

DEPARTMENTS OF TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2007

THURSDAY, APRIL 27, 2006

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

The subcommittee met at 9:35 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Christopher S. Bond (chairman) presiding.

Present: Senators Bond, Murray, Durbin, and Dorgan.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENTS OF:

MARK W. EVERSON, COMMISSIONER
RAYMOND T. WAGNER JR., CHAIRMAN, IRS OVERSIGHT BOARD
J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

ACCOMPANIED BY:

DAVID A. POWNER, INFORMATION DIRECTOR, GOVERNMENT ACCOUNTABILITY OFFICE
JAMES WHITE, DIRECTOR, STRATEGIC ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Good morning. The Subcommittee of the Senate Transportation, Treasury, the Judiciary, HUD, and Related Agencies, Appropriations will come to order.

This is the budget hearing on the fiscal year 2007 budget for the Internal Revenue Service. We have a very distinguished panel of witnesses today. I welcome back IRS Commissioner Mark Everson. I also welcome Ray Wagner, Chairman of the IRS Oversight Board; Nina Olson, the National Taxpayer Advocate, and I believe that Russell George, Treasury Inspector General for Tax Administration will be joining us shortly.

I also note that the Government Accountability Office has submitted a statement for the record at my request and has sent two senior officials to answer any questions during the hearing, and we appreciate that. GAO has served us extremely well, especially with

their detailed reviews and oversight of the IRS Business Systems Modernization program.

Before I begin my formal comments, personally I thank all of the witnesses today for their service and commitment to the IRS. The IRS is probably one of the least appreciated Federal Agencies, but it is definitely one of the most important to the functioning of our Government and the payment of our salaries. I would add as a personal note, as for those who would wish to take my questions and comments out of context and suggest that I am opposed to the IRS or question its leadership, let me be clear. We had our hearing 3 weeks ago on the Treasury, and I commended Secretary Snow for doing an excellent job, but in the course of our questions, as we do in all agencies, we asked them about problem areas, and we are here, my distinguished ranking member and I, not only to commend what is going on, but to find out how we can help in areas where additional resources are needed.

So we will be asking tough questions because there are many challenges in this area, and we want to be as supportive of Commissioner Everson and the people who assist him in their roles today, and I want that known for the record.

The tax filing deadline ended 10 days ago. So we will be able to review some of the preliminary results of the IRS performance for this tax filing system. We will also focus on the agency's efforts and plans in addressing the so-called tax gap. I look forward to all the witnesses' views on these issues and their suggestions on how we can improve taxpayer compliance.

To the IRS credit, the Service continues to improve its tax administration performance. Based on preliminary results from the current filing season, returns processing has been smooth and taxpayers are receiving refunds without too many problems. Electronic filing is growing. More taxpayers are turning to the IRS website for information. Telephone service has improved. The accuracy of IRS responses to tax law and accounting questions has improved. Compared to the 1990's, the IRS has come a long way in its service delivered to taxpayers and to the people of the United States.

On the enforcement front, IRS has made major strides. Enforcement revenue over the past 5 years has increased by \$13.5 billion from \$33.8 billion to \$47.3 billion, or almost 40 percent. The IRS has accomplished these results by stepping up audits, combating illegal and abusive tax shelters, and increasing criminal convictions. These actions are very positive not only deterring taxpayers from cheating, but in increasing honest taxpayers' confidence in the Government.

There are, however, some troubling signs. Electronic filing is growing at a slower pace compared to previous years, and the IRS will not meet the congressionally mandated goal of 80 percent of taxpayers E-filing by 2007. The IRS continues to be overly dependent upon an antiquated system which will limit both service and enforcement capabilities, and most troubling is the tax gap does not appear to be shrinking. Some believe that the tax gap may be actually higher than projected.

The gap, which is the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law, not only creates an unfair burden on taxpayers who volun-

tarily and honestly pay their taxes, but also hurts our Nation's fiscal stability for our future generations. I would urge everyone to read the Comptroller General's February 15 testimony before the Senate Budget Committee. I think the CG did a commendable job of putting the tax gap in context of our Nation's fiscal health. While most of the attention on our fiscal health is on discretionary spending or tax cuts in the economy, the CG adds that we cannot ignore the tax gap. He concludes that while our long-term fiscal imbalance cannot be eliminated with a single strategy, reducing the tax gap is one approach that could help address the looming fiscal challenge facing the Nation, closed quote, and I agree with that assessment.

The views of the CG should be more than sobering. They should energize us to attack the tax gap because it is about good Government. The Government has a moral obligation in punishing those who unfairly burden honest citizens who voluntarily pay their taxes as their civic duty. It is also about our future. The consequence of a persistent tax gap hurts our long-term fiscal and economic health. It harms our children's future and the future of the children's children, and ultimately their future will be directly impacted by the actions we take today in addressing the tax gap.

Closing the entire tax gap is not realistic, but there is not any reason, there is no excuse, not to dedicate ourselves to attacking this problem and lessening the tax gap. Even small or moderate reductions will yield significant results. Even a 1 percent reduction in the tax gap could yield some \$3 billion annually. The administration has set a very laudable goal in addressing the tax gap to increase voluntary compliance to 85 percent by 2009. I support this goal, but 85 percent should be a floor. We need a detailed plan. So today, I will direct the IRS to work with the IRS Oversight Board, the National Taxpayer Advocate, and other important stakeholders to develop a plan to achieve this goal by 2009 and to quantify the amount by which this will reduce the gap.

To achieve any reduction in the tax gap, multiple strategies will be required, such as simplifying the tax code, which I happen to believe is a compelling overwhelming need, conducting more sustained research, obtaining better data on noncompliance, improving taxpayer service, enhancing enforcement, and leveraging technology. I support all of these strategies, but I recognize that some of these strategies require additional resources. Therefore, it is through the lens of the tax gap that we scrutinize the budget request before us today. To say that I am disappointed in what came out of OMB would be an understatement.

In terms of the 2007 budget request, the administration proposes some \$10.6 billion for the IRS. This budget request is an increase of \$18.1 million or 0.2 percent above the 2006 enacted level. The request, however, contains a number of budget assumptions that pose significant risks to the IRS. Some might even call them a slight of hand. Specifically, it assumes \$135 million in new user fees, some \$121 million in savings through program efficiencies, and \$137 million in budget cap adjustment. There is some merit to these ideas, but if these assumptions are not attained, the IRS would face a cut of some \$240 million from the fiscal year 2006 en-

acted level, and to be blunt, I question whether these assumptions are realistic and that the bases can be achieved.

Moreover, even if the IRS attains savings in new fees, the GAO calculates that the budget request is still a small decrease compared to the 2006 enacted level after adjusting for expected inflation. In fact, the GAO notes that the budget request would result in staffing cuts to both service and enforcement.

The budget request cuts the IRS Business Systems Modernization program by \$30 million or 15 percent. I will be the first to admit that the BSM has had challenges and risks; however, cutting this program by 15 percent when the IRS continues to be highly dependent upon systems from the dark ages makes no sense to me. From my young sports car enthusiasts, I have heard that it is equivalent to running a Formula One race with a Ford Pinto. I strongly believe that the BSM should be the IRS's top priority due to its impact on service and enforcement and ultimately in reducing the tax gap. GAO noted the reduction to the BSM "could delay delivery of improved services for taxpayers." Further, the IRS team, led by a very competent Associate CIO, has begun to make real progress on BSM. For example, the new Customer Account Data Engine System processed over 6 million returns and dispersed 5.3 refunds this year without disruptions and faster than under the old system. Cutting BSM greatly damages the momentum built up over 2 years. To me, cutting the BSM is equivalent to punishing good behavior.

Frankly, I question cutting any part of the IRS budget. The IRS needs more resources. It needs more resources for taxpayer services. It needs more resources for enforcement. It needs more resources for system modernization.

In terms of taxpayer services, this budget request cuts these activities by some \$85 million from the 2006 enacted level without assuming new user fees. While I do not object to the IRS retaining user fees for their activities, using them to offset direct appropriations is not appropriate in my view. The IRS has made significant improvements in taxpayer services over the past several years, but some services may be in peril. Since 2004, IRS taxpayer services have been cut by \$180 million, or 4.8 percent. While these cuts have not appeared to impact performance, IRS officials have cautioned that, "the agency cannot continue to absorb reductions in taxpayer service without beginning to compromise some services".

Now, all the witnesses here today have acknowledged that improving taxpayer service is a key component of reducing the tax gap. GAO believes that, "providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap".

Over the past year, IRS has forwarded a number of cost-cutting proposals to its taxpayer service programs; however, stakeholders and auditors have raised questions about these proposals. For example, TIGTA reviewed the IRS analysis behind its proposal to close 68 walk-in taxpayer assistance centers and found that the IRS lacked accurate and complete information on its centers, which hindered the IRS's ability to make appropriate decisions when determining locations and services it provides to taxpayers seeking assistance.

In addition, the IRS has justified some of its proposed cuts where programs' reduced usage of service was caused by the IRS's own policies. For example, the IRS established guidelines to reduce tax return preparation in the taxpayer assistance centers by 20 percent.

Another example is the Electronic Tax Law Assistance, or ETLA, feature on the service's website. GAO reported that usage of this program has declined apparently by design. Specifically, the GAO found that the IRS purposely moved the ETLA feature to a less prominent position on the website and found that, "in its current location, IRS does not expect taxpayers to be aware of the ETLA feature unless they stumble on it accidentally". Because of these actions, the reduction in demand and usage of these particular programs becomes a self-fulfilling prophecy.

The IRS must provide an accurate analysis of any reductions to ensure that taxpayer compliance and its effort to reduce the tax gap are maximized, especially as the tax code gets more and more complicated. IRS believes the tax gap includes, "a significant amount of noncompliance due to the complexity of the tax law that results in errors of ignorance, confusion, and carelessness". For those of you old enough to remember the cartoon strip Pogo, I believe it was his famous words that "we have met the enemy, and he is us", and that is Congress.

The IRS repeatedly and justifiably touts the success of its E-filing service on its website with such tools as "Where is my refund?". However, I fear that taxpayers will begin to ask "Where is my service?".

In addition to my concerns about the budget request, I raise concerns about the IRS privacy rule on section 7216 of the tax code and the recent problems identified with the "Free File" program.

In terms of the IRS proposed regulations on disclosure and use of taxpayer information, there are concerns, legitimate concerns, about taxpayer privacy being compromised by the proposed regulations. Some of these concerns seem to be based on misunderstandings whereas others are legitimate issues regarding the disclosure of confidential taxpayer information. This is a complex issue with a number of land mines. As a result, many in Congress, including the Senate Finance Committee, thankfully, are examining the proposed rule and the underlying statute to address taxpayer privacy concerns. I look forward to the wise guidance of the Finance Committee and hope that the Treasury and IRS can balance the needs and problems to ensure that maximum confidentiality of all taxpayer information to the extent possible is under the current statute, but given the limitations under the current statute, additional legislative action may be needed to resolve these concerns.

PREPARED STATEMENT

In terms of Free File, I am concerned that fewer taxpayers are using the program, which is impacting the overall number of E-filings. One possible solution that Senator Grassley and others have suggested is the creation of a direct electronic filing portal through the IRS website. I think that idea has merit and I ask the wit-

nesses to look into that matter and we will be happy to discuss it with them.

It is now my pleasure to turn to my colleague and ranking member, Senator Murray, for her statements and comments.

[The statement follows:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

The subcommittee will come to order. This morning, the Senate Transportation, Treasury, the Judiciary, HUD, and Related Agencies Appropriations Subcommittee will conduct its budget hearing on the fiscal year 2007 budget for the Internal Revenue Service. We have a distinguished panel of witnesses here today. I welcome back the IRS Commissioner Mark Everson to the hearing. I also welcome Ray Wagner, the Chairman of the IRS Oversight Board; J. Russell George, the Treasury Inspector General for Tax Administration; and Nina Olson, the National Taxpayer Advocate. I also note that the Government Accountability Office has submitted a statement for the record at my request and has sent two senior officials to answer any questions during the hearing. GAO has served us extremely well, especially with their detailed reviews and oversight of the IRS's Business Systems Modernization program.

Before I begin my formal comments, I personally thank all of the witnesses today for their service and commitment to the IRS. The IRS is probably one of the least appreciated Federal agencies but is definitely one of the most important to the functioning of our government.

The tax filing deadline ended 10 days ago, so today we will be able to review some of the preliminary results of the IRS's performance for this tax filing season. We also will focus on the agency's efforts and plans in addressing the so-called "tax gap." I look forward to all the witnesses' views on these issues and their suggestions on how we can improve taxpayer compliance.

To the IRS's credit, the IRS continues to improve its tax administration performance. Based on preliminary results from the current filing season, returns processing has been smooth and taxpayers are receiving refunds without too many problems. Electronic filing is growing. More taxpayers are turning to the IRS website for information. Telephone service has improved. The accuracy of IRS's responses to tax law and account questions has improved. Compared to the 1990's, the IRS has come a long way in service.

On the enforcement front, the IRS has made major strides. Enforcement revenue over the past 5 years has increased by \$13.5 billion—from \$33.8 billion to \$47.3 billion—or by almost 40 percent. The IRS has accomplished these results by stepping up audits, combating illegal and abusive tax shelters, and increasing criminal convictions. These actions are very positive in not only deterring taxpayers from cheating, but in increasing honest taxpayers' confidence in government.

There are, however, some troubling signs. Electronic filing is growing at a slower pace compared to previous years and the IRS will not meet the congressionally-mandated goal of 80 percent of taxpayers e-filing by 2007. IRS continues to be overly-dependent upon antiquated systems, which limits both service and enforcement capabilities. And most troubling is that the tax gap does not appear to be shrinking. Some believe that the tax gap may actually be higher than projected.

The tax gap—the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law—not only creates an unfair burden on taxpayers who voluntarily and honestly pay their taxes but also hurts our Nation's fiscal stability for our future generations. I urge everyone to read the Comptroller General's February 15, 2006, testimony before the Senate Budget Committee. I believe the CG did a commendable job in putting the tax gap in context of our Nation's fiscal health. While most of the attention on our fiscal health is on discretionary spending or tax cuts or the economy, the CG adds that we cannot ignore the tax gap. He concludes that while "our long-term fiscal imbalance cannot be eliminated with a single strategy, reducing the tax gap is one approach that could help address the looming fiscal challenges facing the nation." I agree.

The views of the CG should be more than sobering. They should energize us to attack the tax gap because it is about good government. The government has a moral obligation in punishing those who unfairly burden honest citizens who voluntarily pay their taxes as their civic duty. It is also about our future. The consequences of a persistent tax gap hurt our long-term fiscal and economic health. It harms our children's future and the future of our children's children. And ultimately, their future will be directly impacted by the actions we take today in addressing the tax gap.

Closing the entire tax gap is not realistic but this is no excuse to not dedicate ourselves to attacking this problem. Even small or moderate reductions in the tax gap will yield significant results. For example, even a 1 percent reduction in the tax gap would yield some \$3 billion annually. The administration has set a very laudable goal of addressing the tax gap by setting a goal to increase voluntary compliance to 85 percent by 2009. I support this goal but 85 percent should be a floor. However, we need a detailed plan. So today, I direct the IRS to work with the IRS Oversight Board, the National Taxpayer Advocate, and other important stakeholders to develop a plan to achieve this goal by 2009 and to quantify the amount by which this will reduce the tax gap.

To achieve any reduction in the tax gap, multiple strategies will be required such as simplifying the tax code, conducting more sustained research, obtaining better data on noncompliance, improving taxpayer service, enhancing enforcement, and leveraging technology. I support all of these strategies. But, I recognize that some of these strategies require additional resources. Therefore, it is through the lens of the tax gap that we scrutinize the budget request before us today.

In terms of the fiscal year 2007 budget request, the administration proposes some \$10.6 billion for the IRS. This budget request is an increase of \$18.1 million or 0.2 percent above the fiscal year 2006 enacted level. The request, however, contains a number of budget assumptions that pose significant risks to the IRS. Specifically, it assumes \$135 million in new user fee revenues, some \$121 million in savings through "program efficiencies", and \$137 million in a budget "cap adjustment." There is some merit to these ideas. But, if these assumptions are not attained, the IRS will face a cut of some \$240 million from the fiscal year 2006 enacted level. And to be blunt, I question whether these assumptions will be achieved.

Moreover, even if the IRS attains these savings and new fees, the GAO calculates that the budget request is still a small decrease compared to the fiscal year 2006 enacted level after adjusting for expected inflation. In fact, the GAO notes that the budget request would result in staffing cuts to both service and enforcement.

The budget request cuts the IRS's Business Systems Modernization program by \$30 million or 15 percent. I will be the first to say that BSM has many challenges and risks. However, cutting this program by 15 percent when the IRS continues to be highly dependent upon systems from the dark ages makes no sense to me. It is equivalent to running a formula one race today with a Ford Pinto. I strongly believe that BSM should be the IRS's top priority due to its impact on service and enforcement and, ultimately, in reducing the tax gap. GAO noted that the reduction to BSM "could delay delivery of improved services for taxpayers." Further, the IRS team, led by a very competent Associate CIO, has begun to make real progress on BSM. For example, the new Customer Account Data Engine system processed over 6 million returns and dispersed 5.3 million refunds this year without disruptions and faster than under the old system. Cutting BSM greatly damages the momentum built up over the past 2 years. In other words, cutting BSM is equivalent to punishing good behavior.

Frankly, I question cutting any part of the IRS's budget. The IRS needs more resources. It needs more resources for taxpayer services. It needs more resources for enforcement. It needs more resources for systems modernization.

In terms of taxpayer services, this budget request cuts these activities by some \$85 million from the fiscal year 2006 enacted level without assuming the new user fees. While I do not object to the IRS retaining user fee revenues for their activities, using them to off-set direct appropriations is inappropriate. The IRS has made significant improvements in taxpayer services over the past several years. However, some of the services may be in peril. Since fiscal year 2004, IRS taxpayer service programs have been cut by some \$180 million or 4.8 percent. While these cuts have not appeared to have impacted performance, IRS officials have cautioned that "the agency cannot continue to absorb reductions in taxpayer service without beginning to compromise some services."

All of the witnesses here today have acknowledged that improving taxpayer service is a key component of reducing the tax gap. GAO believes that "providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap."

Over the past year, the IRS has forwarded a number of cost-cutting proposals to its taxpayer service programs. However, stakeholders and auditors have raised questions about these proposals. For example, TIGTA reviewed the IRS's analysis behind its proposal to close 68 walk-in taxpayer assistance centers and found that the IRS lacked accurate and complete information on its centers, which hindered IRS's ability to make appropriate decisions when determining the locations and services it provides to taxpayers seeking assistance.

In addition, the IRS has justified some of its proposed cuts where a program's reduced usage of services was caused by the IRS's own policies. For example, the IRS established guidelines to reduce tax return preparation in the taxpayer assistance centers by 20 percent.

Another example is the Electronic Tax Law Assistance feature on IRS's website. The GAO reported that usage of this program has declined apparently by design. Specifically, the GAO found that the IRS purposely moved the ETLA feature to a less prominent position on the website. GAO found that "in its current location, IRS does not expect taxpayers to be aware of the ETLA feature unless they stumble upon it accidentally . . .".

Because of these actions, the reduction in demand and usage of these particular programs became a self-fulfilling prophecy.

The IRS must provide an accurate analysis of any reductions to ensure that taxpayer compliance and its efforts to reduce the tax gap are maximized, especially as the tax code gets more and more complicated. IRS believes that the tax gap includes "a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness." The IRS repeatedly and justifiably touts the success of its e-filing services and its web site with such useful tools as "Where's my refund?" However, I fear that taxpayers will begin to ask "Where's my service?"

In addition to my concerns about the budget request, I raise concerns about the IRS's privacy rule on section 7216 of the tax code and the recent problems identified with the "Free File" program.

In terms of the IRS's proposed regulations on disclosure and use of taxpayer information, there are concerns about taxpayer privacy being compromised by the proposed regulations. Some of these concerns seem to be based on misunderstandings whereas others are legitimate issues regarding the disclosure of confidential taxpayer information. This is a complex issue with a number of landmines. As a result, many in Congress, including the Senate Finance Committee, are examining the proposed rule and the underlying statute to address taxpayer privacy concerns. I am hopeful that the Treasury and the IRS can balance out the needs and problems to ensure the maximum confidentiality of all taxpayer information to the maximum extent possible under the current statute. But given the limitations under the current statute, some additional legislative action may be needed to resolve these concerns.

In terms of Free File, I am concerned that fewer taxpayers are using the program, which is impacting the overall number of e-filing. One possible solution that Senator Grassley and others have suggested is the creation of a direct electronic filing portal through the IRS web site. I think this idea has merit and request that all the witnesses look into at this matter.

I now turn to my colleague and ranking member, Senator Murray for her statement and any comments.

STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Thank you very much, Mr. Chairman.

Exactly 10 days ago, millions of taxpayers hurried to the Post Office to file their 2005 tax return right at the deadline. American taxpayers have come to expect certain things when it comes to the way their taxes are prepared, processed, and collected in this country. First, they expect honesty. They expect that, like themselves, the vast majority of their neighbors are paying what they owe and that the IRS is there to ensure that everyone pays his or her fair share.

Second, they expect integrity. They expect that their taxes will be processed correctly, especially if they have paid a tax preparation firm to do it for them.

Third, they expect privacy. They expect that the personal financial information that they share with the IRS will be kept private and will stay private whether it is in the hands of tax preparers or the IRS.

And, finally, they expect some help. They expect that if they need some help understanding the very complex tax code, the IRS will be there to assist them.

Those are all reasonable expectations. Unfortunately, today the IRS is falling short of meeting those expectations. Rather than everyone paying his or her fair share, it has become clear that we have a huge tax gap in this country—estimated at \$345 billion. That is the difference between the amount that the Americans owe and the amount that the IRS actually collects. Now, I want to note that the IRS Commissioner deserves some credit for being outspoken on this problem.

When it comes to taxes being prepared accurately, the IRS has at times had a spotty record in providing accurate tax advice to inquiring citizens. Now we see more recent reports indicating that even the tax preparation professionals are doing an inadequate job of preparing people's taxes, exposing our citizens to potentially significant fines and tax debts.

When it comes to keeping taxpayer information private, we have seen several instances where IRS contractors have been granted inappropriate access to taxpayers' information—access they do not need to do their job. And now we have a new regulatory proposal from the IRS to modernize the rules that pertain to privacy. In some cases, that proposal actually makes it easier for taxpayer information to be sold to private vendors.

Let me be clear. Taxpayers deserve more privacy, not less. If taxpayers really want salesmen to have access to their tax returns, they can mail it to them themselves. The IRS should not be an accomplice in selling taxpayer information.

Now, I recognize the IRS's new privacy proposal is complicated and some aspects of it can be seen to improve privacy while some aspects certainly can be seen to degrade it. But for me the question is not whether we should make it slightly harder or easier for an individual's taxpayer information to be sold. For me the question is whether any of this taxpayer information should be sold to anybody, ever. What consumer wants to have this information available to marketing firms? What consumer really wants to have their dinner interrupted by a telemarketer who is looking at a copy of their private tax return? If those taxpayers are out there, I don't know any of them.

So I hope the IRS will take a fresh look at those regulations and provide an outright prohibition on this information being shared with anybody. When it comes to the taxpayers getting help from the IRS, the IRS is moving in the wrong direction by trying to cut back on taxpayer services.

Worse still, when the IRS tried to minimize the impact of these service cuts, they couldn't get it right. Last year, Commissioner Everson testified to us his desire to close almost 70 Taxpayer Assistance Centers across the Nation. He told us these reductions would only be made after his careful analysis of the location, costs, demographics, and workloads of those centers. Now, many of us in Congress, including the chairman and myself, had deep-seated doubts about the wisdom of that proposal. As a result, we added language to the fiscal year 2006 Appropriations act that prohibited the Commissioner from closing those centers until the Inspector General completed a study on the impacts of reducing taxpayer services on compliance and assistance. That act further directed the IRS to consult with and get approval from the Appropriations

committees prior to any such eliminations, consolidations, or reorganizations of the workforce.

Well, the Inspector General has now reported that the data the IRS used to close those centers was faulty and outdated. The report makes it clear that the IRS was hastily putting together inaccurate data simply for the purpose of defending its plan to close those centers without any real regard for the needs of local citizens. The record with this proposal raises the question as to whether this subcommittee should believe any representation from the IRS when it comes to the availability of adequate taxpayer services.

Officially, the President's budget for fiscal year 2007 does not include formal cuts to taxpayer services though it is notable that the increase is less than the rate of inflation; however, included in this budget is more than \$84 million in so-called efficiencies—areas where the IRS intends to make budget cuts next year with consequences that are either unknown or unexplained.

Mr. Chairman, I hope we will pursue today exactly what efficiencies the Commissioner intends to launch next year so we don't find out after the fact that taxpayers have once again lost access to important forms of assistance when they are preparing their taxes. Taxpayers should not have their reasonable expectations dashed again.

Thank you, Mr. Chairman.

Senator BOND. Thank you, Senator Murray.

Now we turn to Senator Dorgan for his comments and any questions he may wish to leave for the record.

STATEMENT OF SENATOR BYRON L. DORGAN

Senator DORGAN. Mr. Chairman, thank you very much. I won't be able to stay for the entire hearing, but I wanted to be here. The hearing with respect to the appropriations request for the Internal Revenue Service is very important.

I used to be a tax commissioner, I think probably about the time that the chairman of the committee was the Secretary of State in Missouri and I was State Tax Commissioner in North Dakota.

Senator BOND. When was that?

Senator DORGAN. Back in the 1970's.

Senator BOND. I was Governor.

Senator DORGAN. You were Governor then.

Being a tax commissioner, I understood we had an income tax. I understood that there are fines and jail time for unauthorized disclosure of tax information. And I understood the need for safeguarding taxpayers' information is very important. I want to talk about that for just a moment.

First, I notice the discussion about the tax gap. The tax gap has been around a long time. I want to put up a picture that I have used before. This is called the Uglan House. It is on Church Street in the Cayman Islands. I think perhaps I used this with the IRS previously, but David Evans from Bloomberg News has done some pretty good work of pointing out that this five-story building is home to 12,748 corporations. Let me say that again. This five-story building on a quiet street called Church Street in the Cayman Islands is home to 12,748 corporations. Are they there? No,

they are not there. They just use the address. An attorney fixed them up with an address here.

What does that mean? They are avoiding a lot of taxes. I have used this picture on the floor of the Senate many times. I am wondering whether anybody has been sent down there to take a look at who all these companies are. I assume Treasury or IRS has done that, but if not, I am going to ask if you can give us some information about it.

My point is this: Hundreds of billions of dollars are being shifted away from the tax authorities in this country, some legally, some illegally. Part of that responsibility has to be Congress'. We have to plug the holes here. And part of it has to be aggressive enforcement by the Internal Revenue Service. Frankly, I don't think either has done its job with respect to this, but I point this out as an example of what is going on. It is unbelievable, and we are losing a substantial amount of tax revenue as a result of it.

The new construct, as you know, is to export good American jobs, import cheap labor, and sell your products in America and run the income through the Cayman Islands so you don't pay U.S. taxes. That is a strategy I think that weakens this country dramatically.

But let me get to the point on the IRS's proposed regulation involving section 7216 of the Internal Revenue Code, that one of my colleagues just described. Mr. Commissioner, you have sent me a letter dated yesterday in response to my letter to you about section 7216. This issue about disclosure and the use of taxpayers' information is not about regular business. In your letter to me, Mr. Commissioner, you suggest somehow that there is an unfairness to certain tax preparers because some tax preparers are in businesses with affiliated groups and so they have a broader range of opportunities to use taxpayer information that they have acquired through their tax preparation business for other business enterprises, or business solicitations and because some of the smaller and other tax preparers aren't involved in affiliated groups, you need to give them an opportunity to have as much business opportunity as others do.

This is not about business. With all due respect, this is about safeguarding the information that is filed by the American taxpayers and by preparers. Frankly, I don't believe when someone holds themselves out to do business as a tax preparer and gets paid for it that they ought to be using that tax return information that is given them by American taxpayers for unrelated purposes. You seem to suggest in your written testimony that this might be a radical proposal.

You say if Congress would prohibit the use of tax return information by tax preparers to solicit additional business, that somehow that would be a disadvantage. I don't think so. You say the law has existed 30 years. It may have existed 30 years, but eliminating the affiliated group requirement for solicitations and providing greater opportunity for others is not going to solve the problem. I would say as well, in 30 years, there has been much greater concentration in business through mega-mergers and that has dramatically changed what this affiliated group definition really means.

So I think you are headed in the wrong direction. You say that the rule is not complete and you also say that you are surprised

by the furor over this. Don't be surprised. The furor is going to get worse if you go ahead and do this.

This is not about business, about allowing someone to generate additional business by using confidential return information from their tax preparer business. If that is what we want to do, we are dead wrong, and I hope you will close the door rather than open the door.

Having said all of that, I am going to submit a list of questions on the issues that I have raised, the tax gap, the Uglund House, and the section 7216 proposed regulations. I don't want to brow-beat here, but I hope at the end of the day that you will not be surprised by the outcry from the American people and from Congress about this. They expect the information they file on their tax returns to be kept confidential. Those who would disclose tax return information in an unauthorized basis are subject to fines and jail terms because it is sensitive information. We should not expect this to be widely distributed for commercial or business purposes, and that is where I think this proposed regulation is heading. I think it is dead wrong and I think it disserves American taxpayers. I hope you will re-think that and make a change.

At any rate, thank you for being here. You have a tough job, and you have a chairman and a ranking member who I have the privilege of working with that want you to do your job successfully. This is a tough, tough job, trying to figure out how you collect these taxes, diminish the tax gap, and get rid of tax avoidance and tax evasion. Because it is not easy, we want to work with you to do that.

Mr. Chairman, thank you.

PREPARED STATEMENT OF SENATOR TED STEVENS

Senator BOND. Thank you very much, Senator Dorgan. We will be happy to include your questions for the record. We will also include Senator Stevens' statement for the record at this time.

[The statement follows:]

PREPARED STATEMENT OF SENATOR TED STEVENS

I support the IRS' technology modernization and agree that many benefits are derived from the modernization. However, I am concerned with the difficulties experienced by rural Alaskan taxpayers when they have attempted to use the national toll-free information line. In light of these difficulties, many Alaskans have sought the assistance of the Taxpayer Advocate Service Center when they need help to complete their tax submissions. The Center provides a necessary service to Alaskans. I support the Taxpayer Advocate Service Center in Alaska and believe the Center should be fully staffed in order to answer tax questions.

STATEMENT OF MARK W. EVERSON

Senator BOND. Now, with that, we will turn to the Commissioner.

Welcome, Mark. We will have your full statement, all of your full statements, included for the record, and if you would highlight what you think is most important for us to focus on.

Mr. EVERSON. Certainly. Thank you, Mr. Chairman, Senator Murray, Senator Dorgan.

Before I start, I would like to introduce two people. This is Take Your Kid to Work Day, I am informed, and Emma Everson, if she

could stand up, is here. She knows the chairman pretty well. She has not met the ranking member, but I want to point out that she has never been to Missouri. After school ends this year, she is going to take a trip out to see her cousins in Seattle. So if that gets us some help in the questioning and you choose not to embarrass me a little because my daughter is here, I will take whatever I can get.

Senator BOND. A cheap trick, but a very good defense.

Mr. EVERSON. I try to be effective.

The other person I would like to introduce is Evelyn Petchek. Evelyn, if you could stand. She is my chief of staff who has served for 2 years, and as the chairman knows, she has played an important role from time to time in terms of sorting some things out with the committee. She is retiring about a month from now and she is going back to her beloved New Mexico, but she has done a great job in a long career with the IRS. So I thank her as well.

Senator BOND. We thank her for her service and wish you well and know that it is going to be tough to find somebody to support the Commissioner.

Mr. EVERSON. And, Senator Dorgan, if you have to leave, I would certainly want to come see you directly and visit you soon to talk about some of these important issues, which we will cover.

Senator DORGAN. I would be happy to do that, and we would invite your daughter if she is driving from here to Seattle to stop in North Dakota for an extended stay.

Mr. EVERSON. Very good.

Okay. It is good to be back before the subcommittee to discuss the 2007 budget as proposed by the President. We believe, if fully funded, we can maintain the important balance between strong taxpayer service and the enforcement that is necessary to reduce the tax gap.

Before I discuss the proposed budget, let me first thank the members of the subcommittee for fully funding the IRS as part of the 2006 budget process. This has allowed us to move forward on several important initiatives, particularly in the area of enforcement.

The 2007 budget would sustain this progress. Our request is for \$10.6 billion in direct appropriation supplemented by \$135 million in an incremental user fee to represent a total operational level of about \$10.7 billion or 1.4 percent above the previous budget.

Before taking your questions, let me turn briefly to IRS efforts in our three areas of strategic focus, services, enforcement, and modernization, and then make brief comments on certain legislative proposals accompanying the 2007 budget which would help to close the tax gap.

First, services. We are drawing to a close of a successful filing season. Electronic filing is up by over 6 percent from last year, reflecting in particular a strong increase in the use of tax software on home computers. Our phone level of service is consistent with last year. The accuracy of our answers to tax law questions has improved. I would note that the results on the phones have exceeded our expectations, explained by the fact that call volumes are down from last year.

We have also seen strong growth in our community-based volunteer tax preparation program. The VITA sites are an increasingly important part of our efforts, and, in fact, last year the IRS was recognized by the Points of Light Foundation for its successful efforts. This is the first time a government agency has received this recognition. Usually it has been Mothers Against Drunk Drivers, March of Dimes, organizations like that. This program has grown by 8 percent compared to last year.

As to enforcement, the fiscal year 2005 results demonstrate that we have restored the credibility of our enforcement programs. Individual audits were up 20 percent from 2004 to 1.2 million. They are up 97 percent since 2000. High income audits were also up and have increased 120 percent since 2000. Corporate audits bottomed out in 2003, but by 2005 had recovered by over 50 percent. Collections are more robust. Last year, we had 2.7 million levies versus 200,000 in 2000. All told, enforcement revenues increased from 43.1 billion in 2004 to 47.3 billion last year.

Concerning 2006, we expect continued progress, although not as dramatic as some of these double-digit increases that I have just indicated. We are bringing on new personnel with the monies you provided, but it will take some time before they fully get up to speed.

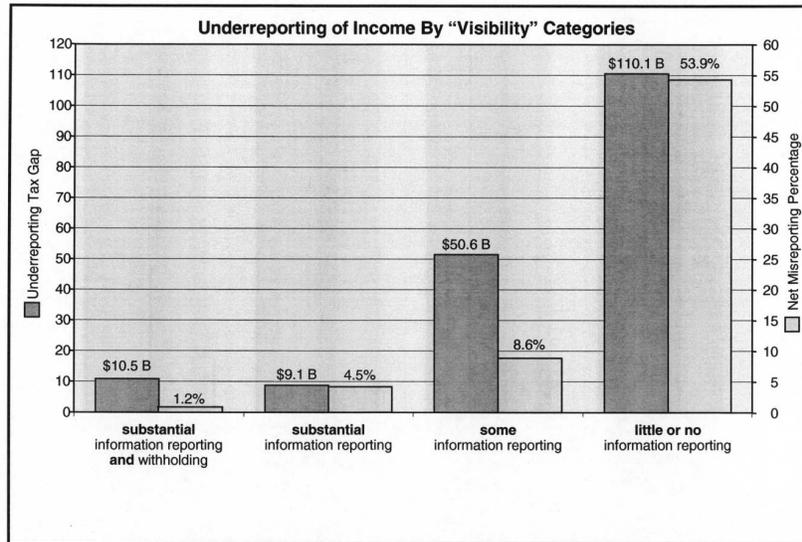
In terms of modernization, we have realized a number of achievements. In particular, I would note the progress of our taxpayer master file update, the CADE system. Last year CADE posted 1.4 million returns. This year, we have processed 6.6 million returns through CADE and refunded more than \$3 billion.

The 2007 budget request has two important components. The funding request keeps the IRS basically at level funding up just slightly to largely absorb inflation. Part of this funding is from increased user fees. If the appropriation request is fully funded, these monies will allow us to maintain the progress we are making both in the service and enforcement missions of the agency as well as to continue our modernization efforts.

Before taking your questions, let me make one additional point. We recently refined our estimates of the tax gap. We will be using this information to update our audit models and selection procedures and to calibrate our resource allocation within business units. The research also clearly indicated that where there is a third-party reporting, there is better compliance.

What this chart says, over to the left, you have a noncompliance rate of about 1 percent on wages. One-hundred-fifty million Americans get W-2s. They don't get it wrong when they report the information to us. All the way out at the right, you have categories where we don't get any information or very little information. Principally, this is about individuals who organize themselves as small businesses, but aren't incorporated and there is no reporting that comes to us. There, the noncompliance rate is over 50 percent.

Tax Year 2001 Individual Income Tax Underreporting Gap



Based on updated estimates derived from the National Research Program underreporting compliance study.

PREPARED STATEMENT

In the President's budget request, we have made several administrative and reporting proposals. The most important of these is the proposal to mandate reporting to the IRS of gross receipts by credit card issuers for their business customers. I believe the five legislative proposals that accompany the funding request can make a significant contribution to reducing the tax gap. So I hope they will enjoy your support.

Finally, let me indicate that I remain a strong advocate of simplification of the code. Thank you.

[The statement follows:]

PREPARED STATEMENT OF MARK EVERSON

INTRODUCTION

Senator Bond, Ranking Member Murray and members of the subcommittee, it is good to be back before the subcommittee to discuss the fiscal year 2007 IRS budget as proposed by the President. We believe if funded fully, we can maintain the important balance between strong taxpayer service and the enforcement that is necessary to reduce the tax gap.

Before I discuss the proposed budget, let me first thank the members of the subcommittee for fully funding the IRS as part of the fiscal year 2006 budget. This allowed us to move forward on several important initiatives, particularly in the area of enforcement.

My goal this morning is to offer you insight on what we are accomplishing with that full funding in fiscal year 2006 and to offer some insight in what we hope to accomplish in fiscal year 2007. I also hope to touch on some current issues that I know are of concern to subcommittee members as well as other Senators.

First, however, I want to provide you the latest information on 2006 Filing Season.

2006 FILING SEASON

We expect to process almost 135 million individual tax returns in 2006, and we anticipate a continued growth in the number of those that are e-filed. In the 2005 filing season, over 50 percent of all income tax returns were e-filed.

We fully expect to exceed that number this year. As of April 15, we have received over 63 million tax returns filed through e-file, an increase of 2.25 percent compared to the same period last year. This represents 63 percent of the more than 100.3 million returns that had been filed as of that date.

This increase in e-filing is being driven by people preparing their tax returns using their home computers. The total number of self-prepared returns that are e-filed is up by over 13 percent compared to this time a year ago. Over 17.3 million returns have been e-filed by people from the comfort of their own home, up from 15.3 million for the same period a year ago. Fully, 27 percent of all electronically filed returns have been done on home computers. This is 2.6 percentage points above last year.

Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in 2 weeks or less. That is about half the time it takes us to process a paper return. Moreover, the error rate for e-filed returns is less than for paper returns, saving IRS resources and avoiding taxpayer inconvenience.

Despite this overall growth in e-file, we are disappointed that we are experiencing a significant decline in the number of taxpayers that are using our Free File program. Currently, we have almost 24 percent fewer taxpayers choosing to use Free File as compared to 2005. I will discuss this in more detail later in my testimony.

More people are choosing to have their tax refunds directly deposited into their bank than ever before. So far this year, we have directly deposited more than 49 million refunds, or 64 percent of all refunds issued this tax filing season. This is up from 60 percent for the same period in 2005.

People are also visiting our web site, IRS.gov, in record numbers. The IRS has recorded over 114 million visits to our web site, up from 110 million for the same period a year ago. This is a 3.4 percent increase.

The millions of taxpayers that have visited IRS.gov have benefited from many of the updates that we have made for this filing season. We have made it easier for taxpayers to get answers to many of their tax questions. The web site:

- Allows a taxpayer to determine whether he or she might qualify for the Earned Income Tax Credit (EITC);
- Assists the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);
- Allows more than 70 percent of taxpayers the option to actually file their tax returns at no cost through the Free File program;
- Assists hurricane victims with information on many of the changes in the tax laws that are designed to help them and provides a toll free number for victims to get their questions answered; and
- Allows taxpayers who are expecting a refund to track its progress via the “Where’s My Refund?” feature on the site.

The 100.3 million individual tax returns received as of April 15 represents a decline of 3.7 percent over the same period as last year. We have issued 78.1 million refunds this year for a total of \$177 billion. The average refund this year is \$2,265, \$98 more than last year. In addition, more than 20 million taxpayers have tracked their refund on IRS.gov, up 14 percent over last year.

Our planning assumptions called for reducing toll-free operating hours from 15 hours to 12 hours while still maintaining the same level of taxpayer service. When this change was not implemented, the expected savings were restored and used to increase overtime. In addition, resources from answering paper correspondence were diverted to telephones. To date, these strategies have produced positive results.

In addition to these personnel actions, we have not yet experienced some of the workload increases that were anticipated as a result of the hurricane disasters. Overall, this filing season through April 15, we have actually received about 1.4 million fewer telephone calls than last year (32.4 million in 2006 vs. 31 million in 2005). As a result, our Customer Service Representative (CSR) Level of Service (percent of calls answered) is above last year (83.25 percent in 2006 vs. 81.65 percent in 2005). However, because we deployed Adjustments staff to the telephones, paper inventories are 117.2 percent of last year (1,108,774 in 2006 vs. 946,223 in 2005). The number of cases that are over-age has also increased significantly (123,425 in 2006 vs. 63,580 in 2005).

As of April 8, our Taxpayer Assistance Centers (TACs) are reporting a 12.5 percent decline in face to face contacts this filing season as compared to last year. We

believe that the decline in visits to our TACs as well as the reduction in the number of calls is largely attributable to taxpayers increasing their use of IRS.gov and other electronic means to get their questions answered and obtain tax forms.

The use of other service alternatives, such as volunteer return assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased while the numbers of TAC contacts have decreased. In fiscal year 2005 over 2.1 million returns were prepared by volunteers. As of April 15, volunteer return preparation is up 7.3 percent above last year's level. Volunteer e-filing is also up, by 4.7 percent over the same period in the last tax filing season. This is reflective of continuing growth in existing community coalitions and partnerships.

PRESIDENT'S FISCAL YEAR 2007 BUDGET MAINTAINS THE BALANCE BETWEEN TAXPAYER SERVICE AND ENFORCEMENT

Our total budget request for fiscal year 2007 is \$10.6 billion in direct appropriations, supplemented by \$135 million in new user fee revenue, for a total operating level of \$10.7 billion. This request represents a total increase of 1.4 percent from the fiscal year 2006 enacted level. The fiscal year 2007 budget sustains the enforcement funding increase provided in fiscal year 2006 to improve tax compliance. More importantly, the budget maintains the balance between service and enforcement.

The IRS's taxpayer service and enforcement activities are funded from three appropriations: Processing, Assistance and Management (PAM); Tax Law Enforcement (TLE); and Information Systems (IS). The total fiscal year 2007 budget request for these three operating accounts is \$10.4 billion supplemented by the \$135 million in new user fee revenue, for a total operating level of \$10.5 billion, or 1.8 percent increase over the fiscal year 2006 enacted level.

The \$135 million in new user fees revenue will be generated from several increased and new user fees earned from special or non-routine services provided to taxpayers by the IRS. These would include such services as providing private letter rulings for interpretations of tax law and applications for exempt status. The largest portion of the anticipated increase in fees will come from new and restructured installment agreements (\$66.7 million). Another \$47.1 million is expected from letter rulings and determinations. The remainder will come from technical training and enrolled agent fee increases. These increased fees were designed to more fully reflect the actual cost of providing these services, as required by OMB Circular A-25.

The budget includes an additional \$137 million for enforcement to fund the pay raise and other cost adjustments needed to maintain the fiscal year 2006 enforcement initiative increase, a 2 percent increase. Similar to last year, the President's budget proposes to fund this enforcement increase through an adjustment to the discretionary cap, which in effect would increase the amount of funding dedicated to tax enforcement from \$6.82 billion in fiscal year 2006 to \$6.96 billion in fiscal year 2007. The IRS will continue to focus its enforcement resources on efforts designed to increase compliance and reduce the tax gap. We will continue our examination of tax-exempt entities used to facilitate abusive transactions and our examination of tax strategies involving international elements for both corporations and high income individuals.

I would remind the subcommittee that in fiscal year 2005 we brought in a record of \$47.3 billion in enforcement revenue, an increase of \$4.2 billion from the previous year. In fiscal year 2006, we expect that total to increase to \$48.1 billion, a 42 percent increase from fiscal year 2001.

We believe taxpayers have a right to expect a return on the additional investment in enforcement. We estimate that when we receive the full productive benefits of the fiscal year 2006 funding increase, the return on investment (ROI) for additional enforcement resources will be 4:1. Stated another way, we estimate that each \$1 invested in enforcement will return \$4 in additional enforcement revenue, although this should not be interpreted as a fixed ratio.

This estimated "return" is based on the amount of additional tax collected and attributes the revenue to the enforcement occupations that originated each case. For each type of IRS enforcement employee, the associated amount of additional tax collections is estimated based on an extensive data base, covering the most recent 11 years of collection experience.

This analysis does not include the indirect effect of increased enforcement activities in deterring taxpayers considering engaging in non-compliant behavior. Econometric estimates of the indirect effects indicate a significant impact from increased enforcement activities.

The \$3.58 billion for taxpayer service in the fiscal year 2007 budget request, including the \$135 million from new user fee revenue, will maintain our commitment

to provide high-quality taxpayer services through improvements to information technology and other targeted efficiencies such as those resulting from increased electronic filing.

The Business Systems Modernization appropriations account funds the IRS's costs to develop and deploy our critical, major information systems. The requested level for BSM is \$167.3 million, a 15.1 percent reduction from the fiscal year 2006 level. This is discussed later in the testimony.

Lastly, the Health Insurance Tax Credit appropriation (HITCA) remains a separate account that funds the administration of a refundable tax credit. The fiscal year 2007 request for HITCA is \$14.9 million, a 25.8 percent reduction from the fiscal year 2006 enacted level.

FISCAL YEAR 2007 DETAILED BUDGET SUMMARY

Our fiscal year 2007 budget request of \$10.7 billion, which includes the \$135 million in new user fee revenue, primarily funds costs to maintain the IRS's current levels of service and enforcement (\$272.2 million) and an initiative to consolidate the Philadelphia Campus (\$20.9 million). This request also includes several program savings and efficiencies that reflect the IRS's aggressive efforts to identify and deploy technology improvements that will benefit both taxpayer service and enforcement programs. Collectively, these cost savings total \$116.1 million:

—*E-File Savings: -\$6,760,000 / -174 FTE.*—This savings results from increased electronic filing (e-file) and a reduction in Individual Master File paper returns. Estimated e-file savings are based on the projected reduction in the number of paper returns processed each year, offset by the cost of processing e-filed returns.

—*Improvement Project Savings: -\$8,215,000 / -135 FTE.*—This savings results from operational improvements generated by the Contact Recording, Queuing Management (Q-Matic), Correspondence Imaging Systems, and End-to-End Publishing improvement projects already in progress.

—*Competitive Sourcing Savings: -\$17,000,000 / -242 FTE (The -242 FTE is a revised figure which corrects an error included in the fiscal year 2007 President's budget request for the IRS).*—These savings reflect efficiencies and savings that will be achieved through the IRS's competitive sourcing efforts resulting from six different projects in various phases of implementation.

—*Program Efficiencies: -\$84,100,000 / -873 FTE (-873 FTE is a revised figure, which corrects an error included in the fiscal year 2007 President's budget request for the IRS).*—These savings reflect Service-wide efficiencies resulting from the elimination of duplicative overhead in internal support functions, increased productivity through improved workload selection, and distribution techniques, automation of certain taxpayer assistance functions, and deployment of the fiscal year 2006 enforcement hires to full time examiner positions. These efficiency savings can be realized with no adverse impact on taxpayer service and enforcement operations.

The \$84.1 million in efficiency savings is broken down into three major categories. *Shared Services in Support of Taxpayer Service and Enforcement Operations (\$31.4 million).*—This includes approximately \$24 million in expected savings from renegotiated information systems and telecommunication contracts that the Treasury Department plans to award. Another \$7.2 million will come from implementing improved processes for issuing notices.

Enhanced Productivity and Efficiencies in Enforcement Programs (\$35.0 million / 433 FTE).—The Service will realize \$14.5 million (256 FTE) in savings due to the implementation of several productivity efficiencies. These savings will be achieved through an improved employee to management span of control, the elimination of non-critical vacancies, and the reduction of resources allocated to overhead and internal support functions. In addition, the Service will benefit from higher productivity levels resulting from the transition of the new hires to examiner work and the return of trainers to full time exam work. Other savings in this area include:

—\$500,000 (5 FTE) due to improved productivity stemming from more effective workload selection techniques such as creating and implementing new discriminate index function (DIF) formulas, which also will decrease taxpayer burden by allowing us to focus enforcement resources on the most egregious examples of abuse.

—\$12.1 million (120 FTE) by implementing improvements in the corporate examination process through improved techniques in data collection and risk identification. These improvements will result in earlier issue resolution, reduced audit cycle time, and increased inventory turnover. In addition, scanned returns will allow examiners to follow and evaluate data electronically.

- \$800,000 (13 FTE) due to the deployment of various technology improvements. The Generalized Integrated Data Retrieval System (IDRS) Interface and the Intelligent Call Management system will increase productivity and improve the quality and level of service to taxpayers.
- \$7.1 million (39 FTE) from enhanced investigations of tax fraud through the implementation of technology improvements to systems that process electronic data and evidence. The streamlined work processes and technological advancements will reduce administrative burden of investigations involving domestic and offshore abusive scheme promoters, corporate fraud, and other complicated investigations involving multi-national financial transactions.

Taxpayer Service Programs and Processes (\$17.7 million/440 FTE).—IRS operations will improve through a variety of efforts, including enhanced workload distribution and the automation of certain taxpayer assistance functions. The IRS will achieve \$14.6 million (355 FTE) in efficiencies from improved employee to management span of control throughout the organization, judicious distribution of management work, identification and elimination of non-critical vacancies, and the replacement of journeymen losses with lower-graded/entry-level positions. The deployment of the Individual Taxpayer Identification Number Real Time System saves time and money for both the Service and taxpayers. The system automates the process of providing a Taxpayer Identification Number (TIN) to those taxpayers ineligible for a Social Security Number but required to provide identifying information on a tax return. The Service anticipates \$3.1 million (85 FTE) in efficiencies due to this new automated system.

In addition to the program savings and increases for taxpayer service and enforcement, the fiscal year 2007 budget includes a \$5.5 million reduction to the Health Insurance Tax Credit Administration (HICTA) Program. This funding adjustment for HITCA reflects the program's effort to align fiscal year costs with contract year expenditures.

IRS MODERNIZATION

The requested level for BSM of \$167.3 million, a decrease of \$29.7 million, will continue the support for Customer Account Data Engine (CADE), Filing and Payment Compliance (F&PC) and the Modernized e-File (MeF) project along with some of the needed investments to upgrade our infrastructure.

After several years of cost, schedule, and performance problems, the BSM program has improved its performance in the past 2 years by delivering projects and releases on time, on budget, and meeting or exceeding expectations. Taxpayers are now realizing the benefits of our enhanced BSM program management capabilities. In fiscal year 2006 and continuing in fiscal year 2007, we are revising our modernization strategy to emphasize the release of projects to deliver business value sooner at a lower risk. We will concentrate on delivering releases of major tax administration projects, along with infrastructure initiatives that support all modernization projects, and continuing our improvements to program management operations. These projects and initiatives address core IRS strategic priorities: taxpayer service, enforcement, and modernization.

As part of our continuing effort to improve taxpayer service, we plan to expand services provided and the number of taxpayers served by Modernized E-File (MeF). MeF uses the latest secure Internet technology and speeds turnaround time for tax return submissions, equating to significant reductions in burden and time for corporate and tax-exempt taxpayers.

As of April 16, MeF had processed nearly 684,000 returns. This compares to approximately 176,000 in 2005, a 289 percent increase. In recent regulations, the IRS has mandated the Nation's largest corporations and tax exempt organizations file electronically in 2006 through the use of MeF.

Finally, we will continue to expand the use of the Customer Account Data Engine (CADE). CADE will ultimately replace our antiquated Master File system, which is the repository of taxpayer information. CADE allows faster refunds, improved taxpayer service, faster issue detection, more timely account settlement, and a robust foundation for integrated and flexible modernized systems. CADE posted more than 1.4 million returns and generated more than \$427 million in refunds in 2005. In 2006, CADE has posted over 6.4 million returns and generated over \$3 billion in refunds. In the 2007 filing season, we expect CADE to process 33 million returns. CADE serves as the single authoritative repository for account and return data for those returns.

PRIVATE COLLECTION AGENCIES (PCA)

The American Jobs Creation Act of 2004 created section 6306 of the Internal Revenue Code, which allows the IRS to use private contractors to collect delinquent taxes in instances where the amount owed is not in dispute. It is important to understand that these PCAs will only be assigned cases where the tax balance is not in dispute and will not be performing audits or assessing penalties, or taking enforced collection actions of any kind. They will only be used in instances where what is owed has been determined but the taxpayer has not paid.

On March 9, we announced the award of contracts to 3 PCAs. It is our expectation that these firms will begin work as soon as issues are resolved regarding protests to these awards. If cases are placed in fiscal year 2006, as allowed by statute, the IRS will retain 25 percent of any posted revenue receipts from this program which we will use to supplement our existing budget (for collection related activities). We anticipate an even greater return for fiscal year 2007 since case placements are expected to increase.

THE TAX GAP

To understand the need for full funding of IRS's proposed fiscal year 2007 budget, one also must understand the nature of the tax gap. The tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws.

It is the need to reduce that gap that drives much of what we do. This is true not only from a revenue standpoint, but also from a taxpayer fairness perspective. Our tax system is largely based on voluntary compliance and that compliance is enhanced if taxpayers believe that everyone is paying their fair share.

A year ago, we released preliminary estimates of the tax gap based on data derived from a National Research Program (NRP) study conducted on individual income tax returns from Tax Year 2001. This was the first comprehensive update of our tax gap estimate since 1988. We have now revised those estimates and I would like to summarize them for you.

Our latest numbers show that the overall gross tax gap for Tax Year 2001 was approximately \$345 billion, resulting in a noncompliance rate of 16.3 percent. Both of these numbers are in the upper end of the range of estimates provided last spring. Our estimate of the corresponding net tax gap, or what remains unpaid after enforcement and other late payments, is \$290 billion, also in the upper end of the earlier range.

Noncompliance takes three forms: not filing required returns on time; not reporting one's full tax liability even when the return is filed on time; and not paying by the due date the full amount of tax reported on a timely return. We have separate tax gap estimates for each of these three types of noncompliance.

Underreporting constitutes 82.6 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes 7.8 percent and underpayment 9.6 percent of the gross tax gap.

Individual income tax accounts for 46 percent of all tax receipts. However, individual income tax underreporting amounts to approximately \$197 billion, or 57 percent of the overall tax gap.

As in previous compliance studies, the NRP data suggest that well over half (\$109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent (\$56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining \$32 billion came from overstated reductions of income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits. The corresponding estimate of the self-employment tax underreporting gap is \$39 billion, which accounts for about 11 percent of the overall tax gap. Self employment tax is underreported primarily because self-employment income, which is not subject to third party reporting, is underreported for income tax purposes. Taking individual income tax and self employment tax together, then, we see that individual underreporting constitutes over two-thirds of the overall tax gap.

INCREASING COMPLIANCE THROUGH SERVICE AND ENFORCEMENT

It is important to understand that the complexity of our current tax system is a significant reason for the tax gap. It is easy for even sophisticated taxpayers to make honest mistakes. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of addressing the tax gap.

IRS is committed to assisting taxpayers in both understanding the tax law and remitting the proper amount of tax. We are continuing to do this by maintaining the balance between service and enforcement that is so critical to tax administration.

Service

I have already talked about IRS.gov and how it can answer many taxpayer questions on issues ranging from the Earned Income Tax Credit (EITC) to the Alternative Minimum Tax (AMT) to refund tracking. On a recent day, our site ranked third in overall hits according to Yahoo's Buzz Index. The American Customer Satisfaction Index has ranked our site well ahead of the government benchmark in the areas of content, functionality, navigation, privacy, satisfaction and in many other areas. Thus far this year, visits to our site are up 3.4 percent over the same period a year ago.

This success has been recognized by others. In 2004, IRS.gov won the Keynote Performance Award as the most reliable Federal web site for performance and availability. It won the 2005 Government Computer News agency award for innovation and is a finalist for the 2005 Excellence.gov Award in recognition of being an outstanding Federal interactive web site.

We believe the internet has become our primary vehicle for delivering service information to taxpayers. Please note that I said primary and not exclusive. We recognize that we will always have a percentage of taxpayers that we need to serve through either direct personal service or over the telephone, but we hope to continually drive that number down, while at the same time improving the levels of service and taxpayer satisfaction. This will not only save us time and resources, but also will provide a valuable service to taxpayers. They can get answers to their questions at their home, at their convenience, rather than visiting a walk-in site.

We continue to get good marks on various customer service surveys. Our toll free telephone service customer satisfaction rating is 94 percent. In fiscal year 2005, the IRS's customer assistance call centers answered 59.1 million calls. We achieved an 82.6 percent toll-free-telephone CSR level of service, exceeding our fiscal year 2005 target of 82 percent. We also improved our toll free tax law accuracy rate to 89 percent, an increase from 80 percent in fiscal year 2004. While this is the highest yearly rate ever, we continue to strive to improve. This filing season through March, the tax law accuracy rate is 90 percent.

We provided and staffed toll-free FEMA phone assistance lines for hurricane victims and answered approximately 950,000 calls. The IRS also implemented numerous tax law changes to help the victims of Hurricanes Katrina, Rita and Wilma, businesses located in the disaster areas, and individuals donating to charities to support the victims.

We continue to leverage community partnerships to provide free tax return preparation assistance through successful programs such as Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). In 2005, 62,000 trained volunteers at 14,000 locations across the country prepared more than 2.1 million tax returns, an 80 percent increase since 2001. We expect the number of customers served this year to exceed 2.2 million.

I personally have had the opportunity to visit several VITA sites and I remain impressed by the diligence, the competence, and the commitment of the thousands of volunteers that make this program work.

For small businesses, we simplified the employment tax filing process for more than 950,000 small companies by allowing them to file their employment tax returns and pay their employment tax liabilities annually, rather than quarterly. Our office of Taxpayer Burden Reduction led a collaborative effort to redesign the Form 1041 Schedule K-1, which among other things, is used to report income, deductions, and credits from trusts and estates to beneficiaries.

We are also making progress on our Taxpayer Assistance Blueprint (TAB). This is an ambitious, agency-wide, 5-year taxpayer services plan aimed at improving IRS services.

Over the past 5 years we have taken significant steps to understand the needs and preferences of individual taxpayers, our primary customers, and their representatives. Many studies, such as the Multilingual Initiative, the EITC outreach, and partnerships with organizations such as AARP and the National Community Tax Coalition have focused on understanding key demographic and behavioral differences in our customers. Before now, those initiatives have not been integrated to form a complete picture of customer needs.

The TAB project will pull the pieces of the puzzle together and develop a complete picture of our customer base. Through a systematic data collection and analysis process, a dynamic plan (or Blueprint) will be developed to meet our short and long

term business needs as it relates to taxpayer assistance and address concerns expressed by Congress and other oversight bodies.

In short, TAB will help us better understand our customers—their characteristics, how they access our services, what services they use and prefer, and if our services truly meet their needs.

We have completed the first phase of the TAB project. In Phase 1, we conducted research and surveyed taxpayers, stakeholders, and IRS employees to form a preliminary assessment of taxpayer needs, preferences, and demands. We have just recently delivered our Phase 1 report to the subcommittee. In Phase 2, we will perform extensive primary research with taxpayers to refine our assessment and conclude by creating an IRS blueprint for taxpayer service delivery. We will complete this phase in October 2006.

Enforcement

The IRS made significant progress towards achieving its enforcement related goals in fiscal year 2005. We achieved increases in every major area of enforcement. We have:

- Audited nearly 220,000 high income taxpayers in 2005, more than double the number audited in 2000.
- Increased audits for individuals to 1.2 million, 20 percent more than 2004 and almost double the level 5 years earlier.
- Audited nearly 5,000 businesses with assets over \$250 million, an increase of 11 percent. In addition, we audited one out of every five companies with assets of \$10 million. Finally, audits of businesses with less than \$10 million in assets rose 145 percent from 2004.
- Generated more than \$4.7 billion in revenue through two prominent settlement initiatives aimed at reducing examination and litigation expenses while deterring the use of abusive tax shelters.
- Increased collection closure cases by 12 percent and dollars collected by 14 percent over 2004.
- Increased criminal convictions to 2,151 (from 1,926 in 2002).
- Increased overall collections by 10 percent through heightened enforcement efforts, from \$43.1 billion in 2004 to \$47.3 billion in 2005.

Combating abusive tax shelters remains a high priority in fiscal year 2006. Last October we announced a global settlement initiative that covered 21 listed and non-listed transactions. They include a wide range of transactions involving funds used for employee benefits, charitable remainder trusts, offsetting foreign currency contracts, debt straddles, lease strips, and certain abusive conservation easements.

Taxpayers had until January 23, 2006 to file an election to take part in the global settlement program. Under the terms of the settlement, taxpayers will generally be required to pay 100 percent of taxes owed, interest and, depending on the transaction, either a quarter or half the accuracy-related penalty the IRS will otherwise seek.

We have been pleased by the response to this initiative, and we believe the response was buoyed by provisions in the Gulf Opportunity Zone Act of 2005 that modified the rules for calculating interest on tax deficiencies of individual taxpayers who participated in certain abusive tax shelters, increasing the incentives for individuals to come forward as part of this program.

In addition, our Large- and Mid-Sized Business Division (LMSB) has issued more than 500 administrative summonses as part of our attack on shelter promoters, and we have approximately 200 active promoter examinations under way. Entities being looked at include banks, accounting firms, law firms and brokerage houses. We want to make it clear that taxpayers who take aggressive return positions relying on the “audit lottery” and the chance they will not be examined have made a really bad decision.

In addition, we are continuing to focus on improper uses of certain tax exempt bonds and trusts, questionable transfer-pricing practices, offshore accounts, and charitable donations of intangible assets.

Another enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures.

We have done quite a bit to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. New Treasury Department regulations took effect last June that revise Circular 230 governing tax

practitioner behavior. The new regulations establish standards for written tax advice prepared by practitioners.

Further, additional revisions to Circular 230 were recently proposed to make disciplinary proceedings more transparent so that practitioners may learn the types of behavior IRS is likely to challenge under the Circular.

The IRS has made noncompliance by tax exempt and governmental entities and misuse of the tax exempt status of such entities by third parties for tax avoidance purposes another major enforcement priority. For example, earlier this year, we concluded that more than 30 credit counseling firms, accounting for more than 40 percent of the industry's revenues, are not entitled to tax exempt status. The proposed revocations of the tax exempt status of these entities are the culmination of more than 2 years of work covering more than 60 credit counseling organizations.

These organizations were originally granted tax exempt status because they were supposed to be educating and assisting people who have credit or cash flow problems. Unfortunately, too many of these organizations instead operate for the benefit of insiders or are improperly in league with profit making companies. We want to make sure that money donated to charities goes for the purpose intended and not into the pockets of individuals associated with the charitable organization.

In 2006, our Tax Exempt/Government Entities (TE/GE) division will continue to focus on key areas where organizations are abusing their exempt status or where others are using them for unintended purposes. Three of the areas in which we anticipate renewed enforcement include political intervention, executive compensation and abusive transactions.

Regarding political intervention by entities claiming tax exempt status, in 2006 we will be finishing up contacts with 130 organizations suspected of political intervention in the 2004 election. Almost half of these are churches. Thus far we have completed 82 examinations and have concluded that nearly three-quarters of the non-profits examined, including churches, engaged in some level of prohibited activity. Most of these exams concerned one-time, isolated occurrences of prohibited campaign activity, which the IRS addressed through written advisories to the organizations. In three cases involving non-churches, the prohibited activity was egregious enough to warrant the IRS proposing the revocation of the organization's tax-exempt status.

We have also issued a fact sheet designed to offer guidance to non-profits on what is and is not permissible activity for tax-exempt organizations. In addition, we have taken steps to ensure that all referrals regarding campaign activity that the IRS receives from the public, as well as activity the IRS itself uncovers, are reviewed expeditiously, and treated consistently and fairly.

Excessive compensation of executives also will be a main focus of our enforcement efforts. There are indications that tax-exempt organizations have allowed key executives too great a voice in determining their own compensation or otherwise have not used due diligence in setting compensation levels. We have contacted almost 2,000 Section 501(c)(3) organizations, including about 400 private foundations regarding this issue. In addition, we are exploring compensation to tax-exempt hospital executives.

In the fiscal year 2006 budget, our enforcement resources increased by \$442 million (post-rescission). I know it is important to you, and it is equally important to us, to show a return on that investment.

Of the total \$442 million in increased funding, \$180 million funds the pay and non-pay inflationary costs to maintain the \$6.4 billion devoted to enforcement. The remaining \$262 million funds direct costs for enhanced enforcement hiring, including staff for the Counsel and Appeals organizations, and associated indirect costs for these hires. We will focus these resources on:

- Increased coverage of high-risk compliance problems to address the largest portion of the tax gap—the underreporting of tax—across all major compliance programs;
- Complex high-risk issues in abusive tax avoidance transactions, promoter activities, corporate fraud and aggressive transactions, resulting in increased corporate and high income audit coverage;
- Efforts aimed at reversing the erosion of individual tax compliance and support of the strategy to implement a balanced compliance program;
- Improved ability to identify compliance risks and significantly expanded coverage of tax-exempt communities;
- Safeguarding compliant customers from unscrupulous promoters through earlier detection of abusive schemes and heightened efforts to prevent their proliferation; and
- Increased vigilance to ensure the assets of tax-exempt organizations are put to their intended tax-preferred purpose and not misdirected to fund terrorism or

for private gain, including enhanced processing of questionable exemption applications and increased technical support to the examination process.

LEGISLATIVE PROPOSALS

While fundamental tax reform is the only comprehensive solution to reducing the tax gap, until that is achieved, we must work within the current system to reduce the tax gap as much as possible. Allow me to discuss five specific legislative proposals that are offered as part of the fiscal year 2007 budget and designed to reduce the tax gap. Collectively, these five changes should generate \$3.6 billion over the next 10 years.

The first and perhaps most important proposal would increase reporting on payment card transactions. Our tax gap study shows clearly that increased information reporting and backup withholding are highly effective means of improving compliance with tax laws. More than 150 million wage earners already have their information reported directly by their employer to the IRS and the non-compliance rate for this group is less than 1 percent. All of these wage earners are also subject to mandatory withholding of taxes.

Payment cards (including credit cards and debit cards) are a growing form of payment in retail business transactions. The failure of some merchants to accurately report their gross income, including income derived from payment card transactions, accounts for a significant portion of the tax gap and creates a significant competitive advantage for those businesses that underreport.

The administration proposes that the Treasury Secretary be given the authority to promulgate regulations requiring annual reporting of the aggregate reimbursement payments made to merchants in a calendar year, and to require backup withholding in the event that a merchant payee fails to provide a valid taxpayer identification number.

Because reimbursement information is already provided to merchants, requiring this information to be reported to the IRS on an aggregate annual basis will impose minimal burden on payment card companies and no burden on the affected merchants. In addition, implementing a backup withholding system for payment card reimbursements to businesses would lead to material improvements in the compliance rates of these taxpayers without imposing a significant burden on the card companies. Finally, the IRS will be able to use payment card reporting information to better focus its resources and relieve the burden that existing audits place on businesses that accurately report their gross income.

The second legislative proposal would clarify when employee leasing companies can be held liable for their clients' Federal employment taxes. Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Typically, these firms prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of the clients' workers.

Non-compliance with the Federal employment tax reporting and withholding requirements is a significant part of the tax gap. Under present law, there is uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to the wages paid by a company that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes are assessed and collected.

The administration's proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also allow employee leasing companies to qualify to be solely liable if they met certain specified standards.

Our third proposal would amend collection due process procedures for employment tax liabilities. Currently, we are authorized to take various collection actions including issuing Federal tax levies to collect past-due taxes. Before a tax levy can be issued, however, the IRS generally must provide the taxpayer with notice and an opportunity for an administrative collection due process (CDP) hearing, and for judicial review.

Frequently, an employer who fails to satisfy its Federal tax liabilities for one period will also fail to satisfy them for later periods, resulting in a "pyramiding" of unpaid taxes. Some employers who request a CDP hearing or judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities dur-

ing the CDP proceedings. Liabilities for the subsequent periods cannot be collected by levy until the employer has been given notice and opportunity for a hearing and judicial review for each period. The existing CDP framework compounds the pyramiding problem by depriving the government of enforced collection as a tool to encourage employers to satisfy their current Federal employment tax obligations.

Our proposal would allow the levy to be imposed prior to a CDP hearing in a fashion similar to current law provisions for levies issued to collect a Federal tax liability from a State tax refund. Taxpayers would have the right to a CDP hearing with respect to employment tax liabilities within a reasonable time after the levy. Taxpayers would also continue to have access to existing pre-collection administrative appeal rights other than CDP.

The fourth proposal would require increased information reporting and backup withholding for certain government payments for property and services. It should be noted that present law generally requires information reporting for the provision of services and direct sales, but does not for provisions of goods and other property. This proposal will extend information reporting, with some exceptions, to the purchase of property by Federal, State, and local governments.

Our proposal would authorize the Treasury Secretary to promulgate regulations requiring information reporting and backup withholding on non-wage payments by Federal, State and local governments to procure property and services. Certain payments would, of course, be exempt. These include payments of interest, payments for real property, payments to tax exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract.

The final legislative proposal would expand the signature requirement and penalty provisions applicable to paid tax return preparers. Under current law a paid tax return preparer is required to sign and include his/her taxpayer identification number (TIN) on an income tax return and related documents that he/she prepares for compensation. Paid return preparers, however, are not required to sign and include their TINs on non-income tax returns, such as employment tax returns, excise tax returns, and estate and gift tax returns, and tax return related documents filed with the IRS. The administration's proposal would expand preparer identification and penalty provisions to non-income tax returns and tax return-related documents prepared for compensation. Further, it would impose penalties for preparing tax return related documents that contain false, incomplete, or misleading information or certain frivolous positions that delay collection.

These five legislative changes strategically target areas where: (1) research reveals the existence of significant compliance problems; (2) improvements will burden taxpayers as little as possible; and (3) the changes support the administration's broader focus on identifying legislative and administrative changes to reduce the tax gap.

In addition to these specific legislative proposals, we will study the distinction between independent contractors and employees under current law. The improper classification of employees as independent contractors is a significant problem and substantial contributor to the tax gap.

FREE FILE

The IRS wants to make free filing of tax returns available to as many taxpayers as possible. We have looked to the private sector for assistance to make this happen as quickly as possible. I referenced earlier the fact that we are experiencing a significant decline in the use of the Free File program in the 2006 Filing season. I also recognize there have been some questions raised as to the renewal of our Free File agreement. Allow me to update you on both the background of Free File and the new agreement.

Free File's roots can be found in the President's fiscal year 2002 Management Agenda. It contained five Government-wide initiatives, one of which was to expand electronic government. The overarching goal was to "champion citizen-centered electronic government that will result in major improvements in the federal government's value to the citizen."

Subsequently, in November 2001, OMB's Quicksilver Task Force established 24 e-government initiatives as part of the President's Management Agenda. These initiatives were designed to improve government-to-government, government-to-business, and government-to-citizen electronic capabilities.

One initiative instructed the IRS to provide free online tax return preparation and filing services to taxpayers. In accordance with this OMB directive, the IRS began working in partnership with the tax software industry to develop a solution.

The IRS believes that private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available. IRS's partnership with private industry: (1) provides taxpayers with high quality services by using the existing private sector expertise; (2) maximizes consumer choice; (3) promotes competition within the marketplace; and (4) meets these objectives at the least cost to taxpayers.

On October 30, 2002, the IRS and the Free File Alliance, LLC, signed an agreement that created a public-private partnership to provide free services to the majority of taxpayers. The Free File Alliance, LLC, is a private-sector consortium of tax preparation software companies. The original agreement was for 3 years with a series of 2-year renewal options. The primary candidates for Free File services were those taxpayers who prepare their own taxes and still file paper returns.

While membership in the Alliance may change from time to time, all members must meet certain IRS standards. Specifically, we must approve each member's proprietary tax preparation software. In addition, each member must obtain third party privacy and security certification. Finally, all Alliance members must adhere to all Federal laws regarding taxpayer privacy.

Each Free File Alliance member was allowed to set taxpayer eligibility requirements for its program. Generally, eligibility was based on such factors as age, adjusted gross income, State residency, eligibility to file a Form 1040EZ or for the Earned Income Tax Credit. But, as a whole, under the original agreement, the Alliance was required to provide free filing services to at least 60 percent or 78 million of the Nation's individual taxpayers. In addition, all active armed forces, Federal reservist and National Guard personnel were eligible to free file through a separate program operated by the military.

While the IRS did not support or endorse any Free File Alliance company or product offering, it did provide a listing of the Alliance members via the Free File web page, which is hosted on IRS.gov. Companies were allowed to offer ancillary services to taxpayers for a fee, but the taxpayer was under no obligation to purchase any of those services as a condition of getting their Federal tax return prepared free of charge.

The intent of the Free File program was to reduce the burden on individual taxpayers, make tax preparation easier and expand the benefits of electronic filing to a majority of Americans. In the 2003 filing season, 2.8 million taxpayers took advantage of Free File. This number rose to 3.4 million in 2004. In 2005, the number increased to over 5 million. Nearly 3.9 million taxpayers have utilized Free File in this filing season.

The 2005 number may be a bit of an aberration in that many of the companies in the Alliance opted to lift qualification restrictions on taxpayers thus allowing any taxpayer, regardless of income, to utilize Free File. This started as some companies sought a competitive advantage by expanding their base and ended with many of the companies in the Alliance offering free return preparation services to anyone.

While this was good for taxpayers in general, it posed a serious threat to the survival of the Alliance and was a prime topic of discussion when the contract was up for renewal at the end of last year. Many of the companies could not continue in the Free File Alliance unless it returned to offering the free service to low and moderate income individuals. The loss of these companies would have jeopardized the continued existence of the Alliance.

As we prepared for negotiations to extend the Free File agreement in 2005, the IRS took the position that Free File should be available to as many taxpayers as possible. The Alliance's position was that Free File should only be available to low and moderate income taxpayers.

As is the case in most negotiations, we compromised and agreed that Free File would be offered to 70 percent of taxpayers, or anyone with an AGI of \$50,000 or less in 2005. This covers approximately 93 million of the 133 million individual taxpayers expected to file returns this year. This is an improvement over our prior agreement which only guaranteed coverage of 60 percent or availability to 78 million taxpayers. The active armed forces, Federal reservist and National Guard personnel continue to be eligible to free file under their own program.

In 2006, three Free File Alliance members are offering State filing for free. Seven members are offering to file Form 4868, Extension of Time to File Individual return. Approximately 46,000 extension forms had been filed as of April 15. In addition, there are two companies offering free packages in Spanish.

While the number of taxpayers taking advantage of Free File in 2006 will likely be less than in 2005, we are unable at this time to fully explain the decline. Certainly the fact that it is not available to everyone is one factor, but there likely are other factors as well.

A year ago, the Free File program benefited greatly from a major article on the front page of USA Today. Immediately following that article, there was a tremendous surge of positive publicity as well as a surge in Free File usage by taxpayers. We have not been the beneficiary of similar publicity this year and to the extent we have received coverage much of it has focused on the taxpayers that Free File does not cover.

One of the major concerns that many critics of the Free File program have had has been the ability of the Alliance members to use Free File to market other services to taxpayers. These include the filing of State tax returns and the offering of refund anticipation loans (RALs). We make it clear to taxpayers that the IRS does not endorse any of these products or services nor is the completion of their tax return at no cost conditioned on the purchase of any product or service.

Because the IRS does not directly monitor Free File return preparation, we generally do not know what, if any, fee services taxpayers actually use from the Free File vendors. The one service that we do have data on is refund anticipation loans (RALs). RALs are designed to provide the taxpayer an immediate refund in the form of a consumer loan. Often the costs incurred with the RAL are disproportionate to the amount of the refund, especially considering that a taxpayer that files electronically will get the refund from the IRS in about 2 weeks. Unfortunately, it is often low income taxpayers, the ones who can least afford it, who choose RALs.

What we are seeing from our Free File data thus far in this regard is encouraging. Only 0.6 percent of the taxpayers utilizing Free File have utilized a RAL. In fact, half of the Free File vendors do not even offer refund anticipation loans. In part this may be due to the strong consumer protection language included in the new agreement. The agreement specifies that any alliance member offering a RAL must include clear language indicating that RALs are a loan and not a faster way of receiving an IRS refund. It also requires them to specify that because the RAL is a short term loan, interest rates may be higher than some other forms of credit available to consumers. The agreement also limits an Alliance member to asking a taxpayer about a RAL only once. If the taxpayer says no, then there can be no other pressure applied to convince him or her to change his or her mind.

This 0.6 percent RAL participation for Free File is the lowest of any of our electronic filing groups. Other online filers have a 0.8 percent participation rate. The rate for online returns done by paid tax return preparers is the highest. Approximately 20 percent of the paid preparer returns submitted electronically include a RAL.

7216 PROPOSED REGULATIONS

Another issue about which there has been considerable controversy is the proposed modification of regulations under section 7216 of the Internal Revenue Code, which addresses use and disclosure of tax return information by tax preparers. I must admit that I was somewhat surprised by the reaction to the proposed regulations particularly since the current regulations have allowed for taxpayer consent to disclosure for more than 30 years. Protecting the confidentiality of tax return information is of paramount importance to the IRS and our intent in proposing the regulations was to tighten existing rules and articulate how the tightened rules should be applied in an electronic return preparation environment.

The furor that has arisen in recent weeks over the proposed changes tells me that few taxpayers were previously aware of this provision and of the consequences of consenting to disclosure or use of their tax return information. To that extent, the debate has been good in that taxpayers are hopefully now better educated about disclosure and sharing of information and will be more careful about what they consent to.

Beyond that, it is important to remember several things. First, this is only a proposed regulation. We have had numerous comments both in writing and at the public hearing we held on April 4. We will evaluate all those comments before going forward with any final regulation.

Second, the proposal contains some important taxpayer protections relative to what a tax return preparer would have to do in order to get consent to share or use any of the taxpayer information the taxpayer gave the return preparer to prepare his or her tax return. In addition, there are important new restrictions on the ability of tax return preparers to shift tax return information overseas for tax return preparation or data processing purposes.

Third, the proposed regulations would treat all tax return preparers the same way. Under the current regulations, tax return preparers that are part of an "affiliated group" of corporations can obtain taxpayer consent to use information to solicit business for their corporate affiliates. This rule was written over 30 years ago and

has no application to the vast majority of return preparers that are not organized as affiliated groups of corporations. This leads to illogical results, particularly when contrasted with the provision in the current rules that allows taxpayers to consent to “disclose” their tax return information to third parties that have no connection whatsoever with the tax return preparer. The IRS has received a number of comments on this issue and will carefully consider them in finalizing the proposed regulation to ensure that the goal of protecting taxpayer privacy is achieved.

Finally, an outright ban on sharing of tax return information raises some interesting questions and may lead to illogical results if taxpayers were prohibited by law from ever consenting to a tax return preparer disclosing or using their tax return information for any purpose.

CONCLUSIONS

Mr. Chairman, members of the subcommittee, I would like to emphasize the following points:

- E-Filing continues to grow. Over 63 million people have already e-filed their return, 63 percent of all returns filed.
- Taxpayers who are e-filing from their home computers show the greatest increase in e-filing, up almost 13 percent from a year ago.
- Hits to IRS’s web site, IRS.gov are almost 114 million, up 3.39 percent over last year.
- Returns filed by VITA and TCE sites are up 7.3 percent over a year ago.

In addition, the best way to maintain our success in our compliance and enforcement efforts, reduce the tax gap, and continue the achievements made in 2006 is the adoption of the President’s proposed budget for fiscal year 2007, particularly the \$137 million for enforcement that is part of a program integrity cap adjustment, and enactment of the five legislative proposals.

Thank you, Mr. Chairman and I will be happy to respond to any questions.

STATEMENT OF RAYMOND T. WAGNER, JR.

Senator BOND. Thank you very much, Commissioner, and now let me turn to Chairman Wagner.

Mr. WAGNER. Thank you, Mr. Chairman.

Before I begin, I almost feel compelled to dial up my 11-year-old daughter, Mary Ruth, and put her on my speakerphone right here or at least take her photo and put it on the front side of my name tag.

Mr. Chairman, members of the committee, Senator Murray, thank you for the opportunity to present the IRS Oversight Board’s recommendations for the fiscal year 2007 budget. Before I begin my testimony on the budget, I would like to take a moment to commend the Commissioner and the Internal Revenue Service on what appears from all accounts to be a very successful filing season.

I have submitted a detailed written statement and ask that it be made a part of the hearing record.

The Oversight Board recommends a fiscal year 2007 IRS budget of \$11.3 billion, an increase of \$732 million or 6.9 percent over the enacted fiscal year 2006 budget as compared to the administration’s request of \$10.6 billion. The two budgets share some essential elements. Both reflect the same adjustments for inflation of \$272 million. Both show a savings and reinvestment of \$122 million, and both are supplemented by \$135 million in increased user fees.

The board recognizes the theme of fiscal austerity in the President’s budget and respects the administration’s request; however, our statutory charge is to recommend a budget that will ensure that the IRS can carry out its mission and annual and long plans.

Mr. Chairman, you are very aware of the large tax gap. You spoke of it in your opening statement. We believe that reducing the

tax gap requires a comprehensive long-term plan with organizational commitment and actions described in my written statement. The board believes that a flat IRS budget does not do enough to shrink the tax gap and recommends an increase of \$705 million in four program areas: \$44 million for more taxpayer services, \$368 million for more enforcement, \$105 million for management and infrastructure, \$189 million for the Business Systems Modernization program.

In the area of customer service, the board seeks to restore the telephone level of service on IRS's main toll-free line to the fiscal year 2004 level of performance or 87 percent. The board also recommends an additional \$368 million for enforcement. Of that, \$308 million would provide for the modest increase in IRS enforcement resources across all taxpayer segments. The IRS has demonstrated there is a positive return on these types of investments.

The remaining \$60 million for our enforcement increase is for additional research. The IRS needs to know much more about the noncompliance to mount a successful campaign against the tax gap. It is time that the IRS make up-to-date research the normal way of doing business. To this end, the board recommends that the IRS make the National Research Program permanent and perform compliance research annually. This effort should be guided by a long-term plan for research. We also need solid research on customer service needs and how customer service affects compliance.

I want to emphasize that taxpayers want more service and more enforcement from the IRS. The board surveys of taxpayer attitudes in 2004 and 2005 indicates that approximately two-thirds of taxpayer support additional IRS funding for both service and enforcement.

Time does not permit me to describe our recommendation for infrastructure and management fully, but I would like to highlight one specific recommendation, the need to restore leadership development training to fiscal year 2003 levels, which is especially critical during a period in which approximately 50 percent of IRS managers are eligible for retirement.

It is also critical to discuss Business Systems Modernization. Despite productivity improvements, the IRS is still forced to rely on a 40-year-old information system for its central recordkeeping, which limits the IRS to weekly updates of its primary taxpayer records. No modern financial institution in the private sector could survive under these conditions. Eliminating these limitations are key to making the IRS as efficient and effective as a modern financial institution.

PREPARED STATEMENT

Improved management focus has helped BSM deliver important technology projects that are generating greater efficiencies and real world benefits for taxpayers, such as CADE and modernized E-file. Cutting back on modernization will force the program to take longer and cost more than necessary in the long run. The board recommends that BSM move forward at an accelerated pace.

Mr. Chairman, this concludes my oral statement and I will be pleased to accept your questions.

[The statement follows:]

PREPARED STATEMENT OF RAYMOND T. WAGNER, JR.

INTRODUCTION AND OVERVIEW

Mr. Chairman, thank you for this opportunity to present the Oversight Board's views on the administration's fiscal year 2007 IRS budget request. I will explain in my testimony why the Board believes its proposed budget is needed to meet the needs of the country and of taxpayers. In developing these recommendations, the Board has applied its own judgment but has also drawn on the collective wisdom of others in the tax administration community, including the IRS, Government Accountability Office (GAO), the Treasury Inspector General for Tax Administration (TIGTA), National Taxpayer Advocate, and Congress.

In fulfilling its responsibilities, the Board must ensure that the IRS's budget and the related performance expectations contained in the performance budget support the annual and long-range plans of the IRS, support the IRS mission, are consistent with the IRS goals, objectives and strategies and ensure the proper alignment of IRS strategies and plans. In addition to my statement today, the Board is developing a formal report in which it will explain why it has recommended this budget for the IRS.

Now is a fiscally challenging time for our Nation. Defense and homeland security needs coupled with rebuilding efforts along the hurricane-ravaged Gulf Coast have placed an enormous strain on the Federal budget.

In addition to our fiscal challenges, taxpayers are expected to comply with an increasingly complex tax code which places heavy burdens on honest taxpayers who wish to comply and offers untold opportunities for mischief by those who do not.

Against this backdrop, it is imperative that government work better and smarter and get the most out of every taxpayer dollar. But there is also a drain on the Treasury that undermines our country's tax revenues and threatens the integrity of our tax administration system—the tax gap.

The IRS recently disclosed that the Nation's annual tax gap—the difference between what is owed and what is collected annually—stands at \$345 billion, and some experts believe it could be even more. The Board considers the existence of such a large tax gap to be an affront to honest taxpayers, and is pleased with the attention that Congress has focused on the tax gap in the last year, especially with the release of the IRS's latest tax gap estimates. The Board, along with many other members of the tax administration community, believe that reducing the tax gap requires a comprehensive, multi-faceted plan with action on many fronts—from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

Such an approach needs to be more thoughtful and comprehensive than merely increasing IRS resources and expecting that the gap will shrink. However, increased IRS resources are certainly a part of the solution. A successful strategy will encompass several separate but interrelated approaches that will reinforce each other to produce the desired result. In the Board's opinion, a number of actions that can be taken will require additional IRS resources.

The Oversight Board recommends an integrated set of strategies to close the tax gap: (1) tax code simplification; (2) improved information reporting and enforcement tools related to the cash economy; (3) improved customer service to make taxpayers aware of their obligations and modern technology to ease their burdens; (4) greater focus on research; (5) more productive partnerships between the IRS and tax professionals; and (6) and more emphasis on personal integrity.

There can be no doubt that in the last 5 years the agency has achieved significant progress in all dimensions of its mission. Customer service has rebounded from the lows of the 1990's and through targeted investments and greater management focus, IRS enforcement has also turned the corner.

This across-the-board improved performance has not gone unnoticed—especially among taxpayers. According to the 2005 American Customer Service Index, overall satisfaction among individual tax filers with the Internal Revenue Service remains stable at 64 percent; it is even higher among e-filers. The IRS Oversight Board 2005 Annual Survey also found that American taxpayer support for overall compliance reached an all-time high. However, the IRS's job is far from complete and it must close the tax gap while achieving balance in other parts of its critical mission.

The Board recommends budget increases in four IRS program areas in fiscal year 2007: customer service, enforcement, Business Systems Modernization, and infrastructure and management tools.

To achieve balance and ultimately compliance, the Board recommends two modest investments in customer service to ensure that there is no slippage in hard won gains. For example, the toll-free telephone level of service is slightly down and wait

times have increased compared to fiscal year 2004. The Board proposes restoring customer service to fiscal year 2003–2004 levels and investing in telephone infrastructure. It is far less expensive to prevent or solve a problem early on than let it grow.

The Board proposes a modest increase in resources for virtually all IRS enforcement activities. This is money well-spent and there is a growing recognition of the positive return on money invested in the IRS. The Board strongly believes that the enforcement increase includes a significant investment in research to better understand enforcement and customer service needs and the impact of customer service on voluntary compliance. The Board's recommended budget puts the IRS on track to make the National Research Program (NRP) permanent and produce annual tax gap estimates. The Board further recommends that the IRS consider developing a long-term strategic plan for research.

Business Systems Modernization is also a priority and the Board advocates a larger investment in information technology to improve IRS productivity and reduce taxpayer burden. Despite productivity improvements in recent years, the IRS is still hampered in its efforts to modernize because of its reliance on a 40-year-old information system for its central recording-keeping functions, which limit the IRS to weekly updates of its central taxpayer records. No modern financial institution in the private sector could survive under these conditions and eliminating these limitations is key to making the IRS an efficient and effective modern financial institution.

Lastly, the Board recommends a number of management increases that will help the IRS cope with unfunded mandates, implement BSM projects, and restore leadership training to fiscal year 2003 levels, which has become especially critical during a period in which over 50 percent of IRS managers are eligible to retire.

Overall, the Oversight Board proposes a budget that is good for the country, good for taxpayers, and allows the IRS to achieve its strategic goals and objectives in an efficient and effective manner. It calls for \$11.3 billion funding for fiscal year 2007, a 6.9 percent increase over last year's appropriation.

The Board has also voiced concern that two items in the administration's proposed fiscal year 2007 budget for the IRS pose significant risks. First, the budget proposes \$84 million in savings from program efficiencies. The Oversight Board believes there is a risk that these reductions will decrease performance. Second, last December the IRS announced that it would dramatically raise fees for certain services and the President's budget assumes that the IRS will receive an additional \$135 million in fee revenue. Although the IRS has expressed confidence it would receive this amount in additional fees based on its estimates, there is still some risk whether the estimated fee revenue can be achieved. In addition, external stakeholders have expressed concern that the additional fees could have an unintended negative impact on taxpayer compliance.

In conclusion, the Board believes that it has constructed a fiscally responsible and realistic budget for the IRS that meets national needs and priorities. It would help shrink the tax gap while providing taxpayers with a level of service they rightly deserve and need. It would speed the modernization of the IRS's antiquated technology and give it the research tools to better understand current and developing trends. Most importantly, it would maintain that delicate but critical balance between enforcement and customer service that America's taxpayers have said time and again they want, and which has been validated through the Board's Taxpayer Attitude Survey. The IRS is now solidly on the right track and is making progress, but we must give it the resources to do its job. It is the right investment for this and future generations of taxpayers.

Recommended IRS Oversight Budget in Brief

The IRS Oversight Board recommends a fiscal year 2007 IRS budget of \$11.31 billion, an increase of \$732 million over the enacted fiscal year 2006 budget.¹ This recommendation compares to the President's budget request for the IRS of \$10.59 billion in direct appropriations. The two budgets share the following characteristics:

- Both reflect the same adjustments for inflation, \$272 million.
- Both show a savings and reinvestment of \$121.6 million.
- Both are supplemented by \$135 million in increased user fees to achieve a higher operating level.

¹ The President's budget includes on pages IRS–127 to IRS–129 of the Congressional Justification, as required by law, a copy of the fiscal year 2007 IRS budget the Oversight Board approved and submitted to the Department of the Treasury. The Board's recommended budget, as shown on these pages, is higher than the request shown above; Appendix 6 provides an explanation of the differences.

The Board's budget, however, proposes program increases of \$705 million compared to a proposed program decrease of nearly \$9 million in the President's budget, as shown in the table below.

COMPARISON OF BOARD AND PRESIDENT'S PROGRAM INCREASES

[In thousands of dollars]

| Function | Oversight Board Recommendation | President's Request |
|--|--------------------------------|---------------------|
| Taxpayer Service | 43,637 | ..... |
| Enforcement | 367,768 | ..... |
| Infrastructure and Mgt Modernization | 104,715 | 20,900 |
| Business Systems Modernization | 188,600 | (29,700) |
| Total Program Increases (Decreases) | 704,720 | (8,800) |

Recommended initiatives for enforcement, customer service, infrastructure and management and Business Systems Modernization can be found in the individual sections of this statement and Appendices 2 through 5.

IRS Performance From Fiscal Year 2001 to Fiscal Year 2005

The agency, which had become synonymous with poor customer service in the late 1990's, has demonstrated a remarkable performance improvement in the last 5 years. Toll-free telephone level of service has steadily increased from 56 percent in fiscal year 2001 to a high of 87 percent in fiscal year 2004. (In fiscal year 2005, there was a slight 3 percent drop which the IRS attributes to reduced funding for taxpayer services.) Toll-free tax law accuracy also rose from 82 percent in fiscal year 2003 to an impressive 88 percent in fiscal year 2005.

Perhaps the most important and notable gain recorded over the past 5 years is the percent of individuals filing electronically—31 percent in fiscal year 2001 to 51 percent in fiscal year 2005.² And although it will miss the 2007 deadline, the IRS is making steady progress in closing in on the 80 percent e-file goal established by the IRS Restructuring and Reform Act of 1998.

Through targeted investments and greater management focus, IRS enforcement has also turned the corner. Enforcement revenue rebounded from \$33.8 billion in fiscal year 2001 to \$44.1 billion in fiscal year 2005. Audit rates also steadily increased. For high-income individuals they rose from 0.79 percent in fiscal year 2001 to 1.61 percent in fiscal year 2005. Over the same time period, corporate and small business audits increased respectively from 13.5 percent to 16.9 percent and 0.88 percent to 1.32 percent.

Taxpayers Respond to Better Performance but Problems Remain

This across-the-board improved performance has not gone unnoticed—especially among taxpayers. According to the 2005 American Customer Service Index, overall satisfaction among individual tax filers with the IRS remains stable at 64 percent. However, the number is much higher among e-filers who had an ACSI score of 77 percent.³ By way of comparison, the IRS received a 51 percent score in 1998. Taxpayer attitudes have also improved. Since 2002, the IRS Oversight Board has conducted an annual survey to gain a deeper understanding of taxpayers' attitudes. Of great concern was the growing number of individuals who thought it acceptable to cheat on their taxes.

In 2003, 12 percent of respondents thought it acceptable to cheat a "little here and there" on their taxes, and 5 percent would cheat as much as possible. However, 2 years later those numbers have dropped to 7 and 3 percent respectively and public support for tax compliance is at an all-time high. Moreover, the 2005 survey found that 82 percent of respondents say that their own personal integrity has the greatest influence on whether or not they report and pay their taxes honestly—double the number who cite any other factor. Significantly, the survey also found two out of three surveyed expressed continued support for additional funding for both IRS assistance and enforcement.⁴ America's taxpayers want a balanced tax administration system.

However, as welcome as the news may be, it cannot disguise the hard fact that the tax gap has remained unacceptably high. In testimony before the Senate Budget

²Statistics provided to the Oversight Board by the IRS.

³Professor Claes Fornell, "ACSI Commentary: Federal Government Scores", December 15, 2005.

⁴IRS Oversight Board, 2005 Taxpayer Attitude Survey.

Committee, Comptroller General David Walker stated that the \$345 billion tax gap estimated by the IRS could indeed be greater: “IRS has concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data and IRS has no estimates for other areas of the tax gap. For example, IRS used data from the 1970’s and 1980’s to estimate underreporting of corporate income taxes and employer-withheld employment taxes.”⁵

The tax gap is more than an abstract number. According to National Taxpayer Advocate Nina Olson, it hurts taxpayers in a very concrete way:

“The collective failure by certain taxpayers to pay their taxes imposes greater burdens on other taxpayers. The IRS receives approximately 130 million individual income tax returns each year. Given the size of the net tax gap, the average tax return includes a ‘surtax’ of about \$2,000 to make up for tax revenues lost to non-compliance. The tax gap may also impose significant costs on businesses in the form of unfair competition by noncompliant competitors who can pass along a portion of their tax ‘savings’ to customers by charging lower prices.

“Most importantly, the tax gap can erode the level of confidence that taxpayers have in the government, thereby reducing Federal revenue and increasing the need for more examination and collection actions. The tax gap, then, can produce a vicious cycle of increased noncompliance and increased enforcement.”⁶

The IRS Oversight Board believes that its fiscal year 2007 IRS budget recommendations are part of the solution to reversing this corrosive trend.

Budget Environment Should Not Discourage Investment

The IRS does not operate in a vacuum and the Oversight Board recognizes that the current budget environment stresses fiscal restraint and austerity. However, at the same time, we should not throw up our hands in defeat and say we can do no more to improve tax administration. We should look at the larger picture.

Unlike other government agencies, there is a positive return on money invested in the IRS. Senate Budget Committee Chairman Judd Gregg agrees. He observed at a recent hearing on the tax gap, “We’ve got to talk to the CBO about scoring on that [investing in IRS enforcement], clearly there’s a return on that money.”⁷

The Board would welcome such a change but also recognizes that this is a problem that has plagued the IRS for decades. Former IRS Commissioner Charles O. Rossotti wrote:

“When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of job, by far, was dealing with the IRS budget. The reaction was usually, ‘Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn’t you be able to get it?’”⁸

Indeed, this lack of recognition of a direct return on investment has left many puzzled. In his April 14, 2004 column, Washington Post financial writer Al Crenshaw wondered why the administration and Congress “aren’t falling over themselves to give the IRS more money. Tax Enforcement pays for itself many times over, and it would be a good way to cut the deficit.”⁹

In its fiscal year 2007 budget recommendation, the Board calls for increases in enforcement that would result in a real return on investment, ranging from \$3 to \$6 on every \$1 spent, resulting in \$730 million revenue by fiscal year 2009 on a \$242 million investment.

The Oversight Board urges Congress to adopt the Board’s budget recommendations and invest in more effective tax administration.

SIX STRATEGIES TO REDUCE THE TAX GAP

The Board considers the existence of such a large tax gap to be an affront to honest taxpayers, and is pleased with the attention that Congress has focused on the tax gap in the last year, especially with the release of IRS latest tax gap estimates. The Board, along with many other members of the tax administration community,

⁵ Comptroller General David Walker, Testimony Before the Senate Budget Committee, “Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions,” February 15, 2006, GAO-06-453T.

⁶ Nina E. Olson, National Taxpayer Advocate, Testimony Before the Senate Subcommittee on Federal Financial Management, Government Information, and International Security Committee on Homeland Security and Governmental Affairs, October 26, 2005.

⁷ Tax Notes, February 16, 2006.

⁸ Charles O. Rossotti, “Many Unhappy Returns: One Man’s Quest to Turn Around the Most Unpopular Organization in America”, Harvard University Press, 2005. p. 278.

⁹ Al Crenshaw, “Letting Cheaters Prosper,” Washington Post, April 14, 2004.

believe that reducing the tax gap requires a comprehensive, multi-faceted plan with action on many fronts—from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

Such an approach needs to be more thoughtful and comprehensive than merely increasing IRS resources and expecting that the gap will shrink. That being said, however, increased IRS resources are a part of the solution. A successful strategy will encompass several separate but interrelated approaches that will reinforce each other to produce the desired result. In the Board's opinion, a number of actions that can be taken will require additional IRS resources.

The Board supports six strategies that it believes would constitute an over-arching plan to reduce the tax gap. This information is presented here only to provide some additional background to understand the Board's fiscal year 2007 budget recommendations, so that these recommendations can be understood in the context of an overall approach where the individual elements reinforce each other.

The first is a simplified tax code. Our complex and ever changing tax code not only confounds honest taxpayers who want to comply with their obligations under the law, but provides ample opportunity for those who exploit its complexity to cheat. The President's Advisory Panel on Federal Tax Reform observed:

"Since the last major reform effort in 1986, there have been more than 14,000 changes to the tax code, many adding special provisions and targeted tax benefits, some of which expire after only a few years. These myriad changes decrease the stability, consistency, and transparency of our current tax system while making it drastically more complicated, unfair, and economically wasteful. Today, our tax system falls well short of the expectations of Americans that revenues needed for government should be raised in a manner that is simple, efficient, and fair."¹⁰

Second, the Oversight Board recommends improved information reporting and enforcement tools to address large areas of the tax gap related to what has been called the cash economy. Although the Board is prohibited by statute from endorsing any specific proposal, we note that in its fiscal year 2007 budget submission for the IRS, the administration makes five legislative recommendations to close the tax gap that include: (1) increasing information reporting on payment card transactions; and (2) expanding information reporting to certain payments made by Federal, State and local governments to procure property and services. They certainly merit congressional discussion and consideration.

The National Taxpayer Advocate also recommended in her 2005 Annual Report to Congress that the IRS create a cash economy program office, similar to the Earned Income Tax Credit program office. The Board is pleased that the IRS Small Business/Self-Employed Operating Division Commissioner has agreed to establish a task force on the cash economy that will seek to determine the feasibility of this and other recommendations.

In testimony before the Senate Budget Committee, the National Taxpayer Advocate further recommended that to address the tax gap "we should begin by identifying various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose."¹¹ The Board supports such analysis.

Third, the Board believes that the IRS must improve customer service to make taxpayers aware of their legal obligations and ease taxpayer burden through modernization. Indeed, not all non-compliance is willful; a significant amount of it is due to the complexity of the tax laws that results in errors. IRS Commissioner Mark Everson recently testified:

"[T]he tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, though, at this point, we do not have sufficiently good data to help us know how much arises from willfulness as opposed to innocent mistakes. This is an area where we expect future research to improve our understanding."¹²

Fourth, there should be a much greater emphasis and focus on research so the IRS can more effectively target areas of major non-compliance. It bears mentioning

¹⁰Statement by the Members of the President's Advisory Panel on Federal Tax Reform, "America Needs a Better Tax System," April 13, 2005.

¹¹National Taxpayer Advocate, "Testimony Before the Senate Budget Committee, Causes and Solutions to the Federal Tax Gap," February 15, 2006.

¹²IRS Commissioner Mark Everson, Testimony Before the Senate Budget Committee, February 15, 2006.

that a lack of research in the 1990's contributed in part to the IRS's failure to detect the emergence and subsequent epidemic of illegal tax avoidance schemes. The Board recommends an additional \$60 million in funding for research. The IRS needs to know much more about non-compliance than it currently does to mount a successful campaign against the tax gap.

Fifth, the Board urges a more productive partnership between IRS and the tax administration community. At the Board's 2006 open meeting, the AICPA supported the IRS's efforts to partner with professional organizations in the area of pro bono tax assistance, noting that such a synergy provides the IRS with the opportunity to leverage precious resources and increase customer service at the same time. The Board would add that such a partnership also contributes directly to compliance.

Sixth, there must be more emphasis on personal integrity in making tax decisions. The Board has found that the vast majority of taxpayers state that their personal integrity is a very important factor in influencing their tax compliance. In the Board's most recent Taxpayer Attitude Survey, 82 percent of taxpayers cite personal integrity as the principal factor for reporting and paying their taxes honestly. Commissioner Everson also testified at the Senate Budget Committee tax gap hearing:

"[A]nother enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures."¹³

Our tax administration system should challenge taxpayers to be conscious of the need for integrity when making tax decisions.

The Oversight Board recognizes that no single initiative or program will solve the tax gap—a multi-faceted effort must be taken to shrink it. The plan must be more comprehensive than just applying additional resources to do more of what is being done today. Indeed as Commissioner Everson told the Senate Budget Committee, a combination of appropriate funding, legislative changes, new enforcement tools, tax simplification and auditing and taxpayer service improvements, will allow the IRS to collect an additional \$50 billion to \$100 billion.¹⁴ The \$705 million in additional funding recommended by Board to help in this effort is dwarfed in comparison to this estimate of new revenues collected.

COMPARING THE PRESIDENT'S AND BOARD'S FISCAL YEAR 2007 BUDGET RECOMMENDATIONS

The size of the tax gap should be a clarion call for our Nation to examine the tax administration system and invest time, energy, and resources to making it better.

This is not the time to stand still but to move forward in a comprehensive and unified way to build on what has already been accomplished and give America's taxpayers a better, more efficient and fair system in return—what the President's tax reform panel suggested. The Oversight Board's fiscal year 2007 budget recommendations focus on the IRS resources needed to move forward in fiscal year 2007, but much more needs to be done.

To this end, the Board recommends additional investments in better service, enforcement, infrastructure and management, and BSM in the following amounts:

- Taxpayer Service—\$43,637.
- Enforcement—\$367,768.
- Infrastructure and Management—\$104,715.
- BSM—\$188,600.

Additionally, the Oversight Board has identified two areas of significant risk in the IRS's fiscal year 2007 budget request. First, the IRS budget justification includes \$84.1 million in savings coming from program efficiencies. The Board is concerned that the IRS may not be able to achieve these efficiencies without decreasing performance.

Second, the proposed IRS budget for fiscal year 2007 in direct appropriations is supplemented by \$135 million in increased user fees. The IRS announced last December that it would charge taxpayers for receiving advance assurance from the IRS

¹³ Everson, *op. cit.*

¹⁴ Tax Notes, "Everson Says IRS Could Collect Up To \$100 Billion More Per Year", February 16, 2006.

about the tax consequences of certain transactions. For example, the fee for IRS Chief Counsel private letter rulings will increase from \$7,000 to \$10,000.¹⁵

The Oversight Board believes that there is risk in assuming that this revenue stream will be available without a proven record of collecting fees at this level, especially since the IRS could not present the Board with fiscal year 2006 data to confirm the realism of the proposed fiscal year 2007 revenue stream. The Board recommends that Congress evaluate actual fiscal year 2006 fee collection data to evaluate the validity of the proposed fiscal year 2007 revenue expected from increased fees.

The Board is also concerned about the negative impact these fees might have on taxpayer compliance. Testifying at the Board's annual public meeting, the AICPA was also apprehensive that these increases will result in a substantial reduction in general taxpayer use of critical IRS programs:

"These programs for the most part encourage taxpayers to seek advance assurance from the IRS that the tax consequences of their proposed actions will be treated consistently by both the taxpayer and the IRS. Actions by the IRS that discourage use of programs, such as private letter ruling requests, could result in greater compliance costs for taxpayers and enforcement costs for the IRS."¹⁶

Customer Service: What Is "Good Enough?"

Good customer service leads to fully informed and satisfied taxpayers who understand their tax obligations and experience few problems in interacting with the IRS. Clearly, there is a linkage between customer service and compliance. Speaking at the Board's 2006 open meeting, Diana Leyden, Associate Clinical Professor of Law, University of Connecticut School of Law Tax Clinic said:

"Customer service at the Internal Revenue Service has a direct impact on voluntary compliance and ultimately on the tax gap. For example: (1) making it easier for taxpayers to get their returns prepared free of charge and quickly encourages taxpayers to become compliant; (2) providing face-to-face interaction with IRS employees helps taxpayers get advice in 'real time' and usually reduces the time for resolution of problems."¹⁷

At the April 14, 2005 Senate Finance Committee hearing on closing the tax gap, Ranking Member Max Baucus similarly observed:

"The IRS cannot close the tax gap simply by increasing enforcement. Issuing more liens. Conducting more seizures. Levying more bank accounts. We do need targeted, appropriate enforcement. If, however, the IRS lets taxpayer service slide—if the IRS diminishes the access and accuracy of taxpayer service—including the essential need for face-to-face taxpayer service—then we fail to help taxpayers comply with the law on the front end. Ensuring up front quality is more efficient than back end enforcement."¹⁸

However, efforts to provide quality customer service are hindered by the fact that there is no consensus among the tax administration community on desired customer service standards of performance, which makes informed decision-making about desired levels of service very difficult. Achieving such a consensus among the executive and legislative branches and external stakeholder organizations would allow customer service requirements to influence budget decisions rather than having budget decisions set service levels.

The drive for improved customer service is further aggravated by the lack of data on the impact that service levels have on taxpayer compliance. Such data could be used to make a stronger case to policy makers about the importance of customer services. We should not retreat from the high customer service levels previously achieved during fiscal year 2003/2004. Two initiatives contained in the Board's budget are designed to prevent such a reduction.

First, although significant progress has been made during the past 5 years, toll-free telephone level of service is slightly down from fiscal year 2004 and call wait-time on hold has increased. To restore the level of service, the Oversight Board proposes an initiative to restore the toll-free telephone service to fiscal year 2003/2004

¹⁵ IRS Press Release, "IRS to Raise Some User Fees in 2006," IR-2005-144, December 19, 2005.

¹⁶ AICPA, Statement Presented to the IRS Oversight Board, "Meeting the Customer Service Needs of Taxpayers and the Importance of Measures", February 8, 2006.

¹⁷ Statement of Diana Leyden, Associate Clinical Professor of Law, University of Connecticut School of Law Tax Clinic Before the IRS Oversight Board, February 8, 2006.

¹⁸ Senator Max Baucus, Opening Statement, Senate Finance Committee, Hearing, April 14, 2005.

levels. Although the cost is \$35 million, the Board believes that this level of service should be provided to taxpayers. The potential impact of lower service is that taxpayers will not get the assistance they need, hurting compliance, and creating a need for additional enforcement. As Senator Baucus rightly observed, preventing problems is more cost-effective than the price of future corrections, such as collection.

Second, the Board also recommends an \$8.7 million investment in telephone infrastructure to expand services to callers and provide telephone representatives with a more state-of-the-art call center environment. The IRS predicts this investment would result in lower queue times across the enterprise for all applications and would counter a negative trend in telephone service. (Wait time on hold for taxpayers has been increasing in the last 3 years. It has gone from 158 seconds in fiscal year 2004 to 258 seconds in fiscal year 2005, and the fiscal year 2006 target is 300 seconds.)

Enforcement Must Continue to Improve; More Research Needed

As noted earlier in this report, the IRS has boosted its enforcement activity, and enforcement revenue has increased during the last 2 years. The IRS is working smarter and it needs to continue to improve and build on this important trend.

However, it should be noted that despite these positive results, it is difficult to evaluate the impact that increased enforcement activity has had on overall taxpayer compliance.

Absent this information, the Oversight Board still believes that one important element of the campaign to reduce the tax gap should be increasing IRS enforcement resources, especially since the application of additional resources has a positive return on investment. The Board recommends a modest increase in enforcement resources in virtually all IRS enforcement activities, including:

- 1. *Combat Egregious Non-Compliance and Prevent Tax Gap Growth (+\$136 million).*—Add 748 FTEs to enhance coverage of high-risk compliance areas and address the tax gap associated with small business and self-employed taxpayers.
- 2. *Intensify Tax Enforcement (+\$28 million).*—Add 86 FTEs to curtail non-compliance in abusive schemes, corporate fraud, non-filers, employment tax and Bank Secrecy Act.
- 3. *Attack Fraudulent Payments (+\$27 million).*—Add 62 FTEs to address fraudulent payments made through the EITC program.

The IRS must also do a better job of identifying where non-compliance is occurring. For example, IRS data indicates impressive results on abusive, high-profile tax shelters, such as Son-of-BOSS. However, the most recent research indicates that a majority of the tax gap is the result of underreporting of income in areas where there is little third-party reporting.

According to the IRS's National Research Program, half (\$109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent (\$56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining \$32 billion came from overstated subtractions from income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits.

Given this situation, the Oversight Board believes that special attention should be placed on the National Research Program and additional research be conducted on customer service and its relation to compliance. Indeed, the National Taxpayer Advocate "recommends that the IRS undertake a research-driven needs-assessment, from the taxpayers' perspective, to help identify what services taxpayers need and want and how best to deliver them."¹⁹ These efforts are necessary to improve tax administration to the point where the effects of IRS activities on taxpayer compliance can be better understood. To this end, the Board proposes two research initiatives: (1) Improve Tax Gap Estimates (+\$46 million); and (2) Additional Customer Service Research (+\$15 million).

The first of these two initiatives, Improve Tax Gap Estimates, will establish permanent staffing for the NRP program and put the IRS on a path to conducting research annually. The Oversight Board recommends that the NRP be made a permanent program. The NRP is now reporting estimates of the tax gap based on 2001 tax returns. Prior estimates were based on extrapolations of 1988 data. It is time to progress from "catching up" to making current research the normal and preferred way of doing business.

¹⁹The National Taxpayer Advocate, 2005 Annual Report to Congress, Executive Summary, p. I-1.

The Board also proposes that the IRS consider developing a long-range strategic plan for research that goes beyond the current 2009 end date for the IRS Strategic Plan, and covers approximately a decade. In such a plan, the IRS should describe how it will bring its research on all taxpayer segments up to date, and perform a limited sample every year so that its research on all segments will be as current as possible.

The Board believes the availability of up-to-date research data will allow the IRS to more effectively focus its service and enforcement programs on areas that have the greatest impact on taxpayer compliance, and use the changes in taxpayer compliance rates as feedback to evaluate the effectiveness of IRS's service and enforcement program on actual taxpayer compliance. Achieving such a capability will be a vast improvement over the current situation in which the lack of data makes it virtually impossible to evaluate the effectiveness of IRS activity on taxpayer compliance and make informed decisions.

The second research initiative recommended by the Board is to add \$15 million to begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers. The need for such research is also consistent with recommendations made by Treasury Inspector General for Tax Administration and the National Taxpayer Advocate in testimony last year to the Senate Appropriations Committee on the closing of a number of Taxpayer Assistance Centers. (The committee has also requested TIGTA to evaluate the connection between service and compliance in its study of TAC closings, but TIGTA was unable to find much existing research.)

However, the IRS has told the Oversight Board that it could extend and update research efforts in two major areas: evaluating the service needs of taxpayers and estimating the effect of customer service on taxpayer compliance. Additional resources in fiscal year 2007 would be used to further evaluate the service needs of taxpayers and to scope and design the data gathering and analysis capability to estimate the effect of customer service on taxpayer compliance.

A modest initial effort should include identifying promising areas of research and determining data needs. If the initial efforts are promising, this could be expanded in future years. Due to the long-term nature of these studies, resources should be provided on a multi-year basis.

Modernizing Infrastructure and Management

The Oversight Board is pleased that the IRS is developing an IRS Infrastructure Roadmap. It is a detailed plan for replacing the agency's aging IT equipment in an orderly and cost-effective manner. Rather than replacing outdated equipment on a one-for-one basis, the roadmap will identify and prioritize opportunities to consolidate equipment, retire redundant and low-demand infrastructure components, and replace old equipment with new technology that is cheaper to maintain and use. Because the IRS fully anticipates that the Infrastructure Roadmap will identify new strategies for IT infrastructure delivery that will mitigate the cost of replacing old IT equipment while assuring a sound IRS IT infrastructure, the Board is deferring any recommendations on modernizing IT infrastructure until fiscal year 2008.

The Oversight Board does recommend funding infrastructure and management initiatives that will assist the IRS to cope with unfunded mandates, implement BSM projects, and restore its capacity for leadership development training to fiscal year 2003 levels:

- 1. Fund Business Unit IT Solutions (Non-Major Investments);
- 2. Implement e-Travel;
- 3. Fund HR Connect;
- 4. Consolidate Philadelphia Campus (included in the President's budget); and,
- 5. Restoration of Leadership Development Training to fiscal year 2003 levels (Board-initiated).

The Board notes that a lack of leadership training capacity at the IRS is especially critical during a period in which approximately 50 percent of IRS managers are eligible for retirement. The Board recommends a consistent budget base to allow planning for these anticipated leadership development training needs.

The requested funds would enable the IRS to: (1) eliminate the backlog of untrained leaders at all levels by the end of fiscal year 2007; (2) ensure enough capacity to train new managers upon selection in all Business Units; (3) improve and expand readiness programs to provide a cadre of manager candidates to step up to management positions; (4) revise the management curriculum to incorporate more e-learning and promote continuous learning; and (5) evaluate the effectiveness and impact of the leadership development training program.

Funding Leadership Development Training at fiscal year 2003 levels will also assist in meeting the objectives of the President's Management Agenda, which in turn

will improve performance and the IRS's objectives of enhanced employee engagement, employee satisfaction and customer satisfaction.

Business Systems Modernization

The Board is pleased that the IRS's once-troubled BSM program experienced better performance in fiscal year 2005. In a recent report submitted to Congress on the BSM fiscal year 2006 expenditure plan, the Government Accountability Office offered these positive comments:

"IRS has made further progress in implementing BSM . . . Future BSM project deliveries face significant risks and issues which IRS is addressing . . . IRS has made additional progress in addressing high-priority BSM program improvement initiatives. [They] appear to be an effective means of assessing, prioritizing, and addressing BSM issues and challenges . . . In response to our prior recommendations, IRS reports having efforts under way to develop a new Modernization Vision and Strategy to address a new modernization roadmap.²⁰

GAO also had some criticism of the IRS and BSM, but improved management focus over the past few years has helped the BSM program deliver within cost and budget targets important technology projects that will generate greater efficiencies throughout the agency and real world benefits for taxpayers.

The first taxpayers have already been moved to a modernized data base known as the Customer Account Data Engine (CADE) and corporate taxpayers are now able to file their income tax returns with the IRS electronically using the Modernized e-File system. Indeed, CADE will process more than 30 million returns in 2007 and will process 70 million by 2009. Daily updates by CADE will allow taxpayers to receive their refund in just a few days.

Future BSM deliverables are also critical to improved customer service and enforcement. The IRS does not yet offer products and services familiar to customers of many financial institutions, such as daily updating of accounts, electronic access by customers to account records, and a full range of electronic transactions. However, with the help of modern technology, the IRS can close this gap.

If the IRS can continue to demonstrate improvement, it would seem desirable and logical to increase BSM's pace and program funding in fiscal year 2007, especially as BSM funding levels were severely reduced in the last several years: from \$388 million in fiscal year 2004 to \$203 million in fiscal year 2005, and a requested \$199 million in fiscal year 2006. In addition to the base, the Board would fund:

- 1. Web-based Self-service (+ \$24 million);
- 2. Filing and Payment Compliance (+ \$30 million);
- 3. Modernized e-Filing (+ \$70 million);
- 4. Customer Account Date Engine (+ \$25 million);
- 5. Core Infrastructure (+ \$18 million);
- 6. Architecture, Integration, and Management (+ \$13 million); and,
- 7. Management Reserve (+ \$9 million).

Therefore, the Board recommends that the BSM program move forward at an accelerated pace. Not only will this allow the IRS to operate more efficiently and effectively, it will strengthen the agency's efforts to enforce the tax law and improve customer service. Despite productivity improvements in recent years, the IRS is still hampered in its efforts to modernize because of its reliance on a 40-year-old information system for its central recording-keeping functions, which limit the IRS to weekly updates of its central taxpayer records. No modern financial institution in the private sector could survive under these conditions, and eliminating these limitations is key to making the IRS an efficient and effective modern financial institution.

We would like to make one last point on modernization. Both GAO and TIGTA have reported on the cost overruns and delays the BSM program has experienced. However, one cost you will not hear about is the significant cost to the taxpayers of delaying the benefits of a modernized IRS.

Professor Joel Slemrod of the University of Michigan testified to the President's Advisory Panel on Federal Tax Reform that individual taxpayers spend approximately \$85 billion a year complying with the tax code.²¹ If a modernized IRS makes

²⁰ General Accountability Office, Report to Congress, "Business Systems Modernization: Internal Revenue Service's fiscal year 2006 Expenditure Plan," February 2006, GAO-06-360, pp. 2-3.

²¹ Statement of Professor Joel Slemrod, University of Michigan Ross School of Business, before the President's Advisory Panel on Federal Tax Reform, March 3, 2005.

taxpayers only 5 percent more efficient, that would still save taxpayers over \$4 billion a year.

CONCLUSION

The IRS Oversight Board believes that it has constructed a fiscally responsible and realistic budget for the IRS that meets national needs and priorities. It would help shrink the tax gap while providing taxpayers with a level of service they rightly deserve and need. It would speed the modernization of the IRS's antiquated technology and give it the research tools to better understand current and developing trends. Most importantly, it would maintain that delicate but critical balance between enforcement and customer service that America's taxpayers have said time and again they want. The IRS is now solidly on the right track and is making progress but we must give it the resources to do its job. It is an investment we must make for this and future generations of taxpayers.

Appendices.—(1) Comparison of the Administration's IRS Fiscal Year 2007 Budget Request and IRS Oversight Board Recommendation; (2) Recommended Fiscal Year 2007 Program Increases: Enforcement; (3) Recommended Fiscal Year 2007 Program Increases: Taxpayer Service; (4) Recommended Fiscal Year 2007 Program Increases: Infrastructure and Management Modernization; (5) Recommended Fiscal Year 2007 Program Increases: Business Systems Modernization; (6) Explanation for Difference in IRS Oversight Board Budget in the Administration's Fiscal Year 2007 Budget Request and This Recommendation.

APPENDIX 1

COMPARISON OF THE ADMINISTRATION'S IRS FISCAL YEAR 2007 BUDGET REQUEST AND IRS OVERSIGHT BOARD RECOMMENDATION

[Dollars in thousands]

| Final Board Budget | Board's Budget | President's Budget | Difference |
|---|----------------|--------------------|------------|
| Fiscal Year 2006 Enacted Budget (with 1 percent rescission) | \$10,573,706 | \$10,573,706 | ..... |
| Fiscal Year 2007 Maintaining Current Levels (MCLs) Adjustments (includes HITCA): | | | |
| Labor Annualization | \$61,994 | \$61,994 | ..... |
| Labor MCL (2.7 percent) | \$149,819 | \$149,819 | ..... |
| Non-Labor MCL (1.5 percent) | \$60,418 | \$60,418 | ..... |
| Total MCL Adjustments | \$272,231 | \$272,231 | ..... |
| Base Reinvestment: | | | |
| Increase Returns processing efficiencies | \$12,237 | \$12,237 | ..... |
| Program Cost Savings: | | | |
| E-file savings | (\$6,760) | (\$6,760) | ..... |
| Improvement project savings | (\$8,215) | (\$8,215) | ..... |
| Competitive sourcing savings | (\$17,000) | (\$17,000) | ..... |
| Program efficiencies | (\$84,121) | (\$84,121) | ..... |
| HITCA program efficiency | (\$5,500) | (\$5,500) | ..... |
| Total Savings and Reinvestments | (\$121,596) | (\$121,596) | ..... |
| Transfer Out to TIGTA | (\$941) | (\$941) | ..... |
| Total, Fiscal Year 2007 Current Service Level | \$10,735,637 | \$10,735,637 | ..... |
| Program Increases: | | | |
| Tax Administration Operations: | | | |
| Taxpayer Service | \$43,637 | ..... | \$43,637 |
| Enforcement | \$367,768 | ..... | \$367,768 |
| Infrastructure and Mgt Modernization | \$104,715 | \$20,900 | \$83,815 |
| Business Systems Modernization | \$188,600 | (\$29,700) | \$218,300 |
| Total, Program Increases Above Fiscal Year 2006 Current Service Level | \$704,720 | (\$8,800) | \$713,520 |
| Total, Fiscal Year 2007 Operating Level | \$11,440,357 | \$10,726,837 | \$713,520 |

COMPARISON OF THE ADMINISTRATION'S IRS FISCAL YEAR 2007 BUDGET REQUEST AND IRS
OVERSIGHT BOARD RECOMMENDATION—Continued

[Dollars in thousands]

| Final Board Budget | Board's Budget | President's Budget | Difference |
|---|----------------|--------------------|------------|
| Fee Adjustment | (\$135,000) | (\$135,000) | ..... |
| Fiscal Year 2007 Budget Appropriation Request | \$11,305,357 | \$10,591,837 | \$713,520 |
| Growth Over Fiscal Year 2006 Enacted Budget | \$731,651 | \$18,131 | \$713,520 |
| Percent Growth | 6.9 | 0.2 | ..... |

APPENDIX 2

RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: ENFORCEMENT

[In thousands of dollars]

| Enforcement Program Increases | Total | Enforcement- Related | Service-Related |
|--|---------|-------------------------|-----------------|
| <i>Combat Egregious Non-Compliance and Prevent Tax Gap Growth.</i> —This initiative provides an increase of 748 FTE and \$135.5 million to enhance coverage of high-risk compliance areas as well as address the tax gap associated with small business and self-employed taxpayers | 135,518 | 132,696 | 2,822 |
| <i>Increase Individual Taxpayer Filing and Payment Compliance.</i> —The initiative provides 84 FTE (87 positions) and \$8 million to support the IRS's enforcement presence through contracts with Private Collection Agencies (PCAs) for Qualified Tax Collection Contracts | 7,773 | 6,968 | 805 |
| <i>Detect and Deter Non-Compliant Enterprise Structures.</i> —This initiative provides an increase of 200 FTE (400 positions) and \$37 million to increase the coverage of the flow-through population, including examination of controlling enterprise entities, that are posing significant compliance risks | 37,008 | 37,008 | ..... |
| <i>Increase Individual Taxpayer Reporting Compliance.</i> —This initiative provides an increase of 100 FTE (125 positions) and \$10.8 million to enable the Automated Underreporter (AUR) program to address reporting compliance in a program that is effective, efficient, less labor intensive and less costly | 10,821 | 8,808 | 2,013 |
| <i>Enhance Enforcement in the Tax-Exempt and Governmental Sectors.</i> —This initiative requests an additional 69 FTE (138 positions) and \$12,940,668 to improve detection of compliance risks, accelerate enforcement actions, and balance the pursuit of critical enforcement initiatives while maintaining adequate coverage of the exempt community | 12,941 | 12,941 | ..... |
| <i>Intensify Tax Enforcement.</i> —This initiative requests an increase of 86 FTE (172 positions) and \$27.6 million to curtail non-compliance in the following areas: abusive schemes, corporate fraud, non-filers, employment tax and Bank Secrecy Act (BSA) | 27,570 | 27,570 | ..... |
| <i>Attack Fraudulent Payments.</i> —This initiative, which provides an increase of 62 FTE (123 positions) and \$27 million, relates directly to the President's Management Agenda Program Initiative "Eliminating Improper Payments," and also supports the IRS's strategies for addressing erroneous payments and non-compliance involving Earned Income Tax Credits (EITC) | 26,998 | 26,837 | 161 |
| <i>Improve Compliance With the Bank Secrecy and PATRIOT Acts.</i> —This initiative provides an increase of 124 FTE (248 positions) and \$25.9 million to improve the Bank Secrecy Act (BSA) compliance program | 25,858 | 25,858 | ..... |

RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: ENFORCEMENT—Continued

[In thousands of dollars]

| Enforcement Program Increases | Total | Enforcement-Related | Service-Related |
|--|---------|---------------------|-----------------|
| <i>Strengthen Regulatory Compliance.</i> —This initiative provides an increase of 38 FTE (76 positions) and \$6.6 million to strengthen regulatory compliance activities to deter fraud, abuse, and terrorist financing in the tax exempt and governmental entities community | 6,616 | 6,376 | 241 |
| <i>Improve Enforcement of Circular 230.</i> —This initiative provides an increase of 8 FTE (16 positions) and \$4.1 million to detect and address tax practitioner misconduct. The IRS, Treasury, and Congress are placing increased emphasis on practitioner misconduct by providing new statutory and regulatory tools to address abusive behavior | 4,104 | 4,104 | ..... |
| <i>Improve Tax Gap Estimates, Measurement and Detection of Non-Compliance.</i> —Supports 268 FTE (536 positions) and \$45.9 million to fund and support ongoing Reporting Compliance Studies through the National Research Program | 45,942 | 45,942 | ..... |
| <i>Study EITC Compliance.</i> —This initiative provides an increase of 49 FTE (65 positions) and \$6.8 million to develop estimates of Earned Income Tax Credit compliance | 6,822 | 6,822 | ..... |
| <i>Improve Compliance Through Data-Driven Workload Identification.</i> —This initiative provides an increase of 67.5 FTE (90 positions) and \$4.8 million to develop and test decision analytical tools and models for improved identification of high-risk filers | 4,796 | ..... | 4,796 |
| <i>Customer Service Research.</i> —Begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers | 15,000 | 15,000 | ..... |
| Subtotal Enforcement | 367,768 | 356,931 | 10,837 |

APPENDIX 3

RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: TAXPAYER SERVICE

[In thousands of dollars]

| Taxpayer Service Program Increases | Total | Enforcement-Related | Service-Related |
|---|--------|---------------------|-----------------|
| <i>Increase Accounts Management Efficiencies.</i> —Provides funding to improve the telephone infrastructure, e.g., Compliance Services and Accounts Management call centers, by expanding services to customers and providing telephone representatives with a more state-of-the-art center environment and providing taxpayers with improved service through multiple access channels. Enterprise queuing will eliminate the queuing of calls at the local level and be queued at the enterprise level, reducing taxpayer wait times | 8,657 | ..... | 8,657 |
| <i>Restore Customer Service to Fiscal Year 2004 Levels.</i> —Supports 450 FTE from W&I to restore telephone level of service back to 87.3 percent achieved in fiscal year 2004 rather than the current 82 percent target. Improves TE/GE service measures for EP and EO determination timeliness, CAS toll-free level of service, correspondence timeliness measures to fiscal year 2004 levels | 34,980 | ..... | 34,980 |
| Subtotal: Taxpayer Service | 43,647 | ..... | 43,647 |

APPENDIX 4

RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: INFRASTRUCTURE AND MANAGEMENT MODERNIZATION

[In thousands of dollars]

| Infrastructure and Mgt Modernization Program Increases | Total | Enforcement-Related | Service-Related |
|--|---------|---------------------|-----------------|
| <i>Expand IT Security—Personal Identity Verification.</i> —This initiative requests an increase of \$20 million to ensure IRS's compliance with Homeland Security Policy Directive-12 (HSPD-12) and Federal Information Processing Standards-201 (FIPS-201) | 20,000 | 12,576 | 7,424 |
| <i>Close Financial Management Material Weaknesses—Custodial Detail Data Base.</i> —This initiative provides \$4.7 million to develop the CFO Custodial Detail Data Base (CDDDB) which will establish the foundation for building an IRS-modernized custodial financial management system | 4,743 | 2,982 | 1,761 |
| <i>Fund Modernization Information Systems (Major Investments) O&M.</i> —This initiative will result in modernized information systems to improve enforcement activities | 15,000 | 9,432 | 5,568 |
| <i>Fund Business Unit IT Solutions (Non-Major Investments) O&M.</i> —This initiative provides an increase of \$15 million for the successful transition of Business Systems Modernization (BSM) projects to the Current Production Environment (CPE), funding their operations and maintenance as they move to full production | 9,972 | 7,121 | 2,851 |
| <i>Implement e-Travel.</i> —Treasury has mandated that IRS must implement e-Travel by October 1, 2006 | 10,000 | 6,288 | 3,712 |
| <i>Fund HR Connect.</i> —The initiative requests \$11.9 million in fiscal year 2007 to fully fund the additional Operations and Maintenance cost associated with the HR Connect system that the IRS has implemented and is billed through the Treasury's Working Capital Fund | 11,900 | 7,482 | 4,418 |
| Consolidate Philadelphia Campus | 20,900 | 14,215 | 6,685 |
| <i>Restoration of Leadership Training to Fiscal Year 2003 Levels.</i> —The requested funds would enable the IRS to: (1) eliminate the backlog of untrained leaders at all levels by the end of fiscal year 2007; (2) ensure enough capacity to train new managers upon selection in all Business Units; (3) improve and expand readiness programs to provide a cadre of manager candidates to step in to management positions; (4) revise the management curriculum to incorporate more e-learning and promote continuous learning; and (5) evaluate the effectiveness and impact of the leadership training program | 12,200 | 7,564 | 4,636 |
| Subtotal Modernization | 104,715 | 67,660 | 37,055 |

APPENDIX 5

RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: BUSINESS SYSTEMS MODERNIZATION

[In thousands of dollars]

| Business Systems Modernization Program Increases | Total |
|---|--------|
| <i>Web-based Self Service.</i> —Identify and design initial set of internet self-service applications | 24,200 |
| <i>Filing & Payment Compliance (F&PC).</i> —Completes delivery of full capability needed to support Private Collection Agencies | 30,000 |
| <i>Modernized e-file (MeF).</i> —Funds development, testing and deployment of modernized electronic filing for Form 1040 | 70,200 |
| <i>Customer Account Data Engine (CADE).</i> —Process 33 million returns for the fiscal year 2007 filing season | 25,000 |

RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: BUSINESS SYSTEMS
MODERNIZATION—Continued

[In thousands of dollars]

| Business Systems Modernization Program Increases | Total |
|---|---------|
| <i>Core Infrastructure Projects.</i> —Improve the facilities which allow pre-deployment testing and integration of modernized systems, which help ensure modernized systems will operate as needed when they are deployed | 17,900 |
| <i>Architecture, Integration & Management.</i> —Ongoing support and improvements to BSM's program with planning, engineering, and management activities | 12,800 |
| Management Reserve | 8,500 |
| Subtotal BSM | 188,600 |

APPENDIX 6

EXPLANATION FOR DIFFERENCE IN IRS OVERSIGHT BOARD BUDGET IN THE
ADMINISTRATION'S FISCAL YEAR 2007 BUDGET REQUEST AND THIS RECOMMENDATION

After the Board-approved budget is submitted to the Department of Treasury, it is reviewed and modified by both the Treasury Department and the Office of Management and Budget (OMB) before being incorporated into the President's budget. During the first several years of IRS Oversight Board operation, the Treasury Department would inform the Oversight Board of changes as the IRS budget progressed through the formulation process. However, for the past 2 years, the Treasury Department has taken the position that although RRA98 provides the Oversight Board with the responsibility of reviewing and approving the budget request prepared by the Commissioner and submitted to the Department of the Treasury, this authority does not include participating in subsequent budget decision adjustments and formulation of the President's Budget.

Consequently, changes in IRS requirements that occur after the Board approves the IRS budget are not provided to the Board, and can only be considered by the Board when the President's budget is made available to the public. The Board adjusted its previously approved budget to account for the following circumstances:

- The Board's initial fiscal year 2007 budget was based on the fiscal year 2006 President's request, not the enacted appropriation, and is adjusted to use the fiscal year 2005 enacted level as the base.
- The inflation factors for labor and non-pay inflation were not known to the Board when it first approved the IRS budget, and are adjusted to reflect the lower base as well as changes in rates.
- The IRS budget submitted to the Board identified approximately \$15 million in savings, which the Board approved. During subsequent reviews with the Treasury Department and OMB, the IRS identified an additional \$106 million in savings, for a total savings of \$121 million. The Board's budget is adjusted to reflect these additional savings, despite the Board's assessment that they may represent some risk.
- The IRS budget submitted to the Board did not identify any fee offsets, which were not yet authorized by Congress. The Board's budget is adjusted to reflect these offsets.
- The budget is adjusted to reflect the development of an IRS Infrastructure Blueprint to define a cost-effective approach to meeting IRS infrastructure needs and the elimination of the need to fund Kansas City growth in fiscal year 2007.

STATEMENT OF J. RUSSELL GEORGE

Senator BOND. Thank you very much, Chairman Wagner.

Now we turn to Treasury Inspector General for Tax Administration, or TIGTA, Mr. Russell George.

Mr. GEORGE. Thank you, Mr. Chairman.

Mr. Chairman, Ranking Member Murray, thank you for the opportunity to testify today regarding the 2007 appropriations for the Internal Revenue Service. Just over a year ago, I testified before you on the IRS's 2006 appropriations. Unfortunately, many of the challenges I discussed last year remain today.

At the outset, I am pleased to report that our reviews thus far have shown that the IRS has done a very good job responding to taxpayers affected by Hurricanes Katrina and Rita. Still, I remain concerned about the potential for fraudulent claims resulting from the response to those disasters. TIGTA will continue to monitor this effort.

I agree with the Commissioner's motto for customer service plus enforcement resulting in greater taxpayer compliance. Given its limited resources, the IRS is attempting to find the proper balance between these two important goals. The IRS proposed curtailing some levels of service, including closing 68 of its 400 taxpayer assistance service centers and reducing the hours of its toll-free telephone service from 15 hours a day to 12.

TIGTA is required to review these plans before they are implemented. We have examined the proposed TAC closures and concluded that the IRS did not have sufficient or reliable data to determine the effects of the proposed closures on taxpayers. One of our concerns about closures is that more taxpayers need to rely on the IRS's volunteer income tax assistance programs, which has significant problems in providing taxpayers with accurate answers. During the 2006 filing season, TIGTA made anonymous visits to both TACs and VITA sites to determine if taxpayers are receiving accurate assistance preparing their tax returns. We found that VITA volunteers accurately prepared tax returns at only 39 percent of the scenarios TIGTA presented to them, which was a slight improvement over last year's accuracy rate of 34 percent.

TIGTA also visited 50 Taxpayer Assistance Centers and posed 200 questions to determine if taxpayers received correct answers to their questions. TAC assisters correctly answered 73 percent of the questions we presented compared to 66 percent during the 2005 filing season. We visited another 20 TACs and posed 80 tax law questions specifically related to the Katrina Emergency Tax Relief Act. Assisters answered 75 percent of those questions correctly.

We are currently assessing the IRS's plans to reduce the operating hours of its toll-free telephone service. Thus far, we have found that the average speed of answering calls to this line is about 60 percent of the time that had been planned by the IRS.

Commendably, the IRS has seen a steady growth in the electronic filing of income tax returns over the last 3 years. While the IRS may not meet its mandated goal of having 80 percent of all tax returns E-filed by 2007, it has done a laudable job of providing helpful information on the internet and is anticipating that 54 percent of filed returns will be filed electronically this year; however, I am concerned that more taxpayers are not using the E-file services offered by the IRS. This year, the number of taxpayers E-filing from their home computers rose by just over 16 percent at the same time the number of taxpayers taking advantage of free online filing has fallen by 22 percent.

This drop may be the result of a change in the "Free File" agreement between the IRS and the Free File Alliance, a consortium of private sector companies that provide preparation software and transmit tax returns pursuant to the agreement. Although the intent of the program was to provide a free method of E-filing to taxpayers, the IRS and the Alliance amended the agreement. This

year, the agreement allowed only taxpayers with adjusted gross incomes of \$55,000 or less to use the service.

In addition, the IRS eliminated its telefile program for individual taxpayers in August 2005. This program allowed taxpayers the simplest tax returns, such as Form 1040EZ, to file by telephone. The alternative filing methods for these taxpayers included using Taxpayer Assistance Centers and VITA sites. They could also use a free-file program if they qualified, among other options. It appears, however, that many taxpayers who previously used the telefile system reverted to using paper tax returns.

We have also found that the IRS is attempting to address its major challenges; however, much more is required on its part. For example, while the IRS is making progress with the Business Systems Modernization program, BSM remains behind schedule, over-budget, and is not delivering all of the functionalities that were promised. In TIGTA's initial review of the IRS's plan to use private debt collectors, we found that the IRS has taken positive steps to implement certain aspects of the program. TIGTA is working closely with the IRS to address security concerns, the protection of taxpayers' rights and privacy, and the development of integrity and fraud awareness training for contract employees.

The last issue I will address is the tax gap, which the IRS has estimated at approximately \$345 million. TIGTA has evaluated the reliability of the IRS-developed tax gap figure, and in a report released just on Tuesday, we think concluded that the IRS still does not have sufficient information to accurately assess the overall tax gap and voluntary compliance rate. The IRS has significant challenges in attaining complete and timely data and in developing the methods for interpreting that data. We urge the Commissioner to continue this effort and have provided recommendations toward obtaining a more accurate assessment of this important measurement.

PREPARED STATEMENT

Mr. Chairman, Ranking Member Murray, Senator Durbin, I hope my discussion of the 2006 filing season and some of the significant challenges facing the IRS will assist you with your consideration of the budget, appropriations rather. Mr. Chairman and the subcommittee, thank you for allowing me to share my views. I will accept your questions at the appropriate time.

[The statement follows:]

PREPARED STATEMENT OF J. RUSSELL GEORGE

INTRODUCTION

Chairman Bond, Ranking Member Murray, and members of the subcommittee, I thank you for the opportunity to testify as you consider the fiscal year 2007 appropriations for the Internal Revenue Service (IRS). It was just over 1 year ago that I appeared before you to testify on the IRS's fiscal year 2006 appropriations. Since my prior testimony, significant events have affected tax administration including Hurricanes Katrina and Rita, which impacted thousands of taxpayers and required rapid responses from many departments and agencies, including the IRS.

When I testified before the subcommittee last year, I had only served as the Treasury Inspector General for Tax Administration (TIGTA) for a few short months. As I testify before the subcommittee today, I have been the TIGTA for 17 months. My four priorities as the TIGTA are to maintain our focus on IRS efforts to modernize its technology, enhance our ability to protect tax administration from corrup-

tion, assist the IRS with improving tax compliance initiatives, and monitor the IRS's use of private debt collection agencies. As the TIGTA, my observations are primarily based on the body of work my organization has developed through audits and investigations of the IRS. To assist you in your consideration of the IRS's fiscal year 2007 budget, I will focus on the 2006 Filing Season, electronic filing, the tax gap, customer service, the IRS's Private Debt Collection initiative and other major challenges facing the IRS.

THE 2006 FILING SEASON

Preparing for the Filing Season

Planning for the 2006 Filing Season was difficult for the IRS because of many tax law changes enacted late last year in response to unprecedented natural disasters. Disaster relief provisions were enacted into law for taxpayers affected by Hurricanes Katrina, Rita, and Wilma, and were intended to provide relief to over 11 million taxpayers who lived in the affected areas of the Gulf Coast, as well as to others who may have been adversely impacted by these storms.

This year, TIGTA reviewed 28 new tax law provisions and is also closely monitoring the implemented changes that are intended to assist taxpayers adversely affected by the 2005 hurricanes. New tax law provisions were included in the Katrina Emergency Tax Relief Act of 2005,¹ the Gulf Opportunity Zone Act of 2005,² and also in the Working Families Tax Relief Act of 2004³ and the American Jobs Creation Act of 2004,⁴ all of which became effective in 2005. The latest legislation, the Gulf Opportunity Zone Act of 2005, was signed into law on December 21, 2005.

TIGTA reviewed the IRS's preparation for the 2006 Filing Season and determined that the IRS accurately updated its tax products and computer programming to incorporate the tax law changes that became effective in 2005. TIGTA reviewed 42 tax forms, publications, and instructions that required updating, and determined that they were accurately updated. The IRS also accurately updated its computer programming and returns processing programs for the new tax law provisions and other adjustments or changes.⁵ TIGTA is continuing to monitor the IRS's processing of income tax returns during the 2006 Filing Season and will report its results later this year.

While planning for the 2006 Filing Season, the IRS considered the impact of Hurricanes Katrina and Rita. Specifically, the IRS accounted for all employees affected by the hurricanes and located alternate office space in affected areas. All Taxpayer Assistance Centers (TAC) in impacted areas were open and operational for the 2006 Filing Season. The IRS also added services to help lessen taxpayer burden, including tax return preparation for taxpayers affected by the hurricanes regardless of the income guidelines. Additionally, the scope of tax law topics in which assistors are trained was expanded to provide assistance to taxpayers with questions about casualty losses. Furthermore, the IRS will treat taxpayers affected by Hurricanes Katrina and Rita as meeting extreme hardship criteria. That designation allows affected taxpayers to request and immediately receive transcripts of prior year tax returns instead of having to order them and wait for delivery.

Processing Tax Returns

During the 2006 Filing Season, the IRS expected to process an estimated 135 million individual returns. So far, TIGTA has not identified any significant problems with the IRS's processing of individual tax returns. As of April 8, 2006, the IRS has received over 87.7 million returns. Of those, 57.7 million were filed electronically (an increase of 3.5 percent from this time last year), and 29.9 million were filed on paper (a decrease of 7.1 percent from 2005). Additionally, \$164.5 billion in refunds have been timely issued. Of this amount, \$124.3 billion were directly deposited to taxpayer bank accounts, an increase of 9.3 percent compared to last year.

Providing Quality Customer Service

While the IRS continues to face longstanding challenges, it deserves recognition for making progress in an area that will always be a challenge: providing quality customer service to the American taxpayer. Providing quality customer service is the first component of Commissioner Everson's principle for the IRS, Serv-

¹Public Law No. 109-73, 119 Stat. 2016 (to be codified in scattered sections of 26 U.S.C.).

²Public Law No. 109-135, 119 Stat. 2577 (2005).

³Public Law No. 108-311, 118 Stat. 1166 (2004).

⁴Public Law No. 108-357, 118 Stat. 1418 (2004).

⁵Draft Report "Tax Products and Computer Programs for Individual Income Tax Returns Were Accurately Updated for the 2006 Filing Season" (Audit No. 200640015, date April 24, 2006).

ice + Enforcement = Compliance. Over the past few years, TIGTA audits have shown that the IRS has improved customer assistance in its face-to-face, toll-free telephone, tax return processing, and electronic services, including the IRS public Internet site (www.irs.gov).

Furthermore, it is encouraging to note that the IRS took numerous actions to provide broad relief to taxpayers affected by Hurricanes Katrina and Rita. These broad relief efforts included postponing deadlines for filing and payment, providing relief from interest and penalties, and waiving some low-income housing tax credit rules. The IRS also waived the usual fees and expedited requests for copies of previously filed tax returns for affected taxpayers that need them to apply for benefits or file amended tax returns to claim casualty losses.⁶

IRS employees also provided tax assistance at Federal Emergency Management Agency (FEMA) Disaster Assistance Sites in a number of locations. Additionally, the IRS assigned 5,000 employees to augment Federal Government telephone call sites and provided additional employees to assist in approximately 34 FEMA disaster recovery centers in 13 States.

IRS.gov

IRS.gov continues to be one of the most visited Internet sites in the world, especially during filing seasons. As of the week ending April 8, 2006, the IRS reported a 6.46 percent increase in the number of visits to IRS.gov over the same period during the last filing season. The IRS now provides practitioners with online tools to provide better service to their customers, such as electronic account resolution, transcript delivery, and disclosure authorization. As of the week ending April 8, 2006, the IRS also reported a 17.02 percent increase in taxpayers obtaining their refund information online via the "Where's My Refund" option found on the Internet site.

Toll-Free Telephone Operations

The 2006 Filing Season presented unique challenges for the IRS toll-free operations. The IRS had also planned to reduce the hours of its toll-free telephone operation in fiscal year 2006. The IRS had about 400 fewer Full-Time Equivalents⁷ for toll-free telephone operations than it had in fiscal year 2005 because of plans to reduce operating hours from 15 to 12 per day. Congress, the Taxpayer Advocate and the National Treasury Employees Union expressed concerns about the IRS reducing operating hours for the toll-free telephone lines. A new law enacted in November 2005 requires the IRS to consult with stakeholder organizations, including TIGTA, regarding any proposed or planned efforts to terminate or significantly reduce any taxpayer service activity.⁸ Congress recently further defined a reduction of taxpayer service to include limiting available hours of telephone taxpayer assistance on a daily, weekly, and monthly basis below the levels in existence during the month of October 2005. TIGTA is currently assessing the IRS's plans to reduce operating hours and will report its results later this year.

As of April 8, 2006, assistor level of service had not been negatively impacted, with an IRS-reported level of service rate of 83.8 percent.⁹ In addition, about 6.49 percent fewer assistor calls were answered, but the number of taxpayers who hung up prior to reaching an IRS assistor was up 10.9 percent. The average speed of answer was about 66 percent of the time planned, so those taxpayers who called and spoke with an assistor did not experience longer wait times.

In planning for fiscal year 2006, IRS management expected fewer calls program-wide, even after taking into consideration taxpayers affected by Hurricanes Katrina and Rita. IRS management believed that most taxpayers needing disaster relief assistance obtained it during the latter part of 2005. Prior to the start of the filing season, TIGTA brought to IRS management's attention our concern that more taxpayers than expected could call the help line with questions due to the effects of Hurricanes Katrina and Rita.

After we shared this concern, IRS management raised the estimated volume of services to these telephone lines by about 78,000 services, from approximately 27,000 to about 105,000. The estimate is for services from January through June

⁶"Planning for the 2006 Filing Season Is on Course, but Challenges Exist for the Toll-Free Telephone Operations" (Reference No. 2006-40-053, dated February 2006).

⁷A measure of labor hours in which 1 Full-Time Equivalent is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For fiscal year 2005, 1 Full-Time Equivalent was equal to 2,088 hours.

⁸The Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, Public Law No. 109-115, 119 Stat. 2396 (2006).

⁹Level of Service is the primary measure of providing service to taxpayers. It is the relative success rate of taxpayers that call for services on the IRS's toll-free telephone lines.

2006, a 365.1 percent increase over the total fiscal year 2005 services provided on those telephone lines.¹⁰ For the 2006 Filing Season it appears that the calls to these telephone lines were higher than anticipated. For example, the IRS had planned 77,235 services for one of its applications devoted to assisting disaster victims; however, through April 8, 2006, the IRS has already provided 136,552 services.

Taxpayer Assistance Centers

2006 Filing Season Services

The TACs are walk-in sites where taxpayers can receive answers to both account and tax law questions, as well as receive assistance preparing their returns. The IRS acknowledged that staffing would be a challenge during the 2006 Filing Season since not all TACs would be fully staffed and not all TACs would provide standard services or standard hours of operation (from 8:30 a.m. to 4:30 p.m., Monday through Friday). As of December 1, 2005, the IRS identified 47 TACs with critical staffing shortages (a critical vacancy is one that must be filled to ensure that a TAC remains open).

The IRS took actions to minimize the impact of the staffing shortages. As of January 31, 2006, the IRS had hired additional frontline technical employees, recalled intermittent employees back to work, detailed former TAC employees from their current positions in other IRS functions back to the TACs, and made plans to have some employees travel between TACs to ensure that all TACs remained open daily. The IRS's decision to focus more resources on compliance activities, however, further limited resources available for the TAC Program. As a result, the IRS limited some assistance services and not all TACs were open during standard operating hours. As of the week ending April 8, 2006, the IRS reported a 12.5 percent reduction in TAC contacts with taxpayers.

Although the IRS publicized when TAC operating hours were limited, it did not publicize when TACs would only provide limited services. When notified by TIGTA, the IRS implemented changes and standardized the list of services offered at each TAC. Furthermore, the IRS modified its Internet site, IRS.gov, to indicate when TACs would provide limited services.

TIGTA made anonymous visits to 50 TACs and asked 200 questions to determine if taxpayers received quality service, including correct answers to their questions. Assistors correctly answered 73 percent of the questions compared to 66 percent during the 2005 Filing Season. TIGTA visited an additional 20 TACs and asked 80 tax law questions specifically related to the Katrina Emergency Tax Relief Act of 2005. Assistors answered 75 percent of those questions correctly. IRS assistors should have been trained to answer these questions. TIGTA's observations were that assistors sometimes inappropriately referred taxpayers to publications to conduct their own research, or responded to tax law questions without following required procedures, such as using the publication method guide that requires them to ask probing questions.

Closure

Over the past few years, customer service at TACs has shown improvement. In May 2005, the IRS announced plans to close 68 of its TACs nationwide. Closing the 68 TACs was expected to yield staffing and facilities cost savings of \$45 million to \$55 million. After the IRS's closure announcement, Congress enacted legislation to delay the closure of any TACs.¹¹ The IRS is prohibited from using funds provided in the fiscal year 2006 budget appropriation to reduce any taxpayer service function or program until TIGTA completes a study detailing the effect of the IRS's plans to reduce services relating to taxpayer compliance and taxpayer assistance. TIGTA completed its study in March.

TIGTA reviewed¹² the IRS's TAC Closure Model and data used to select the 68 centers scheduled for closure and identified that although the structure of the Model was sound, not all data used were accurate or the most current available, and some of the data were based on estimates and projections instead of actual available data. Data discrepancies affected the scores the Model calculated for each TAC and, ultimately, the ranking and overall selection of centers for closure. In addition, data

¹⁰A service is defined when a call is answered by an assistor. When the assistor answers the caller's question, a service is provided. If the same caller has an additional question or issue and is transferred to another area or assistor, an additional service is provided.

¹¹Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006, Public Law No. 109-115, 119 Stat. 2396 (2005).

¹²"The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data" (Reference Number 2006-40-061, dated March 2006).

discrepancies affected the IRS's ability to accurately determine cost savings. The IRS should ensure that data used in any decision-making tool are accurate and reliable before using them. For the TAC Program, the IRS should include data to identify customer characteristics and capture customer input to effectively measure the impact any changes might have on taxpayer service or compliance.

I am concerned that the IRS does not sufficiently ensure that it uses adequate and reliable data for making decisions that impact customer service operations. The decision to close TACs was based primarily on input from IRS functional areas and considered other factors that included internal priorities, resource demands, and shifts in the IRS's customer service perspective. However, data were not obtained from taxpayers who use these services to determine the impact of removing or reducing them.

Volunteer Income Tax Assistance (VITA) Program

The VITA Program plays an increasingly important role in IRS's efforts to improve taxpayer service and facilitate participation in the tax system. The VITA Program provides no-cost Federal tax return preparation and electronic filing to underserved taxpayer segments, including low income, elderly, disabled, and limited-English-proficient taxpayers. These taxpayers are frequently involved in complex family situations that make it difficult to correctly understand and apply tax law.

TIGTA visited VITA sites to determine if taxpayers received quality service, including the accurate preparation of their individual income tax returns. TIGTA developed scenarios designed to present volunteers with a wide range of tax law topics that taxpayers may have needed assistance with when preparing their tax returns. These scenarios included the characteristics (e.g., income level, credits claimed, etc.) of tax returns typically prepared by the VITA Program volunteers based on an analysis of the Tax Year 2004 VITA-prepared tax returns. TIGTA had 36 tax returns prepared with a 39 percent accuracy rate, comparable to the 34 percent accuracy rate reported for the 2005 Filing Season. TIGTA's observations were that volunteers did not always use the tools and information available when preparing returns. TIGTA will report its final results later this year.

The Tax Gap

In an April 2004 U.S. Senate Committee on Finance news release, Senator Max Baucus called for 90 percent voluntary tax compliance by 2010. Senator Baucus stated, in part, that "Today, I'm calling on the IRS to achieve a 90 percent voluntary compliance rate by the end of the decade, which would raise at least an additional \$100 billion each year without raising taxes." Perhaps the greatest challenge facing the IRS is finding ways to improve the voluntary compliance rate.

Using different terms, Senator Baucus challenged the IRS to reduce what is commonly known as the tax gap. The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. In February 2006, the IRS estimated the gross tax gap at \$345 billion for Tax Year 2001.

TIGTA evaluated the reliability of the IRS-developed tax gap figures and concluded that the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and voluntary compliance.¹³ The IRS has significant challenges in both obtaining complete and timely data and developing the methods for interpreting the data.

A reliable estimate of the overall tax gap and its components is important to tax administration and tax policy decision-makers. Without a reliable estimate, inappropriate decisions may be made on how to address the tax gap. If we assume that the total tax liability in Tax Year 2010 is the same as it was in Tax Year 2001, noncompliant taxpayers would have to pay timely and voluntarily an additional \$134 billion to achieve Senator Baucus' challenge to reach a 90 percent voluntary compliance rate by 2010.

Despite the significant efforts undertaken in conducting the individual taxpayer National Research Program (NRP)¹⁴ for underreporting, the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and the voluntary compliance rate. TIGTA's primary concerns are described in the following areas of nonfiling, reporting compliance, and payments collected.

¹³"Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections" (Reference Number 2006-50-077, dated April 2006).

¹⁴The NRP was a study designed to accurately measure reporting compliance of individual taxpayers while minimizing the burden on taxpayers during the process.

Nonfiling

Prior to the NRP, the IRS's estimate of the nonfiling gap was \$30.1 billion, consisting of \$28.1 billion for individual income taxes and \$2 billion for estate taxes. In February 2006, the IRS updated this estimate to \$25 billion for individuals. Supplementary data, however, suggest that substantial amounts are not included in the estimates provided in the tax gap projections. The IRS describes the nonfiling estimate as reasonable despite the missing segments of corporate income, employment, and excise taxes. These facts suggest the nonfiler estimate is incomplete and likely inaccurate.¹⁵

Reporting Compliance

At an estimated \$285 billion, underreporting is by far the largest identified portion of the tax gap. Yet, this estimate may not be complete since there are at least four areas that suggest substantial amounts are not included in the tax gap estimates.

- The effect that the current NRP on Subchapter S corporations will have on individual taxpayer compliance estimates could be substantial, as well as the effect on employment tax estimates.¹⁶
- The \$5 billion underreporting estimate for small corporations and the \$25 billion estimate for large corporations date back to the 1980's and, according to the IRS, are considered weak.
- The estimate for estate taxes was not updated during the current NRP, and no estimate has been made for excise taxes.
- The dated estimate for the Federal Insurance Contributions Act taxes and unemployment taxes are considered weak by the IRS.

Payments Collected

The IRS estimates that it recovers about \$55 billion of the annual tax gap through enforced collections and other late payments.¹⁷ This figure does not represent an actual amount but is an estimate based on formulas devised from historical analyses. The actual basis of these formulas seems to be very limited, as well as dated. Furthermore, these collections have two basic parts—voluntary payments received by the IRS and payments that result from some type of IRS intervention.¹⁸ The IRS does not currently correlate either type of payment to the applicable tax year and thus does not determine actual collections.

Measuring Noncompliance

TIGTA attempted to determine whether the IRS's tax gap estimates coincide with estimates developed by independent sources. Although some independent studies exist, none provided sufficient information to allow close comparisons. One possible source of comparison was the annual Bureau of Economic Analysis estimate of the difference between its personal income figures and the IRS's measure of Adjusted Gross Income to derive what is called an Adjusted Gross Income Gap. IRS Office of Research officials suggested that this is a narrow definition of tax noncompliance based, in part, on IRS estimates. For Tax Year 2001, the Bureau of Economic Analysis reported an Adjusted Gross Income Gap of \$834.4 billion.¹⁹

The private sector has also developed some estimates of the tax gap. For example, in January 2005, financial analysts calculated the number of illegal immigrants in the United States at more than double the United States Census Bureau's estimated 9 million. These undocumented workers may hold as many as 15 million jobs, with perhaps 5 million collecting untaxed cash wages, costing the Federal Government an estimated \$35 billion yearly.²⁰

Performing a compliance measurement program is expensive and time consuming. The estimated cost for performing the Tax Year 2001 individual taxpayer NRP was approximately \$150 million. The IRS Office of Research staff explained that re-

¹⁵There are no plans to update the estate tax segment or to estimate the corporate, employment, and excise tax nonfiler segment.

¹⁶This study is expected to take 2 years to 3 years to complete from its inception in October 2005.

¹⁷According to one IRS representative, these collections can take up to 10 years because of appeals and court decisions.

¹⁸Voluntary late payments are generally those remittances received after their due dates but before collection notices were sent or other collection actions were taken.

¹⁹This number is an income gap rather than a tax gap. Thus, it would have to be multiplied by a tax rate to determine the associated tax gap. Similarly, the \$35 billion stated in the following paragraph could be significantly smaller, depending on whether some of these workers have actual filing obligations. Neither the BEA nor the IRS assumes a tax rate to calculate a tax gap estimate based on this income gap.

²⁰Bear Stearns, "The Underground Labor Force Is Rising To The Surface".

source constraints are a major driver in NRP studies and will affect how often the NRP is updated. From fiscal years 1995 through 2004, the revenue agent workforce declined by nearly 30 percent while the number of returns filed grew by over 9 percent. Additionally, operational priorities must be balanced against research needs. This shortfall in examiner resources makes conducting large-scale research studies problematic.

The IRS's budget submission to the Department of the Treasury (Treasury) for fiscal year 2007 requests funding to support ongoing NRP reporting compliance studies. It requests funding for 268 Full-Time Equivalents and \$45.9 million that will include 26 analytical and technical positions to estimate reporting compliance for new segments of taxpayers (such as S corporations, partnerships, and other business entities) and to update estimates of reporting compliance for other segments. It also requests 510 additional revenue agents to conduct reporting compliance research examinations. The initiative seeks to provide a foundation for conducting compliance studies and to limit the diversion of resources to research audits from operational priorities. The IRS Oversight Board supports ongoing dedicated funding for compliance research. Unfortunately, funding for those resources in previous fiscal years did not materialize. Without a resource commitment to continually update the studies, the information will continue to be stale and less useful in improving voluntary compliance.

TIGTA's review of the tax gap concluded that a determination cannot be made about the IRS's ability to meet Senator Baucus' challenge of 90 percent voluntary compliance by 2010 with the information currently available. Regardless of whether a 90 percent voluntary compliance rate can be achieved, the IRS faces formidable challenges in completely and accurately estimating the tax gap and finding effective ways to increase voluntary compliance.

ELECTRONIC FILING

The IRS has seen a steady growth in electronic filing (e-file) of income tax returns over the past several years. In Calendar Year 2002, 35.9 percent of the 130.3 million individual income tax returns received by the IRS were e-filed. Last year, the percentage of e-filed returns increased to 51.7 percent of the total individual income tax returns received. The number of e-filed returns increased 46.2 percent over the 3-year span. While the IRS will not meet its goal of having 80 percent of all tax returns e-filed by 2007, it does expect to see continued growth in electronic filing, although at a somewhat diminished growth rate from year to year. For example, the IRS expects the e-file percentage to reach 54.1 percent this year, 57.7 percent in 2007, and 60.6 percent in 2008.

Although e-filing continues to increase overall, TIGTA found some indications that taxpayers are shifting between the various types of e-filed returns, and some segments of e-filed returns are starting to show a decrease in the numbers filed. E-filed returns are generated from three basic sources—paid preparers who transmit their clients' tax returns, taxpayers who purchase tax-preparation software and file their own returns via the Internet from their personal computers, and taxpayers who take advantage of free e-filing options, such as the Free File Program, or in previous years via the TeleFile Program.

Overall, as of April 8, 2006, e-filing has increased 3.5 percent compared to the same period in 2005, which is significantly less than the 6 percent increase the IRS expected. While the number of taxpayers e-filing from their home computers is up 16.6 percent this Filing Season, the number of taxpayers taking advantage of free online filing is down 22 percent below last year. I am concerned that more taxpayers are not using the free e-filing services offered by the IRS.

Free File Program

Background

The IRS Restructuring and Reform Act of 1998 (RRA 98)²¹ established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. It also required the IRS to work with private industry to increase electronic filing.

In February 2002, President Bush established the President's Management Agenda to improve the overall management of the Federal Government. One of the five initiatives in the President's Agenda is E-Government. The goal of this initiative is to make it easier for citizens and businesses to interact with the government, save

²¹Public Law No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

taxpayer dollars and streamline citizen-to-government transactions. In response to the President's E-Government initiative, the Office of Management and Budget (OMB) developed the EZ Tax Filing Initiative. EZ Tax Filing was intended to make it easier for citizens to file taxes in an Internet-enabled environment. Citizens would no longer have to pay for basic, automated tax preparation. The goal of this initiative was to increase the number of citizens who filed their tax returns electronically.

In response to this requirement and the statutory requirement of RRA 98, in 2003 the Treasury, the OMB and the IRS launched the Free File Program featuring private-sector partners that allow qualifying taxpayers to prepare and file their taxes online for free. The Treasury, OMB and IRS made this possible through a public-private partnership with a consortium of tax software companies, the Free File Alliance, LLC (Alliance).

The Free File Program provides taxpayers with access to free online tax preparation and e-filing services made possible through a partnership agreement between the IRS and the tax software industry. Eligible taxpayers may prepare and e-file their Federal income tax returns using commercial online software provided by Alliance members. After the IRS and Alliance entered into a Free File Agreement, the Free File Program debuted in January 2003. According to statistics provided by the Alliance, more than 2.79 million taxpayers used the program in its first year. In subsequent years, use of the Free File Program increased significantly to about 3.51 million taxpayers in 2004 and 5.12 million taxpayers in 2005.

The Amended Free File Alliance Agreement and Its Potential Impact on Electronic Filing

After the 2005 Filing Season, the IRS and the Alliance amended their agreement to continue the Free File Program through October 2009. With the amended agreement, the overall focus of the Free File Program changed significantly. While the amended agreement still contributes to the original goal of increasing the number of citizens who electronically file their tax returns, new limits effectively changed the intent of the Free File Program. The original intent of the program was to provide free tax preparation and electronic filing services to all taxpayers. The revised intent is to assist lower income and underserved taxpayers.

The original 2002 agreement between the IRS and the Alliance established a minimum number of taxpayers who should be served by the Free File Program and was more in line with the intent of the EZ Tax Filing Initiative. There is, however, some support in Congress for the shift in the program's focus to lower income and underserved taxpayers. For example, according to the House Appropriations Committee Report accompanying the IRS's fiscal year 2005 Budget Appropriations, the committee reaffirmed its position that the Alliance is first and foremost intended to provide electronic Federal tax return preparation and e-filing services at no cost to the working poor and other disadvantaged and underserved taxpayers.

As part of the amended agreement, new limits were set for participation in the Free File Program. The new limits stem, in part, from the differing objectives of the IRS and the Alliance members. One of the IRS's principal purposes for establishing the program was to add another avenue for electronic filing with the intent of increasing electronic filing overall. However, Alliance members are businesses that incur a cost to provide free services. According to representatives of Alliance member companies who TIGTA interviewed, their primary goal is to keep the Federal Government from entering the tax preparation business.²² A secondary benefit of their participation in the program is the opportunity to market their other products for free. Taxpayers opting to use these services provide additional revenues to Alliance members.

Per the initial agreement, a minimum of 60 percent of all taxpayers (approximately 78 million) were eligible for the Free File Program. Last year, the Alliance opened the program up to almost 130 million taxpayers. However, only 5.12 million taxpayers took advantage of it. The amended agreement now limits the program's availability to 70 percent of taxpayers (approximately 93 million). For Tax Year 2005, this limitation equates to an Adjusted Gross Income (AGI) of \$50,000 or less. The maximum AGI to achieve the 70 percent limit, however, may vary from year to year. The net impact of this new limit is that during the 2006 Filing Season approximately 40 million taxpayers were no longer offered free filing services through the program.

As mentioned earlier, online filing on home computers is up 16.6 percent this Filing Season. This increase, however, appears to be the result of an increase in the number of taxpayers who paid for online filing services. As of April 8, 2006, paid online filing is up 33.7 percent while free online filing is down 22 percent. Two pos-

²²TIGTA interviewed a sample of 6 of the 20 Alliance member companies.

sible explanations for the growth in online filing from home computers and the decline in free online filing are: (1) taxpayers who filed electronically through a practitioner last year may have decided to purchase software and file online this year; and (2) taxpayers who filed through the program last year do not qualify this year and therefore purchased software to file online.

Another factor that appears to have contributed to the decline in free online filing is elimination of the IRS's TeleFile Program. The IRS and the Alliance had hoped that many of the 3.3 million taxpayers who used TeleFile in 2005 would migrate to the Free File Program. However, current Filing Season statistics indicate that many former TeleFile users are no longer filing electronically and instead are filing their returns on paper.

Positive Provisions of the New Free File Alliance Agreement

Although the changes in the amended Free File Agreement limit the number of taxpayers offered free tax return preparation and filing services, several other changes enhance the quality of the program. Under the amended agreement, Alliance members must adhere to more stringent disclosure of the nature, costs, and alternative methods of receiving refunds faster. In addition, not all taxpayers will be offered a Refund Anticipation Loan (RAL). There is some controversy over RALs because of the high fees and rates sometimes associated with those loans. Starting in 2006, the agreement guarantees that some taxpayers using the Free File Program will have the option to prepare and file their tax return without being offered a RAL. The decision of whether or not to accept an RAL lies with the taxpayer; however, these new provisions make the choice more clear. If taxpayers choose to apply for an RAL, all terms of the loans must be fully disclosed.

The amended agreement also increased security requirements and added performance measures for the individual Alliance members. Alliance members must have third-party security assessments to ensure that taxpayer information is adequately protected. Also, performance standards require a 60 percent acceptance rate²³ for providers who e-file returns through the program. This acceptance rate will be gradually increased in future years.

Under the amended agreement, Alliance members also agreed for the first time to provide the IRS with an indicator that identifies those taxpayers who use the Free File Program. Prior to the amendment, the IRS had no way to independently determine how many taxpayers participated in the program, or which taxpayers were using it. Previously, individual Alliance members reported data on participation in the program, and the IRS lacked a method to monitor participation. This significantly hampered the IRS's ability to evaluate the program's success or the effects of changes to the program.

Difficulties Using the Free File Program

Although the Free File Program offers some taxpayers the option to prepare and file their tax return for free, the program may not be accessible to all who are eligible for it, and it is not necessarily easy to use. The Free File Internet site readily allows taxpayers to determine whether they qualify for the program, but finding the best software provider for their needs is time consuming and may be difficult for less savvy computer users.

Taxpayers must access the Free File Program through the IRS's Internet site at IRS.gov. The Internet site clearly identifies the basic requirements for participation in the program and provides a tool that guides taxpayers to free filing providers. This tool presents taxpayers with a number of providers from which to choose based on some basic information that taxpayers provide. Although this tool guides taxpayers to the providers they qualify to use, the tool does not assist taxpayers in determining which of those providers best meets their needs.

Taxpayers must access each provider's Internet site to determine the services offered and must then compare the services offered and select the provider that is the best for them. Additionally, each Alliance member company sets taxpayer eligibility requirements for its own program. These requirements may differ from company to company. Generally, eligibility is based on such factors such as age, adjusted gross income, State residency, military status or eligibility for the Earned Income Tax Credit.

Although the Free File Program is currently focused on low-income taxpayers, many of these taxpayers do not have access to the tools to use it. For example, taxpayers who speak limited English have not been provided access to all of the filing options offered. Only two providers offer services in Spanish and neither of them offer free electronic filing of Form 4868, Automatic Extension of Time to File.

²³The percentage of returns an individual provider must transmit to the IRS error free.

The Free File Program also requires taxpayers to have access to a computer and the Internet. Taxpayers who have access to the necessary technology must also be savvy enough to navigate the IRS's and the Alliance members' Internet sites. The focus of the program on lower-income taxpayers may be at odds with their ability to participate in it. In her 2004 Report to the Congress, the National Taxpayer Advocate wrote that in 2001 approximately 50 percent of low-income families²⁴ used a computer and only 38 percent had access to the Internet. Furthermore, access to a computer or the Internet does not necessarily indicate that a person has the ability to navigate the Internet or use tax preparation software.²⁵

The IRS offers free assistance to taxpayers with tax preparation and filing through its Taxpayer Assistance Centers, Voluntary Income Tax Assistance, and Tax-Aide Programs as well as through the Free File Program. Similar to the Free File Program, taxpayers must meet certain requirements in order to receive assistance from those other programs. The Free File Program, however, is the only free filing option that taxpayers may use from their homes. Taxpayers must bring their tax documentation to an assistance site to take advantage of the other free tax return preparation and filing services.

The addition of the RAL provisions, increased security, and added performance measures to the agreement are important provisions to further promote public confidence in the Free File Program. Adding the electronic indicator to returns filed through the program will provide the IRS with information to measure the program's success. However, limiting the scope of the program to 70 percent of taxpayers has impacted the use of the program. Based on the statistics Alliance members provided in previous years, the new limits in the amended agreement appear to be substantially reducing participation in the program. Furthermore, the AGI limit also keeps the program from achieving the full intent of the EZ Tax Filing Initiative, which never specified any such limits for access to free, basic, automated tax return preparation and electronic filing. Not yet known, however, is whether the IRS's ability to better understand who is using and who is not using the program could help the IRS better market the program and expand its usage despite the new limits. The answer to that question may ultimately have a significant effect on the overall growth rate of electronic filing.

Elimination of the TeleFile Program

As mentioned earlier in my statement, one factor that appears to have negatively impacted the Free File Program is the elimination of the TeleFile Program. The IRS discontinued this program for individual taxpayers in August 2005. The TeleFile Program allowed taxpayers with the simplest tax returns²⁶ to file their returns by telephone. The pilot TeleFile Program was launched on a limited basis in 1992, and the program became available nationally in 1997. The RRA 98 included the expectation that the IRS would continue to offer and improve TeleFile and make a similar program available on the Internet.

Despite its initial success, use of the TeleFile Program began to decrease in 1999. According to IRS electronic filing statistics as of April 17, 2005, approximately 3.3 million filers used TeleFile in 2005, a 12.7 percent decline from the previous year. Until the IRS eliminated the TeleFile Program last year, participation in the program had declined every year since 1999 when 5.2 million filers used it.

Declining use was one factor the IRS considered when deciding whether or not to end the TeleFile Program. Other contributing factors included the increasing cost of maintaining an aging TeleFile system, declining and discontinued State TeleFile programs, and the growing use of other electronic filing alternatives, such as the Free File Program.

According to the IRS, taxpayers who previously used TeleFile may continue to file electronically using one of the following five methods:

- 1. Tax preparers;
- 2. Personal computers with Internet access and tax preparation software;
- 3. IRS's Free File Program;
- 4. Free tax assistance sites, such as the Voluntary Income Tax Assistance and Tax-Aide Programs; and
- 5. IRS Taxpayer Assistance Centers.

However, two of the five alternatives require the taxpayer to pay for tax preparation and filing services that were previously free, and two other options require taxpayers to have access to computers and the Internet. Consequently, in many cases,

²⁴Income of less than \$25,000.

²⁵National Taxpayer Advocate 2004 Annual Report to the Congress, Volume 1", December 2004.

²⁶Forms 1040EZ.

the most cost-effective avenue for the taxpayer is to file a paper tax return. According to initial IRS statistics, a significant number of former TeleFile users are reverting to filing paper returns this year. As of April 8, 2006, the number of paper Form 1040EZ returns filed has increased 19.2 percent compared to this time last year (5.9 million in 2006 compared to 4.9 million in 2005), and there has been a corresponding decrease in electronically filed Forms 1040EZ (6.7 million in 2006 vs. 8.4 million in 2005).

TIGTA will further evaluate the impact of the elimination of the TeleFile Program on taxpayers and the IRS's efforts to increase electronic filing, and will report the results later this year.

PRIVATE DEBT COLLECTION

As of September 2005, the gross accounts receivable to the IRS was \$258 billion. On October 22, 2004, the President signed the American Jobs Creation Act of 2004²⁷ that included a provision allowing the IRS to use Private Collection Agencies (PCA) to help collect Federal Government tax debts. The law allows PCAs to locate, contact, and request full payment from taxpayers specified by the IRS. The law also allows the IRS to retain and use an amount not in excess of 25 percent of the amount collected by the PCAs to pay for the cost of PCA services, and an amount not in excess of 25 percent collected for collection enforcement activities of the IRS. According to the IRS, the initiative to use PCAs will help reduce the significant and growing amount of tax liability deemed uncollectible because of IRS resource priorities, will help maintain confidence in the tax system, and will enable the IRS to focus its existing collection and enforcement resources on more difficult cases.

The provisions of the Fair Debt Collection Practices Act²⁸ apply to PCAs. PCAs are prohibited from committing any act or omission that employees of the IRS are prohibited from committing in the performance of similar services. The IRS requires that PCAs adhere to all taxpayer protections. PCAs are also 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. The PCAs must also adhere to all security and privacy regulations for systems, data, personnel, physical security, and taxpayer rights protections. To ensure compliance with these requirements, the IRS is responsible for providing oversight of PCA actions.

The IRS issued a detailed Request For Quotation²⁹ (RFQ) for solicitation of debt collection services in support of the Private Debt Collection program on April 25, 2005. However, this RFQ was canceled after the United States Court of Federal Claims filed an order on July 25, 2005, informing the IRS it intended to enjoin the solicitation. The order ruled that the IRS's restriction of the solicitation only to vendors with current Federal Government debt collection task orders was arbitrary and capricious. The IRS subsequently revised the RFQ and reissued it on October 14, 2005.

TIGTA reviewed the revised RFQ and determined that it adequately addressed the deficiencies cited by the United States Court of Federal Claims. The IRS deleted the requirement that PCAs must have a current Federal Government debt collection task order to be eligible for the solicitation. TIGTA did not identify any other restrictions in the RFQ which would have unnecessarily limited the procurement process. Further, the revised RFQ was reviewed by the IRS's Office of Procurement Policy Quality Assurance Branch and General Legal Services as required by IRS procurement procedures.

On March 9, 2006, the IRS announced that it awarded contracts to three firms to participate in the first phase of its private debt-collection initiative. The IRS has developed its own guidelines for the private firms, including background checks on all private-firm personnel associated with the projects as well as a mandatory, IRS-directed training program for company personnel. The IRS planned to begin delivering delinquent tax account cases to the selected PCAs by July 2006. However, on March 23, 2006, the IRS announced that it had issued stop-work orders to the three PCAs after two unsuccessful bidders filed bid protests with the Government Accountability Office (GAO).

In the second phase of the private debt-collection initiative, scheduled for 2008, the IRS intends to contract with up to 10 firms. Over the course of 10 years, the

²⁷ Public Law No. 108-357, 118 Stat. 1418 (2004).

²⁸ 15 U.S.C. § 1601 note, 1692-1920 (2000).

²⁹ An RFQ is issued by the IRS's Office of Procurement and describes the requirements that prospective contractors should provide in support of needed products or services. TIGTA reviewed the RFQ dated April 25, 2005. The Private Debt Collection Request for Quotation Outlines Adequate Procedures and Controls (Reference Number 2005-10-156, dated September 2005). TIGTA will soon report on its review of the revised RFQ dated October 14, 2005.

IRS expects that the private firms will help it collect an additional \$1.4 billion in outstanding taxes.

While the use of private collection agencies could result in significant recoveries of unpaid taxes, the potential for abuse exists. Experience at the State level demonstrates that the use of PCAs should be closely monitored. In December 2005, the State of New Jersey Commission of Investigation reported that what began as an effort to privatize the collection of tax debt 12 years ago evolved into a corrupt association between high- and mid-level managers in the Divisions of Taxation and Revenue and the PCAs.³⁰ The State of New Jersey may have been over-billed by more than \$1 million for a 5-year period.

The Commission reported that a lack of oversight and a lack of audits and quality controls directly contributed to the undetected over-billing. Additionally, the PCAs repeatedly ignored contract requirements and Taxation and Revenue officials failed to enforce them. While the Commission's report did not address this particular issue, TIGTA is also concerned about the quality of taxpayer service from PCAs during their attempts to collect outstanding taxes. Poor taxpayer service by PCAs could potentially have a negative impact on voluntary compliance.

Since the IRS is just now embarking on this initiative, TIGTA has not yet seen indications of problems with the IRS's private debt-collection initiative similar to those in New Jersey. However, a recent news story reported that a former official of one of the IRS's three selected PCAs for the first phase of this initiative was indicted for bribery of public officials to win a contract to collect unpaid fines and fees. According to the story, the official pleaded guilty to one count of conspiracy to commit bribery and one count of bank fraud in 2005, and was sentenced to 30 months in prison and a \$1 million fine. This particular case and the State of New Jersey experience clearly illustrate the need for proper oversight of this important initiative. According to the IRS, it has established an oversight unit responsible for ensuring that PCAs adhere to established procedures and that a tremendous amount of rigorous oversight will be applied to the PCAs.

Overseeing the IRS's private debt-collection initiative is a top priority for TIGTA. TIGTA has coordinated with the IRS during the initial phases of implementation of this initiative by addressing security concerns with the contracts and protection of taxpayer rights and privacy, and by developing integrity and fraud awareness training for the contract employees. TIGTA plans to provide a presentation to IRS trainers for PCAs about TIGTA's role in the private debt-collection initiative.

TIGTA has also developed a three-phase audit strategy to monitor this initiative and provide independent oversight. In the first phase, TIGTA is reviewing the IRS's planning and initial implementation of the program. As mentioned previously, our limited scope reviews of the original and revised RFQs did not identify any material omissions that would adversely affect the IRS's ability to manage this initiative effectively. Additionally, TIGTA recently reported that overall, the IRS has taken positive steps to effectively plan and implement certain aspects of the Private Debt Collection program. For example, the IRS has developed a draft letter and a related publication with pertinent information to notify taxpayers when their accounts are transferred to PCAs.

While the IRS has taken positive steps to implement the Private Debt Collection program, TIGTA noted that approximately 72 percent of the IRS's original inventory of cases available for placement in the program had balances due³¹ that were over 2 years old. The IRS is now considering a revision to its case selection criteria that will increase the balance-due age even further. IRS management indicated that there is a long-term strategy in place to include more current cases in the program. However, the new Filing and Payment Compliance project³² currently limits their ability to accomplish this strategy.

For the initial phase of the program, the IRS plans to place simpler cases with PCAs, such as those in which the taxpayer has filed all tax returns due. TIGTA determined, however, that contrary to IRS intentions, the case selection criteria the IRS had established would have allowed certain nonfiler cases to be assigned to the PCAs. The IRS subsequently agreed to review nonfiler conditions and determine whether the nonfiler cases should be excluded from inventory.

In the second phase, TIGTA will review the initiative after full implementation, which may not occur until fiscal year 2007. In the third phase, TIGTA will review the effectiveness of the program. The goal of this audit strategy is to ensure that

³⁰ State of New Jersey Commission of Investigation, "The Gifting of New Jersey Tax Officials" (December 2005).

³¹ A balance due represents an unpaid assessment for which a taxpayer owes the IRS.

³² The Filing and Payment Compliance project was initiated to address the inventory of delinquent tax debt that is not actively being collected by the IRS due to limited resources.

the IRS effectively exercises its new authority to use private debt collectors, while also ensuring that taxpayers' due process and privacy rights are protected.

OTHER MAJOR CHALLENGES FACING THE IRS

Despite the overall progress in customer service and the broad relief provided to Hurricane victims, improvements need to be made in customer service and other areas in which the IRS faces significant challenges in accomplishing its mission. TIGTA has identified the following additional management and performance challenges that confront the IRS:

- Modernization of the IRS;
- Security of the IRS;
- Complexity of the Tax Law;
- Using Performance and Financial Information for Program and Budget Decisions;
- Erroneous and Improper Payments;
- Taxpayer Protection and Rights;
- Managing Human Capital.

Each of the above presents its own unique challenges, which I will address individually in the remaining portion of my testimony.

Modernization of the IRS

Modernizing the IRS's computer systems has been a challenge for many years and will likely remain a challenge for the foreseeable future. The latest effort to modernize the IRS's systems, the Business Systems Modernization (BSM) program, began in fiscal year 1999, and is a complex effort to modernize the IRS's technology and related business processes. According to the IRS, this effort involves integrating thousands of hardware and software components. Through February 2006, the IRS has received appropriations of approximately \$2 billion to support the BSM program, and the President has requested an additional \$167 million for fiscal year 2007.

Succeeding in the modernization effort is critical—not only because of the amount of time and money at stake but also to improve the level of service provided to taxpayers. To accomplish the modernization effort, the IRS hired the Computer Sciences Corporation (CSC) as the PRIME³³ to design, develop, and integrate the modernized computer systems. However, in January 2005, the IRS began taking over the role of systems integrator from the PRIME due to reductions in funding for the BSM program and concerns about the PRIME's performance.

The BSM program has shown progress. The IRS and its contractors have been focusing on defining and delivering smaller, incremental releases of projects.³⁴ For example, the IRS recently issued the fourth incremental release of the Modernized e-File project. The Modernized e-File project has provided the capability for corporations, exempt organizations, governmental entities, private foundations, and trusts to file 106 tax forms electronically. In January 2006, the IRS released the fourth incremental release of the Customer Account Data Engine (CADE) project which will eventually replace the IRS's existing Master File.³⁵

Although progress is being made, the modernization program is behind schedule, over budget, and is delivering less functionality than originally planned. TIGTA has identified four primary challenges that the IRS must overcome for modernization to be successful:

- (1) The IRS must implement planned improvements in key management processes and commit necessary resources to succeed;
- (2) The IRS must manage the increasing complexity and risks of the modernization program;
- (3) The IRS must maintain continuity of strategic direction with experienced leadership; and

³³The PRIME is an acronym for Prime Systems Integration Services Contractor.

³⁴A release is a specific edition of software.

³⁵The Master File is the IRS database for storing taxpayer account information on individuals, businesses, employee retirement plans, and exempt organizations. The CADE will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer account and return data. In conjunction with other applications, the CADE will allow employees to post transactions and update taxpayer account and return data online from their desks. Updates will be immediately available to any IRS employee who accesses the data and will provide a complete, timely, and accurate account of the taxpayer's information. In contrast, the current Master File processing system can take up to 2 weeks to update taxpayer accounts, and IRS employees may need to access several computer systems to gather all relevant information related to a taxpayer's account.

—(4) The IRS must ensure contractors' performance and accountability are effectively managed.

In response to modernization challenges and reduced funding, the IRS began making dramatic changes to significant areas within the BSM program over the last year. For example, the GAO recommended and the House and Senate Appropriations Committees directed the IRS to develop a new version of the Modernization Vision and Strategy. In addition, the IRS's prior modernization approach involved a huge development effort aimed at replacing all current systems. The IRS is now focusing on using current systems to accomplish modernization. I believe these extensive changes signal the beginning of a different design and structure for the entire modernization effort.

As risks and issues are identified within the BSM program, frequent changes are often required. However, the IRS's recent and planned changes do not eliminate the four challenges we have identified. Due to the criticality of the BSM program, the IRS must confront identified challenges and proactively address them in order to come closer to realizing expectations in this new phase of the BSM program.

Security of the IRS

Millions of taxpayers entrust the IRS with sensitive financial and personal data, which are stored and processed by IRS computer systems. The risk of sensitive data being compromised has increased over the last few years because of the increased threat of identity theft. According to the Social Security Administration, identity theft is one of the fastest growing crimes in the United States. The Department of Commerce estimates that more than 50 million identities were compromised in 2005. The sensitivity of taxpayers' information stored by the IRS and the IRS's use of the Social Security Number as a taxpayer identifier on its computer systems add to the risks the IRS must address.

As the Nation's primary revenue collector, the IRS may also be a prime target for attacks on its computer systems by anti-government protestors, international terrorists, and disgruntled employees. In addition to identity theft concerns, computer attacks can cause the loss of revenue and productivity by disrupting computer operations. Although many steps have been taken to limit risks, IRS systems and taxpayer information remain susceptible to threats that could impact the confidentiality, integrity, and availability of data and information systems.

The IRS has focused on technical solutions to protect its computer systems and data, and has established reasonable technical controls to prevent intruders from entering the IRS network. However, managerial and operational controls have not been adequately emphasized, leading TIGTA to conclude that systems and data remain vulnerable. In the past, the IRS relied mainly upon the Chief Information Officer and Chief, Mission Assurance and Security Services, to provide security controls. The IRS has recently increased business unit involvement to ensure adequate security and has added security responsibilities to executives' position descriptions. These changes are critical but will take time to improve the security posture of the IRS.

The IRS has improved its processes and devoted additional resources for certifying and accrediting its systems; however, only 35 percent of its systems had been certified and accredited as of September 2005. Annual testing had not been conducted on a majority of its systems. In addition, only 300 of its 2,737 employees with key security responsibilities had received any specialized training in the last fiscal year. We have attributed several security weaknesses in the past to the lack of training for these employees and expect these weaknesses will persist until specialized training is given more emphasis. In addition, contractors and States who use taxpayer information to administer their States' tax laws have not been given sufficient oversight.

Hurricanes Katrina and Rita affected 25 IRS offices. By adequately planning and taking aggressive actions after the hurricanes hit, the IRS was able to locate its employees and restore its computer operations to continue tax administration activities in the Gulf Coast area. However, disaster recovery plans for the IRS's large computing centers and campuses require additional development, testing, or personnel training to ensure that the IRS can quickly recover in the event of a disaster.

For the IRS to make the largest strides in improving computer security at a relatively low cost, managers and employees must be aware of the security risks inherent in their positions and consider security implications in their day-to-day activities. IRS business unit managers should be held accountable for the security of their systems and key security employees should be adequately trained to carry out their responsibilities. It is also vital that the IRS continues to refine its plans and capabilities to manage emergency situations in a manner that protects employees and allows restoration of business operations in a timely manner.

Complexity of the Tax Law

The scope and complexity of the United States tax code make it virtually certain that taxpayers will face procedural, technical, and bureaucratic obstacles before meeting their tax obligations. The IRS has consistently sought to ease the process for all taxpayers. But each tax season brings new challenges, and old problems sometimes resist solution.

According to the November 2005 Report of the President's Advisory Panel on Tax Reform, last year Americans spent more than 3.5 billion hours doing their taxes, the equivalent of hiring almost 2 million new IRS employees—more than 20 times the IRS's current workforce. About \$140 billion is spent annually on tax preparation and compliance—about \$1,000 per family.

The Joint Committee on Taxation conducted a study in 2001 that demonstrates the vastness of the tax code. The study found that, in 2001, the tax code consisted of nearly 1.4 million words. There were 693 sections of the code applicable to individuals, 1,501 sections applicable to businesses, and 445 sections applicable to tax exempt organizations, employee plans, and governments.³⁶

The complexity of the code hampers the ability of the IRS to administer the Nation's tax system and confuses most taxpayers. The IRS has attempted to provide assistance to taxpayers with questions about the tax code through toll-free telephone lines, TACs, kiosks, and the IRS Internet site. TIGTA has performed numerous audits of the accuracy of IRS responses to taxpayer questions submitted via these methods and found that even some IRS employees cannot apply the tax code correctly.

Tax law complexity contributes to the IRS's challenges in reaching accuracy goals to tax law questions, as well as to taxpayer frustration with attempting to decipher the tax code. For example, assistants are trained and expected to be knowledgeable in 318 tax law topics with 395 subtopics. Additionally, they are expected to be able to respond to taxpayer issues for the current and prior tax years.

In part because of the tax law complexity, taxpayers are continuing to receive inaccurate answers to their tax law questions. TIGTA's results for the 2006 Filing Season show that assistants provided accurate answers to 73 percent of the tax law questions asked at the TACs. Although this is an improvement from the accuracy rate of 66 percent TIGTA reported for the 2005 Filing Season,³⁷ taxpayers are still receiving incorrect answers to 27 percent of their questions asked at the TACs. Using its own methodology to calculate the accuracy rate, however, the IRS did meet its accuracy rate goal of 80 percent for the 2006 Filing Season.

As well as adding to the burden on the taxpayer and the IRS, tax law complexity also may inadvertently contribute to the tax gap. Complexity has given rise to the latest generation of abusive tax avoidance transactions, with taxpayers attempting to take advantage of the tax code's length and complexity by devising intricate schemes to illegally shelter income from taxation. The Son of Boss (Bond and Option Sales Strategies) is one such abusive tax shelter.³⁸ Other than generating tax benefits, the IRS determined it lacked a business purpose.

Overall, the IRS estimated the Son of Boss abusive tax shelter understated tax liabilities in excess of \$6 billion. The IRS describes the Son of Boss abusive tax shelter as a highly sophisticated, technically complex, no-risk scheme designed to generate tax losses without corresponding economic risks, which was promoted by some prominent firms in the financial services industry to investors seeking to shelter large gains from the sale of a business or capital asset.

The scheme used flow-through entities, such as partnerships, and various financial products³⁹ to add steps and complexity to transactions that had little or no relationship to the investor's business or the asset sale creating the sheltered gain. Additionally, the losses generated from the transactions were often reported among other "legitimate" items in several parts of the income tax return. Some losses from the Son of Boss abusive tax shelter, for example, were reported as a reduction to gross sales, cost of goods sold, or capital gains.

Taken together, these characteristics, especially the use of flow-through entities, made it very difficult for the IRS to detect the Son of Boss abusive tax shelter

³⁶"Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986", Staff of the Joint Committee on Taxation, JCS-3-01 (Apr. 2001).

³⁷"Customer Accuracy at Taxpayer Assistance Centers Showed Little Improvement During the 2005 Filing Season" (Reference Number 2005-40-146, date September 2005).

³⁸IRS Notice 99-59 issued in December 1999 described Boss transactions as certain losses involving partnerships and foreign corporations that would not be allowed for tax purposes.

³⁹The IRS defines financial products as instruments used in the global marketplace and include, among others, stocks, bonds, foreign currencies, mortgages, commodities, and derivatives.

through its traditional process of screening returns individually for questionable items.⁴⁰ Administering such a complex tax code makes the job of pursuing abusive tax avoidance schemes, such as the Son of Boss, challenging and costly to the IRS.

As part of its goal to improve service to taxpayers, the IRS includes simplifying the tax process as an objective in its Strategic Plan. Simplification could incorporate a range of actions from developing legislative recommendations to clarifying tax instructions or forms. Changing tax laws, however, can be a lengthy process since the IRS only administers the tax code that is passed by Congress. Thus, the IRS must work extensively with its stakeholders, as well as the Department of the Treasury, to identify and develop legislative recommendations that would reduce tax law complexity and taxpayer burden.

Using Performance and Financial Information for Program and Budget Decisions

The President's Management Agenda aims to place a greater focus on performance by formally integrating it with budget decisions. In addition, without accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people. The IRS has made some progress. However, integrating performance and financial management remains a major challenge.

The IRS has achieved mixed success in establishing long-term goals to integrate performance and financial management. During the fiscal year 2005 budget formulation process, the IRS took the important step of aligning performance and resources requested. The IRS also modified its budget and performance plans to include more customer-focused and "end result" measures. However, TIGTA believes that the IRS must continue to integrate performance into its decision-making and resource allocation processes to completely achieve an integrated performance budget.

The IRS also continues to analyze the critical data needed to develop long-term enforcement outcome measures. For example, the IRS released the first results from its NRP, which provided fresh data on taxpayer voluntary compliance levels—the first in more than a decade. Such data are essential to establishing enforcement measures and effectively allocating resources to related activities. The IRS, however, needs to develop a more strategic approach to the entire tax administration system. Such an effort would better identify the characteristics of an effective and efficient tax administration system, would help pinpoint desired outcomes, and would create a road map for the next decade that would complement the IRS's strategic, budget, and annual performance plans.

This past year TIGTA reported on two circumstances that highlight the need for more integration of performance and budget data. The Federal Workforce Flexibility Act of 2004⁴¹ requires agencies to regularly assess their training efforts to determine whether their training is contributing to the successful completion of the agencies' missions. However, the IRS was not able to assess how effectively the approximately \$100 million spent on training enhanced its ability to fulfill its mission.⁴² Additionally, the IRS could better manage its facilities and office space. TIGTA determined that the lack of appropriate performance data prevents the IRS from cataloging office space freed up by employees who regularly participate in the IRS's telecommuting program. This lack of performance data prevented the IRS from freeing up underutilized space with an estimated annual cost of \$18 million.⁴³

The IRS has reported a yield of more than \$4 in direct revenue from IRS enforcement efforts for every \$1 invested in the IRS's total budget. However, we do not believe there is an adequate basis to use the total IRS budget to determine a return on investment for enforcement activities. Enforcement is only one component of the IRS that collects revenue. Enforcement revenue (\$43.1 billion in fiscal year 2004) compared to the enforcement costs (\$6.1 billion in fiscal year 2004) actually equates to an overall return on investment for enforcement activities of 7 to 1. The IRS also provided estimates that it would eventually achieve approximately \$1.17 billion in additional revenues for its proposed fiscal year 2006 enforcement initiatives. This would equate to a 4.4 to 1 return on investment. However, our analysis indicates the revenue estimate may be too high. Furthermore, the IRS currently does not

⁴⁰"The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters" (Reference Number 2006-30-065, dated March 2006).

⁴¹Public Law 108-411 [S. 129] (2004).

⁴²"The Internal Revenue Service Does Not Adequately Assess the Effectiveness of Its Training" (Reference Number 2005-10-149, dated September 2005).

⁴³"The Internal Revenue Service Faces Significant Challenges to Reduce Underused Office Space Costing \$84 Million Annually" (Reference Number 2004-10-182, dated September 2004).

have a methodology to measure the revenue resulting from any initiatives that it implements.⁴⁴

The IRS's financial statements and related activities also continue to be of concern to IRS stakeholders. The GAO audits the IRS's financial statements annually. The audit determines whether the IRS: (1) prepared reliable financial statements, (2) maintained effective internal controls, and (3) complied with selected provisions of significant laws and regulations, including compliance of its financial systems with the Federal Financial Management Improvement Act of 1996.⁴⁵

In audits of the IRS's financial statements, the GAO has concluded that the statements were fairly presented in all material respects.⁴⁶ The GAO, however, identified some continuing serious deficiencies in the IRS's financial systems, including control weaknesses and system deficiencies affecting financial reporting, unpaid tax assessments, tax revenue and refunds, and computer security. Also, the IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements. Without a financial management system that can produce timely, accurate, and useful information needed for day-to-day decisions, the IRS's financial stewardship responsibilities continue to be one of the largest challenges facing IRS management.

During fiscal year 2004, the IRS collected over \$2 trillion in Federal tax revenue, which constituted approximately 95 percent of all Federal revenue. However, as reported by the GAO for the last several years, the systems used to account for these revenues do not meet current Federal financial management guidelines. For example, the IRS's Federal tax revenue financial management systems lack adequate audit trails, cannot readily produce reliable information regarding unpaid assessments at interim periods, and cannot readily generate custodial financial information needed for year-end reporting.

To address these weaknesses, the IRS is developing the Custodial Detail Database (the Database). The purpose of the Database is to provide sub-ledgers for the custodial financial activities of the IRS. The IRS also plans to use the Database to track unpaid assessments throughout the year and to help support the lengthy extraction, reconciliation, and summarization process needed to produce the IRS's annual financial custodial statements. TIGTA's preliminary assessment indicates that the IRS faces a number of significant challenges in meeting these objectives, especially the development of a system that would support the production of current and reliable information regarding tax receivables throughout the year.

To provide useful information on tax receivables at interim periods, the Database will also need to address collectibility issues, and accurately account for and eliminate duplicate assessments. Furthermore, the IRS continues to be unable to determine the specific amount of revenue it actually collects for three of the Federal Government's four largest revenue sources, primarily because the accounting information needed to validate and record payments to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. The IRS has to use statistical methods to estimate the amounts of these taxes.⁴⁷

Preventing Erroneous and Improper Payments

One of the goals of The President's Management Agenda is to reduce erroneous payments.⁴⁸ Further, the Improper Payments Information Act of 2002⁴⁹ greatly expanded the administration's efforts to identify and reduce erroneous and improper payments in government programs and activities. While the administration has pushed to prevent erroneous and improper payments, stewardship over public funds remains a major challenge for IRS management.

Improper and erroneous payments include inadvertent errors, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from outright fraud

⁴⁴"A Better Model is Needed to Project the Return on Additional Investments in Tax Enforcement" (Reference Number 2005-10-159, dated September 2005).

⁴⁵Public Law No. 104-208, 110 Stat. 3009.

⁴⁶"Financial Audit: IRS's fiscal years 2005 and 2004 Financial Statement" (GAO-06-137, dated November 2005).

⁴⁷The three revenue sources cited are Social Security, hospital insurance, and individual income taxes. "The Custodial Detail Database Should Help Improve Accountability; However, Significant Financial Management Issues Still Need to Be Addressed" (Reference Number 2006-10-029, dated December 2005).

⁴⁸"The President's Management Agenda", announced in the summer of 2001, is the President's aggressive strategy for improving the management of the Federal Government. It focuses on five areas of management weakness across the Government where improvements should be made.

⁴⁹Public Law No. 107-300, 116 Stat. 2350.

and abuse by program participants or Federal employees. For the IRS, improper and erroneous payments generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors.

Some tax credits, such as the Earned Income Tax Credit (EITC), provide opportunities for taxpayer abuse. The EITC is a refundable credit available to taxpayers who do not exceed a certain amount of income per year. The EITC was intended to provide significant benefits to the working poor, but some taxpayers have abused the credit, which has resulted in a significant loss of revenue. The IRS has estimated that approximately 30 percent of all EITC claims should not have been paid, which was approximately \$9 billion of the \$31 billion in EITC claimed for Tax Year 1999.⁵⁰ The IRS has been developing an EITC initiative to combat the problems of fraudulent EITC claims. The initiative is focused on three concepts: certification of qualifying child residency requirements, verification of filing status, and verification of reported income. In October 2005, the IRS reported that as a result of these efforts, it had identified and prevented the payment of over \$275 million in erroneous EITC claims. TIGTA has conducted an ongoing assessment of this initiative as the three concepts have been tested.⁵¹

The Criminal Investigation function of the IRS is responsible for detecting and combating tax refund fraud, through its Questionable Refund Program (QRP). TIGTA has repeatedly reported over the last 6 years that additional controls and procedures were necessary to not only identify additional instances of potential fraud, but also to properly and timely release refunds that are later determined not to be fraudulent. This latter issue recently has been the subject of much debate, coming on the heels of the National Taxpayer Advocate's 2005 Annual Report to the Congress in which the Taxpayer Advocate criticized the IRS for unnecessarily stopping refunds owed to legitimate taxpayers.

TIGTA previously reported in March 2003 that there were unnecessary delays issuing legitimate, non-fraudulent refunds.⁵² That same audit, however, identified expired statutory periods for making civil assessments of tax, thereby preventing recovery of erroneously refunded monies through an examination of income or expense items on the tax returns.

TIGTA is extremely concerned about this issue, believing that a necessary balance must be struck between protecting the revenue by not allowing refund fraud to go unchecked, and ensuring that legitimate taxpayers receive their refunds timely or, if challenged by the IRS, are afforded due process and notification. TIGTA is continuing its review of the IRS QRP and will report on its audit work later in the year.⁵³

Additionally, at the request of the House Committee on Ways and Means, TIGTA initiated an audit of the Electronic Fraud Detection System (EFDS). EFDS was designed to identify potentially fraudulent tax returns. We plan to report our results later in the year.

In addition to erroneous payments of credits, contract expenditures represent a significant outlay of IRS funds and are also susceptible to mistakes or abuse. As of October 2005, the IRS was responsible for administering 553 contracts with a total systems life value of \$28.2 billion. TIGTA continues to perform audits of select contracts to ensure payments on selected vouchers are appropriate and in accordance with contract terms and conditions. TIGTA also provided the IRS with a summary report highlighting several system deficiencies identified by the Defense Con-

⁵⁰ IRS report, "Compliance Estimates for Earned Income Tax Credit on 1999 Returns" (dated February 2002).

⁵¹ Audit reports previously issued: "The Earned Income Tax Credit Income Verification Test Was Properly Conducted" (Reference Number 2005-40-093, dated May 2005); "The Earned Income Credit Recertification Program Continues to Experience Problems" (Reference Number 2005-40-039, dated March 2005); "Initial Results of the Fiscal Year 2004 Earned Income Tax Credit Concept Tests Provide Insight on Ways Taxpayer Burden Can Be Reduced in Future Tests" (Reference Number 2005-40-006, dated October 2004); and "Management Controls Over the Proof of Concept Test of Earned Income Tax Credit Certification Need to Be Improved" (Reference Number: 2004-40-032, dated December 2003).

⁵² "Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected" (Reference Number 2003-10-094, dated March 2003).

⁵³ Audit reports previously issued: "The Internal Revenue Service Can Improve the Effectiveness of Questionable Refund Detection Team Activities" (Reference Number 2000-40-018, dated December 1999); "Revised Questionable Refund Program Procedures Were Not Consistently Implemented" (Reference Number 2001-40-025, dated January 2001); "Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected" (Reference Number 2003-10-094, dated March 2003); and "The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners" (Reference Number 2005-10-164, dated September 2005).

tract Audit Agency (DCAA) in the past 5 years for a major IRS contractor. These deficiencies could lead to overstated and unsupported labor and other costs. Although the contractor is making progress in addressing previously reported system inadequacies, TIGTA believes significant risk still remains for the IRS on this contract.

Taxpayer Protection and Rights

Congress realized the importance of protecting taxpayers and taxpayer rights when it passed the RRA 98. This legislation required the IRS to devote significant attention and resources to protecting taxpayer rights. The RRA 98 and other legislation require TIGTA to review IRS compliance with taxpayer rights provisions. Our most recent audit results on some of these taxpayer rights provisions are:

- Notice of Levy.*—TIGTA reports have recognized that the IRS has implemented tighter controls over the issuance of systemically generated levies, and TIGTA testing of these controls indicated that they continue to function effectively. In addition, revenue officers who manually issued levies properly notified taxpayers of their appeal rights.⁵⁴
- Restrictions on the Use of Enforcement Statistics to Evaluate Employees.*—The IRS is complying with the law. A sample review of employee performance and related supervisory documentation revealed no instances of tax enforcement results, production quotas, or goals being used to evaluate employee performance.⁵⁵
- Notice of Lien.*—The IRS did not completely comply with the law. For example, the IRS did not always timely mail lien notices. In other cases, the IRS could not provide proof of mailing. In addition, the IRS did not always follow its guidelines for notifying taxpayer representatives and resending notices when they are returned as undeliverable.⁵⁶
- Seizures.*—The IRS did not comply with all legal and internal guidelines when conducting seizures. TIGTA's review did not identify any instances in which taxpayers were adversely affected, but not following legal and internal guidelines could result in abuses of taxpayer rights.⁵⁷
- Illegal Tax Protestor Designations.*—The IRS is prohibited by law from designating taxpayers as “illegal tax protestors” but may refer to taxpayers as “nonfilers.” TIGTA has reviewed the Master File⁵⁸ for illegal tax protestor designations. We found that the IRS has not reintroduced such designations on the Master File and formally coded illegal tax protestor accounts have not been assigned similar Master File designations. In addition, the IRS does not have any current publications with illegal tax protestor references and has initiated actions to remove references from various forms of the Internal Revenue Manual. However, a few illegal tax protestor references still exist in isolated case files.⁵⁹
- Denials of Requests for Information.*—The IRS improperly withheld information from requesters in 7.1 percent of the Freedom of Information Act and Privacy Act of 1974 requests, and 3.1 percent of the 26 U.S.C. § 6103 requests reviewed.⁶⁰
- Collection Due Process.*—A significant portion of the Appeals Collection Due Process and Equivalent Hearings closed case files requested could not be located or did not contain sufficient documentation. As a result, TIGTA could not determine if the IRS complied with legal guidelines and required procedures to protect taxpayer rights. Moreover, some Appeals determination letters did not contain clear and detailed explanations of the basis for the hearing officers' decisions and did not adequately communicate the results of the hearings to tax-

⁵⁴“Taxpayer Rights Are Being Protected When Levies Are Issued” (Reference Number 2004-30-072, dated June 2005).

⁵⁵“Fiscal year 2005 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results” (Reference Number 2005-40-157, dated September 2005).

⁵⁶“Fiscal Year 2004 Statutory Review of Compliance With Lien Due Process Procedures” (Reference Number 2005-30-095, dated June 2005).

⁵⁷“Fiscal Year 2005 Review of Compliance With Legal Guidelines When Conducting Seizures of Taxpayers' Property” (Reference Number 2005-30-091, dated June 2005).

⁵⁸The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

⁵⁹“Fiscal year 2005 Statutory Audit of Compliance With Legal Guidelines Prohibiting the Use of Illegal Tax Protester and Similar Designations” (Reference Number 2005-40-104, dated July 2005).

⁶⁰“Some Improvements Have Been Made to Better Comply With the Freedom of Information Act Requirements” (Reference Number 2005-10-089, dated May 2005).

payers. Some determination letters did not address the specific issues raised or tax periods discussed by the taxpayers in their hearing requests.⁶¹

Neither TIGTA nor the IRS could evaluate the IRS's compliance with three RRA 98 provisions since IRS information systems do not track specific cases. These three provisions relate to: restrictions on directly contacting taxpayers instead of authorized representatives, taxpayer complaints, and separated or divorced joint filer requests.

Human Capital

Like much of the Federal Government, managing the extensive human capital resources at the IRS remains a serious concern. Workforce issues, ranging from recruiting to training and retaining employees, have challenged Federal agencies for years. The GAO, the OMB, and the Office of Personnel Management have all made the strategic management of human capital a top priority. Specifically for the IRS, recent reorganization and modernization efforts, such as the focus on e-filing, have made many jobs dealing with processing paper tax returns redundant.

The IRS also faces personnel shortages in certain functions. The Wage and Investment Division is experiencing critical staffing shortages in its TAC program. The IRS's decision to focus more resources on compliance activities has limited available resources and the IRS's Field Assistance Office does not have the resources to offer unlimited services. Additionally, the uncertainty around the TAC closures created critical vacancies as TAC employees left for other jobs in the IRS. As of December 1, 2005, the Field Assistance Office Headquarters had identified 47 TACs with critical staffing shortages. Five vacancies are in TACs located in areas impacted by Hurricanes Katrina and Rita—three in Louisiana and two in Texas. These shortages come at a time when taxpayer visits in these areas may increase and the Field Assistance Office is adding services to help reduce the burden on taxpayers affected by the hurricanes. As noted earlier, the IRS has reported fewer taxpayers are seeking assistance at the TACs.⁶²

The Large and Mid-Size Business Division reported in its fiscal year 2006 strategic assessment that it will continue to lose substantial experience in the revenue agent position through attrition. Similarly, in the Small Business/Self-Employed Division, the human capital crisis continues to intensify as employees in key occupations increasingly become eligible for retirement, are lost through attrition, or migrate to other areas. Stagnant funding allocations have impacted the IRS's ability to attract new hires and retain existing employees. Thus, potential losses in critical occupational groups, coupled with concerns regarding grade and competency gaps, further emphasize the need to strategically manage human capital. The IRS must devote significant attention to managing human capital to overcome the 10 challenges discussed in this testimony.

CONCLUSIONS

While the 2006 Filing Season appears to have been successful based on TIGTA's preliminary results, I am concerned about some of the challenges the IRS faces. In particular, it appears that changes in the Free File Agreement as well as the elimination of the TeleFile Program may have contributed to a significant slowing of the growth in electronic filing this year. This slowed growth comes at a time when the IRS is still far from reaching Congress's goal of 80 percent electronic filing by 2007. This slower growth will defer the efficiency gains for the IRS that result from electronic filing.

Also, without reliable estimates of the tax gap, IRS's compliance and customer service efforts may not be as effective as necessary to improve the voluntary compliance rate and reduce the tax gap. Additionally, reductions in customer services, such as TAC closures, the elimination of the TeleFile Program, and a reduction in toll-free telephone hours of operation, to gain resource efficiencies must be carefully considered before any further decisions are made. TIGTA continues to be concerned that the IRS does not ensure that it has adequate and reliable data prior to making decisions that impact customer service operations. Before proceeding with these efforts, the IRS needs to better understand the impact of such changes on taxpayers as well as taxpayers' abilities to obtain these services through alternative means.

I hope my discussion of the 2006 Filing Season and some of the significant challenges facing the IRS will assist you with your consideration of the IRS's fiscal year

⁶¹ "The Office of Appeals Should Strengthen and Reinforce Procedures for Collection Due Process Cases" (Reference Number 2005-10-138, dated September 2005).

⁶² "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program" (Reference Number 2005-40-037, dated March 31, 2006).

2007 appropriations. Mr. Chairman and members of the subcommittee, thank you for allowing me to share my views. I would be pleased to answer any questions you may have.

Senator BOND. Thank you very much, Mr. George, and we trust you will continue to monitor the Katrina emergency filing to make sure that people who deserve refunds are getting them and only those who deserve them. I think this is a concern that all of us share.

**STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE,
TAXPAYER ADVOCATE SERVICE**

Senator BOND. Now we turn to Ms. Nina Olson, the National Taxpayer Advocate. Ms. Olson, welcome.

Ms. OLSON. Thank you, Mr. Chairman, Senator Murray, and Senator Durbin.

The overriding objective of the IRS should be to maximize voluntary compliance with the tax laws. The IRS recently estimated that the voluntary compliance rate was 83.7 percent in 2001, and it has established a goal of raising the voluntary compliance rate to 85 percent by 2009. That is an appropriate goal. Compared with 10 years ago, there is little doubt that the IRS has become a more responsive and effective organization.

On the customer service side, the IRS Restructuring and Reform Act of 1998 and the IRS response has brought about fairly dramatic improvements. On the enforcement side, the IRS has been stepping up its enforcement of the tax laws over the past 5 years, particularly with regard to corporate tax shelters and high income individuals, but we can't just rest on our recent improvements and say that we are doing good enough. The IRS's central responsibility is to ensure that taxpayers comply with the tax laws. In fulfilling that responsibility, I believe job No. 1 is to provide high-quality outreach, education, and taxpayer assistance to enable taxpayers to meet their tax obligations voluntarily.

In most cases, that will be sufficient, but where taxpayers are unwilling to comply with the laws, job No. 2 for the IRS must be to detect noncompliance where it exists and address it through appropriate enforcement action for the IRS getting the biggest bang for the buck places a premium on superior research and strategic planning. Direct revenue gains resulting from an IRS action are easy to measure, but it is the combination of direct and indirect revenue gains resulting from IRS actions that determine how much progress we are making in reducing the tax gap. Not all service and enforcement actions generate the same return on investment.

Will the IRS ultimately bring in more revenue if it spends its next dollar on services or enforcement and more specifically on which services and on which enforcement activities? The truth is we don't know, and we, therefore, have limited information on which to base strategic decisions. Research is not cheap, but the IRS needs to devote more resources to understanding the causes of noncompliance and the relative returns of alternative compliance strategies in order to do its job more efficiently.

On the service side, the recently released report on phase one of the Taxpayer Assistance Blueprint, or the TAB, is the first step toward establishing a long-term strategy for delivering needed taxpayer services within existing resource limitations. In the next

phase of the TAB, we must focus on a number of areas that could have significant impact on congressional or IRS decisions about service delivery to taxpayers. In phase two, we must develop a baseline of services. We cannot assume that the current level of services reflects taxpayer preferences. The status quo is not necessarily what taxpayers want. It is merely what the IRS is currently willing or able to deliver.

We must identify what we are doing now, what we still don't know about taxpayer needs, and what services we need to provide to meet those needs. We also must identify the best method to deliver those needed services, and we must keep in mind that there are taxpayers who cannot or will not use self-service options.

To identify which services it should provide, the IRS must measure the impact of taxpayer service on compliance. The TAB notes that it is difficult to measure this impact. I believe the IRS does have the capability to develop useful estimates, and in my written testimony, I suggest a general framework for conducting this research. For example, we could identify a group of taxpayers who receive a particular service and an otherwise comparable group who do not receive that service. We could then measure the subsequent compliance of both groups by applying the three measures the IRS now uses to estimate the tax gap: payment compliance, filing compliance, and reporting compliance.

The IRS can also do a better job of estimating the full costs of its programs, including what I call the downstream consequences of its actions. For example, what are the downstream consequences of a lien or a levy, including the resources that TAS, the Taxpayer Advocate Service, Appeals Council and the courts may ultimately devote to resolving a taxpayer challenge? Failure to incorporate these downstream costs can provide an extremely inaccurate portrait of a program's return on investment. Downstream consequences analysis not only tells us the true cost of IRS actions, but it also gives us clues as to how to improve our processes from an IRS and a taxpayer perspective.

PREPARED STATEMENT

In conclusion, I believe that the IRS has taken major strides forward, but it can still do more to deliver its core mission more efficiently and effectively. To increase voluntary compliance, the IRS should incorporate an ongoing taxpayer-centric assessment of taxpayer service needs into its strategic plans. It should conduct research into the causes of noncompliance and apply the resulting knowledge to service and enforcement strategies, including those pertaining to the cash economy; and, finally, it must have sufficient resources to move forward with its technological improvements on both a short-term and a long-term basis.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF NINA E. OLSON

Mr. Chairman, Ranking Member Murray, and distinguished members of the subcommittee, thank you for inviting me to testify today regarding the proposed budget of the Internal Revenue Service for fiscal year 2007.¹

The overriding objective of the Internal Revenue Service should be to maximize voluntary compliance with the tax laws. In general, the IRS seeks to achieve compliance through two main types of activity. First, it seeks to enable taxpayers to comply with their tax obligations voluntarily. In most cases, outreach, education, and taxpayer assistance are sufficient to produce complete or substantial compliance. Second, it targets its enforcement resources at taxpayers who are unwilling to comply with the tax laws.

While a variety of measures can be applied to measure the IRS's performance, one of the best measures is the percentage of taxes that taxpayers pay voluntarily. The IRS's most recent estimate of the gross tax gap (i.e., the amount of tax unpaid before accounting for late payments and collection activity) was \$345 billion in tax year 2001, which implies a compliance rate of 83.7 percent.² The IRS recently established a long-term performance goal of increasing the compliance rate to 85 percent by 2009.³ In my view, this is a laudable goal.

What steps is the IRS currently taking to maximize voluntary compliance? What additional steps should it take? Can the IRS do more to reduce the tax gap without intruding unduly on fundamental taxpayer rights? These are the key questions I would ask in determining whether the IRS is making optimal use of its resources.

In many respects, the IRS is doing a better job of performing its core mission than it did in years past. By the IRS's current objective measures, it is providing customer service at a much higher level than it did a decade ago. On the enforcement side, it is performing more audits and aggressively pursuing corporate tax shelters and noncompliance by high-income individuals. However, the IRS's existing measures do not adequately capture costs associated with the "downstream consequences" of its programs and planning.⁴

To improve, the IRS must conduct an analysis of downstream consequences, including their impact on taxpayer service, and incorporate the results of that analysis into its strategic plans. Without adequate analysis of the downstream consequences of its options, the IRS cannot make informed strategic decisions about how to allocate resources between taxpayer service and enforcement activities and cannot tell its appropriators that it is using its limited resources wisely. Moreover, problems with IRS technology create additional downstream consequences. The IRS must be funded sufficiently to correct problems now with its existing technology—while it simultaneously strives to modernize its computer systems.

In the balance of my testimony, I will identify key issues I believe the IRS should address to get the biggest compliance bang for its buck.

THE IRS COULD DO A BETTER JOB OF ALLOCATING ITS RESOURCES PROPERLY IN ORDER
TO INCREASE OVERALL COMPLIANCE

Over the last 3 years, in hearings before the Senate Finance, Budget, and Homeland Security and Governmental Affairs committees, I have testified about ways to close the tax gap, both by reducing opportunities for noncompliance and by enhancing traditional enforcement actions.⁵ In the National Taxpayer Advocate's 2005 An-

¹The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. The statute establishing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

²See IRS News Release IR-2006-28, "IRS Updates Tax Gap Estimates" (Feb. 14, 2006).

³Office of Management and Budget, Proposed Budget of the United States Government for Fiscal Year 2007, at 232.

⁴By "downstream consequences," I mean the cost of additional work that IRS or taxpayers must perform to correct problems or mistakes that result from an IRS action or failure to take an action. For example, inadequate taxpayer service may lead to inadvertent taxpayer noncompliance, limitations of IRS computer systems may lead to IRS rework and direct harm to taxpayers, and inadequate communication with taxpayers during the audit process may result in rework via audit reconsideration or work performed in Appeals or the Taxpayer Advocate Service.

⁵See Written Statement of Nina E. Olson, National Taxpayer Advocate, Before United States Senate Committee on the Budget on The Causes of and Solutions to the Federal Tax Gap (Feb.

nual Report to Congress, I discussed in detail what the IRS can do administratively and what Congress can do legislatively to address the “cash economy,” which is the largest component of the tax gap.⁶

The question remains, however, whether the IRS is focusing its resources in the right direction to close the tax gap. The answer to that question depends, in part, on how we measure success. Is the IRS’s goal merely to increase enforcement revenues? Or is the goal to increase compliance? Or is it to increase voluntary compliance?

As I noted above, approximately 83.7 percent of the tax dollars known to be due and owing are voluntarily paid to the IRS. That figure is an IRS success, in and of itself. Now, what more can we do to achieve compliance with respect to the remaining 16.3 percent of the tax dollars for which taxpayers need some “nudging” to pay up? What types of “nudging” should the IRS apply? What resources does the IRS need to help these taxpayers comply or, in some instances, make them comply? The answers to these questions should inform the IRS’s resource allocation decisions.

The IRS is properly focused on increasing its traditional enforcement resources, since some taxpayers won’t comply unless they are “helped” in that way. The IRS also needs an enforcement presence so that taxpayers are a bit nervous about fudging—or worse—on their taxes. Yet, although we may want slightly “nervous” taxpayers, we don’t want them intimidated. That is, when taxpayers have a problem or a question, we want taxpayers to call the IRS so they will not make mistakes and join the ranks of noncompliant taxpayers. Every time a taxpayer calls the IRS or visits a taxpayer assistance center (TAC), the resulting interaction gives the IRS an opportunity to help that taxpayer comply with the tax laws. Why would we try to minimize these opportunities and not make positive use of them when they occur?

In my view, then, the real challenge facing the IRS is determining how to allocate its resources to increase overall compliance, including voluntary compliance, and determining what actions it must take—whether service or enforcement—to increase the number of taxpayers who voluntarily comply. In order to answer these questions, we must start with an understanding of taxpayer service needs—not what the IRS is willing or able to provide taxpayers, but what the taxpayer needs to have provided or available. The IRS mantra should be “know your taxpayer.”

THE IRS SHOULD UNDERSTAND MORE ABOUT THE IMPACT OF TAXPAYER SERVICE ON COMPLIANCE AND THE WAYS IN WHICH TAXPAYERS NEED SERVICES TO BE DELIVERED

It is true that the IRS has improved its delivery of many aspects of taxpayer service over the last decade. However, we cannot just rest on this improvement and say that we are doing “good enough.” The IRS’s central responsibility is to ensure that taxpayers comply with the tax laws. In fulfilling that responsibility, the IRS must provide taxpayers with the service, assistance, and education they need to comply. What we must consider now is just what level of service, assistance, and education is necessary for compliance.

I define taxpayer service very broadly—it includes notice clarity, tax law assistance, account resolution, free tax preparation, free e-filing, short response time, clear forms, and excellent education initiatives. This broad definition of taxpayer service makes clear its impact on compliance. Where noncompliance is attributable to complexity or confusion, for example, better forms, notices, and education initiatives can reduce the need for enforcement action.

Acknowledging the impact taxpayer service has on compliance, Congress directed the IRS, its Oversight Board, and the National Taxpayer Advocate to develop a 5-year plan for taxpayer service that includes long-term goals that are strategic and quantitative and that balance enforcement and service.⁷ I have previously voiced my concerns about the IRS’s need to study the trends in taxpayer service in order to

15, 2006); Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the United States Senate Committee on Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Oct. 26, 2005); Statement of Nina E. Olson, National Taxpayer Advocate, Before the United States Senate Committee on Finance on the Tax Gap (April 14, 2005); Testimony of Nina E. Olson, National Taxpayer Advocate, Before the Senate Committee on Finance on The Tax Gap and Tax Shelters (July 21, 2004).

⁶National Taxpayer Advocate 2005 Annual Report to Congress 55–75, 381–396. See also National Taxpayer Advocate 2004 Annual Report to Congress 478–489; National Taxpayer Advocate 2003 Annual Report to Congress 20–25, 256–269.

⁷S. Rep. No. 109–109, at 133–134 (2005).

understand the impact of taxpayer service on compliance and how taxpayers need services to be delivered.⁸

The IRS is facing a challenge. It has a responsibility to serve all taxpayers with limited resources. Thus, it must decide by taxpayer segment how to deliver needed services in the most effective and efficient manner possible, and in a way that does not negatively impact taxpayers' ability to comply with the tax laws. Toward this end, the IRS must gather data and develop criteria to make those decisions. The recently released report on Phase I of the Taxpayer Assistance Blueprint (TAB) is the first step toward developing a comprehensive 5-year plan for taxpayer service that will establish a long-term strategy for delivering needed taxpayer services within existing resource limitations.

In Phase I, we gathered both primary and secondary data about taxpayer needs and preferences. We also collected some information about our current level of services offered to taxpayers. From this and other information, we developed five hypotheses or "themes" that we think will improve service to taxpayers. However, Phase I is only the beginning. Phase II of the TAB will be even more critical because the goal of Phase II should be to test those hypotheses. To determine whether any of the hypotheses is correct, we must collect more primary source data about taxpayer service needs. We must then identify the gaps between taxpayer service needs and our present service offerings by analyzing how well our current level and type of service is actually serving different taxpayer segments. We will then see whether our hypotheses would improve service to different taxpayer segments.

I applaud the dedicated work of the IRS team that has labored over this strategic plan and gathered important information over the last 5 months. While we embark on the next phase of the TAB, we must focus on a number of areas that could have significant impact on Congressional or IRS decisions about service delivery to taxpayers.

We must develop a baseline of services.—This baseline should consist of specific numbers addressing how well the IRS is currently meeting customer service preferences and needs by service, taxpayer segment, and delivery method. Although the TAB Phase I report states that the current baseline of taxpayer services is one item on which the strategic improvement themes of the report are predicated, I do not believe this statement is completely accurate. Throughout the TAB Phase I report, we examine the current usage and volume of current IRS services. However, these current usage statistics do not serve as a proxy for taxpayer preference. We cannot assume that the current level of service reflects taxpayer preferences. The status quo is not necessarily what taxpayers want—it is merely what the IRS has been willing (or able) to deliver. Instead, during Phase II, we must conduct research to develop this baseline of services. Only after this research is completed will we be able to measure how effective we are in improving our ability to meet taxpayer needs.

We must identify what we don't know.—Before we can move forward with our research in Phase II, we need to understand what we still need to know and what questions we need to ask in order to find the right answers. It is important that the TAB not rely on pre-conceived decisions, but instead identify what we are doing now, what we still do not know about taxpayer needs, and what we need to do to address those needs or educate taxpayers and move them to other channels.

We must identify the best channels through which to deliver services to taxpayers.—While electronic and self-assistance channels may be growing in popularity, mere use or access to these services does not necessarily mean that taxpayers are able to frame questions, conduct complex searches, and process or use the information correctly. Additionally, we must always remain cognizant that there is a segment of the population that cannot and will not avail itself of self-service options. However, by providing more self-service opportunities for taxpayers, the IRS should be able to reserve its in-person (face-to-face or telephone) interaction for those issues and taxpayers that need such engagement.

Thus, as part of the TAB, the IRS must commit to conduct—or at least to attempt to conduct—the additional research necessary to enable it to establish a broad baseline identifying how well taxpayer needs and preferences are currently being met for each of the major types of services by customer segment and channel—and to

⁸Statement of Nina E. Olson, National Taxpayer Advocate, Before the United States House Appropriations Subcommittee on Transportation, Treasury, and Housing and Urban Development, the Judiciary, District of Columbia, and Related Agencies (March 29, 2006); National Taxpayer Advocate 2005 Annual Report to Congress 2–24; Statement of Nina E. Olson, National Taxpayer Advocate, Before the United States Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies (Apr. 7, 2005).

quantify the impacts associated with not meeting those needs (i.e., the downstream costs and taxpayer-compliance impact). Moreover, we need to understand why certain taxpayer segments have difficulties with our various types of services and why they are reluctant to use lower cost channels (if indeed they are). Only then can we develop effective “migration” strategies to encourage and educate taxpayers about appropriate lower cost channels—ones that will not ultimately increase non-compliance and lead to greater downstream costs.

For example, it is true that computer ownership and Internet access have increased over the last decade.⁹ But those numbers do not necessarily mean that the computer owner is computer literate and can conduct site searches for complex tax information, much less understand how to apply that information once he finds it. In fact, in the financial services sector, banks have reversed the trend of closing branches in the hope of moving taxpayers to Internet banking.¹⁰ Instead, they are developing migration strategies for customers to complete certain types of transactions on-line or by phone, and are retaining their in-person services for more complicated transactions or for those customers who really cannot navigate the phones or Internet. Banks are certainly not turning those customers away, and now recognize that those customer segments are a relatively untapped market in need of services. There are lessons here for the IRS.

THE IRS SHOULD WORK WITH “PARTNERS” BUT NOT RELY ON THEM EXCESSIVELY

The IRS is increasingly relying on partners to deliver core IRS services. Clearly, partners are very important to effective tax administration, and I applaud the efforts of dedicated professionals and volunteers in assisting taxpayers. However, this reliance raises several concerns. First, when the IRS relies on partners to deliver a message, we need to study what happens to the message in the course of delivery. Does the message change over distance and time? Is it less accurate? The worst result is a broad dispersion, through partners, of an incorrect or distorted message. Second, we need to measure the downstream consequences of this trend. What are the true costs of effective oversight over these partners? Who conducts such oversight and bears the cost? If taxpayers bear the cost, will they continue to comply if the cost is too great or the quality too poor? Will the IRS actually realize any savings or will it incur more expense through additional enforcement activity that could be avoided if the IRS itself delivered the assistance?

On the other hand, if we begin to rely more heavily on our partners for the delivery of services, we must also ensure that we are providing our partners with adequate support and assistance. Without a sufficient support system in place, we cannot expect our partners to act as a delivery channel for services we are unable or unwilling to provide.

Finally, we don’t know what the impact on compliance or what the downstream cost will be if most of the IRS’s direct contact with taxpayers is in the form of enforcement actions and most taxpayer assistance and service is delivered by third parties. As the IRS becomes more remote, except with respect to enforcement actions, will noncompliance increase because taxpayers feel less connection with their government?¹¹

THE IRS SHOULD NOT IMPOSE UNREASONABLE BURDENS ON VOLUNTEER INCOME TAX ASSISTANCE (VITA) PROGRAMS

As the IRS struggles with the challenge of serving all taxpayers with limited resources, we have already begun to reduce free tax preparation assistance previously provided to taxpayers. Over the past 3 years, the IRS has reduced the number of tax returns prepared in Taxpayer Assistance Centers (TACs) from 665,868 tax re-

⁹Internal Revenue Service, Wage and Investment Office of Research, “Taxpayer of the Future” (June 2003), 11.

¹⁰Bruce C. Smith, “In Age of Online Banking, Lenders Branch Out”, Indianapolis Star (Oct. 2, 2005), available at <http://www.indystar.com/apps/pbcs.dll/article?AID=/20051002/BUSINESS/510020335>.

¹¹See Leslie Book, “The Poor and Tax Compliance: Once Size Does Not Fit All”, 51 Kan L. Rev. 1145, 1151, 1175–1176 (2003). Professor Book discusses various studies that note that enforcement may be more effective in addressing intentional noncompliance where the taxpayer segment is disaffected from government and society at large. On the other hand, “taxpayers who felt a shared identity with authorities seem to be more concerned with the overall justice of the tax system and the fairness of their treatment, regardless of individual outcome.” Id. at 1151 n. 21.

turns in fiscal year 2003 to a proposed 305,000 tax returns in fiscal year 2006.¹² Instead, the IRS has increased its reliance on the Volunteer Income Tax Assistance (VITA) Program to fill the gap and provide free tax preparation assistance to taxpayers.¹³ As IRS service has decreased, the VITA Program continues to expand. However, this expansion may have come too fast.

The VITA Program provides a vital service to an underserved segment of taxpayers, but there are limits to what volunteers and volunteer-staffed organizations can do. Although there are a number of successful volunteer organizations around the world, hallmarks of these success stories are that they are year-round organizations supported by a large, paid infrastructure dedicated to the support of the volunteers. The VITA Program primarily operates for 4 months during the tax season and receives limited resources and support from the IRS. This makes it hard to ensure quality and consistency in the returns prepared at VITA sites.

While the service VITA provides is critical, the IRS cannot rely entirely on these volunteers to provide a service the IRS has deemed too costly or time consuming to provide itself. Instead of concentrating on expanding the VITA Program, the IRS should concentrate on developing a fundamental support structure for the program, including site management, training, and quality review.¹⁴ Once the IRS has developed a strong infrastructure for the VITA Program and has established consistent quality in the returns prepared by volunteers, then the IRS can work to expand the program. However, the IRS must remain cognizant that VITA, or any volunteer program, cannot and should not be expected to serve as a substitute for IRS-provided service.

THE IRS SHOULD MAKE IT POSSIBLE FOR TAXPAYERS TO PREPARE AND FILE THEIR TAX RETURNS ELECTRONICALLY WITHOUT PAYING A FEE

Electronic filing of tax returns brings benefits to both taxpayers and the IRS.¹⁵ From a taxpayer perspective, e-filing eliminates the risk of IRS transcription errors, pre-screens returns to ensure that certain common errors are fixed before the return is accepted, and speeds the delivery of refunds. From an IRS perspective, e-filing eliminates the need for data transcribers to input return data manually (which could allow the IRS to shift resources to other high priority areas), allows the IRS to easily capture return data electronically, and enables the IRS to process and review returns more quickly.¹⁶

In my view, the IRS should place a basic, fill-in template on its website and allow any taxpayer who wants to self-prepare his or her return to do so and file it directly with the IRS for free.¹⁷

Some representatives of the software industry have taken the position that such a template would place the IRS in the position of improperly competing with private industry or, worse, create a conflict of interest between the IRS's role of tax preparer and tax auditor.

This is nonsense. Since the inception of the tax system, there have always been two categories of taxpayers—those who are comfortable enough with the rules to self-prepare their returns and those who turn to paid professionals for assistance. In the paper-filing world, the IRS has always made its forms and instructions uni-

¹²Wage and Investment, "Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2006"; Wage and Investment, "Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2005"; Wage and Investment, "Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2004"; Wage and Investment, "Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2003".

¹³The VITA Program was designed to provide free tax preparation to individuals who are unable to afford professional assistance. Stakeholder Partnerships, Education and Communication, "VITA Celebrates Its Thirtieth Year of Service". VITA is a diverse program comprising several segments, including community-based VITA, academic VITA, military VITA, Tax Counseling for the Elderly (TCE), and co-located VITA, each serving a different taxpayer population.

¹⁴The IRS has taken a step in the right direction with the development of the Link & Learn training site which allows volunteers to receive training and become certified online. According to IRS data, the new training program has proven successful and the number of certifications issued for 2006 was 11,885, compared with 10,402 certifications issued as of the same time last year.

¹⁵See S. Rep. No. 105-174, at 39-40 (1998).

¹⁶The IRS Restructuring and Reform Act of 1998 directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007. See Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 2001(a)(2), 112 Stat. 685 (1998). The 80 percent e-filing goal is probably not achievable by 2007. However, we believe Congress should reiterate its commitment to seeing the IRS increase the e-filing rate as quickly as possible.

¹⁷See National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

versally available without charge to all taxpayers, and those taxpayers who require help have always been free to seek the assistance of paid preparers.

Imagine that, shortly after the income tax was enacted, a large group of bricks-and-mortar tax preparers had launched a lobbying campaign to try to persuade Congress to prohibit the IRS from making forms and instructions available to the public on the ground that the availability of these materials improperly placed the government in the position of competing with private industry. Or on the ground that it created a conflict between the government's role as preparer and auditor. Congress almost certainly would have rejected such arguments as ludicrous. Yet those are exactly the same conceptual arguments being raised today by those who contend that the government's provision of a basic web-based, fill-in form to all taxpayers would undercut the private sector.

The answer to these arguments in today's electronic environment should be the same answer that Congress would have provided 80 years ago in a paper environment. For those taxpayers who are comfortable preparing their returns without assistance, the government will provide the means to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they are free to purchase one.

A brief personal anecdote. Although I prepared tax returns professionally for 27 years before I became the National Taxpayer Advocate and don't need assistance from others to prepare my return, my government salary places me above the income cap to qualify to use Free File products. To prepare my return electronically last month, I therefore spent \$19.99 to purchase tax preparation software. When I completed preparing my return, the software program informed me that, to file electronically, I would have to pay a fee of \$14.95. If I wanted this fee deducted from my refund rather than charged to a credit card, an even higher fee would apply. Although I deeply believe that e-filing is best for both taxpayers and the IRS for a host of reasons, I resented the notion that I would have to pay separate fees to prepare my return and to file it, so I printed out my return and mailed it in.

I am hardly alone. IRS data shows that about 40 million returns are prepared using software yet are mailed in rather than submitted electronically.¹⁸ This is a shame, because the practice delays the length of time for processing refunds, it requires the IRS to devote additional resources to entering the data manually when it receives the return, and it creates a risk of transcription error.

There is no reason why taxpayers should be required to pay transaction fees in order to file their returns electronically. A free template and direct filing portal would go a long way toward addressing this problem and would result in a greater number of taxpayers filing their returns electronically. Both taxpayers and the government would stand to benefit.¹⁹

THE IRS CAN AND SHOULD DO A BETTER JOB OF MEASURING THE IMPACT OF TAXPAYER SERVICE ON COMPLIANCE

The Taxpayer Assistance Blueprint notes that it is difficult to measure the impact of taxpayer service on compliance. Of the private sector and government entities that the TAB team surveyed, all had concluded that customer service at least indirectly impacts their organizations, but only one had attempted to empirically measure that impact.

Although little has been done in this area, I believe the IRS does have the capability to develop useful estimates, and am suggesting a general framework for conducting this research. Measuring the compliance impact of customer service would entail identifying a group of taxpayers who received a particular service (the "treatment group") and an otherwise comparable group that did not receive that service (the control group). Compliance of both groups could then be measured on returns filed subsequent to the receipt of service by the treatment group. The three meas-

¹⁸ IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

¹⁹ In addition to benefiting taxpayers and the IRS, I believe this proposal would be good for the software industry. Under the existing Free File arrangement, the industry is making its Federal tax products available for free to tens of millions of taxpayers. By itself, that is hardly a recipe for business success. If industry is able to make a profit under this arrangement, it is only because it is aggressively marketing ancillary products to taxpayers and making money on the sale of those ancillary products. The provision of a basic preparation and filing option would enable taxpayers who don't want to pay a fee and know how to prepare their tax returns to do so, but all taxpayers who want the benefits of a question-and-answer format and checks to ensure they do not overlook any tax benefits to which they are entitled would have to pay to purchase the tax product. Moreover, the IRS would be unlikely to develop a template itself. The IRS almost certainly would contract with the private sector to develop it. In that respect, the IRS would be utilizing the innovation of the private sector—not competing with it.

ures used to estimate the tax gap could be applied: payment compliance, filing compliance, and reporting compliance.

We can determine the payment compliance of survey respondents by simply observing whether the full tax liability was paid at the time of filing. We can estimate their filing compliance by determining whether non-filers appeared to have a filing requirement. To determine reporting compliance, by far the biggest component of the tax gap, we could use IRS developed algorithms for estimating reporting compliance. These algorithms have been updated based on results from the recently completed National Research Program (NRP) and should provide good preliminary estimates. The estimates could subsequently be validated during the next NRP by comparing actual reporting compliance against predicted reporting compliance based on the IRS algorithms.

MEASURING THE DIRECT EFFECT

If we accept the above proposed framework as a valid means of estimating compliance, surveys could then be designed and administered to identify groups of taxpayers who did or did not receive certain services, such as telephone or Internet assistance with tax law questions, Internet or TAC assistance obtaining forms, etc. Subsequent compliance of those who receive the service could then be compared to compliance for a comparable group who do not. Taxpayer satisfaction with services received might also be an interesting variable to examine.

MEASURING INDIRECT EFFECTS

It is possible that taxpayer compliance behavior may be influenced by knowledge and attitudes about IRS customer service offerings, even if the affected taxpayers have not used those services. The same basic proposed framework could be used to measure these indirect effects. We would have to determine a set of relevant attributes to identify taxpayer groups indirectly affected by IRS customer service offerings. It seems to me that such attributes would probably include use, awareness, access and general satisfaction level:

- Use.*—To be indirectly affected, a taxpayer could not have used the service in question (at least during the year being studied).
- Awareness.*—A taxpayer would have to be aware of the existence of a service to be influenced by it.
- Access.*—It seems likely that taxpayers who could access the service if they chose to are more likely to be influenced (e.g., those living close to a TAC).
- Satisfaction Level.*—It seems likely that taxpayers having a generally favorable level of satisfaction with our services are more likely to be positively influenced (and vice versa).

Surveys could be administered to determine whether compliance was impacted based on the values for the above attributes (or others suspected of indirectly affecting compliance).

RETURN PREPARATION

The IRS has data that enable us to estimate compliance for the entire population of returns by type of preparation: IRS prepared, VITA/TCE, commercial, taxpayer prepared. I think it would be interesting to compare estimated reporting compliance for IRS prepared returns against comparable returns (i.e., low income, especially EITC) prepared by the other methods. We might find that IRS-prepared returns are substantially more compliant—especially when EITC is claimed. If so, this would provide strong support for continuing and perhaps expanding return preparation in the TACs.

THE IRS SHOULD INCLUDE THE COST OF THE DOWNSTREAM CONSEQUENCES OF ITS ACTIONS IN ITS RETURN ON INVESTMENT (ROI) CALCULATIONS

The IRS needs to conduct more thorough and accurate analyses when measuring return on investment (ROI) in order to allocate future dollars appropriately. For example, although in the short run it may cost more to process and review an Offer in Compromise and it may appear that the government is writing off revenue, the taxpayer in the long run may pay more tax dollars into the system as a result of his promise to be fully compliant for the 5 succeeding years.²⁰ Five years is a long enough period to enable the taxpayer to “learn” a new norm of behavior, namely,

²⁰If a taxpayer fails to comply with all his tax obligations over the 5-year period following IRS acceptance of an offer, the IRS may rescind the offer and reinstate the tax debt. See IRS Form 656, Offer in Compromise.

compliance. And when you compare the 16 cents on the dollar that IRS receives from offers²¹ to the virtually no cents it collects after year 3 of the 10-year collection period,²² the Offer in Compromise suddenly looks like a very efficient and productive program.

When computing ROI, the IRS should include the costs of the downstream consequences of its enforcement actions. Downstream consequences analysis tells us not only true ROI (i.e., the true cost to the IRS) but also gives us clues as to how to improve our processes from an IRS and a taxpayer perspective. That is, downstream consequences analysis is a form of taxpayer service.

The Criminal Investigation Division's Questionable Refund Program (QRP) is a recent example of the failure to capture an accurate return on investment. The QRP serves an important tax administration purpose by helping the IRS detect and prevent the payment of fraudulent refund claims.²³ Criminal Investigation (CI) dedicates approximately 600 Full Time Equivalents (FTEs) to this program. As we described in the National Taxpayer Advocate's 2005 Annual Report to Congress, the QRP was freezing hundreds of thousands of refunds each year without notifying the affected taxpayers. This failure to notify taxpayers that their refunds were being held generated more taxpayer calls to the IRS toll-free lines and to the Taxpayer Advocate Service (TAS) than CI could respond to in a timely fashion.

In fiscal year 2005, the Taxpayer Advocate Service (TAS) received over 28,000 QRP cases. In TAS's office in the Atlanta campus, approximately 65 percent of case inventory per case advocate involves QRP. Moreover, during fiscal year 2005, the IRS Examination function reviewed 25,621 QRP cases, and some of those cases went on to the IRS Appeals function. This level of activity protected approximately \$2.2 billion in fiscal year 2004, of which \$1.8 billion was attributable to just two returns that should have been discovered anyway, particularly since the Joint Committee on Taxation must review any refund over \$2 million. So, the maximum direct revenue protection generated by all that IRS activity was \$400 million. In addition, my office found in a study of the 28,000 QRP cases that came to TAS that fully 80 percent of taxpayers whose refunds were frozen as potentially fraudulent ultimately were found to be entitled to a full or partial refund. Had the IRS actually tracked the downstream consequences of the QRP and included these costs in the program's ROI, the IRS probably would have figured out a way to protect the same level of revenue with fewer FTE or developed a better method of identifying cases with the same CI FTE that did not generate the need for phone, exam, Appeals, and TAS FTE—not to mention interest the IRS is having to pay to tens of thousands of taxpayers whose refunds were frozen unnecessarily.

The QRP is a prime example of an IRS program that grew up over time without the benefits of true strategic planning or proper oversight. Despite the volume of taxpayer calls coming in on our toll-free lines about these refunds, the Fraud Detection Centers have limited capacity to make or receive phone calls. Thus, their processes are designed to avoid any direct or interactive contact with taxpayers or others. As TIGTA noted in several reports,²⁴ the QRP has inadequate management oversight processes, including inadequate reports of inventory levels and case status. Further, the little taxpayer correspondence generated by QRP was uninformative and intimidating. Today, the IRS is scrambling to meet the terms of its agreement with my office as to how it will correct these program deficiencies. Each day we face challenges, primarily arising from system limitations in re-programming.²⁵

²¹IRS Small Business/Self Employed Division, Offer In Compromise Program, "Executive Summary Report" (Jan. 2006).

²²IRS Automated Collection System Operating Model Team, "Collectibility Curve" (August 5, 2002).

²³For a detailed discussion of the Questionable Refund Program, see National Taxpayer Advocate 2005 Annual Report to Congress 25–54.

²⁴Treasury Inspector General for Tax Administration, "The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners" (Ref. No. 2005–10–164) (September 2005); Treasury Inspector General for Tax Administration, "Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected" (Ref. No. 2003–10–094) (March 31, 2003); Treasury Inspector General for Tax Administration, "Revised Questionable Refund Program Procedures Were Not Consistently Implemented" (Ref. No. 2001–40–025) (Jan. 2, 2001); Treasury Inspector General for Tax Administration, "The Internal Revenue Service Can Improve the Effectiveness of Questionable Refund Detection Team Activities" (Ref. No. 2000–40–018) (Dec. 22, 1999).

²⁵The National Taxpayer Advocate believes that the QRP will only function properly, productively, within the norms of taxpayer rights, and without creating excessive downstream consequences if it is moved out of the sole jurisdiction of CI and into a collaborative arrangement

IRS STRATEGIC PLANNING AND RESOURCE ALLOCATION DECISIONS SHOULD BE BASED
ON MORE AND BETTER RESEARCH

The need for better research underlies all of these challenges. The IRS must conduct research, organized by taxpayer segment, to better understand taxpayer behavior and taxpayer response to IRS's various service and enforcement "touches." The absence of research about taxpayer needs often leads the IRS to place its immediate resource needs over taxpayers' immediate and long-term needs.²⁶ This approach may cause more taxpayers to become noncompliant, thereby requiring more expensive enforcement actions. Concern over the lack of research and taxpayer-centric strategic planning led Congress to enact Section 205 of the fiscal year 2006 Appropriations Act funding the IRS and to direct the IRS to develop a 5-year strategic plan for taxpayer service.²⁷

I have written at length elsewhere on the need to understand the causes of non-compliance so that the IRS doesn't adopt a one-size-fits-all enforcement approach.²⁸ Each year, academics and other scholars propose many ideas that a 21st century tax administrator should be examining and testing. In fact, the IRS has such a vehicle for partnering with academics in the Intergovernmental Personnel Act (IPA) program. Unfortunately, this program is underutilized. The IRS must conduct and underwrite such applied research, just as other world-class tax administration systems do.

Because taxpayer service and enforcement are the drivers of overall compliance, we need to measure taxpayer service needs concurrently with our efforts to measure the tax gap. Thus, the National Research Program should update its analysis of taxpayer service needs at the same time it is measuring taxpayer noncompliance for the particular taxpayer population it is studying. The IRS can make informed resource allocation decisions only if it is armed with both types of information.

THE IRS SHOULD ADDRESS THE IMPACT OF IRS BUSINESS SYSTEMS MODERNIZATION
LIMITATIONS ON BOTH TAXPAYER SERVICE AND ENFORCEMENT INITIATIVES

When I was in private practice as an attorney representing clients before the IRS, I did not have a full appreciation of how significant a role Business Systems Modernization (BSM) plays in both creating and solving problems for taxpayers and the IRS. As the National Taxpayer Advocate, I know that on a regular basis my office

between CI and either the Wage & Investment or Small Business/Self-Employed Operating Division. This approach reflects the current model for the Frivolous Filer program.

²⁶The declining number of Taxpayer Assistance Center (TAC) visits is an example of IRS placing its resource needs over taxpayer needs. For fiscal year 2006, IRS established a goal of preparing 20 percent fewer tax returns in TACs than in fiscal year 2005. Not surprisingly, TAC visits for year-to-date fiscal year 2006 have declined 14 percent compared with this time last year. Even though the decline in TAC usage appears to result from IRS-imposed limitations on service, the IRS is nonetheless citing this decline as a justification for making further reductions in service at the TACs. Wage & Investment, "2006 Filing Season Data: Cumulative Statistics Report" (Feb. 25, 2006).

²⁷Public Law No. 109-115, § 205, 119 Stat. 2396 (2005). Specifically, the statute provides:

"None of the funds appropriated or otherwise made available in this or any other Act or source to the Internal Revenue Service may be used to reduce taxpayer services as proposed in fiscal year 2006 until the Treasury Inspector General for Tax Administration completes a study detailing the impact of such proposed reductions on taxpayer compliance and taxpayer services, and the Internal Revenue Service's plans for providing adequate alternative services, and submits such study and plans to the Committees on Appropriations of the House of Representatives and the Senate for approval: . . . *Provided further*, That the Internal Revenue Service shall consult with stakeholder organizations, including but not limited to, the National Taxpayer Advocate, the Internal Revenue Service Oversight Board, the Treasury Inspector General for Tax Administration, and Internal Revenue Service employees with respect to any proposed or planned efforts by the Internal Revenue Service to terminate or reduce significantly any taxpayer service activity."

The accompanying Joint Explanatory Statement of the Committee of Conference stated: "The conferees direct the IRS, the IRS Oversight Board and the National Taxpayer Advocate to develop a 5-year plan for taxpayer service activities . . . The plan should include long-term goals that are strategic and quantitative and that balance enforcement and service." H. Rep. No. 109-307, 209 (2005).

²⁸See National Taxpayer Advocate 2004 Annual Report to Congress 211 (Most Serious Problem: IRS Examination Strategy) and 226 (Most Serious Problem: IRS Collection Strategy); National Taxpayer Advocate 2005 Annual Report to Congress 55 (Most Serious Problem: The Cash Economy); Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, United States Senate, on "The Tax Gap" (Oct. 26, 2005); Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the Committee on the Budget, United States Senate, on "The Causes of and Solutions to the Federal Tax Gap" (Feb. 15, 2006).

identifies systemic problems for which the complete solution requires some sort of BSM fix.

When Commissioner Everson began his tenure, he ordered three separate reviews—two external, one internal—of the state of IRS BSM projects. Based on these reviews, the Commissioner quickly—and, I believe, correctly—concluded that the IRS was spreading its internal BSM resources too thin. Project managers and experts charged with overseeing our key initiatives—such as the Integrated Financial System (IFS) and the Customer Account Data Engine (CADE)—were also managing scores of smaller projects, all more or less important but all detracting from our central progress on IFS and CADE.

For the past 2 years, the IRS has focused on its primary projects and strictly controlled the number of other BSM projects. This approach makes sense because it is critical to both effective service and enforcement that the IRS move forward with its primary initiatives. On the other hand, many projects cannot be deferred too much longer without significantly impacting taxpayer rights, accuracy of taxpayer data, and effective examination and collection initiatives. Indeed, improvements to TAS's own Systemic Advocacy Management System, our database for receiving, tracking, and managing taxpayer and IRS employee submissions of systemic problems in tax administration, were requested in November 2004. Although worked on intermittently, these changes are not yet completed or delivered. Until recently, this project was ranked number 33 on a list of 33 projects in terms of priority.

I will provide one illustration of the impact of the IRS's outdated computer systems. In the National Taxpayer Advocate's 2004 Annual Report to Congress, I reported that the IRS is miscalculating collection statute expiration dates on certain taxpayer accounts. The collection statute expiration date (CSED) represents the date beyond which the taxpayer is no longer obligated on a tax debt and the IRS must cease its collection efforts.²⁹ Miscalculations of CSEDs can negatively affect a taxpayer when the CSED on a particular tax erroneously appears on the IRS computer systems as being within the statute of limitations period, resulting in continued IRS collection activity, when in fact the statutory period for collections has expired. An incorrectly calculated CSED can also negatively impact the IRS when the CSED is miscalculated to reflect that the statute of limitations period has expired when in fact the debt is still collectible.³⁰ This problem continues today and harms tens of thousands of unsuspecting taxpayers. Where the IRS or the taxpayer identifies a case of unlawful collection, the taxpayer experiences delays in receiving a return of the unlawfully levied proceeds. In some instances, the IRS takes the position that the taxpayer will never receive the unlawfully levied funds because the refund is barred by the applicable statutory period of limitations.

In response to TAS's concerns, the IRS and TAS established a joint team that identified impacted taxpayers, developed additional guidance and training alerts, and submitted requests for systems improvements to eliminate the problem of incorrectly calculated CSEDs. Given the current demand on IRS programming personnel, the final system modifications are not now scheduled to occur until some time in 2007.

Internal Revenue Code Section 7433 permits a taxpayer to file a civil action for damages against the United States in Federal district court where an IRS officer or employee disregards any provision of the Code or its regulations with respect to collection of tax. In general, damages under this provision are limited to \$1 million where the breach is attributable to reckless or intentional disregard and \$100,000 where it is attributable to negligence. Thus, the IRS's knowing failure to correct the CSED problem in a timely fashion exposes the government to potentially large damages.

THE IRS'S FILING AND PAYMENT COMPLIANCE (F&PC) INITIATIVE SHOULD BE MADE A PRIORITY

Filing and Payment Compliance (F&PC) is one of the IRS's most important business modernization initiatives.³¹ The F&PC initiative was designed to offer the IRS a modernized collection system with a focus on applying the right collection "touch" to suit the characteristics of the case. Instead of the automatic three-stage IRS col-

²⁹ IRC § 6502(a)(1).

³⁰ National Taxpayer Advocate 2004 Annual Report to Congress 180–192.

³¹ Testimony of Internal Revenue Service Commissioner Mark W. Everson, Before the Senate Committee on Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development and Related Agencies (April 7, 2005).

lection process that does not differentiate among the causes of non-compliance,³² the implementation of F&PC was going to establish four treatment streams for collection cases:

—*Self-Assist / Self-Correct*.—Using enhanced systems, the IRS would allow for electronic payment, Internet-based payment, and payment via telephone application. Thus, taxpayers would have more payment options to resolve delinquency issues.

—*Assisted Correction*.—Using commercially available decision analytic software, the IRS would select the appropriate treatment for taxpayers depending on factors such as payment history and other actions taken by the taxpayer. Modernized systems would provide up-to-date taxpayer information so that decisions would be made on the most recent data.

—*Private Collection Agencies*.—The IRS proposed using private collectors to locate and contact taxpayers, request that full payment be sent to the IRS, and in appropriate cases, request taxpayer financial information. While we are extremely concerned about the use of private collectors and about the structure being put in place to support the initiative,³³ its use in conjunction with other appropriate treatment streams provided some assurance that the IRS would narrowly tailor the use of private collectors.³⁴

—*Enforcement*.—For those cases that cannot be resolved through communication efforts with the taxpayer, traditional enforcement efforts would be used.³⁵

Release 1 of the F&PC initiative involves the use of private collectors.³⁶ Release 2 will employ commercial off-the-shelf software to assist in case selection for the private collection effort as well as the development of the Self-Assist treatment. In Release 3, the case selection software will be augmented with additional decision analytics software for the development of Assisted Correction treatments.³⁷

The F&PC initiative has not been adequately funded to ensure that the most useful, taxpayer-friendly, and forward-thinking treatments, i.e. Self-Assist and Assisted Correction, will be funded. While it appears that the IRS is fully committed to privatizing collection, having already reached Release 1,³⁸ cuts to F&PC funding will endanger the prospects of achieving F&PC's other objectives—objectives that do not raise the significant taxpayer rights concerns of the Private Debt Collection initiative.³⁹ Thus, the failure to fund F&PC Releases 2 and 3 ensures that the only legacy of F&PC will be private debt collection.

We are also concerned that the lack of funding for F&PC systems not only deprives taxpayers of a sophisticated collection approach but also encourages the IRS to take actions to reduce collection cycle time without adequate consideration for taxpayer rights or taxpayer compliance.⁴⁰

³²In the 2004 Annual Report to Congress, we set forth a critique of the IRS's traditional approach to collection and identified the elements of a modern collection strategy, including the ability to identify the appropriate collection touch for the particular cause of noncompliance. National Taxpayer Advocate 2004 Annual Report to Congress 226.

³³We have addressed numerous concerns about the initiative, including the limited training of frontline private collection employees on issues such as taxpayer rights. See National Taxpayer Advocate 2005 Annual Report to Congress 76. We are also skeptical that the PDC initiative will produce a positive return on investment. See discussion, *infra*.

³⁴In testimony last month before a House Appropriations subcommittee, IRS Commissioner Mark Everson acknowledged that tax debts to be assigned to private collection agencies could be collected more efficiently by additional IRS collection personnel. See Dustin Stamper, "Everson Admits Private Debt Collection Costs More, Defends Return Disclosure Regs," 2006 Tax Notes Today 61-1 (March 30, 2006); Rob Wells, "US Rep. Rothman Calls IRS Pvt Tax Collection Fact Wasteful", Dow Jones Newswires (March 29, 2006).

³⁵Filing and Payment Compliance Concept of Operations, Filing and Payment Compliance Project Office, April 18, 2005, 75-80.

³⁶Treasury Inspector General For Tax Administration, Ref. No. 2006-20-026, "The Alternatives for Designing and Developing the Filing and Payment Compliance Project Should be Re-validated" (Dec. 2005); see also Capital Asset Plan and Business Case, Business Systems Modernization, Exhibit 300 (2005).

³⁷*Id.*

³⁸Challenges to the procurement process have delayed implementation of the initiative. Dustin Stamper, "IRS Orders Private Debt Collectors to Stop Work", Tax Notes Today (March 24, 2006).

³⁹Testimony of James R. White, Director of Tax Issues, General Accountability Office, Fiscal Year 2007 Budget Request, Committee on House Ways and Means Subcommittee on Oversight (April 6, 2006).

⁴⁰By way of example, the IRS has undertaken several initiatives to hasten the issuance of taxpayers' Collection Due Process (CDP) notices in order to reduce collection cycle time. Pursuant to Code sections 6320 and 6330, taxpayers are entitled to a collection due process hearing after the filing of the first Notice of Federal Tax Lien and before the imposition of the first levy on a tax account. One such initiative, termed the "Initial Contact Initiative," required revenue

THE RETURN-ON-INVESTMENT OF THE PRIVATE DEBT COLLECTION INITIATIVE WILL
PROBABLY BE LOWER THAN EXPECTED

The Private Debt Collection (PDC) initiative as envisioned under Phase I of F&PC is another example of a program that might not be undertaken, or would be approached differently, if its downstream consequences were considered. The premise of the PDC initiative is essentially this: "There is a significant amount of tax debt that the IRS can't go after because it doesn't have the resources. If we simply turn those cases over to private collection agencies, they'll collect the debt for us and the government will get to keep 75 to 80 cent of every dollar the PDCs are able to collect."

The problem with that simple approach is that it fails to take into account the enormous amount of IRS resources that need to be devoted to creating and supporting the program. Once the program rolls out, the IRS estimates that only a small percentage of taxpayers—perhaps on the order of 15 percent—will be resolved by the PDC unit itself. The rest of the cases will be sent back to the IRS "Referral Unit" for additional actions that only the IRS can constitutionally take on the account. Keep in mind that these are cases that the IRS currently considers too unproductive to devote resources to. Yet ironically, under the PDC initiative, the IRS will end up pulling employees off high-priority, high-return cases to work on these low-priority, low-return cases.

This approach makes little business sense, and on top of that, the program raises significant concerns about the adequacy of taxpayer rights protections and confidentiality of tax return information. In fact, to make the program profitable, the IRS will be under pressure to expand the authorized actions private collection agencies can take on a case so they can work higher dollar, more complex cases. This expansion would clearly raise constitutional concerns.⁴¹

Thus, the PDC initiative is a paradigm example of how looking at the narrow justification for a program can make it look brilliant, while viewing the program in its totality paints a very different picture.

TRENDS IN TAXPAYER ADVOCATE SERVICE (TAS) CASE INVENTORY

I close with a reflection on the Taxpayer Advocate Service and its role in identifying and mitigating the downstream consequences of IRS actions and programs, and improving taxpayers' attitudes toward the tax system. This recent March 1 marked my 5-year anniversary as the National Taxpayer Advocate. They have been quite remarkable years—I have watched my talented and dedicated employees achieve a quality rating of 91.6 percent through fiscal year 2005, up from 71.6 percent in 2001. They achieved this quality despite a 15 percent decline in case advocates in our statutorily mandated offices around the country, from 1,325 case advocates in March 2003 to 1,127 case advocates in February 2006. And these successes were achieved despite a slight increase in TAS case receipts from fiscal year 2003 to fiscal year 2005.⁴²

In fact, TAS case receipts themselves provide an interesting study in downstream consequences. As IRS increases its enforcement activity, TAS compliance inventory increased to nearly 70 percent of our case receipts for the first quarter fiscal year 2006, up from 67 percent in first quarter fiscal year 2005. In fiscal year 2005, TAS cases involving liens and levies increased by 50 percent and 43 percent, respectively, over fiscal year 2004. During first quarter fiscal year 2006, TAS continued to see an increase in lien and levy cases. Lien and levy cases tend to involve economic urgency to the taxpayer. TAS procedures require case advocates to respond immediately to the taxpayer's request for assistance in these cases. With the increasing

officers to issue CDP rights to taxpayers on initial contact with the taxpayers instead of when a levy was the next planned action. Because we believed this initiative makes CDP hearings less meaningful, we opposed the initiative. After discussions with the IRS, it was agreed that the Initial Contact Initiative would only apply to business taxpayers and to certain individual taxpayers who also have business tax delinquencies. Recently, the IRS planned to move the CDP notice up even further in the collection process to the second notice issued to business taxpayers. After discussion with my office, the IRS agreed that this latest initiative would not be undertaken at this time. We believe that the IRS has been attempting to implement broad collection initiatives because its current business systems do not adequately differentiate among taxpayers based on their compliance history.

⁴¹ For a detailed discussion of the IRS Private Debt Collection initiative and its constitutional and taxpayer rights implications, see "Use of Private Agencies to Improve IRS Debt Collection", Subcommittee on Oversight, House Committee on Ways and Means, 108th Cong., 1st Sess. (statement of Nina E. Olson, National Taxpayer Advocate, May 13, 2003); see also National Taxpayer Advocate 2005 Annual Report to Congress 76–93.

⁴² In fiscal year 2005, TAS received a total of 197,679 cases. In fiscal year 2003, TAS received a total of 196,040 cases.

number, complexity, and urgency of our case load, TAS risks getting behind on cases that involve IRS system failure as we give priority to cases that involve economic harm. If the balance between our staffing and the number of cases we handle continues to deteriorate, TAS is in jeopardy of becoming part of the IRS problem rather than the advocate for the solution, as Congress intended.

Significantly, TAS Customer Satisfaction surveys provide some evidence that the quality and nature of taxpayer service has an impact on taxpayer attitudes toward the tax system. When a taxpayer brings an eligible case to TAS, he is assigned a case advocate who works with him throughout the pendency of the case. Taxpayers have a toll-free number direct to that case advocate, and each TAS office has a toll-free fax number. TAS employees are required to spot and address all related issues and to educate the taxpayer about how to avoid the problem from occurring again, if possible. This level and quality of service drives TAS's high taxpayer satisfaction scores,⁴³ which have averaged about 4.35 on a scale of 5.0 for the last two fiscal years. Most importantly, 57 percent of taxpayers stated that they feel better about the IRS as a whole after coming to TAS. Even among taxpayers who did not obtain the result they sought, an astonishing 41 percent reported that they had a more positive opinion of the IRS because of their experience with TAS.

CONCLUSION

Compared with 10 years ago, the IRS today is a more responsive and effective organization. On the customer service side, the IRS Restructuring and Reform Act of 1998 and the IRS response has brought about fairly dramatic improvements. On the enforcement side, the IRS has been stepping up its enforcement of the tax laws over the past 5 years, particularly with regard to corporate tax shelters and high-income individuals.

But the IRS can, and should, do better. To increase voluntary compliance, it should incorporate an ongoing taxpayer-centric assessment of taxpayer service needs into its strategic plans. It should conduct research into the causes of noncompliance and apply the resulting knowledge to IRS enforcement strategies, including those pertaining to the cash economy. Finally, it must have sufficient resources to move forward with its technological improvements, on both a short-term and a long-term basis.

Senator BOND. Thank you very much, Ms. Olson. You certainly shared my concerns about the funding, and I think that your points about research are well worth considering, because I think there are some opportunities here to improve it.

Before we turn to the questions, we have been joined by Senator Durbin. Senator, would you like to offer an opening statement, either orally or in writing?

Senator DURBIN. No. Proceed, Mr. Chairman.

Senator BOND. Okay. We will turn now to the questions.

TAX GAP

Mr. Commissioner, as I stated in my opening remarks, I believe the IRS needs more resources to effectively attack the tax gap. The budget request flat funds it. How does your budget request reduce the tax gap?

Mr. EVERSON. Well, Mr. Chairman, as I have indicated—we can maybe look at the tax gap map—we have several components. The budget request will continue the enforcement build that this committee and the Senate and the House provided for last year. We have been hiring or are in the process of hiring those people now. So there will be a time of training, and then you will see, as they become more effective, we will continue to bring up the number of audits, the number of collections, the document-matching activities. That will have an impact.

⁴³Taxpayer Advocate Service customer satisfaction survey data for the period from October 2003 through September 2005, as collected by The Gallup Organization.

Beyond that, in the budget request, as I indicated, we have several legislative proposals that I think are terribly important. I would point out that they have been characterized by some as modest. I agree with that, but if you compare them to anything that has been done in 20 years, there have been no requests on additional third-party reporting. If we can agree that is required, as shown in the chart I showed a few minutes ago where you have the No. 1 and No. 2 noncompliance rates where you don't get any reporting, I think that will be an equally important step, sir.

ALLOCATION OF ADDITIONAL RESOURCES

Senator BOND. The IRS Oversight Board recommended additional funding of \$363 million. The Senate took the Oversight Board's recommendation. I know it is above the OMB budget request, but if you were to receive that additional funding, how would you propose to spend it?

Mr. EVERSON. Yes. I am aware of the Budget Committee action, and as you say, it is about \$330 million or \$340 million. We are looking at that now in the event that it should carry through. We would do two things. We would add bodies, of course, across a range of activities, but we would, and I think it would be permitted under the resolution, specifically add to the infrastructure and the systems money. At this stage, it is important for us to invest in technology on both the service, but particularly on the enforcement side of the house.

So I don't have a specific answer yet, but we are working on that.

Senator BOND. I would like to ask the others. I would like to ask Chairman Wagner what he would suggest and any comments from the others.

Mr. WAGNER. Thank you, Mr. Chairman, with the additional funding, of course I would agree with the Commissioner that adding additional FTE toward targeted areas would be warranted and would be contemplated by our recommendation. Certainly some of the additional resources would go toward the research that we have all talked about in order to best determine which area to allocate those additional resources, whether they are toward attacking the fraudulent payments dealing with the cash economy that was suggested in the Commissioner's chart, dealing with non-compliant enterprises and so on and so forth.

The other thing that we would hope would come from additional resources would be the development of more productive partnerships between IRS and tax professionals, more emphasis on the website communicating customer service opportunities toward the taxpayers and, of course, improving customer service through issues such as telephone service and so on.

Senator BOND. That is a heavy burden to put the little \$300-plus million.

Mr. George, any further comments?

Mr. GEORGE. Mr. Chairman, simply to state regarding the tax gap, there is no question that if the complexity of the tax code were simplified or erased, compliance would increase tremendously. I realize that is not within the jurisdiction of this committee. Nonetheless, that would certainly help close the tax gap.

As the chairman's chart showed, you have a major under-reporting within the small business community, and I think if you had third-party reporting, as he noted, of those tax receipts or the income receipts, that would also assist in closing the gap.

Senator BOND. I think everybody knows my commitment to small business. I want to see small business succeed, but we expect them to pay the taxes they owe.

Ms. Olson, any comment on additional dollars?

Ms. OLSON. Well, I think it would be wise to invest in the next phases of filing and payment compliance, particularly the risk-based assessment system of identifying how collection cases should be handled, who should get the touches, and my other point would be that additional personnel would enable the IRS to focus on some current projects that are being shelved because of our rightful focus on our big projects, but there is not a day that goes by that I say to the IRS, "Can't we solve this problem for this group of taxpayers?" and I am told, "We can't do that right now; we have to focus on this big project."

Senator BOND. Thank you very much, Ms. Olson.

Now we turn to the ranking member.

Senator MURRAY. Thank you very much, Mr. Chairman.

PRIVACY OF TAXPAYER DATA

Mr. Everson, I wrote to you on March 22 to express my opposition to the proposed regulations regarding the privacy of taxpayer information. In some respects, the proposed regulations I know tighten some of the restrictions, but in other ways, they really loosen them—I know there is taxpayer's sign-off—to allow them to sell that to unidentified unaffiliated third parties.

My view personally is this: taxpayers are not likely to want their information going to marketers at all. I would like you to share with this committee why you are providing any opportunity for tax preparers and their affiliates to use personal financial data to sell mortgages or mutual funds or IRA accounts or life insurance—don't taxpayers already have enumerable opportunities to shop for services like that without subjecting their personal tax returns to perusal by marketers?

Mr. EVERSON. I appreciate the question, Senator. This is an important subject, and I have testified on it several times already. The first thing I would like to say is we are taking a lot of comments on this. I have gotten a lot of letters. We have actually had hearings on this, which we do with important regulatory proposals. We are going to assess all of those.

What we are trying to do here is have a balanced approach. This piece of the law has been in effect for over 30 years, but the world has changed since that time. The regulation is prompted, as much as anything, by Congress in terms of inquiries on the outsourcing, the preparation of tax returns overseas in India where nobody was aware of that happening.

So we are trying to move to make better protections here. I guess the basic question is: "Whose information is it?" Is it the taxpayers' information or is it the Government's information? We at the IRS, as you know, don't share their information with anybody. So it is a question of preparers, and I guess we don't think that under cur-

rent law the IRS can say you as an individual don't have the right to share financial information with Kit Bond if you want to. That is—if I could just finish, I was trying to get to the dynamic here.

So what we are trying to do is provide a really clear protection that in the event that that arrangement starts to take place, that you have a clear detailed consent, a warning as to what could happen, but we don't think under statute now we could say you aren't free to share your information with that preparer.

Senator MURRAY. Do you think there is a critical mass of people in the country who want their information sold?

Mr. EVERSON. I don't. What I do think, though, is that this gets to Senator Dorgan's remarks. Certain firms, the big firms, they now have integrated services and they are providing a range of services, like IRAs or advice, to taxpayers. Other smaller firms who are the trusted real financial advisor of somebody, once a year they sit down and they get their health check-up financially, if you will, and they say how are you doing, and they could be able to maybe advise someone to get the IRA on behalf of a bank or whatever else is there.

The other thing I would point out to your staff, we are very concerned about the possible implication of this to the VITA sites. Those are programs that, as you are aware, operate around the country. Over 2 million returns were prepared this year. They are very exciting to communities because people come in. They file largely for the EITC. That money goes out into the community, but the coalitions that are out there also do other things. They share. They help get the people banked or into other benefit programs.

You may know, in your own State, 2.8 percent of the returns last year in Washington came through the VITA program as opposed to 1.6 percent nationally. Our people are very concerned if we move to outright prohibition of any sharing that you would kill that program and that all the good things that are happening for those people where there is a bundling of services wouldn't be allowed.

So it is a complicated issue, Senator.

Senator MURRAY. Look, I am very worried about this being abused. You know, we know how this works. It is 4 p.m. on April 15. You are signing the last piece of paper the tax preparer has put in front of you. You are signing everything as fast as you can, and I have heard that tax preparers actually want you to loosen this requirement that pertains to the way they get consent from taxpayers to sell their information.

Do you think there is any chance in the world that the final rule is going to loosen consent procedures under your proposed rule?

Mr. EVERSON. Loosen consent procedures? By that, you mean change the consent form that we propose?

Senator MURRAY. Yes.

Mr. EVERSON. I think that clearly the consent procedures are much tighter, but I don't want to say anything precise, because I think that would be wrong under the APA, for me to comment as to what the final rule will look like. I am not involved in that at this stage, but we are really honestly looking at this, and is it is a tough issue.

Senator MURRAY. Well, under your proposed regulation, you require written consent from the taxpayer if the tax preparer wants to process that overseas.

Mr. EVERSON. Yes.

Senator MURRAY. You justified that requirement because as the Commissioner, you don't have any enforcement authority to prosecute abuses overseas. If you don't have authority to protect taxpayers' privacy overseas, why are you allowing this information to go overseas at all?

Mr. EVERSON. I don't think that we have the authority to stop that. I think that that is something that is done by private parties. There is no law that says people can't contract out, or it is a far broader question. It is not any different than a company hiring a subcontractor to develop parts for an auto or something else.

Senator MURRAY. But the law says you have to enforce privacy.

Mr. EVERSON. Yes.

Senator MURRAY. So you are telling us you can't enforce the law? So why are we allowing this to go overseas?

Mr. EVERSON. Well, I think we are attempting to strengthen the control over the privacy through this proposal. The other thing I would indicate is we have increased our investigations of promoters of return preparers dramatically in the last 2 years. A year ago, we had 125 reviews taking place. This year, we have over 500 reviews taking place.

My understanding is, and perhaps this is a question for Mr. George, that the provisions of 7216 are actually largely enforced by TIGTA. So there is a shared responsibility here on this.

Senator MURRAY. My time is up, but, Mr. Chairman, I am deeply concerned about this privacy issue. I think most people assume their taxpayer information is private that goes to the IRS, and I think we have to be very, very careful that it doesn't become some kind of marketing program.

Senator BOND. I would agree with that, and I think I understand the point that the Commissioner is making. If you read "The World is Flat", you will find that there is a tremendous amount of, heaven forbid, legal research being done overseas too which threatens some of our professions as well as some taxpayers services being done overseas.

I turn now to Senator Durbin.

Mr. EVERSON. Mr. Chairman, could you indulge for me 1 minute? I want to say one thing. Of course, if the Congress looks at this to change the law, which I guess I believe would be necessary to really have an outcome, we, of course, will work with the Congress at looking at all these issues. So it is not beyond the regulation.

Senator BOND. Senator Durbin.

Senator DURBIN. Thanks, Mr. Chairman. Thank you all for being here today.

I have this notion that if every member of Congress was required to prepare their own income tax returns personally, we would see simplification of the tax code overnight. We turn, instead, to bookkeepers, accountants, lawyers to try to guide us through this thick-et, and we can't blame anyone other than others. We write the law.

So I hope that as a result of this hearing and others, we will be inspired to make this a little more easily understood. Nobody likes

to pay taxes, but if they think that they are being taxed fairly, they are a lot more accepting of this responsibility.

INDEPENDENT CONTRACTORS

Speaking of paying taxes fairly and tax evasion, I recently had a group of bricklayers from Chicago meet with me in the basement of the Capitol, and they came in to complain. They said we understand that every contractor isn't a union contractor; we have to compete with non-union contractors, but we are concerned about another problem.

Too many of these so-called non-union contractors don't have employees. They have independent contractors working for them. The net result is taxes are not withheld from the wages or income that is paid to these workers, and so ultimately taxes are not paid, neither State, Federal, local taxes, unemployment compensation, and workers' compensation.

Mr. Wagner, you were former head of the Illinois Department of Revenue.

Mr. WAGNER. Yes, sir.

Senator DURBIN. In 2004 alone, misclassifying these workers as independent contractors when, in fact, they were employees was at a rate of 21 percent in the State of Illinois, 67,745 employers statewide, 7,478 in the construction industry. The State of Illinois alone lost \$158 million in income taxes not withheld from actual employees because they called themselves independent contractors.

So the bricklayers said to me, Senator, what are you going to do about this; we don't mind competing with people who are paying taxes as we are, but why should we have to try to compete with people for evading their taxes; where is the Internal Revenue Service?

So I would like to ask you where is the Internal Revenue Service?

Mr. EVERSON. Senator, you are covering a very important subject. Let me make a couple of points about it. As I indicated, we have five legislative proposals on strengthening tax administration. It is the most ambitious since the Reform Act of 1986, which had effect of where citizens, taxpayers, had to list the Social Security number of their dependents, and the next year, 5 million dependents vanished. So we know when you do more reporting, you get more compliance.

Why is this important? Take a look at this: Starting in 1978, all individual returns, the number of returns we have gotten, have increased by 50 percent. The number of Schedule C filers—these are the folks that are organized as independent contractors—they have increased by 175 percent, and as I indicated, I think before you came in—let us go back to this other chart—the noncompliance rate is 50 percent in this category of individuals where they organize as small businesses, but they are unincorporated, because basically they are not reporting all of their income.

There are issues on the employer side which you are talking about. I can assure you that the number of 1099 miscellaneous forms, the reporting they are supposed to do to us, that has not increased as rapidly as the number of Schedule C returns has increased.

So this is an important area. We have said beyond the five proposals that we want to look at the definition of independent contractor. This is the manual that our people have to go through to assess whether somebody is an independent contractor. We have been precluded by statute since 1978, I believe was the year, from addressing what is the definition of an independent contractor. We are going to study that and hopefully make some proposals, but it is terribly important because the world has changed, as those charts indicated and as your constituents indicate.

We do need to address this jointly.

Senator DURBIN. Let me ask you are you saying that it is a problem in definition or a problem in law or it is a lack of resources to investigate and enforce?

Mr. EVERSON. It is both, sir. We have been precluded from changing the standards by which we look at independent contractors for approaching 30 years now. That is because of the importance, which is legitimate, of small business in this country and a reluctance to look at that issue, but we have said as an administration that we want to study it and then work to get a better definition and more consistency so that people fall on the right side of the line just as you are indicating, because what happens is what you are saying. Somebody is paid as an independent contractor, as a business that isn't absorbing those employment taxes that they ought to be, and then the individual, as we have indicated here, is not reporting the gross income.

Senator DURBIN. How long is this going to take?

Mr. EVERSON. Well, we will be making the study over the course of coming months, and what is important now, I would suggest to you in a leadership position, it is very important to take a look at these five proposals that we have made right now on gross receipts, say for credit card issuers. That is a big start in this area.

Senator DURBIN. This is all well and good, and I support what you are doing, but let me suggest in the meantime a few cops on the beat wouldn't hurt. Sending some investigators out and starting to ask questions of contractors who are using so many independent contractors may put a chill on this practice while we are trying to come up with the modernization of the law and more resources for you to enforce it.

Mr. EVERSON. We are increasing our audits, sir.

Ms. OLSON. If I may.

Senator BOND. Go ahead.

Ms. OLSON. In this year's annual report to Congress, my annual report to Congress, I reported on this very issue. I reported on a program that the United Kingdom has to address this very issue that they have had for the last 30 years. They have focused on the construction industry because there is so much cash economy in underreporting, and they require workers who are independent contractors in the construction industry that when they are hired, they have to present to the person who is hiring them a compliance certificate from England Revenue that states that they are fully in compliance with the tax laws and with their payment, and if they are not in compliance, then the person who is hiring them has to do a withholding on the gross payments that they are making. They find that that approach has really helped with that cash econ-

omy and leveled the playing field between people who are treated as employees and independent contractors.

Senator DURBIN. Thank you.

PRIVACY OF TAXPAYER DATA

Senator BOND. Ms. Olson, you may want to comment on the proposed rules. I know you have been involved in the development on the rule on privacy, and for the record, I would like to get your comments on that.

Ms. OLSON. Thank you, sir. The 7216 rules have two categories of approaches, use and disclosure, and I think there are concerns with each one of those applications. I find the proposed rules, which I worked on very closely with the IRS, to be a vast improvement over the current rules, which I find very anti-taxpayer and provide very little consumer protection.

I want to make the distinction that “use” is the term that we use where the taxpayer is having a conversation with the preparer. The information doesn’t go outside the room, and the preparer is asking for permission to use the taxpayer’s information to peddle a product, but you are not talking with a third person at that point.

“Disclosure” is where the information is leaving the room with a preparer and going out to the taxpayer. Under the current rules, the taxpayer isn’t told the impact of that disclosure, isn’t told what might happen if the information goes overseas, isn’t told that that third party when you get that information can be disseminated and sold and reused by anyone for any amount of time. So the current rules really focus on a lot of restrictions and up-front notification.

Now, I am the first to admit that we could do more, but I think that we need legislation in this area. The current rules only apply to preparers. So we have no rules about what happens to people who receive this information if we don’t do an out-and-out ban. We have no criminal penalties against them. We have no civil fines against them.

So there are a number of things that we can do to improve it.

Senator BOND. Thank you, Ms. Olson.

BUSINESS SYSTEMS MODERNIZATION

I would like to ask the GAO witnesses to join us at the table because I want to talk about the BSM. We are hearing that BSM is making some progress, but the budget request, the OMB request for BSM, looks like they are, as I said, punishing good performance.

How do you see, Mr. Commissioner, the performance of BSM and how does it compare to the success 2 years ago?

Mr. EVERSON. Mr. Chairman, as you know from following this, we have made modernization of the IRS one of our three strategic priorities, and that relates to work processes and in particular the systems. I think we have made a great deal of progress on this. We downsized the portfolio a couple of years ago, provided greater focus to it, and inserted more business people into the process that had been done largely with just the tech folks. That has made a lot of difference. The CADE project is on sounder footing now. One huge success is the modernized E-filing.

It hasn't been mentioned yet, but in December 2004, we mandated the electronic filing of returns by corporations and nonprofit institutions over a certain size. We have received over 300,000 returns this year thus far. There was no technology to do that at the time that we did this. There was a lot of uproar from industry saying you can't do this, industry told us or the software people said, until you mandate it, we won't have the product. So it was a chicken and the egg thing.

We mandated it. The software was developed, and now we are moving forward. So there are successes.

Your point, drawing it down, I think that this is a minimal level for us to proceed. It is a complicated question, as you know, as to the overall funding levels. In those negotiations as we work with the administration, I spread the money to what I thought was the most responsible way, sir.

Senator BOND. Mr. Powner, if you would give us your full name and comments on the BSM performance, better or worse.

Mr. POWNER. I am David Powner with the Government Accountability Office. Performance has improved consistently over the years. Our work for you, Mr. Chairman, in looking at the expenditure plans on an annual basis has shown that is performance perfect? No, but when you compare this to past performance of other programs across the Federal Government, this is one of the better-run programs when you look at their performance over the past couple of years, if you look at the leadership of this program. Decreasing funding on the BSM at this point in time clearly, as our statement indicates, will decrease the pace and momentum and could affect the long-term delivery of systems such as CADE.

Senator BOND. I appreciate your good work, your very technical analysis of all of this. I have a former GAO worker, who can translate for me, who seems to indicate that you are saying we should provide more money to the BSM program. Is that an accurate assessment of your very good technical analysis?

Mr. POWNER. Yes. Mr. Chairman, at this point in time, if you inched up their budget, we are clearly in that camp given their past performance. I think they deserve that. I think it is an opportunity to keep the pace going. We are not in the camp with Chairman Wagner, looking at a doubling of the budget. There still are many risks associated with the program and contractor performance, we should report to you, last week, in looking at IRS's internal capacity to manage requirements.

So yes. I think it would be prudent to increase the budget slightly, but a doubling of the budget, we are clearly not in that camp today.

Senator BOND. Mr. George, do you have a comment on it?

Mr. GEORGE. I would just note, Mr. Chairman, that there is no question BSM has improved over the progress in the last few years. At the same time, as I noted in my oral statement, it is still behind schedule and it is also over budget. For example, the CADE system, if fully implemented, would certainly have expedited the return of refunds to taxpayers tremendously, and it is not yet fully implemented. So that is a problem, and then the modernized E-file system that the Commissioner averted to, they have had three re-

leases thus far. That too is 18 months behind schedule and is over \$37 million over budget.

So there is a recurring problem in that report, sir, and it is not limited solely to BSM. I think it is throughout the service. Again, progress has been made, but more needs to be done.

Senator BOND. Thank you very much, Mr. George.
Senator Murray.

TAXPAYER ASSISTANCE CENTERS

Senator MURRAY. Mr. George, I wanted to ask you when you analyzed the data that the IRS used to justify their proposal to close the Taxpayer Assistance Centers, you found that IRS's data for as many as one-quarter of the TACs was found to be fraught with errors. You found that not all the data used was accurate or the most current available and some of the data was based on estimates and projections instead of actual data currently available. Those errors affected the ranking and overall selection of the TACs the IRS wanted to close.

Mr. EVERSON. I wanted to give you an opportunity to respond.

Mr. EVERSON. Sure. I was a little hurt by your strong statement earlier that this called into question anything the IRS ever said. I know I am exaggerating a little.

Senator MURRAY. I will let you rebut.

Mr. EVERSON. I don't think that is the case, and I think that we do our very best to be credible in any representation we make either to the public or, of course, to the Congress. Sometimes we make mistakes or information is incomplete.

On the TACs, the IG looked at it. We had something like 35 or 36 categories that went in to the model. The conclusion that was reached was that the model was a good one. It weighted appropriately a whole series of demographic and other cost factors. You are correct. There were individual data errors, but the model was not particularly sensitive to those conclusions. In something like—I can't recall the exact number—maybe 10 of the numbers would have changed the relative rankings, but it didn't take something that was No. 40 on the list and make it No. 380, if you will.

This was a tool that we wanted to use to identify the best candidates for reduction. It was never going to be so incredibly precise that we had overridden the criteria, the strict criteria for a couple of factors. You may recall we didn't want to eliminate more than half the TACs, in any State. We said the TACs had to be in the 35 major metropolitan areas no matter how they came out.

So I think perhaps that statement that the model produced nothing of value, I wouldn't agree with that. Can we do better? We always can do better on data integrity. So yes.

The last thing I will say is this did cause a lot of concern last year. We stood down in our proposal well before this report was ever done, as you know. We stood down on that proposal, oh, last July, I guess it was when I suspended it. Closing down those 68 centers is not a part of the current request. Both you and the chairman have talked about our savings proposals. We believe that we will be able to achieve those savings proposals without reducing services or closing any of these walk-in centers.

So I want to reassure that is not an active proposal at all. My concern would be the chairman is talking about adding money, potentially, to BSM. I want to make sure that we do fully fund the services piece, as is well within this budget. My worry would be if it was cut a little bit or, as you know, a lot of this is salary dollars. If the pay increase comes in above what is proposed, there could be pressure here.

Senator MURRAY. Well, in a briefing that we had last year by TIGTA on these Taxpayer Assistance Centers, I learned that some of the TACs have as little as one or two staff and what TIGTA called a critical staffing storage. Now, the House and Senate majority and minority said no to the proposal to cut back TACs until the TIGTA completed a study on the impact of the reductions, but are you, in fact, allowing these TACs to eventually close by just letting the staffs dwindle?

Mr. EVERSON. No, we are not. There were some employees who chose to move to other parts of the agency while this was currently before the Congress. So we had some storage shortages as the filing season approached, and what we did was we reassigned employees out of other pieces of the agency to make sure that we would keep the centers open.

A year ago, I had several inquiries from members of Congress about—

Senator MURRAY. Are you currently filling those vacancies?

Mr. EVERSON. Yes. We are moving to re-hire those people, and we don't have any plans for closing TACs at this time and would not draw them down. If what you are saying is just somebody leaves and we don't re-fill the position, no, we are not doing that.

Senator MURRAY. Mr. George or Ms. Olson, do either one of you want to comment?

Mr. GEORGE. Just briefly, Senator Murray. There is no question that the model that the IRS has developed, we determined it was sound. Some of the data was inaccurate. Other parts of it were not current, but all of the ranking of the TACs were not accurate as a result of having inaccurate or outdated information.

Ms. OLSON. I believe that regardless of what the actual architecture of the model looked like that it was based on flawed assumptions. It was based on the current status quo of what services the IRS was offering, and as we know, over the last year, it has been declining as a goal, the number of tax returns that they have prepared within the TACs. So when you say, well, usage is dropping, it is because we are turning people away at the door.

We never measured the number of people who were lined up outside the walk-in sites, and my employees in Federal buildings throughout the United States informed me that people were lined up during filing season outside the doors, blocking access to the Taxpayer Advocate Service doors for my employees.

Yesterday and the day before yesterday, I was in North Dakota. Senator Dorgan is not here, but I was in North Dakota, and I held a town hall meeting with taxpayers, and one person informed me that they drove quite a distance to the walk-in site to ask a question as an agriculture taxpayer, and that is determined out of scope. They said, I'm sorry; we don't answer those questions in the

TAC. And I think for States like North Dakota and Wyoming, that is silly.

So these are the sorts of things that we are using as base measurement for the services that we are offering in the TAC, and then saying taxpayers aren't coming there, no surprise there.

Mr. EVERSON. Could I make one comment?

Senator BOND. If you will forgive me, I am going to have to ask one complicated question for brief answers and then turn the rest of the hearing over to Senator Murray, because I was expected for an important Intelligence Committee meeting at 11:00, and I apologize, but I know that you can continue these discussions.

E-FILE

I would like to ask you, Mr. Commissioner and then Chairman Wagner and Ms. Olson, about the E-filing problem. Getting the 80 percent appears out of reach. One possible reason, there was a media report that due to the cost of the E-filing, more than a quarter of a million individual filers, some 36 million, prepared their tax returns on computer, printed them out and mailed them to the IRS.

Would you outline your current plans and what you see as the problem with E-filing? And also, Senator Grassley and other experts have suggested that the IRS develop a direct filing portal through the IRS website to increase E-filing, and I would like to hear you include that in your comments.

Mr. EVERSON. Yes. You have covered a lot of ground there. Electronic filing continues to increase. We think it will continue to do so. It is true that in terms of some of the software providers, you buy the package and then there is a built-on cost at the end to file, to actually make the electronic filing. I don't think that the Government regulates the price of products from private parties. So that is a question of the private participants.

The Free File Alliance, which has generated a lot of discussion, that was in existence for 3 years. The term of that agreement lapsed last year after the filing season. We then worked to conclude a new agreement. We had two objectives. One was to get more protections on these RALs, these predatory loans that take place, not a huge issue for the free file participants, but it is still something, and also we wanted to have as high a participation rate.

The consortium members were concerned because the program had moved toward where anybody could file. They didn't want that, and in the late stages of the negotiation, the number was around 70 percent. We wanted to get it higher as to eligibility. They wanted to get it lower.

Then I do have to say the Senate had a voice vote to an amendment to the appropriations bill that was moving, whenever it was, in November of last year or October, that the IRS couldn't develop software, that no free file software could be developed without the Alliance. That had the effect of gutting our negotiation position with the Alliance because we can't force private parties to provide free file services. The reason they do it is because of their concern that one day there would be a portal or that one day there will be—the government will provide the software and they will be out of business. That is why they do this.

So that dynamic is complicated one.

The final point I would make, Mr. Chairman, the question of developing a portal, that would be a very costly and complicated endeavor, I am informed, for the IRS to do that. Right now, it is only the top 20 filers. All these returns are bucketed, if you will, or grouped. They do 82 percent of the electronic filing. If we were to do this, you would have to compare companies like Intuit who are spending \$200 million a year in research. This would be a big effort. It sounds simple, but it would be a big effort is what I would say.

Senator BOND. Well, we tried to make it clear that the IRS and Free File should come together to make an agreement. We only took the floor amendment because there did not appear to be agreement and our amendment was not intended to restrict the IRS. So we need to continue to work on that.

Chairman Wagner.

Mr. WAGNER. Mr. Chairman, just a couple of points. I know you are in a rush. We too believe the E-filing objectives are very sound and very good. We are pleased that more people are choosing to file electronically these days and the rate is going up. We are troubled by the fact that it is increasing at a lower pace than it has in the prior years. We have concerns over the Free Filing Alliance and have expressed those concerns, in particular the caps.

The notion of a portal is something that ought to be considered on behalf of the taxpayers. Certainly I can access Government in so many other areas by going directly on line and submitting my information. There are two components of paying your taxes: preparing the return and filing the return. Certainly the IRS ought to do everything it can to facilitate the filing of the return.

The goal, the 80 percent goal by 2007, is not going to be met. We have recommended that that goal be extended to 2011, applying a statistical analysis to it because we do believe the goal is a motivator and that it does keep the IRS focused on the goal as well as preparers. There are additional mandates that might be considered by this committee, including mandated filing by preparers, extending the filing date for electronic-filed returns to perhaps April 30 to provide an additional incentive for consumers to file electronically and so on.

Senator BOND. Ms. Olson.

Ms. OLSON. Well, I believe that the lack of free electronic filing is a major barrier to reaching our 80 percent goal. I think contrary to what some may suggest, taxpayers want to provide their financial data directly to the Government without any intermediaries and certainly with no add-on charges, and in this way a portal is like telefile, which was a very successful program, was simple, was easy to use, and the information went directly to the IRS.

I note, as Chairman Wagner does, that on the education website, you can file your FASA, your Financial Aid Student Application, directly with the Government in a fill-in simple form and you push the button and it is there. I think it galls taxpayers who are giving over their hard earned dollars to have to pay to E-file, and that is why we have 40 million taxpayers who buy a software package and then they print out the returns. I am one of those 40 million taxpayers this year.

And the last thing I would note, because I have a visually impaired employee, and he attempted to go on to Free File, and because these are private products, they are not required to be accessible for people who visually impaired. Federal websites under section 508, we have this 508 rule that says that all of our websites have to be accessible for visually impaired persons, and I think that is another really significant thing that we have to think about. There is a whole population out there.

Senator BOND. Thank you, Ms. Olson and other witnesses, and now my apologies and my thanks to Senator Murray. I will turn the hearing over to the her.

Senator MURRAY [presiding]. Thank you, Mr. Chairman. I just have few questions and then I will close it out.

BUDGET CUTS

Mr. Everson, the fiscal year 2007 budget doesn't make any reference to specific reductions in taxpayer services, as you shared, but your budget does refer to \$84.1 million in savings and the elimination of more than 2,000 FTEs due to contemplated "program efficiencies". Can you share with us how much of these savings in FTE reductions is associated with taxpayer service cuts and how much is associated with enforcement cuts?

Mr. EVERSON. The \$84 million comes across three major categories. There are cuts. If you go to page 6 of my written statement, Senator, it sort of lays this all out. There are shared services, and one of the examples here is for a new telecommunications contract, we are going to save \$24 million. That doesn't have an impact. Obviously, it is just a cost reduction. That is a shared area between enforcement and services.

We have what we think will be \$35 million against enforcement programs in terms of efficiencies, and that is a wide variety of categories where we are working more efficiently—we are a big organization. We are spending \$7 billion on enforcement. As you would expect, each year we reassess our processes and we go through and we make changes to become more efficient. So we have laid out there a whole series of reductions ranging from 5 FTE to, you know, over a 100.

The services piece, if you will, is down to about \$18 million of reductions which we believe, again, we will get through improved performance, better use of technology, redesigning our processes in ways that won't have an impact on you as a taxpayer or anybody trying to do business with the IRS. These have been developed over months. We can share more details if the committee wants them, certainly, and we will continue to develop new opportunities as we go on.

We are always looking look at—my charge to my team is particularly to look at the reduction of overhead. I have conversations with Colleen Kelly, the head of the union, who says: "Look, you have got too many middle and other managers." We are working on the span of control to try and increase the span of control so that there are more employees per supervisor. That gives you the ability to hold down the cost and yet keep the number of employees on line who are either in walk-in centers or who are out there doing audits.

Senator MURRAY. Bottom line, can you ensure us on the subcommittee that none of those so-called efficiencies will negatively impact taxpayer services?

Mr. EVERSON. Yes, I can, again, as long as we get that funding level, you know, within a reasonable proximity. The problem you get to, Senator, as you are well aware, we come in with a request and it does get nicked from time to time, even through the rescission process, where 1 percent gets whacked. There is always space. If we are quite close to it, I think have no problems we will be able to cover this, but if something dramatic happens, then we have to revisit it.

Senator MURRAY. Okay. Well, Chairman Wagner, your fiscal year 2007 special report from the IRS Oversight Board states your belief that the \$84 million in program efficiencies may decrease performance. Can you tell me what specific IRS functions you are concerned would be eroded under this proposal?

Mr. WAGNER. Senator Murray, we did express in our 2007 report, the 2006 report, as well as my testimony that I have submitted today that this is one of the areas of risk. Accumulating savings of \$84 million just does seem to the board inherently to present a risk, and we are going to continue to watch it to ensure that customer services are not compromised and that the enforcement continues to stay on track. We are also concerned that it could impact the rate at which the systems modernization is proceeding and so on.

But to spread \$84 million across the entire organization could be done and hopefully will be done, as the Commissioner suggests, without any cut in services, any detectable noticeable cut in services, but on the other hand, it might very well cause some damage, and we will continue to monitor that as well.

Senator MURRAY. Thank you. Mr. Everson, you have cut some taxpayer services conducted through telephone or face-to-face contact and you propose to eliminate Telefile by arguing that it would be cheaper for the IRS if those citizens filed electronically. Now that Telefile is eliminated, taxpayers who used Telefile are not filing electronically. Instead, a significant number of those taxpayers are reverting back to paper filing, which is, as we know, a more expensive form to process. How do you explain that result?

Mr. EVERSON. Well, Senator, as you may be aware, the Congress in RRA 98 directed the IRS to have an advisory committee in this area. That was established, and they advised over a course of a couple of years that we eliminate telefile as a part of this overall program. So we did take that advice and we did it, as you indicate, largely through as a measure of cost savings. There may very well be, as you have indicated—I haven't seen the final data on this—migration into paper, but the Telefile piece was the most expensive way to process the returns. I don't have the precise figure. I certainly can get it to you, but we saved, I believe, something between \$15 million and \$20 million through the curtailment of that program, which we ramped down, as you know, over the course of fiscal year 2005 and took effect this filing season.

Senator MURRAY. I think we have to be very careful, when we cut back taxpayer services, of the unintended consequences.

Mr. EVERSON. Yes.

Senator MURRAY. Which I think we are seeing with that.

Ms. Olson, do you have any concerns in this area?

Ms. OLSON. Well, I think that this is an example where the IRS said that they were going to make some savings in the short run and incur longer-term costs and they also missed an opportunity to take those taxpayers and help migrate them to another electronic approach, and we just walked away from that. I just think if that is the wave of the future, we are going to have a real reduction in taxpayer services.

Senator MURRAY. So we need to help taxpayers find—

Ms. OLSON. Exactly. We have to help them, assist them. A good example is, again, from my visiting the United Kingdom, what they used were screeners that would greet taxpayers at the door, and they would say what are you needing. They would say: “Well, I would like to find an answer to a question”, and they would say: “Do you know that you can look this up on the computer?” and they would walk them over to a computer bank and they would stand there just like people in the airline industry, stand by you as you are trying to do those confusing screens as you get your ticket. But they walk you through. So you do that two or three times, you have learned, you have migrated.

Senator MURRAY. So we need an education process.

REFUND ANTICIPATION LOANS

Let me go back to Commissioner Everson. The Taxpayer Advocate recently highlighted refund anticipation loans, RALs, as a serious problem facing taxpayers, in her 2005 report to Congress. More than half of those RAL customers are EITC recipients despite the fact that the EITC recipients constitute only 15 percent of all of our taxpayers. The money that is received by EITC recipients is also often very minimal, but the paperwork isn't. So many of our EITC recipients often seek out paid tax preparers to help them and frequently they pay for tax preparer services by signing up for a RAL, never realizing that it is a loan and not the refund itself.

Can you share with us what you are doing to help reduce the number of taxpayers who fall victim to these predatory refund anticipation loans?

Mr. EVERSON. Well, the first thing is we try to cajole and work with the industry. I think these are distasteful vehicles, and I have said that publicly. It is not a direct regulatory role for us in the sense of a loan. It is not something that we are charged with monitoring.

At the same time, I do have real questions as to conflicts of interest where big preparers, they are in the tax preparation business, but then they are marketing other products. In part, it comes back to this question we started out with some time ago about what is the suite of services that are proper for a tax preparer to provide. What I find particularly concerning here is that some of the firms, they end up keeping an interest in the loan, if you will, over the life of the loan, and I think the banks want that because they want the preparer to make sure they are doing adequate fraud reviews and not providing the loans, if you will, to someone who is not going to get the money back.

I do think it is area of continuing inquiry, maybe mostly for the Congress. There is a lot more concern about paid preparers now, including the big chains. There was reference to the recent GAO report. What you see is if you look at, frankly, the tax gap figures we showed, you see the same problems within the returns prepared by a preparer than you do in the overall population. That is hardly surprising given the fact that over half of returns are prepared by preparers. They obviously have to be a part of those problems.

Senator MURRAY. I have spoken on this committee before about that. I am very concerned about that. I think it is a huge problem.

I just want to end, Ms. Olson, if you could, just what else can we do?

Ms. OLSON. Well, right now, the IRS in cooperation with my offices is working on a report about refund anticipation loans and the debt indicator and identifying alternatives to RALs. The Treasury Department has a banking initiative and is looking at alternatives to RALs, ways of getting people into the system, and I think that some of the things that we will be reporting on will be very helpful to Congress.

Senator MURRAY. When do you expect that?

Ms. OLSON. I think that the legislation says the conference report is June 30, and I think we are planning to deliver that on that date, and we are going out and talking to stakeholders, you know, the consumer groups to hear their concerns as well as members of the industry.

I do have to respectfully disagree with the Commissioner about the IRS's role in this. We do set the rules for the electronic return originators who are the people who are offering these RALs, and our rules allow up to a 49 percent ownership interest in these loans. So we could change those rules. We also could do much more oversight. I did cover that in my annual report to Congress. We don't do sufficient oversight on these electronic return originators, in my opinion, and I think that we could also impose some due diligence requirements on the banks, that they make sure that the retail outlets are doing what they are required to do now in terms of disclosure. We don't know that.

So I think there are some areas for improvement even in the current environment.

Senator MURRAY. Yes.

Mr. WHITE. Senator, if I could just add, my name is James White at GAO. I think this highlights the importance of systems modernization at IRS. Taxpayers use RALs because they are a vehicle for getting their refund money faster. To the extent that IRS can process refunds faster, that would reduce the demand for RALs.

Ms. OLSON. Absolutely.

Senator MURRAY. Okay.

Mr. WAGNER. Senator, that is exactly a point that I was about to make, that modernizing the system will allow the turnaround of refunds more promptly, within 2 to 3 days, and alleviate the need for the RALs. I might also add that I think the IRS has additional leverage in connection with these RALs in the process of the Free File Alliance and negotiating that.

Senator MURRAY. Okay. Mr. Everson, why don't we just lower the time?

Mr. EVERSON. Well, I think as the advocate indicated, we are actively continuing to look at all of these areas. I don't mean to say that we are precluded from doing anything. My remark was the principal regulation on the loans. So we are actively looking at this on a concerted basis, and we did do something in the Free File Alliance. We got additional protections in as to how people would be notified and what they would be told before a product like that would be offered. We focused on that very clearly in that negotiation. The RAL percentage there is not very high. I am hoping it is actually less than 1 percent. I am hoping that it goes away entirely maybe after this filing season.

So we continue to work on it, most recently on that area.

ADDITIONAL COMMITTEE QUESTIONS

Senator MURRAY. Well, thank you very much to all of our witnesses today.

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

QUESTIONS SUBMITTED TO MARK W. EVERSON

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

TAXPAYER ASSISTANCE BLUEPRINT

Question. As mandated by our appropriations act, the IRS recently issued the first phase of the Taxpayer Assistance Blueprint. I asked for this business plan so that the IRS and the Congress could plan strategically on developing future taxpayer services based on taxpayer needs. I also expected the plan to address demographic and geographic differences. Ultimately, this plan should help to improve voluntary compliance with the tax code. I expected the plan to focus beyond current IRS services and develop innovative approaches.

Please explain how the blueprint is meeting my needs, when we will receive the final plan, and how it will be integrated in the administration's future budget requests.

Answer. The Taxpayer Assistance Blueprint (TAB) team is conducting and reviewing extensive research regarding taxpayer expectations. The TAB Phase 1 report, delivered to Congress in April 2006, discussed initial findings, including an inventory of current services and service channels. Several new studies, including a 40,000 taxpayer survey, are underway to add to the knowledge base. When released, the TAB Phase 2 report will address differences in taxpayer demographics and geography based on empirical data and recommend changes in service delivery options. It will also include development of an implementation plan for its recommendations; integration of recommendations; integration of recommendations into the budgeting process; and integration of the blueprint into the IRS Strategic Plan. We anticipate delivery of the report to Congress in October 2006, at which time we will have completed integrating its findings into our strategic planning and ultimately assisting in improving voluntary compliance.

BETTER TAX GAP ESTIMATES

Question. While the IRS has done a commendable job in updating the tax gap estimates, there remain significant gaps in the gap. The IRS and others have expressed concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data (from the 1970's and 1980's) and it has no estimates for other areas of the tax gap. GAO, TIGTA, the Taxpayer Advocate, and the IRS Oversight Board also have all recommended greater and more frequent data collection and studies of the tax gap. I wholeheartedly agree.

What will it take in terms of resources to address these concerns? Should the IRS conduct research on how services affect compliance?

Answer. The difference between the amount of tax for a given tax year paid voluntarily and timely and the corresponding estimate of the true tax liability for that

tax year is the Tax Gap. The three components of the Tax Gap include underpayment, nonfiling, and underreporting.

The IRS regularly tabulates the underpayment tax gap from Master File data for each major tax and for major groups of taxpayers. This component of the Tax Gap is the only one that is actually observed; the rest must be estimated.

The IRS currently estimates the nonfiling gap only for the individual income tax and for the estate tax. We must overcome some conceptual and data issues before we can develop nonfiling gap estimates for the remaining taxes, which requires the successful completion of various research projects.

The underreporting gap has been estimated for various types of taxes (except excise taxes) and usually has been based on operational audits or audits of randomly selected returns. In general, the latter situation is believed to generate better estimates of the extent of underreporting in the population. The resources required to undertake a sufficient number of audits of randomly selected returns can be substantial. Therefore, much of the data underlying the underreporting gap estimates, for areas other than the individual income tax, date from the Taxpayer Compliance Measurement Program (TCMP) which conducted its last audits for Tax Year 1988.

When the IRS conducted compliance studies under the auspices of the TCMP in the 1970's and 1980's, it generally sought to conduct studies of several components of the tax gap simultaneously, and to repeat the reporting compliance studies as often as every 3 years. IRS examination resources are nowhere near the levels they were 2 or 3 decades ago, so a schedule along these lines is not feasible. In fact, for some groups of taxpayers, the IRS used to conduct a greater number of random audits under TCMP than the total number of operational audits conducted today on those taxpayer groups. This change in resource allocations has led the IRS currently to conduct these research audits at a measured pace, and to consider conducting studies over more than 1 tax year—for example, the IRS is currently conducting a reporting compliance study of S-Corporations over a 2-tax-year period, to spread out the workload.

Fully funding the President's budget request would be a start in establishing a resource base for undertaking reporting compliance audits on a recurring basis, with different types of reporting compliance being studied over time. As Congress increases the resource level the IRS can devote to operational audits, it becomes increasingly possible to use some of these resources for reporting compliance studies. Moreover, to the extent research resources permit, we will investigate alternative methodologies for estimating portions of the Tax Gap.

In the past, the IRS has attempted to determine the impact that our service activities have on compliance. However, this area is extremely difficult to evaluate, in part because there is no direct link between the level of service provided/received and the consequent level of taxpayer compliance. The relevant research in tax administration has focused much more attention on the link between enforcement activity and overall compliance levels (the so-called indirect effect of enforcement actions). The results have generally shown a positive effect on compliance of increased enforcement activity (such as more audits), but the magnitude of the effect is subject to some dispute.

The link between service and compliance has been even harder to define. Taxpayers who take advantage of service opportunities (asking tax law questions, searching the IRS website) generally cannot be linked to specific compliance outcomes. The IRS has had to look for indirect ways to detect this relationship. In some cases, the IRS has designed narrow studies to see if a particular intervention had a detectable effect. In other cases, it has meant devising complicated analytical approaches to establish the relationship (if any). However, these studies have not been comprehensive and have barely scratched the surface on understanding how provision of enhanced services affects overall compliance (both in the short and long term).

The Taxpayer Assistance Blueprint study (now underway) is an attempt to understand better the relationship between service levels and compliance (among other things). We expect this to be an integral part of laying out a future research strategy to enhance our understanding in this area.

BALANCE BETWEEN SERVICE AND ENFORCEMENT

Question. There continues to be questions and debate on the proper balance between taxpayer service and enforcement. But given the data limitations of the tax gap and the IRS's inability to measure quantitatively the return on investment on service or enforcement, it is a difficult question to answer.

What is known quantitatively about the impact of taxpayer service and enforcement on compliance? How much do IRS's service programs affect compliance? How

much do IRS's enforcement programs affect compliance? What is your analytical basis for deciding on the balance between service and enforcement? What evidence do you have that IRS is striking the correct balance between its taxpayer service and enforcement efforts? Do you believe that one approach is more cost-effective than the other?

Answer. We do not know the quantitative impact of taxpayer service and enforcement upon compliance. During TAB Phase 1, the IRS conducted interviews with private sector organizations and other governmental agencies to identify customer service leading practices and the impact of service upon business results. Most of the organizations acknowledge the inherent challenge in quantitatively linking customer services to business results. They indicate that current metrics used to measure business impact from customer services are predominantly how those organizations measure qualitative or quantitative proxies. However, we have eight distinct initiatives in the TAB research plan to evaluate whether establishing a quantitative link is possible.

It is not clear at this time whether the limited effects on compliance detected so far result from the difficulty in detecting this relationship between service and compliance (for example, the difficulty of disentangling all other potential effects), the design of the research studies or experiments, or the existence of a fairly weak relationship. We must do careful research in this area in order to support definitive conclusions about the strength and direction of the effect. Two papers presented at the IRS Research conference in June examined the link between service levels and compliance. One study found some service and education interventions led to modest improvements in compliance for some groups of taxpayers, and no improvements for other groups. Another paper noted that educational programs can have offsetting effects on compliance—on the one hand, they can inform taxpayers about potential ways to inappropriately report their tax liability, while on the other hand they can discourage this inappropriate behavior. At this point, the literature exploring the relationship between taxpayer service levels and compliance is in its infancy and there are few, if any, definitive results.

We know slightly more about how enforcement programs affect compliance levels. A few IRS and academic studies have addressed this issue (for example, Dubin, Graetz, and Wilde (1990), Plumley (1996), and Dubin (2004)). All these studies find that increased enforcement (measured, for example, by increased audit coverage) is associated with increased voluntary compliance levels (this is the so-called indirect effect). However, the magnitude of the effect estimated by these studies varies widely. Further research is needed to pin down the size of this relationship and to estimate how it varies for different types of taxpayers.

Ideally, the IRS would like to be able to estimate the cost-effectiveness of each enforcement program and service offering, and how the effectiveness varies with level of effort. Cost-effectiveness in this context would take into account both the direct revenue effect (e.g., payments of back taxes from taxpayers subject to audit) and the indirect effect (the increased voluntary compliance levels in the general population resulting from the enforcement action taken or service provided). The costs of the activity would include all the costs to the IRS, including any overhead costs. If all these benefits and costs could be quantified, then in principle, it would be possible to determine the appropriate mix of services and enforcement.

At this point, the IRS believes that a balanced program, maintaining service levels at those achieved in recent years while devoting any additional resources to enforcement activities is the best approach to improving voluntary compliance. However, ongoing research in several areas (such as the Taxpayer Assistance Blueprint project) will provide us with the data needed to determine if this is the correct balance or if we need to devote a greater or lesser proportion of resources to taxpayer service offerings.

INCREASING E-FILING

Question. The current growth rate of e-filing will not allow the IRS to reach the congressionally-mandated goal of having 80 percent of all tax returns e-filed by 2007. One possible reason is the lack of financial incentive for taxpayers. There are reports that due to the cost of e-filing, more than a quarter of individual filers (40 million) prepared tax returns on a computer, printed them out, and mailed them to the IRS.

What is your current plan on how and when you will achieve the 80 percent goal? When does IRS project that electronic filing will meet or exceed the IRS Restructuring and Reform Act of 1998 goal of 80 percent? What actions and strategies are most likely to facilitate increased electronic filing? What can IRS do to eliminate or at least reduce the cost to taxpayers of electronic filing? How does your plan address

the 40 million people that prepared tax returns on a computer, printed them out, and mailed them to the IRS so that they will be incentivized to e-file instead of mailing in paper returns? As suggested by the GAO, should the IRS consider expanding the use of electronic filing mandates?

Answer. The vision of IRS electronic tax administration is one in which we accomplish electronically any exchange or transaction that currently occurs in person, over the phone, or in writing. All taxpayers would have the option of conducting their transactions electronically. Taxpayers would have multiple choices in terms of how they interact with us and what value-added services (for example, Where's My Refund, and paying electronically via debit or credit card) they choose to use. Taxpayers would become e-customers.

Our e-strategy for growth outlines our plans to reduce taxpayer burden and increase electronic filing. Key strategies include:

- Making electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer them to calling and mailing.
- Substantially increasing taxpayer access to electronic filing, payment, and communication products and services.
- Aggressively protecting transaction integrity and internal processing accuracy.
- Delivering the highest quality products and services as promised.
- Partnering with States and other governmental entities to maximize opportunities to reduce burden for our common customer base.
- Encouraging private sector innovation and competition.

To achieve these strategic goals, we will continue to develop and implement e-file marketing strategies, expand the use of electronic signatures, and enhance our website services for both practitioners and taxpayers. Ultimately, our goal is to offer all taxpayers and their representatives the ability to conduct nearly all of their interactions with the IRS electronically.

We have collaborated with the private sector in developing a Free On-Line Electronic Tax Filing Agreement. The agreement makes available to 70 percent of taxpayers, at no cost, the tax preparation and filing services of 20 participating companies. In processing year 2005, more than 5.1 million taxpayers took advantage of the opportunity to file electronically at no cost.

Section 6011(e)(1) indicates that the Secretary may not require returns of any tax imposed by subtitle A on individuals, estates and trusts to be other than on paper forms supplied by the Secretary. The IRS does not support a general e-file mandate for individual taxpayers. There are too many individual circumstances that might make such a mandate a burden to some taxpayers and make it impossible to enforce. The IRS believes that there are approaches other than individual mandates that lessen the chance for burden on specific taxpayers. However, we strongly urge Congress to act on the administration's proposal to provide the IRS with additional authority to require electronic filing, short of blanket individual mandates. This proposal, on page 262 of the Analytical Perspectives, will allow the IRS to process more returns and payments efficiently.

Regarding the people who prepare their returns on a computer and then mail them to the IRS, a group of taxpayers whom we call "V-Coders," we have a plan, developed by our Stakeholder Partnerships, Education and Communications (SPEC) organization, to specifically target these filers and reduce these types of returns by using leveraged outreach through partner channels to market our full portfolio of electronic products and services.

PRIVATE COLLECTION AGENCIES

Question. One new tool that you have mentioned that will help in collections and enforcement is the use of private collection agencies (PCAs).

What is the status of the PCAs? What controls are you providing to protect taxpayer rights and privacy?

Answer. On June 14, 2006, the Government Accountability Office (GAO) denied protests of the IRS contract award of March 9, 2006 to three Private Collection Agencies (PCAs). GAO's resolution of the protests lifts the 100-day Suspension of Work Order and clears the way for IRS plans to begin placing cases with the PCAs by early September 2006.

The IRS has a variety of safeguards in place to protect taxpayer rights and privacy as the private debt collection initiative moves forward. Before they can receive delinquent taxpayer account information, PCA employees are required to undergo background investigations and complete all IRS-mandated training. Individual privacy will be protected by the confidentiality provisions of the Internal Revenue Code (IRC) Section 6103 and the Privacy Act of 1974, as amended. Private collection agency (PCA) employees will be held to the same ethical standards regarding disclo-

sure and privacy as IRS employees and are subject to the same penalties as IRS employees. Failure to adhere to these laws and regulations may subject employees to criminal penalties or to civil causes for action.

Additionally, PCA firms will be monitored for compliance with all applicable Federal and State laws, including the Fair Debt Collection Practices Act. The IRS established a Private Debt Collection Oversight Unit (OU) and a Referral Unit (RU) to: manage PCA inventory; monitor security and privacy requirements; monitor quality, and; evaluate PCA performance and compliance with contractual requirements. Through the OU and the RU, the IRS will ensure that the PCAs maintain taxpayer confidentiality at all times through a combination of training and strict oversight. The IRS will conduct on-site security reviews to ensure PCAs implement appropriate access controls to segregated areas where IRS work will be performed.

Failure to comply with the confidentiality safeguards will be considered a breach of contract. Contractors are not authorized to communicate with third parties (other than the taxpayer's designated representative) and are prohibited from soliciting direct receipt of funds from taxpayers. Unauthorized disclosure of confidential tax information by officers or employees of the firms will subject those individuals to felony charges punishable by up to \$5,000 and 5 years in prison.

E-FILING FOR CORPORATIONS

Question. Electronic filing is now required for corporations having assets of \$50 million or more. Next year, for 2006 returns, the threshold drops to \$10 million in assets.

Do you believe the corporate world will be ready for this filing requirement? What is your basis for your response? What steps are you taking to assist corporations to meet the new e-filing mandate? Along this same requirement, will the IRS have the capacity to handle what is likely to be a significant increase in corporate electronic filings?

Answer. We believe the corporate world will be ready for next year's e-filing requirement for several reasons. By June 18 of this year (which is relatively early in the corporate filing season) over 15 percent of the corporations required to e-file (those corporations with assets greater than \$50 million) had e-filed their 2005 tax returns. As has been publicly announced, General Electric (GE) successfully e-filed the Nation's largest tax return on May 18, 2006. On paper, GE's e-filed return would have been approximately 24,000 pages long. After filing, GE received IRS's acknowledgement of its filing in about an hour. The file was 237 megabytes.

The ability of these firms to meet the electronic filing requirements also clearly indicates the IRS Modernized e-File system is fully operational and is accepting and processing large and complex corporate tax returns. We also believe the necessary support for the corporations being added to the e-file requirement next year will be available. A few of the corporations that have e-filed so far this year used their own software and/or transmitted their own returns to the IRS. However, the clear majority of the corporations are using commercial tax preparation software and/or third-party transmitters to e-file their returns. Corporations with assets between \$10 to \$50 million will use the same software packages and return transmitters as are currently being used by those with assets over \$50 million.

Additionally, the vast majority of the corporations being added to the e-filing requirement next year generally rely on CPA's as their tax advisers. We are actively working with the AICPA on efforts to get their members knowledgeable about corporate e-filing and the related requirements. So far these efforts have included contacting the five largest CPA State Societies to work towards getting e-filing information and presentations as part of their 2006 CPE programs and, jointly developing an e-filing course to be available to all CPA CPE programs.

Lastly, with regard to the system being able to handle increased capacity demands because of the filing requirement dropping to \$10 million, since bringing the system online we have followed a continual program of monitoring filing patterns, adjusting our projections accordingly, and then developing and executing stress tests of the system to ensure its ability to respond to our return projections. Based on this program of stress testing and projections, we make the necessary adjustments to ensure that we have the infrastructure in place to support the anticipated volume. Thus, we believe we will be well positioned to handle next year's increase in corporate e-filed returns.

STRATEGIC PLAN FOR ADDRESSING THE TAX GAP

Question. As I stated at the hearing, the IRS is directed to work with the IRS Oversight Board, the National Taxpayer Advocate, and other stakeholders to develop a strategic plan for meeting the administration's stated goal of increasing vol-

untary compliance to 85 percent by 2009. The strategic plan should identify a wide range of goals, objectives, and strategies, at least some of which would be beyond the scope of the IRS, such as implementing tax code simplification, and providing new tax administration tools such as additional reporting requirements.

How will the IRS develop such a plan? How long will it take the IRS to complete such a plan?

Answer. We recognize that the best way to address the tax gap is to maintain a balance between service and enforcement. The IRS will consult with the Oversight Board, the National Taxpayer Advocate, and other stakeholders to ensure that our plan for improving voluntary compliance maintains the proper balance. While the IRS has restored credibility to its compliance programs over the last 2 years, additional enforcement alone is not the answer. Studies show that voluntary compliance is higher where there is third-party reporting and/or tax withholding. Therefore, our plan will likely involve both recommendations for improving voluntary compliance and tax administration efficiency, such as the legislative proposals for improving IRS operations submitted with the fiscal year 2007 IRS budget. The IRS will use also the results from its recent compliance studies to improve audit selection models, and we will continue to combat abusive tax shelters by corporations and high-income individuals and vigorously pursue those who promote these illegal schemes.

The IRS has already begun laying the groundwork for a strategic compliance plan that will improve voluntary compliance and reduce the tax gap. We intend to present a proposal for consideration this fall. Because this proposal may include administrative and legislative changes, we will need to coordinate the proposal with the IRS's budget submission.

LONG-TERM BSM PLAN

Question. The GAO has informed the subcommittee that the 5-year IT Modernization Vision and Strategy document should be supplemented with an additional plan that covers the remainder of the BSM program. GAO further recommended that the plan be tied to a known spending level, so that Congress can understand the funding requirements to implement the plan and the impact of funding delays.

Has the IRS begun to develop a plan for the remainder of the BSM program? How would you develop the plan? What information will it contain to give Congress the information it needs to monitor program execution?

Answer. In August 2005, the IRS embarked on a lengthy, comprehensive, and collaborative IT modernization planning effort involving more than 80 IRS employees from across the Agency. The resulting strategy, known as the Modernization Vision and Strategy (MV&S), will speak to the modernization of IRS's core tax administration functions and include BSM projects as well as smaller-scale system efforts.

Presented as a 5-year plan, MV&S will outline the projects that the IRS plans to carry out to meet the highest business priorities identified by individual business units. The plan will include all IT modernization investments (not just BSM) and ensure that the complete set of modernization initiatives is optimized and coordinated. The MV&S approach emphasizes enhancing existing systems in lieu of full replacement; full replacements are to be undertaken in those few cases where upgrade is impractical.

To keep the MV&S current, the IRS is instituting a planning process to annually update the 5-year plan. Further, the annual BSM Expenditure Plan will address major project enhancements emanating from MV&S planning. Congress will be able to assess and monitor program performance against the Expenditure Plan.

BSA DIRECT

Question. During our last hearing with the Treasury, we discussed the problems surrounding the BSA Direct system. I understand the IRS is helping FinCEN in ensuring continuity of service to users and is looking at how to meet other BSA Direct needs.

Please provide a status report on the IRS's work on BSA Direct in terms of the specific actions the IRS has taken to address the needs of FinCEN and how much money the IRS plans to spend on carrying out these actions.

Answer. To ensure continuity of service to FinCEN users, IRS and FinCEN IT representatives have met weekly since April 2006 to address FinCEN's unique Gateway (case information) requirements and develop connectivity, training, and conversion plans for their users to WebCBRS. The IRS implemented their unique Gateway processing requirements in the WebCBRS on June 1, 2006. FinCEN reimbursed the IRS for associated programming costs of \$300,000. FinCEN's internal users are connected and are testing WebCBRS, with plans to continue training and incrementally

converting their Regulatory and Law Enforcement users to WebCBRS by September 2006.

On June 7, 2006, the IRS and FinCEN met to discuss other BSA Direct needs that FinCEN is defining, including new and changed BSA forms, with estimated costs of \$750,000. The IRS's first priority is to ensure FinCEN users are connected, trained and converted by September 2006. Once this step is accomplished, the IRS will continue to partner with FinCEN to address specific BSA Direct requirements, along with estimated costs and proposed delivery dates.

ESTATE AND GIFT TAX

Question. I understand that the IRS is implementing a survey of the Estate and Gift (E&G) tax returns filed from 2000 to 2007.

What is the purpose of that survey?

Does the IRS have any plans to reduce the number of Estate and Gift Tax Attorneys? If so, what timeline are you considering?

Answer. The IRS is studying the projected volume of filings of estate and gift returns in light of the increasing filing threshold amounts. Furthermore, we are reviewing the staffing levels and audit coverage within the estate and gift program to effectively balance enforcement resources.

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

CUTTING THE IRS OFFICE RESPONSIBLE FOR SERVICE WHILE EXPECTING MORE FROM VOLUNTEER PROGRAMS

Question. Mr. Everson, the IRS's Stakeholder, Partnership, Education and Communication (SPEC) office has overall responsibility for community partnerships such as the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. In recent years, this IRS office has suffered cutbacks while the number of taxpayers seeking help from by VITA and TCE for tax preparation continues to increase dramatically. Moreover, you stated recently that you expect to rely heavily on VITA programs to improve taxpayer services.

How do you justify continuing to cut the SPEC office while giving it an increasing workload?

Answer. The IRS is devoting the necessary staff to support the Stakeholder Partnerships, Education and Communication (SPEC) business model that partners with external organizations to deliver volunteer return preparation (VITA/TCE), outreach/education, and asset building services. Since the reorganization of the IRS in 2000, the SPEC organization has evolved from 531 SPEC on-rolls (staffing) in fiscal year 2001 to 565 on-rolls (staffing) in fiscal year 2006.

We believe the community-based programs play an important role in improving taxpayer service and are critical in providing no-cost tax return filing assistance to underserved taxpayers, including low-income, elderly, disabled, and taxpayers with limited English proficiency. As such, the IRS has established partnerships with more than 60 national organizations representing financial institutions, educational institutions, tribal governments, community and volunteer organizations and many others. At the local level, the IRS has formed over 295 coalitions (up from six coalitions in fiscal year 2001), representing thousands of partners. As our experience, program knowledge, and relationships with external partners have grown and matured over time, our capacity to deliver more service through the leveraged business model has significantly increased. For example, as of June 17, 2006, community-based partners had prepared 2.24 million returns compared to 1.17 million returns for the entire fiscal year of 2001.

Question. Ms. Olson, what is your opinion on this matter?

The VITA program operates for only about 4 months of the year during tax season and receives limited support from the IRS. Ms. Olson, in your statement, you say that the IRS should concentrate on developing a fundamental support structure for the program and expand the program. You also say that the IRS should not let VITA or any other volunteer program serve as a substitute for IRS-provided service.

Ms. Olson, why do you take that position, and Mr. Everson, what is your response to this?

Answer. As previously stated, the assistance the SPEC organization provides through the support of its partners play an important role in improving taxpayer service and is critical in providing no-cost tax return filing assistance to underserved taxpayers, including low-income, elderly, disabled, and taxpayers with limited English proficiency. However, it is important to note that the success we have achieved each filing season, as outlined in the preceding paragraph, is largely predi-

cated on the rigorous planning effort that takes place throughout the fiscal year with national and local partners. A national program of this magnitude requires year-round support to incorporate planning, training, filing season assessment, partner recruitment activities and partner satisfaction improvement.

This support is essential to maintaining existing partner relationships and attracting new partners and the investment is substantial. It provides partners with tax law and software training, marketing materials, educational products, research data for optimal site placement and effectiveness, supplies, technology support (software, computers and printers) and the necessary products, procedures, and technical expertise for effective site operations. SPEC, with its partners, supports over 12,000 volunteer return preparation sites nationwide that are strategically placed to facilitate access for low-income taxpayers. Our annual research report on SPEC site coverage indicates 99 percent of low-income taxpayers have access to a free tax return preparation site within 45 minutes of their home. This coverage is a complement to, rather than a replacement of, IRS-provided services.

SETTING TAXPAYER ASSISTANCE CENTERS (TACS) UP TO FAIL

Question. In a briefing last year by TIGTA on Taxpayer Assistance Centers, I learned that some TACs have as little as one or two staff, what TIGTA calls a “critical staffing shortage”. The House and Senate, Majority and Minority, said no to your proposal to cut back TACs until TIGTA completes a study on the impact of such reductions on taxpayer compliance and taxpayer services.

Mr. Everson, are you, in fact, allowing these TACs to eventually close by letting the staffing levels dwindle? Do you believe that is consistent with the direction from this committee?

Answer. In response to the congressional directive received with our fiscal year 2006 budget appropriation, a concentrated effort was made to keep all of our 400 Taxpayer Assistance Centers (TAC) open during filing season. I am pleased to report that we not only kept all of these TACs open, but we addressed all potential critical staffing shortages in our one and two person TACs. Specifically, during the fiscal year 2006 filing season, we hired almost 60 critical permanent front line employees, returned seasonal employees and detailed back former TAC employees who were assigned to other IRS organizations. We also temporarily deployed technical employees as necessary from other TACs in an effort to keep every TAC open daily. We initiated a second wave of hiring after the filing season and expect to employ over 300 front line employees to fill behind attrition. These actions will bring our staffing levels at the end of fiscal year 2006 to the same on-rolls we had at the beginning of fiscal year 2006 (2,080), as well as position us to deliver services in fiscal year 2007 with a minimal amount of contingencies required.

While we expect the Taxpayer Assistance Blueprint (TAB) initiative to guide future decisions about the proper staffing levels for the TACs and the kinds of services we will offer, we are committed to achieving and maintaining an appropriate level of staffing and service in the TACs as demonstrated this fiscal year.

Question. Mr. George or Ms. Olson, do either of you care to comment?

Mr. Everson, your statement mentions the identification and elimination of non-critical vacancies as one of the means through which you intend to achieve efficiencies within taxpayer service programs and processes.

When it comes to staffing at the taxpayer assistance centers, are you trying to achieve through attrition what you couldn't achieve due to legislative restrictions?

Answer. As indicated in our above response, we are committed to achieving and maintaining an appropriate level of staffing and service in the TACs. The IRS demonstrated this commitment by the staffing actions taken to prepare for the 2006 filing season and the post-filing season actions to fill behind attrition. We expect to employ over 300 front line employees to address staffing vacancies caused by attrition. These actions will bring our staffing levels at the end of fiscal year 2006 to the same on-rolls we had at the beginning of fiscal year 2006 (2,080, including the 300 attrition hires), as well as position us to deliver the same level of services in fiscal year 2007 with little to no alternative staffing contingencies.

SERVICES OFFERED AT TACS

Question. Mr. Everson and Ms. Olson, why hasn't the IRS involved taxpayers who need or desire face-to-face assistance in determining what services are offered at the TACs?

Answer. Since September 2005, the Taxpayer Assistance Blueprint (TAB) team has been conducting extensive research directly with taxpayers to identify taxpayer needs and preferences for receiving services including those offered at our TACs. As you know, we delivered the TAB Phase 1 Report to Congress in April 2006. The

TAB Phase 2 report, which we expect to deliver to Congress in October 2006, will validate the service recommendations through extensive primary research with taxpayers. Current ongoing customer preference and needs research includes surveys, focus groups, and experimental research aimed at providing customer-centric information to decision-makers.

Question. Mr. George, your recent audit report says that prior to making decisions on closing any TACs, the IRS should ensure that it is known which taxpayers visit the TACs for assistance and why, so the IRS can determine the impact on these taxpayers and ensure alternative service delivery channels are effective in meeting the needs of these taxpayers.

Ms. Olson, I would imagine you agree?

Mr. Everson, TIGTA recently found that 8 of 11 stakeholder groups believe that closing the TACs may make it harder for their constituents to stay compliant with tax laws and file tax returns. TIGTA also found that 11 of 11 stakeholder groups believe their constituents are not currently likely to use alternative methods, such as the internet or email to obtain the services they need.

In light of your efforts to reduce face-to-face interaction between the IRS and the taxpayer and your efforts to increase compliance, have you re-thought some of your earlier decisions on reducing taxpayer services?

Answer. Balancing customer service with enforcement to achieve compliance has been and will continue to be a fundamental goal of the IRS. Currently there are no efforts underway to reduce face-to-face interaction between the IRS and taxpayers. However, we are optimistic that the TAB study, which includes comprehensive research around the needs and preferences of taxpayers, will not only identify more efficient and cost-effective service delivery channels, but also provide a business model that balances taxpayer preference with business values. Our goal is to make service investment decisions in order to reach the most taxpayers through their preferred service channel within available resources.

REDUCTION OF TAXPAYER SERVICES

Question. Mr. Everson, last year, you:

- eliminated “TeleFile”, the ability to file taxes by telephone;
- proposed the elimination of as many as one quarter of all walk-in Taxpayer Assistance Centers;
- proposed shortening phone assistance hours; and
- began the process to eliminate several telephone call-routing sites.

In a profile of online population, Census data indicates that in any given age group (ages 18–29; 30–39, etc.), not even one-third of adults are on-line. We know that the Nation’s large senior citizen, limited proficient English, and underserved populations are not as likely to use or have access to the internet as other forms of communication.

Given this and the digital divide at every generation, how do you rationalize the elimination of face-to-face and telephone interaction in favor of electronic communication?

Answer. The Taxpayer Assistance Blueprint (TAB) team is analyzing taxpayer needs, preferences and behaviors to determine the optimal delivery of service across all channels. As stated previously, the TAB Phase 2 report, which we expect to deliver to Congress in October 2006, will use extensive primary research with taxpayers to validate its service recommendations. Current ongoing customer preference and needs research includes surveys, focus groups, and experimental research aimed at providing customer-centric information to decision-makers. In this context, careful consideration is being given to those taxpayers facing a barrier to online self-service options. Again, our goal is to maintain a balanced service portfolio that meets the needs of the greatest number of taxpayers within limited resources.

We made our initial proposal to shorten phone assistance hours in an effort to more closely match our hours of operation to the hours of our customer’s greatest demand to ensure the most efficient usage of our scarce resources while providing the best service possible to our customers. We decided not to implement this change as planned due to language in the 2006 appropriation bill directing the IRS not to reduce services.

We made the decision to close three call sites (Boston, Chicago and Houston) because the IRS identified them as non-continuing sites in the early 1990’s. This decision was made after a nationwide study showed the benefits of reducing the number of call sites and the best locations for consolidating our telephone operations based on rent, cost of living, competitive salaries and similar factors. Throughout the intervening years, we did not fill vacancies in Boston, Chicago, and Houston because of our long-standing plans to close those sites. As the number of employees in Bos-

ton, Chicago, and Houston continued to shrink it was no longer fiscally responsible to rent large, underused offices. By closing these sites and consolidating call operations, the IRS saved a significant amount of rent and support costs and gain productivity efficiencies with no impact whatsoever on our telephone customers.

To further put this action in context, in the early 1970's we were operating 135 call sites. The IRS derived efficiencies from consolidating smaller sites into larger operations so that by 1975, the IRS had reduced the total number of sites to 85. By the early 1990's, the IRS had undertaken further consolidations toward achieving a 25-site footprint. We designated Boston, Chicago, and Houston as non-continuing, no-growth sites, along with others that have since closed including Anchorage, Brooklyn, Honolulu, Los Angeles, Milwaukee, Newark, Omaha, Phoenix and St. Paul.

We serve our telephone customers using an enterprise approach and a toll-free telephone network that now consists of 25 call sites nationwide. Since we manage toll-free traffic nationally, the calls previously answered in Boston, Chicago and Houston are automatically routed to other call sites without affecting overall telephone service. Regardless of our customers' geographic locations, when they call us, our system routes their call to an available assistor who can best answer their type of question at any of our 25 sites. This routing occurs within seconds and is transparent to callers.

HOW HAVE YOU SPENT THE ADDITIONAL ENFORCEMENT FUNDING YOU GOT IN FISCAL YEAR 2006?

Question. Mr. Everson, the fiscal year 2005 budget resolution included language that enabled our bill last year to provide an additional \$446 million to be used for enforcement. Your March 7, 2006 report on enforcement indicates that 40 percent of that funding will maintain your base costs and 60 percent of that funding will allow hiring of 1,146 new enforcement FTEs, which you have already begun.

At this point in time, how many of those positions have you hired?

Answer. As of June, we have hired 1,224 positions for our fiscal year 2006 enforcement initiatives. These positions include over 500 Revenue Agents, as well as additional front-line enforcement staff. The number of positions hired corresponds to 959 FTE.

Question. What is your time frame for the rest of these hires?

Answer. Several IRS business units are planning additional hires during the remainder of the fiscal year. Through the fourth quarter we will be hiring approximately 120 additional Revenue Agents and 60 additional enforcement staff, though some of these will be allocated to attrition hiring.

Question. How much money has not yet been obligated?

Answer. Approximately \$13.3 million in initiative enforcement funds remain to be obligated, primarily in salary and benefit resources that will be used to pay current and future staff costs through the balance of the fiscal year.

FREE FILE ALLIANCE

Question. Mr. Everson, recently, the Finance Committee found that taxpayers using the Free File on-line tax return preparation services are presented with surprise fees, expensive add-ons, loan solicitations and other marketing pitches. While there is no obligation to buy these services, the fees occur so late in the process that taxpayers may feel forced to pay them or completely redo their taxes with another vendor who may also charge fees. It is my understanding that the IRS has not conducted much research on how many taxpayers fall prey to these sales pitches.

What is the IRS doing to protect taxpayers from predatory sales pitches and do you plan to do more comprehensive research on these activities?

Answer. The new Free File Alliance agreement contains a number of program improvements meant to increase the overall quality of the program and customer satisfaction. For example, the new agreement contains enhanced standards for consumer protection if a refund anticipation loan (RAL) is offered by a Free File Alliance (Alliance) member. Also, Alliance members must disclose on the members' individual landing pages if State tax return preparation and filing services are available and, if so, whether a fee will be charged for such services. If a fee is charged for such services, the cost to the taxpayer must be clearly stated on the members' landing pages.

For the 2007 filing season, we will continue to be vigilant with the Alliance members to ensure that the companies are adhering to the terms of the agreement, including those provisions designed to ensure the protection of taxpayer rights and confidentiality of taxpayer information. We also acknowledge that the companies

may offer products and services which are closely related to the tax preparation process and are of beneficial value to taxpayers.

In order to conduct more research, we are conducting a Free File survey this year with the following objectives:

- To determine, among taxpayers using Free File in 2006, how they were introduced to Free File, their reasons for choosing this electronic product, how they used it, and how they perceived the product in terms of its ease of use, use of specific product features, and satisfaction with the usage experience.
- To provide results that can be used to assist the IRS with making policy decisions related to expanding the use of e-file.

ADDRESSING SHODDY WORK BY TAX PREPARERS AND PRACTITIONERS

Question. Just this month, GAO reported that there may be serious problems with the accuracy of the tax returns prepared by many of the private tax preparation companies. The GAO found that these companies often prepared returns that were incorrect, with tax consequences that were sometimes significant. Some of these mistaken returns could have exposed taxpayers to penalties for such things as negligence and willful or reckless disregard of tax rules. Furthermore, TIGTA found, this month, that the IRS is not taking the necessary disciplinary action against tax practitioners who have been convicted or had their licenses revoked by State authorities.

Mr. Everson, why aren't you taking a more aggressive approach to regulating these individuals?

Answer. I agree that all taxpayers should be able to receive accurate return preparation assistance. While most paid preparers do their best to provide their clients with tax returns that are fully compliant with our Nation's tax laws, preparers who violate this public trust should be identified and subjected to the full range of sanctions available. Although more can always be done, the IRS is aggressively pursuing those paid preparers who are negligent or encourage out-right fraud.

In 2006, the IRS developed a new multi-functional Preparer Strategy, improving our coordination of preparer-related workload and ensuring that we work preparer non-compliance issues consistently, timely, and effectively. More than 500 Program Action Cases (PACs) were in process at the end of the first quarter of fiscal year 2006, a 500 percent increase over the number in process for the same period in fiscal year 2005. PACs are one of the processes used to investigate appropriate return preparer penalties. The main preparer penalty provisions are § 6694, Understatement of Taxpayer's Liability by Income Tax Return Preparer, and § 6695, Other Assessable Penalties With Respect to the Preparation of Income Tax Returns for Other Persons. These two sections are exclusively applied to return preparers and range from \$50 to \$1,000 per offense.

In fiscal year 2005, the Department of Justice secured injunctions, based on IRS referrals, against more than 40 promoters/preparers, preventing these individuals from preparing returns and promoting abusive schemes. The IRS continues to make referrals and work with the Department of Justice on securing injunctions against additional promoters/preparers to prevent these individuals from further participating in unscrupulous conduct.

The Criminal Investigation Division (CI) initiated 248 return preparer investigations in fiscal year 2005, a 20 percent increase from the previous year. CI utilizes many techniques, including the use of the undercover program, search warrants, witness interviews; and contacts with informants, banks, and local law enforcement, to vigorously pursue investigations of unscrupulous return preparers.

INAPPROPRIATE COMPETITIVE SOURCING OF MAILROOM WORK

Question. Mr. Everson, the fiscal year 2004 Transportation-Treasury Appropriations Act included a prohibition on funding for the conversion of work performed by 10 or more Federal employees to a contractor without holding a public-private competition. At the time the bill was enacted (January 23, 2004), approximately 65 Federal employees, including those with disabilities, were performing mailroom work. Yet, in 2004, the IRS permitted a private contractor to replace the RIF'ed mailroom employees.

How is it that the IRS did not conduct a public-private competition for its mailroom operations?

Answer. In fiscal year 2003, the IRS made the decision to directly convert the mailroom positions and selected a contractor under the Javits-Wagner-O'Day Act Program, which provides greater employment opportunities for people with disabilities. The IRS chose to conduct an A-76 Direct Conversion to a NISH (formerly the National Institute for the Severely Handicapped) provider because fewer than 25

employees would be affected and because of the proven past performance with IRS mailrooms (the IRS already contracted 10 mailrooms through NISH). In October 2003, the IRS signed the contract with 4 option years with ServiceSource for mail delivery in 33 locations. ServiceSource is a Community Rehabilitation Partner which creates opportunities for individuals with disabilities, is certified by NISH and has over 30 years of experience providing mailroom services to Federal and State agencies in both on-site and off-site facilities. The contract provided the capability for IRS and the contractor to incrementally on a site-by-site basis issue task orders to phase-in contractor performance. This phase-in approach afforded the IRS greater opportunity to work with employees on mitigation strategies to reduce the number of potential employees facing a reduction-in-force.

The IRS had previously begun reduction-in-force negotiations with the National Treasury Employees Union (NTEU) and offered assistance to impacted employees—voluntary early retirement and voluntary separation incentive, some placement opportunities within IRS for other positions, and potential employment with the contractor. The IRS issued the reduction-in-force notices to 12 employees in October 2004. The IRS placed two of the employees in other agency positions and most of the remaining 10 employees went to work for the contractor.

Question. Furthermore, I'm told that the Federal employees performed administrative and support activities, in addition to their mailroom responsibilities, such as opening mail and delivering mail to employee desks. I understand that the contract employees would not have done these additional duties, yet the IRS used the same assumptions when comparing these costs.

How do you explain that?

Answer. The IRS addressed the duties of opening and subsequent desktop delivery of mail during the data gathering phase of the Business Case Analysis for this Competitive Sourcing Initiative. That data indicated that desktop delivery of mail was not being performed in 94 percent of the sites impacted by the study before the conversion to contract delivery. We retained that desktop delivery feature at those locations (2 of 32) when the Contractor took over this operation. As for opening of all mail, these duties were not identified as being performed in any sites.

The process of researching mail where the delivery point was unidentifiable by the address provided was reflected in the data gathering phase as being performed at all locations. This research task did require the opening of this small percentage of correspondence by IRS mail clerks, and this practice has continued within the statement of work for the contractor.

Question. A lawsuit was filed against the IRS, challenging the legality of the conversion of the mailroom employees. Subsequently, an IRS spokesperson said in mid-March that the IRS is currently reviewing the judge's decision.

What is the result of that review?

Answer. The interim court ruling concluded that even though the IRS had signed a contract prior to the enactment of the fiscal year 2004 appropriations, the IRS could have exercised discretion on whether or not to issue the individual task orders, and therefore, violated the provisions of the 2004 appropriations. Both parties (NTEU and IRS) are currently exchanging proposals of remedy for the former employees who were involuntarily separated.

TAX GAP

Question. Mr. Everson, at a recent Senate hearing on the tax gap, you testified that the IRS could collect an additional \$50–\$100 billion each year without changing the way the Government interacts with the taxpayer. However, the five legislative proposals in your budget, aimed at reducing the tax gap, are estimated to raise only \$3.5 billion over 10 years, or \$350 million per year.

Mr. Everson, with a requested budget increase of 0.2 percent next year—basically a flat budget—how will the IRS be able to collect this \$50–\$100 billion?

Answer. The collection of an additional \$50 to \$100 billion each year is a possibility without significant change in IRS interactions with taxpayers, however, the IRS cannot accomplish this alone. The IRS cannot audit its way out of the tax gap. Tax simplification must accompany any meaningful effort to reduce the tax gap, and would allow the IRS to further streamline its operations and increase the effectiveness of its compliance strategies. Additionally, legislative proposals such as those requiring increased information reporting in certain sectors, as well as the increase in information-sharing from other agencies, will further contribute to reducing the largest element of the tax gap—underreporting. Admittedly, the five proposals included in the fiscal year 2007 budget request are only first step toward addressing the quarter-trillion dollar tax gap. But they are a step in the right direction, and represent one critical element of a successful strategy.

Question. Individuals have long been evading the payment of taxes by hiding income in other countries. The IRS recently won court approval to ask PayPal, a popular on-line payment service, to turn over customer records as part of an investigation into tax cheats who hide money overseas. This would involve those who sent money to a bank or credit card account in more than 30 foreign countries and would cover the past 8 years.

What is the latest about whether PayPal will comply?

Answer. We expect compliance, but the disclosure restrictions of IRC § 6103 prohibit us from further discussion about the status of our efforts at this time. However, the Offshore Credit Card Project (OCCP), in furtherance of which the court issued the PayPal summons, is a continuing effort. The IRS has requested and the courts have issued prior John Doe summonses to major credit card companies, third-party credit card processors, and over 100 merchants in an effort to identify individuals who have evaded tax by moving money offshore. The IRS has completed several thousand examinations and over 1,200 are currently in process. In addition, the OCCP has provided leads and other information which has led to numerous successful criminal prosecutions.

Question. What else are you doing to prevent offshoring of taxpayers' money?

Answer. The IRS has several other initiatives to address this concern:

Broker Initiative.—The IRS is identifying withholding agents for Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) examinations. The dual purpose of these examinations is to assess the withholding and information reporting compliance of the withholding agent, as well as that of the U.S. beneficial owners of accounts established in the names of entities domiciled in secrecy jurisdictions. The IRS is currently examining several withholding agents, with more planned.

Seven Country Initiative.—Although this initiative was originally formed under the auspices of the Pacific Association Tax Administrations (PATA), the group's members currently consist of Australia, Canada, France, Germany, Japan, United Kingdom and the United States. The purpose of this group is to enhance each country's capacity to deal with compliance risks associated with offshore secrecy jurisdictions, share best practices and approaches addressing abusive offshore arrangements and their promoters. These discussions will provide opportunities for bilateral action and exchange of information. To further expand its compliance initiatives, the group formed subgroups to address non-compliance facilitated through the brokerage and banking industries and International Business Corporations (IBC). The Seven Country Initiative is focused on high wealth individuals and closely-held entities involved in abusive offshore arrangements using tax secrecy jurisdictions.

Promoter Program.—The IRS has made significant strides in combating the offshoring of taxpayers' money through its efforts on promoters of offshore schemes and transactions. Based on referrals, the IRS has authorized investigations pursuant to I.R.C. § 6700 (Promoting Abusive Tax Shelters) for various promoters of offshore schemes. When appropriate, the IRS has referred these promoters to the Department of Justice for potential pursuit of penalties and injunctions. This process prohibits the promoter from continued marketing of abusive schemes and assists the IRS in identifying participants in offshore transactions for compliance purposes.

IS THE IRS COMPLYING WITH SECTIONS 205 AND SEC. 204 OF THE TTHUD BILL?

Question. The Fiscal Year 2006 Transportation-Treasury Appropriations Act included a provision (Sec. 205) stipulating that no funds may be used to reduce taxpayer services as proposed in fiscal year 2006 until TIGTA completes a study detailing the impact of such proposed reductions on taxpayer compliance and taxpayer services, and the IRS's plans for providing adequate alternatives services, and submits such study and plan to us for approval. Despite this language and the provision Sec. 204 stating that funds shall be available to improve and increase 1-800 help line service, you decided to decrease those telephone hours last year after enactment of our bill. We had to add clarifying language in the Supplemental Appropriations Act last year so that you would not reduce telephone service hours.

So, Mr. Everson, I'd like to ask you: Is the IRS complying with Sec. 205 and Sec. 204?

Answer. Yes. We continue to provide the same number of daily hours of service as in fiscal year 2005 with our toll-free telephone lines open from 7:00 a.m. to 10:00 p.m. Monday through Friday (local time) and limited service on Saturdays during the filing season. In January 2006, we actually extended the operational hours of service from 7:30 a.m. to 6:00 p.m. Monday through Friday (local time) to 8:00 a.m. to 8:00 p.m. Monday through Friday (local time), for the Practitioner Priority Service telephone line.

Our proposal to change the operational hours in fiscal year 2006 was another step towards providing our customers with the highest level of service as we continue to identify ways to improve our toll-free operation. To put our proposal to reduce hours of service into context, in 1999, we increased our operational hours to 24 hours a day, 7 days a week in an effort to expand service to our taxpayers. However, after identifying periods of low call demand (assistors were available and waiting for incoming calls) and alternate periods of excess demand (we did not have enough assistors on the phones to handle incoming call traffic during specific hours), we re-evaluated our decision to provide service around the clock. In October 2001, we reduced our operating hours to 7:00 a.m. to 10:00 p.m. Monday through Friday (local time) with limited service on Saturdays during filing seasons. This reduction afforded us the most efficient usage of our scarce resources while providing the best service possible to our customers.

However, despite our attempt at providing coverage during the right periods of time, we continued to experience periods of low call demand, primarily before 8:00 a.m. and after 8:00 p.m., resulting in assistors sitting idle during these times. After further evaluation of incoming call demand and available assistor resources, we proposed a reduction to our fiscal year 2006 hours of service. However, we did not implement this change, in accordance with Sec. 205.

BUSINESS SYSTEMS MODERNIZATION (BSM)

Question. Over the long-term, Business Systems Modernization (BSM) has suffered numerous project delays and cost overruns, which has warranted oversight and recommendations from GAO. On an encouraging note, in the past 2 years, progress has been made. GAO's No. 1 concern is that since the BSM vision and strategy is no longer current given project delays, the IRS must develop brand-new long-term program goals and strategies. Although the IRS is developing a 5-year plan, GAO still believes further longer-term goals are necessary.

Mr. Everson, how do you respond?

Answer. We appreciate the Senate Appropriations Committee's acknowledgement of BSM's improved performance.

The MV&S team specifically chose a 5-year planning horizon for two reasons. First, given the rapid pace of technological change, it is increasingly difficult to predict what technology will become commonplace over longer planning horizons. Second, IRS's business emphasis can likewise change over longer planning periods. Recognizing these issues, the IRS believes that the key element is not the planning horizon, but rather the commitment to institutionalize an annual planning process that reassesses and updates the MV&S 5-year plan based on IRS's current technology environment, foreseen future technology enablers, and the current IRS strategic focus.

Given this context, longer-term goals have provided a meaningful backdrop to MV&S planning. The first goal is to make investments in technology that will have a demonstrable impact on lowering the \$300 billion-a-year tax gap. IT initiatives that both support increased voluntary compliance (through better IRS service) and enforcement (through improved compliance productivity) are vital to lowering the tax gap over time. Second, given the explosion of the Internet, the IRS needs to leverage its power to offer better service to our constituents while lowering our own costs (chiefly by offering self-assist/self-correct capabilities). Finally, we recognize that true IT modernization will only come about when the IRS can finally retire our aging master files and the Integrated Data Retrieval System (IDRS)—systems built originally in the 1960's and 1970's. These systems are the core of the U.S. tax administration system today, but hamper the IRS's ability to provide real-time, accurate, and complete data to our constituents. The IRS must place continued focus on replacing these systems with modernized systems, including the Customer Account Data Engine (CADE) to replace the master files and projects to replace IDRS.

QUESTIONS SUBMITTED BY SENATOR BYRON L. DORGAN

PROPOSED DISCLOSURE REGULATIONS

Question. Mr. Commissioner, I am deeply concerned about the disclosure regulations proposed by the Internal Revenue Service (IRS) last December. I believe these regulations put at risk rampant distribution of private taxpayer information by tax return preparers for all kinds of unrelated marketing purposes.

You point out that tax return preparers can currently seek consent from customers to use tax return information to solicit their customers to purchase products by the tax preparer or its affiliated group. The approach taken in the regulations

now expands this by allowing tax preparers to solicit their customers to purchase products from third parties including marketers and data brokers—risking even further dissemination of taxpayer information.

Do you believe that this proposed change provides additional disclosure protections for taxpayers?

Answer. I want to assure you that protecting taxpayer privacy by preventing return preparers from improperly disclosing or using tax return information is of utmost importance. The proposed rules represent a significant improvement over existing regulations in protecting taxpayer privacy interests and would strengthen taxpayers' control over their tax information in the hands of tax preparers and tax preparation software companies. Specifically, the proposed rules provide that tax return preparers must give all taxpayers clear warnings and consent notices that allow taxpayers to make a knowing, informed, and voluntary decision over the disclosure or use of their tax information by their preparer.

In addition, Congressional concerns and inquiries led to proposed changes to the rules requiring written taxpayer consent before a return preparer may outsource preparation services or send tax return information outside the United States. This protection does not exist under the current regulations. The proposed rules also retain the requirement that tax return preparers obtain written consent from taxpayers to "use" tax return information. The current rules, however, do not define "use," creating uncertainty in a number of areas, including whether the term includes targeted advertising. The proposed rules eliminate this uncertainty by expressly defining "use" to include return preparers' reliance upon tax return information to target advertising to their customers.

Under the proposed regulations, return preparers must still obtain customer consent before using any information gleaned from tax returns as a basis for marketing any product or service. The consent must identify each specific type of product or service that may be solicited. If the taxpayer declines to execute the consent, the information cannot be used and the return preparer cannot ask for the taxpayer's consent again.

Question. You appear to justify this particular change because you believe that such solicitations may be for products that positively affect taxpayers' financial lives.

Answer. Our primary focus in proposing the regulations was to update existing rules, promulgated in the early 1970's, that do not provide adequate guidance to protect taxpayers' return information in an era of electronic return preparation and filing. While the IRS is sensitive to the impact that these rules may have on taxpayers' finances, our primary concern is protecting taxpayer privacy. Other reasons for publishing the proposed regulations include concern about whether return preparers were engaged in practices not contemplated when the regulations were originally promulgated, including outsourcing preparation services or sending tax information outside the United States. Congressional inquiries about the appropriateness of outsourcing preparation services and sending tax return information overseas without the knowledge of the taxpayer contributed to prioritizing the project.

Additionally, there has been a misunderstanding regarding the proposed rules with respect to the difference between "disclosure" and "use" of tax return information that has led to confusion over how the proposed rules relating to the disclosure of tax return information have been strengthened. The misunderstanding of the proposed rules stems from a proposed change relating not to preparer disclosure of information to third parties, but rather to a return preparer's own use of tax return information to solicit additional products and services for itself or other parties. Currently, return preparers may seek consent from customers to use tax return information to solicit their customers to purchase current products or services offered by the preparers or their "affiliated group." Since few return preparers are organized in a corporate structure, much less an "affiliated group," this provision has little current relevance or application. Moreover, notwithstanding the "affiliated group" limitation on "use" of return information, the existing regulations do not limit the permissible "disclosure of return information to third parties with the taxpayers' consent." Such disclosures may be for products that positively affect taxpayers' financial lives or participation in government benefit programs.

As before, the regulations afford taxpayers the ability to control and direct the disclosure or use of their own tax return information. Under the proposed regulations, return preparers must still obtain customer consent before using information gleaned from tax returns as a basis for marketing any product or service. The consent would need to identify each specific type of product or service that may be solicited and if the taxpayer says no, the information cannot be used and the return preparer cannot ask again.

Question. Do you think that when Section 7216 was enacted and imposed a stiff fine and possible jail time for tax preparers who make unauthorized disclosures of taxpayer return information that Congress intended to allow sweeping exceptions for widespread marketing?

Answer. Neither the current regulations, which have been in place since 1974, nor the proposed regulations, contain sweeping exceptions for widespread marketing. To the contrary, the existing regulations require taxpayer consent for most disclosures and the proposed regulations tighten the applicable consent provisions to help ensure that the consents are informed. That is, the taxpayer, and only the taxpayer, can control and direct the disclosure or use of tax return information by a tax return preparer. Section 7216 as enacted in 1971, provides the Secretary with the authority to prescribe regulations governing the disclosure or use of tax return information. It was clear at that time that Congress understood that there would be circumstances when the disclosure or use of tax return information by tax return preparers for purposes other than tax return preparation would be permissible. Consistent with this understanding and the long-standing regulations, it has been common industry practice to solicit taxpayer disclosure consents for a variety of purposes other than tax return preparation.

Question. You indicate that in both the current regulations and the proposed regulations tax return preparers have been permitted to disclose their customers' tax return information to affiliates and third parties if the customers consent.

Do you have the authority to prohibit such disclosures to affiliates or third parties if such disclosure is not for purposes relating to the preparation of a taxpayer's return? Would legislation be required to prohibit such disclosures?

Answer. Congress provided broad authority to the Secretary under Section 7216(c) to prescribe regulations permitting the disclosure or use of tax return information. By giving the Secretary this broad authority, it is clear Congress understood there would be circumstances when the disclosure or use of tax return information by tax return preparers for purposes other than tax return preparation would be permissible. The regulations implementing Section 7216(c) have been in place for more than 30 years. Given the long-standing existence of the current regulations under Section 7216, the absence of virtually any controversy with respect to consensual disclosures under the current regulations, and the fact that the current controversy is the result of a mischaracterization of the nature and scope of both the current regulations and the proposed regulations, I believe that legislation would be the way to completely prohibit the types of disclosures to affiliates or third parties that you reference.

TAX HAVEN ABUSES

Question. We have known for many years that some very profitable U.S. multinational businesses are using offshore tax havens to avoid paying their fair share of U.S. taxes. In fact, recent evidence suggests that the tax-haven problem is getting much worse and may be draining the U.S. Treasury of tens of billions of dollars every year.

According to an investigative report written by David Evans with Bloomberg News, there is a building called the Uglend House in Grand Cayman that is used as the address of 12,748 companies. In my judgment, it is the hood ornament of the growing tax haven abuse problem.

I have authored legislation with Senator Levin that we believe would put an end to the tax benefits for U.S. companies that shift income to offshore tax-haven subsidiaries. The Joint Tax Committee says our legislation to close this tax avoidance scam would save U.S. taxpayers some \$15 billion over the next decade.

Do you agree that the use of offshore tax havens by large multinational firms to park profits that would otherwise be taxed in this country is a problem? If so, what is the IRS doing to tackle it?

Answer. As I stated in my testimony of June 13, 2006, we recognize that certain taxpayers seek to shift significant profits offshore. These taxpayers manipulate the price of related transactions so they can claim that the income is earned outside the United States, preferably in a low- or no-tax jurisdiction. Further, the transfer of intangibles outside the United States has been a high risk compliance concern for the Service and we have seen a significant increase in such transactions in recent years. Cost-sharing arrangements are often the method for this activity. The buy-in amount in cost-sharing arrangements is frequently troublesome. It is often understated, resulting in the improper shifting of income offshore.

In response to the compliance risks of pricing issues, the LMSB Commissioner issued guidance to all field examination personnel regarding potential transfer pricing issues and we require all field examination personnel to request and review tax-

payer transfer pricing studies. As a subset of the transfer pricing issue category, a section 936 Termination Strategy issue has been identified for additional compliance coordination. Associated with the sunset of section 936, taxpayers have created structured transactions to transfer U.S. intangibles that were used in Puerto Rico to other low tax jurisdictions. An Issue Management Team (IMT) has been established to identify, coordinate, and propose resolution alternatives for this issue.

As part of our response to the cost-sharing arrangements issues, we proposed a comprehensive set of cost-sharing regulations in August 2005 to ensure that such arrangements do not facilitate a disguised transfer of intangible assets outside the United States in a manner inconsistent with the arm's-length standard. We intend to finalize these regulations this year.

We have also established a cost-sharing IMT to improve Service-wide coordination in the identification, development, and resolution of cost-sharing issues. The IMT issued a cost-sharing audit checklist in 2005 that provides guidance to field examiners for developing potential cost-sharing audit issues and ensuring consistency. The team has completed its efforts to identify and review cases with a cost-sharing issue to determine the impact and compliance risk. The team is developing a coordinated issue paper that will provide the basis and support for examining issues and to assist with potential Appeals Settlement Guidelines.

Question. What action did the IRS take when the Uglund House matter was reported in the press?

Answer. The IRS has recognized that companies are using entities such as international business corporations (IBCs) in offshore financial secrecy jurisdictions. Depending on the offshore jurisdiction, shareholders of the IBC may remain confidential. When the article you cited came out in 2004, we canvassed a number of offshore jurisdictions (including the Cayman Islands) and requested they provide a list of their registered IBCs. At that time the jurisdictions we contacted could not provide the information due to their financial secrecy laws. If we have a name or IBC number we are able to contact public registries directly and get information on companies incorporated or registered in the jurisdiction, but that information is limited to IBC name and number, name and address of registered agent, authorized capital, and status of the IBC (whether it is active or inactive.) The public registries do not contain ownership information or shareholders. That information is held by registered agents (RA) and is often subject to the secrecy and privacy laws.

Over the past few years, the IRS and Treasury Department have been negotiating Tax Information Exchange Agreement (TIEAs) with these jurisdictions. We can now make requests under these TIEAs for the ownership information. The Cayman Islands TIEA became effective March 10, 2006 for civil tax issues. If we have a valid tax administration purpose, the TIEAs enable us to request information such as books and records, minutes of meetings, and analysis of functions a company performs to determine whether they have complied with U.S. tax provisions. This is predicated upon the fact that such documentation exists in the jurisdiction.

QUESTION SUBMITTED BY SENATOR BARBARA A. MIKULSKI

Question. I remain very concerned about any proposals to reduce taxpayer services or close any of the 68 Taxpayer Assistance Centers (TACs) across the country, including 4 of 8 in my home State of Maryland. According to a recent Treasury Inspector General for Tax Administration (TIGTA) report (Reference Number: 2006-40-061), management does not have reliable data on the Taxpayer Assistance Centers (TACs) to make decisions about TAC operations. TIGTA also points out that 47 of the 400 TACs nationwide—nearly 12 percent—are “critically” understaffed, meaning that they would be in danger of closing were it not for the dedicated IRS employees who are filling in from nearby TACs and through the use of seasonal employees. In its first report, TIGTA sharply criticizes the business model the IRS used to justify the TAC closings last year (see TIGTA Reference Number: 2006-40-067). These two reports strongly indicate that the IRS lacks the management information necessary to provide adequate oversight of its TAC operations, much less make a decision to close any of them.

How does IRS plan to report to Congress with reliable and verifiable data on the status of taxpayer services and explain how cuts to customer services would affect underserved populations such as the elderly, low-income taxpayers, minorities, those with language barriers and those without access to the Internet? How will you measure the affect of such closures on taxpayers when TIGTA points out that the IRS does not track this data?

Answer. We have taken a number of steps to improve both the data capture methodology and the reliability of management information discussed in the TIGTA re-

ports you mention. Efforts include automating a previously manual process of capturing the number of taxpayers served in the Taxpayer Assistance Centers and development and piloting of a web-based Management Information System that provides critical program planning and control data at the local and national levels. Input data from all of these sources will be incorporated in future iterations of the TAC Business Model.

In addition, the research and initiatives currently underway in the Taxpayer Assistance Blueprint (TAB) will significantly enhance collection of customer information and customer characteristics. As you know, we delivered the TAB Phase I report in April 2006. The TAB Phase II report, which we expect to deliver to Congress in October 2006, will use extensive primary research with taxpayers to validate its service recommendations. Current ongoing customer preference and needs research includes surveys, focus groups, and experimental research aimed at providing customer-centric information to decision-makers. The service-related research includes the underserved taxpayers identified in your question. We intend to continue extensive research initiatives in future years to enrich and refine our understanding of these taxpayers' needs.

Finally, we do not envision that taxpayer services will be reduced. Careful consideration is being given to those taxpayers facing a barrier to online self-service options and how to best meet those needs. The goal is to maintain a balanced service portfolio that meets the needs of the greatest number of taxpayers within available resources.

QUESTIONS SUBMITTED TO RAYMOND T. WAGNER, JR.

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

BSM FUNDING

Question. As noted at our hearing and as recommended by the Board, the IRS's Business Systems Modernization (BSM) program should receive more funding for fiscal year 2007 above the budget request.

If additional funding were to be provided to the BSM account, which projects could most benefit from additional funding? How would additional funding benefit the BSM program?

Answer. Two BSM projects would particularly benefit from additional funding during fiscal year 2007: the Customer Account Data Engine (CADE) and Modernized e-Filing (MeF). The CADE project is so central to IRS modernization that any additional money spent on speeding up the replacement of the 40-year-old Individual Master File (IMF) by CADE would offer many benefits to taxpayers. The legacy IMF system limits the IRS to weekly updates, but CADE will give the IRS the ability to update taxpayer records daily, and provide the IRS with the capability to serve taxpayers much like modern financial institutions serve their customers. On the other hand, using additional BSM funding in fiscal year 2007 on the Modernized e-Filing project would allow the IRS to begin the modernization of the e-filing platform for Form 1040 tax returns a year earlier than currently planned. Such modernization is a prerequisite for the IRS to offer a direct filing portal to individual taxpayers. The Electronic Tax Administration Advisory Committee (ETAAC), in both its 2005 and 2006 annual reports has stressed the importance of modernizing the system for receiving individual tax returns.

Based on consultations with IRS BSM personnel, the Board believes that the MeF project would be a better choice for additional funding in fiscal year 2007. The CADE project is already funded in fiscal year 2007 but the MeF project is not. Funding MeF in fiscal year 2007 would allow this project to start a year earlier, and bring the benefits of improved electronic filing systems to taxpayers a year earlier. The Board believes this would be of more benefit to taxpayers than spending additional money on the CADE project, which is already underway.

BETTER TAX GAP ESTIMATES

Question. While the IRS has done a commendable job in updating the tax gap estimates, there remain significant gaps in the gap. The IRS and others have expressed concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data (from the 1970's and 1980's) and it has no estimates for other areas of the tax gap. GAO, TIGTA, the Taxpayer Advocate, and the IRS Oversight Board also have all recommended greater and more frequent data collection and studies of the tax gap. I wholeheartedly agree.

What will it take in terms of resources to address these concerns? Should the IRS conduct research on how services affect compliance?

Can your office conduct research on the impact of taxpayer service on compliance?

Answer. The IRS Oversight Board believes additional research will provide the IRS with better data on taxpayer compliance, which will help the IRS better identify areas of non-compliance and ultimately provide some feedback on how IRS service and enforcement programs are affecting taxpayer compliance. This belief is consistent with recommendations from the National Taxpayer Advocate, who recommended that the IRS undertake a research-driven taxpayer needs-assessment that will identify services taxpayers need and how best they should be delivered.

For these reasons, the Board recommended that the following research initiatives be included in the fiscal year 2007 budget: (1) Improve Tax Gap Estimates (+\$46 million); and (2) Additional Customer Service Research (+\$15 million).

The first initiative, Improve Tax Gap Estimates, will establish permanent staffing for the National Research Program (NRP) and put the IRS on a path to conducting research annually, without affecting the existing examination staff in place within the operating divisions. Currently it takes too long to conduct research that can be used on a timely basis; the tax gap estimates released by the IRS in 2006 are based on an analysis of 2001 tax returns. Prior estimates were based on extrapolations of 1988 data.

As part of an overall strategy to conduct more research and use it to guide IRS service and enforcement efforts, the Board believes the IRS would be well-served to develop a long-range strategic plan for research that is separate from its overall IRS Strategic Plan and goes beyond the current 2009 end date for that plan, covering approximately a decade. In such a plan, the IRS should describe how it will bring its research on all taxpayer segments up to date, and perform a limited sample every year so that its research on all segments will be as current as possible.

The GAO was particularly supportive of this approach during its testimony to the committee. It testified that “doing compliance studies once every few years does not give IRS or others information about what is happening in the intervening years. Annual estimating of the compliance rate could provide information that would enable IRS management to adjust plans as necessary to help achieve the goal in 2009. One option that would not increase the cost of estimating compliance would be to use a rolling sample. IRS Oversight Board officials and we agree that instead of sampling, for example, once every 5 years, one-fifth of the sample could be collected every year.”

The Board believes the availability of up-to-date research data will allow the IRS to focus more effectively its service and enforcement programs on areas that have the greatest impact on taxpayer compliance, and use the changes in taxpayer compliance rates as feedback to evaluate the effectiveness of IRS’s service and enforcement program on actual taxpayer compliance. Achieving such a capability will be a vast improvement over the current situation in which the lack of data makes it virtually impossible to evaluate the effectiveness of IRS activity on taxpayer compliance and make informed decisions.

The second research initiative recommended by the Board is to add \$15 million to begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers. The need for such research is also consistent with recommendations made by Treasury Inspector General for Tax Administration and the National Taxpayer Advocate in testimony last year to the Senate Appropriations Committee.

In response to the Board’s request, the IRS has said that it could extend and update research efforts in two major areas: evaluating the service needs of taxpayers and estimating the effect of customer service on taxpayer compliance. Additional resources in fiscal year 2007 would be used to further evaluate the service needs of taxpayers and to scope and design the data gathering and analysis capability to estimate the effect of customer service on taxpayer compliance.

With respect to your question on whether the Board could conduct research on the impact of customer service on compliance, please see the answer to question 4. The Board has a limited budget for survey work, but did conduct a survey of customer service needs and channel preferences, which has been provided to the IRS.

DIRECT FILING PORTAL

Question. Some experts have suggested that the IRS develop a direct filing portal through the IRS website to increase e-filing. To be clear, this is not about the Government preparing tax returns but to simply provide an easier, cheaper way for taxpayers to file their returns.

What are your thoughts on the direct filing portal? Do you believe it would significantly increase e-filing? Would this approach be more cost-effective for the IRS than continuing to use an extremely labor-intensive approach to processing paper returns?

Answer. As your question noted, the concept of a direct filing portal has received considerable attention lately, although much of the expert commentary has not been based on a common definition of a direct filing portal. The best way to explore these differences is to start by differentiating the act of tax preparation from the act of tax filing.

Commercial tax software products, including products available through the Free File Alliance, typically perform both functions. They guide the taxpayer through the process of tax preparation by using a series of questions, checklists, interview techniques, and reference material to ensure that all tax obligations have been identified, critical choices explained, relevant decisions made, and all calculations completed accurately. At the end of this process, most programs provide a summary review of the process to let the taxpayer know that preparation is complete.

At the completion of the tax preparation phase, the program then presents the taxpayer with filing and payment options. The taxpayer may choose to print the completed return and mail it to the IRS, or file it electronically. Payment or refund options, both paper and electronic, are also presented to the taxpayer.

If a taxpayer elects to file electronically, an output file is sent, not to the IRS, but to the tax software company, which combines individual returns into large batches, and sends these batched returns to the IRS. The IRS receives the batched returns and notifies the transmitter, usually the software company in the case of self-prepared returns, if the return has been accepted. Returns prepared by professional tax preparers go through a similar process, except that professional preparers may use a third-party transmitter instead of the software company to transmit batched returns to the IRS. A direct filing portal would allow taxpayers to file their already completed returns directly to the IRS without going through a third-party intermediary.

There has been some confusion because there are different interpretations of the term "direct filing portal." Many experts, when speaking of a direct filing portal, only refer to the capability of the IRS to receive a completed output file in what is known as Extensible Markup Language (XML). The creation of the output file must still be accomplished by a separate software package that assists the taxpayer to perform tax preparation. The developers of the tax preparation software must ensure that the output file created is compatible with IRS's direct filing portal. However, the software gives the taxpayer the opportunity to send the output file directly to the IRS instead of the software company. This feature relieves the software company of the responsibility to receive the output files created by its software product, batch them, send them to the IRS, and maintain and protect them. The elimination of this responsibility reduces cost to the software developer and consequently is expected to remove a barrier to entry of new tax preparation software companies from the marketplace.

However, other experts have used the term direct filing portal to refer to the capability for a taxpayer to access an IRS site where the taxpayer may do both elementary tax preparation as well as electronic tax filing, all in a single operation. Under this definition, tax preparation is combined with electronic filing, both of which are performed under the auspices of the IRS. Some States (e.g., Maryland) offer direct filing portals that offer taxpayers the opportunity to fill in a simple tax form and file it directly with the State department of revenue.

The Oversight Board believes that the IRS should explore the possibility of developing a direct filing portal that is capable of receiving output files produced by commercial tax preparation packages. The Modernized e-File program for 1120 tax returns offers the taxpayer the option of filing the return directly with the IRS. The Board believes that individual filers would benefit if offered such a choice, and that the availability of such a choice would promote electronic filing. A recent survey completed by the Board indicated that many taxpayers have concerns about security on the Internet, and the availability of a direct filing portal may alleviate some of these concerns. However, a complete cost benefit analysis should be conducted to determine if the benefits of developing this capability justified the development costs. The Board encourages further evaluation of this important issue.

On the other hand, the Board has reservations about the development of a direct filing portal to perform both tax preparation and filing functions, except for possibly the simplest of tax returns, as was the case with the TeleFile program. The IRS Restructuring and Reform Act of 1998 states that it is Congress's intent for the IRS to offer a comparable program to Telefile on the Internet. However, such a development involves complex public policy issues, such as the appropriate role for govern-

ment in tax preparation. The Act encourages the IRS to cooperate with the private sector and encourage competition in the private sector. The Board believes that creation of a direct filing portal strictly to receive output files from commercial tax software products would be one effective method to promote private sector competition. Again, the Board encourages further evaluation of this issue.

TAXPAYER ASSISTANCE BLUEPRINT

Question. As mandated by our appropriations act, the IRS recently issued the first phase of the Taxpayer Assistance Blueprint (TAB). I asked for this business plan so that the IRS and the Congress could plan strategically on developing future taxpayer services based on taxpayer needs. I also expected the plan to address demographic and geographic differences. Ultimately, this plan should help to improve voluntary compliance with the tax code. I expected the plan to focus beyond current IRS services and develop innovative approaches.

Since the IRS is mandated by the act to work with the Board on the TAB, please explain how the Board has been involved with this project and if the Board believes the TAB is addressing my needs and expectations.

Answer. The IRS has provided the Oversight Board with several opportunities to participate in the process of developing the Taxpayer Assistant Blueprint (TAB). The Board Chairman has been asked to become a member of the TAB Executive Steering Committee (ESC), and has participated both directly and through representation in a number of ESC teleconference meetings.

The IRS has also provided to the Board access to its working documents and plans, and has invited Board members and staff to participate in TAB in-process planning and review meetings. Board staff have attended several meetings in Atlanta during the development of the Phase I report as well as a Phase II planning meeting.

The Board has recently completed its own survey of taxpayer service needs and channel preferences. The survey results were recently presented to the full Board at its last meeting, and the full results provided to the IRS. The Board Staff Director and survey company Project Director traveled to Atlanta to present and discuss the results of the Board's survey with IRS's complete TAB project team, which lead to a comprehensive discussion of the results and how the IRS might incorporate the results into the Phase II report.

The Board is currently preparing a public report on the results of its survey, but would be pleased to present the results to you and your staff at any time.

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

SERVICES OFFERED AT TACS

Question. Mr. Everson and Ms. Olson, why hasn't the IRS involved taxpayers who need or desire face-to-face assistance in determining what services are offered at the TACs?

Mr. George, your recent audit report says that prior to making decisions on closing any TACs, the IRS should ensure that it is known which taxpayers visit the TACs for assistance and why, so the IRS can determine the impact on these taxpayers and ensure alternative service deliver channels are effective in meeting the needs of these taxpayers.

Ms. Olson, I would imagine you agree?

Mr. Everson, TIGTA recently found that 8 of 11 stakeholder groups believe that closing the TACs may make it harder for their constituents to stay compliant with tax laws and file tax returns. TIGTA also found that 11 of 11 stakeholder groups believe their constituents are not currently likely to use alternative methods, such as the Internet or email to obtain the services they need.

In light of your efforts to reduce face-to-face interaction between the IRS and the taxpayer and your efforts to increase compliance, have you re-thought some of your earlier decisions on reducing taxpayer services?

Mr. Wagner, the IRS Oversight Board has recommended budget increases in customer service and toll-free telephone service in particular.

Would you care to comment?

Answer. Based on the belief that good customer service leads to fully-informed and satisfied taxpayers who understand their tax obligations and experience few problems in complying with the tax code, the Board recommends funding an increase in customer service to restore customer service to fiscal year 2003/4 levels and investing in telephone infrastructure. The rationale behind these recommendations is that it is less expensive to prevent problems before a taxpayer files than

to correct it later. While some IRS services have continued to improve, others have not and should be restored to their prior levels.

To restore the level of service in fiscal year 2007 to those achieved during fiscal year 2003 and fiscal year 2004, the Board recommends adding \$32 million to the IRS's service budget. The Board also recommends an \$8.7 million investment in telephone infrastructure to expand services to callers and provide telephone representatives with a more state-of-the-art call center environment. The IRS predicts this investment would result in lower queue times across the enterprise for all applications and would counter a negative trend in telephone service. (Wait time on hold for taxpayers has been increasing in the last 3 years. It has gone from 158 seconds in fiscal year 2004 to 258 seconds in fiscal year 2005, and the fiscal year 2006 target is 300 seconds.)

With respect to taxpayers' needs for in-person services, I would note that the Board has recently completed its own survey of taxpayer service needs and channel preferences. The survey results were recently presented to the full Board at its last meeting, and have been presented and discussed with the IRS's complete Taxpayer Assistance Blueprint project team. The Board's survey resulted in an innovative approach to segmenting taxpayers by attitude, behavior, and need, which led to a comprehensive discussion of the results and how the IRS might incorporate them into the Phase II report.

The Board is currently preparing a public report on the results of its survey, but would be pleased to present the results to you and your staff at any time.

QUESTIONS SUBMITTED TO J. RUSSELL GEORGE

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

ADDRESSING SHODDY WORK BY TAX PREPARERS AND PRACTITIONERS

Question. Just this month, GAO reported that there may be serious problems with the accuracy of the tax returns prepared by many of the private tax preparation companies. The GAO found that these companies often prepared returns that were incorrect, with tax consequences that were sometimes significant. Some of these mistaken returns could have exposed taxpayers to penalties for such things as negligence and willful or reckless disregard of tax rules. Furthermore, TIGTA found, this month, that the IRS is not taking the necessary disciplinary action against tax practitioners who have been convicted or had their licenses revoked by State authorities.

Mr. George, do you think the IRS is doing an adequate job here?

Answer. Recently, the IRS has placed a greater emphasis on the oversight of tax practitioners. To help ensure adequate resources are devoted to provide this oversight, the IRS substantially increased the budget and staffing of the Office of Professional Responsibility (OPR). In fiscal year 2002, the OPR had a budget of \$1.8 million and a staff of 15. By fiscal year 2005, it had a budget of \$5 million and a staff of 56.

During this time, the number of disciplinary actions by the OPR also increased, primarily because of expedited suspensions, which are generally used by the OPR in response to action already taken by Federal or State Government agencies to convict or disbar a tax practitioner or to revoke a practitioner's license.

Notwithstanding the increases in enforcement activity, there are still a significant number of tax practitioners whose conduct appears to warrant disciplinary action by the IRS but who have not been identified by the OPR. TIGTA believes the OPR needs to improve its ability to identify such practitioners so it can take appropriate disciplinary actions. Some tax practitioners who have been convicted of tax-related crimes or whose licenses have been suspended or revoked by State authorities have not been suspended from practice before the IRS.

In March of this year, TIGTA reported that the IRS does not have an adequate method to notify the OPR of tax practitioners who are not compliant with their own tax obligations. In a statistical sample of 750 of the approximately 407,000 licensed tax practitioners, there were 34 (4.5 percent) who were not compliant with their individual tax obligations. These 34 practitioners had a total of 81 tax periods with balances due of \$826,709 and 34 tax periods for which required tax returns had not been filed. Based on this sample, TIGTA estimates that there are approximately 22,500 licensed tax practitioners who are not compliant with their tax obligations but who have not been identified for referral to the OPR.

TIGTA previously reviewed the OPR in 2001 (the OPR was then known as the Office of the Director of Practice) and reported problems with the lack of informa-

tion needed to assess or manage the resources used for the disciplinary proceedings program. During the March 2006 review, TIGTA found that the OPR had not implemented some of the recommendations from 2001. Consequently, the problems reported in 2001 still existed. The OPR still does not have the information needed to effectively monitor program activities and resources, and the case management system still contains unreliable information.

In March 2006, TIGTA recommended that the Director, OPR: (1) work with other law enforcement agencies, including the Department of Justice, to improve the referral process and develop a process to obtain relevant information on State disciplinary actions by coordinating with State licensing authorities such as State bar associations and boards of accountancy; (2) coordinate with other IRS functions to identify practitioners who are not compliant with their individual tax obligations; and (3) implement the recommendations from the 2001 report. The IRS agreed to take corrective actions on our recommendations.

Question. In a briefing last year by TIGTA on Taxpayer Assistance Centers, I learned that some TACs have as little as one or two staff, what TIGTA calls a "critical staffing shortage." The House and Senate, Majority and Minority, said no to your proposal to cut back TACs until TIGTA completes a study on the impact of such reductions on taxpayer compliance and taxpayer services.

Mr. Everson, are you, in fact, allowing these TACs to eventually close by letting the staffing levels dwindle? Do you believe that is consistent with the direction from this committee?

Mr. George or Ms. Olson, do either of you care to comment?

Answer. During the 2006 Filing Season, TIGTA auditors visited 70 TACs from January through April 2006. The 70 TACs consisted of 10 TACs in each of the IRS's five geographical areas, plus 20 TACs in areas heavily affected by Hurricanes Katrina and Rita. TIGTA did not identify or report any significant concerns relating to staffing or wait times. All TACs that TIGTA visited were open and their addresses and hours of operations matched the addresses posted on the IRS's Internet site (irs.gov) and provided through the IRS's toll-free telephone numbers.

TIGTA plans to audit the Taxpayer Assistance Blueprint in fiscal year 2007 and also plans to monitor the 2007 Filing Season.

QUESTIONS SUBMITTED TO NINA E. OLSON

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

BALANCE BETWEEN SERVICE AND ENFORCEMENT

Question. There continue to be questions and debate on the proper balance between taxpayer service and enforcement. But given the data limitations of the tax gap and the IRS's inability to measure quantitatively the return on investment on service or enforcement, it is a difficult question to answer.

Based on your expertise, what are your views on the balance between service and enforcement? Do you believe that one approach is more cost-effective than the other? Since most revenue is collected voluntarily, should the IRS invest more in service than enforcement?

Answer. Without a doubt, voluntary compliance is more cost-effective than enforced compliance. When a taxpayer complies voluntarily, the Government incurs no costs beyond the cost of processing the taxpayer's return. When a taxpayer fails to comply, the Government must spend funds identifying errors on a return if submitted, locating the taxpayer, and seeking to collect the balance due. The IRS is spending billions of dollars to audit and collect balances from substantially less than 1 percent of taxpayers. Even if we were somehow able to double the examination rate, more than 98 percent of taxpayers would not be examined each year. So we need to focus on maximizing voluntary compliance by simplifying the tax laws, increasing third-party information reporting, and improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear disputes or abuses and send a message to all taxpayers that noncompliance has consequences.

As it is, Congress seems likely to appropriate nearly \$5 billion for enforcement and only about \$2 billion for taxpayer services for fiscal year 2007, and the IRS seems inclined to continue to seek a higher proportion of resources for enforcement in the future. I am concerned that the IRS is emphasizing stepped-up enforcement over stepped-up taxpayer service without data to support this approach.

To arrive at an optimal allocation of resources to close the tax gap, the IRS needs to do a better job of understanding the reasons why the tax gap exists.

At the risk of oversimplifying matters, let me suggest that we consider three types of taxpayers: (1) taxpayers who will go to great lengths to comply with whatever requirements exist; (2) taxpayers who view taxes as one of many burdens they face in everyday life and who will comply if doing so is straightforward and not time-consuming; and (3) taxpayers who willfully seek to evade their tax obligations.¹

For each type of taxpayer, what is the reason for noncompliance and what is the optimal government response?

—For taxpayers who generally will go to great lengths to comply, the likely source of noncompliance is the complexity of the tax code. Thus, our approach should be to emphasize simpler laws and better explanations.

—For taxpayers who will comply if doing so is easy enough, our main emphasis should also be simpler laws and procedures, and better outreach and education. Here, though, we might also want to incorporate gentle enforcement action in our approach to try to persuade taxpayers that paying taxes must be a higher priority. In doing so, the IRS should incorporate taxpayer service within its enforcement actions. That is, at the same time that the IRS conducts audits or seeks to collect unpaid tax liabilities, the IRS should be courteous and should focus on trying to teach taxpayers how to avoid getting into trouble in the future. The IRS also must be careful to avoid creating noncompliance by imposing unrealistic procedural burdens on taxpayers who are trying to comply.

—For taxpayers who willfully seek to avoid paying taxes, enforcement is required—although even for these taxpayers, I think IRS employees generally should focus on trying to induce the taxpayers to comply prospectively.

What percentage of taxpayers falls into each of these three categories? I suspect that the middle category is largest, although it is impossible to know with precision. But we need to know more. Determining the reasons for noncompliance and measuring the impact of taxpayer service on compliance and the indirect impact of enforcement actions on compliance (i.e., the increase in compliance that results from taxpayers not subject to audits when word of the IRS's increasing audit coverage spreads) is admittedly difficult research to do, but that is not an adequate reason not to do it. At present, the IRS has very little hard data to compare the return on investment of a dollar spent wisely on enforcement against the return on investment of a dollar spent wisely on taxpayer service. Indeed, there is very little hard data that has been developed to show what a "wise" expenditure would be on either the service or the enforcement side.

I believe this committee and the IRS itself would benefit considerably if more research were conducted in this area to help guide us in making intelligent resource allocation decisions.

DIRECT FILING PORTAL

Question. Some experts have suggested that the IRS develop a direct filing portal through the IRS website to increase e-filing. To be clear, this is not about the government preparing tax returns but simply provide an easier, cheaper way for taxpayers to file their returns.

What are your thoughts on the direct filing portal? Do you believe it would significantly increase e-filing? Would this approach be more cost-effective for the IRS than continuing to use an extremely labor-intensive approach to processing paper returns?

Answer. I believe the IRS should provide a direct filing portal to enable taxpayers to e-file their returns directly with the IRS for free. In fact, I made exactly this recommendation in my 2004 annual report to Congress.²

E-filing brings benefits to both taxpayers and the IRS. From a taxpayer perspective, e-filing eliminates the risk of IRS transcription errors, pre-screens returns to ensure that certain common errors are fixed before the return is accepted, and speeds the delivery of refunds. From an IRS perspective, e-filing eliminates the need for data transcribers to input return data manually (which could allow the IRS to shift resources to other high priority areas), allows the IRS to easily capture return data electronically, and enables the IRS to process and review returns more quickly. For these reasons, Congress in 1998 directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007.³

¹Analysis has been conducted on types of noncompliance that is more detailed and subdivides taxpayers into narrower categories. See Leslie Book, "The Poor and Tax Compliance: One Size Does Not Fit All", 51 U. Kan. L. Rev. 1145 (2003).

²See National Taxpayer Advocate 2004 Annual Report to Congress 471–477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

³Internal Revenue Service Restructuring and Reform Act, Public Law No. 105–206, § 2001(a)(2), 112 Stat. 685 (1998).

To its considerable credit, the IRS has succeeded in raising the e-file rate above 50 percent. That is a significant achievement, but the rate remains substantially below 80 percent. In addition, the IRS reports that nearly 40 million returns are currently prepared using software—which means they are generally in a form that could be easily transmitted electronically—yet are printed out and mailed into the IRS on paper.

If the IRS could persuade these nearly 40 million taxpayers to file these returns electronically, it would achieve its 80 percent e-filing goal. Under the current system, there are two significant reasons why taxpayers shy away from e-filing. First, some taxpayers are unwilling to pay a separate fee to third-party software providers to file their tax returns. This is an understandable sentiment. As it is, taxpayers are filing tax returns to comply with the requirement that they pay a high percentage of their income—often 33 percent or more—to the Government. The notion that they should have to pay a fee in order to pay over all this money is unpalatable to many. Second, some taxpayers have concerns from a security standpoint about routing personal financial and tax information through third parties. In focus groups, taxpayers have said they would be comfortable transmitting this information directly to the IRS, but they are concerned that the risk the data could be improperly accessed increases when routed through third parties.

A direct filing portal would address concerns about fees and security. For that reason, I believe it could help the IRS considerably in its efforts to boost the e-filing rate.

BETTER TAX GAP ESTIMATES

Question. While the IRS has done a commendable job in updating the tax gap estimates, there remain significant gaps in the [data]. The IRS and others have expressed concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data (from the 1970's and 1980's) and it has no estimates for other areas of the tax gap. GAO, TIGTA, the Taxpayer Advocate, and the IRS Oversight Board also have all recommended greater and more frequent data collection and studies of the tax gap. I wholeheartedly agree.

What will it take in terms of resources to address these concerns? Should the IRS conduct research on how services affect compliance?

Can your office conduct research on the impact of taxpayer service on compliance?

Answer. Determining the resource commitment required to update all components of the tax gap is a complex problem. Given the information, planning assumptions and analyses required, TAS cannot provide an accurate estimate in response to this question. The actual cost would vary greatly depending on the methods chosen to address the various tax gap components, the time frames in which the research would be done, and the commitment made to periodically refresh information to assure continued accuracy. For example, where the IRS relies on examinations to identify underreporting for a particular class of returns (e.g., individual income as reported on the Form 1040 series of returns), costs would vary depending on a variety of factors, including:

- The total number of examinations (increasing the number of examinations allows the IRS to study more subsets of the taxpaying population in isolation—e.g., EITC taxpayers, self-employed taxpayers, etc.);
- The number of examinations conducted face-to-face (as opposed to via correspondence);
- The number of issues that would not have to be addressed during the examination because they could be resolved using data available through electronic means;
- The number and kinds of analyses conducted once examination results became available (which would depend on the purposes for which the information is to be used).

This question could probably best be addressed by the IRS, based on experience to date with the National Research Program (NRP), and current planning assumptions. I do believe, however, that conducting such research is vital to increasing IRS productivity and taxpayer compliance. Each year, the IRS should identify a particular category of taxpayers—individual, pass-through, corporate, or tax-exempt—and dedicate a unit of its auditors to examining a random sample of returns. The revenue resulting from the improved selection of returns for audit should more than offset the minor reduction in audit resources used to conduct these studies. The IRS must learn to view this type of research as part of its regular tax administration activity instead of as a special activity that “distracts” its auditors from their “real” work.

Concerning the need to conduct research on how services affect compliance, as I stated above in my response to question No. 1, the IRS has very little hard data to compare the return on investment of a dollar spent wisely on enforcement against the return on investment of a dollar spent wisely on taxpayer service. In addition, the data that is available suggests that a substantial percentage of noncompliance is inadvertent. Additional research is needed to develop better information on the underlying causes of noncompliance and the degree to which different approaches, including enhancements to customer service, can improve compliance.

TAS is working with the Taxpayer Assistance Blueprint (TAB) team to develop and conduct research projects that will help identify the impact customer service has on taxpayer compliance. Several studies are currently underway that are exploring various facets of this issue, including:

- The impact of IRS return preparation on compliance;
- The impact of other customer service options on compliance; and
- The impact of high-end account resolution services on compliance.

We will be in a better position to assess the need for additional research once we have reviewed the results of these studies.

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

CUTTING THE IRS OFFICE RESPONSIBLE FOR SERVICE WHILE EXPECTING MORE FROM VOLUNTEER PROGRAMS

Question. Mr. Everson, the IRS's Stakeholder, Partnership, Education and Communication (SPEC) office has overall responsibility for community partnerships such as the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. In recent years, this IRS office has suffered cutbacks while the number of taxpayers seeking help from by VITA and TCE for tax preparation continues to increase dramatically. Moreover, you stated recently that you expect to rely heavily on VITA programs to improve taxpayer services.

—How do you justify continuing to cut the SPEC office while giving it an increasing workload?

—Ms. Olson, what is your opinion on this matter?

Answer. I strongly support the VITA Program, and commend the tireless efforts of its volunteers in assisting an underserved segment of taxpayers. If the IRS wants to retain responsibility for VITA and set the standards that sites must meet, however, it must be willing to give the sites more assistance than it currently provides. The IRS must be willing to change its relationship with VITA from one that is merely supplementary, where VITA sites are providing a service the IRS is unwilling to provide, to a relationship that is complementary, where the IRS and VITA sites work together to provide a service and achieve specific goals. As the IRS considers the future of VITA, it must take a hard look at the needs and concerns of local and national partners, without whose continued support the program will cease to exist.

The IRS must also provide adequate funding for the VITA Program. From 1999 to 2004, the number of VITA sites grew dramatically from 6,000 to nearly 14,000, an increase of 8,000 sites.⁴ From 2001 to 2004, the amount of technology support provided to the VITA Program increased only modestly, from \$2.9 to \$3.3 million, an increase of \$400,000.⁵ In combination, technology support decreased from \$483.00 per site to \$236.00 per site on average, a decrease of more than 50 percent. Thus, aggregate funding and support provided by the IRS have not been increasing at a rate sufficient to keep up with the growth of the program. The IRS needs to determine the growth limit of the VITA Program and how to respond when that limit is reached. It must also undertake more comprehensive strategic planning regarding the future of the VITA program and the support it is providing before it continues to increase the amount of assistance it expects these sites to provide.

Question. The VITA program operates for only about 4 months of the year during tax season and receives limited support from the IRS. Ms. Olson, in your statement, you say that the IRS should concentrate on developing a fundamental support structure for the program and expand the program. You also say that the IRS should not let VITA or any other volunteer program serve as a substitute for IRS-provided service.

⁴Stakeholder Partnerships, Education and Communication, "VITA Celebrates Its Thirtieth Year of Service"; additional information provided by the IRS.

⁵Information provided by the IRS. It is important to note that budget information is not available for years prior to 2001 when the VITA Program operated under the Taxpayer Education function.

Ms. Olson, why do you take that position?

Answer. As the IRS struggles with limited resources to meet the service needs of all taxpayers, we have already begun to reduce free tax preparation assistance previously provided to taxpayers. Over the past 3 years, the IRS has reduced the number of tax returns prepared in Taxpayer Assistance Centers (TACs) from 665,868 tax returns in fiscal year 2003 to a proposed 305,000 tax returns in fiscal year 2006.⁶ To fill the gap, the IRS has increased its reliance on the VITA Program to provide free tax preparation assistance to taxpayers.

Clearly, partners are very important to effective tax administration, and I applaud the efforts of dedicated professionals and volunteers in assisting taxpayers. However, this reliance raises several concerns. First, when the IRS relies on partners to deliver a message, we need to study what happens to the message in the course of delivery. Does the message change over distance and time? Is it less accurate? Second, we need to measure the downstream consequences of this trend. What are the true costs of effective oversight over these partners? Who conducts such oversight and bears the cost? Will the IRS actually realize any savings or will it incur more expense through additional enforcement activity that could be avoided if the IRS itself delivered the assistance?

On the other hand, if we begin to rely more heavily on our partners for the delivery of services, we must also ensure that we are providing our partners with adequate support and assistance. Without a sufficient support system in place, we cannot expect our partners to act as a delivery channel for services we are unable or unwilling to provide.

While the service VITA provides is critical, the IRS cannot rely entirely on these volunteers to provide a service the IRS has deemed too costly or time-consuming to provide itself. Instead of concentrating on expanding the VITA Program, the IRS should concentrate on developing a fundamental support structure for the program, including site management, training, and quality review. Once the IRS has developed a strong infrastructure for the VITA Program and has established consistent quality in the returns prepared by volunteers, then the IRS can work to expand the program. However, the IRS must remain cognizant that VITA, or any volunteer program, cannot and should not be expected to serve as a substitute for IRS-provided service. Taxpayers have the right to expect some level of assistance from the tax agency they fund with their tax dollars.

SETTING TAXPAYER ASSISTANCE CENTERS (TACS) UP TO FAIL

Question. In a briefing last year by TIGTA on Taxpayer Assistance Centers, I learned that some TACs have as little as one or two staff, what TIGTA calls a “critical staffing shortage.” The House and Senate, Majority and Minority, said no to your proposal to cut back TACs until TIGTA completes a study on the impact of such reductions on taxpayer compliance and taxpayer services.

Mr. Everson, are you, in fact, allowing these TACs to eventually close by letting the staffing levels dwindle? Do you believe that is consistent with the direction from this committee?

Mr. George or Ms. Olson, do either of you care to comment?

Answer. The IRS is facing a challenge. It has limited resources yet also has the responsibility to serve all taxpayers. Thus, it must decide by taxpayer segment how to deliver needed services in the most effective and efficient manner possible, and in a way that does not negatively impact taxpayers’ ability to comply with the tax laws. Toward this end, the IRS must gather data and develop criteria to make those decisions. The Phase I report of the Taxpayer Assistance Blueprint (TAB) is the first step toward developing a comprehensive 5-year plan for taxpayer service that will establish a long-term strategy for delivering needed taxpayer services within existing resource limitations.

The IRS must take a close look at what services taxpayers need and want. The status quo is not necessarily what taxpayers want—it is merely what the IRS has been willing (or able) to deliver. Instead the IRS must conduct research to develop a baseline of services. Only after this research is completed will we be able to measure how effective we are in improving our ability to meet taxpayer needs and begin to study how any changes to our current service offerings will affect taxpayer compliance.

⁶Wage and Investment, “Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2006”; Wage and Investment, “Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2005”; Wage and Investment, “Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2004”; Wage and Investment, “Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2003.”

SERVICES OFFERED AT TACS

Question. Mr. Everson and Ms. Olson, why hasn't the IRS involved taxpayers who need or desire face-to-face assistance in determining what services are offered at the TACs?

Answer. The Taxpayer Assistance Blueprint Team (TAB), as part of its work developing a 5-year plan for taxpayer service, conducted a number of research projects designed to identify the needs and preferences of taxpayers. As part of these studies, the IRS is looking specifically at taxpayers who use the TACs to determine what services these taxpayers need. This data will hopefully allow the IRS to structure the TACs in order to best meet the needs of the taxpayers who require face-to-face assistance.

Question. Mr. George, your recent audit report says that prior to making decisions on closing any TACs, the IRS should ensure that it is known which taxpayers visit the TACs for assistance and why, so the IRS can determine the impact on these taxpayers and ensure alternative service deliver channels are effective in meeting the needs of these taxpayers.

Ms. Olson, I would imagine you agree?

Answer. Before the IRS makes any decision about altering the current services offered to taxpayers, it should study the trends in taxpayer service in order to understand the impact of taxpayer service on compliance and how taxpayers need services to be delivered. The Taxpayer Assistance Blueprint Team (TAB) conducted a number of research projects designed to identify the needs and preferences of taxpayers. One research study involves interviews with taxpayers who sought TAC services, including those who were not actually served or did not receive the service they requested. This information will be invaluable in determining taxpayer needs and preferences. However, additional research must be conducted to determine the impact of taxpayer service on compliance. This research would allow the IRS to determine how changes to taxpayer service will potentially impact compliance.

REDUCTION OF TAXPAYER SERVICES

Question. Mr. Everson, last year, you:

- eliminated “TeleFile”, the ability to file taxes by telephone;
- proposed the elimination of as many as one-quarter of all walk-in Taxpayer Assistance Centers;
- proposed shortening phone assistance hours; and
- began the process to eliminate several telephone call-routing sites.

In a profile of online population, Census data indicates that in any given age group (ages 18–29; 30–39, etc.), not even one-third of adults are on-line. We know that the Nation's large senior citizen, limited-proficient English, and underserved populations are not as likely to use or have access to the internet as other forms of communication.

Given this and the digital divide at every generation, how do you rationalize the elimination of face-to-face and telephone interaction in favor of electronic communication?

Ms. Olson, does this concern you?

Answer. I believe the IRS should work harder to identify the best channels through which to deliver services to taxpayers. While electronic and self-assistance channels may be growing in popularity, mere use or access to these services does not necessarily mean that taxpayers are computer literate and can conduct website searches for complex tax information—much less understand how to apply that information once they find it.

Moreover, we need to understand why certain taxpayer segments have difficulties with our existing services and why they are reluctant to use lower cost channels (if indeed they are). Only then can we develop effective “migration” strategies to encourage and educate taxpayers about appropriate lower cost channels—ones that will not ultimately increase noncompliance and lead to greater downstream costs. Additionally, we must always remain cognizant that there is a segment of the population that cannot and will not avail itself of self-service options. However, by providing more self-service opportunities for taxpayers, the IRS should be able to reserve its in-person (face-to-face or telephone) interaction for those issues and taxpayers that need such engagement.

FREE FILE ALLIANCE

Question. Mr. Everson, recently, the Finance Committee found that taxpayers using the Free File on-line tax return preparation services are presented with surprise fees, expensive add-ons, loan solicitations and other marketing pitches. While

there is no obligation to buy these services, the fees occur so late in the process that taxpayers may feel forced to pay them or completely redo their taxes with another vendor who may also charge fees. It is my understanding that the IRS has not conducted much research on how many taxpayers fall prey to these sales pitches.

What is the IRS doing to protect taxpayers from predatory sales pitches and do you plan to do more comprehensive research on these activities?

Ms. Olson, do you have a view on this?

Ms. Olson, you've advocated for free tax preparation on the IRS website.

Do you believe that is the only way the IRS will achieve its goal of having 80 percent of taxpayers filing electronically?

Answer. I have significant concerns about the Free File Program. It is very confusing for taxpayers to navigate, some of the participating companies subject taxpayers to an array of confusing sales pitches, and it has done very little to achieve the IRS's objective of increasing the e-filing rate. On this latter point, I note that only about 4 million taxpayers used Free File during the 2006 filing season out of approximately 135 million individual income tax returns filed—and IRS data from the prior year shows that the significant majority of Free File users filed their returns electronically in prior years,⁷ which means that Free File's success at creating new e-filers is limited at best. As I have recommended previously, I believe the IRS and taxpayers would both be much better off if the IRS were to create a direct filing portal and to make available a basic electronic filing template on its website for those taxpayers who are unwilling to pay fees to purchase fully functional software products.⁸

As for navigating Free File, several experienced attorneys in my office tested each of the Free File sites in March 2006 seeking to prepare returns reflecting four fact patterns on each site. We conducted the tests partly to follow up on testing my office performed in 2004 and partly in response to a request from the staff of the Finance Committee. The goal of the testing was to determine the experience of taxpayers as they attempt to navigate the sites and prepare and file their returns through Free File products accessible through the official IRS website. The results of our tests, in my view, were disappointing.⁹ We found that Free File is not generally an easy service for taxpayers to navigate, and it can even result in inaccurate returns. As structured during the 2006 filing season, Free File amounted to a Wild, Wild West of differing eligibility requirements, differing capabilities, differing availability of and fees for add-on products, and many sites were difficult to use.¹⁰

From an IRS perspective, the rationale for creating the Free File program was to make e-filing more accessible to taxpayers and thereby help it to achieve the congressionally-mandated goal of having 80 percent of all taxpayers filing their returns electronically. However, the relatively low usage of Free File, the remarkably low usage by new e-filers, and the decline in usage in 2006 as compared with 2005 indicate that the program is not meeting its objectives. Taking into account the additional concerns about cross-marketing of other products, the appearance that the IRS is endorsing the Free File products (notwithstanding disclaimers, taxpayers start out from the official IRS website), and taxpayer concerns about the confidentiality of their tax data, I see little justification to continue with Free File and every justification for the IRS to develop a tax preparation template and to provide free e-filing for all taxpayers—just as it does for paper filers. If the IRS template and direct filing portal are simple, accurate, and confidential, I think both the IRS and taxpayers will benefit enormously and the e-file rate will increase.

SUBCOMMITTEE RECESS

Senator MURRAY. This subcommittee is recessed until Thursday, May 4 when we take testimony from the Federal Aviation Administrator.

⁷ IRS Wage & Investment Research Group 6, "Final Report: Free File Survey Analysis, Research Project 6-05-08-2-038N" 12 (Aug. 31, 2005).

⁸ See National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

⁹ The objective of our study was to determine the existence and extent of limitations and problems that a user of the Free File sites would encounter. In some instances, the tax attorneys testing the sites found them very difficult to navigate and were unable to locate forms or answers that later testing was able to locate. Therefore, the results we describe reflect simply what our attorneys experienced and not necessarily what a site was capable of accomplishing.

¹⁰ For a detailed discussion of the tests, see "Preparing Your Taxes: How Costly Is It? Hearing Before Senate Comm. On Finance", 109th Cong., 2nd Sess. (Apr. 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, IRS).

Thank you very much.
[Whereupon, 11:25 a.m., Thursday, April 27, the subcommittee
was recessed, to reconvene subject to the call of the Chair.]