GARDINER. A common problem is just simply the number of months that a child resides with the taxpayer that would determine whether they do or do not get the credit, and that is a common mistake.

Senator SHELBY. There is a problem of verification, too, is it not?

Ms. GARDINER. It is verification as well, but what we find is simply that they are not asking enough questions to get to the right answer.

IMPROVING THE ACCURACY OF RETURN PREPARATION

Senator SHELBY. Mr. Commissioner, what actions have you taken to improve the accuracy of tax returns prepared by the IRS personnel?

Mr. EVERSON. I think that as Ms. Gardiner has suggested, this is an area that needs our concern, and that is a relatively recent set of findings. We have had recent discussions—in fact, I think the issues here, Senator, extend beyond returns we prepare. As you may be aware, there are up to about 2 million returns that are prepared through volunteer organizations that work closely with the Service, to which people are referred and they may go visit one of these volunteer sites.

Senator SHELBY. How accurate are those returns?

Mr. EVERSON. I think we are seeing that there are some of the same issues. This comes back to what you spoke about, it comes back to the complexity of the code. That is a root cause here. I would just expand upon Ms. Gardiner's remarks, which I think hit it correctly. There are a couple things that are difficult here. One is the true desire of our employers or others to help. If they are sitting there with you and they think they understand the situation, they may fail to ask that next probing question. It is on a script that they are supposed to be using, but they have made an assumption, and they probably should not have made that assumption.

The way the scoring that TIGTA uses works and that we use works, sometimes it holds against them the fact they just have not asked that next question. Now, they may actually have been right but they did not fully follow the procedure, so there is a real risk that they have got the wrong answer. We need to keep working on our training. We are doing that. I think that this area—

Senator SHELBY. Does a lot of it go to training?

Mr. EVERSON. Training is it, and getting good scripts. The same thing applies to the tax law accuracy question where we made some changes earlier this filing season. Overall, our filing season results are excellent, but we did have a dip in tax law accuracy, and that was because we were making changes to actually get better. We were changing some of these scripts. They proved a little more difficult to use. And we were also having some people who worked in the account area, which Ms. Gardiner talked about, that is the area where you call in and you say, "I cannot remember what my payment ought to be," if you are on an installment plan, or "I got a notice from you," or a question like that. We were taking some of those folks and having them work in the tax law area. Getting them properly trained and up to speed took a little more time than we thought.

So this is an ongoing challenge. Whatever you can do to simplify the code, though, would really help us.

Ms. GARDINER. Yes.

Senator SHELBY. I have tried.

Mr. EVERSON. I know you have.

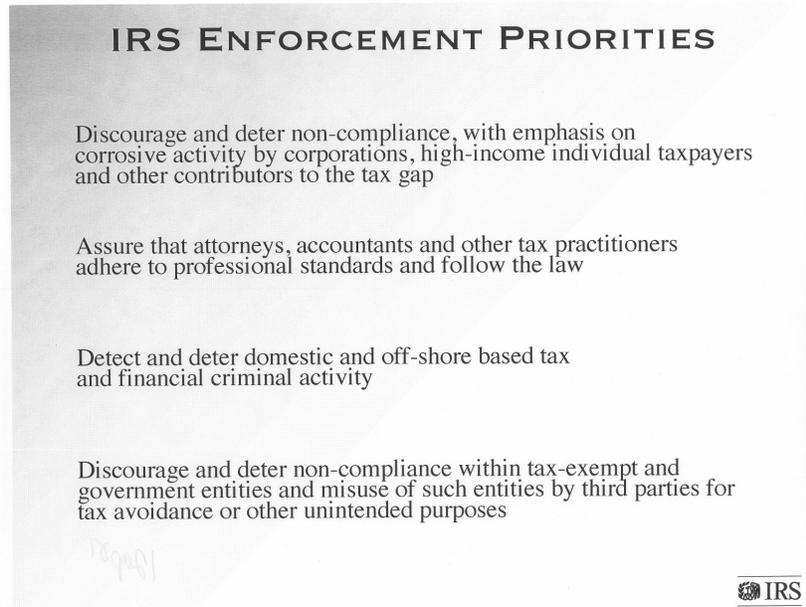
CORPORATE TAX SHELTERS

Senator SHELBY. Mr. Commissioner, I think we all know there have been a lot of abuse of tax shelters. We often hear of large corporations or high income taxpayers creating shelters that are obviously designed to avoid paying taxes. They do not have a real purpose, a business purpose, other than that. On top of that, these shelters are designed by a handful of attorneys, accountants, and tax practitioners whose standards and ethics are very, very questionable. You know this yourself. We have talked about it a little.

Does the budget request reflect your plan for attacking these corporate shelters and the few unprofessional individuals who created them? I think you have got to go to the heart of this.

Mr. EVERSON. Absolutely. If we could show the four enforcement priorities. We have very carefully constructed, through our plan-

ning process, four mutually reinforcing enforcement priorities. This issue is really at the heart of all four of these priorities.



ENFORCEMENT PRIORITIES

Senator SHELBY. Go over them.

Mr. EVERSON. The first is to discourage and deter non-compliance, with emphasis on the corrosive activities of corporations and high income individuals. That is the meat of the shelter question.

The second is to assure that—

Senator SHELBY. A lot of these people just exist to think of creative ways to beat the tax code, do they not?

Mr. EVERSON. That is the second point here: assure that attorneys and accountants and other tax practitioners adhere to professional standards and follow the law. If you could indulge me for just a minute. I started out my career at Arthur Andersen in the mid-1970s. The firm had one of the best reputations, and the standard of any Big Eight accounting firm was clear, any good law firm: you make sure that your clients follow the law. This all changed over a period of decades to become about value creation and risk management, and now you have interlocking networks of investment banks, accounting firms, law firms, commercial brokerages.

Senator SHELBY. Trying to beat the tax code?

Mr. EVERSON. They are working to do this. So this element of it is terribly important.

The third priority, augmenting our criminal investigations, gets to it too. Some of this gets to a criminal level. We have active criminal investigations, including against professionals, that will hold people to account.

Senator SHELBY. You have to do this, do you not?

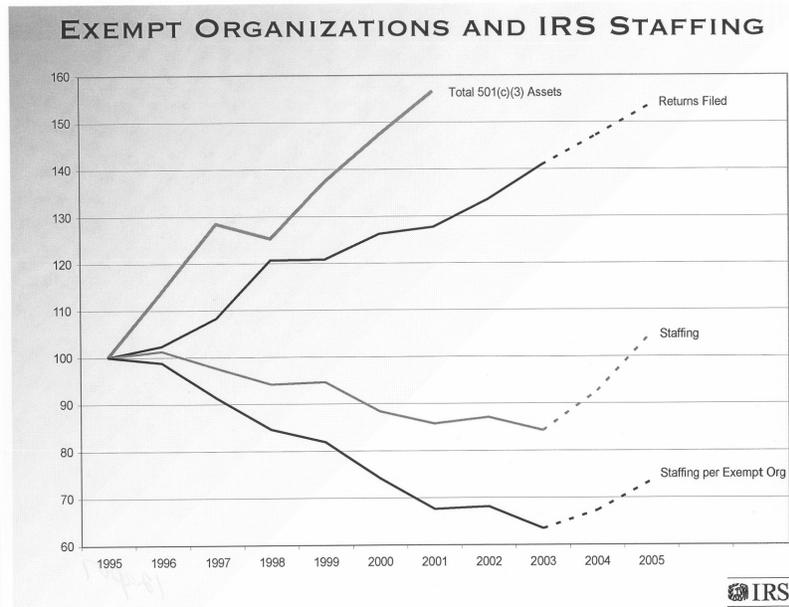
Mr. EVERSON. We have to. We are getting excellent support from the Department of Justice. They have litigated for the first time, as you may have seen, against law firms who have acted as promoters. They are not providing traditional advice to clients. They are acting as promoters of generic tax products that have had a corrupting influence on the practice of law and accounting.

IRS ENFORCEMENT PRIORITIES

Senator SHELBY. A lot of this advice has no real business purpose, does it?

Mr. EVERSON. That is exactly right. And it gets even to the fourth point here, which is about the abuse of tax-exempt entities. This is a very serious one, where we have seen some of these charities are being used. We just prohibited a transaction last week where people would take advantage of charitable organizations in order to actually promote a tax avoidance scheme. If I could just show you one chart as to the problem we have got ourselves into over a period of years, and then I want to address one thing you said in your statement.

Senator SHELBY. You go ahead.



IRS STAFFING

Mr. EVERSON. This green line, this is the growth over 6 years starting in 1995 in total assets of 501(c)(3) entities. This is the number of returns filed, together with some projections. This is what happened to the staffing at the IRS. What happened, basically, was we maintained—as you said, we kept working on service,

and that was good. We needed to do that. But the fallout in this was a dramatic decline across-the-board—but this is just the people working on tax-exempt groups. And if you adjust for this volume increase in terms of number of charitable entities, this shows you how far we are down.

This is bringing it back up. We brought it back up in 2004. What I wanted to say here, the only correction I would have, and I agree with your statement, is that in 2004 after I got here, the first thing I did was direct my two deputies to make sure that as we dealt with funding shortfalls we did not just take it out of enforcement. We stopped that last year, so that the fiscal year we are in now, we do have the enforcement increment the President and you want us to follow.

But this just shows, we are bringing this back. This is a terribly important area because of what you just said. It is also terribly important because of abuses, the credit counseling industry—

Senator SHELBY. How much money are we talking about in abuses, in your judgment?

Mr. EVERSON. In this area, in tax-exempt entities I would not have a precise figure but what I would tell you, let me give you—

Senator SHELBY. Could you furnish something for the record?

[The information follows:]

We do not have data with which to provide a precise answer. Lost revenues would generally result from tax-exempt organizations that are not operating in accordance with their exempt status, and therefore should be subject to tax. The market segment studies we are currently undertaking will enable us to better estimate revenue losses in particular segments or industries, but will not provide data that can be extended to exempt organizations generally.

Mr. EVERSON. Let me tell you one statistic on this. There is a \$1 billion credit counseling industry that is operating as not-for-profit, calling around to people, taking advantage of the fact that they are exempted from the do-not-call list because they are a charity, taking advantage of the fact that they are not regulated by your State or others for consumer protection laws. They are preying, many of these entities are preying on good average Americans who have found themselves in trouble with debts, and they are no longer providing counseling and educational services, which is their mission under tax-exempt status.

So we are going after them. We may very well lift some of the tax exemptions, and I believe there may very well be criminal referrals on some of these entities.

Senator SHELBY. That is what you ought to do.

Mr. EVERSON. This is all what needs to be done. To get back to your statement, I want to give you my personal commitment that as we go forward—I am obviously asking for the President's full request. I am not asking for a penny more, but I am asking for the full request. I want to be crystal clear with you and your colleagues that we will protect that enforcement build and be very responsible at addressing shortfalls, should there be across-the-board rescissions and things like there have been in the past, or other gaps.

Senator SHELBY. You have got to have the money to do your job. What percentage, and you might want to furnish this for the record, of 501(c)(3) tax-exempt groups are abusing their status?

Mr. EVERSON. That is a very difficult question, and I would tell you, we have fallen so far behind—

Senator SHELBY. A lot of them are very clean, very straight-up.

Mr. EVERSON. Yes. Most of them are. What is really at stake here, Senator, is that Americans could lose faith in the integrity of charities and stop supporting our charitable institutions, which are so important to our way of life.

[The information follows:]

Currently, we do not have data that would yield a meaningful statistic. The 501(c) exempt organization community is made up of many different kinds of charities and other exempt organizations, with diverse activities and needs and correspondingly diverse compliance challenges. To address this diversity, we have divided the exempt organization community into several dozen market segments, and in fiscal year 2002 we began to conduct market segment studies. To date, we have begun studies looking at labor unions, business leagues, social clubs, community trusts, hospitals, colleges and universities, social services organizations, religious organizations (other than churches), private foundations, 509(a)(3) supporting organizations, fraternal organizations, elder housing organizations, arts & humanities organizations, as well as others. Although the results of these studies will allow us to make generalizations about compliance levels in particular segments or industries, we do not expect that they will allow us to make generalizations about the percentage of organizations that are not operating in accordance with their tax-exempt status.

Recently, we have devoted more of our limited resources to enforcement areas with known or suspected compliance problems, such as donor advised funds, credit counseling organizations, excessive compensation issues, and others. Although we will continue with market segment studies, we anticipate that fewer resources will be devoted to new studies as we increasingly concentrate on existing areas of non-compliance.

EARNED INCOME TAX CREDIT

Senator SHELBY. Absolutely.

Let us now focus on the earned income tax credit. As we all know, there is an estimated \$8 billion to \$10 billion of annual fraud. This is a lot of money. We were talking about \$1 billion a minute ago, or \$260 million, which is still a lot of money. But there is an estimated \$8 billion to \$10 billion dollars of annual fraud that occurs in the earned income tax credit program. What is the IRS doing currently to crack down on this? What is the status of your five-point initiative to improve the administration of the earned income tax credit (EITC)? And how and when does the IRS plan to determine whether the earned income tax credit pilot initiative, including the qualifying child certification filing status and income report, will be a success? Because we know a lot of people who receive the benefit do not abuse it. But we also know that there is a high rate of erroneous payments to people who should not receive it. It looks like it is a question of correlating information before you pay out, if you are double paying in areas. Do you want to respond?

Mr. EVERSON. Certainly, Senator.

Senator SHELBY. This is important.

Mr. EVERSON. It is very important. We want to make sure that everybody who qualifies for this program takes advantage of this program. That is our first objective. But the second one is, we want to, obviously, make sure that we are not paying out monies to people who legitimately do not qualify. As was indicated before, Ms. Gardiner indicated, there is some complexity in the program, so I would not want anybody to draw the impression that it is all fraud in there.

Senator SHELBY. No, it is not all fraud, but there is a lot of fraud.

Mr. EVERSON. There is a legitimate error rate that accounts for a good chunk of what you talked about. Our studies have indicated an error rate somewhere between 25 and 30 percent, which is the highest in government.

Let me draw the distinction, because your statement made reference to some things I said in my prior life over at OMB and this is something I looked at when we were there. The difference between this program and food stamps, or housing subsidies, is there is no front-end application process. In a lot of benefits programs, the government, either the Federal Government or a State entity, or somebody is going through an application process to determine whether you or I qualify for a benefit. That does not exist in the EITC. It is treated like it is embedded in the tax code. It is the largest means-tested program we have, so it is an odd animal.

Senator SHELBY. How much money, overall, is involved in the Earned Income Tax Credit?

Mr. EVERSON. Last year I believe it was about \$36 billion with about 21 million filers who took advantage of the program.

Senator SHELBY. A \$36 billion program and, say, 25 percent of it's more or less questionable?

Mr. EVERSON. Yes, 25 percent of it. So let me come back directly to your question. We do have the five-point program which is geared to hit those objectives, to help people participate, simplify forms. We are working on all that. We are bringing in a backlog of the old audits. The core of this though is this certification pilot. Right now we have got a certification—

EARNED INCOME TAX CREDIT CERTIFICATION PILOT

Senator SHELBY. How does that work?

Mr. EVERSON. We are asking people to demonstrate their eligibility this year at the time that they are filing for the credit, rather than getting—if they were in a high-risk category, rather than automatically getting their—

Senator SHELBY. Preapproval, in a sense?

Mr. EVERSON. It is not quite preapproval, but in lieu of getting their refund held. What would happen in the past is, they might go down a corridor where if their return looked suspect—I will give you an example where you typically might see a problem. You see the same address for a husband and wife, but they are filing as head of household and splitting their kids. That is not the right thing to do, obviously, because the presumption would be that since they are living together that it is one family. That would be something—and there are other indicators where you might end up holding the refund.

What we are doing here with this pilot group is we are looking, in a real-time basis, and asking them to complete the paperwork so that then their refund does not get held. I do not have the results for that yet. That is underway right now. My impression, and it is just an impression, is that so far, so good. But we are going to have an independent evaluation of this pilot done. We will not know until, I would tell you later in the summer, later in the year, how it has gone.

Senator SHELBY. Will you let us know how it is going?

Mr. EVERSON. Of course we will. We want to ramp this up, but only if we prove that it works and that it gets us a good answer, that it does not dampen the participation of those who qualify, and that it does the job that it is supposed to do, which is reduce the error rate.

ADDRESSING FRAUD AT ALL INCOME LEVELS

Senator SHELBY. But you can have fraud at the highest level, the richest people, and you can have big fraud, as you pointed out, in the Earned Income Tax Credit. It is our job to root it out in both places, is it not?

Mr. EVERSON. Absolutely correct. It is our job to run a balanced program. That is what I am seeking to do with this budget increase. But I do emphasize that where we start is at the high income and the corporate in the criminal area, because the basic sense of fairness of Americans is that the big guy should not get away with something here.

Senator SHELBY. Absolutely. And the little guy should not get away with it either.

Mr. EVERSON. We want everybody to be compliant.

Senator SHELBY. Both of them. Because you cannot have fraud by anybody, can you?

Mr. EVERSON. You cannot.

Senator SHELBY. Ms. Gardiner, what are your thoughts about the pilot and other initiatives in this area?

Ms. GARDINER. We have been looking at the pilot concept, the design of the original test, and it looked pretty good. We made some suggestions that in the early stages of planning for it, because they did not seem to have good measures on how they would determine whether the pilot was a success or not. They have improved that.

Senator SHELBY. Does the pilot relate to a software program that can correlate all this information?

Ms. GARDINER. No, it really is examining a sample of returns and related documentation, that would support the eligibility. So it is manual. The results could go into a database, of course.

Senator SHELBY. But this is a lot of money involved, as the Commissioner has pointed out, over time. There is a lot of money involved here in cheating. There is a lot of money involved in these fraudulent tax shelters, too.

Mr. EVERSON. Yes, sir.

Senator SHELBY. If you could cut down on both tremendously it would mean a lot of savings to the IRS. It would mean a lot more revenue, legitimate revenue coming in, would it not, sir?

TAX GAP

Mr. EVERSON. Senator, what you are getting to here is of great concern. It is what we call this tax gap. Our estimates are that this combination of non-filing, underreporting and underpayment is north of \$250 billion a year. Now that number is not very precise and that is because it is based on a model that was last updated in the late 1980s, and adjusted for changes in demographics and economics. We are just now doing the research, through a new series of more in-depth audits, that will give us a basis for updating that number.

My fear is that it might well be greater than the \$250 billion a year because of these shelters, the changes in behavior, and this change in compliance attitudes. So this is a serious problem, but anything that we do—and this is why I am so anxious to get the money—we help out on the deficit, we help out States, because when we get a dollar for the Federal Government, on average the blended rates across the country is that the States get 20 cents. So it is important everywhere.

Senator SHELBY. What are the current spending plans and changes the IRS has made to the Earned Income Tax Credit initiative as a result of the merger of appropriations with Tax Law Enforcement?

Mr. EVERSON. Last year we had an increase from the previous year in the EITC, and if you look at 2004 versus 2005, the spending actually goes down. It is not going to affect this program that we are talking about or our ability to do more audits, because we were making some one-time investments as we got ready to do these pilots and some of the other educational data requirements. So that number has gone down from about \$201 million in 2004, to, I believe, it is \$176 million. But it will not hurt our ability to move forward and do just what we were talking about.

FUEL TAX EVASION

Senator SHELBY. Mr. Commissioner, part of my duties as an appropriator of this subcommittee is transportation, as you know. Fuel tax fraud creates a drain on the Highway Trust Fund revenues which the Federal Highway Administration estimates could cost at least \$1 billion a year. In testimony before this subcommittee, the Secretary of the Department of Transportation, Secretary Mineta, stated that he was not satisfied with the IRS's effort to combat evasion of Federal motor fuel taxes.

Mr. Commissioner, does the IRS agree with the Federal Highway Administration's estimate of the loss; in other words, a loss of \$1 billion or more, from the fuel tax?

Mr. EVERSON. I have not looked at that specific number.

Senator SHELBY. Can you furnish that information?

Mr. EVERSON. I have no reason to challenge it. I understand that there is a legislative fix pending that would actually provide the Service more resources to go after this important area. When I was recently traveling, I went to a fuel depot, a tank farm, and saw the testing procedures we have. This is a big issue, and it comes down to fairness again. If the fellow who is running a gas station sees the guy across the corner mixing his fuels, he has got a competitive advantage that is not fair. So we need to do more. I am hopeful that the fix that I have talked about will get the extra agents to keep on this issue.

Senator SHELBY. Will that be a collaborative effort with the States?

Mr. EVERSON. I think that is more our own area. I could be wrong about that, but I believe—these are our folks that do the work themselves, and the fellows I met were just Service employees.

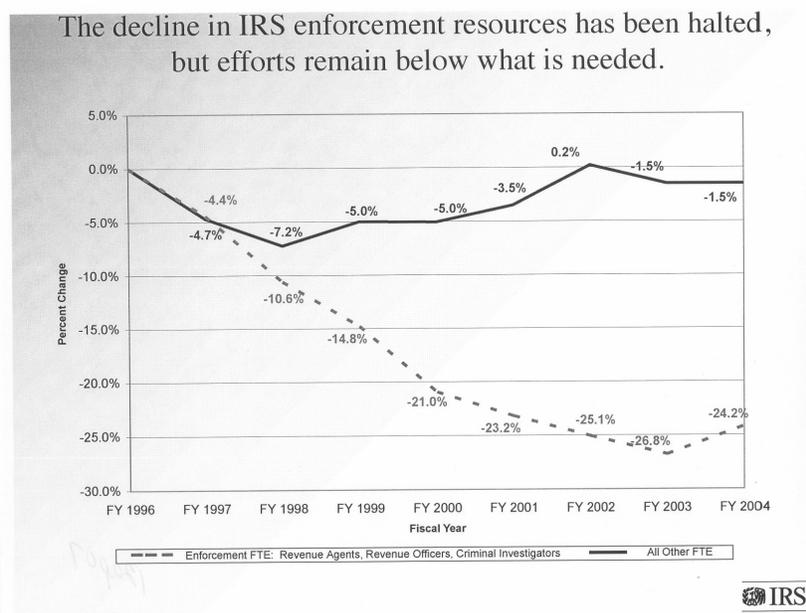
Senator SHELBY. It is still a lot of money involved.

Mr. EVERSON. It is a lot of money and it goes into, again, business fraud. We need to be attentive, not just to individuals, but to the businesses here.

WORKFORCE REALIGNMENT

Senator SHELBY. Mr. Commissioner, following the IRS's reform legislation of 1998, the IRS realigned significant levels of resources out of tax enforcement and compliance activities to customer service, telephone assistance, and submission processing activities. How do your fiscal 2005 realignment proposals and new funding initiatives compare to the pre-reform legislation levels for the tax enforcement and compliance programs?

Mr. EVERSON. Maybe I could show a chart on that.



This just shows you what happens. I am not quibbling with RRA 1998. I want to be clear about that. The reforms that were contemplated were necessary to improve services. We were not doing everything we needed to do on service. I want to be clear about that. But as the IRS worked in a single-minded fashion to improve services—these are our service and infrastructure personnel—it kept those resources stable and invested in phone services, restructured the agency, did a lot of things to get things better.

But what fell out was a decline in enforcement. This red dotted line represents FTEs as dollars turned into bodies for revenue agents, people who do audits, revenue officers, people who collect monies due, and criminal investigators. Over a period of time they fell by over a quarter.

Now we have turned that back in 2004, as I indicated to you, by absorbing some of the shortfalls in congressional spending. Last year, you know we ended up \$250 million short at the end of the

day, plus the pay raise, plus the child credit; a series of factors. But for the first time what we did was, for this year, forced an allocation of these cuts in a way that protected enforcement, the enforcement initiative.

We will bring this back further. There will be another several thousand FTEs that we will get through the 2005 increment and about 4,000 positions. So this will make a difference in 2005. It does not bring us all the way back.

Senator SHELBY. It is progress, though.

Mr. EVERSON. My commitment to the Secretary and to Josh Bolten at OMB is we will look at this on an ongoing basis to see that we run a balanced system. We are also improving our processes so that we get more leverage. You do not always have to have more money, but in this case we felt that we needed the money to improve our processes.

IRS SERVICE AND STAFFING LEVELS

Senator SHELBY. Mr. Commissioner, does your fiscal year 2005 request reflect a belief on your part that sufficient service and staffing levels have been achieved for the customer service and processing program areas?

Mr. EVERSON. As a general rule, I would suggest that I would like to continue to maintain and improve services with a relatively stable resource commitment on the service. We are near inflation, if you look at what we have got in the 2005 request. I think that is appropriate.

We need to challenge our people to get the same kind of productivity gains that you get in the private sector. That sometimes results in some painful adjustments in the workforce. You probably read of some of the actions we are taking. But I believe that it is difficult for me to come and ask you for money in this resource-starved environment, and time of deficits, if I have not done everything I can to run the agency efficiently. So we are asking our people to look at that productivity, and I think that we can continue to run our services and improve them at a relatively stable investment level.

TAX LAW ENFORCEMENT FUNDING

Senator SHELBY. Has the IRS invested all the resources appropriated by the Congress in recent years for tax law enforcement or have some of the new resources been reallocated to other areas?

Mr. EVERSON. No, this is what we were just saying. The standing rule until I got here was that when there was a shortfall you took it out of enforcement to protect services. I have reversed that.

Senator SHELBY. That would be a mistake.

Mr. EVERSON. I am not in the business of challenging the past. I am not sure there was a great deal of choice, given the overall environment and the absolute imperative to improve services. But, clearly, now we need to rebuild the enforcement side and that is what I have started to do in the last year and I am asking your support for going down the road.

Senator SHELBY. Mr. Commissioner, why has the IRS been unable, if this is true, to hire the revenue agents and revenue officers requested and funded in prior fiscal years? Is this about not com-

peting in the market? Is there not enough money to hire people? Are the salaries too low or what?

Mr. EVERSON. It has been, I would tell you, primarily a funding question. It is dependent, obviously, on the overall economy and the desirability of Federal employment. Right now we are doing very well, as we look at this enforcement build. We are very pleased with the caliber and the interest we are getting. We are doing some creative things.

Senator SHELBY. But you cannot do it overnight, can you?

Mr. EVERSON. You cannot. This is why it is so important to get strong, continued support from you and your colleagues because what the IRS did, it stopped and started on its hiring. You do not develop a relationship with a good university to draw in accountants if you are there once and then you do not come back for 7 years. You have got to be there every year, develop a reputation as a good employer and then you get good people.

Senator SHELBY. Continuity is important.

Mr. EVERSON. Continuity is important, and I think that we will be able to address demographics. The only other thing I would say on this is: in the group that works with our large and mid-size businesses, corporations over \$10 million in assets, for the first time we are hiring outside the IRS from mid-career people; folks who have been 10, 15 years at companies or accounting firms. This is a good, helpful thing too, because as you know, people in America, they do not tend to stay with the same employer for their whole career any more. Why shouldn't we in the government be able to take advantage of that a little bit too?

Senator SHELBY. I think you can and you are.

RETURN ON ENFORCEMENT INVESTMENT

What benefits does the IRS expect to derive from the additional \$300 million that you have requested for 2005 in tax law enforcement?

Mr. EVERSON. As we have looked at this, we think will get about a 6 to 1 return. That is a blended return in terms of the dollars that we are asking for. It will increase audit rates. Let me just give you one example.

We will increase the penetration on corporations, largely mid-size corporations where we are not very active, from 7 percent up to 13 percent. That is one area where we do not have adequate coverage, in my opinion, right now. This will get us more dollars, and it will also then have a derivative effect on behaviors.

Same thing, we are going to be adding 350 special agents, plus support staff, to go after the crooks. Across the board there will—the chart that I showed before, for the first time in many years we will be adding to our agents in the tax-exempt area so they can look at these charities that have problems.

Senator SHELBY. Ms. Gardiner, is the IRS headed in the right direction, and can the Service execute the plan to improve the tax law enforcement without jeopardizing advances in taxpayer service? In other words, how do you balance that?

Ms. GARDINER. I believe they are, because the areas in customer service where we find deficiencies rarely have anything to do with resources anymore. I would say several years ago that that was a

problem. But now the phones are being answered, there are people available, the wait times are less than an hour. So there are people available to provide the customer service, so I would agree with the Commissioner's conclusion that keeping a steady resource level there is appropriate.

On the flip side, with enforcement, clearly, the volume and complexity of returns is growing. Those resources have declined. I share the Commissioner's concern that the average American's perception has grown that you can cheat on your tax returns. That needs to be addressed, so I think it is the appropriate thing to increase enforcement.

RESOURCES FOR TAX ADMINISTRATION

Senator SHELBY. Mr. Commissioner, in recent testimony on Capitol Hill, you indicated that Congress has not provided you with the resources you need to meet your tax administration responsibilities. A review of your request by the subcommittee and independently confirmed by the General Accounting Office (GAO) shows that at least 98 percent, not all, but 98 percent, of the request has been funded. The GAO has estimated that even if this Subcommittee on Appropriations gives you every dime of your enforcement request, the IRS would have already spent at least one-third of any increase on unbudgeted expenses. Is this correct, or is the GAO wrong?

Mr. EVERSON. The figure that we have overall is that—you know this. We are not the kind of agency that gets topped up in the appropriations process. If you look back over a 10-year period, the average shortfall to the President's request, that could be President Bush or President Clinton, is about 3 percent. Now last year's shortfall was \$250 million. Now that has got a bunch of things in it. It has got things that you do here in the subcommittee or the full committee, and then it has got the overall, end-of-the-day rescissions that go across-the-board.

That gets compounded further by a gap. Seventy percent of our costs are in the pay area. So that if the administration proposes a civilian pay raise at one level and the Congress funds it more generously, then of course we do have an additional handicap.

What I would suggest to you, Senator, is I very much want 100 percent of the President's request. If we end up in a situation where there are issues like that I think it is reasonable for me to challenge my organization to find those levels.

What happens is, if you work to absorb 1 percent or 2 percent and then you get further whacked by another 2 percent or 3 percent, then it gets a lot harder to redress some of the problems you have got.

Senator SHELBY. To do your job.

Mr. EVERSON. To do the job, yes, sir.

COMMITMENT TO ENFORCEMENT FUNDING

Senator SHELBY. Mr. Commissioner, would you commit to this Subcommittee on Appropriations that any enforcement resources that we allocate to you will be used for the purpose it was appropriated for? In other words, for the enforcement initiatives which you have been pushing?

Mr. EVERSON. Yes, sir, I will. The only exception I would give you is that if this problem you just talked about was so severe that if I had to take cuts, I will take them. I commit to you that I will take them across-the-board. I would take them at the service side, infrastructure, and I might have to touch some of the enforcement base. But we will make this build, the new programs on enforcement, we will do.

DELINQUENT TAX INVENTORY

Senator SHELBY. Every year the IRS fails to collect billions in delinquent tax obligations. What headway will the IRS make in curbing the growing delinquent tax inventory that exists? Do you anticipate another large write-off of delinquent taxes as was the case last year?

Mr. EVERSON. Collections are an important element of this enforcement build. The revenue officers that I mentioned, those are the folks that actually go out and work to collect the dollars owed. We will add many collection officers through this.

The other thing you may be familiar with that is important to us, is pending legislation to get private collection agencies to do some of the work here. This is somewhat more controversial, but frankly, over 40 States have this, in terms of their own tax programs. We will run this with full protection of taxpayer rights.

Senator SHELBY. But collection agencies would help you collect money that is owed to the government.

Mr. EVERSON. Absolutely, and what it will enable us to do, sir, is focus on the more complicated matters, the ones—there was a hearing up here not too long ago on monies owed by defense contractors that we are not fully getting after. This initiative will enable us to work on things like that, if we have relatively more simple matters being attended to by some of the private collection agencies.

Senator SHELBY. Ms. Gardiner, has your office, the Treasury Inspector General for Tax Administration, reviewed the efforts of the IRS to collect outstanding tax debts? Would you comment on the proposal to improve the collection case management?

Ms. GARDINER. We actually did an audit some time ago of the original pilot for using outside contractors, and then we looked at what IRS was proposing in this newer effort and believe it is an appropriate effort. I would guess that if IRS is not going to get the money to collect it themselves then we do believe that using outside debt collection agencies is a good move.

Our only concern there would be that IRS still would need a sufficient level of staffing themselves to provide proper oversight, because it would be a little tricky in terms of just monitoring the accounts that are turned over to the private collection agencies, ensuring that they do the work appropriately, protect taxpayers' rights, and those issues.

WORKFORCE REALIGNMENT

Senator SHELBY. Mr. Commissioner, you announced a realignment of your workforce in January. You also expect savings from a related initiative to close some facilities, such as the Brookhaven

service center. How much do you expect to save from these cost-reduction efforts?

Mr. EVERSON. Through a variety of programs, Senator, we would expect to save over \$100 million on an annual basis. What these actions do is enable us to free up a couple thousand folks that would work on the enforcement side of the house. A lot of this is due to the tremendous success we have in electronic filing. As electronic filing increases—it was 53 million last year, up again 12 percent so far this year—you obviously do not need as many people opening the mail and doing the data entry.

At the same time what we are doing is consolidating some of our processing operations where after we realigned the Service around four lines of business, we did not fully realign all of the support efforts, which a business would have done. Some of this is consolidation of activities, administrative activities that businesses did 10 and 20 years ago. We are doing this because—I think, again, it goes back to our earlier dialogue—it is responsible that we be as efficient as possible.

Senator SHELBY. Ms. Gardiner, how likely are the anticipated savings the IRS is talking about to materialize?

Ms. GARDINER. Some things are tied to you just working smarter, not harder. The National Research Program is an example of that. As IRS can devote its resources, the limited resources in a smarter way, then they really should have savings. Modernization should bring about savings too.

For these particular efforts, we would have to look into them to see if the savings actually materialized.

TAX LAW ACCURACY

Senator SHELBY. The TIGTA testimony indicates that the telephone access rate for the IRS is steadily increasing. At the same time, the accuracy rate on tax law questions declined to 73 percent. Do you have a plan to bring that rate up? Does the telephone staff receive enough training? Are there specific questions that should not be answered by the telephone staff? How do you work all that?

Mr. EVERSON. This comes back, Senator, to the conversation we had a little while ago about how we are continually trying to improve tax law accuracy both at the phones and also for the walk-in centers. It comes down to training. We did some things, as I mentioned, earlier this year that we believe in the long term will actually increase the accuracy rate, but because of training some people who had been working on the accounts side of it, and rewriting the scripts, there was a short-term degradation and the accuracy went down about 6 percent.

Our figures are just a little bit different from TIGTA's, but they are basically consistent. They do show that decline. I think over time they will get better. We assess this on a weekly basis. We have real-time monitoring of conversations where supervisors are sitting in and listening randomly to the workers' calls. So we are continually trying to improve this.

But again, work on the simplification; it will help us too.

BUSINESS SYSTEMS MODERNIZATION

Senator SHELBY. On the subject of modernization, the Congress has appropriated approximately \$1.7 billion for the Business Systems Modernization (BSM) program. The IRS has requested an additional \$285 million in this year's fiscal year 2005 submission. This substantial investment is on top of almost \$4 billion we provided and was lost by BSM's predecessor, TSM. The investment in TSM was a total loss. That was before your time, I have to say that to both of you. After serving a year as Commissioner of the IRS, what is your assessment on the progress of BSM at this time?

Mr. EVERSON. This is a very important question. I established three themes, as I testified before the Finance Committee before my confirmation, and I continue to believe that they are the correct themes. They are to continue to improve service and implement the reorganization that former Commissioner Rossotti and his team did a splendid job on before I got here. They are to augment the enforcement efforts, as we have been discussing. But it is also to successfully execute the modernization of the IRS. That is fundamental to achieving the first two. We will not be able to continue to improve service and help taxpayers, we will not be able to enforce the law adequately, if we do not modernize the IRS. So it is terribly important.

After I arrived, we commissioned a series of studies last summer to look at this basket of projects. I would say to you that, first of all, it is not all bad news. I give the Service a mixed grade here. There are many successes. It is true, some of them have cost more than they should have. As a taxpayer, you can check the status of your refund on the Internet, and you can file electronically. Practitioners now can get employer identification numbers. There is a whole suite of products where I would suggest to you the IRS has improved its services to the taxpayer—I would be hard-pressed to find another government agency that has made the dramatic leaps that we have made largely through technology. So that is a lot of good news.

Where we have failed, though, is on these big ticket projects, like CADE that you discussed, that are at the core of our master files. Or also another one that you did not mention—

Senator SHELBY. We cannot afford to fail this time.

Mr. EVERSON. We cannot afford to fail. The other one was the financial system we have been struggling to put in.

These studies indicated three problems. The first was that the IRS business units did not have adequate ownership of the projects. They were running as independent technical solutions, so that the businesses were not involved in setting specifications or the testing and development schedules.

The second observation was we were trying to do too much. GAO had said this, and as we studied this I concurred with all those observations.

The third was that we were getting uneven performance from the vendor. We are working on each of these. We have got the business units much more involved. They are participating every step of the way. We have resized the portfolio, as you indicated. I am comfortable with this. It will provide more focus. I believe in the long

run we will actually get more done because as we change our work processes and hold people accountable to get things done, I think we will actually move faster.

We are working with the contractor. I meet with the president and chief operating officer of CSC—a big company, Computer Sciences Corporation runs the consortium—every month and we go over the deliverables. We will see. Later this summer we will have that long-delayed first step of CADE, which works on a section of the 1040EZ filers. The feedback I am getting is pretty optimistic at this stage. It is not done till it is done. And the same thing is true on the financial system. I will report back to you. We will know for sure what is happening here.

Just to close I would say, we have held the contractor accountable in a way that I would say is fairly unusual in government. I sent a letter after they missed their last deadline and I said, look, for the next big piece of work we are going to do, which is a filing and payment compliance system, we are going to not automatically award that to this PRIME alliance. We are going to open it up to competition. That is a strong statement, very strong statement because it hurts them financially, and I think it got their attention.

Senator SHELBY. When do you expect BSM to be completed?

Mr. EVERSON. I will have to get back to you on that. That is a big, complicated project.

Senator SHELBY. It is an important question.

Mr. EVERSON. It is important. I think we will have a much better idea as we adjust our programs here. If we are successful with CADE, this first section of CADE, I will tell you that in about a year we will have a better capability of giving you a longer term projection.

[The information follows:]

The hallmark application of the Business Systems Modernization Program (BSM) is the Customer Account Data Engine (CADE), which is the application we are building to eventually replace the existing Individual Master File (IMF) and the Business Master File (BMF). CADE is now in service and handling its first filing season. Currently CADE is only handling a subset of Form 1040EZ filers, with the expectation that it will process approximately 1.9 million returns this calendar year. Our plans for CADE are now set for the next 2 years, with the expectation that CADE will handle 33 million returns in calendar year 2007. It is not possible, however, for us to predict when CADE will be fully implemented, since timing is based on a variety of unknown factors, including BSM funding levels, insertion of new technology to improve development productivity on CADE, and policy decisions regarding the extent to which CADE will need to handle returns from prior years. As a point of comparison, former Commissioner Charles Rossotti stated that he expected BSM implementation to last 10 years. Progress anticipated in the first 4 years of the project, however, fell far short of our goals for reasons that we have publicly stated. In addition, we based that plan on extremely robust funding levels for fiscal year 2005 and fiscal year 2006. Because of steps we have taken to streamline and focus the work we are doing on BSM, we requested and received lower funding levels than Commissioner Rossotti anticipated when he provided his estimate.

Additionally, given the size and complexity of the IRS's IT assets, modernization must be an ongoing endeavor. Modernization programs at the IRS have been difficult, mainly due to the fact that we did not have a program of continual modernization of its IT assets. This deficiency has led to a situation of increasingly antiquated software applications that are not well documented, are difficult to maintain and upgrade, and are difficult with which to interface. Given that the heart of our IT efforts is to increase the effectiveness and efficiency of tax administration, modernization will always be an ongoing activity at the IRS.

RESOURCES NECESSARY TO COMPLETE MODERNIZATION

Senator SHELBY. Ms. Gardiner, I want to ask you a few of these questions since you are the Inspector General. How much more is needed to complete this effort to modernize the IRS's outdated systems and processes? And how is the IRS's 2005 budget request consistent with that vision?

Ms. GARDINER. As far as what is needed, the estimates are that it would be \$7 billion to complete the whole—

Senator SHELBY. Say it again.

Ms. GARDINER. Seven billion dollars to complete the whole effort, and those are the estimates.

Senator SHELBY. How many years?

Ms. GARDINER. A total of 15, and I believe that includes the 6 that have already passed.

Senator SHELBY. That is a continuous modernization.

Ms. GARDINER. Correct. Even with that, I am not sure that you will ever get to a point where you will say, okay, we are all done and we do not have to spend—you know, there will be upgrades and changes as time goes on.

Senator SHELBY. You will have to continue to do that to keep up.

Ms. GARDINER. But I agree with the Commissioner that getting CADE, the first release accomplished, that has to occur before you can make any projections on anything else.

Senator SHELBY. When do you think that will be?

Ms. GARDINER. I think everybody is giving it about 60 to 70 percent odds that the first part will be rolled out this year in August.

Senator SHELBY. What do you think? You said everybody.

Mr. EVERSON. I am interested in this answer.

Ms. GARDINER. Actually I could answer it for IFS. I am not as sure for CADE.

Senator SHELBY. Give me your best judgment.

Ms. GARDINER. It does appear that the testing and everything is going well. Certainly, the contractor is on notice that they need to do this. I would say it is probably a very good bet that in August they will be—

Senator SHELBY. Who is the main contractor here?

Ms. GARDINER. CSC is the one that is overseeing the whole effort.

Senator SHELBY. What about the total cost overruns so far on this project? Does that bother you, Ms. Gardiner? You are the Inspector General.

Ms. GARDINER. It does. We have been making recommendations for the past 2 years that we think have all been incorporated in these recent studies too, which is good, that it has validated what we have said and I think that that is getting the attention of Treasury and IRS and others. Some of the cost overruns were changing requirements. These projects are hard projects. They are totally new, and they are huge and complex. It would be one thing if you were just starting today to say, okay, let us create a master file. But the problem is they have to interface and talk to the old system. That is the biggest piece—

Senator SHELBY. Plus, you are doing business every day as you are doing this.

Ms. GARDINER. That is right.

Mr. EVERSON. Let me just expand, if I could, for a second on that last remark. This tie back to the legacy systems is very difficult because the IRS did a lousy job over a period of decades of keeping documentation of all the multitude of changes it made to the systems each year when the tax code would change. So when people have done the work, they developed a road map, but then all of a sudden when they get into doing the work they find it is much, much more complicated than they had contemplated. That, together with governance issues, too many changes in overall requirements, they all contributed to a very bad cocktail, I would suggest.

BSM COST OVERRUNS

Senator SHELBY. How much money are we talking about in overruns, hundreds of millions of dollars?

Ms. GARDINER. I would have to get back to you on that. We do know that information and we keep track of it.

[The information follows:]

Through BSM spend plans, the IRS requests funding for program level activities (e.g. MITRE Corporation assistance, PRIME Program Management Office, etc.) and modernization projects (e.g. Infrastructure Shared Services (ISS), Customer Account Data Engine (CADE), etc.). As of February 2002, we determined that 20 BSM projects had experienced costs increases of approximately \$75 million.¹

At the time of our analysis, the majority of the projects were in the planning phases. IRS officials responded that the reliability of costs estimates for the development and deployment phases would be much greater than that for the planning phases. This belief has not proven to be true. Most projects have now moved into the development and deployment phases and cost increases have risen, partially due to the fact that projects require more funds during the development and deployments phases.

The GAO testified in February 2004 that the IRS had experienced cost variances of approximately \$290 million for 10 completed or ongoing projects.² The chart below is reprinted from the most recent data available (GAO testimony).

Project Name	Cost Variance (In Thousands)	Reported/Revised Estimated Cost (In Thousands)
Completed Projects:		
Security and Technology Infrastructure Release 1	+ \$7,553	\$41,287
Customer Communications 2001	+ 5,310	46,420
Customer Relationship Management Exam	- 1,938	7,375
Human Resources Connect Release 1	+ 200	10,200
Internet Refund/Fact Of Filing	+ 12,923	26,432
Ongoing Projects (as of 09/30/2003):		
Modernized e-File	+ 17,057	46,303
e-Services	+ 86,236	130,281
CADE Release 1	+ 36,760	97,905
Integrated Financial System Release 1	+ 53,916	153,786
Custodial Accounting Project Release 1	+ 72,058	119,219
TOTAL	+ 290,075	.....

Senator SHELBY. Mr. Commissioner, we hold the American taxpayers to a high standard: file your return by April 15 or face stiff penalties and interest payments. Why should we not hold the IRS

¹ Analysis of Business Systems Modernization Cost, Schedule, and Functionality Performance (Reference Number 2003-20-007, dated October 2003).

² Business Systems Modernization: Internal Revenue Service Needs to Further Strengthen Program Management (GAO-04-438T, dated February 2004).

acquisition process and the Service's contractor to a similar standard and enforce penalties when deadlines are missed and costs are increased? Ms. Gardiner, what steps have been taken or would you recommend that the IRS take to improve acquisition and management and discipline?

Ms. GARDINER. We actually have suggested that disincentives, or penalties so to speak, are built into contracts and that has not been looked on that favorably by the Service.

Senator SHELBY. Who has not looked on it favorably? I know the contractors never look on it favorably.

Ms. GARDINER. IRS as well. The folks that do the contracting have not really accepted those types of recommendations. They have accepted another, and that is that we have recommended early on that IRS use firm fixed-price contracts as often as possible. When we looked at it in the first year they were used very infrequently, and now they are using them more. So that puts the burden on the contractor and we think that certainly is a step in the right direction.

Mr. EVERSON. If I could, the other thing I would note on this is—after the contractor missed this deadline on the financial system, I did take that action of saying, we will open this up to competition for the next enforcement module. That is a very strong action because they contemplated, they had built their—

Senator SHELBY. That is a strong message.

Mr. EVERSON. They built their business on a projection of how much work they were going to get over a period of years, and I just said, wait a minute, you have just potentially lost this piece of work. They can compete for it, but it is very different. I have run businesses, and when you have a 100 percent account, that is different than running an account where there are other players in there. So that is a strong statement.

I have also communicated that these upcoming deliverables for CADE and IFS are critical to the maintenance of our continued relationship. So I think the stakes are very clear at this point.

BSM MANAGEMENT

Senator SHELBY. Good. Mr. Commissioner, what is the IRS's plan and schedule for fully implementing and institutionalizing all management processes and controls needed to effectively manage the BSM program? I know that is a big job.

Mr. EVERSON. This goes back to the point a few minutes ago of first and foremost getting an overall business sensitivity to this project. After I arrived at the Service I created a second deputy. It follows a model that we put in over at Homeland where we consolidated all of the support functions, CFO, CIO, human resources, in our case, mission assurance, which is security. We have cyber-security and physical security, people security, all of that, plus facilities management under one individual. He was our senior career official—came out of the business units—so that we would get proper attention to the long-term needs of the Service in our functions including the CIO function. I appointed our CFO, moved him over to be the CIO, to shake this up and to make sure that we are addressing this on a long-term basis.

I would suggest to you that—you mentioned earlier the \$4 billion that had been squandered in the early 1990s. One of the reactions to that was the way this BSM project was done, perhaps too much was actually given to the PRIME alliance. We are taking a careful look at where we need to augment our own skills. It comes back to what Ms. Gardiner was saying before, it does not do us any good to just have contractors if you do not have enough people inside who are monitoring and working and understanding. So we are looking at that as well.

Senator SHELBY. Ms. Gardiner, do you view BSM's current problems as resource related, management related, or both?

Ms. GARDINER. One of the big, broad issues was just matching the capability in-house with the portfolio of projects. That would be somewhat resource related because they tried to take on more than they really could. But I would say probably the bigger part is management. Things like, if your process says that you are going to clearly define requirements and you are going to follow certain steps before you go to the next stage of the project, that you have to stick with that, and that has been a problem. Or for testing, in order to move the project on to the next stage the same thing applies, that you have to test and make sure that defects are identified and fixed, and they really have had some problems with that. But they do recognize those problems and are addressing them.

Senator SHELBY. As far as modernization is concerned, we both noted that \$4 billion was lost, squandered or misused. Could you assure this subcommittee that your current refocus can put the program back on track so it will not go the way of TSM? That is important. In other words, we do not want it to go the way of TSM. TSM money was squandered or wasted, and it was \$4 billion.

Mr. EVERSON. Senator, I can tell you that this is getting a lot of my attention. I am doing my level best to make sure it is being done responsibly, and we will reach a very real decision point. If this first piece of CADE and the financial system do not roll out correctly now, I will have to very seriously reassess it because we would run the risk of going down that corridor. I do not expect that will be the case, but we are not home free until we make sure we get that far. I give you my commitment that this will not leave my attention.

CUSTOMER ACCOUNT DATA ENGINE

Senator SHELBY. The Customer Account Data Engine (CADE), is the first major component of BSM and will replace the IRS's Master Files with a modern database management system. That is the goal. It will serve as the foundation for the rest of the BSM initiative. Thus far, the delivery of the first of CADE's five phases—I believe there are five phases—has already been delayed by at least 3 years. I think it has gotten off to a poor start. When will CADE be delivered, if you can say within some time frame? The first phase?

Mr. EVERSON. It is our expectation that this first phase will be delivered this summer. So far the testing is proceeding according to plan.

Senator SHELBY. How much will CADE cost over the original estimate?

Mr. EVERSON. I would want to respond for the record. It is many tens of millions of dollars. There are functions of complexity, also delay that have contributed to that problem.

Senator SHELBY. Do you have a figure on that, Ms. Gardiner?

Ms. GARDINER. No.

Senator SHELBY. Can you give us a figure for the record?

Mr. EVERSON. We will certainly do that. Let me say this though, we have just recently negotiated a cap on what this first module will cost, and that is responsive to what Ms. Gardiner was saying a few minutes ago about a change in philosophy in the last months that we have brought in, and we have worked very well with the vendor to do that. So that protects the Government's interest a lot more.

[The information follows:]

While we do not have current cost figures from the Automated Financial System (AFS) for the CADE, the following chart represents the funding that has been requested and received for the CADE project (all releases).

BSM Spend Plan	Amount Requested	Amount Received
Spend Plan #1	\$3,500,322	\$3,500,322
Emergency Funding Release #1	1,616,000	1,616,000
Spend Plan #2	15,312,000	15,312,000
Emergency Funding Release #2	1,400,000	1,400,000
Spend Plan #3		
Spend Plan #4	40,038,000	40,038,000
Spend Plan #5	53,974,000	53,974,000
Spend Plan #6	27,683,000	27,683,000
Spend Plan #7	62,800,000	62,800,000
TOTAL	¹ 206,323,322	¹ 206,323,322

¹This amount includes \$15,574,000 that was requested in spend plan 5, but never spent on the CADE.

As shown in the response to Question 1, the CADE Release 1 has experienced a \$36,760,000 cost variance.

Future releases of the CADE have also experienced cost variances of \$25,723,000. Please see the table below.

Release or Activity	Amount Originally Requested	Current Estimate (As of September 2003)	Variance
Release 2	\$38,400,000	\$44,755,000	\$6,355,000
Business Rules Management (Phase 1)		8,300,000	8,300,000
Business Rules Management (Phase 2)	17,000,000	17,000,000	
Release 3	9,779,000	20,837,000	11,058,000
TOTAL			25,713,000

According to the CADE Baseline Business Case from March 2001, the overall estimated cost of CADE is \$982 million over its life cycle.

CADE COST OVERRUN (FROM THE ORIGINAL ESTIMATE)

The description below explains the costs that GAO reported in their Audit of the fiscal year 2004 Expenditure Plan:

- (1) Design work from September 2000 to July 2001:
 - \$15.3 million.—Initial estimate in March 2000 Expenditure Plan;
 - \$19.3 million.—Actual cost;
 - \$4.0 million.—Variance due to design period being extended by 3 months to add detail in some areas and to bridge to Development.
- (2) Development work from July 2001 to March 2004:
 - \$40.0 million.—Initial estimate in March 2001 Expenditure Plan;
 - \$53.6 million.—Actual cost;

—\$13.6 million.—A 2-month extension for a pilot using real tax returns (cost of \$5.3 million) and the addition of capacity at the Martinsburg Computing Center to support Development and Testing (cost of \$4.0 million) created \$9.3 million of this variance. We incurred the cost of the delays outlined below, creating the remaining variance of \$4.3 million.

(3) Cost impact of 2-year delay in delivering CADE:

—\$2.4 million.—Hiring of non-PRIME contractors to support our IRS testing;

—\$1.9 million.—Establishing a CADE Program Office (work to build an organizational framework to support multiple CADE releases simultaneously);

—\$18.0 million.—Cost to apply tax law and other changes for 2003 and 2004 filing season.

These costs do not reflect any changes since the GAO audit of the fiscal year 2004 Expenditure Plan.

IRS ACTIONS IN REGARD TO THE PRIME

Senator SHELBY. Let me ask you a tough question. What steps will the IRS take, Mr. Commissioner, if the PRIME contractor fails to deliver?

Mr. EVERSON. I have made it very clear through the action to date—

Senator SHELBY. You are on top of them.

Mr. EVERSON [continuing]. That we will hold them accountable. And I have also said that we will have to reassess the very continuance of the relationship if we cannot do what we have said we will do.

Senator SHELBY. You would change that if the effort continues to flounder?

Mr. EVERSON. We will have to consider that, absolutely.

Senator SHELBY. Would you change if you thought you needed to?

Mr. EVERSON. I retain that latitude, yes.

Senator SHELBY. What is your view, Ms. Gardiner, for the slowness of this program?

Ms. GARDINER. I think some of it, as I mentioned, it certainly is complex. It is unique.

Senator SHELBY. It is complex.

Ms. GARDINER. But I do think a big part of it too is just the whole cost and scheduling process was flawed. It gave much more optimistic deadlines than it should have in the first place, so it caused people's expectations to be higher than they should have been.

For example, even just in simple segments of it for testing, they were so optimistic and they did not build in time for recovery in terms of if certain defects occurred, or there were failures, to fix those and then to start over again. So to some degree it is that, and then the rest is that it is very complex, and then also changing requirements. So I think everybody is disappointed, and we are too, as far as how long it is taking.

Senator SHELBY. But your modernization program is essential.

Mr. EVERSON. We cannot back away from this effort. We have to do it. We have got aging technology right now and we have got an aging workforce. I liken this, as I have said before, to the movie "Space Cowboys", if you ever saw that, where they send Clint Eastwood out into outer space because they have got these old guys who are the only ones who understand the technology. We have a bunch of people who want to retire, but they are still helping us

because we have got 1960s and 1970s technology that we are running. We cannot keep doing that forever.

PERFORMANCE OF THE CONTRACTOR

Senator SHELBY. Do you believe that the contractor is up to the challenge here? This is a very complex undertaking, but it has to be done. You are spending a lot of money here to modernize the IRS, which we think is important.

Mr. EVERSON. I feel that I have seen an improvement in the attitude and the work that is being done in the year that I have been involved with the Service, and I very much appreciate the leadership of Mike Laphen, is the president of the company. He has been in my office once a month. That is quite a devotion of resources for someone who is running, I think it is a \$13 billion business. We have got a relationship that I believe is starting to improve. We had to let it all out, if you will. There had to be this accountability of what most recently happened. So I am cautiously optimistic that they can do this.

Senator SHELBY. But you are also guarded because you know what happened to \$4 billion with TSM.

Mr. EVERSON. This is the old Ronald Reagan, "trust but verify", attitude.

Senator SHELBY. We hope you will, and we wish you every success, and we will continue to help you.

Mr. EVERSON. Thank you, sir.

ADDITIONAL PREPARED STATEMENT

Senator SHELBY. The subcommittee has received a statement from the Internal Revenue Service Oversight Board which will be included in the record.

[The statement follows:]

PREPARED STATEMENT OF THE INTERNAL REVENUE SERVICE OVERSIGHT BOARD

INTRODUCTION

The IRS Oversight Board thanks the Chairman for the opportunity to submit this statement to the Subcommittee on Transportation/Treasury and General Government of the Committee on Appropriations. The Internal Revenue Service (IRS) Oversight Board is required by 26 U.S.C. Section 7802(d) to review and approve the budget request prepared by the IRS, submit a request to Treasury, and ensure that the approved budget supports the annual and long-range strategic plans of the IRS.

This year, the IRS drafted a special report presenting its recommended fiscal year 2005 IRS budget, comparing it to the administration's request, and explaining why the Board believes its recommended budget is needed to support the annual and long-term needs of the IRS. This statement discusses that report. The complete version is available on the Board's website at www.irsoversightboard.treas.gov and the Board asks that this report be entered into the record as well.

THE IRS OVERSIGHT BOARD BUDGET RECOMMENDATION

The IRS budget is more than dollars and cents. It represents the choices that we as a Nation make about the future of our tax administration system and how we help over 100 million American taxpayers deal with an increasingly complex tax code while ensuring that everyone pays his or her fair share of taxes.

The IRS Oversight Board acknowledges that the IRS's budget has increased in each year of President Bush's Administration, and that the administration's request for fiscal year 2005 is significant against other non-defense, non-homeland security discretionary funding. That commitment is commendable, and the Board recognizes and thanks Secretary Snow for his efforts, especially at a time when the Nation must balance many important and competing priorities.

However, the Board believes that now is a critical time for our tax system to be strengthened, not merely maintained at current levels. Enforcement activities are still at unacceptable levels. Our Nation's tax gap is estimated at \$311 billion,¹ leaving billions of dollars on the table simply because the IRS does not have the resources to do its job.²

The Board's own research shows that each year, more Americans believe it is acceptable to cheat on their taxes. At the same time, our already complex tax code continues to be a changing, tangled mystery to most honest taxpayers—and an asset to those intent on skirting the law. Every effort must be made to provide quality service to honest taxpayers who want to comply with the law.

In crafting its fiscal year 2005 budget for the IRS, the Board addressed these concerns head on by reinvesting in the IRS to produce tangible benefits and results for America's taxpayers and our Nation. It is a sensible and pragmatic budget that reflects the real world in which the IRS must operate and be funded.

The Board recommends a 10 percent increase in funding from fiscal year 2004 to \$11.204 billion, with a significant increase of 3,315 full-time equivalents (FTEs) to boost enforcement efforts. If enacted, the Board's budget would increase our Nation's revenue by approximately \$5 billion each year once the IRS has hired and trained additional enforcement personnel.³

Under the Board's budget, the IRS would have the additional resources to:

- Close over an additional 1,000 cases involving high risk/high-income taxpayers and promoters who avoid paying income taxes by using offshore credit cards and abusive trusts and shelters.
- Boost audit rates by 42 percent from fiscal year 2004 to examine companies that use aggressive tax avoidance tactics, such as offshore transactions and flow-through entities.
- Contact an additional 200,000 taxpayers who fail to file or pay taxes due; a 40 percent boost from fiscal year 2004 and a 27 percent increase from the administration's request. This alone will allow the IRS to collect \$84 million more in revenue owed than the administration's request would allow.
- Sustain the one-on-one assistance that millions of Americans rely on at tax time. The Board's budget will ensure that the IRS will be able to maintain its improved service to taxpayers by answering eight out of ten phone calls.

IRS MUST STAY THE COURSE ON CUSTOMER SERVICE

Mr. Chairman, the vast majority of Americans want to file their returns and pay their fair share, yet our Nation's tax code continues to become more complex. Resources must be available so the IRS can answer taxpayers' questions and promptly and accurately, whether it is over the phone, through the IRS website, by mail, or at walk-in center.

Under the board's proposed budget, customer service funding will remain at about the same level as fiscal year 2004; however, service should improve due to the deployment of self-service technology.

For taxpayers, that means eight out of ten phone calls will be answered. For tax practitioners calling the IRS toll-free hotline to resolve problems regarding clients' accounts, hold-time will remain at current levels.

The IRS call-routing systems as well as website applications that allow taxpayers to check the status of their tax refunds have already shown dramatic benefits in speeding service to taxpayers. New systems, such as e-Services, will soon be available, providing additional automated services to tax practitioners.

Clearly, service to taxpayers has improved in the past 5 years. Such improvements make it all the more imperative that we sustain them and not allow this positive trend to languish, or worse, decline. The agency must stay the course.

DAYS OF "OUTMANNED AND OUTGUNNED" IRS MUST END

The IRS is doing a better job of identifying egregious noncompliance—now it needs the resources to fight back. In the past 2 years, the IRS sharpened its compliance focus to identify and pursue promoters and participants of abusive tax shelters

¹Nina Olson, National Taxpayer Advocate's 2003 Annual Report to Congress, (Washington, DC: December 31, 2003) p. 20–21. This is based on a July 2001 IRS Office of Research report.

²Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System (Washington, DC: September 2002), p. 16.

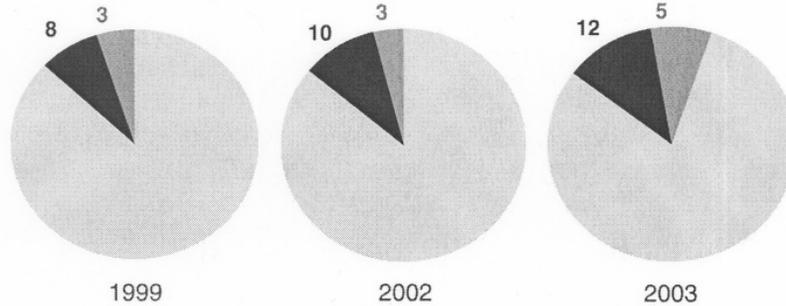
³These estimates are based upon the projected revenue anticipated by hiring and training full-time employees who would audit or collect owed taxes in known cases of taxpayers who did not file or pay, or who substantially underreported their taxes, as described in former IRS Commissioner Charles O. Rossotti's Report to the IRS Oversight Board: Assessment of the IRS and the Tax System, p. 16.

and tax evasion schemes. For example, the agency is now targeting its resources on promoters of illegal tax schemes that are often marketed to high-income individuals, but are also finding their way to middle-market businesses.

Despite this focus, enforcement activities are still at an unacceptable level simply because the IRS does not have the resources needed to accomplish its mission. It continues to be outmanned and outgunned. In fiscal year 2003, the agency was able to pursue only 18 percent of known cases of abusive devices designed to hide income, leaving an estimated \$447 million uncollected.⁴

TAX CHEATING: ALARMING TRENDS

Public attitudes towards tax cheating show some alarming trends, particularly among young Americans. The Board's 2003 Survey on Taxpayer Attitudes found that support for total tax compliance diminished by four points over the previous year to 81 percent. In other words, nearly one out of five Americans now believe that it is acceptable to cheat at least a little on their taxes. Almost one-third (30 percent) of young adults age 18–24 are among those most likely to feel that any amount of cheating is acceptable, an increase of six points since last year. Yet ironically, "fear of being audited" has the greatest impact on these non-compliers at a time when actually being audited is near historic lows.⁵



How much, if any, do you think is an acceptable amount to cheat on your income taxes?

- Not at all
- A little here and there
- As much as possible
- Don't know/NA

The IRS must prove to the public that it can and will identify and pursue those who show contempt for the tax code. The Board's proposed budget allows the IRS to begin to reverse this disturbing trend.

The Board's recommendation would increase our Nation's revenue by almost \$5 billion each year once the IRS has hired and trained additional enforcement personnel. The Board believes the additional revenue achieved makes a strong business case for the recommended additional enforcement resources. While this is a modest boost in closing our compliance gap, it will also send a message to those contemplating tax avoidance: the IRS's hands are no longer tied.

⁴Rossotti, p. 16.

⁵Roper ASW, 2003 IRS Oversight Board Annual Survey on Taxpayer Attitudes, September 2003, p.17.

MODERNIZATION CRITICAL TO TAX ADMINISTRATION

In December 2003, the Oversight Board released an independent analysis of the IRS Business Systems Modernization (BSM) program. The Board called for nine specific recommendations for turning around the critical but troubled program that has experienced significant and unacceptable delays and cost overruns.

However, the Board still believes that the overall Modernization plan is sound and well-designed. Moreover, it is critical to the future of tax administration. As a Nation, we must remain committed to the IRS's computer modernization program. The Board testified before the House Ways & Means Subcommittee on Oversight on Feb 12, 2004:

“The IRS Oversight Board firmly believes that the IRS Modernization program cannot be allowed to fail. The IRS cannot continue to operate with the outmoded and inefficient systems and processes it uses today. Over time, the existing systems will become impossible to maintain and at that point, the ability to administer our country's tax system will be in grave danger. Such a risk to our nation is unacceptable. We remain convinced that the overall Modernization plan is sound and well-designed. The challenge is executing that plan. The IRS and the Prime must get it right this time.”⁶

The Board's proposed budget provides the stable resources needed to focus and stabilize the steady stream of funding for the IRS's computer modernization initiative. Special controls are in place to ensure that no funding in this account is spent until the IRS has the capability to spend it effectively. If the IRS does not correct the weaknesses in the BSM program by fiscal year 2005, the Board advocates that the funds earmarked for modernization should not be spent. However, the Board does not believe the IRS should plan for failure. The agency must be poised to move forward with BSM once it has demonstrated that it has corrected the program's weaknesses. The funding level recommended by the Board sets the foundation for genuine progress for the program in fiscal year 2005.

The Board expects that the Customer Account Data Engine (CADE) Release 1 will occur in 2004. Over the next year, the IRS will test and build upon that system. The IRS should continue to strengthen its ability to manage the program and the Prime to deliver projects on budget and on time. By the end of fiscal year 2005 and early fiscal year 2006, the IRS should be able to proceed with the remaining releases of CADE as quickly as possible. This will minimize future risk and the long-term cost of modernization while providing a basis to deliver tangible results for taxpayers.

If the IRS's fiscal year 2005 BSM funding is reduced to \$285 million, as it is in the administration's budget, future funding likely will be adversely affected. If that happens, the projects will drag on, risk will increase, and ultimately, the program will cost taxpayers much more.

For that reason, the Board believes fiscal year 2005 BSM funding should be set at \$400 million, with only \$285 million put into the fiscal year 2005 spend plan. This will allow the IRS's Business Systems Modernization fund to operate like a multi-year fund, as originally envisioned by Congress and as the Board has recommended each year since its inception.

Further, as its archaic, tape-based computers begin to give way to modern business systems, the IRS must plan for a smooth transition. The Board's budget recognizes that need. As new systems are incorporated, the IRS must plan to operate both the old and new systems in parallel for some time. The IRS must also retain employees with critical skills while training existing and new employees to use new systems. This will allow the IRS to reduce the risk of a catastrophic disruption to the system.

In addition, the Board believes that the transition to modernization is a real cost that must be incurred. There are no short cuts to successful modernization—the IRS's budget must reflect the real cost of maintaining legacy systems while simultaneously supporting modernized systems. Accordingly, the Board recommends an additional \$25 million to cover these costs. The administration's budget fails to acknowledge them.

THE ADMINISTRATION'S FISCAL YEAR 2005 BUDGET REQUEST

By comparison, the Board believes the administration's fiscal year 2005 budget cannot achieve its stated goal to add almost 2,000 personnel to bolster the IRS's enforcement efforts, and will threaten hard-earned improvements in customer service.

⁶Larry R. Levitan, IRS Oversight Board Testimony before House Ways and Means Oversight Subcommittee Hearing on IRS BSM Program, February 10, 2004.

This year's request will lead to a \$230 million shortfall in the IRS budget because it fails to budget adequately for the anticipated \$130 million of congressionally-mandated civilian pay raises, rent increases, and at least \$100 million of unfunded expenses.

In its fiscal year 2005 budget recommendation, the Board anticipates a 3.5 percent pay raise for civilian employees, which achieves parity with the administration's call for a 3.5 percent military pay raise. The administration, but contrast, calls for a 1.5 percent civilian pay raise. While discussions are now underway in Congress regarding parity, the Board believes that the 1.5 percent civilian pay increase fails to recognize recent history.

In fact, fiscal year 2005 is the fourth year in a row in which the administration has called for IRS staff increases, while not covering pay raises or required expenses.

As a result, the administration's proposed increase in the IRS's fiscal year 2005 budget will erode before new employees can be hired, more taxpayer phone calls can be answered, or new audits of possible tax cheats can be conducted.

IMPACT OF \$230 MILLION BUDGET SHORTFALL ON THREE MAJOR IRS FUNCTIONS

Function	Performance Measure	Fiscal Year 2005 Performance Goal	Revised Goal After \$230 Million Cut
Field Collection	Number of tax delinquent account cases resolved	981,000	463,000
Toll-free Telephone Level of Service.	Calls answered	32,000,000	17,000,000
Field Exam	Exams of individual taxpayers <\$100,000 AGI	118,840	73,000

BOARD CITES COMPLEXITY AS FUNDAMENTAL FLAW

The IRS Oversight Board is precluded by law from addressing tax policy issues, but it would be remiss not to address the cost of our Nation's complex tax system; a cost ultimately borne by taxpayers and the IRS. The administration's legislative proposals contained in its budget request only begin to address the problems caused by complexity. The approach so far to tax simplification fails to address a fundamental flaw in our tax system: its costly, confusing, and debilitating complexity. The administration has, however, requested that Congress provide some relief in fiscal year 2005 on the Alternative Minimum Tax, but has not yet identified a long-term solution.⁷ In her annual report, IRS National Taxpayer Advocate Nina Olson recommended repeal of the AMT, saying:

"The AMT is extremely and unnecessarily complex and results in inconsistent and unintended impact on taxpayers . . . [T]he AMT is bad policy, and its repeal would simplify the Internal Revenue Code, provide more uniform treatment for all taxpayers, and eliminate the oddity of dual tax systems. AMT repeal would also allow the IRS to realign compliance resources to facilitate more efficient overall administration of the tax code."⁸

The Board fully concurs with her assessment, and urges the administration and Congress to consider accepting this recommendation in future legislation.

CONCLUSION

The Board was established to bring to bear its collective expertise and familiarity with private sector best practices on the IRS's problems. To the private-life Board members, investments in enforcement pay for themselves many times over, not only in revenue dollars but by the deterrence value of reinforcing the belief that all taxpayers are paying their fair share. A strong business case can be made for providing the IRS with several hundred million dollars so it can collect billions in revenue. At a time when Federal revenue as a percentage of the economy has shrunk to

⁷ Recent public remarks by Treasury Secretary Bodman noted that the President's budget extends through 2005 the temporary increase in the AMT exemption and the provision that allows certain personal credits to offset the AMT. These temporary provisions will keep the number of taxpayers affected by the AMT from rising significantly in the near-term. More importantly, they will allow the Treasury Department the time necessary to develop a comprehensive set of proposals to deal with the AMT in the long-term. Treasury Press Release JS-1250 contains the full statement of his remarks.

⁸ Olson, p. 16.

1950s levels and we face a \$500 billion deficit, the Board believes it imperative that we strengthen our tax collection system.

For that reason, the Board recommends that both Congress and the administration reevaluate their methodology by including the revenue value to the country when estimating budget requests for the IRS. Indeed, considering the positive impact of additional resources provides a better framework for making informed decisions and will lead to a more effective IRS.

In conclusion, the Board calls for Congress to stay the course it set more than 5 years ago with the passage of the IRS Restructuring and Reform Act. The IRS has made progress in carrying out the spirit and letter of the Act; we must now give it the resources to finish the job.

ATTACHMENT 1.—IRS OVERSIGHT BOARD FISCAL YEAR 2005 IRS BUDGET
RECOMMENDATION AND ADMINISTRATION REQUEST: PROGRAM SUMMARY COMPARISON

ADMINISTRATION FISCAL YEAR 2005 BUDGET REQUEST PROGRAM SUMMARY

[Dollars in millions]

Appropriation Title	Fiscal Year 2004 Enacted	Fiscal Year 2005 OB Request	Increase	
			Enacted vs. Request	Percent
Processing, Administration and Management	\$4,009	\$4,148	\$139	3.5
Tax Law Enforcement	4,171	4,564	393	9.4
Information Systems	1,582	1,642	60	3.8
Business Systems Modernization	388	285	—103	—26.5
Health Insurance Tax Credit Administration	35	35	.....	.....
Appropriation	10,185	10,674	490	4.8

IRS OVERSIGHT BOARD FISCAL YEAR 2005 BUDGET REQUEST PROGRAM SUMMARY

[Dollars in millions]

Appropriation Title	Fiscal Year 2004 Enacted	Fiscal Year 2005 OB Request	Increase	
			Enacted vs. Request	Percent
Processing, Administration and Management	\$4,009	\$4,291	\$282	7.0
Tax Law Enforcement	4,171	4,770	598	14.3
Information Systems	1,582	1,708	126	8.0
Business Systems Modernization	388	400	12	3.1
Health Insurance Tax Credit Administration	35	35	.....	0.3
Appropriation	10,185	11,204	1,019	10.0

ATTACHMENT 2.—UNFUNDED IRS COSTS, FISCAL YEAR 2002–2003

UNFUNDED IRS COSTS, FISCAL YEAR 2002–2004

[Dollars in millions, rounded]

Detail	Fiscal Year 2002	Fiscal Year 2003	Fiscal Year 2004
Labor Inflation:			
Unfunded Pay Raise Increase (President's Request to Congressional Action) ...	\$42.3	\$128	
	42.3	128	
Non-Labor Inflation:			
Rent Shortfall	32	54	
Postage	16	53	
Corporate & Electronic Contracts .....	.....	23	
Health Service Contract	3	2	
Interpreter's Contract	0.5	0.3	
Child Care Subsidy	1	.....

UNFUNDED IRS COSTS, FISCAL YEAR 2002–2004—Continued

[Dollars in millions, rounded]

Detail	Fiscal Year 2002	Fiscal Year 2003	Fiscal Year 2004
Increased Department of Labor EFAST Contract Processing Costs	2	.....
TOTAL	55	132	
Added Requirements:			
Background Investigations .....	.....	4	
Increase Cash Awards from 1.24 percent to 1.42 percent	8	16	
Competitive Sourcing .....	.....	8	
Campus Security Response	15	.....
Congressional Mandates	5	.....
Guard Services	20	16	
Public Transportation Subsidy	9	.....
TOTAL	56	44	
Total	153	304	
Total Less Pay Raise and Rent	79	122	

ATTACHMENT 3

WHERE THE ADDITIONAL ENFORCEMENT RESOURCES ARE APPLIED

[Dollars in thousands, rounded]

Enforcement Initiatives	Oversight Board Recommendation		Administration Recommendation		Difference	
	Budget	FTE	Budget	FTE	Budget	FTE
SBSE–2 Curb Egregious Non-Compliance	\$159,264	1,408	\$90,161	874	\$69,103	534
SBSE–3 Select High-Risk Cases for Examination	5,500	.....	.....	.....	5,500	.....
SBSE–7 Savings through Consolidation—Case Processing	16,085	200	14,469	144	1,616	56
SBSE–8 Savings through Consolidation—Insolvency Processing	7,656	69	5,531	65	2,125	4
WAGE–2 Increase Individual Taxpayer Compliance	46,406	521	15,469	175	30,937	346
WAGE–9 Improve ITIN Application Process	15,484	50	.....	.....	15,484	50
WAGE–10 Eliminate Erroneous EITC Payments	18,000	.....	.....	.....	18,000	.....
LMSB–1 Combat Corporate Abusive Tax Schemes	60,017	394	36,100	207	23,917	187
TEGE–1 Combat Diversion of Charitable Assets	3,914	44	3,914	44	.....	.....
TEGE–5 Stop Abusive Transactions in the TEGE Community	11,140	100	11,140	100	.....	.....
CI–1 Combat Financial Fraud in the Corporate Sector	25,600	98	25,600	98	.....	.....
CI–2 Dismantle International and Domestic Terrorist Financing	12,208	80	.....	.....	12,208	80
CI–3 Reinforce Core Mission Tax Enforcement Resources	34,086	130	34,086	130	.....	.....
CI–7 Forensic Electronic Evidence Acquisition and Analysis	3,104	4	3,104	4	.....	.....
CI–10 Leverage/Enhance Special Agent Productivity	2,500	28	2,500	28	.....	.....
APPEALS–1 Resolve Appeals	13,945	112	7,000	56	6,945	56
COUNSEL–1 Combat Abusive Tax Avoidance	10,852	75	5,426	38	5,426	37
NHQ–2 Deliver Strategic Compliance Data	2,712	2	.....	.....	2,712	2

WHERE THE ADDITIONAL ENFORCEMENT RESOURCES ARE APPLIED—Continued

(Dollars in thousands, rounded)

Enforcement Initiatives	Oversight Board Recommendation		Administration Recommendation		Difference	
	Budget	FTE	Budget	FTE	Budget	FTE
Fiscal Year 2005 Enforcement Increases	448,472	3,315	254,500	1,963	193,972	1,352

ADDITIONAL COMMITTEE QUESTIONS

Senator SHELBY. There are some additional questions that will be submitted in writing for your response.

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

QUESTIONS SUBMITTED TO THE INTERNAL REVENUE SERVICE

QUESTIONS SUBMITTED BY SENATOR RICHARD C. SHELBY

Question. Following the IRS Reform legislation of 1997, the IRS realigned significant levels of resources from Tax Enforcement and Compliance activities to customer service, telephone assistance, and submission processing activities.

How do the fiscal year 2005 realignment proposals and the new funding initiatives proposed for 2005 compare to the pre-reform legislation levels for those programs?

Answer. The proposed fiscal year 2005 realignment proposals and new funding initiatives strive to better balance service and enforcement.

The IRS's service lagged in the 1990's. In response to the IRS Restructuring and Reform Act of 1998 (RRA 98), the IRS took important and necessary steps to upgrade service—significantly improving the answering of taxpayer telephone inquiries and electronic filing. Unfortunately, improvement in service coincided with a drop in enforcement activity. Since 1996, the number of IRS revenue agents, officers, and criminal investigators has dropped.

The President's fiscal year 2005 budget—if approved by Congress—will help with IRS efforts to continue strengthening enforcement activities while maintaining and enhancing levels of service. The submission requests an enforcement increase of \$300 million over the fiscal year 2004 consolidated appropriations level. This increase will allow a partial recovery in the numbers of enforcement personnel, but will not fully restore the workforce.

Enforcement Workforce	FTE Fiscal Year 1997	FTE Fiscal Year 2004	FTE Fiscal Year 2005 Initiatives	FTE Fiscal Year 2005	FTE Percent Change
Revenue Agents	14,592	12,172	841	13,387	-9
Revenue Officers	7,333	5,238	332	5,734	-28
Criminal Investigators	3,244	2,553	160	2,739	-22

Question. Will IRS essentially restore those realignments from 1997, or does the request make real advances in tax compliance efforts?

Answer. As in the past 2 years, the IRS has identified efficiency improvements that could generate resources to be applied to high priority areas. These resources will be applied to enforcement in fiscal year 2005. However, they are not sufficient to completely reverse the decline in enforcement performance. The IRS needs the increase in enforcement resources requested in the fiscal year 2005 budget to carry out an appropriate level of activity in the enforcement arena.

The primary goal in the fiscal year 2005 budget request is to continue restoring the strength of the enforcement function. Staffing devoted to compliance and enforcement operations declined in the 1990's as the IRS focused on customer service; it is just beginning to recover. The number of revenue agents, revenue officers, and criminal investigators each declined by over a quarter from fiscal year 1997 to fiscal year 2003. Annual growth in return filings and additional work related to RRA 98 have contributed to a steady decline in enforcement presence, audit coverage, and case closures in front-line compliance programs.

This budget has an increase of \$300 million for a more vigorous enforcement of the tax laws. This strong commitment to tax administration will provide a significant augmentation of enforcement resources, but will not completely restore enforcement personnel to 1997 levels. Improvements will also come from productivity increases (e.g. reengineering, better audit targeting).

Question. Are the realignment proposals recognition that sufficient service and staffing levels have been achieved for IRS customer service and processing program areas?

Answer. While the ultimate desired level of taxpayer service remains to be reached, the IRS has improved and increased recognition of, and respect for, taxpayer rights. The IRS has made steady gains in better serving American taxpayers. Each filing season and year is appreciably better than the previous one and the IRS continues to build on those successes.

FISCAL YEAR 2004 FILING SEASON SUCCESSES—DATA AS OF APRIL 23 COMPARED TO SAME PERIOD IN FISCAL YEAR 2003

Service ¹	Fiscal Year 2003	Fiscal Year 2004	Percent Change
Free Filed Returns	2.7	3.4	26
Where's My Refund	9.5	12.4	31
Telephone Level of Service (Percent)	83	85	2
E-Filing From Home	11.7	14.2	21

¹ Service usage in millions, except percentages.

The IRS is doing a better job; however, much more remains to be done. The objectives for improved taxpayer service are three-fold:

- improve and increase service options for the taxpaying public;
- facilitate participation in the tax system by all sectors of the public;
- simplify the tax administration process.

Although the IRS is not requesting increases in fiscal year 2005 for taxpayer service initiatives, the IRS will be able to build upon its experience over the past 6 years and will continue to improve taxpayer service. In recognition of the need to rebalance service and enforcement activities, consistent with the formula of service plus enforcement equals compliance, the only increases the IRS requested in fiscal year 2005 are for enforcement.

Question. What headway will IRS's request make in the growing delinquent tax inventory that exists, or do you still anticipate large write-offs of delinquent taxes similar to this past year, even with the resource requests in the fiscal year 2005 budget?

Answer. Delinquent tax write-offs declined by 35 percent from 818,000 in fiscal year 2001 to 533,000 in fiscal year 2003. The dollar value of this inventory declined from \$10.5 billion in March 2001 to \$7.4 billion in March 2004. The fiscal year 2005 budget staffing increase will enable the IRS to continue this progress in reducing the delinquent tax inventory. Passage of the administration's proposed Private Collection Agent legislation would further reduce delinquent inventory.

Question. A continuing priority of the IRS has been to maintain and improve the Tax Fraud and Criminal Investigations program area. This committee has supported IRS requests in this area.

Has IRS invested all the resources granted by the Congress in recent years for the Criminal Investigations area or have some of the new resources been reallocated to other areas in the IRS?

Answer. The IRS has directed all the resources provided by the Congress for the Criminal Investigation area to the Criminal Investigation division (CI). None of the resources have been reallocated to other areas in the IRS; however, the IRS has applied any across-the-board rescissions or unfunded pay raises to CI proportionally. The IRS has protected all new CI initiatives.

Question. The IRS, in recent testimony, indicated that Congress has not provided the resources it needs to meet tax administration responsibilities. A review of IRS requests by GAO has shown that more than 98 percent of IRS's requests have been funded since fiscal year 2002, with most reductions relating to across-the-board reductions and absorptions beyond the control of this committee.

What is the basis of IRS's assessment on Congress' review of your requests?

Answer. The IRS has based its budget strategy on increasing productivity in current operations from reengineering, modernization, and increases in electronic filing to free up resources for reinvestment in taxpayer service and enforcement. The administration also has sought modest FTE increases in the last few years. If success-

ful, this strategy would have enhanced taxpayer service and met the demands of increased return workload. However, this strategy has not been as effective as anticipated due to unexpected cost increases. For example, the IRS absorbed \$97 million to fund a portion of the fiscal year 2004 pay raise, in addition to an appropriation reduction of \$252 million from the President's Budget.

The IRS absorbed these costs across the agency, protecting only the new fiscal year 2004 enforcement initiatives from reduction. Nevertheless, although the IRS protected these enforcement initiatives, the enforcement base absorbed a prorated share of these unexpected cost increases discussed above, and this resulted in FTE reductions in enforcement activities.

Question. Does IRS's assessment imply that the administration did not request sufficient resources for the IRS in past years' budgets?

Answer. The IRS has received the administration's full support, and funding requests have been sufficient. However, unfunded expenses absorbed throughout the agency have negatively affected budget goals. These unfunded expenses have been driven primarily by pay raises higher than those proposed by the administration.

Question. What is IRS's assessment of the request for fiscal year 2005? Is it adequate to support IRS tax administration responsibilities?

Answer. The proposed fiscal year 2005 budget takes a balanced, measured approach to the challenges facing the American tax system, with a needed emphasis on strengthening enforcement. The goal is to ensure that the tax system is fair for all while protecting taxpayer rights.

The request, if funded, is adequate to support IRS tax administration responsibilities. However, the fiscal year 2005 budget request includes a 1.5 percent increase for the pay raise, as proposed by the administration. If Congress approves the 3.5 percent increase proposed by some members, it would result in a shortfall of \$109 million.

Question. What is IRS's assessment of long term requirements?

Answer. The vision of the IRS is to re-center the agency with the proper balance of service and enforcement poised to quickly meet technological and demographic changes, new challenges of taxpayer compliance, and customer expectations.

The IRS's goals remain the same—to improve taxpayer service, enhance enforcement through uniform application of the law, and improve the IRS infrastructure and modernize technology. The IRS's working equation is that service plus enforcement equals compliance. The IRS is maintaining high levels of taxpayer service, while focusing on corrosive areas of non-compliance. Ensuring fairness will help maintain the taxpaying public's faith in the Nation's tax system.

Question. How is the IRS's fiscal year 2005 request consistent with that vision?

Answer. The IRS will enforce the law and it will continue to improve service and respect taxpayer rights. The administration's fiscal year 2005 budget request will help the IRS restore the balance between service and enforcement envisioned in the IRS's Strategic Plan.

The fiscal year 2005 request allocates \$300 million toward enforcement initiatives designed to curb abusive tax practices, end the proliferation of abusive tax shelters, improve methods of identifying tax fraud, identify and stop promoters of illegal tax schemes and scams, and increase the number and effectiveness of audits to ensure compliance with the tax laws. This budget will allow the IRS to apply resources to areas where non-compliance is greatest: promotion of tax schemes, misuse of offshore accounts and trusts to hide income, abusive tax shelters, underreporting and non-reporting of income, and failure to file and pay large amounts of employment taxes. The administration also has proposed a number of legislative changes to significantly enhance current enforcement programs and prevent the promotion of abusive tax avoidance transactions. The goal of these initiatives is to ensure that the tax system is fair for all, while protecting taxpayer rights.

Question. Besides the across the board reductions, what other expenses did the IRS pay that were not budgeted?

Answer. Examples of the expenses incurred that were not budgeted include \$97 million for a portion of the unfunded pay raise, and unanticipated rent increases causing a shortage of \$40 million. The IRS is working to manage our space inventory to minimize future rent increases to the extent possible.

Question. The GAO states that IRS has requested more enforcement staff to be funded partly by budget increases and partly through internal savings.

Please provide, for fiscal year 2002 and fiscal year 2003, a detailed breakout of the anticipated internal savings and the actual amount saved.

Answer. In fiscal year 2002, the IRS intended to offset projected non-labor inflation of \$57 million by reducing travel and contractual services and improving purchasing power through interdepartmental consolidation of procurements. Actual results of those actions in fiscal year 2002 were:

Object Class	Obligations Variance From Fiscal Year 2001–2002
Temporary Space Leases	(\$19,765,165)
Management and Professional Support Services	(10,462,898)
Contractual Labor—Private Sector	(10,052,952)
Training/Travel	(4,114,005)
Misc Expenses, Foreign Posts—Government	(3,151,254)
Printing, Reproduction, & Related Services—Commercial	(1,900,000)
Support Services—Private Sector	(1,711,693)
Local Telephone Service	(1,280,417)
Services and Maintenance to Buildings and Space	(1,088,284)
Administrative Mail Costs	(1,042,750)
Telecommunications Equipment, Capitalized	(912,880)
Communication, Telephone Service—EE	(811,571)
Travel of Experts & Witnesses	(577,566)
Total	(56,871,435)

The IRS highlighted specific initiatives for savings in fiscal year 2003. Actual results of those reductions were:

[Dollars in millions]

Savings—Fiscal Year 2003	Budgeted		Realized, EOY		Difference	
	Dollars	FTE	Dollars	FTE	Dollars	FTE
CI—Narcotics Program	\$14.6	85	\$4.0	33	(\$10.6)	(52)
CI—Realigned Attrition	\$11.6	80	\$9.7	80	(\$1.9)	.....
COUNSEL—Reduced Tax Court Cases	\$0.6	5	\$0.6	5	.....	.....
WAGE—E-File	\$18.5	490	\$12.0	475	(\$6.5)	(15)
WAGE—Reengineering/Quality Improvements	\$67.4	1,044	.....	.....	(\$67.4)	(1,044)
WAGE, SBSE—e-services release	\$4.0	69	\$0.3	6	(\$3.7)	(63)
LMSB—Customer Relationship Management (CRM) Exam	\$11.9	119	\$1.2	12	(\$10.7)	(107)
MIT—Selected Tier B Projects	\$3.3	57	.....	.....	(\$3.3)	(57)
SBSE—Reduced Field Innocent Spouse	\$13.8	184	\$7.7	103	(\$6.1)	(81)
SBSE—Reduced Filing Season Support	\$12.1	154	\$17.9	230	\$5.8	76
GRAND TOTAL	\$157.8	2,287	\$53.4	944	(\$104.4)	(1,343)

Question. The GAO states that the IRS realized only 32 percent of its claimed internal savings in fiscal year 2003. Is this correct? If so, does this point to a weakness in budget formulation at the IRS?

Answer. The actual figure is 34 percent. The fiscal year 2003 budget submission is the first such submission to identify specific reduction initiatives that could be used to fund high priority initiatives. Since then, the IRS has been improving. For example, in fiscal year 2004, the IRS expects to achieve 68 percent of the projected savings. The savings result either from modernization projects or reengineered systems that generate productivity increases. Because the IRS starts development of budget estimates over 15 months prior to execution year, the assumptions made can change, and any changes in assumption will affect the actual savings realized. In many cases these savings have been delayed, but will eventually be realized.

Question. Does it point to a lack of conviction to realize the savings promised to promote change at the IRS? If the IRS does not realize the savings assumed in its budget requests, how does it make up for the shortfall?

Answer. The IRS's prior experience in realizing specific reduction initiatives, particularly with respect to fiscal year 2003, in no way reflects a lack of commitment by the IRS to achieve cost savings and efficiencies.

In most cases, the savings generated are used to fund other high priority areas in the same business unit. Therefore, there is an incentive to ensure that the re-engineering actions are taken so that the new work can be done. However, if for some reason the savings are not generated at the time expected, then the business unit must either scale back its hiring plans, and, therefore, projected performance, or reduce non-labor costs in other areas to maintain its performance level. Part of the problem experienced in fiscal year 2003 and 2004 was that the IRS did not use

generated savings to fund higher priority work, as planned in the budget, but used the savings mainly to fund unfunded mandates and unexpected costs.

Question. Congress has appropriated approximately \$1.7 billion for the Business Systems Modernization program. IRS has requested an additional \$285 million in this year's fiscal year 2005 budget. The current program is showing mounting delays in project milestones, with few results to show for the taxpayer.

What is the current status of this program?

Answer. The BSM program is—without a doubt—one of the largest, most visible, and most sensitive modernization programs ever undertaken in the world.

The results have been mixed; but first, the good news. The IRS built a strong technical infrastructure and designed and implemented stringent security and control mechanisms into the infrastructure. The IRS also developed a rigorous enterprise life cycle methodology. Over the past 2 years, the IRS has been working toward instituting and integrating established streamlined governance and management processes. The IRS has made progress, but a major thrust now focuses on sustaining a solid balance of business commitment, accountability, and scope management. Finally, the IRS has achieved a great deal of success with the projects delivered to date.

The IRS has fully deployed all e-Services Release 1.0 products and made them available over the Internet, including: registration and online address change access for third parties and IRS employees through secure user portals; Preparer Tax Identification Number (PTIN) online application; interactive Taxpayer Identification Number (TIN) matching; secure Electronic Return Originator (ERO) application processing; and access to e-Services registration and application processes by Modernized e-File (MeF) participants.

E-Services Release 2.0 products are also now in production and available for use by IRS staff and taxpayers, including: Application for e-Filing (external); Electronic Account Resolution (EAR); Electronic TIN Bulk Matching (Bulk Requests); Disclosure Authorization (DA); and infrastructure support for outbound facsimile service.

In March 2004, James D. Leimbach appeared before the Ways & Means Oversight Subcommittee on behalf of the National Association of Enrolled Agents (NAEA) and said, "This new capability is truly going to revolutionize the way we conduct future business with the IRS. The ultimate beneficiary is the American taxpayer. We are truly amazed and thrilled beyond description at this way of doing business with the IRS, and we would like for you to understand why we feel as we do."

The IRS delivered several additional applications that are providing tangible benefits to taxpayers and improving the efficiency and effectiveness of the tax administration systems such as Where's My Refund?, Where's My Advance Child Tax Credit?, Internet EIN, Modernized e-File, HR Connect, etc. The following chart highlights the applications the IRS has delivered, as well as the measurable business benefits being realized.

BSM DELIVERS REAL BUSINESS VALUE (RESULTS AS OF 6/15/04)

Project	Description	Recent Statistics
Internet Refund Fact of Filing (2002)	Improves customer self-service by providing instant refund status information and instructions for resolving refund problems to taxpayers with internet access.	<ul style="list-style-type: none"> —17.9 million inquiries in 2003; 22 million inquiries to date in 2004 (1/1/04–6/6/04). —32 percent of all real time IRS assistance calls come from IRFoF. —Modest reduction of telecommunications costs (about \$250,000). —Every 1,000 IRFoF contacts eliminate 1,500–2,000 refund assistance calls. —15.5 million inquiries in 2003; 11.9 million inquiries to date in 2004 (10/1/03–6/13/04). —Peak date 1.1 million interaction. —68,000 calls in one 3-minute period during initial week (coincided with start of Advanced Tax Refund of 2001). —50 percent reduction in waiting time for assistor to answer call. —50 percent reduction in abandoned calls. —Number of Spanish calls doubled. —More accurate pre-routing of calls. —1.37 million internet EIN applications received to date (as of 6/5/04).
Advanced Child Tax Credit (2003)	Modifies the Internet Refund application to provide taxpayers with Advance Child Tax Credit refund status on the internet.	
Customer Communications (2001)	Improves communications infrastructure, including telephone call management, call routing and customer self-service applications.	<ul style="list-style-type: none"> —Cited by Commissioner Everson as an enabling factor in the redirection of approximately 750 staff years to enforcement. —Treasury was selected as 2004 ComputerWorld Honors Laureate for HR Connect development and implementation. —Over 69,624 PTIN applications (W7P) entered to date, data entry productivity doubled (from 8/15/03–6/10/04). —Over 58,201 e-File applications to the Third-Party-Data-Store (TPDS) entered to date (from 8/15/03–6/10/04). —Approximately 24,939 Registered (and confirmed) User Portal (RUP) to date (from 10/1/03–6/10/04). —Deployed to almost 4,000 Revenue Agents.
Internet Employee Identification Number (2003)	Allows businesses and taxpayers to apply for and receive employer identification numbers over the internet.	
HR Connect (2002)	Delivers an enterprise solution to allow IRS employees to access and manage their human resources information online.	
e-Services R1 (2003–2004)	Creates a web portal and value adding e-Services services to promote the goal of conducting most of the IRS's transactions with tax practitioners electronically.	<ul style="list-style-type: none"> —75,000 internal users. —Cited by Commissioner Everson as an enabling factor in the redirection of approximately 750 staff years to enforcement. —Treasury was selected as 2004 ComputerWorld Honors Laureate for HR Connect development and implementation. —Over 69,624 PTIN applications (W7P) entered to date, data entry productivity doubled (from 8/15/03–6/10/04). —Over 58,201 e-File applications to the Third-Party-Data-Store (TPDS) entered to date (from 8/15/03–6/10/04). —Approximately 24,939 Registered (and confirmed) User Portal (RUP) to date (from 10/1/03–6/10/04). —Deployed to almost 4,000 Revenue Agents.
Customer Relationship Management Exam (2001)	Provides standard tax computation software to Large & Mid-Sized Business Revenue Agents.	
Modernized e-File (2004)	Provides e-filing to large businesses (1120 family) and tax exempt organizations (990 family).	<ul style="list-style-type: none"> —Went live on 2/23/04. —Over 35,090 returns (1120 family) accepted as of 6/13/04. —Over 3,287 participating Electronic Return Originators as of 6/13/04. —Winner of Government Solutions "Best-of-the-Best" Pioneer Solutions.

The bad news, however, is major. Significant cost overruns and repeated schedule delays have plagued critical projects, such as the Customer Account Data Engine (CADE), the Integrated Financial System (IFS), and the Custodial Accounting Project (CAP). CADE replaces the current master files that are the IRS's repository of taxpayer information. IFS will be the IRS's new core accounting system. CAP provides an integrated link between tax administration (revenue) and internal management (administrative) financial information.

The IRS has delayed the CADE program four times. It originally planned to deliver the first release of CADE in December 2001. The IRS then rescheduled it for August 2003, and later rescheduled it for April 2004. The IRS recently finalized the re-planning effort for CADE and set the latest delivery date for September 2004. While CADE is farther along than the IRS has ever been in replacing a component of the master file, there are still major hurdles to overcome. The CADE delays stemmed from infrastructure upgrades, initial poor software quality during the startup of systems integration testing combined with the failure to understand the complexity of balance and control, and the resolution of operational and performance issues that occurred during Phase 3 of the Release 1.0 pilot.

Like CADE, IFS has been plagued with schedule delays. The IRS originally planned to deliver the first release of IFS in October 2003. The IRS then rescheduled it for January 2004. The IRS later rescheduled it for April 2004. The IRS has subsequently scheduled Release 1.0 for October 2004. The IRS delayed the first release of IFS because of the need to make technical changes to comply with the enterprise architecture, the inability to resolve key design and integration issues in a timely manner, the identification of the health coverage tax credit interface requirement late in the development process, and delays experienced in integration testing due to poor application quality and interface testing issues.

IFS Release 1.0 will cover core accounting functions such as budget preparation, general ledger, accounts payable, accounts receivable, financial reporting, and purchasing. Problems continue to seriously jeopardize the scheduled delivery of this first release of IFS. The IRS is 2 weeks behind schedule on testing, which puts the data conversion schedule at risk. The IRS is negotiating a fixed price contract for the October delivery.

The IRS is also encountering delays on the first release of the Custodial Accounting Project (CAP), which provides an integrated link between tax administration (revenue) and internal management (administrative) financial information. The first release of CAP will address revenue from individual taxpayers on initial tax payments. Later releases of CAP will address businesses and collections. CAP delays resulted from unstable CADE and IFS interface definitions, needing additional testing time due to a much larger than anticipated volume of data anomalies discovered during the conversion of data from the current Individual Master File (IMF), and the time required resolving system performance issues.

In addition, though not directly responsible for CAP delays to date, the IRS has made some adjustments to the functionality that it needs to have in CAP Release 1 to support the GAO financial audit as well as internal accounting and management. These adjustments will increase the cost of later sub-releases of CAP Release 1. The IRS has now completed all testing for CAP Release 1, and is adding changes to reflect IMF changes from the start of the 2004 filing season (Release 1.1). The IRS plans to start production, which includes the initial load of IMF data, in mid-August. The IRS negotiated a fixed price contract for Release 1 and Release 1.1 in May 2004.

Question. Are the current problems resource-related or management-related?

Answer. The current problems experienced by the IRS are a combination of both. The IRS needs a more versatile team of seasoned executives to provide long-term stability to the program. The IRS is complementing the skills of experienced IRS tax executives with outside seasoned technology executives who have experience managing large-scale, complex IT projects. As such, the IRS is hiring two Associate Chief Information Officers to join the MITS organization, and an executive search firm is conducting searches for five senior executives with a wide range of diverse experience in developing and implementing large modernization systems. As a result of missing CADE and IFS key deliverables last summer, the Commissioner and Computer Sciences Corporation (CSC) commissioned external assessment studies from outside experts. The studies produced no major surprises; but, the IRS now understands more about the issues. All of the assessments confirmed that the IRS modernization effort is a massive, highly complex, high-risk program that is confronting a number of critical management and technological challenges. These studies also made it clear that the IRS should not turn back, but rather make a series of changes to strengthen the BSM program.

While all of these studies assessed different components of the modernization program, three major recommendations emerged, including:

- Scaling back the modernization portfolio to better align with IRS and CSC’s capacities;
- Engaging IRS business units to drive the projects with a business focus; and,
- Improving contractor performance on cost, scheduling, and functionality.

The assessments also raised a number of other key improvement opportunities, including:

- Adding outside expertise to help manage the program and to complement IRS skills;
- Strengthening human resources capacity management;
- Adhering to methodologies in areas such as configuration management, cost and schedule estimating, and contract management;
- Reducing the burden from oversight organizations;
- Simplifying the budget process; and,
- Initiating the testing of the business rules engine on CADE.

Question. How much more is needed to complete this effort and modernize IRS’s outdated systems and processes and is the fiscal year 2005 budget request consistent with that projection?

Answer. It is virtually impossible to estimate how much more is needed to complete the modernization effort and modernize IRS’s outdated systems and processes. There are just too many unknown variables at this time. The IRS has a BSM Expenditure Plan in the approval process that includes a proposal on how it plans to allocate the \$285 million in the administration’s fiscal year 2005 budget request for the BSM program. This is the first time that the Business Systems Modernization Office (BSMO) has forecast so far ahead in an Expenditure Plan. The purpose of providing a 2-year plan is twofold. First, the goal is to provide key stakeholders with a comprehensive understanding of the sequencing of activities and to show the impact of changes to the plan across multiple years. Second, the objective is to provide enough information in advance so that funding for future fiscal years can be made available earlier in the fiscal year. The IRS will provide an updated BSM fiscal year 2005 Expenditure Plan in the summer of 2004, reflecting any adjustments made during the upcoming months.

A key component to delivering on the challenge of modernizing America’s tax system is for the IRS to establish credibility with key stakeholders that it is identifying and addressing barriers to achieving business modernization success, and to show its constituents that it can and will get modernization done “right.” The IRS must gain the trust of its stakeholders by consistently delivering systems on time and within budget, and significantly improving its productivity, quality, and effectiveness in building modernized systems.

Getting modernization “right” means building systems that meet the business needs of tax administration, while delivering tangible benefits to taxpayers. The right balance of IRS business leaders are now engaging with the modernization technology team to help determine how to best apply technology in order to improve service to taxpayers, support enforcement activities, and improve compliance.

Sharing leadership roles requires clarifying responsibilities, empowering managers with decision making authority, and holding individuals (both contractors and employees) accountable for delivering measurable results on time and within budget. The IRS has implemented processes and procedures to enable and enforce accountability, such as establishing a governance structure, clearly defining roles and responsibilities, and defining project milestone requirements.

Scope growth and unresolved issues can easily derail the best laid plans for developing and implementing large, complex, high-risk systems. The IRS resized the business systems modernization project portfolio, adopted policies to support the prompt escalation of issues, and reached an agreement to significantly control discretionary change requests. Maturing management processes, strategically driven business requirements, and improved project life cycle methodologies will define and drive the modernization initiative going forward.

The IRS has placed an emphasis on increasing the timeliness and accuracy of BSM communications to ensure that key stakeholders are well informed of program goals and the status of projects against schedule and cost targets.

There is much more work to do, but the Commissioner is committed to modernizing the IRS’s archaic computer systems. While progress to-date has been decidedly mixed, the IRS owes it to taxpayers to stay the course and put a solid foundation in place upon which the IRS can build for decades to come.

Question. Please provide an update of all core systems being developed. In the update, please provide the original estimated cost of each program, the current cost estimate, the original estimated date of completion and the new completion date.

Answer. Response is combined with the response to the subsequent question.

Question. Please provide a list of any core system of the BSM program that the IRS has delivered on time and within the original budget estimate?

Answer. The IRS and PRIME have not delivered any BSM projects on time and within the original budget estimate. The following describes the major projects and includes a table detailing cost and schedule variances to date.

Modernized e-File (MeF)

Modernized e-File Release 1.0, which provides electronic filing for the first time ever to large corporations and tax exempt organizations, went live in February 2004. MeF provides 53 forms and schedules for 1120/1120S (corporations) and 990 (tax exempt organization) e-filing. It also provides the functionality to support those forms including:

- applicable interfaces;
- validation;
- retrieval and display options;
- the capability for large taxpayers to file using the internet; and,
- the capability to use Adobe files.

Release 1.0 has exceeded project volume for the year after only 2 months of operation. The project won the Government Solutions Pioneer Award from Federal Computer Week Magazine (1 of 15).

Modernized e-file release 2.0 will include 36 additional forms and schedules that are filed with Forms 1120/1120S (corporations) and 990 (tax exempt organizations). The IRS exited Release 2.0 Milestone 3 System design in March 2004. The IRS plans deployment for the summer of 2004. The IRS provides a chart listing the cost and schedule variances at the end of this response.

E-Services

The e-Services project focuses on providing electronic account resolution and fostering easy-to-use electronic products and services targeted at specific practitioner segments that will inform, educate, and provide service to the taxpaying public. In addition, e-Services will provide electronic customer account management or Indirect Channel Management capabilities to all businesses, individuals, and other customers in a safe and secure manner. This project will help the IRS move toward the Congressional goal of receiving 80 percent of tax returns and information filings by electronic transaction, while achieving a 90 percent customer and employee satisfaction rate by 2007. Taxpayers who e-file will have the benefit of quicker refunds, more accurate transaction processing, and access to an array of new electronic services. The IRS has made noticeable improvements in the 2003 and 2004 filing seasons, with considerable improvement resulting from a series of strategic enhancements resulting from a series of planned releases late in 2003.

The IRS has delivered electronic services to tax practitioners, and other third parties such as banks and brokerage firms that report 1099's. The IRS deployed all Release 1.0 and Release 2.0 initial operations functionality by the end of April 2004, except for Transcript Delivery System (TDS), which will be available in June 2004. The IRS conducted additional pilot and performance testing of both releases prior to deployment to the broad practitioner community.

The IRS fully deployed, and made available over the Internet, all e-Services Release 1.0 products, including: registration and online address change access for third parties and IRS employees through secure user portals; Preparer Tax Identification Number (PTIN) online application; interactive Taxpayer Identification Number (TIN) matching; secure Electronic Return Originator (ERO) application process; and, access to e-Services registration and application processes by Modernized e-file (MeF) participants.

E-Services Release 2.0 products are now in production and available for use by IRS staff and taxpayers, including: Application for e-Filing (external); Electronic Account Resolution (EAR), Electronic TIN Bulk Matching (Bulk Requests); Disclosure Authorization (DA); and infrastructure support for outbound facsimile service. A chart listing cost and schedule variances for the e-Services program is provided at the end of this response.

Customer Account Data Engine (CADE)

The IRS has delayed the CADE program four times. The IRS originally scheduled the first release of CADE for delivery in December 2001. The IRS then rescheduled it for August 2003 and again for April 2004. The IRS recently finalized the re-planning effort for CADE—under a fixed price contract—and set the latest delivery date for September 2004.

While CADE is farther along than the IRS has ever been in replacing a component of the master file, there are still major hurdles to overcome. The CADE delays stemmed from:

- Infrastructure upgrades;
- Failure to understand the complexity and control function combined with poor software quality during the startup of systems integration testing; and,
- Resolution of operational and performance issues that occurred during an initial release of the pilot.

The delivery of the CADE project is particularly important because, for the first time, it moves taxpayer data from the outdated tape-to-tape reels into an updated tax administration data and processing system that can be accessed and updated in real time. Like the new online technical infrastructure that the IRS deployed, CADE is a core fundamental component of the modernized systems. As such, CADE is the IRS's highest priority technology project. As of May 14, 2 weeks remained on 2004 filing season release pilot (Reprocesses cycles 4–8 from earlier this year). The pilot has gone well. The IRS recently signed a fixed-price contract through initial operating capability (IOC) and has started work on the 2005 filing season release.

Integrated Financial System (IFS) Release 1

Like CADE, IFS has been plagued with schedule delays. The IRS originally planned to deliver the majority of the first release of IFS in October 2003, and the balance in January 2004. The IRS later rescheduled it for April 2004. The IRS has subsequently scheduled Release 1.0 for October 2004. Delay of the first release of IFS occurred because of:

- The need to make technical changes to comply with the enterprise architecture;
- The inability to resolve key design and integration issues in a timely manner;
- Identification of the health coverage tax credit interface requirement late in the development process; and
- Delays experienced in integration testing due to poor application quality and interface testing issues.

IFS Release 1.0 will cover core accounting functions such as budget preparation, general ledger, accounts payable, accounts receivable, financial reporting, and purchasing. Problems continue to seriously jeopardize the scheduled delivery of the first release of IFS.

The IRS is currently negotiating a fixed-price contract for October delivery. Testing is behind schedule by 2 weeks and data conversion is at risk within the scheduled 6-week window. The IRS lists IFS cost and schedule variances in the chart at the end of this response.

Custodial Accounting Project (CAP) Release 1

The IRS has encountered delays on the first release of the Custodial Accounting Project (CAP). This project provides an integrated link between the tax administration (revenue) and internal management (administrative) financial information. The first release of CAP will address revenue from individual taxpayers on initial tax payments. Later releases of CAP will address businesses and collections. CAP delays resulted from unstable CADE and IFS interface definitions. Additional testing time is necessary due to a much larger than anticipated volume of data anomalies discovered during the conversion of the data from the current individual Master File (IMF), and the time required resolving system performance issues.

In addition, though not directly responsible for CAP delays to date, the IRS has made some adjustments to the functionality that it needs to have in CAP Release 1 to support the GAO financial audit, as well as its internal accounting and management. These adjustments will increase the cost of later sub-releases of CAP Release 1. The IRS has now completed all testing for CAP Release 1, and is adding changes to reflect IMF changes from the start of the 2004 filing season (Release 1.1). The IRS plans to start production, which includes the initial load of IMF data, in mid-August.

The IRS has scheduled the completion of negotiations of a fixed price contract for Release 1.0/1/1 for no later than the end of June. Once those negotiations are complete, the IRS will begin negotiating a fixed price contract for Release 1.2 (mid-year 2004 changes). The IRS lists cost and schedule variance information in the chart at the end of this response.

Project	Initial Est. Cost	Actual/Revised Est. Cost	Cost Variance	Initial Est. Completion Date	Actual/Revised Est. Completion Date	Schedule Variance
Customer Communications (CC) 2001 Improves communications infrastructure, including telephone call management, call routing, and customer self-service applications. Recent Statistics: —68,000 calls in one 3-minute period during initial week —50 percent reduction in waiting time for assistor to answer call —50 percent reduction in abandoned calls —Number of Spanish calls doubled —More accurate pre-routing of calls Customer Relationship Management Exam (CRM Exam) Provides standard tax computation software to Large & Mid-Sized Business Revenue Agents. Recent Statistics: —Deployed to almost 4,000 Revenue Agents —Software meets 91 percent of LMSB requirements —Average case time reduced due to new automated tax computation —Improved accuracy in computing corporate taxes Security and Technology Infrastructure Release (STIR) Release 1 Internet Refund/Fact of Filing (IR/FoF) Improves customer self-service by providing instant refund status information and instructions for resolving refund problems to taxpayers with Internet Access. Recent Statistics: —17.9 million inquiries in 2003, 19.2 million to date in 1994 (1/1/04–4/25/04) —32 percent of all real time IRS assistance calls come from IR/FoF —Modest reduction of telecommunications costs (about \$250,000) —Every 1,000 IR/FoF contacts eliminate 1,500–2,000 refund assistance calls Human Resources (HR) Connect Release 1	\$41,110,000	\$46,420,000	+\$5,310,000	5/31/01	2/26/02 (Full Deployment)	+ 9 mo.
\$9,313,000 \$7,375,000 \$(1,938,000) 6/30/02	9/30/02 (Full Deployment) + 3 mo.	\$33,734,000 \$13,509,000 \$41,287,000 \$26,432,000 +\$7,553,000 +\$12,923,000 8/31/01 7/31/02	1/31/02 (Initial Operation) 9/26/03 (Full Deployment) + 5 mo. + 14 mo.	\$10,000,000 \$10,200,000 +\$200,000 12/31/02	12/31/02 (Initial Operation) N/A.	

<p>Delivers an enterprise solution to allow IRS employees to access and manage their human resources information online.</p> <p>Recent Statistics:</p> <ul style="list-style-type: none"> —75,000 internal users —Cited by Commissioner Everson as an enabling factor in the redirection of approximately 750 staff years to enforcement —Treasury was selected as 2004 Computerworld Honors Laureate for HR Connect development and implementation 	\$44,045,000	\$130,281,000	+\$86,236,000	10/31/03	4/30/05 (Full Deployment)	+ 18 mo.
<p>E-Services</p> <p>Creates a web portal and value adding e-Services services to promote the goal of conducting most of the IRS's transactions with tax practitioners.</p> <p>Recent Statistics:</p> <ul style="list-style-type: none"> —Over 57,000 PTIN applications (WFP) entered to date; data entry productivity doubled (from 8/15/03–4/21/04) —Over 56,000 e-file applications to the Third-Party-Data-Store (TPDS) entered to date (from 8/15/03–4/15/04) —Approximately 23,000 Registered (and confirmed) User Portal (RUP) to date from (10/14/03–4/21/03) —4.7 million Bulk TIN requests 	\$29,246,000	\$46,303,000	+\$17,057,000	11/03: Assurance Testing ... 12/22/03: Web-Filing	11/04/03: Assurance Testing 2/9/04: Web-Filing	+ 4.5 mo. + 1 day. + 7 weeks. + 6 weeks.
<p>Modernized e-File (Wef) Release 1</p> <p>Provides e-filing to large businesses (1120 family) and tax exempt organizations (990 family).</p> <p>Recent Statistics:</p> <ul style="list-style-type: none"> —Went live 2/23/04 —Over 30,600 returns (1120) family accepted as of 4/25/04 —Over 3,109 participating Electronic Return Originators as of 4/25/04 	\$61,145,000	\$97,905,000	+\$36,760,000	12/31/02	September 2004	+ 21 mo. ¹
<p>Customer Account Data Engine (CADE)—Individual Master File (IMF) Release 1.</p> <p>Creates authoritative computations and stores data for individual taxpayer accounts and tax return information; it provides timely complete, accurate taxpayer information to IRS employees.</p> <p>Custodial Accounting Project (CAP) Release 1</p> <p>Provides integrated, reliable tax operations and internal management information to support evolving decision analytics, performance measurement, and management information needs.</p>	\$47,161,000	\$119,219,000	+\$72,058,000	1/31/03	August 2004	20 mo.
<p>Integrated Financial System (IFS) Release 1</p>	\$99,870,000	\$153,786,000	+\$53,916,000	3/31/04	October/November 2004	7–8 mo.

Project	Initial Est. Cost	Actual/Revised Est. Cost	Cost Variance	Initial Est. Completion Date	Actual/Revised Est. Completion Date	Schedule Variance
<p>Modernizes IRS financial management systems by providing a single general ledger for custodial and financial data and a platform to integrate core financial data with budget, performance, and cost accounting data.</p> <p>Customer Account Management (CAM) Release 1</p> <p>Delivers an enterprise solution to support access to tax account data, contact management, case management, outbound correspondence management, and workflow management.</p>	\$57,578,000	TBD ²	TBD ²	10/31/04	TBD ² (Initial Operation)	TBD ²

¹ CADE, CAP and IFS project schedules are currently under review.
² CAM project work suspended following completion of preliminary design activities (\$15,452,000 expended). No further work planned until at least fiscal year 2005.
 Source: GAO analysis of IRS data contained in Business Systems Modernization (BSM) Expenditure Plans.

Question. The budget contains an initiative related to Private Collection Agencies. Please provide some detail justifying this initiative.

How will taxpayer privacy rights be protected?

Answer. Private Collection Agencies (PCAs) will be required to comply with all taxpayer protections with which IRS employees are required to comply, including the provisions of RRA98, and 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.

—PCAs will be required to comply with the Fair Debt Collection Practices Act.

—Under the proposal, taxpayers would be permitted to seek damages from PCAs and their employees who violate the protections provided.

—The IRS will approve PCA operational plans that will detail the actions a PCA will take to resolve IRS accounts.

—The IRS will establish an oversight group with responsibility for managing case referrals, monitoring and evaluating PCA performance against the approved operations plan, and reviewing and approving PCA actions.

—The IRS oversight function will use live phone monitoring, recorded phone monitoring, review of PCA systems for adherence to operation plans, and on-site reviews to ensure taxpayer rights are fully respected.

Question. The IRS implemented a similar pilot program in 1996. What lessons were learned from that pilot?

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

—*Funding.*—The pilot program was funded from the IRS's Tax Law Enforcement appropriation.

—*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.

—*Selection of Accounts.*—The pilot program required the IRS to place accounts where the IRS had previously made attempts to collect. 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.

—*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 debts had to be returned by the PCAs to the IRS due to the PCAs' inability to respond to often-straightforward questions about a taxpayer liability.

—*Contract Structure.*—The pilot program involved a fixed-price contract with incentive payments.

Question. Have those lessons been implemented in the new initiative?

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 this proposal addresses those issues, are set out below.

—*Implementation Period.*—In contrast, this proposal has been developed over the past 2 years and has involved discussions between the IRS, Treasury Department, Office of the National Taxpayer Advocate, Department of Justice, and prospective contractors. Moreover, even if authorizing legislation were enacted in the next 6 months, this proposal contemplates that an additional ramp-up period of over a year would be required before the PCA program could begin. This additional time would be required 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 conducted in 1996/1997 was funded from IRS's Tax Law Enforcement appropriation. Funding in this manner resulted in a net reduction to the IRS compliance resources. In contrast, the administration's proposal to fund PCA activities from proceeds would allow PCAs to supplement, not displace, existing IRS resources.

—*Processing and Communications.*—The IRS will invest in modernized Collection Decision and Inventory Management Systems to ensure the successful integration of PCA activities into the IRS collection process.

—*Selection of Accounts.*—The IRS, under the administration's proposal, would focus on ensuring that the outstanding liabilities referred to PCAs are those that not only are within the authority of the PCA to resolve but also represent cases with the greatest likelihood of payment if a PCA were to handle the liability.

—*Taxpayer Information.*—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, 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 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 IRS oversight of the PCAs participating in the program. This IRS oversight would ensure that procedures are followed, and that any issues are identified and resolved early.

Question. How much outstanding tax debt owed to the Federal Government is likely to be collected if this initiative moves forward?

Answer. The Treasury Department has estimated net revenue will total \$1.5 billion over 10 years. The gross revenue collected in the Treasury calculations is \$1.9 billion over 10 years.

Question. The Customer Account Data Engine (CADE) is the centerpiece of the modernization effort. It holds the promise of moving the IRS from the tape driven system of the 1960’s to a modern reliable database.

What needs to occur to make this plan a reality for the IRS?

Answer. As you have so appropriately noted, the delivery of the CADE project is particularly important because—like the new online technical infrastructure that the IRS deployed—CADE is a core fundamental component of the modernized systems. As such, CADE is the IRS’s highest priority technology project.

The first release of CADE is scheduled for delivery in September 2004. The IRS has 2 weeks remaining on the fiscal year 2004 filing season release pilot. The pilot has gone well. The IRS is scheduled to go into initial production operation sometime in July or August under a fixed price contract through initial operating capacity.

Question. What has caused the 30-plus month delay in the delivery of Phase 1 of this system?

Answer. The CADE delays stemmed from infrastructure upgrades, initial poor software quality during the startup of systems integration testing combined with the failure to understand the complexity of balance and control, and the resolution of operational and performance issues that occurred during Phase 3 of the Release 1.0 pilot.

Question. Why has the estimated cost gone from \$61,145,000 to \$97,905,000? When can the committee expect a delivery of Phase 1? What is the IRS doing to control the massive cost increases to this system?

Answer. *CADE Cost Overrun (from the original estimate of \$61,145,000 to \$97,905,000).*—The description below explains the costs that GAO reported in their Audit of the fiscal year 2004 Expenditure Plan:

Design Work from September 2000 to July 2001

\$15.3 million—initial estimate in March 2000 Expenditure Plan.

\$19.3 million—actual cost.

\$4.0 million—variance due to design period being extended by 3 months to add detail in some areas and to bridge to Development.

Development Work from July 2001 to March 2004

\$40.0 million—initial estimate in March 2001 Expenditure Plan.

\$53.6 million—actual cost.

\$13.6 million—\$9.3 million of the variance was due to a 2-month extension for a Pilot using real tax returns (cost of \$5.3 million) and the addition of capacity at the Martinsburg Computing Center to support Development and Testing (cost of \$4.0 million). The remaining variance of \$4.3 million was due to incurring the cost impact of delays (see first two items outlined below).

Cost Impact of 2-Year Delay in Delivering CADE

\$2.4 million—hiring of non-PRIME contractors to support IRS testing.

\$1.9 million—establishing a CADE Program Office (work to build an organizational framework to support multiple CADE releases simultaneously).

\$18.0 million—cost to apply tax law and other changes for 2003 and 2004 filing season.

These costs do not reflect any changes since the GAO audit of the fiscal year 2004 Expenditure Plan.

Question. Please provide the committee with an update of the review.

Answer. The IRS used the results from independent studies commissioned during the summer of 2003 to create a BSM Challenges Plan comprised of 40 some action items. Given the strategic importance of the plan, the Commissioner appointed an IRS business unit deputy commissioner to oversee the implementation of the plan.

As a first step, the BSM project team developed a crosswalk to ensure that the BSM Challenges Plan's definition of the issues addressed and/or satisfied all of the recommendations from the four commissioned studies as well as the recommendations submitted by the IRS Oversight Board, and the Software Engineering Institute (SEI) study of CADE.

While the deputy commissioner made significant progress in implementing the plan, the full closure of all actions items was unrealistic within the elapsed timeframe of the 6-month appointment. Concurrently, the CIO created a new direct report position for modernization management and assigned responsibility for implementing the plan to the individual recently hired into this newly created position.

Under the leadership of the deputy commissioner, the IRS and CSC team brought closure to several key actions items, including: clarifying the roles of committees as advisory, identifying "blockers" on contracting issues, appointing business leaders to each project, establishing a risk-adjusted schedule and new baseline for CADE Releases 1.0 and 1.1, and increasing the frequency of CADE reviews with the business owner to twice monthly. The majority of the action items are still works-in-progress, some of which will take time to fully complete. Others will span the life of the BSM program.

For example, strengthening systems engineering capabilities by hiring external candidates will take time since it involves conducting the searches, interviewing the candidates, and negotiating the new hires to come on board. The IRS and CSC developed ground rules for escalating issues, but they will need to be continually enforced throughout the life of the program. The IRS rewrote the charters of the governing committees to reflect their advisory role and clearly articulated their responsibilities, however, it will probably take a year to truly evaluate and measure their effectiveness.

As stated, the IRS has made progress toward closing all the action items, but it has much more work to do in critical areas. For example, the IRS needs to religiously follow the proper methodologies and hold people accountable if they do not. The IRS must start "doing things right" as opposed to "doing things fast" such as exiting milestones prematurely. An ongoing challenge will be balancing the scope and pace of projects consistent with capacity, ensuring that the right people are in place before launching a project, and setting realistic delivery schedules and cost estimates. The IRS is committed to staying-the-course and delivering on its promise to modernize America's tax systems, but it is important for everyone to acknowledge this is a monumental effort.

The magnitude and evolution of the BSM program dictates that the IRS will always be going through an evolution of assessment and improvements. In that regard, the BSM Challenges Plan is still evolving and the IRS is using certain action items to continuously improve the program.

Question. What changes need to be implemented to get this mission critical system back on track?

Answer. As a result of missing CADE and IFS key deliverables last summer, the Commissioner and CSC commissioned external assessments studies from outside experts. The studies produced no major surprises; but the IRS now understands more about the issues. All of the assessments confirmed that the IRS modernization effort is a massive, highly complex, high-risk program that is confronting a number of critical management and technological challenges. These studies also made it clear that

the IRS should not turn back, but rather make a series of changes to strengthen the BSM program.

While all of these studies assessed different components of the modernization program, three major recommendations emerged including:

- Scaling back the modernization portfolio to better align with IRS and CSC’s capacities;
- Engaging IRS business units to drive the projects with a business focus; and
- Improving contractor performance on cost, scheduling, and functionality.

The assessments also raised a number of other key improvement opportunities, including:

- Adding outside expertise to help manage the program and to complement IRS skills;
- Strengthening our human resources capacity management;
- Adhering to methodologies in areas such as configuration management, cost and schedule estimating, and contract management;
- Reducing the burden from oversight organizations;
- Simplifying the budget process; and
- Initiating the testing of the business rules engine on CADE.

The Software Engineering Institute (SEI) will periodically review the CADE program, and a third party (MITRE) will regularly assess the overall health of the modernization program reporting directly to the CIO.

The IRS committed to scaling back the modernization efforts to better match its management capacity as well as the PRIME’s, and to focus on the most critical projects and initiatives. The IRS reduced the size and scope of the modernization program considerably, and has initially developed a human resource capacity planning model to help ensure the right people, with the right skills, are dedicated for the right amount of time to each IT project it undertakes.

The Commissioner is holding IRS senior business unit managers accountable for the success of modernization efforts as it relates to defining, developing, and controlling business requirements. For example, the involvement and leadership of the Deputy Commissioner for Wage and Investment played a key role in the successful delivery of Modernized e-File.

It was evident that CSC, as the PRIME contractor, needed to significantly improve their performance. While CSC has improved their performance somewhat, delays and cost increases persist, as evidenced by the continual delays in delivering CADE, IFS, and CAP. As a result, the IRS will expand the competition for the new enforcement projects that it plans to start later this year and next year. The IRS is also moving to capped or fixed price contracts for development work to balance the financial risk between the Government and the contractor in modernization projects.

The IRS needs a more versatile team of seasoned executives to provide long-term stability to the program. It is complementing the skills of experienced IRS tax executives with outside seasoned technology executives who have experience managing large-scale, complex IT projects. As such, the IRS is hiring two Associate Chief Information Officers to join the MITS organization, and an executive search firm is conducting searches for five senior executives with a wide range of diverse experience in developing and implementing large modernization systems.

The IRS has placed an emphasis on increasing the timeliness and accuracy of BSM communications to ensure that key stakeholders are well informed of program goals and the status of projects against schedule and cost targets.

There is much more work to do, but the IRS is committed to modernizing its archaic computer systems. While progress to-date has been decidedly mixed—the IRS owes it to the taxpayers to stay-the-course and put a solid foundation in place upon which the IRS can build for decades to come.

Question. The committee understands that the E-Services program is expected to be fully operational by fiscal year 2005. Is this program still on schedule? What has occurred to make this project cost go from \$44,045,000 to \$130,281,000? Why is it 18 months behind schedule?

Answer. The IRS has achieved a great deal of success with the e-Services project. The IRS has delivered electronic services to tax practitioners, and other third parties such as banks and brokerage firms that report 1099s. The IRS deployed all Release 1.0 and Release 2.0 initial operations functionality by the end of April 2004. The IRS conducted additional pilot and performance testing of both releases prior to deployment to the broad practitioner community. The response has been extremely positive.

In March 2004, James D. Leimbach appeared before the Ways & Means Oversight Subcommittee on behalf of the National Association of Enrolled Agents (NAEA) and said, “This new capability is truly going to revolutionize the way we conduct future

business with the IRS. The ultimate beneficiary is the American taxpayer. We are truly amazed and thrilled beyond description at this way of doing business with the IRS, and we would like for you to understand why we feel as we do.”

All e-Services Release 1.0 products are fully deployed and available over the Internet, including:

- Registration and online address change access for third parties and IRS employees through secure user portals;
- Preparer Tax Identification Number (PTIN) online application;
- Interactive Taxpayer Identification Number (TIN) matching for payers and/or authorized agents who submit any of six information returns subject to backup withholding (Forms 1099-B, INT, DIV, OID, PATR, and MISC);
- Secure Electronic Return Originator (ERO) application process; and
- Access to e-Services registration and application processes by Modernized e-file (MeF) participants.

E-Services Release 2.0 products are now in production and available for use by IRS staff and taxpayers, including:

- Electronic Account Resolution (EAR);
- Electronic TIN Bulk Matching (Bulk Requests);
- Disclosure Authorization (DA); and
- Infrastructure support for outbound facsimile service.

Statistics gathered as of May 13, demonstrate that the e-services program is providing important benefits for taxpayers and tax practitioners:

- No. of Individuals registered=24,000;
- No. of Individuals changing address during registration=3,000;
- No. of Interactive TIN Match requests=221,000;
- Bulk TIN Requests=4.7 million.

There were five main causes for the schedule delays and cost increases from \$44,045,000 to \$130,281,000.

Budget Omission for Infrastructure Functionality/Acquisition (\$8–9 million).—The original project budget failed to consider the integration of the e-services application with the modernized infrastructure or budget for the acquisition of specific hardware or software to support e-Services development and production environments.

Extended Testing and Infrastructure Integration (\$15–17 million).—The quality of the software that CSC and Unisys delivered to the IRS for e-Services was lower than anticipated and the time it took to resolve each of the errors took longer than anticipated. In addition, there was a series of actual integration issues between the application and the infrastructure that were greater in number and took longer than anticipated to resolve.

Modernized e-file 1040 e-file support (\$4–6 million).—In reviewing the proposed design for the Modernized e-file project, it was discovered that the project plan called for a system that would not be multifunctional. The IRS developed an alternative plan to expand e-Services functionality to provide these services for Modernized e-file in a manner that was consistent with the Enterprise Architecture, which describes the business and information systems and technical infrastructure that are both in place (Current) and planned (Target). In addition, the Enterprise Architecture defines the architectural strategies to be followed and prescribes standards and technologies to be used.

IRS Initiated changes including filing season changes (\$8–10 million).—Due to the fact that it took longer than anticipated to build the e-Services system, the IRS made a number of significant changes to ensure that the e-Services system was consistent with filing season requirements and current production changes.

Extension of MS5 and a misestimate of MS5 costs (\$45–48 million—increased estimates for costs through 9/30/05).—Because the e-Services project ran over cost and schedule estimates, the IRS deployed the project using version 8.1 Peoplesoft, CRM. Peoplesoft will stop maintenance of this version of the software in 2005. The IRS must upgrade the production system to conform to latest Peoplesoft CRM 8.8 release. Due to the complexity of the upgrade, the BSM program had to make the changes before turning it over to ITS for operations and maintenance. The BSM program was originally scheduled to turn the e-Services project over in May 2004. The program will now be maintaining and upgrading the system a year longer, until May 2005.

Question. Of the ten computer modernization projects ongoing as of September 2003, nine are currently over their original cost estimate by a total of \$292,013,000.

What needs to occur for the IRS to better monitor the escalating costs of these systems?

What types of oversight does the IRS provide over the contracts for development and acquisition of these projects?

Answer. The IRS is currently putting in place several control mechanisms for Contractual, Enterprise Life Cycle, Earned Value Management, Performance and Cost and Schedule Estimating that directly address the estimate overruns. In particular, the IRS is enacting methodologies that will eliminate future “escalating costs.”

The IRS has been working jointly with MITRE and CSC (the PRIME Contractor) to improve cost and schedule estimating capability. The IRS is using the well-recognized Carnegie Mellon Software Engineering Institute’s (SEI) Requisites for Reliable Estimating Processes as a guide. The requisites provide for development and execution of the following key cost and schedule estimating objectives:

- Maintaining historical data;
- Structured estimating processes;
- Mechanisms for extrapolating estimates from successful past projects;
- Audit trails; and
- Ensuring integrity in dealing with dictated costs and schedules.

Both CSC and the IRS have made significant progress towards achieving these key objectives. The IRS has implemented procedures for validating contractors’ estimating systems and for reviewing cost and schedule estimates. The procedures provide guidance for evaluating reliability of documentation supporting individual estimates and for tracking compliance with sound estimating practices. Furthermore, the procedures also address professional development of personnel with the right skill set for developing and evaluating cost and schedule estimates. CSC has established a historical database, calibrated estimating models and developed detailed requirements for documenting and supporting bases of estimates along with related guidance and directives. Work is also in progress for continuing refinement and improvement in each of these elements.

In addition, joint training is being conducted for IRS, CSC and MITRE personnel as an integral part of the overall plan to ensure competent deployment of improved processes and procedures. The IRS, with MITRE’s assistance, recently completed a review of CSC’s estimating system. The IRS is finalizing the results and will issue them in a report in the latter part of June. In general, there have been improvements. The report will include a time phased corrective action plan for addressing deficiencies. To ensure the tools, guidance, processes and procedures are part of a mature repeatable process, a concerted effort is underway to fully validate all aspects of the processes and procedures prior to official roll-out within the IRS. This pilot program is intended to verify the soundness of the processes and procedures and provide lessons learned, before full implementation is effected.

Every effort is being made to hire qualified staff and fully implement improved tools, guidance, processes and procedures as soon as possible. However, this is taking more time than the IRS would like. This is a pervasive problem on programs of the size and complexity of the modernization initiative. Nonetheless, the IRS believes that there will be evidence of increased accuracy by the end of fiscal year 2004 and continued improvements over time.

Finally, all of these efforts are part of a highly visible set of plans geared to identifying, tracking, reporting, and reviewing the critical cost and schedule estimating commitments with IRS Executive Management and GAO/TIGTA.

The following initiatives have been implemented (or are pending) to improve performance in the other areas:

- Application of Performance-Based Contracting (PBC) Techniques.*—Applying performance-based contracting techniques and leveraging lessons learned enhances the IRS’s ability to proactively establish expectations for and manage the PRIME contractor’s performance.
- Determination of Task Order for Acquiring Modernization Systems.*—To further improve modernization controls and capabilities, the IRS has established and is implementing a process for determining the type of task order to be awarded when acquiring modernization systems. The IRS issued a policy stating that contracts and task orders for the BSM projects in Milestones 4 and 5 (development and deployment) will be fixed price, as appropriate. This type of task order will shift most or all risks from the IRS to the PRIME.
- Implementation of Fixed Price Contracting Policy.*—The IRS’s Contracting organization and the Enterprise Life Cycle program are developing a joint approach to implement the fixed price contracting policy.
- Identification of Issues and Tracking Progress.*—The IRS is making use of Earned Value Management, Program Performance Measurements, and a sophisticated electronic analysis and reporting mechanism (the Dashboard) to track progress, identify variances early, and facilitate escalation of issues early in the life cycle.

- Development of Metrics.*—Finally, the Program Performance Management Office (PPMO) is developing efficiency and outcome metrics to:
- decrease contracted program variances,
 - decrease requirements volatility, and,
 - increase contracted requirements delivery.

These metrics support program management effectiveness, and provide the ability to assess achievement of program performance goals relative to cost, schedule, requirements scope, and requirements delivery.

FUEL TAX EVASION

Question. The Federal Highway Administration (FHWA) Motor Fuel Tax Evasion Project supports Federal and State efforts to enhance motor fuel tax enforcement. The program was established by the Intermodal Surface Transportation Efficiency Act of 1991 (Public Law 102-240) and continued under the Transportation Equity Act for the 21st Century (TEA-21) (Public Law 105-178).

Since 1998, the Department of Transportation has provided the Internal Revenue Service (IRS) \$31 million from Highway Trust Fund revenues to enhance motor fuel tax enforcement, primarily by developing and operating an automated excise fuel tax reporting system, the Excise Fuel Information Reporting System (ExFIRS). The administration's proposed Safe, Accountable, Flexible and Efficient Transportation Equity Act (SAFETEA) of 2003 includes \$163 million for the IRS through fiscal year 2009, and the Surface Transportation Authorization bill as passed by the Senate proposes about \$300 million.

The IRS has been struggling to modernize its automated systems. For example, the committee has been told that Commissioner Everson excluded one contractor from a project to update the IRS's tax enforcement systems after learning the contractor would miss an April deadline for putting in a new general ledger accounting system.

How is ExFIRS currently being used to enhance motor fuel tax enforcement and what are its capabilities? Is the system fully operational and functioning as envisioned? If not, what is needed to complete the systems development effort?

Answer. ExFIRS is an umbrella system made up of several subsystems/modules that support the collection of motor fuel industry information, support automated analysis of this information, and help identify areas with the highest risk for non-payment of excise tax liabilities (therefore offering higher potential for return on investigative and enforcement activities). The most important of the subsystems is the Excise Summary Terminal Activity Reporting System (ExSTARS), which tracks all petroleum movements, in and out, through approved terminals, and captures information that the IRS shares with State taxing agencies.

ExSTARS is the information reporting system that was designed similar to the IRS 1099 matching system that matches information received from employers, financial institutions and other businesses with information reported by taxpayers. It enables the IRS to track all reported fuel transactions that occur within the fuel industry's bulk shipping and storage system. It provides tracking capabilities of fuel from the pipeline/barge delivery system to the point of taxation for the Federal Excise Tax at the terminal. This information is then matched by the IRS to fuel sales transactions reported by taxpayers and to verify their tax liabilities reported on the quarterly Forms 720.

ExSTARS was operational on April 1, 2001. However, the large volume of paper returns filed each month has hampered the maximum use and benefit of the system. ExSTARS requires information reporting from over 1,400 terminals registered to transact fuel sales in this country, as well as the pipelines and barge carriers that transport the fuel from the refineries to the terminals. The IRS receives information reports on 10 to 14 million fuel transactions monthly. Approximately 70 percent of these are filed electronically. Working with the remaining 30 percent filed on paper documents is both impractical and cost prohibitive. Senate Bill S. 1072, the Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2004 (SAFETEA), would require electronic filing of any return containing more than 25 transactions, as proposed in the administration's SAFETEA bill. This legislation, if passed, will greatly enhance the tracking capabilities of ExSTARS.

ExFIRS includes a Data Warehouse module that interfaces with ExSTARS. This module uses the information reported in ExSTARS, on the distribution of fuel, to match against the reported amounts on taxpayer's 720 Excise Tax Returns. ExFIRS also includes legacy systems that the IRS used to track and monitor compliance in the motor fuel area. The Excise Tax Registration Authentication System (ExTRAS) contains the monitoring system for the registration program of taxpayers allowed to carry on tax free transactions within the fuel distribution system. The Excise

Fuel On-line Network (ExFON) is the management information system used to monitor the Dyed Fuel Program. The IRS included these systems in the ExFIRS Program because they are an integral part of the motor fuel tax program and must be included in the IRS's tracking of activities that impact compliance in this area. The funding for the update and enhancement of these systems came from IRS operating funds. These systems have been operational for several years and the updated versions are in place and operating within the ExFIRS Program. The Excise Tax Agent Work Center (ExTAC) is an automated work center that will enable IRS Excise Tax Agents to receive tax returns in electronic format and to conduct examinations in an automated environment. ExTAC is a part of ExFIRS and will receive information from the system to assist in the examination of returns. ExTAC was funded by the IRS and is currently a working prototype version. The system will be in full production and used by agents by the end of the first quarter of fiscal year 2005.

Question. Given the problems IRS has experienced fixing its other automated systems, what reasonable assurance can you provide this committee that taxpayers are getting a good return on their investment in ExFIRS and that the project is being properly managed?

Answer. In 1998, Congress passed the Transportation Equity Act for the 21st Century, requiring the IRS to develop a fuel tracking system. This act required the IRS to use an outside contractor for the development and maintenance of the system. The IRS has met this requirement, and is using Software Engineering Institute (SEI) CMMI Level 2 development processes to manage the development efforts of the contractor and subcontractor personnel in order to ensure a continuous, uninterrupted, integrated approach to the development, installation and implementation of the ExFIRS subsystems.

As stated above, the ExSTARS module of ExFIRS was operational April 1, 2001. The design and development of this system was a joint effort between the IRS, industry and the States. The IRS is using the system, but the ability to date to maximize the effectiveness has been limited by two factors.

Due to the high volume of paper returns that contain thousands of individual transactions, the IRS only captures summary information from paper returns. This limits the IRS's ability to meet the goal of matching ExSTARS information to filed Excise Tax returns.

The filing requirements for ExSTARS required a significant investment for the fuel industry and at the time of ExSTARS becoming operational, some companies were not fully prepared to meet all of the filing requirements. Since April 1, 2001, the IRS has worked closely with industry filers to ensure accurate and timely filing of the information returns required for the operation of ExSTARS. The IRS formed a Data Perfection Team composed of IRS personnel along with outside contractors to work with and assist individual companies meet their filing requirements. Although the IRS has made great progress this area, some companies are still experiencing problems. The IRS has made a decision to continue to work in a cooperative manner with all companies that demonstrate a desire to address their problems and come into compliance with the ExSTARS filing requirements.

The IRS is using the system today. It has the ability to track the movement of fuel in all States—but within the limitations of the problems outlined above. If the issue of paper returns is addressed, the IRS will be able to match individual filers to the ExSTARS database. This will enable the IRS to better determine where to allocate its enforcement resources to combat fuel tax non-compliance. This same information will allow States that have the same tax point as the Federal Excise Tax to “piggyback” on this data to enhance their own compliance efforts.

On the question of the return on investment to the American taxpayers, one needs to look at the effectiveness of information reporting for compliance with income taxes. Matching information received from employers, financial institutions, and other businesses with information reported by taxpayers has long been recognized as one of the most powerful tools that the Internal Revenue Service has used to ensure income tax compliance. In fact, third parties report approximately 80 percent of the personal income received by taxpayers. Through its document matching programs, the Internal Revenue Service is able to use this data as an effective compliance tool. The ExFIRS Program will deliver the same effectiveness to the Excise Fuel Tax arena. The information gathered by the ExFIRS Program will be shared with all State motor fuel taxing agencies and will lead to increased compliance for the States. The States will directly benefit from the increased revenues that will be generated by a higher level of compliance in both the Federal and State areas.

Question. How were systems requirements determined and were other Federal and State law enforcement agencies involved in defining the requirements?

Answer. The design, development, and implementation of ExSTARS is a result of a working collaboration between the Internal Revenue Service, Contractors, Federal Highway Administration, State tax administrators, and industry stakeholders over more than a 5-year time period. A key goal in the development process was to create a system that would benefit State revenue agencies as well as the IRS. The system uses the Uniform Reporting Standards developed by the States to ensure all data is compatible with State systems. The Excise Tax On-line Exchange (ExTOLE) module was developed specifically for use by the States. ExTOLE allows States to exchange data that relates to motor fuel tax issues.

Question. What is the total cost of ExFIRS to date? What is the cost, funding, and schedule status of any development effort still needed for the system? What is the annual cost to operate and maintain the system?

Answer. The IRS and FhWA have provided funding for ExFIRS. The IRS funding is used to cover the incorporation of legacy system into ExFIRS. The two charts below show the cost to date:

FHWA ExFIRS EXPENDITURES

Cost Categories	Fiscal Year 1999	Fiscal Year 2000	Fiscal Year 2001	Fiscal Year 2002	Fiscal Year 2003	Totals
Initial Distribution from FHWA	\$9,430,000	\$7,923,000	\$4,479,000	\$4,609,000	\$4,739,000	\$31,180,000
Budget Reduction from FHWA	(180,000)	7,923,000	(11,000)		(32,500)	(223,500)
Total Available for Project	9,250,000	4,237,216	4,468,000	4,609,000	4,706,500	30,956,500
Contractors	6,151,747	4,237,216	3,913,663	3,938,222	2,922,850	21,163,698
Labor	517,849	943,910		114,489		1,593,948
Training	20,615	33,270	85,320	112,165	96,653	348,023
Travel	521,052	968,000		165,000	287,610	1,941,662
Background Investigations		32,175	20,000	4,000	5,425	61,600
Hardware	1,871,037	772,693	89,015	108,315	271,358	3,112,418
Software		769,676	146,079	13,819	918,060	1,847,634
Maintenance		2,000	28,140	2,990	54,544	87,674
Criminal Investigation Division	150,000	150,000	150,000	150,000	150,000	750,000
Telecom		14,060	35,783			49,843
Total Spent on Project	9,232,300	7,923,000	4,468,000	4,609,000	4,706,500	30,956,500

IRS ExFIRS EXPENDITURES

Cost Categories	Fiscal Year 1999	Fiscal Year 2000	Fiscal Year 2001	Fiscal Year 2002	Fiscal Year 2003	Totals
Initial Request from IRS	\$2,510,000	\$2,101,000	\$3,758,000	\$5,204,000	\$9,106,000	\$22,679,000
Budget Reduction from IRS	(92,338)		(1,037,469)	(3,406,000)	(7,220,000)	(11,755,807)
Total Available for Project	2,417,662	2,101,000	2,720,531	1,798,000	1,886,000	10,923,193
Contractors	1,173,062	2,077,039	2,720,531	1,319,000	1,886,000	9,175,632
Labor						
Training						
Travel						
Background Investigations						
Hardware	967,462	8,000		62,000		1,037,462
Software	149,998	15,961				165,959
Maintenance	127,140			417,000		544,140
Criminal Investigation Division						
Telecom						
Total Spent on Project	2,417,662	2,101,000	2,720,531	1,798,000	1,886,000	10,923,193

In addition, here are spreadsheets detailing future development, maintenance and operating cost through fiscal year 2006. Funding is provided each year to assist the IRS CI in their efforts on motor fuel issues.

ExFIRS SUPPORT CONTRACTOR COST ESTIMATES BY FISCAL YEAR

[In thousands of dollars]

ExFIRS SW Develop/Enhance/Maint Via TIPSS Type Contract	Fiscal Year 2004 Oct 2003–Sep 2004	Fiscal Year 2005 Oct 2004–Sep 2005	Fiscal Year 2006 Oct 2005–Sep 2006
ExFON Dev/Maint/Enhancement (includes Legacy Maint, New ExFON Dev In Web Envir and Data Migration)	700.8	790.4	160.0
ExSTARS Dev/Maint/Enhancement (includes Maint of ExSTARS 1 and Dev/Maint of ExSTARS 2)	2,945.0	1,594.2	400.8
ExTRAS Dev/Maint/Enhancement (includes legacy maint and development in Web environment)	80.0	372.8	160.0
BTRIS Dev/Maint/Enhancement (includes maint of current BTRIS and development of the Analyst Module)	424.0	1,118.2	225.0
ExCIDS Dev/Maint/Enhancement (includes devel of case mgt and workflow modules)	190.6	1,182.7	120.0
ExTAC Dev/Maint/Enhancement (includes maint of current system, development of GM module, and migration to Web environment)	770.8	691.2	320.0
ExTOLE Maint/Enhancement (includes maint of current system and development of enhancements called out in SOW)	80.0	160.0	120.0
ExMIS Dev/Maint/Enhancement (includes DW and ExCIS maint and analysis/reporting enhancements)	546.0	597.1	120.0
Common Costs Associated with all Subsystems (includes Prog Mgt, Sys Engr, CM, QA, Testing, SEI/CMM, Security, Subcontract Mgt, travel expenses, etc.)	2,466.2	2,476.1	1,866.4
Infrastructure Costs—See Infrastructure sheet (includes SW/HW Upgrades/Migrations, Tier 2 and Modernization Requirements, COTS and SW Licenses/Maintenance, Technology Advancements, Service Center Support, etc.)	3,779.0	3,789.0	3,568.0
Subtotal	11,982.4	12,771.7	7,060.2
FhWA Funding at Current Rate	4,200.0	4,200.0	4,200.0
Projected Need	7,782.4	8,571.7	2,860.2
IRS Funding Allotted	4,959.0	4,250.0	3,453.0
Funding Shortfall	2,823.4	4,321.7	–592.8

ExFIRS INFRASTRUCTURE COST ESTIMATES BY FISCAL YEAR

[In thousands of dollars]

ExFIRS Infrastructure Estimates	Fiscal Year 2004 Oct 2003–Sep 2004	Fiscal Year 2005 Oct 2004–Sep 2005	Fiscal Year 2006 Oct 2005–Sep 2006
Annual COTS Licenses, Yearly Maintenance and New User Licenses (Oracle, Informatica, Paper Free, Mecator, Business Objects, MapInfo, FileNet, Ventic)	656.0	637.0	668.0
ExFIRS SW Migrations for New RDBMS/OS/COTS (Oracle/Sun/NT). Major migration every other year (even years)	924.0	236.0	970.0
Tier 2 Requirements (New CM tool, additional security, move to Tier 2 infrastructure and web page compliance—508J)	231.0	243.0	100.0
ExFIRS Hardware Migrations (production, development, and test servers/user desktops, laptops and handheld devices/gateway firewalls and routers/technology upgrades). Major upgrade every other year (odd years)	236.0	892.0	248.0
ExFIRS Service Center Expenses (SA/DBA personnel and training covered by SLA—9.9 staff years)	982.0	1,031.0	1,082.0
Other ExFIRS Expenses (SW upgrades for technology advancements, new user functionality and IRS modernization initiatives)	750.0	750.0	500.0
Subtotal	3,779.0	3,789.0	3,568.0

Question. What benefits does FHWA derive from the system? Does IRS believe FHWA receives satisfactory return on investment from the system?

Answer. Tax receipts deposited in the Highway Trust Fund Account totaled \$35.2 billion in fiscal year 2003, of which \$30.2 billion went to the Highway Account and \$5 billion to the Mass Transit Account. As described above, the ExFIRS Program will enhance fuel tax compliance directly impacting the FHWA's mission. In addition, the FHWA will be able to use data from the system in its own planning process. Just recently the IRS met and provided summary data to FHWA to assist in its efforts to develop their model of State revenue sharing.

Question. Has an independent audit or review ever been performed of the ExFIRS development effort?

Answer. ExFIRS has a requirement to operate at a minimum of Maturity Level 2 of the SEI CMM. Yearly Process Appraisal Review Methodology (PARM) review of the process was completed in February 23, 2004. At Technology Solutions Center a CMMI SEI Level 2 rating was verified by independent evaluations (external SCAMPI Class A) on February 27, 2004.

Question. Fuel tax fraud creates a drain on Highway Trust Fund (HTF) revenues, which FHWA estimates costs at least \$1 billion annually. Department of Transportation Secretary Mineta has called evasion of Federal motor fuel taxes "a serious and growing problem that requires a serious Federal response." The loss of motor fuel taxes is also detrimental to State programs. The impact of these losses is even greater coming at a time when we have experienced a reduction in the growth of HTF revenues, while demands on highway capacity have reached unprecedented levels, and replacement and rehabilitation costs for aging infrastructure are rapidly increasing.

Although fuel excise taxes represent less than 2 percent of total Federal tax revenues, they are a critical funding source for DOT programs. Taxes on gasoline, diesel, and other fuels provide about \$33 billion each year, or 89 percent of the HTF revenues used to finance highway and transit projects nationwide. Increased tax collections mean increased Federal revenues for funding the Nation's highways and transit programs.

In July 2002, FHWA Administrator Peters testified before Congress that the administration proposed to halt fuel tax evasion through "a vigorous and more collaborative enforcement effort by State and Federal agencies" and a significant increase in funding over TEA21. The administration proposed providing \$202 million for the Highway Use Tax Evasion Project, of which \$163 million would be transferred to the IRS.

What does IRS currently estimate the losses from fuel tax evasion to be and how was this estimate derived?

Answer. KPMG, not the Federal Highway Administration, estimates drain on the Highway Trust Fund revenues to be the \$1 billion. Although it is difficult to estimate evasion because the IRS does not know what is not being reported, the IRS identified and is addressing critical areas of excise tax non-compliance. These include the:

- Continuing misuse of dyed diesel fuel;
- Smuggling to evade payment of taxes;
- Cocktailing (increasing the fuel volume by mixing in other products) to illegally reduce the effective tax rate; and
- Diverting aviation jet fuel to highway use to illegally evade motor fuel taxes.

The IRS continues to discover misuse of dyed diesel fuel for tax evasion purposes despite the numerous legislative and regulatory steps Federal and State governments have taken. The 140 fuel compliance officers (FCO) monitor 1,400 terminals, all fuel wholesalers, thousands of retail motor fuel outlets, and U.S. border crossings. Additionally, FCOs periodically inspect on-road vehicles on highways throughout the country. From January 1, 2003 through December 15, 2003, FCOs have assessed over 1,400 penalties totaling over \$1,400,000 for misuse of dyed diesel fuels. A further analysis of these results indicates that 70 percent of the penalties involved the misuse of fuel by taxpayers in the construction and agriculture industries. Both of these industries are subject to broad-based tax exemptions for non-highway use of motor fuels, thereby, presenting opportunities for abuse.

Another critical compliance problem is smuggling of motor fuel. This involves the illegal introduction of fuel into the United States to evade payment of excise taxes. This problem may occur at border crossing points and points of entry for ocean-going vessels. More than 9 million trucks pass through the 55 border crossings between Canada and Mexico into the United States each year.

The IRS also has found instances of fuel smuggled into the country by people using barges that off load from ocean-going vessels. The IRS is involved in two investigations of barges being used to smuggle fuel; however, it does not know the full

extent of activities in this area. These activities are extremely hard to identify due to the multitude of locations and means smugglers may use. The Corps of Engineers has identified over 600 locations that are not terminals but are known to have the ability to off load fuel from barges. In addition, barges may have portable devices that become mobile racks, providing the ability to off load fuel at any location.

Another compliance problem is the use of adulterated fuel through cocktailing. This technique increases profits by increasing the volume of diesel fuel with used motor oil and other distillates including pollutants, cleaning agents, and unfinished refinery products. This form of tax evasion is attractive for two reasons. First, the substances used to extend the fuel are often not regulated, so they are not recorded in any fuel reporting system. Second, in some cases, the substances are regulated as waste materials, providing an unscrupulous individual an opportunity to get paid to dispose of the product(s) and then blend them into gasoline and get paid again. This tax evasion technique results in an ongoing revenue loss. It may also be dangerous to the public when the taxable fuels are blended with hazardous waste.

Aviation fuel is the last interchangeable product available within the legal fuel distribution system that is not taxed when the fuel leaves a terminal. In any given month, hundreds of millions of gallons of aviation fuel flow into and out of registered terminals. This exempt removal at the rack creates incentives and opportunities to divert aviation fuel to highway use. From fuel inspections, the IRS knows aviation fuel is being diverted. However, the IRS does not know for certain the amount diverted. The IRS is finding aviation fuel in small amounts blended into normal diesel in the propulsion tanks of trucks/tractors. Also, the IRS has found aviation fuel in larger quantities in retail outlets through its Below The Rack compliance efforts. The IRS has found a blend of 5 to 10 percent in most cases.

In 2002, KPMG released a report alleging that the possible loss each year to aviation fuel diversion may exceed \$1 billion. The results from IRS internal efforts do not support or disprove an estimate of that size. The IRS initiated an audit program to determine if it could identify significant diversion through aviation fuel distributors operating as 637 H Registrants. In most situations, the distributor had the paperwork to support a tax free/reduced tax sale of the fuel. To date, the IRS has not identified registrants with massive amounts of fuel for which they cannot account. Due to the lapse of time between the sale of the fuel and the audit, the IRS could not successfully track down the ultimate users of the fuel to verify that the fuel was, in fact, used in a proper fashion. The only way to ensure the fuel is used properly is to track the fuel to each end user. The diversion of 1 percent of the aviation fuel that leaves the terminals in the United States represents the loss of over \$65,000,000 per year. Based on IRS's findings in the fingerprinting test, it believes that a 3 percent diversion is a conservative estimate. This amount of diversion would cost \$195,000,000 per year.

Dyed Fuel Misuse.—Dyed Fuel used on highways.—The IRS does not have an exact figure that it can state as the extent of total non-compliance for the misuse of dyed fuel. Based on penalties asserted over the past 3 years, the IRS assesses a penalty on an average of 1 percent of the trucks it inspects on the highway and 6 percent of the end user sites that it inspects. The IRS does not have data on the total volume of fuel involved in each of these cases; however, these results indicate a continuing non-compliance issue with the proper use of dyed fuel. Based on this experience, the IRS believes that at least 1 percent of dyed fuel sold each year is diverted, resulting in loss of tax of at least \$50,000,000.

Cocktailing/Illegal Blending.—The Internal Revenue Service has developed a “fuel fingerprinting” technology to combat fuel tax evasion occurring “below the rack”—particularly bootlegging, smuggling, and adulterated fuel through “cocktailing” or blending the product. Fuel fingerprinting is a technique that examines the “chemical fingerprint” of samples taken from retail stations for adulteration or for a mismatch with samples taken from the terminal racks that normally supply those stations. This technology allows for the detection of untaxed kerosene intended to be used as aviation fuel, “transmix” taken out of pipelines, waste vegetable oils, used dry-cleaning fluids, and other chemicals that may be mixed with diesel fuel and find their way into the tanks of trucks on the road. Fuel fingerprinting provides a more efficient and comprehensive method to monitor compliance compared to traditional audit techniques. The IRS has conducted sampling on diesel fuel in several parts of the country. Results indicate approximately 8 percent of the diesel fuel tested has some form of adulterant. The amount of adulterant found in retail outlets has been in the range of 2 percent–25 percent with an average of 8.2 percent. Using these results, the IRS estimates that there is a minimum of \$50,000,000 each year in tax loss due to illegal blending of diesel fuel.

Due to safety issues with handling gasoline, the IRS has not conducted fuel fingerprinting tests for gasoline. The IRS has anecdotal information from informants

that illegal blending is much more common for gasoline than diesel. The reason given is the huge demand for gasoline and the ease to hide the adulterants among the large volume of fuel moving through a location. Using estimates for diesel fuel and comparing the sale of gasoline to diesel (3 to 1), the IRS has a minimum estimate of \$150,000,000 per year for illegal gasoline blending.

Although the IRS has evidence of fuel being smuggled into the country, it does not have a reasonable basis for an estimate at this time. As mentioned in the discussion of the various schemes used for motor fuel tax non-compliance, the IRS does not have exact estimates of the potential revenue losses. All of these schemes are outside the law and the information is based on information the IRS has gathered through examinations and fuel testing. The IRS believes this is a conservative estimate and, in fact, does not include any estimation for smuggling in these numbers. In summary, estimates for the overall loss of revenue are as follows:

	Amount
Misuse of Aviation Fuel	\$195,000,000
Misuse of Dyed Fuel	50,000,000
Cocktailing of Diesel	50,000,000
Cocktailing of Gasoline	150,000,000
Overall Estimate	445,000,000

Question. How is IRS working with other Federal agencies and States to leverage enforcement resources? Since 2000, how many cases are being jointly investigated with other Federal and State law enforcement agencies?

Answer. The IRS has a long history of working fuel cases with its State counterparts and, when appropriate, with other Federal agencies. With current disclosure provisions it is difficult to jointly investigate motor fuel cases with other Federal agencies. In the past, the IRS has successfully worked with other Federal agencies under the umbrella of the grand jury. Working with State counterparts is most effective when the State has a similar point of taxation, that being at the terminal rack.

The IRS does not have a measurement process for determining how many cases have been worked with State or other Federal agencies. These situations have been on a case-by-case basis with the documentation in the case file.

Question. Who is responsible for coordinating the overall Federal and State efforts for pursuing all fuel tax evasion-related offenses?

Answer. The Internal Revenue Service is responsible for Federal efforts to pursue fuel tax evasion. It works in a collaborative fashion with State agencies and other Federal agencies. In these efforts, the IRS does not direct the resources of the other agencies; however, it does share information that it can properly share under the existing disclosure provisions. As stated earlier, the ability to share information with these partners must conform with the provisions of IRC 6103 for disclosure of taxpayer information.

Question. What is the total Federal "level of effort" in terms of staff and resources, being directed at these crimes?

Answer. The IRS has several programs/activities that support motor fuel tax compliance and other taxes that support the Highway Trust Fund. The Small Business/Self Employed (SB/SE) Division has approximately 260 revenue agents who are excise tax specialists and approximately 140 fuel compliance officers (FCOS). Historically, IRS's revenue agents spend 40-50 percent of their direct examination time on the taxes that support the Highway Trust Fund. The FCOS spend 100 percent of their time enforcing the dyed fuel laws and detecting illegally blended fuel through its below the rack (BTR) efforts. In addition to these employees, the IRS has approximately 50 tax examiners that audit claims for excise tax refunds, the majority being for motor fuel taxes. Motor fuel excise tax compliance is a priority for Criminal Investigation (CI) and included in its fraud program along with bankruptcy, insurance, healthcare, and other financial frauds. CI resources are applied to this program area based on the degree of criminal activity identified.

Question. What is the IRS's budget request for fuel tax enforcement activities for fiscal year 2005? Please compare to funding allocated to this area of enforcement for the past 5 fiscal years. Does IRS have any plans to increase the number of resources devoted to this area? Should funding for this project increase?

Answer.

COSTS FOR EXCISE AGENTS¹

	FTE	Salaries	Benefits	Total
Fiscal year 2000	271	\$59,636	\$18,832	\$21,264,828
Fiscal year 2001	267	61,249	19,342	21,517,797
Fiscal year 2002	285	63,451	20,037	23,794,080
Fiscal year 2003	282	65,421	20,659	24,274,560
Fiscal year 2004	252	68,103	21,506	22,581,468
Fiscal year 2005 ²	240	69,465	21,936	21,936,240

¹ Based on GS-13 Step 5 RUS.

² Projected.

The above chart reflects the total number of Excise Agents that worked all Excise returns. The IRS is currently evaluating the staffing levels for fiscal year 2005 but no decisions have been made to date. In its SAFETEA legislation, the administration proposed \$54.5 million for highway use tax evasion projects in fiscal year 2005. This funding would enable the IRS to increase resources applied to motor fuel tax compliance. As ExFIRS becomes a more viable system, the IRS anticipates having improved data to determine the appropriate level of future staffing.

Question. What is IRS's current fuel tax evasion investigative caseload? How many staff does IRS devote to this area? Does the IRS need to devote additional revenue agents or criminal investigators to fuel tax evasion fraud? Why or why not?

Answer. Criminal Investigation currently has fourteen motor fuel cases under investigation. In fiscal year 2003 the IRS devoted nine special agent FTE and three non-special agent FTE to excise tax cases. Criminal Investigation does not anticipate a significant increase in resources devoted to motor fuel excise tax evasion cases because the legislative changes enacted over the past decade have significantly curtailed opportunities for abuse that previously existed, but CI will commit additional resources if local or regional compliance problems arise.

Question. How does IRS measure the success or failure of its fuel tax evasion efforts? What indictments, recoveries, and convictions has IRS attained as a result of their fuel tax evasion efforts? What successes or failures have the States and other Federal agencies had in this area?

Answer. Criminal Investigation has no formal measures to gauge the success of its excise tax program. Ultimately, it is the impact of successful prosecutions that ultimately determine success or failure. During the period fiscal year 1993 through fiscal year 2003, the IRS prosecuted 364 people for participating in schemes to evade excise taxes. In aggregate, these prosecutions involved over \$500,000,000 in tax revenue and involved many prominent members of organized crime. CI reported the magnitude of this effort in the excise tax case summaries contained in their annual reports from fiscal year 1993 through fiscal year 2001. These summaries chronicle many prominent cases and the history of motor fuel enforcement efforts over the last decade. After fiscal year 1997, motor fuel tax evasion case initiations began to decline. Subsequent schemes lacked the complexity and scope previously seen. This decline is attributable to the following factors:

- The cooperative efforts of Federal and State revenue and regulatory agencies;
- Support from the motor fuel distribution industry and professional associations;
- Effective criminal prosecutions;
- Development of improved auditing and compliance tools (particularly fuel tracking systems, fuel dyeing and the on road inspection programs; and,
- Passage of fundamental legislative changes that reduced the opportunities for evasion.

Question. Does the IRS have a plan for achieving a more vigorous and collaborative Federal and State effort for pursuing fuel tax evasion? If so, please describe the plan. Does IRS see any barriers to expanding current efforts to collaborate with other agencies on fuel tax fraud-related investigations?

Answer. The IRS is continuing to work closely with other Federal and State agencies that enforce motor fuel laws. It also works with State environmental agencies when notified of misuse of hazardous materials in illegal cocktailing and blending. The IRS is participating with nine regional task force groups as part of the joint project with FHWA. IRS staff meets periodically with State counterparts to share information and conduct joint investigations. The IRS is involved in several ongoing cases with multiple States and agency.

With the expansion of the ExSTARS reporting, several of the holes will be plugged in tracking motor fuel products. With the enhanced reporting, the States and the IRS will be able to easier identify fuel diversions. The principal roadblock

to collaborating with other Non-revenue State and Federal agencies is the disclosure restrictions.

Question. How do fuel tax evasion-related crimes relate to homeland security? How is IRS working with the U.S. Customs and Border Protection agency to combat this problem?

Answer. Motor fuel product is a very volatile liquid and in the hands of the wrong individuals could have disastrous results. Criminal Investigation is a member of the FBI's Joint Terrorism Task Forces. These task forces are aware fuel tanker trucks could be utilized by terrorists to perpetrate a terrorist attack. Since September 11, 2001, all allegations involving fuel tanker trucks have been vigorously investigated, as have allegations that persons potentially affiliated with terrorist groups may be acquiring licenses to operate fuel tankers or transport hazardous materials.

The IRS believes the ExFIRS/ExSTARS programs have the capability to handle enhanced tracking of fuel systems and it supports the legislation that would track vessels both for security and tax purposes. The IRS has also developed an acoustical device for identifying product that is being transported to ensure that the actual product being shipped matches the shipping paperwork.

BANK SECRECY ACT ENFORCEMENT

Question. Given the limited resources in the IRS budget for enforcement and compliance, what standards does the IRS use to select cases to review for Bank Secrecy Act (BSA) compliance?

Answer. The Internal Revenue Manual (IRM) 4.26.3.2.4, Selection for Assignment provides specific guidelines to the Anti-Money Laundering (AML) coordinators about case selection. It provides:

- The AML coordinator should select entities from the nonbank financial institution (NBFI) database or the Form 8300 inventory, using risk-based analysis to select those entities with the highest potential for noncompliance for compliance examinations or reviews, such as:
 - Entities with a high volume of cash transactions or abnormal cash activity;
 - Entities in local geographic areas with high potential in money laundering;
 - Entities which have a previous history of noncompliance; and
 - Entities which have been cited for poor or inadequate recordkeeping.
- The AML coordinator should consider available resources as well as balanced coverage (geographic area and industry) when selecting NBFIs or Non-financial trade or Businesses (NFTB) for compliance examinations or reviews.
- Input from other operating divisions (e.g. TE/GE) can assist the coordinator in assessing risk.
- Prior to opening the exam or review the names of selected entities are to be furnished to Criminal Investigation (CI) for clearance.

The IRS and the Financial Crimes Enforcement Network (FinCEN) jointly establish the priorities for types of NBFIs to be examined, and the IRS provides these priorities to its AML coordinators in an annual program letter. In addition, as part of the efforts to improve the effectiveness of the AML program, the IRS provided training for its AML coordinators in March 2003 on methods to apply against the Currency Banking and Retrieval System (CBRS) to identify cases. Since that time, CBRS analysis has been provided to the coordinators on a regular basis to assist them in the identification of cases. To further ensure consistency in case selection, the IRS plans to centralize the case identification process by October 2004. The IRS is also working with its SBSE Research to enhance the case selection criteria.

Question. Are the standards for determining BSA cases for review uniform in every office? Please provide a copy of those uniform standards.

Answer. The standards for selecting cases for review are detailed in the response to the question above. During the AML program reviews conducted by the headquarters office, conformity with these guidelines is reviewed specifically.

The IRS is currently centralizing case selection. BSA typed inventory varies demographically and changes or moves constantly. The IRS is seeing the shift of currency cells away from banks and larger cities. Efforts to centralize inventory selection will better help the IRS recognize these trends and quickly shift field resources as needed.

Question. How many cases were reviewed for BSA compliance? How many possible cases are there? What percentage of total cases are forwarded for prosecution or further review?

Answer. In fiscal year 2003, the IRS closed 3,655 NBFI cases. The IRS also contacted an additional 8,800 businesses to determine if those that had a requirement to register had done so. The number of possible Money Service Businesses (MSB) is constantly changing, but there are currently more than 88,000 potential NBFIs

on the database. One of the objectives of the program is to identify new businesses while removing from the database those that no longer are in business.

In fiscal year 2003, seven cases were forwarded to the IRS's Criminal Investigation Division and two cases were referred to FinCEN for penalty consideration. The number of cases is less than 1 percent of those examined.

Question. Does the IRS train its compliance personnel in the IRS's responsibilities under the USA PATRIOT Act?

Answer. IRS Compliance personnel involved in the AML program receive specific training regarding BSA AML Compliance Programs and related proposed regulations. IRS revised its Basic AML Course to reflect the changes resulting from the USA PATRIOT Act. As part of this training, personnel are:

- Instructed on how to access the Office of Foreign Asset Control's (OFAC) website to identify individuals and countries which have been placed on OFAC's Specially Designated Nationals (SDN) list. In addition, information regarding the SDN list is placed on the AML Website to insure that examiners are aware of any changes to the list.
- Trained to look for transactions going to OFAC sanctioned countries. If such transactions are found, personnel are trained to contact the OFAC's Compliance Hotline and proceed directly to OFAC.
- Trained to look for unlicensed money transmitters. Two Continuing Professional Education (CPE) modules have been developed specifically addressing Informal Value Transfer Systems and Section 352 of the USA PATRIOT Act.
- Trained in audit procedures to detect structuring, using data from actual examples of structured transactions. They are taught to follow the transaction through the final clearing in order to identify structured transactions through OFAC sanctioned countries.

Question. What training does each compliance officer receive each year related to BSA and the USA PATRIOT Act?

Answer. This year, the IRS provided CPE modules to IRS's AML examiners: Suspicious Activity Reports, Structuring, Informal Value Transfer Systems, and Section 352 of the USA PATRIOT Act. The IRS provides examiners with workshops regarding the BSA during group meetings held at least once a year. The IRS makes AML Technical Advisors available to attend these group meetings.

In addition, information regarding new regulations is forwarded from Headquarters to Territory Managers for immediate dissemination to examiners, and examiners review FinCEN's SAR Activity Reviews Digests as well as other issued guidance. In addition, examiners are required to refer to the AML website on a regular basis for any changes to procedures and/or regulations.

Question. When the IRS audits a casino, is the auditor versed in the intricacies of the Patriot Act?

Answer. AML examiners, all of whom have received training that deals specifically with the USA PATRIOT Act (for example, the four recent CPE modules: Suspicious Activity Reports, Structuring, Informal Value Transfer Systems, and Section 352 of the USA PATRIOT ACT), conduct the IRS's examinations of casinos. In addition, the Casino Course these examiners attend includes changes in the law under the Patriot Act, and the IRS makes these changes available to all casino examiners on the AML web page.

Question. Does IRS have any performance measures to determine auditor knowledge of the laws they enforce?

Answer. The official IRS position descriptions for the AML examiners outline the job knowledge required as well as Critical Job Elements. The Critical Job Elements on which AML examiners are evaluated include Knowledge and Application of Anti-Money Laundering Law. The IRS is currently developing case review procedures that will centralize closed case reviews using full time reviewers as well as provide managers with a review document. The attributes in the case review document include the interview conducted, managerial involvement, interpretation and application of the law, fact gathering, penalty determination, and documentation.

Question. Is there any follow-up with the casinos or money service businesses to get feed-back on its audit?

Answer. The IRS has an effort under way to develop a customer satisfaction survey for the AML Program by the end of fiscal year 2004.

Question. How many cases were referred by the IRS in fiscal year 2003 for enforcement action? What were the outcomes of the referrals?

Answer. In fiscal year 2003, seven cases were referred to IRS's Criminal Investigation (CI) Division; three are currently under active investigation. In addition, during the first 6 months of fiscal year 2004, SB/SE referred an additional seven cases to CI, five of which are under investigation. As a result of referrals from its

AML program, the IRS also examined and closed 538 cases for income tax violations in fiscal year 2003.

Question. How many cases were referred by the IRS in fiscal year 2003 to FinCEN for further review? What were the outcomes of the referrals?

Answer. In fiscal year 2003, the IRS referred two cases to FinCEN for penalty consideration. Both were issued warning letters. The IRS referred two additional cases in the first half of fiscal year 2004, and is currently developing another two for referral.

Question. What level of oversight regarding the compliance of casinos and money service businesses (MSB's) does the IRS exercise? Please describe those efforts in detail.

Answer. The IRS has been delegated responsibility for civil examinations for BSA compliance. In addition to examinations, the IRS also conducts outreach (in coordination with FinCEN) to ensure businesses are aware of their filing, recordkeeping and registration responsibilities. The IRS currently has approximately 350 examiners (including managers) assigned to the Anti-Money Laundering (AML) program. They are supported by 16 Area AML coordinators and approximately 8 computer audit specialists from LMSB. IRS AML examiners currently are conducting 5,576 examinations, which reflects 6 percent of the IRS-known potential population.

In addition to the examination of NBFIs, the AML examiners also conduct reviews for compliance with the currency reporting requirements of Sec. 6050I of the Internal Revenue Code. Since Sept. 30, 2000, the IRS has added 48,688 potential NBFIs to the database. As of March 31, 2004 the NBFIs database reflected over 88,000 potential NBFIs. The IRS is also conducting investigations on 690 businesses for potential registration requirements.

From September 30, 2000 through the present, the IRS has closed 13,288 cases and conducted 5,940 (fiscal year 2003 and fiscal year 2004) registration examinations.

Since 2002, the AML Compliance program has transitioned from conducting individual education visits to focusing on examinations. The education and outreach now is performed by the Small Business and Self-Employed operating Division's (SB/SE) Taxpayer Education and Communication (TEC) Division. TEC delivers education/outreach to external stakeholders, using leveraged resources to reach a larger number of covered businesses. The National TEC AML strategy was designed in conjunction with SB/SE Compliance, IRS's Criminal Investigation Division and FinCEN to increase compliance of MSBs, NBFIs and casinos with the BSA.

Question. What performance measures are in place to measure IRS compliance efforts as they relate to MSB's and casinos?

Answer. The current measures for the AML examination program include the number of NBFIs identified, the number of examinations conducted and closed, and the results of completed examinations. The IRS also now has a database in place that provides information on the hours per closed case as well as the cycle time of cases. In the course of the BSA examinations conducted, the IRS also identifies potential cases for unreported income under Title 26. On the education/outreach side, the TEC organization monitors the number of outreach events they deliver and the number of participants at the events.

Question. The Tax Inspector General for Tax Administration (TIGTA) reports that the IRS small business/self employed (SB/SE) division responsible for compliance of the BSA for non-bank financial institutions lacks meaningful performance measures, has no useful data to provide oversight of program performance, and does not base case selection in risk factors. Similar findings also occurred in a previous audit in December of 2000. The IRS has known since at least 2000 that these problems were pervasive in the compliance program. In September of 2003, the IRS continues to fail in delivering compliance results commensurate with the resources spent. In the response on this issue to the committee the IRS has stated that the agency "does not characterize this as a problem". There are two TIGTA audit reports which demonstrate the IRS has failed repeatedly to make meaningful progress in its compliance efforts for BSA. If the IRS and FinCEN do not believe this as a problem, what would elevate it to warrant recognition? How can the IRS allow these types of lapses to recur?

Answer. In 2002, the IRS made a commitment to ensure the effective operation of the Anti-Money Laundering Program. In particular, the IRS has taken the following steps:

- Named a national AML program manager in February 2002;
- Created 32 groups nationwide dedicated to the AML program (added one additional group in 2004);
- Replaced part-time revenue agents, for whom AML was a collateral duty, with full-time, fully trained revenue agents dedicated to AML;

- Minimized the use of lower-graded tax compliance officers, who previously handled many of the AML examinations;
- Designated a territory manager in each IRS Area for AML program responsibility;
- Designed a Management Information System to capture the results of BSA examinations; and
- Secured funding from FinCEN, beginning in fiscal year 2003, to add 70 additional FTEs to the AML compliance program.

As a result of these improvements, all program indicators (numbers of MSBs identified, outreach contacts, and examinations) are trending up. In the first half of fiscal year 2004, the IRS's SB/SE Division made more referrals to FinCEN and had more referrals accepted by CI than in all of fiscal year 2003. In fiscal year 2003, SB/SE also focused on ensuring that MSBs that had a requirement to register did, in fact, register. Those efforts resulted in an additional 2500 registrations, which represented a 20 percent increase in the number of registered MSBs.

In a recent review of the AML program, TIGTA acknowledged the IRS's efforts to enhance the program but identified the need for further improvements. Ongoing efforts include the following:

- Centralization of case identification, incorporating leads from the field and CI, as well as CBRS analysis for October 2004;
- Piloting of MSB examinations at the entity's corporate headquarters level to facilitate the identification of MSB agents with the highest risk of noncompliance;
- Incorporation of quality performance measures into the embedded quality process in October 2004;
- Transition of outreach activities from Compliance to TEC within SB/SE to provide broad educational opportunities to external stakeholders;
- Completion of a template for a Fed/State MOU to provide reciprocal opportunities to leverage resources for examinations, outreach, and training;
- Partnership with FinCEN to identify locations of potential noncompliance, as well as the first joint examination of a major MSB with FinCEN; and
- MOU with FinCEN to allow IRS full access to SARs (for purposes of BSA examinations only).

Question. What is the IRS doing to ensure case selection criteria are uniform? Please provide a copy to explain how case selection criteria have changed since the Tax Inspector General for Tax Administration (TIGTA) audit in 2003.

Answer. As mentioned previously in questions 1 and 2, the Internal Revenue Manual provides guidelines about case selection to the AML coordinator in IRM 4.26.3.2.4, Selection for Assignment. During AML program reviews conducted by the SB/SE headquarters office, conformity with the guidelines is an item specifically reviewed.

TIGTA identified a concern that there was no consistency in how the IRS selected AML cases for examination. To remedy this situation, the IRS increased program oversight to ensure the compliance risk case selection tools provided to the field are being used to identify cases. The centralization of case identification, incorporating leads from the field and Criminal Investigation, as well as CBRS analysis, is scheduled to be in place by October 2004. The centralization of workload identification will ensure consistency in risk based case selection. The IRS is including FinCEN in this process. Case selection methods are addressed in Area program reviews. In addition, SB/SE's Research organization has undertaken a project to possibly identify other methods for selection.

Question. The IRS has a poor record regarding regulatory compliance operation and management of BSA data according to numerous IG, GAO, and TIGTA reports. What is the IRS doing to correct these long-standing problems? What guarantees can the IRS provide that will show they will do the job right this time?

Answer. In recent years, the IRS has shown significant commitment to the effective operation of the Anti-Money Laundering Program, and considers the identification of opportunities for improvement to be an ongoing process. Improvement efforts in progress include the centralized review process, the embedded quality initiative, improved management information systems and centralized compliance examinations.

In particular, the IRS has taken the following steps to enhance the effectiveness and professionalism of the AML program:

- Named a national AML program manager in February 2002;
- Created 32 groups nationwide dedicated to the AML program (added one additional group in 2004);
- Replaced part-time revenue agents, for whom AML was a collateral duty, with full-time, fully trained revenue agents dedicated to AML;

- Minimized the use of lower-graded tax compliance officers, who previously handled many of the AML examinations;
- Designated a territory manager in each IRS Area for AML program responsibility;
- Designed a Management Information System to capture the results of BSA examinations; and
- Secured funding from FinCEN, beginning in fiscal year 2003, to add 70 additional FTEs to the AML compliance program.

As a result of these improvements, all program indicators (numbers of MSBs identified, outreach contacts, and examinations) are trending up. In the first half of fiscal year 2004, the IRS's SB/SE Division made more referrals to FinCEN and had more referrals accepted by CI than in all of fiscal year 2003. In fiscal year 2003, SB/SE also focused on ensuring that MSBs that had a requirement to register did, in fact, register. Those efforts resulted in an additional 2500 registrations, which represented a 20 percent increase in the number of registered MSBs.

In a recent review of the AML program, TIGTA acknowledged the IRS's efforts to enhance the program but identified the need for further improvements. Ongoing efforts include the following:

- Centralization of case identification, and incorporating leads from the field and CI, as well as CBRs analysis for October 2004;
- Piloting of MSB examinations at the entity's corporate headquarters level to facilitate the identification of MSB agents with the highest risk of noncompliance;
- Incorporation of quality performance measures into the embedded quality process in October 2004;
- Transition of outreach activities from Compliance to TEC within SB/SE to provide broad educational opportunities to external stakeholders;
- Completion of a template for a Fed/State MOU to provide reciprocal opportunities to leverage resources for examinations, outreach and training;
- Partnership with FinCEN to identify locations of potential noncompliance, as well as the first joint examination of a major MSB with FinCEN; and
- MOU with FinCEN to allow IRS full access to SARs (for purposes of BSA examinations only).

Question. The IRS, in its response to the committee, states that there are standards in place to select cases in all compliance programs. TIGTA states in its 2000 and 2003 audit that the program still lacks performance standards. The only performance goal that exists for this program is "delivery of Direct Examination Staff Years (DESYs)." To accomplish this goal the IRS need only assign sufficient personnel to the program to meet the allocated DESYs. There are no other measures for evaluating the program's performance. Does the IRS consider this performance measure sufficient to measure the outputs and outcomes of this program? Are other compliance programs held to such a low threshold?

Answer. In addition to the delivery of DESYs, the AML Program currently measures the number of NBFIs identified, the number of examinations conducted and closed, the results of completed examinations, the number of Title 26 information items prepared and related income tax examinations completed. The TEC organization monitors the number of outreach visits, seminars, participants, and mailings accomplished. Recent improvements to the MIS now provide information on the hours per closed case, as well as the cycle time of cases.

Question. The committee understands that IRS has begun to review its performance measures and is in the process of establishing measurable performance-based indicators for BSA programs. What is the status of this effort? Please include in your response the new performance measures being used to measure fiscal year 2004 performance?

Answer. The current measures for the AML examination program include the number of NBFIs identified, the number of examinations conducted and closed, and the results of completed examinations. The IRS also now has a database in place that provides information on the hours per closed case, as well as the cycle time of cases. In the course of the BSA examinations conducted, examiners also identify potential cases for unreported income under Title 26. On the education/outreach side, the TEC organization monitors the number of outreach events they deliver and the number of participants at the events.

Question. In Treasury's April 30 responses to the committee, the Department and the IRS contend that IRS compliance programs include reviews of examiners work. Performance plans for all managers include the requirement to review cases and to be involved in case development. Yet the IRS in its response to the TIGTA report state "there continues to be significant risk of undetected noncompliance and inconsistent program delivery. Based on our review of a judgmentally selected sample of 76 cases from 3 Area Offices, standard case selection criteria are not used, cases

are not properly documented and potential noncompliance information is not available". How does the IRS explain the discrepancy between stated requirements and failed results?

Answer. The quote attributed above to the IRS was actually a statement made by TIGTA in their Report (Audit No. 200330004). The relevant TIGTA recommendations from that report, and the actions the IRS is taking to implement them, are as follows:

- Develop standard risk-based case selection criteria that would provide minimum requirements and parameters for case selection.

The SB/SE Division Research function is developing a scoring system, or set of rules, to prioritize workload by using Currency Banking Retrieval System data. Until the scoring system is implemented, the IRS has taken other steps to ensure appropriate case selection. The IRS has increased program oversight to ensure the compliance risk case selection tools already provided to the field are being used to identify cases. In addition, case selection methods are addressed as part of the Area program reviews. The centralization of case identification, incorporating leads from the field and Criminal Investigation, as well as CBRIS analysis, is scheduled to be in place by October 2004. This centralization will ensure consistency in using risk based case selection for the AML cases.

- Reinforce the importance of case documentation with specific instructions or case models and implement a centralized quality review process.

The IRS has taken a number steps to increase the quality of the cases. In July 2003, two technical advisors were added to headquarters staff to provide technical assistance to the field. Since their arrival, they have visited several areas, to review cases and meet with the examiners and managers to discuss their observations. This has been well received by the field personnel, and requests for their participation continue to increase. The first AML Technical Digest, which addresses examination issues, will be published on the AML web page in late May 2004.

The IRS is on target to incorporate quality performance measures for AML into the new embedded quality process that will be in place in October 2004. Including AML in the embedded quality process will provide a systemic method for consistent managerial feedback. In addition, the centralized closed case review process, which will be a part of embedded quality, will provide headquarters with the ability to identify trends and training needs.

- Coordinate with the FinCEN to secure BSA examiner and RA access to SARs.

The Commissioner, SB/SE Division, initiated a Memorandum of Understanding with the Director of the FinCEN to permit BSA examiners access to SARs for the purpose of MSB compliance checks. That MOU has been signed by both the IRS and FinCEN. IRS senior executives are continuing to pursue access to SARs for RAs in the regular examination program.

Question. TIGTA found that "no standard criteria exist for selecting BSA compliance cases."

Should the committee be concerned that there are no standards that exist for case selection?

IRS states that AML coordinators use their own criteria. Please provide a complete list of those criteria.

Given Mr. Everson's strong statements about the need for more resources, does this program not point out that IRS has enormous savings to be realized by using its current resources in a smarter and more efficient manner?

Answer. Through its Internal Revenue Manual (IRM) 4.26.3.2.4, Selection for Assignment, the IRS provides specific guidelines to its AML coordinators about case selection. It reads as follows:

- The AML coordinator should select entities from the nonbank financial institution (NBF1) database or the Form 8300 inventory, using risk-based analysis to select those entities with the highest potential for noncompliance for compliance examinations or reviews, such as:

- Entities with a high volume of cash transactions or abnormal cash activity;
- Entities in local geographic areas with high potential in money laundering;
- Entities which have a previous history of noncompliance;
- Entities which have been cited for poor or inadequate recordkeeping;

- The AML coordinator should consider available resources as well as balanced coverage (geographic area and industry) when selecting NBFIs or NFTBs for compliance examinations or reviews;

- Input from other operating divisions (e.g. TE/GE) can assist the coordinator in assessing risk;

—Prior to opening the exam or review the names of selected entities are to be furnished to Criminal Investigation (CI) for clearance.

The IRS has increased program oversight to ensure these compliance risk case selection tools provided to the field are being used to identify cases. In addition, the IRS and FinCEN jointly establish the priorities for types of NBFIs to be examined, and the IRS provides these priorities to its AML coordinators in an annual program letter. Further, as part of the efforts to improve the effectiveness of the AML program, the IRS provided training for its AML coordinators in March 2003 on methods to apply against the Currency Banking and Retrieval System (CBRS) to identify cases. Since that time, CBRS analysis has been provided to the coordinators on a regular basis to assist them in the identification of cases. Case selection methods also are addressed during Area program reviews.

To further ensure consistency in case selection, the IRS plans to centralize the case identification process by October 2004. This centralization, which will incorporate leads from the field and Criminal Investigation, as well as CBRS analysis, will ensure consistency in risk based case selection and allow for improved trend analysis. In addition, SB/SE's Research organization has undertaken an effort to enhance the case selection criteria.

To improve its utilization of resources, the IRS is piloting the examination of Money Service Businesses (MSB) at the entity's corporate headquarters level. Three such examinations are currently underway. Working with the business, IRS will be able to identify the MSB's agents with the highest risk of noncompliance. This is a new approach for the program, one that was developed in cooperation with FinCEN, and one that will provide better customer service.

Question. IRS indicates that it is creating a scoring system to prioritize its BSA workload. Please provide an update to the committee on the development of this system?

Answer. SB/SE Research is designing a process that uses the Currency and Banking Retrieval System (CBRS) data to prioritize or select entities for Title 31 and Form 8300 examinations based on risk factors. The project is organized into five phases, including assessment of current processes used to select workload (Phase 1), development of rules that express predictive and evaluative factors of non-compliance with BSA requirements (Phase 2), engineering of formulas to evaluate and rank entities for risk of non-compliance based on CBRS data and completion of the decision factor set that will be used (Phase 3), suitability testing to ensure the proposed system follows the best practices identified by AML technical advisors (Phase 4), and assessment of automation and programming needs required to pilot the proposed system (Phase 5).

To date, much of the data and knowledge acquisition activity has been completed. As a by-product of this work, the research team developed a work flow diagram depicting "best practices" of processes, tools, techniques, and decisions in the AML program. Following review by the technical advisors, the IRS plans to make this interim work product will be available to Compliance Policy/AML examiners in July 2004 for use in the current program. The work that SB/SE Research is doing to develop a risk-based selection process using CBRS data will assist the IRS in applying case selection standards uniformly across the country. The proposed system will use the same identified scoring factors (with priorities and weights) to rank all entities for examination potential. Subsequently, local program managers will be able to filter the ranked list for geographic location, providing a local list that reflects the same selection criteria as any other case. A potential side benefit of the proposed system will be IRS's ability to assess whether their resources are appropriately deployed geographically and make adjustments based on where the prioritized workload actually exists.

Question. TIGTA has identified that IRS examiners have a perception that FinCEN does not assess penalties. TIGTA has also identified that FinCEN has a negative perception of the IRS case quality and that the cases referred for enforcement actions do not contain sufficient information to assess penalties. What are these two organizations doing to overcome these barriers?

Answer. FinCEN and the IRS are jointly committed to identifying opportunities to improve case development and the ability to assess civil penalties when appropriate. As a part of the IRS's revamped training efforts, FinCEN is participating in AML basic training classes to provide guidance on developing cases for penalty referral to FinCEN. For fiscal year 2004 the IRS has committed to taking a more proactive approach to getting FinCEN's input when serious violations have been identified, by providing them opportunity for involvement early in the development of the penalty case. To support this commitment, the IRS also has developed new referral guidelines based on previous well-developed cases, and has included these guidelines in the AML Technical Digest.

Question. The SB/SE division is responsible for compliance with the BSA. This unit spends \$43 million for BSA compliance including examinations outreach and compliance. Please provide a detailed break out of how the \$43 million is spent on by activity. Given the numerous reports about the failures of the SB/SE division, what is the IRS doing to correct the deficiencies identified?

Answer. The original estimate of \$43 million for BSA compliance included some one-time training costs related to BSA, but did not include costs associated with Currency Transaction Report (CTR) processing (which is essential to the AML program). Based on a revised estimate, which reflects only annualized costs, SB/SE expects to spend \$53.7 million in fiscal year 2004 in support of BSA compliance, including examinations, education and outreach activities, and processing of CTRs. The breakdown of these costs for both fiscal year 2003 and fiscal year 2004 is shown in the following table:

EXPENDITURES FOR BSA COMPLIANCE

[In millions of dollars]

Functional Activity	Fiscal Year 2003 (Actual)	Fiscal Year 2004 (Projected)
Compliance	33.66	34.97
Taxpayer Education and Communications	0.86	1.14
CTR Processing ¹	7.81	17.57
Total for SB/SE	42.33	53.68

¹In fiscal year 2003, IRS's Modernizing Information Technology Systems spent \$8.84 million in support of CTR Processing. In fiscal year 2004, SB/SE is responsible for the full program.

As described in the responses to the earlier questions, the IRS has taken, and is continuing to take, a series of proactive steps to improve its AML program. To summarize, the IRS has:

- Revamped the structure and staffing of its AML program by:
 - Naming a national AML program manager in February 2002;
 - Creating 32 groups nationwide dedicated to the AML program (added one additional group in 2004);
 - Replacing part-time revenue agents, for whom AML was a collateral duty, with full-time, fully trained revenue agents dedicated to AML;
 - Minimizing the use of lower-graded tax compliance officers, who previously handled many of the AML examinations;
 - Designating a territory manager in each IRS Area for AML program responsibility; and
 - Securing funding from FinCEN, beginning in fiscal year 2003, to add 70 additional FTEs to the AML compliance program;
- Focused increased attention on case selection using current guidelines, while developing a centralized case identification process;
- Ensured all AML examiners receive appropriate training, including the changes resulting from the USA PATRIOT Act;
- Undertaken a research-driven effort to design and develop a method for prioritizing case selection based on CBRS data;
- Taken steps to improve AML case quality via technical case reviews and included the AML program in the embedded quality measures process to be implemented in October 2004;
- Transferred AML outreach activities from Compliance to TEC within SB/SE to provide broad educational opportunities to external stakeholders; and
- Increased its coordination with FinCEN, especially in the areas of training, workload identification and penalty referrals.

WORKFORCE AND FACILITY REALIGNMENT

Question. The IRS expects to receive some savings from the closure of the Brookhaven Service Center. Are you going to increase the frontline enforcement personnel with these savings?

Answer. The IRS anticipates savings in fiscal year 2005 of \$6 million and 147 FTE because of e-file efforts, including the closure of the Brookhaven facility. These savings, along with \$105 million additional savings, will be reapplied as described in the IRS's fiscal year 2005 Congressional Justification. These reinvestments are:

(Dollars in millions)

Reinvestment	Millions of Dollars	FTE
Curb Egregious Noncompliance	\$31.4	293
Select High Risk Cases for Examination	\$6.0	.....
Embedded Quality ¹	\$1.6	26
Consolidation—Case Processing	\$13.7	80
Consolidation—Insolvency	\$2.1	15
Combat Corporate Abusive Tax Schemes	\$5.0	34
Leverage/Enhance Special Agent Productivity	\$2.5	28
Standardize CLMC Training Rooms	\$0.5	.....
IRS Reorganization Transition	\$5.0	.....
Servicewide Competitive Sourcing	\$9.1	.....
MITS Reorganization Transition	\$34.0	236
Total	\$110.9	712

¹This initiative, through an Embedded Quality system in Submission Processing (EQSP), will create a new measurement system that will identify the cause and impact of errors, apply common measures to every level of the new organization, and enable frontline employees to understand how their contributions impact IRS's performance. An embedded quality system links individual and business performance with multiple quality review sources. EQSP will instill complete accountability for quality performance across operations.

TAX LAW ENFORCEMENT BUDGET PRIORITIES AND RESOURCE ALLOCATION

Question. Given IRS's inability to increase enforcement in recent years, what will be different in fiscal year 2005?

Answer. The IRS's enforcement statistics for fiscal year 2003 demonstrate that IRS has arrested the enforcement decline that began in the 1990's and continued through the implementation of RRA 98. Audits, criminal investigations, and monies collected have all increased. In particular, when compared with fiscal year 2001, audits of taxpayers with incomes over \$100,000 increased by over 50 percent by fiscal year 2003.

The administration's 2005 budget request for the IRS will continue to rebuild its enforcement activities. Two-thirds of the new monies requested will be devoted to addressing abuses by high-income taxpayers and corporations, and increasing criminal investigations.

In fiscal year 2005, the IRS is seeking an additional \$300 million for enforcement activities to focus on the following four objectives in enforcement:

- Discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individuals and other contributors to the tax gap;
- Ensure that attorneys, accountants and other tax professionals adhere to professional standards and follow the law;
- Detect and deter domestic and off-shore tax and financial criminal activity; and
- Discourage and the misuse of tax-exempt and government entities for tax avoidance and other purposes.

These incremental resources will help IRS to address the tax gap, the difference between what is owed and what is paid due to non-filing, underreporting, and underpayment, and secure billions of extra dollars for the Treasury. Once the IRS hires and trains enforcement personnel, it estimates the direct return on investment will be about 6 to 1 for direct revenue-producing initiatives. Beyond the incremental revenues directly associated with the increased audits, investigations and collection activity, the increased publicity of these actions will discourage other taxpayers from cheating.

FUTURE STAFFING REQUIREMENTS

Question. What is IRS's assessment of the IRS's long term requirements?

Answer. The vision of the IRS remains to re-center the agency with the proper balance of service and enforcement poised to quickly meet technological and demographic changes, and customer expectations.

The IRS's goals remain the same—to improve taxpayer service, enhance enforcement through uniform application of the law, and improve the IRS infrastructure and modernize technology. The IRS working equation is that service plus enforcement equals compliance. The IRS is maintaining high levels of taxpayer service while focusing on corrosive areas of non-compliance. Ensuring fairness will help restore faith in the Nation's tax administration system.

Question. Can the IRS assure this committee that the current refocus can put this program back on schedule so that it will not go the way of TSM?

Answer. The IRS needs a more versatile team of seasoned executives to provide long-term stability to the program. The IRS is complementing the skills of experienced IRS tax executives with outside seasoned technology executives who have experience managing large-scale, complex IT projects. As such, the IRS is hiring two Associate Chief Information Officers to join the MITS organization, and an executive search firm is conducting searches for five senior executives with a wide range of diverse experience in developing and implementing large modernization systems.

In addition, the IRS used the results from independent studies commissioned during the summer of 2003 to create a BSM Challenges Plan comprised of 40 some action items. Given the strategic importance of the plan, the Commissioner appointed an IRS business unit deputy commissioner to oversee the implementation of the plan.

As a first step, the BSM project team developed a crosswalk to ensure that the BSM Challenges Plan's definition of the issues addressed and/or satisfied all of the recommendations from the four commissioned studies as well as the recommendations submitted by the IRS Oversight Board, and the Software Engineering Institute (SEI) study of CADE.

While the deputy commissioner made significant progress in implementing the plan, the full closure of all actions items was unrealistic within the elapsed timeframe of the 6-month appointment. Concurrently, the CIO created a new direct report position for modernization management and assigned responsibility for implementing the plan to the individual recently hired into this newly created position.

Under the leadership of the deputy commissioner, the IRS and CSC team brought closure to several key actions items, including: clarifying the roles of committees as advisory, identifying "blockers" on contracting issues, appointing business leaders to each project, establishing a risk-adjusted schedule and new baseline for CADE Releases 1.0 and 1.1, and increasing the frequency of CADE reviews with the business owner to twice monthly. The majority of the action items are still works-in-progress, some of which will take time to fully complete. Others will span the life of the BSM program.

For example, strengthening systems engineering capabilities by hiring external candidates will take time since it involves conducting the searches, interviewing the candidates, and negotiating the new hires to come on board. The IRS and CSC developed ground rules for escalating issues, but they will need to be continually enforced throughout the life of the program. The IRS rewrote the charters of the governing committees to reflect their advisory role and clearly articulated their responsibilities, however, it will probably take a year to truly evaluate and measure their effectiveness.

As stated, the IRS has made progress toward closing all the action items, but it has much more work to do in critical areas. For example, the IRS needs to religiously follow the proper methodologies and hold people accountable if they do not. The IRS must start "doing things right" as opposed to "doing things fast" such as exiting milestones prematurely. An ongoing challenge will be balancing the scope and pace of projects consistent with capacity, ensuring that the right people are in place before launching a project, and setting realistic delivery schedules and cost estimates. The IRS is committed to staying-the-course and delivering on its promise to modernize America's tax systems, but it is important for everyone to acknowledge this is a monumental effort.

The magnitude and evolution of the BSM program dictates that the IRS will always be going through an evolution of assessment and improvements. In that regard, the BSM Challenges Plan is still evolving and the IRS is using certain action items to continuously improve the program.

BSM MANAGEMENT

Question. Is IRS's schedule for completing the remaining corrective actions identified in the associated BSM Action Plan?

Answer. Please see response to previous question.

ACTUARIAL SOFTWARE PROGRAM

Question. What number of life insurance companies or what percentage of the industry does the IRS consider an appropriate amount to examine in order to provide the IRS with "sufficient data to conduct a cost benefit analysis?"

Answer. The IRS has determined that a sample of four Coordinated Industry life insurance audits (based on the criteria as described in the question below) will give sufficient data for preliminary results from a cost benefit analysis. The fact that the IRS anticipates closing four cases led it to determine that a 5 percent completion

rate would give it preliminary figures so that it could project over the total population.

Question. What selection criteria is the IRS using to make sure that the initial examination results analyzed are an accurate estimation or cross-section of the industry?

Answer. The IRS based the selection criteria it used on a mix of variables, such as the stage of the audit cycle, product mix, and size of taxpayers. These criteria allowed the IRS to have a cross-section of the industry. Due to the length of time it takes to examine life insurance reserves, the stage of the audit means that the IRS needs to examine reserves very early in the audit and not when the audit's estimated completion date is approaching. Product mix means that the IRS attempted to select taxpayers for audit who sold different kinds of policies such as traditional life insurance, universal life insurance, variable life insurance, single premium annuities, and etc. Size of the taxpayer means that the IRS is looking to select not only the extremely large taxpayers in the Coordinated Industry arena but also the ones who have lesser gross receipts and assets in size.

Question. When does the IRS expect to have sufficient data?

Answer. The IRS is projecting to have four audits complete by the end of the fiscal year that would give sufficient data. The fact that the IRS anticipates closing four cases led it to determine that a 5 percent completion rate would give it preliminary figures so that it can project over the total population.

Question. Congress has funded the program for 3 years, yet due to the very late start date of the program, although the program has been provided fiscal year 2004 funding, the program is still using fiscal year 2003 funding. Has the IRS set aside the fiscal year 2004 funding provided for the third year of the program?

Answer. The appropriation language for fiscal year 2003 reads that the IRS will provide up to \$4 million from available funds to support the program. As services are rendered and invoices received, the IRS is currently paying amounts to the vendor out of fiscal year 2003 funding for the actuarial software license, maintenance, actuary salaries, and related travel costs to conduct training sessions. In addition, the IRS has available \$2 million from fiscal year 2004 funding for IRS employee travel and training expenses, testing and the related implementation costs, the purchase of additional memory to upgrade revenue agent computers to 512MB capacity, the purchase of additional software which is required for the vendor's Total Life software to work, and the possibility of hiring additional life insurance actuaries to assist on examinations.

Question. What plans does the IRS have for this funding?

Answer. Please see response to previous question.

Question. In March 2004, the IRS stated that after software training for 2004 is complete, "this will result in 41 coordinated life insurance examinations having the use of the software." How many coordinated life insurance examinations currently exist?

Answer. There currently are approximately 75 Coordinated Industry life insurance examinations, of which 30 are either using the software or are planning to use it in the near future. Another class is scheduled for the second week in June where more teams will receive training in using the software. The fact that the IRS anticipates closing four cases led it to determine that a 5 percent completion rate would give it preliminary figures so that it can project over the total population.

Question. Should not the software be used on all life insurance examinations?

Answer. If the results of the cost benefit analysis prove productive and promote compliance, the goal would be to use the software on any life insurance examination, as appropriate. The stage of the audit cycle, as mentioned in the second question above, will dictate when it is appropriate to use the software on the balance of the Coordinated Industry life insurance cases.

Question. Given the technical nature of the program, does the IRS have personnel with sufficient expertise and knowledge to effectively implement the program? What additional personnel, if any, does the IRS believe it needs to make the program fully effective?

Answer. Experience has shown over the last year of training revenue agents and computer audit specialists that they would have the expertise to utilize the software on audits immediately following training with the assistance of a life insurance actuary. The Large and Mid-Size Business Operating Division has two in-house life insurance actuaries with the level of expertise and knowledge to implement the program. Since audit cycles are normally 2 to 3 years in length, on an average, a revenue agent may only use this software once during this time frame, which may result in a high learning curve or the need for additional refresher training for subsequent and additional audit cycles. The IRS believes that it is essential for life insurance actuaries to be involved as the focal point to utilize this software effectively.

Depending on the benefit analysis results, the IRS will evaluate the opportunity to hire additional life insurance actuaries as funding permits.

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

FAILURE TO COLLECT DELINQUENT TAXES

Question. Based on your collections to date, it appears that IRS is not pursuing billions of dollars in uncollected taxes. In recent testimony before the Finance Committee, Treasury Deputy Secretary nominee Samuel Bodman stated that:

- As of the end of fiscal year 2003, \$16.5 billion was in deferred status, meaning that these taxpayers have filed a return and owe tax, but have not paid it or have only partially paid.
- The largest delinquent amount in deferred status is more than \$50 million.
- In recent years, accounts in deferred status have decreased slightly but the dollar amounts have increased.

Mr. Everson, how do you respond to this pathetic record of collecting unpaid taxes?

Answer. The collection results for accounts that are in a deferred status are not indicative of the IRS's overall Collection effort. During fiscal year 2003, the IRS issued first notices to about 11.8 million new balance due accounts, as required by IRC section 6303. During the same period, the IRS resolved about 7.6 million accounts by full payment, installment agreement, or other means as a result of the taxpayer's response to the first or subsequent notices. The IRS subsequently resolves a significant portion (on average, about 67 percent) of the balance due accounts, which are not resolved in notice status and become Taxpayer Delinquent Accounts (TDAs), through full payment or the initiation of an installment agreement.

Deferred accounts are placed in a suspended category because of other collection priorities and resource limitations and they are first subject to risk and collection probability analysis. Cases that have a modest compliance risk, i.e., lesser impact on tax administration and subsequent noncompliance, and low probability of collection are deferred, freeing Collection resources to work more in-business trust fund cases and cases where there is a likelihood of full payment. However, the IRS is refining its Collection models for these cases and evaluating the benefit of filing notices of Federal tax liens on deferred accounts.

Question. Mr. Everson, your budget documents say that a growing number of Americans think it is okay to cheat on their taxes and that "this trend threatens the government's future revenue stream and basic respect for the law." Why should these taxpayers take their IRS debt seriously if the agency never presses for collection?

Answer. All delinquent accounts receive Collection action. The treatment for a particular delinquent account depends on the amount owed and the predicted compliance risk. Taxpayers generally receive at least two notices and if they fail to respond, enforcement action is likely. Each year, the IRS resolves a large percentage of its delinquent accounts through full payment or installment agreement. Many others are ultimately resolved through refund offsets, abatements, and Offers in Compromise. As shown in the following chart, overall enforcement actions on taxpayer delinquent accounts have increased significantly since fiscal year 2000. In fiscal year 2003, the IRS filed 548,683 Notices of Federal Tax Lien and served 1,680,844 Notices of Levy. Passage of the administration's proposed Private Collection Agent (PCA) legislation will further improve these results.

Activity	2000	2001	2001	2003
Enforcement activity (actual numbers):				
Number of notices of Federal tax liens filed	287,517	426,166	482,509	548,683
Number of notices of levy served upon third parties	219,778	674,080	1,283,742	1,680,844
Number of seizures	74	234	296	399

In addition, the IRS has taken a number of steps recently to further address taxpayers' noncompliance with their filing and payment obligations, including:

- Case Selection.*—The IRS refined its inventory delivery system so that the higher priority cases (in terms of impact on tax administration and subsequent non-compliance as well as potential for collection) are selected for assignment to the Collection field function and the Automated Collection System. The IRS continually examines how case selection can be improved.

- Employment Taxes.*—The failure of employers to make their Federal tax deposits and pay over the withheld trust fund taxes is a serious compliance issue. The IRS has developed and is implementing a strategy to improve collection of employment taxes.
- Causes for Underpayment and Non-Filing.*—The IRS is working to identify the components of its potentially collectible inventory, the main causes of non-compliance, and the contributing market segments. The information obtained is being used to address taxpayers through outreach and education, and to determine potential systems and policy changes. One significant component involves estimated tax compliance.
- Taxpayer Education.*—The IRS is aggressively reaching out to taxpayers before they either intentionally or inadvertently, fail to file or fail to pay the full amount of tax due. Stopping noncompliance before it occurs is far preferable than having to find it afterwards. The IRS website has been a tremendous success and has been an important resource for taxpayers. It also is an important way for the IRS to communicate to taxpayers, including reaching out to those taxpayers who may be missing out on important tax benefits when they fail to file a return. The IRS is continuing to examine how taxpayer outreach can be improved and made more effective.

Question. A recent report by the Treasury Inspector General for Tax Administration (TIGTA) found that IRS's existing procedures are ineffective in ensuring even that criminals who are convicted in court for tax evasion are paying their civil tax liabilities. Why can't IRS collect from tax cheats?

Answer. In response to problems identified in the TIGTA audit, the IRS completed a review of the process for referring criminal cases for civil disposition that have conditions of probation. CI conducted this review in partnership with SB/SE. Furthermore, CI and SB/SE have taken the following steps:

- The Chief CI and SB/SE Commissioner issued a joint memorandum on April 13, 2004, to field office personnel stressing the importance of cooperation in handling civil closings for sentenced taxpayers and provided operating procedures for processing the civil closings of all sentenced taxpayers. CI and SB/SE are revising the Internal Revenue Manual to implement these procedural changes.
- The Technical Service, Advisory Unit within SB/SE is reviewing assessed tax liabilities in these cases to identify cases wherein the conditions of probation were not met and will report this information to CI.
- CI's Research Unit has identified all cases within their management information system that have outstanding conditions of probation or appear anomalous. The Research Unit forwarded the information to the appropriate CI field office for review and corrective action, if necessary. Twice a year, the Research Unit will submit similar information to the responsible field office(s) for verification and correction.
- The CI Research Unit added additional tracking codes to the management information system to ensure that management only tracks and reviews viable open cases.
- CI revised its Criminal Investigation Closing Report. This report will serve as CI's notice to the SB/SE Territory Manager of Technical Services that the court has sentenced a taxpayer and document the tax-related conditions of the sentence.
- CI is developing a "Fraud Life Cycle" communications model as an educational tool to improve its understanding of the interaction among the various CI and SB/SE functional processes. This model will help CI and SB/SE develop ways to improve the processing of conditions of probation cases.
- CI front line managers received refresher training on using current systems to effectively identify, report, and monitor terms and conditions of probation on tax investigations.
- CI's Review and Program Evaluation (RPE) Section has incorporated, as part of its field office review process, an analysis of the CIMIS information on terms and conditions of probation. Senior executives in CI will use RPE reports to ensure that all conditions of probation procedures are effectively implemented in each field office.
- The Program Manager, Technical & Insolvency of SB/SE will include the monitoring of conditions of probation in fiscal year 2005 reviews of Technical Services operations and keep the Director, Payment Compliance informed of adherence to IRM procedures. These procedures require Technical Services to immediately report to CI evasive or uncooperative taxpayers, as well as taxpayers who have fully complied with conditions of probation. For other non-compliant taxpayers subject to conditions of probation, Technical Services must provide

the required reports to CI no later than 6 months before the probation expires. CI will advise the Courts of these conditions.

These steps will improve coordination between CI and SB/SE, clarify areas of responsibility, enhance employees' understanding of newly implemented procedures, and improve the processing of conditions of probation cases.

Question. Ms. Gardiner, given the fact that the head of IRS-Criminal Investigations disagreed with a number of your recommendations, are you confident that this grotesque abuse will be stopped? Mr. Everson, would you care to comment as well? Ms. Gardiner, why do you believe that IRS has not cleared up even the simplest of cases of uncollected taxes? Do you consider it a possibility that IRS has not done so in order to build a case for the use of private collection agencies?

Answer. The IRS unequivocally states that no collection action has been taken or not been taken for the purpose of building a case for the use of private collection agencies (PCAs). Under the administration's proposals, PCAs would supplement, and not supplant, IRS collection efforts. PCAs would expand the IRS's overall capability to address outstanding tax liabilities while also allowing the IRS resources to be directed at more complex cases and issues.

TIGTA will respond separately.

Question. Ms. Gardiner, why do you believe that IRS has not cleared up even the simplest of cases of uncollected taxes?

Answer. TIGTA will respond separately.

Question. Do you consider it a possibility that IRS has not done so in order to build a case for the use of private collection agencies?

Answer. TIGTA will respond separately.

Question. In response to questions posed at the Treasury Deputy Secretary's nomination hearing, Mr. Bodman said that IRS has implemented several actions to ensure that all deferred accounts receive adequate collection. But as I read it, only one of these four actions actually tries to collect from the taxpayer: the annual notices that remind taxpayers to pay their obligations. The other three seem to only further penalize the already delinquent party. How do these other activities really help in the collection of tax debts? Don't they simply compound the problem? Are these really the best ways to go after tax cheats?

Answer. The actions described by Dr. Bodman (refund offsets, the Federal Payment Levy Program (FPLP), and reactivation) are the principal methods of collection for deferred accounts; the IRS also uses these techniques as supplemental collection techniques for other types of cases. Since these methods generally employ automated processes, they allow the IRS to pursue these accounts at relatively low cost. Reactivation of a deferred account may be triggered when the taxpayer incurs a new liability, a tax filing delinquency occurs, or the IRS learns of a source of income. Based on the triggering event, the IRS reevaluates the priority of the case in terms of compliance risk and potential to collect the delinquency. Typically, if the case is deemed collectible, the IRS can expect to collect 64 percent of the debt through full payment or an installment agreement.

As noted in Dr. Bodman's response, many of the accounts in deferred status represent taxpayers who have filed a tax return showing an amount of tax due, but who have failed to pay the tax. Other accounts represent taxpayers who have been assessed additional tax by the IRS and have made three or more voluntary payments to satisfy that additional tax, but who have stopped making payments. These taxpayers are aware of their outstanding liabilities. The IRS, however, is unable to continuously pursue each taxpayer with an outstanding tax liability because of other resource and collection priorities. Many taxpayers with outstanding tax liabilities, however, would make payment if contacted by telephone and, if necessary, offered the ability to make payment of the full amount in installments. The administration's fiscal year 2005 budget proposes to permit the IRS to use private collection agencies (PCAs) to address accounts in deferred status.

Question. Mr. Everson, a recent IRS Oversight Board report claims that each year, "the IRS must absorb millions of unfunded costs, such as rent increases and postage, left uncovered by the administration's budget request." The Board estimates that in both fiscal year 2004 and fiscal year 2005, there will be at least \$100 million in unfunded expenses. Further, the "resulting shortfalls mean that the IRS is consistently unable to hire the personnel assumed in the administration's request." In what areas has the IRS cut, in order to pay these unfunded costs?

Answer. The IRS took reductions across-the-board from all programs to fund pay parity, but protected enforcement initiatives. When absorbing the appropriation reduction, the IRS protected enforcement initiatives and related support costs, and took the majority of the cut from Information Systems and other support.

The fiscal year 2005 budget includes a 1.5 percent increase for pay. If Congress approves and the President signs the anticipated 3.5 percent increase, the impact

of this increase would result in a shortfall of \$109 million. Most of the IRS budget is composed of labor (71 percent) and most of the remainder is composed of items that support staff directly (travel, rent, supplies and equipment). The total percentage of the IRS budget that does not support staff directly is less than 18 percent. Any reduction to IRS funding or any absorption of an unfunded mandate like a pay raise would, of necessity, have a direct impact on FTE. Because most IRS staffing is devoted to taxpayer casework—answering telephones, collecting overdue money, or auditing returns—reductions inevitably affect these taxpayer assistance areas, affecting both taxpayer service and enforcement.

[CLERK'S NOTE.—The report follows:]

REPORT

BACKGROUND

The National Commission on Restructuring the IRS issued a report in 1997 defining "A Vision for a New IRS." In 1998, the IRS Restructuring and Reform Act (RRA 98) codified much of that vision into law. Since the passage of RRA 98, the IRS has undergone enormous changes, including the most extensive reorganization of the agency in the past 50 years. Prior to the IRS reorganization, all ten IRS Submission Processing Centers performed similar functions and processed returns for both the Individual Taxpayers (IMF) and Business Taxpayers (BMF). Each center also handled Taxpayer Accounts (correspondence/telephones) and Compliance programs for both IMF and BMF.

Although the ten-center configuration was successful and worked for many years, we felt we could improve our business results and better respond to customer needs by organizing around our customer segments. We based the initial IMF Consolidation Strategy of our 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 realigned the ten Processing Campuses into eight W&I (IMF) and two SB/SE (BMF) Submission (paper returns) Processing Centers. We completed this realignment of the customer base in 2002. Now, all BMF taxpayers file their paper returns at our processing centers located at either Ogden, Utah or Cincinnati, Ohio. All IMF taxpayers file their paper returns at one of the W&I centers.

The RRA 98 also mandated that the IRS improve the Electronic Tax Administration program to reach the goal of 80 percent of individual returns filed electronically by 2007. With increased emphasis and success of electronic filing, the volume of paper returns has decreased. To effectively administer and manage this change in taxpayer behavior, the IRS analyzed "E-file versus Paper Trends" and developed a detailed business plan to gradually reduce the number of IMF paper Processing Centers. We approved this "Business Plan," which will take several years to fully implement, in 2002. The plan calls for the consolidation of an IMF paper processing center every few years, contingent on the public's continued migration from paper to electronically filed returns.

At the completion of each filing season, we assess both the e-file progress and the paper return filing pattern to see if we need to adjust the consolidation timelines for the next filing season. Flexibility is a key component in this plan, allowing the IRS to plan and react appropriately as paper return volumes fluctuate. Many restructuring changes have already taken place at the Ogden, Utah; Cincinnati, Ohio; and Brookhaven, New York campuses. At Memphis, Tennessee; Philadelphia, Pennsylvania; and Andover, Massachusetts, the IRS will consolidate the paper return processing function over the next several years.

However, compliance and tax account work will remain at all the campuses, making them key employment centers. Our timetable for consolidating IMF paper processing at the campuses is as follows:

- Consolidate the processing of BMF paper returns into two sites (Ogden, Utah and Cincinnati, Ohio). We completed this migration in 2002.
- Discontinue the processing of IMF paper returns at Brookhaven, New York. We completed this change in October 2003.
- Discontinue the processing of IMF paper returns at Memphis, Tennessee by June 2005.
- Discontinue the processing of IMF paper returns at Philadelphia, Pennsylvania by June 2007.

We will determine the specific dates for consolidating of the remaining centers based on e-file and paper volume projections for subsequent years.

ELECTRONIC FILING

In 1999 the IRS processed 29 million electronically filed returns, and in 2003, 53 million taxpayers chose to file electronically. We estimate that nearly half of all taxpayers will e-file in 2004. We are encouraged by both the growth of e-file to date and the projected growth through 2010. We will continue to strive to reach the RRA 98 goal, but believe that individual returns filed electronically will not reach 80 percent by 2007; however the IRS's electronic tax filing program has experienced tremendous gains in customer acceptance. The chart below reflects the progress we made in e-file from 1997 through 2003, and our projections for the future look equally promising.

ACTUAL

[Volume in millions]

	1997	1998	1999	2000	2001	2002	2003
Total Returns	120.7	125.2	126.0	128.4	131.0	131.7	130.1
Total Paper	101.5	100.6	96.7	93.0	90.9	85.0	77.2
Total Electronic	19.2	24.6	29.3	35.4	40.1	46.7	52.9
Percent e-filed	15.9	19.6	23.3	27.6	30.6	35.5	40.7
Percent growth Electronic .....	.....	28.1	19.1	20.8	13.3	16.5	13.3
Percent decrease Paper .....	.....	0.9	3.9	3.8	2.3	6.5	9.2

PROJECTED—2004 AND BEYOND

[Volume in millions]

	2004	2005	2006	2007	2008	2009	2010
Total Returns	130.9	133.3	135.5	137.3	139.0	140.5	141.9
Total Paper	71.1	66.6	62.2	58.1	54.8	51.9	49.5
Total Electronic	59.8	66.7	73.3	79.2	84.2	88.6	92.4
Percent e-filed	45.7	50.0	54.1	57.7	60.6	63.1	65.1
Percent growth Electronic	13.5	11.5	9.9	8.0	6.3	5.2	4.3
Percent decrease Paper	8.1	6.3	6.6	6.6	5.7	5.3	4.6

PROCESSING PAPER RETURNS

As a result of the increase in e-file volume, the paper return volume has decreased each year since 1998. For example, in 1999 we processed over 97 million paper returns, or 77 percent of the total returns processed by the IRS. From 1999 through 2003, paper return volume has decreased by almost 26 million returns, a 26 percent reduction. In 2004, we project we will process 71 million paper returns, which is 54 percent of the total returns processed. This is an average of over 4 million fewer paper returns each year; a trend that we expect will continue. Based on these trends, we analyzed the impact on operations and developed a comprehensive business plan by looking at the impact e-file would have on our processing centers (Phase I), and then developing a strategy to address the decline in paper return volumes (Phase II).

PHASE I OF CONSOLIDATION STRATEGY

Due to the actual and projected increases in electronic filing (ELF), we decided to assess the current and future impact of e-file on our paper processing sites. In 2000, we developed a long-term strategy by answering three key questions about the future of IMF return processing:

- How does an increased ELF volume affect the workforce?
- What is the ideal configuration (end state) of centers when we achieve 80 percent ELF?
- How will the IRS manage the path toward the end-state configuration?

We assessed projected volumes of ELF and paper processing capacity at each site, multiple transition scenarios, and business objectives to arrive at a consolidation strategy. The results of this analysis showed that continuing to operate ten paper processing sites was inefficient. Although we analyzed multiple strategies, consolidating one IMF center at a time (as the volume of e-file returns continues to increase) was the most efficient strategy. We shared this strategy with all our internal and external stakeholders, then proceeded to implement this “Modernization/Consolidation of Submission Processing Centers,” starting with the consolidation of the

Brookhaven IMF Submission Processing operation. As a result, Brookhaven stopped processing individual paper returns as of October 2003.

Our strategy will allow us to improve customer service, increase business performance, and adjust the plan as paper and e-file volumes and patterns dictate. It will also permit us to reduce overhead and real estate costs campus by campus.

PHASE II OF CONSOLIDATION STRATEGY

For the second phase of our analysis, we reviewed each site against factors including business operational alignment, economies of scale, labor market issues, and real estate costs. This analysis identified the order of the consolidation of IMF processing centers, starting with the Brookhaven Submission Processing center in October 2003, the Memphis Submission Processing center in October 2005, and the Philadelphia Submission Processing Center in October 2007.

We expect these consolidations to be followed by the Andover Submission Processing center, and so forth, until the IRS reaches its "end state" configuration. Again, this plan is contingent on the continued growth in the number of e-filed returns.

TAXPAYER IMPACT

At the very beginning of our modernization efforts, we recognized the challenge we would face in ensuring our customers understood the reason for consolidating our operations and the changes they could expect to see. We have tried to minimize the impact of these changes by consulting with various groups including the National Treasury Employees Union (NTEU) and Tax Practitioner groups. Working with our own Multi-Media operation, we made sure that various tax packages included updated instructions on the location to send returns. We also made presentations at various tax forums around the country. Although this effort has been challenging, we have successfully consolidated IMF and BMF customer processing sites and the Brookhaven Submission Processing operation. Even though we substantially reduced the number of returns processed at Brookhaven in 2003, we completed one of our most successful filing seasons. We review each consolidation process and build on that foundation as we continue our consolidation efforts.

WORKFORCE IMPACT

We recognize that one of our greatest assets is the people who help in the daily processing of taxpayers' returns. We also recognize that consolidating paper processing operations will affect our workforce. In anticipation of the consolidation, we stopped hiring "career conditional" employees and started hiring "temporary" employees in Memphis, Philadelphia, and Andover. The new hires understand their appointment is temporary. When job reductions occur, we will make every effort to minimize the adverse effects on our employees. For example, when we realigned the processing of IMF/BMF paper returns into eight IMF centers and two BMF centers, we did so without a loss of jobs. In addition, in the Brookhaven and Memphis centers we prepared for staff downsizing by consolidating our Centralized Offer in Compromise (COIC) program in the centers, creating hundreds of job opportunities at each location. We also recently announced the proposed consolidation of Case Processing and the Insolvency Program, which will also create hundreds of jobs in Memphis and Philadelphia.

We are working with NTEU to develop workforce transition plans and to take advantage of every tool we have to help employees through this transition. We have held "Town Hall" meetings with the employees at all our campuses and will continue to do so as we schedule specific campuses for consolidation. We will also continue to provide our employees with job placement assistance. Of course, if we must involuntarily separate employees from the IRS, we will give them all the benefits to which they are entitled under the law.

CONCLUSION

We began modernizing our paper processing centers in 1998. We conducted an extensive business plan analysis before making consolidation decisions, and we continue to rely on this business plan as we move forward with consolidation. We also adjust our plan based on our initial experiences with the streamlining of the service centers. This report captures at a high level the analysis, efforts and progress we have made in improving our processing operations. We would welcome the opportunity to present this extensive business case to you and your staff at your earliest convenience.

Question. In addition to the new enforcement funding IRS is seeking from Congress, the IRS's budget justification states the following about its intention to fund enforcement from other areas: "In fiscal year 2005, \$111 million will come from current operations to improve enforcement and infrastructure." "The majority of resources (\$61 million) generated from base mining will be diverted to enforcement activities. . . ." Why is only a little more than half of the money going toward enforcement? For what specific purposes is the other money going and what is meant by infrastructure?

Answer. The IRS is emphasizing enforcement, but it cannot ignore service or the infrastructure supporting it. Thus, in order to balance its efforts, the IRS redirected some funds to modernizing IRS infrastructure. The IRS budget strategy is designed to redirect productivity enhancements from increases in electronic processing and modernization of business systems to continue to improve taxpayer service and enforcement.

Of the \$111 million in redirected resources, \$61 million will be diverted to enforcement activities. The remaining \$50 million will be redirected as follows:

INFRASTRUCTURE EXPENSES

[In millions of dollars]

	Amount
Cost of Transitioning Employees ¹	39.0
Continue Competitive Sourcing Studies	9.0
Embedded Quality ²	1.6
Create ADA-Compliant Training Facility	0.5
TOTAL	50.1

¹Includes lump-sum leave, severance and relocation.

²This initiative, through an Embedded Quality system in Submission Processing (EQSP), will create a new measurement system that will identify the cause and impact of errors, apply common measures to every level of the new organization, and enable frontline employees to understand how their contributions impact IRS's performance. An embedded quality system links individual and business performance with multiple quality review sources. EQSP will instill complete accountability for quality performance across operations.

Infrastructure refers to programs and activities that support enforcement and taxpayer service. These activities align with the IRS's third strategic goal, "modernize the IRS through its people, processes, and technology."

Question. As part of its budget request, IRS proposes spending \$121.6 million and 1,167 FTE to "curb egregious noncompliance". Please provide a table citing each instance of egregious noncompliance, along with the associated dollar amount and FTE.

Answer. The "Curb Egregious Noncompliance" (CEN) enforcement initiative addresses the continuing concern over the proliferation of abusive domestic and international tax avoidance transactions and schemes. In addition, requested staffing will allow the IRS to address issues associated with certain individual taxpayers and those who use structured transactions and flow-through entities to conceal or improperly reduce taxable income and avoid payment of taxes owed. This non-compliance represents a real threat to the American system of voluntary compliance. Traditional approaches aimed at maintaining audit coverage and managing growing case inventories with a declining resource base have failed to adequately address these complex enforcement issues.

To address these issues, the CEN initiative will allow the IRS to hire and train new staff in the Examination, Collection and Document Matching programs during fiscal year 2005.

The following table shows the projected expenditures of FTE and dollars by program.

[Dollars in millions]

Program	FTE	Amount
Field Examinations	492	\$66.0
Field Collection	332	\$29.2
Automated Underreporter	53	\$4.2
Automated Collection (ACS)	125	\$10.9
Correspondence Exams	165	\$11.3
Total	1,167	\$121.6

Question. Please provide a breakdown by percentage of how proposed enforcement resources would be allocated toward the various segments of the taxpayer population within \$25,000 increments.

Answer. In fiscal year 2005, proposed increases for the Tax Law Enforcement account, including annualization and enforcement initiatives, total \$393 million. The IRS aligns increases in enforcement as follows:

- Corporations.*—\$59 million (22 percent) and 562 FTE;
- High-income taxpayers (>\$100,000).*—\$57 million (21 percent) and 674 FTE;
- Criminal activity.*—\$64 million (23 percent) and 299 FTE;
- Tax-exempt organizations.*—\$16 million (6 percent) and 180 FTE; and
- Other contributors to the tax gap.*—\$76 million (28 percent) and 1,226 FTE.

The increase also includes \$121 million for inflation to maintain current levels.

IRS REORGANIZATION

Question. Please summarize in detail what has happened to IRS employees who were determined to be “transitional”, stating from which program area they were taken and when, how many reassigned, how many were lost due to attrition, as well as how the requested \$5 million will remove the remaining employees “from the rolls.”

Answer. Upon stand-up in September 2000, approximately 5,000 employees did not align with the new organizational structure. Over the next 3 years, the IRS placed approximately 4,450 employees into permanent positions or they voluntarily left the IRS. Approximately 1,000 of these employees left under Voluntary Early Retirement Authority (VERA) or Voluntary Separation Incentive Payment (VSIP). On August 9, 2003, the IRS terminated the “transition” designation and declared permanent all employees previously designated as “transition.” At that time, there were approximately 550 formerly transition employees. Of this group, the IRS placed approximately 290 employees in permanent positions and 260 remained in non-continuing positions. The IRS expects to offer VERA/VSIP to the employees in the non-continuing positions to facilitate voluntary separations.

Question. In early January, IRS officials announced a major organizational restructuring resulting in 2,400 layoffs as well as office consolidations. As part of the same announcement, IRS indicated its intention to then fill 2,200 new positions. What is the cost of the 2,200 new enforcement positions the IRS intends to add? What is the cost savings associated with the layoffs and consolidations?

Answer. As noted in the January announcement, as a result of our planned consolidation, the IRS expects to perform its Case Processing and Insolvency operations while using fewer full-time employees—saving approximately 350 staff years. Similarly, the IRS expects that Support Optimization initiative will allow it to deliver its operations support services while saving approximately 750 staff years. The Memphis Submissions Processing ramp-down will eliminate approximately 2,200 positions. The January announcement stated the intention to redeploy the personnel reductions towards enforcement priorities.

In determining the approximate numbers of full-time positions that could be redirected to enforcement activities, the IRS assumed a 1-for-1 redeployment of the full time positions (i.e., approximately 350 from Case Processing and Insolvency and 750 from Support Optimization) and a 2-for-1 redeployment for the submissions processing positions (i.e., for every two submission processing positions eliminated the IRS could expect approximately one full-time position available for redeployment, or approximately 1,100 positions). Thus, the IRS estimated that approximately 2,200 positions would be available for redeployment to enforcement activities that would not be otherwise available without such efficiencies.

In determining the numbers of employees potentially subject to involuntary separation, the IRS estimated the numbers of employees in positions to be eliminated, and reduced that figure to account for the numbers of employees who are expected to voluntarily leave through normal attrition, the use of Voluntary Early Retirement Authority (VERA) and Voluntary Separation Incentive Payments (VSIP), and those employees expected to be placed in other positions with the IRS. For this determination, the IRS did not include employees hired for limited-term appointments, because employees accepted these positions with the understanding that the positions would “sunset” in 2005 and because the elimination of these positions does not require the same involuntary separation procedures.

For the income tax returns processing initiative, the IRS estimates that approximately 2,200 positions will be eliminated. Of this number, approximately 400 are term appointments. Therefore, the IRS determined that approximately 1,800 permanent (full-time or seasonal) positions would be eliminated. Based on this figure, the IRS anticipates approximately 1,000 employees will be involuntarily separated. For

the case processing and insolvency initiatives, the IRS estimates that approximately 1,400 positions will be eliminated. Of this number, it anticipates that approximately 1,000 employees will be involuntarily separated (because the case processing and insolvency initiative involves consolidating work, i.e., eliminating positions in field offices while creating positions in the four consolidated campus locations, the net number of positions available for redeployment (approximately 350) is less than the gross numbers of positions being eliminated (approximately 1,400)). The Support Optimization initiative involves eliminating approximately 750 positions, and based on that figure, the IRS anticipates approximately 400 employees will be involuntarily separated. Thus, the total number of employees estimated to be subject to involuntary separation is estimated to be 2,400.

Question. The nationwide case processing and insolvency support workforce would be reduced from 1,600 positions to 1,200, a 25 percent reduction. What analysis has been done to show that 25 percent fewer employees can perform this work? What cost savings does the IRS project from this? All background on how the savings are projected should be provided.

Answer. The IRS has been studying the reengineering of the case processing and insolvency operations since 2000. Even after taking into account costs such as severance, hiring, training, salary cost differentials, and infrastructure, the IRS expects these initiatives to yield more than \$300 million in savings over the next 10 years. These savings will allow us to redirect the equivalent of 350–425 full-time employees to front line tax law enforcement.

The IRS considered alternative approaches, including switching staffing allocations from the area offices to the campuses at a pace driven by natural attrition. The IRS rejected this approach because of low return on investment and implementation difficulties. Competitive outsourcing was also considered and rejected because case processing and insolvency work is mainly inherently governmental.

The IRS's analysis involved baselining the existing case processing and insolvency processes currently performed in the areas, identifying best practices, and standardizing the processes to be implemented in the campus from these baselines and best practices. The new operational structure builds on existing processes currently being performed at IRS campuses, provides economies of scale and standardization, allows the creation of a quality review unit, offers staffing flexibility, and creates space savings due to shift work.

The IRS's analysis of sources such as OMB and best practices used in private industry predicted that a 35 percent reduction in case processing and insolvency costs would be possible through consolidation and process standardization. The results predicted from external indicators were compared with area and campus case closure efficiencies. Centralized staffing calculations were updated based on area and campus efficiency and projected work plans resulting in a more conservative of 25 percent cost savings projection.

Question. IRS has stated that no employee would be involuntarily separated before January 2005. When would new employees be hired and what kind of training will be provided? How would IRS deal with an inexperienced workforce—reduced by 25 percent from current levels—that will have no institutional memory?

Answer. The IRS is currently in negotiations with NTEU regarding the potential reduction in force. Until negotiations are finalized, no employee will be involuntarily separated. However, the IRS has recently entered into a separate memorandum of understanding with NTEU that authorizes a staged hiring at the campus consolidated sites to address excess workload in the area offices created by the natural attrition of staff. This step will allow the organization to begin ramp up by providing training and significant experience with the work before any off rolls occur.

Once this IRS reaches its final agreement with NTEU, full implementation will occur with a staged deployment of hiring at the campuses, redirecting work from the field, and workforce transition in the non-continuing sites. This approach allows campus personnel additional experience with total centralization before off rolls will occur in 2005.

The IRS established a training team made up of subject matter experts from case processing, insolvency, and campus employees to revise existing training material, write additional training lessons and develop training guidelines and timeframes. All campus hires will be given a combination of classroom and on the job training as soon as they are hired, which is a significant improvement over current field practices in case processing and insolvency.

Learning curves were projected for centralized case processing and insolvency new hires aligned by grade level and skill set. These learning curves provided the underpinnings for decisions regarding the timing for early ramp up and staging the implementation. Projections for the time needed for training are conservative as many of the hires will already have experience from positions and activities cur-

rently performed on the campus that are similar to those in centralized case processing and insolvency.

Question. How is it more efficient to move these case processing staff away from the collection staff they are supporting to centralized locations?

Answer. In a centralized situation, a smaller team of employees can focus on one function for longer periods of time, and can work more efficiently than the larger number of staff in the separate locations. The workload can also be more easily managed and scheduled because of the consolidation. Training expenses and other costs have been considered, and the resulting savings shows centralization is cost effective.

Many revenue officers and revenue agents currently mail their work to the area offices and under the new design the only change for them would be the address they mail to. To address lingering concerns of the collection staff there will be a FORT (Field Office Resource Team) consisting of revenue officers who will be responsible for assisting tax examiners and field collection personnel in making any necessary corrections to reports or closing documents.

Question. How is it more efficient to centralize insolvency/bankruptcy staff when this work is ruled in large part by 50 different State laws?

Answer. Over 900 Insolvency Specialists and Advisors will remain in the area offices to address the more technical issues. They will no longer be pulled away from the technical work to help with clerical and para-professional duties. Therefore, centralization will actually enhance the relationships with the bankruptcy courts, trustees and external stakeholders that have been established over the years and increase customer service.

The new structure provides economies of scale and standardization, allows the creation of a quality review unit, offers staffing flexibility, and creates space savings due to shift work. Centralization will also help create an environment suitable for electronic processing and transmission of Proofs of Claim. The planned use of an electronic knowledge system will provide a national resource for State law information.

Question. Have you discussed this reorganization with the affected parties? What do the revenue officers and agents think the impact of this will be on their efficiency? What do tax practitioner groups think of this?

Answer. There is a natural concern and uneasiness that accompanies any change. Focus interviews and customer surveys were conducted with area directors, revenue officers, revenue agents, and other bargaining unit employees in which the case processing redesign team received valuable information on issues and ideas to be considered for possible centralization. As a result of this feedback, the IRS developed the concept of the Field Office Resource Team (FORT). The FORT, consisting of revenue officers, will be available to address the needs of field collection personnel in making any necessary corrections to reports or closing documents.

Insolvency has little contact with revenue officers, revenue agents, or practitioners. A centralized phone number and phone unit will be established to answer calls and concerns of trustees, taxpayers as well as any internal customers.

The Case Processing Team had conversations with some of the large institutional practitioner groups and received support for the redesign.

Question. At the Memphis Service Center, 2,200 current employees would be laid off and not replaced. IRS claims that this is aimed at reducing paper processing staff in response to increases in electronic filing. IRS has already downsized returns processing employees at the Brookhaven, NY Service Center. The House report accompanying the fiscal year 2004 Transportation, Treasury Appropriations bill recommended that IRS refrain from initiating any premature and ill-considered reductions in force until reporting to Congress. What progress has been made on the report to Congress and when will it be submitted? What are the cost savings associated with the reduction in force?

Answer. The IRS delivered the report to Congress on April 22, 2004. A copy is attached. The IRS estimates the cost savings for Memphis to be \$12.5 million for the period 2004 through 2006 and then an annual cost avoidance of \$9.5 million dollars a year starting in 2007.

Question. GAO has indicated that electronic filing is far short of IRS projections. What is the level of electronic filing compared to IRS projections? What level of increase in electronic filing is IRS projecting that will make it plausible to lay off 2,200 return processing employees within the next year?

Answer. While the IRS is below projections needed to achieve the goal of 80 percent of individual returns filed electronically by 2007, it is continuing to make strong gains. The Consolidation Strategy is based on projections that are keyed to the workload shifts necessary to process the reduced paper volumes. In 2004, the IRS projected 59.8 million electronic returns would be filed. As of May 14, taxpayers

exceeded the number e-filed returns from the prior year by over 8 million returns to reach the 60 million mark. This figure equates to approximately 50 percent of all individual returns filed and represents a milestone in e-file progress. The IRS's Consolidation Strategy is on track.

PROBLEMS WITH IRS BUSINESS SYSTEMS MODERNIZATION (BSM)

Question. In a March 2004 review, GAO found that although IRS has made some progress in implementing their recommendations and improving its modernization management, certain recommendations have not yet been fully implemented or institutionalized. These weaknesses have contributed, at least in part, to BSM project cost and schedule shortfalls. GAO states that, "Projects continue to incur cost increases and schedule delays for several reasons, including inadequate definition of systems requirements, increases in project scope, and cost and schedule estimating deficiencies." Mr. Everson, this modernization effort has been plagued with these problems from the start. What have you done to ensure that IRS staff is adequately prepared to define its systems requirements instead of relying completely on the contractors to do so? What steps are you taking to ensure that cost and schedule estimates, which have been grossly off-track, will now be more accurate?

Answer. Recent improvements to the IRS Enterprise Life Cycle (ELC) will ensure that the IRS adequately defines system requirements in the future. The recent updates to the ELC include a new milestone (Milestone 4A), that requires a detailed definition of a systems' physical design baseline under strict configuration management (CM) control. This baseline can be used for awarding fixed priced contracts for the development, integration, and testing of the system. As a prerequisite to the implementation of MS 4A, the ELC now requires redefinition of requirements management, and strict CM control for projects in prior milestones. For example, at Milestone (MS) 2, business requirements constitute the functional baseline. The functional baseline is then decomposed into logical systems requirements that are baselined under CM control at MS 3. Requirements that evolve from milestone 1 through 4A are verifiable and traceable in both directions and must be compliant with the Enterprise Architecture in order for a project to gain approval to move to the next stage of development. There will be a major systems engineering review at the end of each development phase, conducted by IRS business and technical personnel.

As the IRS moves forward, constant involvement of the IRS stakeholder organizations is critical. Stakeholder involvement in the definition, approval, and coordination of system requirements will ensure that what the IRS develops is closely traced to IRS's business needs and that ownership is clearly identified and understood. As this revised ELC strategy is unveiled, training will be provided to ensure that IRS personnel are adequately prepared to achieve success.

The IRS has been working jointly with MITRE and CSC (the PRIME Contractor) to improve cost and schedule estimating capability. The IRS is using the well-recognized Carnegie Mellon Software Engineering Institute's (SEI) Requisites for Reliable Estimating Processes as a guide. The requisites provide for development and execution of the following key cost and schedule estimating objectives:

- Maintaining historical data;
- Structured estimating processes;
- Mechanisms for extrapolating estimates from successful past projects;
- Audit trails; and
- Ensuring integrity in dealing with dictated costs and schedules.

Both CSC and the IRS have made significant progress towards achieving these key objectives. The IRS has implemented procedures for validating contractors' estimating systems and for reviewing cost and schedule estimates. The procedures provide guidance for evaluating reliability of documentation supporting individual estimates and for tracking compliance with sound estimating practices. Furthermore, the procedures also address professional development of personnel with the right skill set for developing and evaluating cost and schedule estimates. CSC has established a historical database, calibrated estimating models and developed detailed requirements for documenting and supporting bases of estimates along with related guidance and directives. Work is also in progress for continuing refinement and improvement in each of these elements.

In addition, joint training is being conducted for IRS, CSC and MITRE personnel as an integral part of the overall plan to ensure competent deployment of improved processes and procedures. The IRS, with MITRE's assistance, recently completed a review of CSC's estimating system. The IRS is finalizing the results and will issue them in a report in the latter part of June. In general, there have been improvements. The report will include a time phased corrective action plan for addressing

deficiencies. To ensure the tools, guidance, processes and procedures are part of a mature repeatable process, a concerted effort is underway to fully validate all aspects of the processes and procedures prior to official roll-out within the IRS. This pilot program is intended to verify the soundness of the processes and procedures and provide lessons learned, before full implementation is effected.

The IRS is making every effort to hire qualified staff and fully implement its improved tools, guidance, processes, and procedures as soon as possible. However, this is taking more time than the IRS would like. This is a pervasive problem on programs of the size and complexity of the modernization initiative. Nonetheless, the IRS believes that there will be evidence of increased accuracy by the end of fiscal year 2004 and continued improvements over time.

Finally, all of these efforts are part of a highly visible set of plans geared to identifying, tracking, reporting, and reviewing the critical cost and schedule estimating commitments with IRS Executive Management and GAO/TIGTA.

Question. The modernization of IRS business systems has suffered numerous problems and delays and now some IRS staff integral to the process are leaving, including the director of BSM. How will this affect the program, what steps are being taken to ensure that institutional knowledge of the modernization program remains?

Answer. In addition to putting a succession management plan in place, the IRS needs a more versatile team of seasoned executives to provide long-term stability to the program. The IRS is complementing the skills of its experienced tax executives with outside seasoned technology executives who have experience managing large-scale, complex IT projects. As such, the IRS is hiring two Associate Chief Information Officers to join the MITS organization, and an executive search firm is conducting searches for five senior executives with a wide range of diverse experience in developing and implementing large modernization systems. The new Associate CIOs will assume modernization management responsibilities so that the Associate CIO of business systems modernization can focus primarily on delivering projects.

Question. Until recently, IRS has used its information technology services staff with minimal input from its business units. The business units will be the ultimate users of this program. What steps has IRS taken to incorporate the business managers into BSM?

Answer. The Commissioner is holding IRS senior business unit managers accountable for the success of modernization efforts as it relates to defining, developing, and controlling business requirements. For example, a senior business unit manager is responsible for working closely with the BSM and Modernization and Information Technology Services (MITS) executives to ensure that the delivery of the CADE project meets all business requirements.

Question. GAO has concluded that the IRS must institutionalize the management processes and controls necessary to resolve the deficiencies identified by the reviews and assessments in order to strengthen management of the Business Systems Modernization program. What steps is IRS undertaking to accomplish this?

Answer. Over the past 2 years, the BSM organization has been working diligently toward integrating and institutionalizing the management processes of the BSM program. While the IRS has achieved real progress, as recognized by TIGTA and GAO, the BSM Challenges Plan has complemented ongoing efforts by providing a special focus on significant issues that needed more attention.

GAO recognized the need for continual growth in the maturity of the BSM management processes and raised concerns in key areas such as configuration management, human capital management, contract management, and cost and schedule estimating. Accordingly, BSMO committed to maturing its management processes and established corrective action plans for each area, assigned responsibilities and set milestones, and initiated a formal monitoring process for measuring progress in each area.

For example, the IRS has developed configuration management processes and is institutionalizing configuration procedures. It established a process for determining the type of task order to be awarded and MITS is implementing plans for attracting, developing, and retaining requisite human capital resources. Key stakeholders are reviewing documented procedures for how to effectively validate the cost and scheduling estimates submitted by the PRIME.

Question. The IRS Oversight Board stated in a December 2003 report that, as the foundation of the modernization project, the Customer Account Data Engine (CADE), requires special attention. CADE will replace the existing IRS Master File of taxpayer accounts. It is the most costly, complex, largest, and longest-running project within the BSM portfolio. IRS has engaged Carnegie Mellon's Software Engineering Institute (SEI) to review CADE. One of SEI's findings is that a key compo-

ment of CADE, its “business rules engine” which translates tax processing rules into computer code, must be defined and modeled in order for CADE to succeed. Is IRS following this recommendation and if so, what is the status? If not, why not?

Answer. The IRS is following the recommendation from Carnegie Mellon’s Software Engineering Institute. The IRS tasked PRIME to do a business rules engine performance engineering study that measured and modeled the performance of the business rules engine. The IRS also tasked PRIME to evaluate design alternatives that lowered risk of implementing business rules. The PRIME has completed performance tests.

Senior engineers from IRS, PRIME, MITRE, and Sapiens (the business rules vendor) met the week of May 10, to review the test results and assess alternatives that will improve the performance of CADE and lower the risk of implementing business rules. Design changes will be modeled using the performance data obtained in the tests. The final report is due to be completed June 20, 2004.

Question. In Ms. Gardiner’s formal testimony, she states that oversight groups are starting to lose confidence in the ability of your PRIME contractor to meet its commitment in modernizing the IRS’s business systems. This observation is clearly based on the deadlines that have already been missed and the cost overruns already incurred. Mr. Everson, what is your current assessment of your PRIME contractor’s ability to get the job done without further delays and further cost overruns? Are you giving any consideration to changing your PRIME contractor on this critically important endeavor? If so, what would be the cost to the taxpayer of changing your PRIME contractor at this time?

Answer. There are no current plans to replace CSC as the PRIME contractor, however, Commissioner Everson has made it vividly clear to Mike Laphen, the President and Chief Operating Officer of CSC, that CSC needs to significantly improve their performance. In February 2004, he announced his decision to direct the upcoming enforcement modernization projects for collection contract support and filing and payment compliance to other contractors. It is the Commissioner’s hope that this action, while no doubt unwelcome to CSC, will lead to a sharpened focus and discipline, and will in fact enhance the prospects for successful and timely delivery of other modernization projects by CSC.

While CSC has improved their performance somewhat, the IRS carefully assessing CSC’s performance on current projects and the results of CSC’s overall program management and integration efforts before awarding any follow-on work for existing projects. The IRS needs consistent, high-level performance and service from CSC. The IRS has also moved to capped or fixed price contracts for almost all development work to balance the financial risk on modernization projects.

COMPETITIVE SOURCING

Question. Mr. Everson, you are very familiar with the President’s competitive sourcing initiative since you served as Deputy Director for Management at OMB. I understand that you plan to spend \$9.1 million in unbudgeted funds in fiscal year 2005. What areas are you planning to contract out?

Answer. The \$9.1 million you cite is the amount the IRS has requested in the fiscal year 2005 budget submission to support the Competitive Sourcing program. The IRS plans to use public-private competition to improve operations, but only if it makes economic sense. Traditionally, the employee government bid teams have won over 50 percent of the public-private competitions. Historically, organizations that have successfully used competition to improve operations have achieved an overall 30 percent reduction in operating costs. These reductions are typically in the support functions and are achieved through such actions as consolidation of existing facilities (releasing commercially leased space), staff reductions, and increased use of technology. Similarly, the IRS focus is on support functions.

Question. What is the status of all the competitive sourcing studies that have been undertaken at IRS? Please include year, area, and result. How much money has been spent on these competitions? Since the competitions are not budgeted for, where has the money come from?

Answer. It has been difficult to finance the Competitive Sourcing Program since the IRS does not know the outcomes in advance, the exact level of savings are yet to be determined, and it takes time to realize these savings. The IRS had to internally realign. However, the investments made today in public-private competitions show a return on investment usually within 2–3 years (including payment of transition costs—voluntary early retirement, voluntary separation incentive, etc.). At that time, the IRS plans to reinvest the savings to fund future competitions and cover transition costs. It will take several years to get there. The IRS does request funding in the fiscal year 2005 budget for the Competitive Sourcing program.

Status of IRS Competitive Sourcing Studies

Architects and Engineers (10 FTE).—Streamline competition resulted in in-house award. The in-house team was most efficient.

No savings achieved.

Area Distribution Centers (500 FTE in Bloomington, IL; Rancho Cordova, CA; Richmond, VA).—The three Area Distribution Centers distribute tax forms, instructions and publications to taxpayers and internal use documents to IRS employees.

Standard Competition with award decision scheduled for June 28, 2004.

Expected Saving and Benefits: Consolidation of activities and geographic locations resulting in the release of commercial space, revised operational processes and procedures to gain efficiencies, new information system, reduced staff and increased managerial span of control.

Anticipated return on investment (fiscal year 2005–fiscal year 2009): \$22 million.

Building Delegations or Operation and Maintenance (O&M) of Delegated Buildings (100 FTE in Covington, Fresno, Austin, Ogden, Philadelphia, Headquarters).—O&M are those functions identified in the Building Delegation Agreements between the General Services Administration (GSA) and the IRS. These services include responsibilities to operate and maintain building systems (electrical, HVAC, control systems, etc.).

Standard Competition with solicitation release scheduled for June 2004.

Expected Saving and Benefits: Revised operational processes and procedures to gain efficiencies; reduced staff; and increased managerial span of control.

Anticipated return on investment (fiscal year 2006–fiscal year 2010): \$3.9 million.

Mail Rooms (70 FTE).—Mailroom services functions include all aspects of the delivery of mail from full service delivery to mail stop or desktop to self-service mailrooms where customers pick up their own mail. The IRS made a decision to divide the study among headquarters, nationwide “stand alone sites” and campuses.

The IRS plans to use public-private competition to improve operations.

Direct Conversion—in progress.

Fully Implemented—Denver, CO; Detroit, MI; Plantation, FL; Detroit Computing Center, MI; Houston (Leland), TX; Laguna Niguel, CA; Oklahoma City, OK; and San Francisco, CA.

Partially Implemented—Washington, DC; New Carrollton, MD.

Scheduled for Implementation—Cincinnati, OH; Jacksonville, FL (5/17); and Nashville, TN.

Implementation Not Scheduled—Atlanta, GA; Baltimore, MD; Boston, MA; Buffalo, NY; Dallas, TX; Greensboro, NC; Hartford, CT; Houston (Alliance), TX; Indianapolis, IN; Los Angeles, CA; Milwaukee, WI; New Orleans, LA; Oakland, CA; Philadelphia, PA; Phoenix, AZ; Richmond, VA; Chicago, IL; Springfield, NJ; St. Louis, MO; St. Paul, MN.

Anticipated return on investment (fiscal year 2005–2009): \$399,000.

Campus Operations (Information Technology) (350 FTE in Ogden, UT; Atlanta, GA; Brookhaven, NY; Andover, MA; Cincinnati, OH; Fresno, CA; Austin, TX; Memphis TN; Kansas City, MO; Philadelphia, PA).—This functional area provides the Information Systems (IS) computer operations at the ten IRS Campus facilities. The positions include computer operators, production controllers, tape librarians, computer specialists, and clerks.

Standard Competition with award decision scheduled for July 2004.

Expected Saving and Benefits: Revised operational processes and procedures to gain efficiencies; reduced staff; and increased managerial span of control.

Anticipated return on investment (fiscal year 2005–2009): \$12.7 million.

Logistics Support (formerly Warehouse and Transportation) (160 FTE in Andover, MA; Philadelphia, PA; Brookhaven, NY; Atlanta, GA; Covington, KY; Austin, TX; Kansas City, MO; Ogden, UT; Fresno, CA; Memphis, TN).—This functional area provides warehousing and transportation, mainly at the 10 campus sites. This activity includes positions such as material handlers, warehouseman, motor vehicle operators, laborers, and clerks.

Standard Competition with Performance Work Statement development underway.

Expected Saving and Benefits: Revised operational processes and procedures to gain efficiencies, release of leased space, reduced staff and increase of managerial span of control.

Anticipated return on investment (fiscal year 2006–2010): \$4.8 million.

Campus Files Activity (1458 FTE in Austin, TX; Andover, MA; Philadelphia, PA; Brookhaven, NY; Cincinnati, OH; Memphis, TN; Atlanta, GA; Kansas City, MO; Ogden, UT; Fresno, CA).—This functional area receives, controls, shelves and maintains all returns/documents for retention and retirement. They retrieve documents as requested by customer organizations. Liaison work is critical with the Federal

Records Centers for final retention of documents. The work is routine and does not involve making complex determinations or present unique fact patterns.

Standard Competition with solicitation release scheduled for the fourth quarter of 2004.

Expected Saving and Benefits: Revised operational processes and procedures to gain efficiencies; reduced staff; and increased managerial span of control.

Anticipated return on investment (fiscal year 2006–2010): \$22 million.

Learning and Education (617 FTE Service-wide).—This functional area is responsible for determining service-wide and division-level professional training requirements, developing training plans and curriculum, evaluating the effectiveness of training, and performing a broad spectrum of program administration.

Standard Competition with Performance Work Statement development underway.

Expected Saving and Benefits: Consolidation of activities, revised operational processes and procedures to gain efficiencies, implementation of learning content management and learning management systems, reduced staff and increased managerial span of control.

Anticipated return on investment (fiscal year 2006–2010): \$25 million.

Competitive Sourcing Competition Costs

[In millions of dollars]

	Amount ¹
Fiscal year 2003	5.0
Fiscal year 2004	6.3

¹Travel, training, staffing, expert contractor support (PWS, Most Efficient Organization, Independent Review)—does not reflect transition/separation costs.

Note.—Return on investment includes cost of conducting competition and transition/separation costs. The IRS calculated savings calculated through fiscal year 2007.

Business Case Analysis/Feasibility Studies

Tax Law Telephone.—This is a preliminary feasibility assessment of having a vendor provide tax law telephone assistance. After the completion of the preliminary feasibility assessment, the IRS will make a decision as to whether to go forward with the competition.

Fuel Compliance Activity (140 FTE Service-wide).—This function area monitors 1,400 terminals, all fuel wholesalers, thousands of retail motor fuel outlets, and U.S. border crossings. Additionally, these personnel are charged with conducting periodic inspections of on-road vehicles on highways throughout the country.

IT Support (Service-wide).—This is identification and development of sourcing strategy to identify candidate public-private competition activities.

Question. One of the provisions included in last year’s appropriations bill was a prohibition against using fiscal year 2004 funds to contract out any Federal job overseas. To my shock, the President’s budget specifically requests that this provision be deleted for fiscal year 2005. Mr. Everson, could you cite for me some instances at IRS where you might take work that is currently be conducted by Federal employees and send that work overseas?

Answer. The IRS has no specific plans to move work overseas. There are added complexities and security challenges that make moving work that would involve access to the IRS’s information technology systems and/or sensitive data cost prohibitive.

However, while the IRS has no specific plans to contract work overseas, it is conceivable that qualified bidders with overseas operations may be responsive to future IRS public-private competitions that do not involve access to the IRS’s information technology systems and/or taxpayer return information. The IRS will continually identify a series of functions that are commercial in nature in accordance with the FAIR Act. At that time, a business case is developed that indicates whether or not a more efficient method of operation may be available. If so, a competitive sourcing initiative is begun under the guidelines of the OMB A–76 Circular. A contractor may then bid for that work. It is highly unlikely that a contractor would bid work to be performed overseas given the nature of the work the IRS has identified to date or anticipates identifying. Under the IRS Competitive Sourcing Program, no initiative has resulted in Federal jobs being outsourced overseas. The IRS adheres primarily to the Federal Acquisition Regulations (FAR) and the A–76 Circular when conducting public-private competitions for work performed by Federal employees. The FAR currently contains some limitation on issuance of contracts to some overseas locations.

CUSTOMER SERVICE

Question. IRS consistently finds its own accuracy rates higher than TIGTA does when measuring taxpayer assistance functions, whether we are talking about toll-free telephone assistance, walk-in service at Taxpayer Assistance Centers, or the IRS website. Mr. Everson, how do you explain the discrepancy? Ms. Gardiner, would you care to comment?

Answer. Typically, TIGTA's reports on accuracy are based on limited judgmental sampling conducted during the brief period of their fieldwork on a particular audit. The results that they report are not statistically valid. The IRS results for telephone accuracy and for irs.gov e-mail assistance are based upon an on-going process that is statistically reliable. TIGTA typically acknowledges the limitations of their data in their reports with statements such as, "We selected a judgmental sample of calls to monitor between April 21 and May 16, 2003. Our results cannot be compared to the statistical results reported by the IRS."

The discrepancy between the TIGTA accuracy rates and the Taxpayer Assistance Center (TAC) walk-in service accuracy rates is due to the calculation methodology. TIGTA and the IRS treat responses to tax law questions differently. In contrast to the IRS, TIGTA includes referrals to publications, service denied, and referrals to other employees in its accuracy calculation. The IRS disagrees with the assertion that a non-response is synonymous with providing an incorrect answer. While it is clear that there is some disparity in methodology, it is important to note that neither of these methods of measuring walk-in service accuracy is statistically reliable.

TIGTA will respond separately.

Question. As stated in testimony, TIGTA found that IRS employees incorrectly prepared 19 of the 23 tax returns prepared during TIGTA audit visits to Taxpayer Assistance Centers. What steps has IRS taken to remedy this egregious example of inaccuracy and Mr. Everson, do you plan to implement the additional actions that TIGTA recommended?

Answer. The IRS implemented the recommendations made by TIGTA and has taken several steps to remedy inaccurate return preparation. The IRS directed all TAC employees to adhere to existing screening procedures to ensure taxpayers meet the return preparation criteria. In addition, the IRS required all employees to use the appropriate worksheets in the return preparation software and the publication method guide to assist in determining a taxpayer's eligibility for deductions and credits claimed on the tax return.

The IRS also implemented a quality review plan to ensure TAC employees adhere to these and other return preparation procedures in the Internal Revenue Manual. The IRS requires group managers to complete three employee return preparation reviews and the quality review staff is required to visit each Area and conduct at least two return preparation reviews.

Question. As stated in testimony, TIGTA found that IRS didn't respond to several of the questions TIGTA submitted anonymously to the website. Do you have statistics about the number of questions that go unanswered? How is this allowed to happen? What is being done to prevent this in the future?

Answer. During the period from February 22 to March 6, 2002, TIGTA anonymously submitted 90 questions through the website. TIGTA reported that they did not receive a response to 14 of these questions. During that period of time, the IRS was making system changes that affected its responsiveness. As it transitioned to a new server and a new contractor, some messages did not transfer between servers. The IRS was able to recover most messages, but unfortunately lost several, including some initiated by TIGTA.

In an October 2002 report, Reference No. 2003-40-014, TIGTA recommended that the IRS improve its control system by sending an e-mail receipt acknowledgement to the requestor and develop a system to track each question submitted to ensure the IRS provides a response. The IRS concurred with these recommendations and modified the program to add both new features in 2003. Both of these enhancements are performing as designed. However, taxpayer e-mail limitations, such as address problems, discontinued service, mailbox full, and stringent spam filters may continue to block delivery of an IRS response.

Question. Ms. Gardiner points out that the IRS revised its modernization plan for fiscal year 2003 to focus on executable segments that could be accomplished in a timely manner. Despite all of the IRS's assurances to the contrary, all of the projects on the newly downsized list still experienced delays and most incurred significant cost increases. What are her observations regarding the IRS's abilities to deliver modernization projects on time and on budget for the current fiscal year and next year? Why should we believe that the IRS and its contractors will improve its per-

formance on these projects going forward? Mr. Everson, do you care to comment on this matter?

Answer. The BSM program is—without a doubt—one of the largest, most visible, and most sensitive modernization programs ever undertaken in the world.

When nominated in February 2003, the Commissioner set three priorities for his term as Commissioner. First, the IRS must continue to improve service to make it easier for taxpayers to understand and comply with tax laws. Second, modernization of IRS information technology is also a high priority. The third priority is to strengthen the integrity of the American tax system with enhanced enforcement activities. The Commissioner's first action to address the modernization priority was to appoint two new leaders to the modernization effort.

Commissioner Everson appointed John Dalrymple, a 30-year IRS veteran who has spent his career focusing on front-line taxpayer issues, as the Deputy Commissioner for Operations Support to own the modernization initiative and drive productivity across the IRS. Simultaneously, he appointed the former IRS Chief Financial Officer, W. Todd Grams, to the position of Chief Information Officer to bring stronger leadership and discipline to the technology modernization program.

These executive appointments to the IRS modernization program represent a major change in the way the IRS has managed previous modernization projects. They were necessary steps to bring more management discipline and increased business unit knowledge and involvement to the modernization program. The following is a brief recap of IRS's progress and struggles over the past year.

The results have been mixed. The IRS built a strong technical infrastructure, and designed and implemented stringent security and control mechanisms into the infrastructure. It also developed a rigorous enterprise life cycle methodology. Over the past 2 years, the IRS has been working toward maturing its management processes. The IRS has made progress, but a major thrust now focuses on sustaining a solid balance of business commitment, accountability, and scope management. Finally, the IRS has achieved a great deal of success with the projects delivered to date.

For the first time ever, corporations and tax exempt organizations have the option of filing their annual income tax and information returns electronically using Modernized e-File (MeF). This new electronic filing system significantly reduces the time and cost for corporations and tax exempt entities to file their Forms 1120 and 990. Simply by using a secure Internet connection to file 1120 and 990 forms, corporations and tax exempt organizations eliminate the need to submit hundreds of pages of paper returns. The e-Gov Institute recently chose MeF as a winner of the Government Solutions Center Pioneer Awards.

The IRS has achieved a great deal of success with the e-Services projects. All e-Services Release 1.0 products are fully deployed and available over the Internet, including: registration and online address change access for third parties and IRS employees through secure user portals; Preparer Tax Identification Number (PTIN) online application; interactive Taxpayer Identification Number (TIN) matching; secure Electronic Return Originator (ERO) application processing; and access to e-Services registration and application processes by Modernized e-File (MeF) participants.

E-Services Release 2.0 products are also now in production and available for use by IRS staff and taxpayers, including: Application for e-Filing (external); Electronic Account Resolution (EAR); Electronic TIN Bulk Matching (Bulk Requests); Disclosure Authorization (DA); and infrastructure support for outbound facsimile service.

In March 2004, James D. Leimbach appeared before the Ways & Means Oversight Subcommittee on behalf of the National Association of Enrolled Agents (NAEA), the professional society of enrolled agents, to present NAEA's views regarding e-Services delivering electronic services to tax practitioners. NAEA's overall assessment was that the 2003 filing season has run very smoothly—and the NAEA gave the IRS a great deal of praise.

Mr. Leimbach said, "The difficulty in integrating a 1960's era mainframe with the Internet and doing so in an environment using highly complex encryption is enormous, costly, and worth every effort and every dime spent." He added, "This new capability is truly going to revolutionize the way we conduct future business with the IRS. The ultimate beneficiary is the American taxpayer. We are truly amazed and thrilled beyond description at this way of doing business with the IRS and we would like for you to understand why we feel as we do."

Mr. Leimbach cited numerous examples of eliminating time delays of over a week and reducing response times from weeks and months to 3 days simply by having the ability—24 hours a day, 7 days a week—to submit information directly to the IRS using the Internet.

The IRS delivered several additional applications that are providing tangible benefits to taxpayers and improving the efficiency and effectiveness of tax administration systems such as Where's My Refund?, Where's My Advance Child Tax Credit?,

Internet EIN, Modernized e-File, HR Connect, etc. The following chart highlights the applications the IRS delivered, as well as the measurable business benefits being realized.

BSM DELIVERS REAL BUSINESS VALUE (RESULTS AS OF 6/15/04)

Project	Description	Recent Statistics
Internet Refund Fact of Filing (2002)	Improves customer self-service by providing instant refund status information and instructions for resolving refund problems to taxpayers with internet access.	<ul style="list-style-type: none"> —17.9 million inquiries in 2003; 22 million inquiries to date in 2004 (1/1/04–6/6/04). —32 percent of all real time IRS assistance calls come from IRFoF. —Modest reduction of telecommunications costs (about \$250,000). —Every 1,000 IRFoF contacts eliminate 1,500–2,000 refund assistance calls. —15.5 million inquiries in 2003; 11.9 million inquiries to date in 2004 (10/1/03–6/13/04). —Peak date 1.1 million interaction. —68,000 calls in one 3-minute period during initial week (coincided with start of Advanced Tax Refund of 2001). —50 percent reduction in waiting time for assistor to answer call. —50 percent reduction in abandoned calls. —Number of Spanish calls doubled. —More accurate pre-routing of calls. —1.37 million internet EIN applications received to date (as of 6/5/04).
Advanced Child Tax Credit (2003)	Modifies the Internet Refund application to provide taxpayers with Advance Child Tax Credit refund status on the internet.	
Customer Communications (2001)	Improves communications infrastructure, including telephone call management, call routing and customer self-service applications.	
Internet Employee Identification Number (2003)	Allows businesses and taxpayers to apply for and receive employer identification numbers over the internet.	
HR Connect (2002)	Delivers an enterprise solution to allow IRS employees to access and manage their human resources information online.	
e-Services R1 (2003–2004)	Creates a web portal and value adding e-Services services to promote the goal of conducting most of the IRS's transactions with tax practitioners electronically.	<ul style="list-style-type: none"> —75,000 internal users. —Cited by Commissioner Everson as an enabling factor in the redirection of approximately 750 staff years to enforcement. —Treasury was selected as 2004 ComputerWorld Honors Laureate for HR Connect development and implementation. —Over 69,624 PTIN applications (W7P) entered to date, data entry productivity doubled (from 8/15/03–6/10/04). —Over 58,201 e-File applications to the Third-Party-Data-Store (TPDS) entered to date (from 8/15/03–6/10/04). —Approximately 24,939 Registered (and confirmed) User Portal (RUP) to date (from 10/1/03–6/10/04). —Deployed to almost 4,000 Revenue Agents.
Customer Relationship Management Exam (2001)	Provides standard tax computation software to Large & Mid-Sized Business Revenue Agents.	
Modernized e-File (2004)	Provides e-filing to large businesses (1120 family) and tax exempt organizations (990 family).	<ul style="list-style-type: none"> —Went live on 2/23/04. —Over 35,090 returns (1120 family) accepted as of 6/13/04. —Over 3,287 participating Electronic Return Originators as of 6/13/04. —Winner of Government Solutions "Best-of-the-Best" Pioneer Solutions.

The bad news, however, is major. Significant cost overruns and repeated schedule delays have plagued critical projects, such as the Customer Account Data Engine (CADE), the Integrated Financial System (IFS), and the Custodial Accounting Project (CAP). CADE replaces the current master files that are the IRS's repository of taxpayer information. IFS will be the IRS's new core accounting system. CAP provides an integrated link between tax administration (revenue) and internal management (administrative) financial information.

The IRS has delayed the CADE program four times. It originally planned to deliver the first release of CADE in December 2001. The IRS then rescheduled it for August 2003, and later rescheduled it for April 2004. The IRS recently finalized the re-planning effort for CADE and set the latest delivery date for September 2004. While CADE is farther along than the IRS has ever been in replacing a component of the master file, there are still major hurdles to overcome. The CADE delays stemmed from infrastructure upgrades, initial poor software quality during the startup of systems integration testing combined with the failure to understand the complexity of balance and control, and the resolution of operational and performance issues that occurred during Phase 3 of the Release 1.0 pilot.

Like CADE, IFS has been plagued with schedule delays. The IRS originally planned to deliver the first release of IFS in October 2003. The IRS then rescheduled it for January 2004. The IRS later rescheduled it for April 2004. The IRS has subsequently scheduled Release 1.0 for October 2004. The IRS delayed the first release of IFS because of the need to make technical changes to comply with the enterprise architecture, the inability to resolve key design and integration issues in a timely manner, the identification of the health coverage tax credit interface requirement late in the development process, and delays experienced in integration testing due to poor application quality and interface testing issues.

IFS Release 1.0 will cover core accounting functions such as budget preparation, general ledger, accounts payable, accounts receivable, financial reporting, and purchasing. Problems continue to seriously jeopardize the scheduled delivery of this first release of IFS. The IRS is 2 weeks behind schedule on testing, which puts the data conversion schedule at risk. The IRS is negotiating a fixed price contract for the October delivery.

The IRS is also encountering delays on the first release of the Custodial Accounting Project (CAP), which provides an integrated link between tax administration (revenue) and internal management (administrative) financial information. The first release of CAP will address revenue from individual taxpayers on initial tax payments. Later releases of CAP will address businesses and collections. CAP delays resulted from unstable CADE and IFS interface definitions, needing additional testing time due to a much larger than anticipated volume of data anomalies discovered during the conversion of data from the current Individual Master File (IMF), and the time required resolving system performance issues.

In addition, though not directly responsible for CAP delays to date, the IRS has made some adjustments to the functionality that it needs to have in CAP Release 1 to support the GAO financial audit as well as internal accounting and management. These adjustments will increase the cost of later sub-releases of CAP Release 1. The IRS has now completed all testing for CAP Release 1, and is adding changes to reflect IMF changes from the start of the 2004 filing season (Release 1.1). The IRS plans to start production, which includes the initial load of IMF data, in mid-August. The IRS negotiated a fixed price contract for Release 1 and Release 1.1 in May 2004.

Question. Ms. Gardiner, in her testimony, points out that she found several instances where the Business System Modernization project teams at the IRS were cutting corners and not following established testing procedures due to their desire to meet overly optimistic project schedules. It seems that the IRS responds to missing its deadlines by cutting corners and thus undermining the likelihood that the agency will get what it paid for. What has Ms. Gardiner concluded about the IRS's ability to manage these projects effectively and ethically? Is there any reason to hope that the IRS is turning a corner and actually getting value for the taxpayer from these modernization projects? Mr. Everson, would you care to comment?

Answer. The IRS used the results from independent studies commissioned during the summer of 2003 to create a BSM Challenges Plan comprised of 40 some action items. Given the strategic importance of the plan, The Commissioner appointed an IRS business unit deputy commissioner to oversee the implementation of the plan.

As a first step, the BSM project team developed a crosswalk to ensure that the BSM Challenges Plan's definition of the issues addressed and/or satisfied all of the recommendations from the four commissioned studies as well as the recommendations submitted by the IRS Oversight Board, and the Software Engineering Institute (SEI) study of CADE.

While the deputy commissioner made significant progress in implementing the plan, the full closure of all actions items was unrealistic within the elapsed timeframe of the 6-month appointment. Concurrently, the CIO created a new direct report position for modernization management and assigned responsibility for implementing the plan to the individual recently hired into this newly created position.

Under the leadership of the deputy commissioner, the IRS and CSC team brought closure to several key actions items, including: clarifying the roles of committees as advisory, identifying “blockers” on contracting issues, appointing business leaders to each project, establishing a risk-adjusted schedule and new baseline for CADE Releases 1.0 and 1.1, and increasing the frequency of CADE reviews with the business owner to twice monthly. The majority of the action items are still works-in-progress, some of which will take time to fully complete. Others will span the life of the BSM program.

For example, strengthening systems engineering capabilities by hiring external candidates will take time since it involves conducting the searches, interviewing the candidates, and negotiating the new hires to come on board. The IRS and CSC developed ground rules for escalating issues, but they will need to be continually enforced throughout the life of the program. The IRS rewrote the charters of the governing committees to reflect their advisory role and clearly articulated their responsibilities, however, it will probably take a year to truly evaluate and measure their effectiveness.

As stated, the IRS has made progress toward closing all the action items, but it has much more work to do in critical areas. For example, the IRS needs to religiously follow the proper methodologies and hold people accountable if they do not. The IRS must start “doing things right” as opposed to “doing things fast” such as exiting milestones prematurely. An ongoing challenge will be balancing the scope and pace of projects consistent with capacity, ensuring that the right people are in place before launching a project, and setting realistic delivery schedules and cost estimates. The IRS is committed to staying-the-course and delivering on its promise to modernize America’s tax systems, but it is important for everyone to acknowledge this is a monumental effort.

The magnitude and evolution of the BSM program dictates that the IRS will always be going through an evolution of assessment and improvements. In that regard, the BSM Challenges Plan is still evolving and the IRS is using certain action items to continuously improve the program.

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

TAX EVASION/IRS COLLECTION

Question. In the days leading up to April 15, newspapers around the country ran features on personal and corporate tax evasion and the IRS’s failure to collect many of the taxes it is owed. The President proposes a 4.6 percent increase in IRS funding for fiscal year 2005, claiming that this will allow the hiring of 5,000 new auditors and collectors. While increasing the number of IRS agents and officers is central to more effective tax collection, the IRS Oversight Board argues that much of the 4.6 percent increase will be swallowed by rising salaries and administrative costs. In fact, the Oversight Board claims that fiscal year 2005 is the fourth year in a row in which the administration has called for IRS staff increases while failing to cover pay raises or required expenses.

In your estimation, how many new auditors and collectors would be hired as a result of a 4.6 percent increase in IRS funding in fiscal year 2005, and what would be the impact of such an increase on the IRS’s ability to collect some of the estimated \$250 billion in owed taxes that go unpaid each year due to tax evasion?

Answer. The IRS will hire approximately 5,000 new enforcement personnel. These new hires will improve voluntary compliance by increasing the number of individual and corporate returns examined and directly increasing collections of delinquent revenue owed to the government by approximately \$3 billion in the first 3 years of the initiative, fiscal year 2005 through fiscal year 2007, and additional collections of \$1.5 billion annually thereafter. This increase in IRS enforcement personnel also improves voluntary compliance by deterring would-be tax cheats from engaging in illegal behavior.

TAX ASSISTANCE PROGRAM—ILLINOIS

Question. In the fiscal year 2004 Senate Transportation-Treasury Appropriations report, language was included regarding the Tax Assistance Program in Chicago, Illinois. “The Committee is aware of an innovative financial literacy and tax assist-

ance project in Chicago, Illinois—Tax Assistance Program—designed to assist low income workers and their families with tax education and filing, in cooperation with the State of Illinois and the City of Chicago’s Earned Income Tax Credit (EITC) outreach efforts. The Committee encourages the IRS to continue to provide appropriate technical and financial assistance for this worthwhile initiative.”

Is the IRS working with the Tax Assistance Program in Chicago, Illinois, and what Federal resources are being provided? Will the IRS continue to work with programs like TAP in Chicago in fiscal year 2005?

Answer. The IRS has partnered with the Tax Assistance Program (TAP) for several years and each year has been increasingly impressed with the achievements and the dedication of the staff and volunteers. The IRS is very fortunate to have this fine organization as a partner in providing free tax preparation to low income taxpayers in the Chicago metro area. The IRS hopes to sustain this relationship in fiscal year 2005 and for many years to come. However, outside the Low Income Tax Clinic (LITC) Grant Program, the IRS has no legal authority to offer funding to the TAP organizations. The TAP currently receives Federal funds available through the LITC Grant Program, and the IRS anticipates that the TAP will continue to apply for funding through this program in the future.

QUESTIONS SUBMITTED TO THE TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

QUESTIONS SUBMITTED BY SENATOR RICHARD C. SHELBY

MODERNIZATION

Question. How much more is needed to complete and modernize the IRS’s outdated systems and processes?

Answer. We do not know the true total cost needed to complete the Business Systems Modernization (BSM) effort. To date, the Internal Revenue Service (IRS) has received \$1.6 billion for this effort. The IRS anticipates that the value of the PRIME¹ contract will be \$8 billion. However, the PRIME contract is not the only cost associated with the BSM effort as other contractors, such as Northrop Grumman, International Business Machines, and MITRE Corporation, are involved in the BSM effort. In addition, the IRS is incurring substantial internal costs in managing the BSM effort. The sum of all PRIME contractor, other modernization contractors, and IRS costs for the life of the BSM program is not known.

Question. Is the fiscal year 2005 budget request consistent with that TIGTA assessment?

Answer. Yes. We have recommended since September 2002 that the IRS slow the pace of the BSM program due to some of the risks that have surfaced. The fiscal year 2005 budget request is consistent with our past recommendations.

Question. When will BSM be completed?

Answer. The BSM program is currently in its sixth year of a 15-year contract. However, the IRS and the PRIME contractor have been experiencing significant delays. For example, the Customer Account Data Engine (CADE)² project is approximately 30 months behind schedule, and the detailed planning for the business taxpayer account portion (Federal tax deposits, corporate entities, partnerships, etc.) of the project has not been completed. Unless the IRS and the PRIME contractor take actions to make up the lost time and thoroughly plan all projects, it is difficult to know how long the BSM effort will last.

Question. What is the status of IRS’s efforts to resolve the findings and deficiencies identified by the various internal and independent assessments of BSM?

Answer. To address the results of the recent assessments, the IRS and the PRIME contractor have developed a 48-point action plan, known as the “BSM Challenge Plan”. While the 48 planned corrective actions should help improve the BSM program, it will take time to institutionalize new processes and ensure they are being followed. Only at that time will it be possible to determine if the actions have been effective.

¹The PRIME contractor is the Computer Sciences Corporation, which heads an alliance of leading technology companies brought together to assist with the IRS’s efforts to modernize its computer systems and related information technology.

²The CADE is the foundation for managing taxpayer accounts in the IRS’s modernization plan. It will consist of databases and related applications that will replace the IRS’s existing Master File processing systems and will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer tax account and return data.

The IRS recently reported that 44 of the 48 action plan items were closed. However, our preliminary analysis shows that additional actions are scheduled for many of these closed items. The IRS Chief Information Officer acknowledged that follow-on actions are required to completely address the various internal and independent BSM assessments.

It should be noted that the various assessments resulted in 21 recommendations for improvement in the BSM program, 15 of which are similar to those made in Treasury Inspector General for Tax Administration (TIGTA) reports issued during the past 3 years. In several instances, the principal recommendations were reported multiple times during this period. Since many of the prior TIGTA recommendations have resurfaced as part of the recent assessments, we conclude that previous weaknesses have proven difficult to correct. Only time will tell whether actions taken as part of the 48-point plan will completely address the root causes identified in the various assessments.

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

MODERNIZATION

Question. Ms. Gardiner, your testimony says that IRS plans to request \$142 million—the remainder of the \$388 million appropriated last year—for Business Systems Modernization in fiscal year 2004. In your opinion, based on performance to date, should the Congress withhold or make conditional the approval of that \$142 million?

Answer. While we have not been provided with a copy of the revised spending plan, our opinion is that the Congress should approve the release of the remaining \$142 million. In February 2004, the Commissioner testified, “It’s no secret that our projects have consistently run late, delivered less functionality than planned, and cost significantly more than targeted.” The IRS’s track record is of concern; however, the withholding of funds could cause projects to stop, which would result in the loss of contractor expertise and would lead to additional costs needed to restart the projects. In addition, there has been little time to determine if the actions being taken as part of the 48-point plan are leading to improvements.

We believe the \$142 million in additional funding should be provided, but we would recommend to the Appropriations Subcommittee that the BSM program be monitored closely to determine if future funding is warranted. The IRS and the PRIME contractor have developed a 48-point plan to respond to various internal and independent assessments. Once the 48-point plan is implemented, it will take time to institutionalize new processes and ensure they are being followed. Only at that time will it be possible to determine if the corrective actions have been effective.

Question. Ms. Gardiner, you point out that the IRS revised its modernization plan for fiscal year 2003 to focus on executable segments that could be accomplished in a timely manner. Despite all of the IRS’s assurances to the contrary, all of the projects on the newly downsized list still experienced delays and most incurred significant cost increases. What are your observations regarding the IRS’s abilities to deliver modernization projects on time and on budget for the current fiscal year and next year? Why should we believe that the IRS and its contractors will improve its performance on these projects going forward? Mr. Everson, do you care to comment on this matter?

Answer. We believe that there are two critical areas that the IRS needs to address to be able to deliver modernization projects on time and on budget: requirements management and contract management. We have provided recommendations for improvement to the IRS in these areas, and the 48-point plan also addresses these areas. In addition, we have additional concerns in the areas of portfolio management, integration management, and staffing.

Requirements Management

The PRIME contractor testified that the heart of the problem has been the lack of fully defined requirements. While it is inevitable that some requirements changes will be needed, e.g., legislative changes, the PRIME contractor testified that it often began work without fully understanding requirements, and requirements were still being identified during the testing phase. In our opinion, this is the fault of both the IRS and the PRIME contractor. The IRS should create detailed requirements before moving forward, and a contractor at the maturity level of the PRIME contractor should know not to start work without a full understanding of requirements. Requirements instability will continue to lead to increased costs and schedule delays if not corrected. This area has been a continuing concern and has been reported in several TIGTA reports, beginning in November 2001.

Contract Management

Beginning in February 2001, we have made recommendations to assist the IRS in shifting financial risk to the PRIME contractor. Our recommendations have ranged from including positive and negative contractor incentives in task orders to using firm-fixed price task orders whenever possible. The recent BSM assessments also recommended moving toward a firm-fixed price model. When requirements are fairly stable, a firm-fixed price task order shifts some of the risk away from the government and to the contractor. If requirements become stable and firm-fixed price task orders begin to be issued, this will begin to curb some of the cost overruns that have been experienced to date. However, this may not have an effect on the timeliness of delivery.

Portfolio Management

Beginning in 2002, both the TIGTA and the General Accounting Office recommended that the IRS slow the pace of the BSM program due to some of the risks that have surfaced. The recent internal and independent assessments also make this point. While the IRS responded to this concern by scaling back the scope and number of projects in fiscal year 2003, we noted the fiscal year 2004 BSM plan includes an additional modernization project (Collection Contract Support—part of the Filing and Payment Compliance project).³ Since the IRS and its contractors have been unable to deliver the scaled-back portfolio of projects on time and within cost, we continue to be concerned that the IRS and its contractors may not have the ability to successfully manage the BSM portfolio.

Integration Management

When the BSM effort began, the PRIME contractor was responsible for all modernization projects, with the exception of the Custodial Accounting Project.⁴ As such, one significant role of the PRIME contractor was to ensure integration between all modernization projects. This role has become blurred recently with the PRIME contractor not being responsible for the Modernized e-File project. In addition, the Commissioner testified that he had decided to direct upcoming enforcement modernization projects to other contracts. With more modernization work being performed outside of the PRIME contract, the risk increases that modernization projects will not work in a fully integrated fashion.

Staffing

Recently, the IRS reported to the IRS Oversight Board that it has or will make changes in six of eight executive positions within the BSM program in an effort to bring more outside experience into the program. While the addition of new executives from outside the organization may bring new ideas and energy to the program, we are concerned about the potential disruption that it may cause. As part of our annual BSM assessment, we have included the following challenge for the last 3 fiscal years: “Maintain the continuity of strategic direction with experienced leadership.”

Question. Ms. Gardiner, in your testimony, you point out that you found several instances where the Business System Modernization project teams at the IRS were cutting corners and not following established testing procedures due to their desire to meet overly optimistic project schedules. It seems that the IRS responds to missing its deadlines by cutting corners and thus undermining the likelihood that the agency will get what it paid for. Ms. Gardiner, what have you concluded about the IRS’s ability to manage these projects effectively and ethically? Is there any reason to hope that the IRS is turning a corner and actually getting value for the taxpayer from these modernization projects? Mr. Everson, would you care to comment?

Answer. Our audits are not designed to examine the ethics of project management and, therefore, we cannot answer this portion of the question. The IRS and its contractors have deployed projects that provide value to taxpayers and have built the infrastructure needed to support these projects. Some of the BSM projects that have delivered value to taxpayers are the Customer Communications, Internet Refund/Fact of Filing (IRFOF), Internet Employer Identification Number (I-EIN), e-Services, and Modernized e-File (MeF) projects.

Customer Communications.—This project has improved customer service by increasing the capacity of the toll-free telephone system and providing the ability to

³The Filing and Payment Compliance project will provide support for detecting, scoring, and working nonfiler cases (filing compliance) and delinquency cases (payment compliance).

⁴The CAP will be a single, integrated data repository of taxpayer account information, integrated with the general ledger and accessible for management analysis and reporting.

route taxpayers' calls to the appropriate IRS employees. This project became operational in August 2001.

IRFOF.—This application (also known as “Where’s My Refund?”) offers improved customer self-service by providing refund status information via the Internet. The pilot version of the “Where’s My Refund?” application was deployed in May 2002. The application was upgraded in 2003 and was accessed 17.9 million times that year according to the IRS. In 2003, the application was modified to provide taxpayers with Advance Child Tax Credit refund status via the Internet. The IRS stated that 15.5 million Advance Child Tax Credit inquiries were received in 2003.

I-EIN.—This application allows small businesses and self-employed taxpayers to obtain EINs online, eliminating the need to send paperwork to the IRS. This application was deployed in May 2003. The Commissioner recently testified that the application had processed over 450,000 applications as of February 2004.

e-Services.—Deployed in August 2003, this project allows tax professionals the ability to register online, create an electronic account, and apply for a Preparer Tax Identification Number to use in place of their Social Security Number for submitting returns. The IRS reported in January 2004 that over 16,000 tax professionals had applied to use the e-Services application.

MeF.—This project is developing the modernized, web-based platform for electronically filing approximately 330 IRS forms. The first release of the MeF project was deployed in late February 2004 and provided electronic filing for 59 forms, including United States (U.S.) Corporation Income Tax Return (Form 1120), U.S. Income Tax Return for an S Corporation (Form 1120S), Return of Organization Exempt From Income Tax (Form 990), Short Form Return of Organization Exempt From Income Tax (Form 990-EZ), U.S. Income Tax Return for Certain Political Organizations (Form 1120-POL), and Application for Extension of Time To File an Exempt Organization Return (Form 8868). The IRS has stated that over 18,520 tax returns had been accepted by March 21, 2004.

Progress is being made. Nonetheless, BSM projects are taking longer and costing more to deliver less than originally anticipated. Over the past 2 fiscal years, we have cited 4 primary challenges the IRS and its contractors must overcome to be successful: (1) implement planned improvements in key management processes and commit necessary resources to enable success, (2) manage the increasing complexity and risks of the BSM program, (3) maintain the continuity of strategic direction with experienced leadership, and (4) ensure PRIME contractor performance and accountability are effectively managed. Based on the results of recent TIGTA audits, as well as the assessment findings, we believe these four challenges still need to be met to achieve program success.

While the actions in the 48-point plan mentioned previously should help improve the BSM program, it will take time to institutionalize new processes and ensure they are being followed. Only at that time will it be possible to determine if the corrective actions have effectively addressed the four major challenges.

FAILURE TO COLLECT DELINQUENT TAXES

Question. A recent report by the Treasury Inspector General for Tax Administration (TIGTA) found that IRS’s existing procedures are ineffective in ensuring even that criminals who are convicted in court for tax evasion are paying their civil tax liabilities. Why can’t IRS collect from tax cheats?

Answer. In response to our recommendations in the subject report, the IRS issued an April memorandum to both the Small Business/Self-Employed Division and the Criminal Investigation organization containing interim procedures to process cases with terms of probation and to monitor compliance with these cases.

Question. Ms. Gardiner, given the fact that the head of IRS-Criminal Investigations disagreed with a number of your recommendations, are you confident that this grotesque abuse will be stopped?

Answer. The IRS did, in fact, disagree with several of our recommendations. First, the IRS disagreed with our recommendation concerning a technical legal matter on disclosure of tax information, stating that it believed it already had sufficient instructions on the matter. Our main concern in reporting the issue was to ensure that the disclosure rules were interpreted consistently and with the broadest possible application. The disclosure issue itself is tangential to the main problem of inadequate monitoring of, and follow-up on, probation cases.

The IRS also disagreed with our characterization of the impact of the errors in the Criminal Investigation Management Information System. Again, this issue is tangential to the main problem and does not affect the IRS’s need for or commitment to improving its processes on monitoring terms of probation.

Finally, although the IRS disagreed with a recommendation to establish certain procedures and part of another recommendation to establish periodic systemic reports, it committed to reemphasizing its existing instructions and procedures, which it did in the April memorandum referenced above. As we stated in our report, we believe that this commitment satisfied the intent of our recommendations.

As to whether we are confident that this abuse will be stopped, the key will be the proper implementation and monitoring of the corrective actions recently taken or planned. If done properly, the IRS should be in a much better position to report to the courts whenever terms of probation are not met. Of course, collecting delinquent taxes or securing delinquent returns will also be a function of the taxpayer's ability to pay or requirement to file.

Question. Ms. Gardiner, why do you believe that IRS has not cleared up even the simplest of cases of uncollected taxes?

Answer. The IRS collection process for most cases begins with a series of notices mailed to taxpayers, asking them to pay the balance due. If the taxpayers do not respond, the cases are assigned either to the Queue (which is a holding area for cases waiting further assignment to the Collection Field function (CFf)) or the Automated Collection System (ACS) to be worked by telephone collectors. Generally, higher-priority cases are placed in the Queue while lower-priority cases are assigned to the ACS. If the ACS cannot resolve the cases, some of them are also assigned to the Queue. Cases in the Queue are assigned to Revenue Officers in the CFf according to priorities established by IRS management. In addition, the IRS has recently implemented a risk-based approach that attempts to select those cases with the highest probability of being collected. As a result, many lower dollar amount cases for individual taxpayer liabilities may not be collected if the taxpayer did not respond to the notice or a phone call.

Overall, the IRS is making some progress in collecting unpaid taxes. As we reported in April 2004, the level of compliance activities and the results obtained in many Collection function areas in fiscal year 2003 showed a continuing increase. Enforcement actions were higher in fiscal year 2003 than in fiscal year 2002, but they have not returned to pre-1998 levels. Enforcement revenue collected increased substantially in fiscal year 2003, while the total amount of uncollected liabilities and the gap between new delinquent accounts and account closures decreased slightly. Finally, the amount owed on accounts in the Queue decreased in fiscal year 2003, but the number of accounts in inventory increased.

Question. Do you consider it a possibility that IRS has not done so in order to build a case for the use of private collection agencies?

Answer. The IRS does not have the resources to work every delinquent account case. It has established risk-based priority systems in an attempt to use ACS and CFf resources as efficiently as possible. We have no evidence that the IRS is intentionally not working these cases to build a case for the use of private collection agencies.

CUSTOMER SERVICE

Question. IRS consistently finds its own accuracy rates higher than TIGTA does when measuring taxpayer assistance functions, whether we are talking about toll-free telephone assistance, walk-in service at Taxpayer Assistance Centers, or the IRS website. Mr. Everson, how do you explain the discrepancy? Ms. Gardiner, would you care to comment?

Answer. The large number of taxpayers who use Toll-Free Telephone, Taxpayer Assistance Centers (TAC), or the IRS's website, IRS.gov, to get answers to their tax law and account questions prohibits us from using statistical sampling techniques in our audits to determine the accuracy of IRS answers.

Type of Service	IRS-Reported Customers Served	IRS-Reported Accuracy (Percent)	TIGTA-Reported Accuracy (Percent)
Taxpayer Assistance Centers	8,588,850	175	69
Referral-Mail	279,558	72	74
Toll-Free Accounts	27,645,540	89	78
Toll-Free Tax Law	5,381,687	83	73
Internet-based IRS website, IRS.gov	119,036	N/A	Over 80

¹ IRS accuracy rate reported in the Wage and Investment Operating Division Business Performance Report, page 10, dated May 11, 2003.

Figures for TACs, Referral-Mail, Toll-Free Accounts, and Toll-Free Tax Law reported by the IRS are for fiscal year 2003. Figures for IRS.gov reported by the IRS are for the 2002 Filing Season.

Toll-Free Telephone Assistance

The differences in the TIGTA's and IRS's accuracy rates are based largely on the differences in the sampling methodologies, including the sample sizes. For example, during the 2004 Filing Season, we monitored over 350 toll-free tax law calls while during the same time period for the same types of tax law questions (referred to as applications) the IRS selected for monitoring a statistically valid sample of 1,527 tax law calls. For fiscal years 2002, 2003, and 2004, we monitored a judgmental sample of live taxpayer toll-free tax law calls received by the IRS during the filing season, generally considered the months of January through April. Although our judgmental sample is not statistically valid, we attempt to ensure it is representative of the population by creating a sampling plan in which the percentage of calls monitored by type of tax law question is reflective of the IRS's planned filing season volumes of calls per application. However, we do not always monitor calls on late evenings and on the weekends.

See "Improvement Is Needed in E-Mail Responses to Complex Tax Questions Submitted Through Toll-Free Telephone Help Lines" (Reference Number 2004-40-029, dated December 2003); "Toll-Free Account Assistance to Taxpayers Is Professional and Timely, but Improvement Is Needed in the Information Provided" (Reference Number 2004-40-057, dated February 2004); "Toll-Free Tax Law Assistance to Taxpayers Is Professional and Timely, but Improvement Is Needed in the Information Provided" (Reference Number 2003-40-216, dated September 2003).

Taxpayer Assistance Centers

The IRS did not measure the accuracy of its answers to tax law questions asked in the TACs until fiscal year 2003. For 2003, the IRS used judgmental sampling to determine accuracy. In fiscal year 2004, the IRS is attempting to establish a baseline using statistical sampling.

Though we used judgmental sampling for Calendar Years 2002 and 2003 to determine whether taxpayers were provided correct and prompt answers to their questions, we did ensure all TACs were visited during these 2 years. For Filing Season 2004, we again used a judgmental sample of TACs, ensuring that we visited at least one TAC in each of the IRS's territory offices. We visited 199 TACs in 2002, 209 in 2003, and 64 in 2004 (note that these numbers are only TACs visited to ask questions within the scope of TAC employees' training).

However, we average 80 questions per month while the IRS's Field Assistance quality reviewers average 420 a month (Wage and Investment Operating Division Business Performance Report, page 6, dated May 11, 2003). In addition, the IRS does not compute its accuracy rates the same way we compute it. TIGTA results present the overall results of auditor visits. Accuracy rates are calculated by dividing the total response for each category (i.e., correct, incorrect, refer to publication, etc.) by the total number of questions asked. In contrast, the IRS disagrees with our methodology for including referrals to publications and service denied when computing accuracy rates.

See "Taxpayer Assistance Center Employees Correctly Answered More Tax Law Questions During September and October 2003 Than Compared to One Year Ago" (Reference Number 2004-40-037, dated January 2004), "Accuracy Rates Have Increased at Taxpayer Assistance Centers, but Improvement Is Needed to Provide Taxpayers Top-Quality Customer Service" (Reference Number 2004-40-065, dated February 2004), and "Taxpayer Assistance Center Employees Correctly Answered More Tax Law Questions During November and December 2003 Than Compared to One Year Ago" (Reference Number 2004-40-090, dated April 2004).

IRS.gov

The differences in the TIGTA's and IRS's accuracy rates are based on the different methodologies, including the sample sizes. For the TIGTA fiscal year 2002 audit, TIGTA auditors anonymously submitted 90 tax law questions typical of those that may be submitted by an individual taxpayer. We rated the answers to those questions we submitted. In contrast, during the 2001 Filing Season, the IRS quality review system selected 995 questions for quality review.

The IRS has a centralized quality review site that samples email responses for accuracy and measures accuracy with a statistically valid sampling plan designed by its Statistics of Income function. The sampling plan requires the selection of email responses without regard to the type of taxpayer or tax law category, i.e., whether the tax law question pertains to individual or business taxpayers.

See "Response Accuracy Is Higher for the Internet Program Than Other Options Available to Taxpayers Needing Assistance With Tax Law Questions" (Reference Number 2003-40-014, dated October 2002) and "Management Advisory Report: The Internal Revenue Service Needs a Reliable Measure of the Quality of Electronic Tax

Law Assistance Provided to Small Businesses and Self-Employed Taxpayers” (Reference Number 2002–30–120, dated July 2002).

SUBCOMMITTEE RECESS

Senator SHELBY. I appreciate both of you appearing here, and we will be meeting and talking from time to time.

Ms. GARDINER. Thank you very much.

Senator SHELBY. The hearing is recessed.

[Whereupon, at 11:27 a.m., Wednesday, April 7, the subcommittee was recessed, to reconvene subject to the call of the Chair.]