FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

THURSDAY, MAY 9, 2007

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

The subcommittee met at 3:09 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Nelson, and Allard.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENT OF HON. KEVIN BROWN, DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

ACCOMPANIED BY:

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STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. The hearing will please come to order. I am pleased to welcome you to this session before the Financial Services and General Government Appropriations Subcommittee.

Our focus today is on the President's fiscal year 2008 budget request for the Internal Revenue Service (IRS). Funding for the IRS alone constitutes just over one-half of the total amount requested by the administration for the nearly 30 Federal agencies with accounts under the jurisdiction of this subcommittee. Each year IRS employees make hundreds of millions of contacts with American taxpayers and businesses and really represent the face of Government to more U.S. citizens than almost any other agency.

I welcome my colleagues who will join me on the panel later.

Appearing before the subcommittee this afternoon is a distinguished panel of witnesses who each bring valuable expertise and experience to their testimony. I welcome: Kevin M. Brown, Acting IRS Commissioner, and Deputy Commissioner for Services and Enforcement; J. Russell George, Treasury Inspector General for Tax Administration (TIGTA); and Nina Olson, the National Taxpayer Advocate. I look forward to your presentations.

I also want to welcome Linda Stiff, Deputy IRS Commissioner for Operations, accompanying Acting Commissioner Brown.

I acknowledge the helpful contributions of the Government Accountability Office (GAO) in response to our request for analyses. I welcome senior GAO officials James R. White, Director of Strategic Issues, and David Powner, Director of Information Technology Management Issues, and members of their team. Their prepared statement will be made part of the record and they stand ready to respond to questions.

In addition, the IRS Oversight Board has submitted for inclusion in the record its special report on the recommendations for the fiscal year 2008 budget proposal. Colleen Kelley, President of the National Treasury Employees Union, on behalf of the employees of the Internal Revenue Service has submitted a written statement. Without objection, these materials will be made part of the record.

[The information follows:]

The IRS Oversight Board Fiscal Year 2008 IRS Budget Recommendation Special Report can be found at http://www.treas.gov/irsob/reports/fy2008-budget-report.pdf.

Senator DURBIN. The Internal Revenue Service administers tax laws and collects the revenues that fund over 95 percent of the Federal Government's operations. With approximately 100,000 employees, the IRS is effectively the accounts receivable department for the United States. Simply stated, the more revenue the IRS collects, the more revenue Congress may spend on programs and use for cutting taxes and reducing the deficit. Conversely, the less revenue the IRS collects, the less revenue Congress has available.

The IRS relies on three sources for the funds it needs to operate: appropriated funds, user fees, and reimburseables, which are payments the IRS receives from other Federal agencies and State governments for services provided. Nearly the entire budget, 97 percent of it, is derived from appropriated funds.

For fiscal year 2008, the administration is seeking a direct appropriation of $11.1 billion, an overall increase of $498.4 million, 4.7 percent above the 2007 full year continuing resolution level. The full year joint continuing resolution enacted for fiscal year 2007 provided funding of nearly $160 million more to the IRS than the earlier continuing resolution allowed. So we are hopeful that the resources are there.

I am not going to go into the details breaking down the entire budget. I would rather have the testimony from our panelists. There are a few issues that will be discussed in depth today as we examine the IRS funding. First, the tax gap. The great majority of Americans pay their fair share of taxes. There is still a significant tax gap, the difference between what taxpayers are supposed to pay and what they actually pay. The estimated gross tax gap of $345 billion consists of: underreporting tax liability, $285 billion;

nonfiling of tax returns, $27 billion; and underpayment of taxes, $33 billion.

I note that as a part of its budget submission the IRS proposes 16 legislative reforms to recoup $29 billion, 10 percent of the $290 billion net tax gap, over 10 years. Questions have been raised that such an approach is far from aggressive and amounts to a return of just a penny on the dollar. I am anxious to hear the perspectives of our panel members.

Second, we are going to consider the proper balance between enforcement and service. It is fundamental that as enforcement initiatives to boost compliance are advanced, resources devoted to taxpayer services are not sacrificed. Taxpayer service plays an integral role in facilitating voluntary compliance with our tax laws.

Third, critical information technology enhancements. I am interested in the status of the IRS business systems modernization program, efforts that the IRS migrates from its antiquated and obsolete legacy systems to bring tax administration systems to a level equivalent to private and public sector best practices. This is a challenge in almost every Federal agency.

I would like to turn now to our panel and invite Acting Commissioner Brown to begin. I ask you to make your presentation. We will make your written statement part of the record and we may have some questions to submit to you after the hearing. Possibly some of the other colleagues who cannot join us will send questions as well. So if you would not mind starting, I invite your testimony, Mr. Brown.

ORAL STATEMENT OF ACTING COMMISSIONER KEVIN BROWN

Mr. BROWN. Good afternoon. Thank you, Chairman Durbin. I also want to thank the other members of the subcommittee who will be coming for their efforts in increasing IRS funding in the joint resolution over the level proposed under the continuing resolution.

The President's request for fiscal year 2008 provides additional money for IRS systems, infrastructure, and modernization, as well as for enforcement and, notably, for increased research. There is also an increase for taxpayer services. We ask the members of the subcommittee to support the President's budget and to help enact an appropriation before the start of fiscal year 2008.

These requested moneys will help us generate continued progress in attacking the tax gap. But they are not the only things we need to do. The administration has made 16 legislative proposals. I would direct your attention to four that I think are particularly important: first, the reporting of credit card gross receipts; second, making the willful failure to file a tax return a felony rather than a misdemeanor; third, requiring basis reporting for sales of securities; and fourth, lowering the threshold for mandatory electronic filing for large corporations and partnerships.

With this budget, we can build on our progress in service and enforcement. We again enjoyed significant increases in our enforcement results in fiscal year 2006 and I am pleased to report that we are making continued strides in fiscal year 2007. I believe the IRS has restored the credibility of its enforcement programs with-

out generating a significant amount of public discontent or increased allegations of infringement of taxpayer rights.

In addition, to improve our service to taxpayers we have developed a taxpayer assistance blueprint. This subcommittee was the principal force in bringing about the taxpayer assistance blueprint. Begun in July 2005, the blueprint is a collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate. Under this project we learned a great deal about taxpayer needs and how to meet them. From the blueprint, we created a strategic plan with a host of improvement initiatives. For example, our 2008 budget request includes funding for telephone service and web site enhancements recommended by the strategic plan.

Before taking your questions, let me say a few things about the filing season we just completed. At the IRS we recognized some time ago that this would be a challenging filing season. Two of the reasons were Congress' late action on the extender legislation and the fact that we did not have an operating budget until well into February. The one-time refund of the telephone excise tax and the initiation of the split refund were also of concern. Taken together, we anticipated the most difficult filing season in a number of years.

Nevertheless, we kept up with the work and the system functioned well. The extenders were successfully implemented and our software updates were taken care of by early February. Electronic return filing continues to grow and our service indicators are healthy.

Along with the increase in the e-file rate, we have seen a 17 percent gain in our volunteer-prepared returns, a cornerstone of our outreach program. As you may know, this effort helps eligible participants claim the earned income tax credit.

PREPARED STATEMENT

Thank you for the opportunity to testify today and I will be glad to take your questions.

Senator DURBIN. Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF KEVIN BROWN

INTRODUCTION

Chairman Durbin, Ranking Member Brownback, and members of the Subcommittee, thank you for the opportunity to testify today on the fiscal year 2008 budget request for the Internal Revenue Service. I am accompanied this morning by Linda Stiff, IRS's Deputy Commissioner for Operations and Support. She will assist me in responding to questions that Members of the Subcommittee may have.

Under the leadership of Commissioner Everson, our working equation at the IRS has been and continues to be that service plus enforcement equals compliance. A balanced program between service and enforcement leads to sound tax administration.

However, a balanced program can be successful only if the IRS is provided the resources necessary to fulfill its mission. Two years ago in the fiscal year 2006 budget, the Service was provided those resources when Congress approved the President's request for the IRS. This fiscal year, however, we were forced to operate under a Continuing Resolution (CR) for the first four months of the fiscal year until Congress approved the Joint Resolution (JR) in February.

I want to thank the Members of the Subcommittee for their efforts in increasing our level of funding in the JR over the levels proposed originally under a full year CR. As a result, we anticipate that there will be little or no negative impact on our

taxpayer service, operations support, or our Business Systems Management (BSM) programs.

While our enforcement programs also fare much better under the JR, the increase is not sufficient to prevent some negative impacts. The JR provided $4.7 billion for enforcement, which is $55.4 million below the level requested by the President in his fiscal year 2007 budget request.

While we are attempting to partially offset this reduction through user fee receipts, this reduction increases the importance of providing full funding of our fiscal year 2008 budget request, which I will discuss later in my testimony.

PRODUCING RESULTS

The best case for full funding of the fiscal year 2008 budget can be made by looking at the results we achieved with the resources we do have. In fiscal year 2006, we spent just 42 cents to collect each $100 of tax revenue, the third lowest figure in the last 25 years and down from 46 cents in fiscal year 2005.

In fiscal year 2006, we continued making improvements in both our service and enforcement programs. This claim is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards "transforming itself into a modern institution that provides efficient and effective tax administration services to America's taxpayers."

Improving Taxpayer Service

According to a survey commissioned by the Board in 2006, taxpayers increasingly recognize that the IRS provides quality service through a variety of channels, such as our Web site, toll-free telephone lines, and Taxpayer Assistance Centers (TACs). This finding is supported by the metrics that we use to determine the effectiveness of our taxpayer service efforts. In category after category, we continue to see improvement in the numbers in our telephone services, electronic filing, and IRS.gov access. This improvement is demonstrated by the following fiscal year 2006 business results:

—Electronic filing by individuals continued to increase. It rose three percentage points from fiscal year 2005 to 54 percent of all individual returns.

—The level of service for toll-free assistance was 82 percent, about the same level of fiscal year 2005 and up substantially from fiscal year 2001. The level of customer satisfaction with the toll-free line remains 94 percent.

—The tax-law accuracy of toll-free responses improved to 91 percent and account accuracy increased to over 93 percent.

—Visits to the IRS Web site jumped nearly 10 percent in fiscal year 2006 to more than 197 million visits.

—More taxpayers used the online refund status tool "Where's My Refund." In fiscal year 2006, there were 24.7 million status checks, up nearly 12 percent from fiscal year 2005.

At the IRS, we continue to work to improve services. Clearly, we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the completion of the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July 2005 in response to a Congressional mandate to develop a five-year plan for taxpayer service delivery. We sent Phase 1 of the Blueprint to Congress in April 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer, partner, and government value:

—*Improve and expand education and awareness activities*.—This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.

—*Optimize the use of partner services*.—This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.

—*Enhance self-service options to meet taxpayer expectations*.—This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.

—*Improve and expand training and support tools to enhance assisted services*.—This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.

—*Develop short-term performance and long-term outcome goals and metrics*.—This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

We delivered Phase 2 of the Blueprint to Congress in April. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year TAB Strategic Plan for taxpayer service.

The TAB Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder, partner, and employee engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance.

The fiscal year 2008 budget request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the TAB Strategic Plan. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help. The TAB Strategic Plan also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding noncompliance, the fiscal year 2008 budget includes funding for research to understand better the effect of service on compliance.

Expanding Enforcement Efforts

Another reason for the Oversight Board's positive assessment of our work in fiscal year 2006 is that IRS enforcement efforts have increased in virtually every area. According to the Board, "As demonstrated by a variety of measures, the IRS' performance on enforcement has improved considerably, and real progress has been achieved over the past six years." One of the most obvious measures is the increase in enforcement revenue, which has risen from $34 billion in fiscal year 2002 to almost $49 billion in fiscal year 2006, an increase of 43 percent.

In fiscal year 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This level is almost 75 percent more than were conducted in fiscal year 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.58 percent in fiscal year 2001 to more than 0.97 percent in fiscal year 2006.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over $1 million. The number of examinations in this category rose by almost 78 percent compared to fiscal year 2004, the first year the IRS began tracking audits of individuals with income over $1 million. The coverage rate has risen from 5 percent in fiscal year 2004 to 6.3 percent in fiscal year 2006.

Growth in audit totals and coverage rates extend to other taxpayer categories. Preliminary estimates show that the IRS examined over 52,000 business returns in fiscal year 2006, an increase of nearly 12,000 over fiscal year 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over $10 million, examinations rose from 8,718 in fiscal year 2001 to 10,578 in fiscal year 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over $250 million, examinations have increased by over 29 percent growing from 3,305 in fiscal year 2001 to 4,276 in fiscal year 2006.

We have also been active in the tax exempt community. Overall, examination closures for tax exempt organizations have risen from 5,342 in fiscal year 2001 to 7,079 in fiscal year 2006. In addition, we have an innovative program utilizing correspondence contacts to leverage our activities in the compliance area. We have used it successfully in the hospital and executive compensation areas, and will be using it elsewhere.

While examinations in the tax exempt community generally do not provide the tax collection "return on investment" that audits in other areas might, it is important that we keep a "cop on the beat" in order to prevent abuses in the exempt sector and an erosion of the tax base. Maintaining a strong enforcement presence in the

tax-exempt sector is particularly important given the role that a small number of these entities have played in the past in accommodating abusive transactions entered into by taxable parties. In appropriate cases, this results in the collection of income or excise taxes—and in the most egregious cases, revocation of exempt status.

One area to which we have paid particular attention is the credit counseling industry. Through a compliance initiative in this area, as of March 23, we had revoked or proposed revocation of the tax-exempt status of 45 credit counseling agencies, with another 16 examinations still in process. Proposed or final revocations to date represent 41 percent of the revenues of the credit counseling industry.

Using our correspondence contact techniques, we have also sent more than 700 questionnaires to all tax-exempt credit counseling organizations we know of that were not already under examination. Based on responses to the questionnaires and our independent research, we expect to examine at least 82 additional credit counseling organizations from this group.

We also have been actively reviewing seller-funded down payment assistance programs that provide cash assistance to homebuyers who cannot afford to make the minimum down payment or pay the closing costs involved in obtaining a mortgage. When properly structured and operated, down payment assistance programs can qualify as tax-exempt charitable and educational organizations. In May 2006, we issued Revenue Ruling 2006–27, which provides examples of organizations that may qualify for tax exempt status, but also makes it clear that organizations providing seller-funded down payment assistance do not qualify for tax exemption.

Seller-funded down payment assistance programs improperly benefit the home seller through circular funding arrangements that result in the home buyer paying for all or much of the down payment "gift" he or she receives from the organization. They also result in buyers becoming overextended as the cost of the down payment is added to the purchase price of the home. A Housing and Urban Development (HUD)-commissioned study and a Government Accountability Office (GAO) report found that seller-funded programs led to underwriting problems and resulted in an increase in the cost of homeownership.

In the audits we have conducted in this area, not only have we found improper private benefit and activities, but also that the down payment assistance organizations often provide excessive compensation to their officials. Revocation of exempt status will shut down abusive seller funded programs without harming the innocent low income home buyers who participated in these arrangements.

We will continue to look at other areas within the exempt sector that have the potential for abuse.

2007 FILING SEASON

The progress made in fiscal year 2006 has continued during the 2007 filing season despite the fact that this filing season presented the potential to be one of the most challenging in recent memory. The Tax Relief and Health Care Act of 2006 (TRHCA), which passed late last year, included the extension of several significant tax benefits. Since forms and publications for Tax Year 2006 were printed and distributed prior to enactment, we were required to notify taxpayers on IRS.gov as to how to modify those forms to claim the allowable benefits. Due to separate developments in the tax law, we were faced with implementing the Telephone Excise Tax Refund Program (TETR), and this was the first filing season that we allowed taxpayer refunds to be split and deposited into separate accounts. Finally, because the normal April 15th filing date fell on a Sunday and the following Monday was a legal holiday in the District of Columbia, we had to adjust our programs to provide taxpayers an extra two days to file and pay this year. Many of these changes also necessitated significant changes in our information technology systems.

Despite these challenges, I am proud to report that the filing season has gone very well. By early February, we were able to begin processing tax returns claiming the tax benefits authorized by the enactment of TRHCA in December. We have also taken a number of steps to make sure that taxpayers understand how to claim the benefits. For example, we provided instructions on IRS.gov and conducted extensive outreach and media events to publicize these provisions. In addition, we sent a special mailing of Publication 600, which included the state and local sales tax tables and instructions for claiming the sales tax deduction on Schedule A (Form 1040), to six million taxpayers who had previously claimed the state and local sales tax deduction.

From a technology perspective, we were able to deliver the timely release of 329 of 330 information system for the 2007 filing season. The one exception to timely delivery was the enhancements to the Customer Account Data Engine (CADE). This

system, one of key components of the IRS' modernization strategy, will ultimately replace the antiquated master files.

Significant functionality was added to CADE this year. We included the ability to handle married taxpayers, dependents, and a number of schedules including Schedules C, D, E, F, and SE. Due to system testing issues, the IRS did not deploy CADE into production until March 6th. To ensure taxpayers filing prior to March 6th were not negatively impacted, the IRS continued to process CADE-eligible taxpayers through the master file. Hence, the impact to such taxpayers was a delay of a couple of days on refund processing.

The IRS originally estimated that if the enhancements were put into production on time, we would have processed 33 million individual tax returns through CADE in 2007. Given that we were late and missed many of the taxpayers that would be now be CADE-eligible, we processed only 10.4 million tax returns through CADE as of May 4th. While the 10.4 million tax returns are more than the 7.4 million posted last year, it is still disappointing because it fell well short of our estimates. CADE is now operating well in production and we expect that the full functionality intended for this year will be there for CADE going forward.

Because of the issues with getting CADE into production this year, the IRS is taking more management control of the CADE project, and working to embed additional IRS subject matters experts on the CADE team. A significant amount of the delay this year is attributable to the complexities of the interfaces between CADE and other IRS legacy systems.

In planning for next filing season, the IRS is revisiting the scope of what is to be delivered, to ensure that CADE will be in production the first day of the 2008 filing season.

I will discuss the TETR Program later in my testimony, but let me first give an update on our filing season numbers.

Numbers Thus Far

We expect to process almost 136 million individual tax returns in 2007, and as anticipated the number of those that were e-filed continued to grow. In the 2006 filing season, 54 percent of all income tax returns were e-filed. As of April 28, we have received over 76 million tax returns electronically, an increase of 8.74 percent compared to the same period last year.

This increase in e-filing is being driven by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by over 11 percent compared to this time a year ago. Over 22 million returns have been e-filed by people from their personal computers, up from over 19 million for the same period a year ago.

Overall, nearly 61 percent of the 125.7 million returns filed thru April 28 have been e-filed. 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 two weeks or less. That is about half the time it takes us to process a paper return. For the IRS, the error reject rate for e-filed returns is significantly lower than that for paper returns.

More people are choosing to have their tax refunds directly deposited into their bank account than ever before. So far this year, we have directly deposited over 58 million refunds, or 63.2 percent of all refunds issued this tax filing season. This level is up from 62.3 percent for the same period in 2006.

People are also visiting our Web site, IRS.gov, in record numbers. Through April 28th, we have recorded over 137 million visits to our site this year, up over nine percent from 124.8 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the Web site. We have made it easier for taxpayers to get answers to many of their tax questions online. Important functions on the Web site provide capabilities to:

—Assist the taxpayer in determining whether he or she qualifies for the Earned Income Tax Credit (EITC);
—Assist the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);
—Allow more than 70 percent of taxpayers the option to file their tax returns at no cost through the Free File program;
—Allow taxpayers who are expecting refunds to track the status via the "Where's My Refund?" feature; and
—Allow taxpayers to calculate the amount of their Sales Tax Deduction.

As of April 21, we have received 125.7 million returns, a very slight increase (1.4 percent) over the same period as last year. We have issued 91.9 million refunds so far this year, for a total of $209.7 billion. The average refund thus far is $2,280,

$63 more than last year. In addition, as of April 28th, over 26.6 million taxpayers have tracked their refund on IRS.gov, up more than 26 percent over last year.

As of April 28th, our Taxpayer Assistance Centers (TACs) are reporting a very slight increase in face- to-face contacts this filing season as compared to last year. We have seen a slight decline in the number of calls answered (−0.32 percent) as well as automated calls (−5.65 percent). The decline in the number of calls answered can be attributed to a few weather-related temporary call site closures earlier this winter and a slight decrease in overall caller demand.

Free File

Over 3.7 million people have utilized Free File as of April 28, down 1.8 percent from last year. This year, anyone with adjusted gross income of $52,000 or less is eligible for Free File, which includes 95 million taxpayers.

We think there are two major reasons for this decline. First, other websites advertising free tax preparation service siphoned off a significant number of customers. In addition, traditional tax preparation sites such as Intuit and TaxAct offered and advertised their own free services.

Second, taxpayers are inundated with advertising and promotions by major tax preparation firms such as Intuit, H&R Block, and Liberty Tax. This is in contrast with IRS' limited promotion and marketing budget for FreeFile.

A key difference in this year's Free File program is that Alliance members are no longer offering ancillary products, such as refund anticipation loans (RALs), through the Free File program. IRS data from the last filing season shows that only 0.5 percent of Free File users chose to utilize a RAL. The Free File Alliance may still offer customers the option of having their state tax return prepared for a fee, though some Alliance members are offering to do the state return along with the Federal at no cost.

In the 2006 filing season, an indicator was included for the first time on Free File returns that allows the IRS to identify those taxpayers using Free File. As a result, the Service was able to obtain important information such as customer satisfaction and demographic data that had never before been available. This information allowed us to verify that there was a high level of customer satisfaction with Free File. According to a survey conducted for the IRS, 94 percent said they intend to use Free File again next year; the same number said they found Free File very easy or somewhat easy to use; and 97 percent said they would recommend Free File to others. Convenience, not the free cost, was the most appealing factor of Free File.

VITA/TCE Sites and Other Community Partnerships

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased. In fiscal year 2006, over 2.2 million returns were prepared by volunteers. As of April 28, volunteer return preparation is up 17 percent above last year's level. Volunteer e-filing is also up slightly, by 1.7 percent over the same period last year. This is reflective of continuing growth in existing community coalitions and partnerships.

We have also made a concerted attempt to improve outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored EITC Awareness Day on February 1 in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge them to claim the credit.

Telephone Excise Tax Refunds

In the middle of 2006, the IRS announced plans to refund at least $13 billion in telephone excise taxes to more than 160 million taxpayers. To do this task, the IRS modified every individual and business tax return form, retooled our systems to handle the forecast demand, and launched an extensive communications campaign to increase awareness and encourage people without a filing requirement to request a refund anyway.

One difficulty in administering this refund was that taxpayers could have experienced significant burden if they had been required to find 41 months of old phone bills in order to obtain the information they needed to compute their refunds. For this reason, the IRS created a set of standard amounts that individuals can claim in lieu of actual amounts. For businesses and non-profits faced with potentially more paperwork than individuals, the IRS developed an estimation method that could require significantly less paperwork than requesting an actual amount.

A review of returns filed so far this year turned up a surprising fact: over 28 percent of returns we have received did not include a telephone excise tax refund request. Though one of our communications goals was to encourage taxpayers not to overlook the telephone tax refund, it appears many taxpayers are missing out. In

response to these early numbers, we consulted with tax professionals, citizens groups, and tax software companies to determine potential causes for the low take-up rate. The only logical reason we were given was that despite our best efforts, some taxpayers were still not aware of the credit and how to claim it. We then conducted additional media outreach to increase awareness of the refund and were able to generate broad national media coverage, including CNN, the Associated Press, and USA Today.

As we monitored the initial returns, we also noticed some problems. Even though 99.5 percent of all taxpayers who are requesting the refund are claiming the appropriate standard amount, some tax-return preparers are requesting thousands of dollars of refunds for their clients in instances where clients are entitled to only a tiny fraction of that amount. This behavior may indicate criminal intent on the part of the return preparer. In some cases, taxpayers requested a refund in the thousands of dollars, suggesting that the taxpayer paid more for telephone service than they received in income. While some of the large claims may be the result of misunderstandings—a number of refund requests appear to be for the entire amount of the taxpayer's phone bill, rather than just the three-percent long-distance tax—others may be deliberate attempts to scam the system.

To address this problem, in late February, IRS special agents executed search warrants seeking evidence from a small number of tax-preparation businesses suspected of preparing returns on behalf of clients requesting large, improper amounts in telephone excise tax refunds. Special agents temporarily closed these businesses, seizing computers and documents to use in their investigations. In addition, IRS revenue agents (auditors) and special agents also visited other tax preparers who were suspected of preparing questionable telephone tax refund requests.

On a positive note, the number of returns with seemingly high telephone excise tax refunds dropped significantly. This change suggests our enforcement actions, along with increased communications, may be having the desired effect.

Tax Scams

Each year, we alert taxpayers about the "Dirty Dozen," 12 of the most blatant tax scams affecting American taxpayers. This effort is, in part, an effort to alert taxpayers so that they may be wary if approached and encouraged to participate in any of the listed schemes. It also alerts promoters that we are aware of the scam and will be taking steps to prevent them from getting away with it.

This year the "Dirty Dozen" highlights five new scams that IRS auditors and criminal investigators have uncovered. Topping the list this filing season are fraudulent refunds being claimed in connection with TETR, which I have already discussed. Other scams making the list include:

—*Abusive Roth IRAs*.—Taxpayers should be wary of advisers who encourage them to shift under-valued property to Roth Individual Retirement Arrangements (IRAs). In one variation, a promoter has the taxpayer move under-valued common stock into a Roth IRA, circumventing the annual maximum contribution limit and allowing otherwise taxable income to go untaxed.

—*Phishing*.—This technique is used by identity thieves to acquire personal financial data in order to gain access to the financial accounts of unsuspecting consumers, run up charges on their credit cards or apply for loans in their names. These Internet-based criminals pose as representatives of a financial institution—or sometimes the IRS itself—and send out fictitious e-mail correspondence in an attempt to trick consumers into disclosing private information. A typical e-mail notifies a taxpayer of an outstanding refund and urges the taxpayer to click on a hyperlink and visit an official-looking Web site. The Web site then solicits a social security and credit card number. It is important to note the IRS does not use e-mail to initiate contact with taxpayers about issues related to their accounts. If a taxpayer has any doubt whether a contact from the IRS is authentic, the taxpayer should call 1–800–829–1040 to confirm it.

—*Disguised Corporate Ownership*.—Domestic shell corporations and other entities are being formed and operated in certain states for the purpose of disguising the ownership of the business or financial activity. Once formed, these anonymous entities can be, and are being, used to facilitate underreporting of income, non-filing of tax returns, listed transactions, money laundering, financial crimes and possibly terrorist financing. The IRS is working with state authorities to identify these entities and to bring their owners into compliance.

—*Zero Wages*.—In this scam, which first appeared in the Dirty Dozen in 2006, a Form 4852 (Substitute Form W–2) or a "corrected" Form 1099 showing zero or little income is submitted with a federal tax return. The taxpayer may include a statement rebutting wages and taxes reported by the payer to the IRS. An explanation on the Form 4852 may cite statutory language behind Internal

Revenue Code sections 3401 and 3121 or may include some reference to the paying company refusing to issue a corrected Form W–2 for fear of IRS retaliation.

—*Return Preparer Fraud*.—Dishonest return preparers can cause many headaches for taxpayers who fall victim to their schemes. Such preparers make their money by skimming a portion of their clients' refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Some preparers promote filing fraudulent claims for refunds on items such as fuel tax credits to recover taxes paid in prior years. Taxpayers should choose carefully when hiring a tax preparer. As the old saying goes, if it sounds too good to be true, it probably is. Remember that no matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. In recent years, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others. During fiscal year 2006, 109 tax return preparers were convicted of tax crimes and sentenced to an average of 18 months in prison.

—*American Indian Employment Credit*.—Taxpayers submit returns and claims reducing taxable income by substantial amounts citing an American Indian employment or treaty credit. Although there is an Indian Employment Credit available for businesses that employ Native Americans or their spouses, there is no provision for its use by employees. In a somewhat similar scam, unscrupulous promoters have informed Native Americans that they are not subject to federal income taxation. The promoters solicit individual Indians to file Form W–8 BEN seeking relief from all withholding of federal taxation. A recent "phishing" variation has promoters using false IRS letterheads to solicit personal financial information that they claim the IRS needs in order to process their "non-tax" status.

—*Trust Misuse*.—For years, unscrupulous promoters have urged taxpayers to transfer assets into trusts. They promise reduction of income subject to tax, deductions for personal expenses and reduced estate or gift taxes. However, these trusts do not deliver the promised tax benefits. There are currently more than 150 active abusive trust investigations underway and 49 injunctions have been obtained against promoters since 2001. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering into a trust.

—*Structured Entity Credits*.—Promoters of this newly identified scheme are setting up partnerships to own and sell state conservation easement credits, federal rehabilitation credits and other credits. The purported credits are the only assets owned by the partnership and once the credits are fully used, an investor receives a K–1 indicating the initial investment is a total loss, which is then deducted on the investor's individual tax return.

—*Abuse of Charitable Organizations and Deductions*.—The IRS continues to observe the use of tax-exempt organizations to improperly shield income or assets from taxation. This action can occur when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund but maintains control over the assets or income. Contributions of non-cash assets continue to be an area of abuse, especially with regard to overvaluation of contributed property. In addition, the IRS is noticing the return of private tuition payments being disguised as charitable contributions to religious organizations.

—*Form 843 Tax Abatement*.—This scam rests on faulty interpretation of the Internal Revenue Code. It involves the filer requesting abatement of previously assessed tax using Form 843. Many using this scam have not previously filed tax returns and the tax they are trying to have abated has been assessed by the IRS through the Substitute for Return Program. The filer uses the Form 843 to list reasons for the request. Often, one of the reasons is: "Failed to properly compute and/or calculate IRC Sec 83—Property Transferred in Connection with Performance of Service."

—*Frivolous Arguments*.—Promoters have been known to make the following outlandish claims: the Sixteenth Amendment concerning congressional power to lay and collect income taxes was never ratified; wages are not income; filing a return and paying taxes are merely voluntary; and being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy. Taxpayers should not believe these or other similar claims. These arguments are false and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law or else they may subject themselves to increased penalties. As part of the Tax Relief and Health Care Act of 2006 [Public Law No. 109–432], Congress amended the Code to increase the amount of the penalty for frivolous tax returns from $500 to $5,000 and to impose a penalty of $5,000 on any person who submits a "specified frivolous position." Last week,

we released guidance identifying these and other frivolous claims that, when asserted by a taxpayer on a tax return filed with the Service or submitted in a collection due process request, offer-in-compromise, application for an installment agreement, or application for a Taxpayer Assistance Order, expose the taxpayer to the $5,000 penalty.

PRESIDENT'S FISCAL YEAR 2008 BUDGET MAINTAINS THE BALANCE BETWEEN TAXPAYER SERVICE AND ENFORCEMENT

The IRS and its employees represent the face of the Federal Government to more American citizens than any other government agency. The IRS administers America's tax laws and collects 95 percent of the revenues that fund government operations and public services. Our taxpayer service programs provide assistance to help millions of taxpayers understand and meet their tax obligations. Our enforcement programs are aimed at deterring taxpayers inclined to evade their responsibilities while vigorously pursuing those who violate tax laws. Delivering these programs demands a secure and modernized infrastructure able to fairly, effectively, and efficiently collect taxes while minimizing taxpayer burden.

The IRS fiscal year 2008 President's budget request supports our agency-wide strategic plan as well as Treasury's compliance improvement strategy. These documents underscore the IRS' commitment to provide quality service to taxpayers while enforcing America's tax laws in a balanced manner. The IRS' strategic plan goals are:

—*Improve Taxpayer Service*.—Help people understand their tax obligations, making it easier for them to participate in the tax system;

—*Enhance Enforcement of the Tax Law*.—Ensure taxpayers meet their tax obligations, so that when Americans pay their taxes, they can be confident their neighbors and competitors are also doing the same; and

—*Modernize the IRS through its People, Processes and Technology*.—Strategically manage resources, associated business processes, and technology systems to effectively and efficiently meet service and enforcement strategic goals.

Budget Request

Our total budget request for fiscal year 2008 is for $11.1 billion in appropriated resources and represents a 4.7 percent increase over the recently enacted fiscal year 2007 Joint Resolution (JR) level of $10.6 billion.

The IRS' taxpayer service and enforcement activities are funded from three appropriations: Taxpayer Services (TS); Enforcement (ENF); and Operations Support (OS). The total fiscal year 2008 budget request for these three operating accounts is $10.8 billion supplemented by $180 million from user fee revenue, for a total operating level for these accounts of $10.9 billion—a 5.5 percent increase over the fiscal year 2007 operating level. As in fiscal year 2006 and fiscal year 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment, and I am pleased that the House and Senate Budget Committee marks for the 2008 Resolution include the full cap adjustment for this activity, recognizing the return on investment from these enforcement investments.

The budget also includes $282.1 million for Business Systems Modernization (BSM) and $15.2 million to administer the Health Insurance Tax Credit program—a 32.6 percent and 2.6 percent increase, respectively, over the fiscal year 2007 JR level.

Our fiscal year 2008 budget request provides $409.5 million for new initiatives and $340 million for the pay raise and other cost adjustments needed to sustain base operations.

The IRS' initiatives focus on the most significant needs for fiscal year 2008:

—$20.0 million to enhance taxpayer service through expanded volunteer tax assistance, increased funding for research to determine the most effective means to help taxpayers, and implementing new technology to improve taxpayer service;

—$246.4 million to expand enforcement activities targeted at improving compliance; and

—$143.1 million to improve the IRS' information technology (IT) infrastructure, including $62.1 million for the BSM program and $81.0 million for security and infrastructure enhancements.

This request also includes several program savings and efficiencies that reflect the IRS' aggressive efforts to identify and deploy work process and technology improvements that will benefit both taxpayer service and enforcement programs. Collectively, these cost savings total $120.0 million:

—*Taxpayer Service Efficiencies −$23.4 million/−527 FTE*.—These savings will result from operational efficiencies achieved through ongoing efforts to automate and enhance IRS taxpayer service programs' workload distribution, such as the implementation of automated issuance of Employer Identification Numbers and Correspondence Imaging System. Additional efficiencies and savings are expected to be achieved through the implementation of optimal service delivery initiatives identified by the Taxpayer Assistance Blueprint.

—*Enforcement Program Efficiencies −$60.2 million/−620 FTE*.—These savings will result from productivity and efficiency improvements realized through the implementation of enhanced technology and business processes, such as improved case selection tools and techniques. In addition, the completion of initial training and transition of the fiscal year 2006 new hires back to their front-line enforcement activities will result in additional efficiencies for the examination and collection programs.

—*Shared Service Support Efficiencies −$36.4 million/−37 FTE*.—These savings will result from several efforts, including the optimization and consolidation of space projects; implementation of cost-efficient government-wide contract support; and postage savings achieved through the consolidation, automation, and renegotiation of contract services for correspondence delivery.

A STRATEGIC PLAN TO IMPROVE VOLUNTARY COMPLIANCE AND REDUCE THE TAX GAP

The fiscal year 2008 budget supports our goal of improving voluntary compliance. The IRS has been working closely with the Office of Tax Policy at the Department of the Treasury to develop a strategic plan to achieve that goal. Key components of that goal and how they relate to the IRS budget are discussed below.

Enhancing Taxpayer Service

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the IRS.gov web site, Taxpayer Assistance Centers (TACs), Volunteer Income Tax Assistance (VITA) sites, and Tax Counseling for the Elderly (TCE) sites.

Assisting taxpayers with their tax questions before they file their returns reduces burdensome post-filing notices and other correspondence from the IRS, and proactively addresses inadvertent noncompliance.

The fiscal year 2008 budget request contains three significant taxpayer service initiatives. First, we are requesting $5 million to expand the VITA program, a significant component of our effort to support taxpayers eligible to claim the Earned Income Tax Credit. This taxpayer service initiative will help expand our volunteer return preparation, outreach and education, and asset building services to low-income, elderly, Limited English Proficient (LEP), and disabled taxpayers.

The budget also requests $5 million for additional resources to enhance our understanding of the role of the taxpayer service on compliance. This research will focus on understanding taxpayer burden, opportunities for enhanced service to help reduce errors made on returns, and the impact of service on overall levels of voluntary compliance.

Finally, the budget requests $10 million for four of the initiatives recommended by the Taxpayer Assistance Blueprint (TAB) Strategic Plan for taxpayer service. As part of the Blueprint effort, we conducted a comprehensive review of our current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the Blueprint, the funding for this initiative will implement the following telephone service and Web site interaction enhancements:

—Contact Analytics provides an analytical tool for evaluating contact center recordings for the purpose of improving business processes and lowering business costs, as well as improving customer service.

—Estimated Wait Time provides a real-time message that informs taxpayers about their expected wait time in queue, allowing them to make more informed decisions based on the status of their call and thus reducing taxpayer burden and increasing customer satisfaction.

—Expanded Portfolio of Tax Law Decision Support Tools enables taxpayers to conduct key word and natural language queries to get answers to tax law questions through the Frequently Asked Questions database accessed on IRS.gov, thereby steadily increasing customer satisfaction and operational savings.

—Spanish "Where's My Refund?" adds the ability to check refund status to the Spanish Web page on IRS.gov, enabling the Spanish-speaking community to re-

ceive the same level of customer service on the Web as available to the English Web page.

Continued technological advancements offer significant opportunities for the IRS to improve the efficiency and effectiveness of call center services. Web site enhancements are designed to maximize the value of IRS.gov, making the site taxpayers' first choice for obtaining the information and services required to comply with their tax obligations.

Improving Compliance Activities

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. We will continue to reengineer our examination and collection procedures to reduce cycle time, increase yield, and expand coverage. As part of our regular examination program, we are expanding the use of cost-efficient audit techniques first pioneered in the National Research Program (NRP).

We are also expanding our efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as nonfilers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

There are seven specific initiatives proposed in the fiscal year 2008 budget aimed at improving compliance. These initiatives provide:

—*$73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance*.—This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating persons who have evaded taxes for possible criminal referral. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year, once new hires reach full potential in fiscal year 2010.

—*$26.2 million for increasing compliance for large, multinational businesses*.—This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for noncompliance is significant in the reporting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 to 8.2 percent in fiscal year 2008, and produce over $74 million in additional annual enforcement revenue, once the new hires reach full potential in fiscal year 2010.

—*$28 million for expanded document matching in existing sites*.—This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. We believe the additional resources will result in an increase in AUR closures from 2.05 million in fiscal year 2007 to 2.64 million in fiscal year 2010. We expect $208 million of additional enforcement revenue per year, once the new hires reach full potential in fiscal year 2010. In addition, the budget requests $23.5 million to establish a new document matching program at our Kansas City campus. This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this new AUR site should result in over $183 million in additional enforcement revenue per year once the new hires reach full potential in fiscal year 2010.

—*$6.5 million to increase individual filing compliance*.—This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in fiscal year 2008 and produce $82 million of additional enforcement revenue per year, once the new hires reach full potential in fiscal year 2010.

—*$15 million to increase tax-exempt entity compliance*.—This enforcement initiative will deter abuse by entities under the purview of the Tax-Exempt and Governmental Entities Division (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE compliance contacts by 1,700 (six percent) and em-

ployee plan/exempt organization determinations closures by over 9,000 (eight percent) by fiscal year 2010.

—*$10 million for increased criminal tax investigations*.—This funding will help us aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which include an emphasis on the fraud referral program. Our robust pursuit of tax violators and the resulting publicity is aimed to foster deterrence and enhance voluntary compliance.

—*$41 million for conducting research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance*.—The data collected from these studies will enable the IRS to develop strategies to combat specific areas of noncompliance.

In addition to these initiatives, I would stress the importance of allowing us to continue with the private debt collection program. The Congress authorized the use of private collection agents (PCAs) in the American Jobs Creation Act of 2004. As we continue to debate the efficacy of this program, I want to take this opportunity to make a couple of points for purposes of our ongoing discussions.

One issue that has been debated is the relative efficiency of using PCAs versus IRS employees to collect the taxes owed. The most important question is not whether IRS employees or PCAs can do the job more efficiently, but rather whether PCAs collect money that would otherwise go uncollected. The IRS lacks the resources to pursue the relatively simple, geographically dispersed cases that are now being assigned to PCAs. It is not realistic to expect that the Congress is going to give the IRS an unlimited budget for enforcement, and if Congress provided the IRS additional enforcement resources, I believe those resources would be applied best by allocating them to more complex, higher priority cases that are not appropriate for PCAs.

The IRS continues to work with PCAs to ensure that the program is fair to taxpayers and respects taxpayer rights. The Treasury Inspector General for Tax Administration (TIGTA) agreed with that assessment. Earlier this month, TIGTA issued a report which noted that "IRS has taken proactive measures to effectively develop and implement the (PCA) Program."

The report said that we had taken the appropriate steps to ensure contractor employees received sufficient and adequate training on applicable laws and regulations before allowing them access to Federal tax information. This process included providing contractors with an orientation and overview of the training required and conducting an onsite assessment of the contractor training.

TIGTA also recognized that we had required all contractor employees assigned to the Program contract, or who have access to Federal tax information, to undergo background investigations. We granted either interim or final approval of background investigations for each employee working on the contract at the time of our review.

We currently estimate that between now and fiscal year 2017, our partnership with PCAs will result in approximately 2.9 million delinquent cases receiving treatment that would otherwise have gone unworked. This partnership will help reduce the backlog in outstanding tax liabilities, which has grown by 118 percent over the last 12 years.

From September 7, 2006, when cases were first assigned to PCAs, through March 22, 2007 PCAs collected $19.47 million in gross revenue. We estimate that cases worked by PCAs will generate estimated gross revenue of $1.4 billion through fiscal year 2017.

Another reason to continue to use this tool is to evaluate whether we in the public sector can learn anything from these PCAs that will enable us to do our jobs better. Particularly over the last 20 years, government agencies at all levels have adopted many practices and ways of doing business that have been pioneered in the private sector. One need look no further than the vastly expanded use by the government of the Internet in providing services to the public as an example of a practice that was pioneered in the private sector, but adopted quickly and effectively by the government. We should not remove PCAs as a tool for addressing the problem before we have an opportunity to evaluate the potential of this initiative to help improve compliance, and perhaps even to show the government how to be more effective in its own efforts.

Reducing Opportunities for Evasion

The IRS is already aggressively pursuing enforcement initiatives designed to improve compliance and reduce opportunities for evasion. As I pointed out earlier, these efforts have produced a steady climb in enforcement revenues since 2001, as

well as an increase in both the number of examinations and the coverage rate in virtually every major category.

In the budget request, the Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties in the following ways:

—*Expand information reporting*.—Specific information reporting proposals would:
  —Require information reporting on payments to corporations;
  —Require basis reporting on sales of securities;
  —Expand broker information reporting;
  —Require information reporting on merchant payment card reimbursements;
  —Require a certified taxpayer identification number (TIN) from non-employee service providers;
  —Require increased information reporting for certain government payments for property and services; and
  —Increase information return penalties.

—*Improve compliance by businesses*.—Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:
  —Require electronic filing by certain large businesses;
  —Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes; and
  —Amend collection due process procedures applicable to employment tax liabilities.

—*Strengthen tax administration*.—The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:
  —Expand IRS access to information in the National Directory of New Hires database;
  —Permit the IRS to disclose to prison officials return information about tax violations; and
  —Make repeated failure to file a tax return a felony.

—*Expand penalties*.—Penalties play an important role in discouraging intentional noncompliance. Specific proposals to expand penalties would:
  —Expand preparer penalties;
  —Impose a penalty on failure to comply with electronic filing requirements; and
  —Create an erroneous refund claim penalty.

The Administration also has four proposals relating to IRS administrative reforms.

The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.

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

The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding $50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.

The fourth proposal modifies the way that Financial Management Services (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to add the fee to the liability being recovered, thereby shifting the cost of collection to the delinquent taxpayer. The offset amount would be included as part of the 15-percent limit on continuous levies against income.

Collectively, these proposals should generate $29.5 billion in revenue over 10 years. The proposed budget provides $23 million to begin implementation of these initiatives. This funding will allow the purchase of software and the modifications to IRS information technology systems necessary to implement these legislative proposals.

Enhancing Research

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line-by-line audits of random samples of returns. This study provided us with information on compliance trends and allowed us to update audit selection formulas. However, this method of data gathering was extremely burdensome on the taxpayers who were forced

to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without the benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done for Tax Year (TY) 1988.

We have conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, until the recent NRP data, all of our subsequent estimates of the tax gap were rough projections that basically assumed no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program (NRP), which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 individual returns for TY 2001. This population sample was less than previous compliance studies, even though the population of individual tax returns had grown over time. Like the compliance studies of the past, the NRP was designed to allow us to estimate the overall extent of reporting compliance among individual income tax filers, and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The NRP provided updated estimates for determining the sources of noncompliance. The IRS also uses the NRP findings to better target examinations and other compliance activities, thus increasing the dollar-per-case yield and reducing "no change" audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among those major tax gap components, since the most recent compliance estimates were compiled (i.e., for TY 1988 or earlier).

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target resources, effectively provide the best service possible, and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts.

The fiscal year 2008 budget request includes funds for two significant research initiatives. First, the budget requests $41 million to improve compliance estimates, measures, and detection of noncompliance. This funding will allow research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance. Unlike in the past, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This approach will provide fresh compliance estimates each year, and by combining samples over several years, will provide a regular update to the larger sample size needed to keep our targeting systems and compliance estimates up to date.

The second initiative funded by the request is to research the effect of service on taxpayer compliance. The budget requests $5 million for this project, which will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:

—Meeting taxpayer needs by providing the right channel of communication;
—Better understanding taxpayer burden;
—Understanding taxpayer needs through the errors they make; and
—Researching the impact of service on overall levels of voluntary compliance.

Continuing Improvements in Information Technology

Tax administration in the twenty-first century requires improved IRS information technology (IT). We are committed to continuing to make improvements in technology and the fiscal year 2008 budget request reflects that commitment. The request includes $81 million to improve the IRS' information technology infrastructure. Sixty million dollars of this amount is requested to upgrade critical IT infrastructure, addressing the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in fis-

cal year 2008 include procuring and replacing desktop computers, automated call distributor hardware, mission critical servers, and Wide Area Network/Local Area Network routers and switches.

The other $21 million will be used to enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Finally, the fiscal year 2008 budget request includes a total of $282.1 million to continue the development and deployment of the IRS Business Systems Modernization (BSM) program in line with the recommendations identified in the IRS Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

The development of the CADE (Customer Account Data Engine) and AMS (Account Management Services) systems is the heart of the IT modernization of the IRS. The combination of these two systems working together will enable the IRS to process tax returns and deal with taxpayer issues in a near real-time manner. Our objective is that the IRS operate similarly to what one expects from one's bank—account transactions occurring during the business day will be posted and available by the next business day. In addition, AMS will enable the IRS representatives who work with taxpayers to have access to all the information regarding that taxpayer, including electronic access to tax return data, and electronic copies of correspondence. Equipped with such comprehensive and up-to-date information, our representatives will be in a much better position to help taxpayers resolve their issues.

MeF is the future of electronic filing. It provides a standard data format for all electronic tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns, resulting in a quicker acknowledgement of the filing to the taxpayer or their representative. In fiscal year 2007, the IRS will start development and implementation of the 1040 on the MeF platform.

CSP will provide funding for new portals, which are technology platforms that meet many IRS business needs through Web-based front-ends, and provide secure access to data, applications, and services. The portals are mission-critical components of the enterprise infrastructure required to support key business processes and compliance initiatives.

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, the business community, and government, but also contribute to operational improvements and efficiencies within the IRS.

OTHER ISSUES

In recent weeks, there has been much publicity over identity theft and the loss of IRS laptops. Please allow me to bring you up to date on these issues.

Identity Theft

Taxpayer and employee privacy is a foremost concern of the IRS. We are charged with protecting confidential information about every taxpayer. In recognition of this responsibility, we continue to update our systems and our training so that employees who have access to sensitive information are aware of the steps they must take to prevent that information from being compromised.

This job has never been tougher. According to the FBI, identity theft is one of the fastest growing white collar crimes. There has been a 4,600 percent increase in computer crime since 1997. Nearly 10 million Americans each year are affected by identity theft, according to the Federal Trade Commission (FTC). Deloitte-Touche has reported that financial institutions and U.S. banks have also experienced a significant increase in the number of computer based attacks and attempted intrusions into financial systems.

The FTC also reports, "About 90 percent of business record thefts involve payroll or employment records, while only about 10 percent are generated from customer lists." These business record thefts also include job applications, personnel records, health insurance and benefits records, and payroll related tax documents that pro-

vide personal information that identity thieves use to steal employees' identities. While most identity theft is use of consumer's personal information to make purchases, almost 1.5 million victims indicated that their personal information was misused in non-financial ways to obtain government documents or tax forms.

Through our Automated Underreporter Program (AUR), we see firsthand potential instances of identity theft. The AUR matches W–2s for the same SSN to ensure that the taxpayer has reported all sources of income. If identity theft has occurred the SSN may have been used with multiple employers who have issued multiple W–2s for the SSN. In Tax Year (TY) 2004, the latest year for which we have data, there were 16,152 identity theft claims made through the AUR program. This level is far less than the 30,639 cases in TY 2002, but a few more than the 12,618 claimed in TY 2003. In these cases, if the affected taxpayer provides the necessary documentation on an identity theft claim, the income in question will not result in an additional assessment.

We have tried to take the initiative in proactively analyzing processes to identify areas of vulnerability, and in educating taxpayers and employees about identity theft. We have teamed with other federal agencies, such as the Federal Trade Commission (FTC), the Department of Justice (DOJ) and the Social Security Administration (SSA) to address identity theft crime. Treasury was also a member of the Identity Theft Task Force, created by executive order in May 2006, and which recently submitted to the President an identity theft plan entitled "Combating Identity Theft: A Strategic Plan".

In 2005 we began an aggressive strategy to research and address this growing problem. We established an Identity Theft Program Office charged with implementing the IRS' policy on identity theft. This policy requires the IRS to take the necessary steps to provide assistance to victims of identity theft within the scope of their official duties. Our Identity Theft Program Office works with offices throughout the IRS to implement the agencies' Identity Theft Enterprise Strategy comprised of three components—Outreach, Prevention and Victim Assistance.

Outreach

The IRS has undertaken several outreach initiatives to provide taxpayers, employees, and other stakeholders with the information they need to proactively prevent and resolve identity theft issues. For example, the IRS:

—Revised the most widely used documents, such as the Form 1040 instructions and Publication 17, Your Federal Income Tax, to include information about identity theft.

—Launched an identity theft website on IRS.gov to provide victims with updated information and links to SSA and FTC and with information on how to contact the Taxpayer Advocate.

—Participated with Department of Treasury and the SSA in a multi-agency panel discussion on identity theft, which was held at the IRS nationwide tax forums in 2006 that reached approximately 30,000 tax preparers.

—Developed an internal web communication tool to alert IRS employees to issues of identity theft.

—Lead a multi-agency working group (Treasury, FTC, SSA, and Homeland Security) with a goal of providing consistent information and services to victims, consistent with recommendations being made by the President through the Identity Theft Task Force.

—Partnered with the Treasury Inspector General for Tax Administration (TIGTA) to develop and promote a consistent message to inform taxpayers that the IRS does not communicate with taxpayers via e-mail, with the goal of reducing the number of identity thefts accomplished by "phishing."

—Jointly with TIGTA published an e-mail address on IRS.gov to serve as a repository for the fraudulent emails so they could be tracked to the source and destroyed.

Victim Assistance

We recognize that outreach alone is not enough and that we also must be prepared to assist victims when identity theft occurs. With respect to the victim assistance prong of the Enterprise Strategy:

—The IRS established a new identity theft policy that provides for consistent procedures across its functions to ensure timely resolution of identity theft issues affecting taxpayer accounts.

—The IRS has developed new standards for documentation required from taxpayers to validate the identity of the taxpayer, address, and the fact of the identity theft. These documentation standards are consistent with those required by FTC and SSA.

—The IRS has worked closely with SSA to reduce the time required to resolve cases where more than one taxpayer uses the same SSN on a tax return (called the Scrambled SSN process). The average timeframe to resolve the case is now approximately 10 months compared to 18 months previously. As of March 24, 2007, the current scrambled SSN inventory count is approximately 5,000 cases. Approximately 38,000 cases have been referred to SSA in 2003–2006.

—The IRS updated its processes and notices to help taxpayers whose name and SSN were used by an identity thief for employment purposes. When the IRS matches an identity thief's W–2 information with a legitimate taxpayer's income tax return, the IRS sends the taxpayer a notice regarding the under-reported income. This notification is often the first time the victim is aware of the identity theft. To aid these victims of identity theft, the under-reporter notices were updated with specific instructions on the type of documents and information needed to validate the identity theft cases.

—The IRS is taking additional steps to reduce taxpayer burden associated with identity theft. By January 2008, the IRS will implement a new Service-wide identity theft indicator that will be placed on a taxpayer's account upon the authentication of identity theft. Once the new process is fully deployed, taxpayers should have to provide identity theft authentication only one time, and the IRS will be able to reject returns which do not appear to be from the legitimate owner of the SSN.

Prevention

There are three types of identity theft crimes in tax administration: refund crimes, employment and income diversion.

—Refund crimes are perpetrated by criminals who use another person's tax information to fake a return and steal a refund. The Refund Crimes Unit of the IRS' Criminal Investigation Division identifies those returns through the Questionable Refund program.

—The IRS is developing several initiatives to reduce the incidence of theft related to employment, such as working with SSA to explore initiatives to improve the accuracy of SSN reporting.

—Individuals who make false identity claims to underreport income will face additional tax and penalties, as will preparers who promote such schemes.

To augment the IRS Identity Theft Enterprise Strategy composed of outreach, assistance, and prevention, the IRS initiated a Service-wide Identity Theft Risk Assessment to qualify and quantify existing threats and vulnerabilities related to IRS processes that could directly or indirectly facilitate identity theft and/or taxpayer burden. As an output of this risk assessment, the IRS developed (and has began the implementation of) targeted remediation strategies designed to address the identified threats and vulnerabilities.

Where justified, we have referred cases of identity theft to our Criminal Investigation (CI) unit. In the past two years, CI has successfully investigated a number of cases that were successfully prosecuted in which identity theft has led to tax fraud. Just last month, two women from Ohio were sentenced to 63 and 188 months, respectively, and ordered to pay $300,000 in restitution for perpetuating an identity theft scheme. As part of this scheme, the women claimed nearly $114,000 in tax refunds to which they were not entitled.

Last November, a Florida man was sentenced to 63 months in prison to be followed by three years of supervised release for making false claims against the IRS and for identity theft. He was also ordered to pay a personal money judgment of $152,171, and to pay $152,171 in restitution to the IRS. To carry out this scheme, the man used the Internet to obtain personal information, including names and dates of birth, for at least 150 Florida inmates.

We are also continuing to review ways we can protect our employees from identity theft. The IRS Office of Privacy is identifying ways to reduce or eliminate the Service's use of employee SSNs in certain applications to minimize the risk of improper use. We are closely coupling privacy and identity theft protections with the agency security program, so that when we do need to collect SSNs—either employee or citizen, we can ensure that they are adequately protected within our systems.

The main focus for the annual IRS' Security Awareness Week, last November, was "Identity Theft/Fraud." We focused activities on raising awareness and making employees aware of their responsibilities.

While research shows that the IRS has one of the lowest rates of identity theft in all the Federal government, we still take this situation very seriously. We have made significant progress, but additional work remains—including implementing additional mediation strategies and conducting in-depth analyses of the remaining high-priority processes.

Laptop Security

Every year, the IRS processes over $2 trillion in revenues to fund the U.S. operating budget. Although the majority of this is collected in an automated banking system throughout the year, about $300 billion is collected through 8 IRS campuses where taxpayers send their tax returns for processing. We house computing systems that hold data on all taxpayers, and also process enormous volumes of paper data in our more than 500 offices across the country. We have more than 82,000 full time and 12,000 part-time employees across the United States. Our workforce is highly mobile, as revenue agents and officers are often in the field working directly with taxpayers.

IRS computers, networks, and databases are protected by multiple layers of security, including modern security technology devices such as firewalls, encrypted communication links, and automatic intrusion detection devices.

The IRS is one of the few government agencies operating its own 24/7 computer security incident response center (CSIRC) to monitor IRS computer and network security, and to collect and follow up on any security incidents. The IRS' CSIRC works in close coordination with the Treasury Department and the Department of Homeland Security's CSIRCs and the US–CERT incident reporting center.

As I mentioned earlier, the fiscal year 2008 budget for IRS proposes $21 million to be used to enhance CSIRC and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

The IRS has always had policy guidance in place requiring employees to protect taxpayer information and other personal and private data. Protection of taxpayer information is emphasized and stressed in all employee orientation and refresher training as one of the Service's highest priorities.

Prior to January 2007, all IRS laptops included encryption tools that IRS employees were required to use to encrypt all sensitive information. We recognize that this previous generation of encryption tools may have been technically complex and challenging for many employees and as a result some may have not have done the proper encryption. Therefore, we have recently completed installation of an automatic full disk encryption product on all IRS laptops that automatically encrypts all data on the laptop, without requiring any employee action. We have tested this encryption system and certified that it meets mandatory standards. We have also provided physical security locks for all IRS laptops.

IRS employees have reported the loss or theft of over 500 laptop computers over the last five years. Prior to May 2006, these reports primarily focused on reporting the theft or loss of IT equipment. Given the heightened awareness across the Federal Government in 2006 to the protection of sensitive personally identifiable information (PII), all government agencies now are focused more on the reporting of any sensitive information that may have been lost when a laptop is lost or stolen.

The IRS laptop losses were reported to TIGTA, which investigated these incidents and provided reports back to IRS management. We recovered very few devices, as they are quickly re-sold.

We are also working with our Federal and State partners with whom we share information to implement encryption solutions on data tapes. The encryption solutions are planned to be completed by October 1, 2007. In the interim, the IRS is using special security shipping containers and courier services to ensure that tapes shipped from IRS are protected. Recipients of the data are subject to implementing specific safeguards and complying with published standards for the protection of the data. Appropriate documentation is required for the transport of the tapes.

As the President's Taskforce on Identity Theft recommended, the Office of Management and Budget (OMB) is working closely with all agencies, including the IRS, to develop policy guidance for notification in instances where an individual's personally identifiable information has been compromised. The IRS has everything in place to comply with this new policy. We have reviewed all incidents, and there are a few that likely will require follow up (notification).

SUMMARY

One of the questions that the IRS is asked frequently is how much money, beyond the budget request, we could use productively. My honest answer to that question

is that while I want Congress to appropriate every cent that has been requested, our ability to absorb additional funding beyond that amount is limited by our capacity to hire and train new personnel.

The fiscal year 2008 budget request includes significant increases for IRS enforcement efforts. Fully funding that request will help us make progress in greatly improving voluntary compliance. Based on our analysis, covering the most recent 11 years of collection experience, we estimate that every dollar we have spent on enforcement has generated a direct return of an average of four dollars in increased revenue to the Federal Treasury. This return can be expected to occur when the full productive benefit of the investment is realized.

This direct return on investment does not consider the indirect effect of increased enforcement activities in deterring taxpayers who are considering engaging in noncompliant behavior. Econometric estimates of the indirect effects indicate a significant impact from increased enforcement activities. Stated another way, taxpayers who see us enforcing the law against their friends, neighbors, or competitors are more likely to comply voluntarily and not risk the chance that we might audit them. We do not measure this indirect impact, but research suggests that it could be as much as three times or more the direct impact on revenue.

We also believe that dollars spent on taxpayer service have a positive impact on voluntary compliance. The complexity of complying with the nation's current tax system is a significant contributor to the tax gap, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of improving voluntary compliance. To this end, the IRS remains committed to a balanced program assisting taxpayers in both understanding the tax law and remitting the proper amount of tax.

In addition, the President's fiscal year 2008 budget request contains a number of legislative proposals that provide additional tools for the IRS to enforce the existing tax law. Perhaps the most critical of these tools is greater third party reporting. An analysis of the data from the National Research Program of TY 2001individual income tax returns leads to one very obvious conclusion. Compliance is much higher in those areas where there is third party reporting. For example, only 1.2 percent of wages reported on Forms W–2 are underreported. This compares to a 53.9 percent underreporting rate for income subject to little or no third party reporting.

The fiscal year 2008 budget request asks Congress to expand information reporting to include additional sources of income and make other statutory changes to improve compliance. These legislative proposals are intended to improve tax compliance with minimum taxpayer burden. When implemented, it is estimated that these proposals will generate $29.5 billion over ten years.

I appreciate the opportunity to testify this morning, and I will be happy to respond to any questions that Members of the Committee may have.

Senator DURBIN. Mr. George.

STATEMENT OF RUSSELL GEORGE

Mr. GEORGE. Thank you, Mr. Chairman. Mr. Chairman, thank you for the invitation to appear to discuss the Internal Revenue Service's fiscal year 2008 proposed budget. At your request, my testimony will also address the 2007 tax filing season as well as TIGTA's 2008 budget request.

The IRS's total budget request of approximately $11.4 billion includes funding for programs that pose significant long-term and short-term challenges to the service. Some of these concerns include improving taxpayer services, enhancing enforcement of the tax laws, as well as the IRS's modernization efforts, all while attempting to ensure their security. The IRS is making progress in some of these areas. However, several concerns remain.

For example, in the area of taxpayer services the IRS has indicated that it wants to expand its voluntary income tax assistance program. However, during the 2007 filing season our auditors found that only 56 percent of the test tax returns we used to help test the system were accurately prepared by the volunteers. While this is an improvement over the test TIGTA conducted in 2006, it

is unacceptable that taxpayers who use this IRS-sanctioned service have a slightly better than 50–50 chance that their tax returns will be accurately prepared. TIGTA believes that taxpayers would be better served if the resources were allocated in a way to allow these programs to achieve better results.

Another area of concern is the IRS's implementation of the taxpayer assistance blueprint. The initiatives in this document focus on services that support the needs of individual taxpayers. TIGTA reviewed the development of the first phase of the blueprint and found that most but not all the information it contained was accurate. Our review concluded that the inaccurate information did not affect the service's improvement themes. However, we are concerned that if these problems were to continue there is a heightened risk of bad data leading to bad choices.

The 2008 IRS budget request also includes approximately $62 million to develop and deploy the IRS's business systems modernization program. This increase would allow the service to continue projects such as the customer account data engine (CADE), which is the foundation of the IRS's modernization efforts. Referred to as CADE, it will replace the antiquated master file system, which is based on technology from the 1960s.

The IRS has estimated that CADE would process 33 million tax returns during the 2007 filing season. However, due to delays in implementing the newest release of the project, the service now estimates that the system will process fewer than 20 million returns this season. While this delay is a short-term concern, there has been a pattern of deferring CADE requirements and missing deployment dates. Allowing this pattern to continue could undermine the long-term success of the program.

It is widely recognized that continued emphasis on enforcement is needed if we are to successfully narrow the tax gap. Indeed, a significant portion of the IRS's proposed funding for fiscal year 2008 is for enhanced enforcement personnel and an initiative to improve compliance, estimates and measures. Although having new information about individual taxpayers is useful as they are the largest taxpaying segment, there is no current information available about employment, small and large corporations, and other compliance segments. Without firm plans to study these segments, the current tax gap estimate is an incomplete picture.

Despite the challenges of implementing last-minute tax law changes, the 2007 filing season appears to be progressing without major problems. The number of electronically filed returns has increased, as has use of the IRS's Internet site and many of its other customer services. However, I have raised concerns about the IRS's telephone excise tax refund program conducted this year. Many taxpayers have not claimed the one-time refund even though the IRS simplified the process and publicized it. In addition, some taxpayers have submitted highly questionable refund claims which did not garner further IRS scrutiny.

Mr. Chairman, as requested, I have included in my written statement the challenges confronting TIGTA, many of which are similar to those of other Federal agencies. Our workload, labor costs and rent continue to increase. However, due to budgetary constraints

our staffing level over the last several years declined by over 12 percent.

PREPARED STATEMENT

Mr. Chairman, members of the subcommittee, I hope my discussion of some of the fiscal year 2008 budget and 2007 tax filing season issues will assist you in your consideration of the IRS's appropriations. I would be happy to answer questions at the appropriate time.

Senator DURBIN. Thanks, Mr. George.

[The statement follows:]

PREPARED STATEMENT OF J. RUSSELL GEORGE

Chairman Durbin, Ranking Member Brownback, and Members of the Subcommittee, I thank you for the opportunity to testify today. My comments will focus on the Internal Revenue Service's (IRS or Service) fiscal year 2008 budget, the 2007 Filing Season, and, at your request, the Treasury Inspector General for Tax Administration's (TIGTA) fiscal year 2008 budget request. The IRS administers America's tax laws and collects approximately 95 percent of the revenues that fund the Federal Government. It is therefore important to identify the resources required to support the IRS' role as steward of the Nation's tax administration system.

OVERVIEW OF THE IRS' FISCAL YEAR 2008 BUDGET REQUEST

The major component of the Department of the Treasury, IRS has primary responsibility for administering the Federal tax system. Since this is a self-assessment system, almost everything the Service does is in some way related to fostering voluntary compliance with tax laws. It provides taxpayer service programs that help millions of taxpayers to understand and meet their tax obligations. The IRS' resources also provide for enforcement programs aimed at deterring taxpayers who are inclined to evade their responsibilities, and vigorously pursuing those who violate tax laws.

The IRS must strive to enforce the tax laws fairly and efficiently while balancing service and education to promote voluntary compliance and reduce taxpayer burden. To accomplish these efforts, the proposed fiscal year 2008 IRS budget requests resources of approximately $11.4 billion. Included in this amount are approximately $11.1 billion in direct appropriations, $133.5 million from reimbursable programs, and $180 million from user fees. The direct appropriation is approximately a $657 million increase, or 6.3 percent, over the budget provided by the fiscal year 2007 Continuing Resolution. Highlights of the increase include: $131 million for taxpayer service initiatives; $440 million for enforcement initiatives; $282 million for the IRS' Business Systems Modernization program; and $60 million for critical Information Technology (IT) infrastructure upgrades (included in the enforcement and taxpayer service totals above).

The fiscal year 2008 budget also includes funding to implement the Department of the Treasury's (Department) tax gap strategy. In September 2006, the Department published a comprehensive plan to improve tax compliance. Additionally, delivery of IRS programs demands a secure and modernized infrastructure capable of fairly, effectively, and efficiently collecting taxes while minimizing taxpayer burden. The fiscal year 2008 budget request supports the Service's five-year strategic plan and the Department's compliance improvement strategy. The IRS' strategic plan goals are to improve taxpayer service, enhance enforcement of the tax law, and modernize the Service through its people, processes and technology.

IMPROVE TAXPAYER SERVICE

The fiscal year 2008 budget increases funding for taxpayer service by $131 million. This includes $56 million for new service initiatives and $75 million for cost increases. IRS employees represent the face of the Federal Government to more American citizens than most other government agencies. The request includes $20 million to enhance taxpayer service through expanded volunteer income tax assistance, increased funding for research, and implementing new technology to improve taxpayer service.

TIGTA is concerned about the taxpayer service initiative to expand the IRS' volunteer return preparation. The IRS is requesting an additional $5 million and 46

Full Time Equivalents (FTE)[1] to expand the VITA Program. According to the IRS, this will help "expand the IRS' volunteer return preparation, outreach and education, and asset building services to low-income, elderly, limited English proficient, and disabled taxpayers."[2]

TIGTA believes the IRS should proceed cautiously in its expansion efforts, given the importance of the accuracy of tax return preparation. TIGTA is reviewing the IRS' Volunteer Income Tax Assistance (VITA) program as part of our 2007 Filing Season oversight activities. As of April 12, 2007, TIGTA has had 39 tax returns prepared with a 56 percent accuracy rate. While the 2007 Filing Season accuracy rate is an improvement compared to the 39 percent accuracy rate reported for the 2006 Filing Season, taxpayers still have just a 1 in 2 chance of having their tax returns accurately prepared by VITA program volunteers.[3] TIGTA's observations are that volunteers did not always use the tools and information available to them when preparing returns. There is the potential that these resources might be put to better use by funding IRS assistance programs that achieve better results.

The fiscal year 2008 IRS budget request also includes $10 million to implement the Taxpayer Assistance Blueprint (TAB). The TAB initiative provides additional resources for new research on the needs of taxpayers in order to better understand the role of taxpayer service on compliance. The research will focus on meeting taxpayer needs by providing the right channel of communication; providing a better understanding of taxpayer burden; understanding taxpayer needs through the errors they make; and evaluating the impact of service on overall levels of voluntary compliance.

In July 2005, Congress issued a conference report requesting that the IRS develop a five-year plan for taxpayer service activities.[4] In November 2005, the IRS was asked to provide the report to the House and Senate by April 14, 2006.[5] The Senate committee report stated that the plan should outline the services the IRS should provide to improve service to taxpayers; detail how the IRS plans to meet the service needs on a geographic basis; and, address how the IRS would improve taxpayer service based on reliable data. The plan was to be developed with the IRS Oversight Board[6] and the National Taxpayer Advocate.

The IRS conducted a comprehensive review of its current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the TAB review, the funding for this initiative would implement telephone service and Web site enhancements.

To satisfy the report submission date of April 14, 2006, the IRS designed the TAB as a two-phased process. The TAB Phase I report identified strategic improvement themes by researching IRS service relative to taxpayers' needs and preferences. The TAB Phase II report will validate those themes through further research of taxpayers' service preferences and will develop the five-year plan for service delivery. The 2006 TAB Phase I report, issued April 24, 2006, presented strategic themes to improve education and awareness; optimize partner services; elevate self-service options; improve and expand training and services; and, develop performance and outcome goals and metrics.

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[1] A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For fiscal year 2005, 1 FTE was equal to 2,088 hours.

[2] *U.S. Department of the Treasury Fiscal Year 2008 Budget in Brief*, February 5, 2007, page 62.

[3] The population of VITA sites is not fixed, and VITA sites open and close throughout the filing season. Therefore, TIGTA could not determine a total population of VITA sites and could not select a statistical sample from which to project results. The filing season is the period from January through mid-April when most individual income tax returns are filed.

[4] United States Congress, Senate Report 109–109. Transportation, Treasury, The Judiciary, Housing and Urban Development, and Related Agencies Appropriations Bill, 2006: Internal Revenue Service, Processing, Assistance and Management, Committee Recommendation, July 26, 2005.

[5] United States Congress, Conference Report 109–307. Joint Explanatory Statement of the Committee of Conference: Internal Revenue Service, Processing Assistance, and Management (Including Rescission of Funds), November 14, 2005.

[6] A nine-member independent body charged with overseeing the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction.

The focus of the TAB initiative is on services that support the needs of individual filers who file or should file Form 1040 series tax returns.[7] TIGTA reviewed the development of the TAB, and found that while the majority of the information it contains is accurate, some of the information is not accurate. The compilation of some of the data could adversely affect IRS management decisions. For example, TIGTA noted inaccuracies in the report related to changes in Taxpayer Assistance Center visits and the number of telephone calls answered. Overall, TIGTA concluded that information found to be inaccurate and inconsistent did not affect the IRS' strategic improvement themes.[8]

The inaccuracies and inconsistencies resulted primarily from the IRS not having an effective process to ensure that all statements in the TAB Phase I report correctly reflected the results of its research and data analyses. According to IRS officials, actions were taken to improve the process for the validation of information included in the TAB Phase II report. The actions included an in-depth review to locate and verify the accuracy of all data in the report. Verifications were also performed to ensure the accuracy of statements and representations included in the report. Based on these actions, TIGTA did not make recommendations on the TAB Phase I report.

If these inconsistencies exist in the Phase II report, the risk increases that the IRS will draw inaccurate conclusions based on erroneous data.[9] TIGTA was unable to determine the impact the inconsistencies may have on results outlined in the TAB Phase II report because it was not available for review. The IRS did not provide TIGTA with a copy of the report before it was officially issued.

2007 FILING SEASON

The 2007 Filing Season appears to be progressing without major problems. As of April 28, 2007, the IRS reported that it had received more than 125 million individual tax returns. Of those returns, more than 76 million (61 percent) were filed electronically. The number of electronically filed tax returns is 8.7 percent higher than at the same time last year. The IRS has issued almost 92 million refunds for a total of $209 billion.

While the IRS has seen a growth in the number of electronically filed tax returns so far this filing season, the number of Free File returns is down slightly. As of April 28, 2007, the IRS received approximately 3.7 million tax returns through the Free File Program, compared to approximately 3.8 million returns at the same time last year.

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).[10]

Use of IRS.gov is up with over 133 million visits to the Web site, while the Taxpayer Assistance Centers (TACs) have received 2.2 million walk-in contacts, approximately 3 percent more than this time last year. TIGTA made anonymous visits to TACs to determine if taxpayers are receiving quality service, including correct answers to their questions. The assistor level of service in the IRS' toll-free operations was higher than was planned, as the IRS answered 14.6 million calls. The IRS also completed 17.5 million automated calls; a decrease of 5.4 percent from last year's 18.5 million.

Telephone Excise Tax Refunds

A concern so far this filing season has been the IRS' telephone excise tax refund program. The IRS estimated that between 151 million and 189 million people would seek this one-time refund, including many without a filing requirement. Taxpayers may claim either a standard refund amount or an itemized refund for the actual excise tax they paid on their telephone bills. By using the standard amounts individuals do not have to assemble 41 months of telephone bills to determine the amount of their refund. Requesting one of the standard amounts requires the completion of only one additional line on the tax return.

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[7] Form 1040 series tax returns include any IRS tax forms that begin with "1040" such as U.S. Individual Income Tax Return (Form 1040), U.S. Individual Income Tax Return (Form 1040–A), and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040–EZ).

[8] Draft Audit Report—*The Strategic Improvement Themes in the Taxpayer Assistance Blueprint Phase I Report Appear to Be Sound; However, There Were Some Inaccurate Data in the Report* (TIGTA Audit Number 200740012, dated April 13, 2007).

[9] The TAB Phase II report was issued the week of April 9, 2007, after completion of TIGTA's TAB Phase I review. TIGTA has begun a review and evaluation of the TAB Phase II report and will include testing of the quality review process.

[10] *Taxpayer Service Is Improving, but Challenges Continue in Meeting Expectations* (TIGTA Reference Number 2006–40–052, dated February 2006).

The standard amounts developed by the IRS have proved to be very effective. Through the week ending April 21, 2007, IRS records indicate that 99.5 percent of telephone excise tax refund claims were filed for standard amounts. However, over 28.5 percent of the total number of individual tax returns filed contained no claim for a telephone excise tax refund, which indicates that many taxpayers may not be aware of their opportunity to claim this refund. TIGTA is continuing to monitor the steps the IRS is taking to address this issue.[11]

TIGTA raised concerns to the IRS regarding the processing of returns claiming telephone excise tax refunds for non-standard amounts. Specifically, thresholds were set too high for the IRS to take action when taxpayers:

—claimed refunds for more than the standard amounts but did not provide the required Form 8913, Credit for Federal Telephone Excise Tax Paid, to substantiate their claims.

—claimed one amount on their tax return and a different amount on their Form 8913.

When TIGTA reported these issues, the IRS took immediate steps to address the problems.

TIGTA has also raised concerns with the IRS' implementation of its compliance strategy related to these claims. In TIGTA's opinion, the dollar threshold used to identify potentially egregious claims is set too high. As of April 28, 2007, over 51,000 such claims had been received that did not meet the IRS' criteria for review. The amount of telephone excise tax refunds on these claims totaled more than $44.1 million. Over 38,000 of these claims were on tax returns with no Schedules C, E or F,[12] which makes the claimed amounts even more questionable. If each of the 38,000 returns claimed the standard excise tax refund amount of $60, the total refunds would equal $2.3 million. While small business claims for actual excise taxes paid would likely be greater than the standard amount, the lack of corresponding Schedules C, E or F raises questions about the claims.

The IRS reported that it set the threshold high because its examination resources are limited, and because it believes that examinations of returns claiming the Earned Income Credit (EITC)[13] and other discretionary examinations will result in higher assessment rates than examinations of the telephone excise tax refund claims. TIGTA recommended that the IRS re-examine all options at its disposal to address significantly more inappropriate telephone excise tax refund claims. The IRS responded to TIGTA's concerns, stating that it did not plan to make adjustments to the threshold amounts.

TIGTA has also shared concerns about paid preparers and the telephone excise tax refund with the IRS. As of April 28, 2007, one paid preparer had filed over 1,500 returns with telephone excise tax refund claims exceeding the standard amounts. Only eight of this preparer's claims have exceeded the Service's tolerance. TIGTA referred this preparer to the IRS' Criminal Investigation function. The IRS requested information from TIGTA regarding other questionable preparers who may be avoiding IRS scrutiny. TIGTA provided the requested information to the Service on other preparers. Among them:

—One preparer has filed 1,019 claims totaling over $677,000. The claims are all under IRS' tolerance, and most of the claims are for one of five amounts that are repeated on the filed claims.

—Another preparer has filed 1,138 claims. The preparer has filed returns for taxpayers in 31 different States. In addition to telephone excise tax refund claims, over 95 percent of the returns also claim employee business expenses.

ENHANCE ENFORCEMENT OF THE TAX LAWS

The fiscal year 2008 budget request is designed to continue the IRS' emphasis on tax enforcement. The request increases funding for enforcement by approximately $440 million, which includes $291 million for new enforcement initiatives and $149 million in cost increases. The increase includes funding for additional enforcement personnel. According to the request, increased resources for the IRS' examination and collection programs will yield direct measurable results each year of $699 million.

Included in the IRS' fiscal year 2008 budget request is an initiative to improve compliance estimates and measures, and also improve detection of non-compliance.

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[11] Ongoing Audit—*Telephone Excise Tax Refund* (TIGTA Audit Number 200630036).

[12] Various schedules may be attached to a tax return, if needed. Schedule C is for reporting Profit or Loss From Business; Schedule E is for Supplemental Income and Loss; and Schedule F is for Profit or Loss From Farming.

[13] The Earned Income Tax Credit (EITC) is a refundable credit designed to help move low-income taxpayers above the poverty level.

This enforcement initiative would fund research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance. Unlike the past, the IRS plans to conduct an annual study of compliance among Form 1040 filers based on a smaller sample size than the 2001 National Research Program study.

TIGTA reviewed the tax gap estimates that were developed from the 2001 National Research Program data and concluded that the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and voluntary compliance rate. Although having new information about Tax Year (TY) 2001 individual taxpayers is an improvement when compared to the much older TY 1988 information from the last major compliance study, some important individual compliance information remains unknown. Additionally, although individuals comprise the largest segment of taxpayers and were justifiably studied first, no new information is available about employment, small corporate, large corporate and other compliance segments. With no firm plans for further studies or updates in many areas of the tax gap, the current tax gap estimate is an unfinished picture of the overall tax gap and compliance rate.

The IRS' fiscal year 2008 budget request also includes funding for an initiative to improve compliance among small business and self-employed taxpayers in the areas of reporting, filing, and payment by increasing audits of high-risk tax returns, collecting unpaid taxes, and investigating and, where appropriate, prosecuting persons who have evaded taxes. According to the budget request, this initiative would produce $144 million in additional annual enforcement revenue, once newly hired employees reach their full performance potential in fiscal year 2010.

MODERNIZE THE IRS THROUGH ITS PEOPLE, PROCESSES AND TECHNOLOGY

The IRS must optimally manage its resources, business processes, and technology systems to effectively and efficiently support its service and enforcement mission. The IRS' fiscal year 2008 budget request includes initiatives to update critical information technology infrastructure ($60 million), and to enhance the IRS' Computer Security Incident Response Center (CSIRC) and its network infrastructure security ($21 million).

Upgrading the Service's critical IT infrastructure initiative would include upgrading equipment that has exceeded its life cycle. According to the budget request, failure to replace the IRS' IT infrastructure will lead to increased maintenance costs and increase the risk of disrupting business operations. Planned expenditures in fiscal year 2008 include replacing desktop computers, automated call distributor hardware, mission critical servers, and Wide Area Network/Local Area Network routers and switches.

Enhancing the CSIRC would require $13.1 million to allow the CSIRC to keep pace with the ever-changing security threat environment through improved detection and analysis capability, improved forensics, and increased capacity to identify and respond to potential intrusions before they occur. An additional $7.9 million would fund enhancements to the IRS' network infrastructure security, providing the capability to perform continuous monitoring of the security of operational systems, using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Less than two months ago, TIGTA reported that IRS employees reported the loss or theft of at least 490 computers and other sensitive data in 387 separate incidents. Employees reported 296 (76 percent) of the incidents to the TIGTA Office of Investigations but not to the CSIRC. In addition, employees reported 91 of the incidents to the CSIRC; however, 49 of these were not reported to TIGTA's Office of Investigations. IRS procedures require employees to report lost or stolen computers to both the IRS CSIRC and to TIGTA's Office of Investigations. TIGTA reported that coordination was inadequate between the CSIRC and TIGTA's Office of Investigations to identify the full scope of the losses.[14]

Prior to the Department of Veterans Affairs data loss incident in May 2006, the CSIRC had not placed sufficient emphasis on identifying actual taxpayers potentially affected by lost or stolen computers. TIGTA's Office of Investigations did investigate many of these incidents but focused on criminal aspects (e.g., identifying the perpetrator and recovering the stolen equipment).

On July 7, 2006, the Chief, Mission Assurance and Security Services, issued a memorandum that re-emphasized reporting requirements and stated that all com-

[14] *The Internal Revenue Service Is Not Adequately Protecting Taxpayer Data on Laptop Computers and Other Portable Electronic Media Devices* (TIGTA Reference Number 2007–20–048, March 23, 2007).

puter security incidents shall be reported to the CSIRC and to front-line managers. In addition, any incident involving physical loss of equipment that could result in unauthorized access to IRS systems or information must also be reported to the TIGTA Office of Investigations. The IRS Commissioner had issued an earlier email reminding all managers to safeguard personally identifiable information and to immediately report any security incidents to the CSIRC. The email message also stated that managers work with the CSIRC to promptly notify the TIGTA Office of Investigations when appropriate. As a final measure to ensure total coordination, the IRS has entered into an agreement with the TIGTA Office of Investigations to share reports of all incidents relating to the loss or theft of IT assets.

The Service's fiscal year 2008 budget request includes an initiative to fund Business Systems Modernization. The initiative would provide approximately $62.1 million to continue the development and deployment of the IRS' modernization program in line with the recommendations identified in the IRS' Modernization, Vision, and Strategy. According to the request, the increase would allow the IRS to continue progress on modernized projects, such as the Customer Account Data Engine (CADE) and Modernized e-File (MeF).

CADE is the IRS' lynchpin modernization project that will replace the antiquated master file system, which is based on a 1960s architecture. The IRS is developing CADE in stages and expects to retire the Individual Master File in 2012. When fully operational, the CADE database will house tax information for more than 200 million individual and business taxpayers. Congress authorized $58 million for the CADE in fiscal year 2007. Through fiscal year 2007, CADE project release costs total about $233.9 million. The IRS initiated the CADE project in September 1999 and began delivering releases in August 2004.

During Calendar Year (CY) 2006, the CADE posted over 7.3 million tax returns and generated more than $3.4 billion in refunds. This is a significant increase over the 1.4 million tax returns posted in CY 2005 that generated refunds totaling more than $427 million. The CADE is now in the process of completing delivery of Release 2.2. Release 2.2 will process 2007 Filing Season tax law revisions (Tax Year 2006) and additional tax forms.[15]

On February 27, 2007, the IRS put Release 2.2 into production, but because computer reports on the number of returns received did not match the number of returns posted, the CADE was turned off and tax returns were sent back to the current IRS processing system. The IRS reports that a major portion of Release 2.2 was successfully put into production on March 6, 2007 (seven weeks late). On the first day, it posted over 571,000 tax returns of which 566,332 contained refunds. Because of the late start into production, the IRS goal of using the CADE to process 33 million tax returns will not be met. According to IRS officials, the latest estimate was that the IRS would complete the deployment of Release 2.2 by the end of April 2007, and it would post between 16 million and 19 million returns during the 2007 Filing Season. As of April 27, 2007, the CADE has processed 10.3 million returns with $10.9 billion in refunds.

From the project's beginning, there has been a pattern of deferring CADE requirements to later releases and missing release deployment dates. Allowing this pattern to continue will undermine the long-term success of the project. To meet the CADE's long-term computer processing demands, further consideration needs to be given to alternative design approaches. The project design currently includes building a computer system large enough to process the highest daily volume of tax returns received by the IRS even though this processing capacity is needed for only a few days each year. Alternative design solutions, such as obtaining additional computer resources on an interim basis or delaying the processing of some tax return types on extremely high-volume processing days, have been considered but have not been thoroughly developed. In addition, based on the current design of the project, meeting storage and processing demands may be cost prohibitive.

MeF is the future of electronic filing. It provides a single Extensible Markup Language-based standard for filing electronic tax returns. Standardizing the formats/structures for all filings will allow transmitters to submit multiple return types in the same transmission, something that currently restrains e-file growth. In fiscal year 2008, the IRS has scheduled to start development and implementation of the Form 1040 on the MeF platform, which is expected to take two years. TIGTA is currently concluding an audit of the MeF and will report the results later this spring.

[15] DRAFT Audit Report—*Vital Decisions Must Be Made to Ensure Successful Implementation of Customer Account Data Engine Capabilities* (TIGTA Audit Number 200620012, dated May 1, 2007).

LEGISLATIVE PROPOSALS

The fiscal year 2008 budget request includes several legislative proposals that would provide the IRS with additional enforcement tools to improve compliance. It is estimated that these proposals could generate approximately $29 billion in revenue over the next 10 years. These proposals would expand information reporting, improve compliance by businesses, and expand penalties. This enforcement initiative includes funding for purchasing software and making modifications to the IRS' IT systems, which are necessary to implement these legislative proposals.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION FISCAL YEAR 2008 BUDGET REQUEST

TIGTA was created by Congress to provide independent oversight of the IRS. TIGTA's investigations and audits protect and promote the fair administration of the Nation's tax system. TIGTA's responsibilities include ensuring that the IRS is accountable for more than $2 trillion in tax revenue received each year. TIGTA's investigations protect the integrity of IRS employees, contractors, and other tax professionals; provide for infrastructure security; and protect the Service from external attempts to threaten or corrupt the administration of tax laws. TIGTA conducts audits that advise Congress, the Secretary of the Treasury, and IRS management of high-risk issues, problems, and deficiencies related to the administration of IRS programs and operations. TIGTA's audit recommendations aim to improve IRS systems and operations, while maintaining fair and equitable treatment of taxpayers.

TIGTA's Office of Audit (OA) provides comprehensive coverage and oversight of all aspects of the Service's daily operations. Audits not only focus on the economy and efficiency of IRS functions but also ensure that taxpayers' rights are protected and the taxpaying public is adequately served. Overall, as of March 31, 2007, audit reports potentially produced financial accomplishments of $579 million, and potentially impacted approximately 379,000 taxpayer accounts in areas such as taxpayer burden, rights, and entitlements. OA develops an annual audit plan that communicates oversight priorities to Congress, the Department of the Treasury, and the IRS. Emphasis is placed on mandatory coverage imposed by the IRS Restructuring and Reform Act of 1998 [16] and other statutory authorities, as well as issues impacting computer security, taxpayer rights and privacy, and financial-related audits. OA's work focuses on IRS' major management challenges, IRS' progress in achieving its strategic goals, eliminating IRS' systemic weaknesses, and the Service's response to the President's Management Agenda initiatives.

TIGTA's mission includes the statutory responsibility to protect the integrity of tax administration and to protect the ability of the IRS to collect revenue for the Federal Government. To accomplish this, TIGTA's Office of Investigations (OI) investigates allegations of criminal violations and administrative misconduct by IRS employees, protects the Service against external attempts to corrupt tax administration, and ensures IRS employee safety and IRS data and infrastructure security. Employee investigations include extortion, theft, taxpayer abuses, false statements, financial fraud, and unauthorized access (UNAX) of confidential taxpayer records by IRS employees. Investigations of external attempts to corrupt tax administration include bribes offered by taxpayers to compromise IRS employees, the use of fraudulent IRS documentation to commit crimes, taxpayer abuse by tax practitioners, impersonation of Service employees, and the corruption of IRS programs through procurement fraud. TIGTA assists in maintaining IRS employee and infrastructure security by investigating incidents of sabotage, and threats or assaults made against IRS employees, facilities, and infrastructure.

From fiscal year 2001 to fiscal year 2006, TIGTA's labor expenses have grown 22 percent from $88 million to $107.3 million, despite a substantial reduction in FTEs (a decrease of 11 percent from 938 to 838). Labor costs currently account for 81 percent of TIGTA's annual budget. Labor and rent together consume approximately 87 percent of the annual budget. The fiscal year 2007 President's budget request for TIGTA was $136.5 million. TIGTA's actual fiscal year 2007 funding level was $132.9 million, a $3.6 million reduction (2.6 percent decrease). Total resources required in fiscal year 2008 to support its mission are $140.6 million.[17]

Since fiscal year 2001, TIGTA has achieved its performance and quality expectations by implementing several efficiency and cost-cutting initiatives. From fiscal

[16] Pub. L. 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.).

[17] *U.S. Department of the Treasury Fiscal Year 2008 Budget in Brief*, February 5, 2007, pages 29–31.

year 2001 to fiscal year 2006, discretionary spending (such as training, travel, equipment, etc.) fell nearly 21 percent from $19.5 million to $15.4 million. These costs currently consume only 12 percent of TIGTA's annual budget. Through incremental FTE losses and implementation of cost-cutting initiatives in non-labor expense categories, TIGTA has been able to finance annual pay and labor-related benefit increases (health care, pensions and retirement) while also maintaining the FTE level necessary to meet performance and quality expectations.

TIGTA's efficiency-enhancing and cost-cutting initiatives are largely exhausted. The impact of a budget reduction in fiscal year 2008 will fall almost exclusively on labor and, would affect TIGTA's capability to provide comprehensive oversight of IRS operations. TIGTA has lost 100 FTEs because budget increases have not been adequate to finance annual pay increases, labor-related benefit increases, and non-labor related requirement expenses such as contracts, rent, and equipment. Because of decreasing budgets, TIGTA's overall employee population has declined 12 percent from fiscal year 2001 to fiscal year 2006 (a decrease from 938 in fiscal year 2001 to 825 at end of fiscal year 2006) and is expected to continue to decline over the foreseeable future. In addition, 39 percent of TIGTA's current staff is retirement eligible through fiscal year 2010, threatening TIGTA's overall ability to effectively fulfill its core missions.

Labor reductions would reduce TIGTA's enforcement capacity and circumscribe efforts to combat IRS employee misconduct and external threats to the security and integrity of IRS personnel and infrastructure. FTE losses would result in fewer opportunities to examine high-risk areas and, thus, reduce financial benefits from audit recommendations and impact fewer taxpayer accounts. Losses would also require TIGTA to curtail, delay and/or fail to initiate reviews of high-risk areas and/or eliminate entire programs.

TIGTA must also address human capital issues. In order to accomplish its mission, TIGTA employees need to possess the necessary skills. Because of the increasingly modernized and computerized IRS operating systems and environment, the most critical gaps TIGTA faces are in the Auditor and Criminal Investigator occupations.

TIGTA also faces the challenge of addressing increasing requests from Congress and other IRS stakeholders in a timely and efficient manner. In fiscal year 2007, TIGTA has reallocated resources in order to perform congressionally requested audits and comply with new statutory provisions. TIGTA anticipates increased congressional interest and requests in future years.

The fiscal year 2008 President's budget request for TIGTA will be used to continue to provide critical audit and investigative services, ensuring the integrity of tax administration on behalf of the Nation's taxpayers. While there are a number of critical areas in which TIGTA will provide oversight, highlights of TIGTA's investigative and audit priorities include:

—Adapting to the IRS' continuously evolving operations and mitigating intensified risks associated with modernization, outsourcing, and enforcement efforts;
—Responding to threats and attacks against IRS personnel, property, and sensitive information;
—Improving the integrity of IRS operations by detecting and deterring fraud, waste, abuse, or misconduct by IRS employees;
—Conducting comprehensive audits that include recommendations for cutting costs and enhancing IRS service to taxpayers; and
—Informing Congress and the Secretary of the Treasury of problems and the progress being made to resolve them.

Total resources needed in fiscal year 2008 to support TIGTA's mission are $141,753,000, including $140,553,000 from direct appropriations and approximately $1,200,000 from reimbursable agreements. Budget adjustments to maintain current levels in fiscal year 2008 include $4.87 million to fund the cost of the January 2007 pay increase, the proposed January 2008 pay raise, and non-labor related items.

I hope my discussion of some of the fiscal year 2008 budget and 2007 Filing Season issues will assist you with your oversight of the IRS. Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to share my views.

Senator DURBIN. Ms. Olson.

STATEMENT OF NINA E. OLSON

Ms. OLSON. Mr. Chairman and distinguished members of the subcommittee: Thank you for inviting me to testify on the proposed budget of the Internal Revenue Service for fiscal year 2008.

In developing the IRS budget, the logical starting point is to consider the IRS's fundamental mission. The IRS is the Nation's tax collector and its overriding objective should be to maximize voluntary compliance with the tax laws. In my view the IRS should go about maximizing voluntary compliance in four ways:

First, by improving its outreach and education efforts to minimize inadvertent errors attributable to tax law or procedural complexity or confusion;

Second, by conducting compliance-oriented audits to reinforce the perception that taxpayers may be audited;

Third, by utilizing all IRS collection alternatives while collecting tax debts, to bring taxpayers into future compliance;

And fourth, by reserving targeted enforcement actions to combat clear abuses.

In addition, the IRS should launch a public information campaign that reminds taxpayers of what taxes really are about, the price we pay for a civilized society.

I strongly encourage the subcommittee to fund the IRS at approximately the level requested by the administration for fiscal year 2008. In my annual report to Congress, I recommended that Congress provide the IRS with after-inflation increases of about 2 to 3 percent a year for the foreseeable future.

Assuming the funds are wisely spent, I believe that increasing the IRS budget at this rate is an excellent financial investment. The IRS collects about 96 percent of all Federal revenue. The more revenue the IRS collects, the more revenue Congress may spend on other programs or use to cut taxes or reduce the deficit. The less revenue the IRS collects, the less revenue Congress has available for these other purposes.

If the Federal Government were a private company, its management clearly would fund the accounts receivable department at whatever level it believed would maximize the company's bottom line. Since the IRS is not a private company, maximizing the bottom line is not in and of itself an appropriate goal. But the public sector analogy should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden.

Studies show that if the IRS were given more resources, it could collect substantially more revenue. One of the most critical choices facing tax administration is how to allocate resources between taxpayer service and tax law enforcement. While I believe that both categories would benefit from additional funding, I am concerned that the IRS has been emphasizing enforcement at the expense of taxpayer service. Since fiscal year 2004, funding for enforcement has increased substantially, while funding for taxpayer service has been reduced. For fiscal year 2008, the administration has requested a funding increase of 6.5 percent for enforcement to $7.2 billion and 3.8 percent for taxpayer service to $3.6 billion. If the administration's proposal is enacted, funding for enforcement will have increased by 19.4 percent and funding for taxpayer service will have been reduced by 3.8 percent over the 5-year period from fiscal year 2004 to 2008.

I am deeply concerned about this fundamental shift in the balance between taxpayer service and enforcement. Under the pro-

posal the IRS would be spending literally twice as much on enforcement as it spends on taxpayer service. There is no reliable data showing that more enforcement will do more than taxpayer service to increase compliance.

I believe the IRS can produce a positive return on investment from more funding in both areas, but, given limited resources, I think it is misguided to ramp up enforcement at the expense of taxpayer service. Moreover, the absence of an accurate measure of return on investment leads to misguided efforts to privatize inherently governmental activities, such as tax collection, harming taxpayers and tax administration in the process.

Because taxpayer service and enforcement are drivers of overall compliance, we need to measure taxpayer service needs concurrently with our efforts to measure the tax gap. Thus, I believe in addition to additional research about what causes taxpayers to be noncompliant, 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 then make an informed resource allocation only by being armed with information of both types.

Thank you.

Senator DURBIN. Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF NINA E. OLSON

Mr. Chairman, Ranking Member Brownback, and distinguished Members of the Subcommittee: Thank you for inviting me to submit this written statement regarding the proposed budget of the Internal Revenue Service for fiscal year 2008.[1] I will address the mission of the IRS, the overall level of funding I believe the agency should receive, the allocation of that funding between enforcement and taxpayer service, and then a number of important issues in tax administration in which I believe this Committee may have an interest. I approach these issues from my perspective as the National Taxpayer Advocate, the voice for taxpayers and taxpayer rights inside the IRS.

THE OVERRIDING MISSION OF THE IRS SHOULD BE TO INCREASE VOLUNTARY COMPLIANCE

In developing the IRS budget, the logical starting point is to consider the IRS's fundamental mission. The IRS is the nation's tax collector, and its overriding objective 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.

Voluntary compliance—as opposed to enforced compliance—must be our goal for two overriding reasons.

—First, it is far preferable for our civic culture when taxpayers pay voluntarily rather than pursuant to enforcement action. We should strive to make sure taxpayers understand how the tax dollars they pay are used to protect and benefit them, and we should make compliance as easy as possible.

[1] The 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.

—Second, enforced compliance is extremely expensive and therefore must be targeted narrowly. For fiscal year 2006, the IRS reported that its face-to-face audit rate was 0.23 percent, meaning that only one out of every 435 taxpayers was audited in person.[2] Even taking into account less comprehensive correspondence audits, the audit rate was less than one percent.[3] Notably, IRS enforcement actions brought in only about two percent ($48.7 billion)[4] of total IRS collections ($2.24 trillion).[5] As the IRS has acknowledged, it is simply not realistic to close the tax gap one taxpayer at a time.

In my view, the IRS should go about maximizing voluntary compliance in four ways:

—By improving its outreach and education efforts to minimize inadvertent errors attributable to tax law or procedural complexity or confusion;

—By conducting compliance-oriented audits to reinforce the perception that taxpayers may be audited;

—By utilizing all IRS collection alternatives while collecting tax debts to bring taxpayers into future compliance; and

—By reserving targeted enforcement actions to combat clear abuses.

In addition, the IRS should launch a public information campaign that reminds taxpayers of what taxes really are about—the price we pay for a civilized society.

CONGRESS SHOULD PROVIDE INCREASES IN IRS PERSONNEL FUNDING AT A STEADY BUT GRADUAL PACE, PERHAPS TWO PERCENT TO THREE PERCENT A YEAR ABOVE INFLATION

I strongly encourage the Committee to fund the IRS at approximately the level requested by the Administration for fiscal year 2008. In the National Taxpayer Advocate's 2006 Annual Report to Congress, we recommended that Congress provide the IRS with after-inflation increases of about two percent to three percent a year for the foreseeable future. Assuming the funds are wisely spent, I believe that increasing the IRS budget at this rate is an excellent financial investment.

The IRS collects about 96 percent of all federal revenue.[6] The more revenue the IRS collects, the more revenue Congress may spend on other programs or use to cut taxes or reduce the deficit. The less revenue the IRS collects, the less revenue Congress has available for these other purposes.

If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at whatever level it believed would maximize the company's bottom line. Since the IRS is not a private company, maximizing the bottom line is not—in and of itself—an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Studies show that if the IRS were given more resources, it could collect substantially more revenue.

In his final report to the IRS Oversight Board in 2002, former Commissioner Charles Rossotti presented a discussion titled "Winning the Battle but Losing the War" that detailed the consequences of the lack of adequate funding for the IRS. He identified 11 specific areas in which the IRS lacked resources to do its job, including taxpayer service, collection of known tax debts, identification and collection of tax from non-filers, identification and collection of tax from underreported income, and noncompliance in the tax-exempt sector.

Commissioner Rossotti provided estimates of the revenue cost in each of the 11 areas based on IRS research data. In the aggregate, the data indicated that the IRS lacked the resources to handle cases worth about $29.9 billion each year. It placed

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[2] Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006). The actual face-to-face audit rate is apparently lower than the IRS reported. According to a study by the Treasury Inspector General for Tax Administration, the IRS classifies its audits based on which IRS function handled a case. Some cases referred to the IRS function responsible for conducting face-to-face audits are resolved without a face-to-face meeting. By analyzing data from IRS Audit Technique Codes, TIGTA concluded that the face-to-face audit rate was 0.18 percent for fiscal year 2006, about 22 percent less than the IRS reported. See Treasury Inspector General for Tax Administration, Ref. No. 2007–30–056, *Trends in Compliance Activities Through Fiscal Year 2006* at 2 (March 27, 2007); Allen Kenney, *TIGTA Finds Audit-by-Mail Process More Common Than IRS Says*, Tax Notes Today (April 6, 2007).

[3] Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006).

[4] Id.

[5] Government Accountability Office, GAO–07–136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* at 95 (Nov. 2006). The IRS actually collected $2.51 trillion on a gross basis in fiscal year 2006, but issued $277 billion in tax refunds.

[6] Government Accountability Office, GAO–07–136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 68 (Nov. 2006).

the additional funding the agency would have needed to handle those cases at about $2.2 billion.[7]

Significantly, this estimate reflects only the potential direct revenue gains. Economists have estimated that the indirect effects of an examination on voluntary compliance provide further revenue gains. While the indirect revenue effects cannot be precisely quantified, two of the more prominent studies in the area suggest the indirect revenue gains are between six and 12 times the amount of a proposed adjustment.[8]

I want to emphasize that the existing modeling in this area is not especially accurate, and estimates of both the direct and indirect effects of IRS programs vary considerably. As I will discuss below, the IRS needs to develop better modeling to produce more accurate return-on-investment estimates. But I also want to emphasize that almost all studies show that, within reasonable limits, each additional dollar appropriated to the IRS should generate substantially more than an additional dollar in federal revenue assuming the funding is wisely spent.

IRS FUNDING INCREASES SHOULD BE BALANCED BETWEEN TAXPAYER SERVICE AND ENFORCEMENT

One of the most critical choices facing tax administration is how to allocate resources between taxpayer service and tax-law enforcement. While I believe that both categories would benefit from additional funding, I am concerned that the IRS has been emphasizing enforcement at the expense of taxpayer service.

Since fiscal year 2004, funding for enforcement has increased substantially while funding for taxpayer service has been reduced. For fiscal year 2008, the Administration has requested a funding increase of 6.5 percent for enforcement (to $7.2 billion) and 3.8 percent for taxpayer service (to $3.6 billion).[9] If the Administration's proposal is enacted, funding for enforcement will have been increased by 19.4 percent and funding for taxpayer service will have been reduced by 3.8 percent over the five-year period, fiscal year 2004-fiscal year 2008.[10]

I am deeply concerned about this fundamental shift in the balance between taxpayer service and enforcement. Under this proposal, the IRS would be spending literally twice as much on enforcement as it spends on taxpayer service. There is no reliable data showing that more enforcement will do more than taxpayer service to increase compliance. I believe the IRS can produce a positive return on investment from more funding in both areas. But given limited resources, I think it is misguided to ramp up enforcement at the expense of taxpayer service.

I discuss some of the specific consequences of this shortchanging of taxpayer service in the Appendix to this testimony. However, I want to emphasize that the concerns I am expressing about the relative shift in emphasis from taxpayer service to enforcement do not reflect simply the misgivings of a zealous taxpayer advocate. My concerns are shared by former IRS Commissioner Rossotti. In a memoir about his experience running the IRS from 1997 to 2002, Mr. Rossotti wrote:

"Some critics argue that the IRS should solve its budget problem by reallocating resources from customer support to enforcement. In the IRS, customer support means answering letters, phone calls, and visits from taxpayers who are trying to pay the taxes they owe. Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money."[11]

Why is the IRS today putting greater emphasis on enforcement? My sense is that there are two factors at play.

In the aftermath of the IRS Restructuring and Reform Act of 1998, the IRS focused on improving taxpayer service, and its enforcement presence declined. Some observers believe that the IRS's response to the 1998 Act went too far and that the current emphasis on enforcement is needed to restore the balance that existed pre-

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[7] Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002).

[8] Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35–36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax*, 1977–1986, 43 Nat. Tax J. 395, 396, 405 (1990).

[9] Government Accountability Office, GAO–07–673, *Internal Revenue Service: Interim Results of the 2007 Tax Filing Season and the Fiscal Year 2008 Budget Request* 26 (April 2007).

[10] Id. at 27. These numbers are apparently not adjusted for inflation. GAO reports that overall IRS funding would increase, on an inflation-adjusted basis, by a mere 0.5 percent from fiscal year 2004 to fiscal year 2008 under the Administration's proposal. Id. at 26.

[11] Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 285 (2005).

viously. Significantly, this reasoning rests on the premise that the relative balance between service and enforcement that existed prior to 1998—when IRS answered taxpayers' phone calls only 51 percent of the time[12]—was the "correct" one.

That may or may not be the case. The IRS's current strategic formula, "Service + Enforcement = Compliance,"[13] does not contain any coefficients. Did the improvements in service more than balance out the reductions in enforcement, or did compliance suffer? There is no hard data either way, so we're all left to make educated guesses.

In the absence of hard data, I do not believe it is sound public policy to make a shift from helping taxpayers comply on the front end toward clamping down on taxpayers on the back end. The government should prefer to treat its taxpayers courteously and with respect. While enforcement actions are clearly necessary, I think it is unwise to make a significant shift in the relative emphasis on taxpayer service and enforcement in the absence of data showing it would produce a significant boost in overall tax compliance.

The second factor supporting more enforcement funding are the congressional scoring rules. "Direct" enforcement revenue is "scorable," while current modeling does not permit economists to measure the return-on-investment of funds spent on taxpayer service or on the "indirect" (i.e., deterrent) effect of enforcement spending. While this is understandable, it may be leading to bad results. As I noted above, direct enforcement revenue ($48.7 billion in fiscal year 2006) comes to only about two percent of overall IRS collections. To make budgeting decisions by striving to maximize two percent of collections without grappling adequately with what is required to maximize the remaining 98 percent of collections is a bit like letting the tail wag the dog.

The Administration's fiscal year 2008 budget request acknowledges this problem. It states: "The IRS cannot currently measure either the impact of deterrence or service, but they are positive."[14] Then, having acknowledged that the effects of spending that brings in 98 percent of Federal revenue cannot be measured, the budget goes on to recommend the use of a "program integrity cap." Under this concept, additional funding can be provided that does not count against the budget caps if certain conditions are satisfied, notably that the Congressional Budget Office can certify the spending will produce a positive return on investment and thus will not increase the budget deficit. Since the return on taxpayer service spending cannot be quantified, the "program integrity cap" approach leads inexorably toward greater funding for enforcement.

For the reasons I have described, I urge the Committee to consider carefully the appropriate balance between taxpayer service and enforcement in making funding decisions for the fiscal year 2008 IRS budget. Many aspects of taxpayer service are akin to a wholesale operation that reaches groups of taxpayers (e.g., outreach and education), while IRS audits constitute a far more costly retail operation that requires individual taxpayer contact. The IRS should pursue a balanced approach to tax compliance that puts priority emphasis on improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear abuses and send a message to all taxpayers that noncompliance has consequences.[15]

THE IRS SHOULD DEVOTE MORE RESOURCES TO OBTAINING BETTER RESEARCH TO IMPROVE ITS STRATEGIC PLANNING AND RESOURCE ALLOCATION DECISIONS

As described above, the IRS currently does not know whether its next dollar is better spent on taxpayer service or enforcement. It does not know within either category where its funds can be most efficiently deployed. The IRS will be much better off if it has better information to guide its resource allocation decisions.

Congress should consider directing the IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its return on investment (ROI) estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions, including the downstream costs of such work. Improved methods should also be developed to verify, retrospectively, the marginal ROI that the IRS has achieved for each category of work.

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[12] Annual IRS Restructuring and Reform Act of 1998 Joint Congressional Review, Testimony of Mark W. Everson, Commissioner, Internal Revenue Service (May 20, 2003) (indicating level of service on the telephones for fiscal year 1998).

[13] IRS Strategic Plan 2005–2009.

[14] Department of the Treasury, Fiscal Year 2008 Budget-in-Brief at 56.

[15] For research purposes, we believe it is important to study inadvertent errors as well as deliberate misreporting. Knowledge about inadvertent errors can be used to clarify ambiguous laws or administrative guidance both to help increase future compliance and to better apply IRS outreach, education, and other voluntary compliance initiatives.

Among other things, the IRS should measure and report to Congress on its progress in handling all significant categories of work, including the known workload, the percentage of the known workload the IRS is able to handle and the percentage of the known workload the IRS is not able to handle, the additional resources the IRS would require to perform the additional work, and the likely return-on-investment of performing that work.[16]

The IRS Can and Should Do a Better Job of Measuring the Impact of Taxpayer Service on Compliance

The Taxpayer Assistance Blueprint (TAB) 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 work has been done in this area, I believe the IRS does have the capability to develop useful estimates, and I 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 measures 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 walk-in site (also known as Taxpayer Assistance Center 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).

[16] Much of this information was published in former Commissioner Rossotti's final report to the IRS Oversight Board. Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002). However, we have not seen updated statistics published in this format since that time.

Return Preparation

The IRS has data that enable us to estimate compliance for the entire population of returns by type of preparation: IRS prepared, volunteer, commercial, and taxpayer prepared. It would be instructive to compare estimated reporting compliance for IRS prepared returns against comparable returns (i.e., low income, especially Earned Income Tax Credit) prepared by the other methods. If the data show that IRS-prepared returns are substantially more compliant, the IRS might decide to expand return preparation in the TACs.[17]

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 five succeeding years.[18] Five years is a long enough period to enable the taxpayer to "learn" a new norm of behavior—namely, compliance. And when you compare the 16 cents on the dollar that IRS receives from offers[19] to the virtually no cents it collects after year 3 of the 10-year collection period,[20] 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, which include the costs associated with cases handled by Appeals or the Taxpayer Advocate Service. 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 IRS Should 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.[21] 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 five-year strategic plan for taxpayer service.[22]

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[17] As I discuss in the Appendix, existing data suggest that EITC returns prepared in the TACs are more compliant than other returns.

[18] If a taxpayer fails to comply with all his tax obligations over the five-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.

[19] IRS Small Business/Self Employed Division, Offer In Compromise Program, *Executive Summary Report* (Jan. 2006).

[20] IRS Automated Collection System Operating Model Team, Collectibility Curve (August 5, 2002).

[21] The 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).

[22] Pub. L. 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 de-

I have written at length elsewhere on the need to understand the causes of noncompliance so that the IRS doesn't adopt a one-size-fits-all enforcement approach.[23] 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.

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

When former 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 several 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. Thus, Congress should ensure that the IRS has the funding to address and is addressing current taxpayer needs while the IRS moves its primary initiatives forward.

FUNDING FOR THE PRIVATE DEBT COLLECTION INITIATIVE SHOULD BE REDIRECTED TO FUND COLLECTION ACTIVITY BY IRS EMPLOYEES

In my view, the Private Debt Collection (PDC) initiative is a bad idea and should be terminated. The premise of the PDC initiative was 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 debt collectors 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. Because tax collection is considered to be an inherently governmental function, private collection agencies (PCAs) cannot negotiate or compromise tax liabilities, interest, or penalties. Unless a taxpayer contacted by a PCA agrees to pay the tax debt in full, the case must be sent back to the IRS referral unit for additional work that only the IRS can constitutionally take on the account. Keep in mind that these are cases the IRS currently considers too unproductive to

velop 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).

[23] See 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).

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.

As the IRS's PDC initiative moves forward, PCAs will be given more complex cases in order to compensate for the smaller number of easy cases. This change of course began as early as phase 1.2 of the PDC initiative, when the IRS developed case selection criteria that allowed certain nonfiler cases to be sent to the PCAs. The determination that a taxpayer is a nonfiler is a discretionary decision that can be made only by the IRS, not a private collection agency. Therefore, many of these nonfilers will raise issues only the IRS can address. The IRS intends to continue this trend of allowing PCAs to work cases that are complex and difficult to collect, such as innocent spouse cases, trust fund recovery penalty cases and business taxes.[24]

Working on these complex cases increases the likelihood that the PCAs will make mistakes and decreases the likelihood that the PCAs will be able to collect any payment from the taxpayer. Moreover, in these more complex cases, taxpayers are more likely to have questions that the PCA employees are unable to answer because their knowledge regarding tax issues is limited, at best, or because PCAs cannot exercise discretion in either answering a question or working a case. Faced with having to send the case back to the IRS referral unit, the PCAs may attempt to pressure the taxpayer into an unreasonable payment plan. As the expanded case selection increases the likelihood of IRS referral unit involvement, the underlying business case for the PCA initiative evaporates.

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 that private collection agencies can take on a case so they can work higher dollar, more complex cases. This expansion would clearly raise constitutional concerns.[25]

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 1st marked my six-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 89.7 percent for fiscal year 2006, up from 71.6 percent in 2001. The performance of TAS employees over the past two years has been particularly commendable—TAS case receipts rose an overwhelming 43 percent from fiscal year 2004 to fiscal year 2006,[26] while the number of case advocacy employees working those cases declined seven percent from 1,908 to 1,766 over the same period. Yet we have managed to handle this increased workload to date without much decline in our case quality.

The increase in TAS cases is not surprising. The IRS has substantially increased the number of its compliance actions in recent years, and about 70 percent of TAS's cases are classified as "compliance" related. Increasing the number of compliance cases inevitably produces a corresponding increase in TAS cases. Thus, the greater IRS emphasis on enforcement has resulted in a greater need for TAS services. Notably, TAS was able to obtain relief for the taxpayer in 70 percent of the cases we closed in fiscal year 2006.

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

[24] Internal Revenue Service, *F&PC Advisory Council Deck* (Mar. 7 2007).

[25] 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.

[26] In fiscal year 2006, TAS received a total of 242,173 cases. In fiscal year 2004, TAS received a total of 168,856 cases.

scores,[27] which averaged about 4.35 on a scale of 5.0 in fiscal year 2004 and fiscal year 2005.[28] Most importantly, 57 percent of taxpayers stated that they felt better about the IRS as a whole after coming to TAS. Even among taxpayers who did not obtain the result they sought, an impressive 41 percent reported that they had a more positive opinion of the IRS because of their experience with TAS.

I am concerned that with the increasing volume, complexity, and urgency of TAS's caseload, the cycle time for our cases has begun to increase. 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.

CONCLUSION

Compared to the IRS of ten years ago, the IRS of 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 five 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.

APPENDIX: TAXPAYER SERVICE ISSUES

THE IRS NEEDS ADDITIONAL FUNDING TO ALLOW FOR THE IMPLEMENTATION OF NEW INITIATIVES DESIGNED TO IMPROVE TAXPAYER SERVICE

Over the past two years, in response to a directive from this Committee, the IRS—through its Taxpayer Assistance Blueprint (TAB) team—has engaged in extensive research into the needs, preferences, and willingness of taxpayers to use taxpayer services.[1] The TAB is a strategic document that contains a number of recommendations that, if implemented, will improve taxpayer service for many taxpayers. Many of the TAB recommendations focus on strengthening electronic service delivery options, with a focus on the irs.gov website. The goal is to provide increased service capabilities through the least costly electronic delivery channel, thereby reserving the more costly telephone and walk-in services for those taxpayers in need of additional assistance. As the IRS restructures the delivery of services and recognizes savings from increased efficiency, the IRS should reinvest these savings back into taxpayer service programs and initiatives to further improve on service delivery, including person-to-person and face-to-face assistance.

Moreover, the TAB report contains a number of recommendations that can have an immediate impact on the quality of taxpayer service. While the IRS will begin implementing these and other initiatives during fiscal year 2007, additional funding is needed in order to implement the proposed changes fully.

Online Taxpayer Tools.—During fiscal year 2008, the IRS is scheduled to launch the Internet Customer Account Services (I–CAS) platform. I–CAS will provide taxpayers with direct access to account information and services.[2] The first phase of the I–CAS rollout will provide taxpayers online access to account and return transcripts. The second phase will allow taxpayers to submit electronic versions of forms for change of address, disclosure authorization, and extension to file forms. With additional funding, future I–CAS capabilities could include explanation of account issues, movement of payments, and issue diagnosis and resolution.[3] Spanish versions of I–CAS and "Where's My Refund" are also planned for fiscal year 2008.[4] With additional funding, the IRS could expand to other languages.

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[27] Taxpayer Advocate Service customer satisfaction survey data for the period from October 2003 through September 2005, as collected by The Gallup Organization.

[28] Last year, TAS began using a new vendor to conduct its customer satisfaction surveys. We have not yet refined our new measure to make its results comparable to those achieved for years covered by the prior vendor.

[1] Internal Revenue Service, *The 2007 Taxpayer Assistance Blueprint Phase 2* (April 2007).

[2] Id. at 82.

[3] Id.

[4] Id.

Improvements in TAC Services.—During fiscal year 2007, the IRS is testing a Facilitated Self-Assistance Model (FSM) in 15 Taxpayer Assistance Centers (TACs) locations. FSM is designed to help taxpayers who have indicated a willingness to use alternative service channels, such as telephone or computer assistance, to learn how to effectively use those channels—thereby allowing TAC employees to focus on services taxpayers have indicated they want to receive in person. The FSM will provide taxpayers coming into a TAC with the option of using a self-assisted service to resolve a tax-related question. The TACs will be outfitted with workstations containing computers and telephones. This will allow taxpayers to access the irs.gov website or use the toll-free telephone line to receive assistance. TAC employees will be available to answer questions and provide assistance to taxpayers willing to use the workstations.[5] At any point during the process, the taxpayer will be able to request assistance from a TAC employee.

After completing their transaction using the workstation, taxpayers will be asked to complete a brief survey designed to assess the effectiveness of the FSM and satisfaction with the experience. The survey will also collect demographic user information to enhance the IRS's understanding of taxpayer needs, preferences, and behaviors. The goal of FSM will be to help some taxpayers become more comfortable using online and telephone alternatives to answer their questions or to obtain information through forms, publications, and other guidance. TAC employees can focus on those taxpayers who require face-to-face assistance or those services (such as payments or account resolution) that taxpayers cannot or are unwilling to address through alternate channels.

The IRS is also piloting a test to install payment kiosks in TACs. Currently, most TACs will accept cash payments from taxpayers who do not have, or are unable to obtain, a check or money order.[6] TAC employees must then convert the cash payment to a bank draft or money order.[7] This is particularly burdensome in smaller TAC offices where there are only one or two employees and one must leave the office in order to convert the cash payment. The IRS is testing the use of a kiosk located in the TAC that would allow a taxpayer to convert a cash payment into a money order without having to leave the TAC. The IRS will test these kiosks in two locations this year.

FSM and the kiosks have the potential to save both the taxpayer and the IRS time. If FSM and the kiosks prove to be effective, the IRS will likely need additional funding to install these features in all TACs.

THE IRS SHOULD NOT REDUCE CRITICAL TAXPAYER SERVICES

The TAB report puts forth a number of recommendations designed to improve taxpayer service. Although the report provides the IRS with valuable information regarding the needs, preferences, and willingness of taxpayers to use certain services, it is only a starting point. The IRS must continue its research efforts to determine how best to strengthen taxpayer services.

For example, the Taxpayer Advocacy Panel (TAP) has just conducted a survey that will shed light on the needs and preferences of those who visit a TAC. The methodology of the TAP survey differs from prior surveys in that it will attempt to survey taxpayers who attempted to visit a TAC but were unable to obtain assistance for such reasons as the line was too long or the TAC office was closed. The TAP survey gathered some basic demographic information, and it inquired about why the taxpayer was visiting the TAC and whether the taxpayer was satisfied with the service received. If the taxpayer did not receive any service, the survey will ask why none was provided. In addition, the TAP survey asked specifically why the taxpayer chose to visit the TAC instead of using a different IRS service and whether there were any services that were unavailable to them during their visit. The TAP survey results will provide the IRS with information useful not only in improving TAC services but in improving other taxpayer services as well.

As the IRS implements the TAB recommendations and conducts additional research, the IRS needs to maintain its current services until it is proven that the new service offerings are adequately meeting taxpayer needs. One of the effects of the IRS's focus on enforcement at the expense of compliance has been a reduction in taxpayer services that can have a dramatic impact on taxpayers.

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[5] The IRS designed the FSM model to ensure that taxpayer information is protected from unauthorized access and all taxpayers using the self-assistance options are provided with proper notification and information to make them aware that their computer usage is being monitored and recorded for research purposes.

[6] IRM 21.3.4.7.2, Cash Payments (Jan. 10, 2007).

[7] IRM 21.3.4.7.2.3, Converting Cash Payments (Jan. 10, 2007).

IRS Has Substantially Reduced the Number of Returns It Prepares at the TACs

The IRS historically has prepared tax returns for low income taxpayers at its TACs. Low income taxpayers generally qualify for the earned income tax credit (EITC), which is a refundable credit that caps out at $4,536 in 2006. Studies show that the average overclaim rate for EITC benefits is between 27 percent and 32 percent.[8] IRS personnel who prepare tax returns are trained to ask questions that minimize the likelihood of EITC overclaims and thus can save the government hundreds of dollars per return. Yet to free up resources for other program initiatives, the IRS has reduced the number of tax returns it helps low income taxpayers prepare in its walk-in sites by almost 40 percent over the past four years. The number of returns prepared dropped from 665,868 in fiscal year 2003 to 406,612 in fiscal year 2006.[9]

IRS data for tax years 2002 through 2004 suggest that EITC returns prepared by IRS TACs may be significantly more compliant than self-prepared and commercially prepared returns. As compared with TAC-prepared returns, Discriminant Function (DIF) scores were between 21 and 26 percent higher for self-prepared returns and between 25 and 31 percent higher for returns prepared by commercial preparers.[10] The DIF score is an estimate of the likelihood of non-compliance on a return. A higher score indicates a higher likelihood of non-compliance.

These findings are corroborated by examination results for EITC returns for these tax years. As compared with TAC-prepared returns, average audit assessments among EITC returns for tax years 2002–2004 ranged from about $640 to $1,300 higher for self-prepared returns and from about $820 to $1,300 higher for commercially prepared returns.[11] Similarly, a study conducted in 1996 that examined the relationship between IRS return preparation and compliance over a ten-year period showed that an increase in the number of returns prepared by the IRS correlates with substantial improvements in compliance among filers of individual returns. Indeed, taking into account the indirect effects of IRS return preparation, the study estimated the return on investment for each dollar the IRS spent on return preparation was 396:1.[12]

The IRS Is Declaring Increasing Numbers of Issues "Out-of-Scope".

In my 2004 Annual Report, I raised concerns about the increasing number of issues declared "out-of-scope" in TACs, because limiting the issues TAC employees are able to address reduces the level of service available to taxpayers.[13] For example, despite the number of taxpayers in certain states with taxable income from farming activities, I received a complaint at a "town hall" meeting in Fargo, North Dakota last year that questions about Schedule F, the form used to report farming income and expenses, are considered out-of-scope at IRS walk-in sites. I was astounded, but my staff has since confirmed that is the case.[14]

One of the reasons the IRS maintains a geographic presence is to allow taxpayers to obtain assistance with needs that may be different from the needs of taxpayers in other regions. Therefore, TAC out-of-scope questions could differ according to taxpayer needs by geographic region. Questions about farming may be appropriately considered out-of-scope in New York City—an area where complex financial reporting questions may be routine. In Fargo, North Dakota, it is fair to expect that farming questions are "ripe" for consideration.

TACs Are Not Adequately Responding to Emergency Transcript Requests.

Under current IRS policies, taxpayers who request a copy of a return transcript should have the transcript mailed to their address within 10 days.[15] If a taxpayer is requesting a hardship exception, she must provide verification to show why she is unable to wait the normal processing time to obtain her transcript. While these exceptions should be "rare" and require managerial approval,[16] the procedures for

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[8] Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns 3* (Feb. 28, 2002).

[9] Wage and Investment Operating Division, *Business Performance Review Fiscal Year 2006*.

[10] IRS Compliance Data Warehouse, Individual Returns Transaction File data for tax years 2002–2004.

[11] IRS Compliance Data Warehouse, Audit Inventory Management System data for tax years 2002–2004.

[12] See Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996).

[13] National Taxpayer Advocate 2004 Annual Report to Congress 12 (Most Serious Problem: Taxpayer Access—Face-to-Face Interaction).

[14] IRM 21.3.4–1, Scope of Services (Feb. 16, 2007).

[15] IRM 21.3.4.14.4, Tax Return and Tax Account Transcript Requests (Jan. 16, 2007).

[16] Id.

obtaining an exception are not operating as intended. One example comes from our Omaha office, where a taxpayer went to a TAC requesting a return transcript. The taxpayer was scheduled for surgery the next day and needed a copy of a transcript to prove he was financially eligible to receive assistance. The TAC employee indicated that this was not an emergency and the taxpayer would receive his transcript in two weeks. Luckily, the Omaha TAS office was able to immediately provide the requested transcript. The current IRS procedures for hardships are clearly not working. Taxpayers who are in need of transcripts for court proceedings, medical procedures, or student loans are being turned away and instead are coming to TAS for assistance. This reduction in taxpayer service is negatively impacting taxpayers and forcing them to turn to TAS for assistance that the IRS should be providing.

Small Business Outreach Has Declined.

IRS data show that self-employed taxpayers account for the largest chunk of the tax gap and indicate that the tax compliance rate for self-employed taxpayers runs at about 43 percent.[17] Much of the underreporting is deliberate, but some is not. For example, many small businesses are started by individuals who lack detailed knowledge of the tax laws and do not have the resources to hire tax attorneys or accountants. When they hire a few workers, they often do not realize that they are assuming tax reporting, tax withholding, and tax payment obligations, and they often do not understand enough about the details of complying with the requirements to do so with reasonable effort.

After enactment of the IRS Restructuring and Reform Act of 1998, the IRS developed a function known as Taxpayer Education and Communications, or "TEC." TEC was the IRS's outreach arm to small businesses to try to educate them about the complexity of their tax obligations. For 2002, TEC was named the Small Business Administration's agency of the year for what the SBA called its outstanding progress in creating an effective education and compliance assistance program for small business and self-employed taxpayers.[18] Yet in the name of achieving "efficiencies," TEC was "realigned" in February 2005 through a merger with other outreach functions and redesignated as "Stakeholder Liaison." Prior to the realignment, TEC had 536 employees. After the realignment, Stakeholder Liaison staffing included 219 employees.[19]

In my view, the reduction in TEC staffing will reduce tax compliance on the part of small businesses, result in more IRS audits of small businesses, and make more small businessmen and women feel like the government is playing "gotcha" with them by enacting complex requirements and then failing to help them understand how to comply.

IRS Telephone Assistors Are Answering a Reduced Percentage of Calls and Taking Longer to Do It

In 2003, the IRS answered 87 percent of all calls. This percentage dropped to 84 percent in 2006 and to 82 percent through March of this year's filing season. The average time it took the IRS to answer calls increased from 3.1 minutes in 2006 to 4.4 minutes so far this filing season.[20] While the level of service on IRS phone lines is substantially better today than it was in the 1990s, we are moving in the wrong direction.

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.[21] 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

[17] See IRS News Release, IRS Updates Tax Gap Estimates, (Feb. 14, 2006) (accompanying charts).

[18] See *Closing the Tax Gap and the Impact on Small Business*, Hearing Before the House Comm. on Small Business, 109th Cong. (Apr. 27, 2005) (testimony of John Satagaj, President and General Counsel, Small Business Legislative Council).

[19] IRS Small Business/Self Employed Division response to Taxpayer Advocate Service Information Request (Sept. 5, 2006).

[20] Government Accountability Office, GAO–07–673, *Internal Revenue Service: Interim Results of the 2007 Tax Filing Season and the Fiscal Year 2008 Budget Request* 20 (April 2007).

[21] See S. Rep. No. 105–174, at 39–40 (1998).

to easily capture return data electronically, and enables the IRS to process and review returns more quickly.[22]

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.[23]

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 universally 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 purchased tax preparation software. When I completed preparing my return, the software program informed me that, to file electronically, I would have to pay an additional fee. 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.[24] 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 free direct filing mechanism would go a long way toward addressing this problem and would result in a greater number of taxpayers filing their returns electronically. When taxpayers elect to use commercial software but print out their returns for mailing, the IRS should require software developers to convert data to 2D bar codes, so that all tax information can be scanned into IRS systems.[25] Both taxpayers and the government would stand to benefit from these improvements.

Senator DURBIN. I would like to now invite Mr. White and Mr. Powner from the Government Accountability Office to join us at the

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[22] The 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). Although the IRS was not able to achieve this goal, we believe Congress should reiterate its commitment to seeing the IRS increase the e-filing rate as quickly as possible.

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

[24] IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

[25] More than 20 states currently use 2D bar-coding for personal income tax forms. See Federation of Tax Administrators compiled data http://www.taxadmin.org/fta/edi/ecsnaps.html.

panel. Although they did not have opening statements, they are prepared to answer questions. They have done extensive research on the operations of the Internal Revenue Service.

INTERNAL REVENUE SERVICE RECRUITMENT TOOLS

Mr. Brown, did you happen to see the article printed in the New York Times on April 16? It was by David, it appears to be, Schizer, dean at Columbia Law School, and he talked about the need for professional personnel at the IRS.

Mr. BROWN. I believe I did see this article, yes.

Senator DURBIN. It was interesting, some of the things he suggested, that in order to attract the kind of skill that we may need at the IRS to deal with the complexity of filings he said that perhaps we should do more in repaying student loans, student loan forgiveness.

First, could you comment on the need for that type of professional person and whether or not student indebtedness has become a factor?

Mr. BROWN. Indebtedness is a factor and I think he was referring to the chief counsel's side of the organization.

Senator DURBIN. That is right.

Mr. BROWN. Which is where our lawyers reside. Don Korb, who is our Chief Counsel, has taken a number of aggressive steps to attract top legal talent. Don can probably better address that than I could, but I used to work in the Chief Counsel's organization, so I am familiar with some of the things they do.

They offer bonuses when people come on. They accelerate the pay raises that people can get. It is difficult when you come out of law school. You tend to owe quite a bit of money, and our salary is not commensurate with what law firms offer. So it is hard, and with an increasingly complex Tax Code it is difficult to attract people of the quality we need.

Senator DURBIN. Are you using student loan forgiveness now to attract professional personnel?

Mr. BROWN. I do not know the answer. I will find out an answer and get back to you.

VOLUNTEER INCOME TAX ASSISTANCE

Senator DURBIN. Tell me about this, is it "VEE-tah" or "VIE-tah" program?

Mr. BROWN. "VIE-tah," volunteer income tax assistance.

Senator DURBIN. We hear from Mr. George that 56 percent of the returns are done accurately, are assembled accurately. That sounds like a pretty low number for a service being provided by our tax collecting agency.

Mr. BROWN. We are constantly trying to improve that number. As Russell has indicated, that number actually has improved to that point. I think you have got to recognize that the Code is quite complex. These people are volunteers. They are trained by us. We have clearly got to do a better job training them.

I would point out that there are errors on returns and there are errors on returns, and it sort of depends how fundamental the error is on the return. I think Nina would probably have an opinion

on this subject as well because Nina has looked very closely at this issue.

Senator DURBIN. I have always had a theory, incidentally. A few years ago my accountant in Springfield, Illinois, passed away and I decided as a lawyer who took tax courses in law school to just do my own returns. If every Member of Congress did their own personal returns, tax simplification would become a crusade on Capitol Hill. There is no doubt in my mind. What appears to be so simple is not, and we, guilty as charged, have created it in this situation.

FELONY FAILURE TO FILE

Let me ask you about this, the whole question of policy changes that you think will lead to more compliance. One of them was upgrading the penalty for willful failure to file taxes to a felony. Now, what percentage do you think that represents in terms of current noncompliance?

Mr. BROWN. Oh, I think that is an outlier, but it is more symbolic. Right now it is a misdemeanor. I worked for a number of years at the Justice Department as an attorney and, frankly, you cannot interest assistant U.S. attorneys in prosecuting misdemeanors. Perhaps in the drug area, but not in the tax area. They just do not want to spend time on that. They have too many cases competing on their docket.

What we are asking here is if you have willfully failed to file for 3 of the past 5 years, and there is an omission of more than $50,000, we are asking that failure be made a felony. We think that would lead to more compliance. I cannot tell you how much more, but there is symbolism there that we think is quite important.

LEGISLATIVE PROPOSALS

Senator DURBIN. What other changes are you proposing?

Mr. BROWN. Credit card reporting. If you ran a dry cleaning business and you take forms of payment as both cash and credit cards, we would like the aggregate dollar amount at the end of every year for your credit card receipts. That reporting will enable us to do two things. It may be that, given that we know from that industry, that payments are relatively divided evenly, 50 percent cash, 50 percent credit cards. We know not to audit you if it appears that you are in compliance. Or it would help us say, "there is something amiss here, please explain."

Senator DURBIN. Are there any other proposals that you think would have a significant impact on compliance?

Mr. BROWN. Well, we have a number. We have 16 of them. I think the basis reporting for security transactions is one that would be quite helpful. I can tell you from personal aggravation when I went to sell a mutual fund, it is difficult to calculate your basis. It is very difficult. I think that proposal helps both the consumer and it helps us, because the only information we have reported to us is the total sale price. We do not know what your gain is. So unless we start an audit, it is difficult to get to the proper number. So I think that would be helpful as well.

PREPARATION OF RETURNS

Senator DURBIN. I noticed here that, of course, the Internal Revenue Service is in competition with private companies when it comes to the preparation of tax returns. It appears that the number of people who utilize the services of the IRS is not increasing, may be decreasing some, in comparison to private companies. Can you give me some frame of reference there, percentage of those who are using private companies for preparation of returns?

Mr. BROWN. Our estimates are that 85 percent of people now either use a paid preparer or software to prepare their return. So you are down to about 15 percent left trying to navigate the system on their own or coming to us to use a volunteer outfit.

Senator DURBIN. What is your experience with those who do come in? Are they satisfied customers?

Mr. BROWN. I think they are by and large satisfied customers. I think that we have got over 12,000 sites around the country that do this now, 12,000 volunteers that do this for us now, and I think people are largely satisfied. They also serve segments of the population that may not be as fluent with computers and that sort of thing.

Senator DURBIN. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. I would like to make my statement a part of the record if I might, please.

[The statement follows:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Durbin for holding today's hearing.

The American people are no stranger to taxes or the IRS. The first income tax was enacted by President Lincoln and Congress in 1862, to help finance the Civil War. While this income tax was later repealed, today we have a tax code that is very cumbersome and in need of reform.

Recently, I had the pleasure of meeting with several constituents from Colorado. We discussed a very troubling occurrence involving the IRS and many landowners in Colorado. In many of these meeting I heard how frustrating and intimidating it can be to deal with the IRS. American citizens should not live in fear of their government. Taxpayers have a right to expect honesty and integrity in their dealings with the IRS.

According to the IRS' own mission statement, the IRS provides America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

For some time now I have been concerned by increasingly hostile IRS actions towards conservation easements. It would appear that the IRS is attempting to dramatically narrow the number of legitimate conservation easements by applying a standard that has been struck down by federal courts two different times.

Colorado is a national leader in conservation, and it is an issue of great importance to our state's economy and quality of life. It is also critical to our farmers and ranchers whose lands provide important agricultural products, wildlife habitat, water resources, and scenic vistas our state is famous for.

While I support investigation and enforcement of legitimate fraud, we must not target honest taxpayers, and Colorado's reputation should not be tarnished. There is a significant need for conservation easements in Colorado, and a few abuses should not end the charitable tax credit for everyone.

I have been in communication with the IRS over this matter for some months. Therefore, I will follow up with our panel in more detail during our question and answer period.

CONSERVATION EASEMENTS

Senator ALLARD. In Colorado one of the important programs that we have going there is conservation easements. It has been called to my attention that there has been a small amount of fraud. There is one person maybe, an assessor. But a large percentage of what is happening in Colorado I believe is probably not related to this limited fraud. Yet the reputation is spreading in Colorado that you are after the whole, meaning the Internal Revenue Service, is after the whole conservation easement process, period.

The last figure I got was 250 potential cases that were identified by IRS and now you are up to 290. So my question is, you continue to identify these individuals, but how many of these audits or how many of these 290 potential violations have had audits where you have closed it and delivered a revenue agent report?

Mr. BROWN. I do not know the precise number of how many have been closed. I do know that your number is correct on how many are underway. I do know that of the ones I have been briefed on, they have found some instances of abuse, not across the board, but they have found some instances of abuse.

Senator ALLARD. Yes. Well, some individuals that are involved, both ranchers and the environmental groups that have helped encourage conservation easements, have recognized that there was particularly one, a couple of guys or one guy that was involved with some problems. But if you look at their cases, they obviously were not areas where there was a conservation easement need. You could easily identify that.

I would encourage you to try and, let us get these resolved as quickly as possible and make a quick determination how extensive this is, because it is creating some problems. So I am getting complaints back in my office on that.

So the next question I have is, and this gets back to our conservation easement, what specific guidance does the Internal Revenue Service have in using to evaluate whether a conservation easement has conservation purpose?

Mr. BROWN. We publish forms and other booklets that offer tests. Generally it is a three-part test——

Senator ALLARD. Can I interrupt you there?

Mr. BROWN. Sure.

Senator ALLARD. Here is what I understand that you have stated on that issue. You say: "The presence of endangered species has never been a requirement for a conservation easement." Then you go further down and you state: "But the IRS also states endangered species are a factor that can demonstrate a conservation purpose."

So when you have individuals look at that, there is some confusion about how in the world you evaluate a conservation easement, because it seems to be a contradiction of fact there.

Mr. BROWN. Yes, and apparently when we did a briefing out there for people who are interested in taking these credits, the revenue agent was less than crystal clear, and I apologize for that. We will do our best to make sure that people do understand what is required here.

Senator ALLARD. Yes, because we have—well, one of the areas of concern is the sage grouse. Well, the sage grouse in some parts of Colorado has been classified endangered. Well, it's the Gunnison grouse, and then there is the regular sage grouse, a similar bird. But it has not been classified as endangered by—it is not on the endangered species list, but it is recognized as one of the 10 most endangered birds in North America by the Audubon Society.

So I guess the question comes up, well, how do you treat grouse habitat? So you can understand the vagueness on here, and the quicker we can get that clarified the more appreciative I think and the better compliance you will get from these processes that set up a conservation easement. If you could help us out on that I would appreciate it.

Mr. BROWN. We shall.

QUALIFIED APPRAISERS

Senator ALLARD. Now, one of the problems is qualified appraisers also. I had one individual come in to me who had a qualified appraiser, he is touted as being one of the best in Colorado for appraisals. The State of Colorado was involved in it. They did their own appraisal work and everything. Then the Internal Revenue Service comes back and they say the appraisal is not right.

So my question, so it brings up the question, are your appraisers truly qualified and do they meet the provisions that are defined in the Pension Protection Act—this was a bill signed into law by President Bush in August 2006—about following the uniform standards of professional practice? Do you have that qualified appraiser that visits with these folks?

Mr. BROWN. I believe all of our appraisers are qualified. I am going to go back and check and we would be happy to come up and brief you thoroughly on this.

Senator ALLARD. You may believe them qualified, but I want to see whether they meet the qualifications that are laid out within that particular provision.

Mr. BROWN. We will be happy to get you that.

Senator ALLARD. Okay, thank you.

So I see my time is running out here. So I will come back up with some other questions. Thank you.

Thank you, Mr. Chairman.

Senator DURBIN. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman, and thank you to the witnesses who are here today to testify. My opening remarks and my questions will be brief. I am here today to listen to your testimony. I think you are very knowledgeable. As we work to close the tax gap, I have questions about what the taxing authority has such difficulty in collecting the taxes that are owed. The power of the IRS, as they say, it is better to sin against God than it is the IRS because God forgives. I do not for one minute understand why the taxing agencies have so much trouble collecting taxes.

As Governor, I had a tax commissioner and I do not believe that we had the same level percentagewise of tax collection issues. So I have never understood it.

PRIVATE DEBT COLLECTION

But I want to touch briefly on a subject that is of interest to me. The IRS private debt collection initiative is obviously going to come up for discussion. I have long championed the effort to include that and to include within that program a preference for hiring service disabled veterans and other persons with disabilities to perform the debt collection work. In hiring in the Federal Government, there are various preferences offered by other agencies and I have worked with people from your office and my staff has worked with people from your office to try to put in place as part of the debt collection process a preference, a small preference by comparison, for firms that hire a certain number of individuals who are disabled, severely disabled.

What, if any, reservations do you have about including the disabled veterans preference program? I did get a letter saying that you were not sure, some time ago from someone in the IRS, saying that they were not sure that the process would be as good. I do not think they meant that disabled people could not do as good a job, but I did not understand what was meant, either.

Maybe you can give me your ideas about where the IRS is on this program now?

Mr. BROWN. Well, the program is done exclusively through phone calls.

Senator NELSON. I mean on the preference.

Mr. BROWN. Oh, on the preference. I am going to have to go back and take a look. I know that you have an interest in this and I do not know what the obstacles are. I cannot think of any at the moment, but I would have to go back and ask if there are any potential problems.

Senator NELSON. I cannot think of any at the moment either. But some of your staff did have some questions and some issues that we have tried to overcome and work through. I appreciate if you would—I have spoken to Secretary Paulson. I have spoken to Mr. Everson and I have worked with so many to try to get it done. I understand bureaucracy. Bureaucracy is full of "we bees"—we be here when you come, we be here when you go. And I want to move beyond that, to where we get a commitment to do the kinds of things that we should be doing.

Other agencies are able to do it. I do not understand the reluctance that I picked up along the way. Now, we have had some cooperation recently, but I have been 1½ years working to get that done and we have had to go around to get it into other legislation. But we want to make sure that there is no opposition to that or, if there is opposition, that we can understand what it is.

Mr. BROWN. Yes, sir, we will look into this.

Senator NELSON. Mrs. Olson—Ms. Olson, in your testimony you discussed the enormous amount of IRS resources that are devoted to supporting the private debt collection program. You say funding for the private debt collection initiative should be redirected to fund collection activity by IRS employees.

If they have not been able to do it before, what is the change where they can do it now?

Ms. OLSON. Well, sir, I covered in my annual report that I issued in December 2006 seven issues that the IRS could be doing better with the authority that they have right now, that do not raise the serious issues of privacy and perhaps violation of taxpayer rights or constitutionality of outsourcing tax collection.

I would note that my organization, the Taxpayer Advocate Service, has been a leader in the IRS in hiring disabled persons.

Senator NELSON. I did not mean to suggest you were not.

Ms. OLSON. No, but what I am saying is that the IRS I believe can do better in hiring disabled persons itself. Those are not positions that would be here today or gone tomorrow. There is a good side to the "we bees," which is that you have constancy in the position.

Senator NELSON. Absolutely.

Ms. OLSON. So I believe that the IRS, with a 2 percent or 3 percent real funding increase both in enforcement and taxpayer service, could be hiring many of these people and giving them secure and meaningful employment, without violating taxpayer rights or costing the Government money, 20 cents to 25 cents on the dollar. We do not cost that much.

Senator NELSON. Well, the cost per collection is paying money out of money that you otherwise do not have. So at the end of the day there is a net gain, unless you could do it better a different way.

One final thought. My time is running out here, but one final thought about this is that when it comes to privacy the issue generally of privacy has been handled at the State level because the States are outsourcing day in and day out and have had fairly good results in many cases. Foreign governments are today outsourcing. So outsourcing seems to have more legitimacy than I think you are giving it credit for. But if you could find a way to do what I am trying to do another way, I am interested. I can tell you that.

Ms. OLSON. Thank you.

Senator NELSON. Thank you, Mr. Chairman.

Thank you.

Senator DURBIN. Thank you, Senator Nelson.

OBSERVATIONS OF GOVERNMENT ACCOUNTABILITY OFFICE

Mr. White, what has the GAO found when it comes to the performance of the IRS as it relates to tax gap and efficiency? Can you give us your observations?

Mr. WHITE. Yes, Mr. Chairman. Let me talk about taxpayer service first. Over the last 8 to 10 years, we think we have seen a noticeable improvement in taxpayer service at IRS. If you look at things like telephone access, the ability to get through on the phones to a telephone assister, that is noticeably better than it was 8, 10 years ago. And the quality of the answers, the accuracy of the answers, is also noticeably better.

In addition, there are new types of service, especially on the web site, that IRS is providing. So there are features on the web site now, such as where is my refund, that taxpayers can use to get answers to questions about their specific tax situation, that in the past they had to wait in a queue to get through to a live telephone assister. One of the beauties of the web site is that it is available

around the clock 365 days a year. So that is the service side of the house.

On the enforcement side of the house, we think that the IRS has made some progress on enforcement. The direct enforcement revenue has gone up. Things like the national research program, which has been a large effort to better understand compliance, do research on compliance, so that noncompliant taxpayers could be better targeted in the IRS's operational audits, which has two effects. It brings in more money; it also reduces the burden placed on compliant taxpayers because they do not get audited.

On the other hand, the IRS's enforcement efforts are still on GAO's high risk list. We have got a $290 billion net tax gap out there and that has remained relatively constant in proportional terms for several decades now. So for that reason this area is still high risk.

Senator DURBIN. Mr. George, what would you say to that in terms of whether the IRS is aggressive enough on this tax gap and compliance issue?

Mr. GEORGE. Mr. Chairman, I would say that they are doing a good job, but they could certainly do a better job, and that all of the tools that would be helpful in achieving this goal are not necessarily within the possession of the IRS. As was pointed out by an earlier witness, the complexity of the Tax Code is a major component of the reason why the tax gap is as large as it is. If you had a very simple Tax Code, we believe that people would be more inclined to abide by it. But given the fact that they do not necessarily understand their requirements, they do not necessarily pay what it is that they owe.

As was pointed out by Mr. Brown, some of the proposals that the IRS has proposed would certainly help address the issue. For example, third party reporting. In the instance that he gave, it was related to the cost basis of stocks. That could be extended to various other components of the economy. Would it cost much more to do this? Most definitely. Would it achieve much more in terms of receipts to the Treasury? Most definitely. So this is a policy call that the Congress, working with the administration, needs to work out. But nonetheless, that among other ideas would certainly get to this issue.

PRIVATE DEBT COLLECTION

Senator DURBIN. Let me ask you, Mr. Brown, about this contracting out. This has come up a few times. I understand there are some private debt collection operations being used by the IRS. I understand that you terminated one company, Linebarger Goggans. Is that the name?

Mr. BROWN. Yes.

Senator DURBIN. Why were they terminated?

Mr. BROWN. At the 1 year mark of the contract, we had the right to unilaterally renew or terminate with regard to all three of the contractors. We had a high degree of confidence in two of them; we thought they were doing very, very well. We decided to continue with just the two of them. We thought that they were performing very well, honoring taxpayer rights, implementing the program the way we envisioned.

With the third one, it is not to say that they were failing in some regard. They just, in our view, were not performing at the same level as the other two companies.

Senator DURBIN. You or someone, I think it might have been your testimony or someone else, noted with some pride that the cost of collection was down from 46 cents per $100 to 42 cents over the last—the third lowest figure in the last 25 years. So tell me what role you believe that contracting out plays if your collection rates internally are improving at this rate?

Mr. BROWN. It is work we would not get to. I mean, that really is the point of the program, that these are cases that we would not get to with our staffing. If you were to give us more staffing, these are not the cases we would turn to next.

Senator DURBIN. Would these be the more complicated cases?

Mr. BROWN. No, in fact it is the opposite. These are simpler cases. These are cases that really are going to be what we call "full pays." The PCA can only do two things. They can either get the taxpayer to pay in full or they can get the taxpayer to pay in full over time.

Senator DURBIN. It sounds to me like those are the easiest ones for IRS employees to deal with.

Mr. BROWN. They are the easiest, but they are also—they tend to be smaller dollar and cases with a smaller degree of probability of success because of the age of the case and that sort of thing. We tend to work on cases that are more risky and higher dollar with our revenue officers.

Senator DURBIN. So what kind of cost comparison have you done between performing these services in house as opposed to contracting them out?

COMPARISON OF IRS TO PCA COSTS

Mr. BROWN. We are attempting to do that now and we should have some sort of good cost comparison later this year. I would note, though, that our employees have collection tools that are not available to the private sector. We have the power to file a notice of lien. We can file a notice of levy. We can levy on people's bank accounts. They do not have any of these authorities, so it is hard to do a complete apples to apples comparison.

Senator DURBIN. So do you think this decision on contracting out should be driven strictly on monetary terms? If the IRS can say to the taxpayers, "we can hire employees to do this work and bring back more revenue to the Government at a lower cost than doing it contracting out," then you should hire employees as opposed to contracting out?

Mr. BROWN. I think we have a large problem with the tax gap and this is a slice of money that we are not going to get to any time soon.

Senator DURBIN. With the current workforce.

Mr. BROWN. That is correct. But also, we can only hire so many people so fast. We have sort of a rule of thumb at the IRS, between attrition and what we call initiative hiring. If we go beyond 15 percent, we hurt our current year's performance and we tend to start losing control of our training. And the IRS is a bad place to lose control of the training of your employees.

Senator DURBIN. Do you know what the training is at some of the private collectors?

Mr. BROWN. Yes.

Senator DURBIN. Well, it turns out the Buffalo Times described the training process for employees at one of the companies as a 2-week training course. Is that what you think is adequate for the job of collecting for the IRS?

Mr. BROWN. No. The IRS, though, has collection tools that are not available. These people in the private debt collection outfits can only write letters or make phone calls and enter into what we call full pay agreements with the taxpayer. So they are good at locating taxpayers, calling taxpayers, and then trying to convince them to pay in full.

Senator DURBIN. I do not want to dwell on this, but I do want a direct answer. Will you compare the cost of hiring new employees to do this as opposed to contracting out?

Mr. BROWN. We are in the process of doing that, sir.

Senator DURBIN. Good. Thank you.

Senator Allard.

Senator ALLARD. Thank you.

I would like to follow up on that a little bit. You had two contractors who were performing very well, you were pleased. You had a third contractor who was not performing and you ended the contract. Now, if you have a civil—if you have three civil service employees and you have two of them that are performing, fine. But if you have one that is not performing, is it easy to dismiss them?

Mr. BROWN. It would depend on what you define as "not performing." Generally it is——

Senator ALLARD. You hit the problem right there. I mean, your response was it is very difficult because you cannot define it. I can tell you that I have had numerous complaints to us over the years, being in both the House and here, from nonperforming Federal employees. And you ask about disciplinary action: Well, we cannot do that, we cannot take care of them; they are protected by the civil service system.

So here you had a nonperforming entity. You took care of it with a contract and now you can replace it with a performing entity. It seems to me like there is a cost there that I hope gets figured into the figures. And I just wanted to make that point.

CONSERVATION EASEMENTS

I want to get back to what we were talking about with the conservation easements. We were talking about auditing. How many cases—okay. What are the methods the IRS is using to expedite the process of resolving the cases? I do not know as I got that question put to you. Do you have a response to that?

Mr. BROWN. Well, they are underway. It sort of depends. It is a complicated answer. But if it is a valuation question and it is an appraiser versus an appraiser, those tend to take longer. If it is a question of an interpretation of whether the easement was entered into for proper legal purposes, it is a more straightforward answer and those cases can be resolved more quickly.

Senator ALLARD. Okay. If you can get us some more specifics on that, I would appreciate it very much.

Mr. BROWN. We would be happy to.

[The information follows:]

The Service's engineering staff analyzed the sales of several Colorado properties encumbered with conservation easements to determine if commonalities exist among these properties. This analysis has been used as a guide in determining the accuracy of claimed valuations of the donated conservation easements.

The Service has also improved coordination between the Examination personnel and the Foresters and Engineering staff; as a result, revenue agents typically issue examination reports to taxpayers within two weeks from the date on which the agents receive the associated engineering valuation report. In addition, we have assigned some of our appraisers to work full-time on these cases. Where cases involve only a valuation issue, we are exploring all available administrative resolutions.

To better educate IRS personnel on the issues involved in conservation easements, we have implemented a web-based training module. We also continue to conduct workshops with field personnel and to provide technical guidance to those employees working conservation easement returns.

Senator ALLARD. Okay. Then I have been told by a constituent in Colorado that the IRS has been asking audited landowners for a second extension of the statute of appeals for their case. Can you confirm that?

Mr. BROWN. I am not aware.

Senator ALLARD. You will have to answer that question?

Mr. BROWN. We are going to have to answer that.

[The information follows:]

Our field personnel have requested statute extensions on 193 Colorado returns and second statute extensions on 45 of those returns. For the majority of returns for which we have sought only one extension, the statute of limitations will expire on April 15, 2008. Therefore, we expect to request second extensions for many of these returns. In addition, many returns require an extension while in Appeals or in the TEFRA Suspense Unit.

Requests to extend the statute—even a second time—are not unusual in valuation cases, because valuation issues often require more time to resolve than other issues.

Senator ALLARD. Okay, very good.

Well, that is pretty much—the final question: Do you have any expectations of when you might conclude those investigations that are going on in Colorado right now?

Mr. BROWN. As quickly as possible, and we will come back to you with a more detailed answer on that.

Senator ALLARD. I would appreciate that.

[The information follows:]

We do not have firm closure dates on any of the returns currently in process. Each property is unique and therefore we cannot merely apply positions taken in previous cases to subsequent cases without additional work. Rather, we must inspect, evaluate and consider each case on an individual basis, including conducting interviews with the donors and contacting third parties, as necessary. There are approximately 170 open cases that need appraisals of which 145 involve only a valuation issue. Of the 170 cases awaiting appraisals, we currently expect to complete appraisals for approximately 150 cases by March 2008 and the remaining 20 cases by August 2008.

INFORMATION SHARING WITH THE SSA

Senator ALLARD. Now, getting back, there was a question on identity theft by Senator Nelson from Nebraska. One of the problems I have run into is the sharing of information. Even though in the Homeland Security Department we tried to break down these stovepipes so there was some sharing of information, I have run across the situation, I have been informed that the Social Security Administration does not share their information with Homeland

Security. The question I have to you is that if there is fraud do they share that information with you, and do they communicate? Does the Social Security Administration communicate openly with the Internal Revenue Service on this?

Mr. BROWN. I am going to have to go back and get an answer. Social Security can share information with us. Going the other way, we have a prohibition in the Internal Revenue Code called section 6103 that prohibits us from sharing tax return information with other organizations without specified law enforcement purposes.

Senator ALLARD. I can understand that. But here is the problem that has been called to my attention by Secretary Chertoff and others, is that lots of times a taxpayer will not know that his ID has been stolen until a revenue officer knocks on his door maybe 3 or 4 months after his ID has been stolen—he did not know it—and he says, why are you not paying all of your taxes?

So I am trying to figure out why we cannot get an earlier notification to the taxpayer that there is some irregularity showing up on that ID using the Social Security number. Do you have any comment on that?

Mr. BROWN. Well, it does happen, there are some delays. Generally we wait for a return to be filed, and then if W–2s are coming in with the wrong Social Security number, indicating that you have got, for example, more income than just what your Senate salary is, we then have to unravel it. That generally involves contacting the taxpayer, having the taxpayer authenticate that he really is the proper owner of the Social Security number and somebody else is misusing it.

It generally is a process that takes several months to unravel. We need to do better at this.

Senator ALLARD. Now let us turn it around. If the Social Security happens to get, they have the same number come in and all of a sudden they find that there are two names on the same number, are they notifying you?

Mr. BROWN. We do receive information from Social Security on that.

Senator ALLARD. So that is getting shared with you, because I have been told that there might be some language in legislation somewhere that prevents that from happening.

Mr. BROWN. I am not aware of that, but we will get back to you.

Senator ALLARD. Research that.

Mr. BROWN. We will research that for you.

Senator ALLARD. Will you please, because if it is there I think that is a stovepipe we need to break down. I know there is this issue of identity and privacy, but if somebody has stolen your ID you have already lost your privacy and you do not want the victim to be victimized time and time and time again because of some provision here that prevents us from getting an early resolution on the victim and what has happened to the Social Security number.

Mr. BROWN. Yes, sir. We will get back to you on that.

[The information follows:]

We are not aware of any legislation that prohibits SSA from sharing information with IRS when they determine that the same SSN is being used by more than one individual. For example, the Combined Annual Wage Reporting System (CAWRS)

MOU between IRS and SSA states "SSA will convert the wage data to electronic format where necessary and furnish IRS with this data and validated SSNs and names where possible, or indicate which SSNs/names are not valid."

We generally find out that two taxpayers are using the same Social Security Number when a tax administration issue arises. Most of these cases are resolved in conjunction with the SSA through the Scrambled SSN process.

The Strategic Plan from the President's Task Force on Identity Theft briefly discusses the various laws that regulate the sharing of SSN information.

No single federal law regulates comprehensively the private sector or government use, display, or disclosure of SSNs; instead, there are a variety of laws governing SSN use in certain sectors or in specific situations.

In the public sector, the Privacy Act of 1974 requires federal agencies to provide notice to, and obtain consent from, individuals before disclosing their SSNs to third parties, except for an established routine use or pursuant to another Privacy Act exception[1]. A number of state statutes restrict the use and display of SSNs in certain contexts[2]. Even so, a report by the Government Accountability Office (GAO) concluded that, despite these laws, there were gaps in how the use and transfer of SSNs are regulated, and that these gaps create a risk that SSNs will be misused.[3]

PRIVATE DEBT COLLECTION

Senator ALLARD. Okay, thank you.

I guess my time is used up, Mr. Chairman.

Senator DURBIN. I would like to—there is one fact that I left out of this question or this conversation about private debt collection which is important. I think you have said, Mr. Brown, that the debts that are being collected by the private agencies are the easier ones; the more complicated debt collections are taking place within the Internal Revenue Service. Is that correct?

Mr. BROWN. Yes.

Senator DURBIN. And then the numbers you have given us are that it costs 42 cents to collect every $100 of tax revenue in these more complicated cases. Can you tell me how much the private debt collection companies charge the Federal Government on the easier cases for every $100 they collect?

Mr. BROWN. Well, the commissions to date have been running about 18 to 19 percent.

Senator DURBIN. So the comparison figures would be roughly 42 cents to $19 for every $100 collected?

Mr. BROWN. Well, again the comparisons are not pure. We have collection tools that they do not have available to them. They make outbound phone calls. Most of our calls are inbound. We get people's attention. We tell you we are about to levy on your bank account, you tend to call us. You tend to react. They do not have any powers other than the powers of persuasion by calling you and writing you letters.

Senator DURBIN. But you are suggesting then that that explains why they are charging 40 times as much as a person who works for you?

Mr. BROWN. Well, I think the premise of the program was that these were dollars we were not otherwise going to get to collect. We did not have sufficient resources to get to this slice of debt.

Senator DURBIN. I think we are back to the same circle. These are the easier dollars to collect, with employees you could collect them. You are contracting out and paying 40 times as much for

[1] 5 U.S.C. § 552a.

[2] See, e.g., Ariz. Rev. Stat. § 44–1373.

[3] *Social Security Numbers: Federal and State Laws Restrict Use of SSNs, Yet Gaps Remain*, GAO–05–1016T, September 15, 2005.

every dollar collected for the Treasury. So I just want to put it in that perspective because there was an image created of people who were at their desks not performing, where it turns out that the people who were at their desks are performing a lot better than the private collection agencies.

Mr. BROWN. Our employees do very well in terms of collecting money. I am not disputing that point. We think we are the finest in the world at collecting money.

PROTECTION OF PERSONAL INFORMATION

Senator DURBIN. Let me move to the issue of privacy, which Senator Allard has alluded to. Could you tell me about concerns that you might have over the protection of privacy information, personal information, of those who are dealing with the Internal Revenue Service?

Mr. BROWN. Yes. We are extraordinarily worried about this sort of thing. We have 52,000 employees that have laptop computers and we have a far-flung workforce that is out in the field every day attempting to collect taxes and undertaking audits of taxpayers. We have had a concerted effort and we have now managed to encrypt, fully encrypt, every laptop that is issued to an employee. There is no human element. If the laptop is lost, the information is now encrypted and cannot be accessed.

Senator DURBIN. If I am not mistaken, the inspector general has just issued an audit report. Can you tell us what you found about computers at the IRS?

Mr. GEORGE. Yes, Mr. Chairman. We issued this report last month, which found approximately 490 laptops and other personal devices were lost. We estimate those items contained approximately 2,800 personally identifiable information on taxpayers, and that is an estimate; that the procedures that were to be followed in terms of reporting the losses were not necessarily followed in many of the cases; and that this was again a statistical sampling, so we do not know the exact extent of the problem.

But the bottom line is it only takes one computer, laptop, BlackBerry, what have you, to truly cause disruption in someone's life.

Senator DURBIN. Mr. Brown, after you learned this what did you do?

Mr. BROWN. Well, this is what we did. We undertook this effort to encrypt every laptop and also to make sure that data exchanges with States and cities and that sort of thing were also secured properly.

ESTATE AND GIFT ATTORNEYS

Senator DURBIN. I would like to ask you a question if I might about, there was a disclosure recently. The administration announced its intention to eliminate the jobs of nearly one-half the lawyers at the IRS who audit tax returns for those subject to gift and estate taxes by October of last year. Did that happen?

Mr. BROWN. Actually what the IRS did was offer a buyout, and 86 estate and gift tax employees out of a workforce of several hundred did raise their hand and actually availed themselves of that buyout.

Senator DURBIN. The report we have is that these estate tax lawyers are responsible for overseeing audits of estate tax filings, which are the most productive and cost effective audits in the entire Internal Revenue Service system, generating approximately $2,200 for taxpayers in unpaid tax funds every hour that they go to work.

So how do you feel, or do you feel that the elimination of attorneys doing this audit work on estate taxes is going to help us narrow the tax gap and help us increase compliance?

Mr. BROWN. The average is about $2,200 per hour per audit. The median is about $200. Ten percent of the audits generate 90 percent of the work. Not every audit is a productive audit. The trick is to make sure we are working on that 10 percent and make sure we have very good coverage of those cases so that we garner the most dollars.

The idea is to take the 86 bodies and shift them to high income audits in other areas where we also tend to do very well in terms of dollars per hour.

Senator DURBIN. Better than $2,200 an hour?

Mr. BROWN. In some categories we do. Audits over $1 million, we tend to do as well.

Senator DURBIN. What is the signal? One time you tell us you want to make a felony out of willful failure and then the signal is we are going to have fewer auditors in certain divisions. What is the signal to those who are filing returns in those divisions?

Mr. BROWN. The signal is that we want to maximize the use of our resources and where 90 percent of your audits are not productive audits, we want to go to where we have places where we have what we call lower no-change rates.

Senator DURBIN. I think it is a mixed signal.

Mr. BROWN. I would have to disagree. I think that where only 10 percent of your audits are really counting, we want to go to a place where a much higher percentage is counting.

Senator DURBIN. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

Nina Olson, you have not answered any questions. I hate to see you get by with that.

ID THEFT AND TAXES

You have made in your comments that you wanted to maximize voluntary compliance. I look at your mission statement, which I think says a lot differently. And when you think about it, they mean a lot differently. Your mission statement that you have with the Internal Revenue Service says "Helping taxpayers to understand and meet the tax responsibilities by applying tax law with integrity in fairness to all."

This brings me around to, what happens to a victim when we have the identity theft and they are assessed this tax? Do you have them plugged into the computer and the computer keeps kicking out these notices that you owe the money, or is there some attempt to quickly resolve this problem that you have with the individual whose ID has been stolen? How is that handled?

Ms. OLSON. Well, first I would like to say my organization's mission is "Help taxpayers solve their problems with the IRS." So I have a sub-mission here.

Senator ALLARD. Okay.

Ms. OLSON. And many of our cases are, we have a fair number of identity theft cases. What generally happens is if someone else is using a Social Security number that belongs to the taxpayer, say on a W–2, that that W–2 will be processed through Social Security and eventually the IRS will get that information, and we will look to see whether those dollars show up on the true Social Security number owner's tax return. When we do not see those dollars there because the taxpayer did not earn them, they are not his or her dollars—somebody else did—we will send—we do not know that yet. We have to send that taxpayer a notice saying: You did not put dollars on that you should have; come in and talk to us.

The problem there is that we—until we do that notice, we will not know that there has been some act of identity theft. What then happens with the taxpayer unfortunately is sometimes they get caught in the IRS and IRS employees are not able to straighten out quickly who is the correct owner of the income of that Social Security number, and they are asked to supply lots of information.

Once we determine that this taxpayer owns that number, we still have to work with Social Security to make sure that, if it is even more confusing, that Social Security does not freeze that number and cause the taxpayer to use a temporary number. And we have no control over that.

In other instances—and I think this is something that——

Senator ALLARD. Can you communicate with Social Security?

Ms. OLSON. We do communicate with Social Security. On a case-by-case basis, IRS employees and Taxpayer Advocate Service employees communicate with Social Security on a case-by-case basis.

We have also been trying, the IRS Identity Theft Office has been trying to come up with a list of documents that either IRS will accept or that Social Security will accept, saying this taxpayer owns this number, or even giving us the authority to say, yes, we have looked at these documents, we think this is the taxpayer's own number, so we can move on.

Senator ALLARD. I would encourage you to move forward on that, because in 3 years and then all of a sudden to have somebody at your door. And then sometimes they spend lots of money just to get an accountant, to come back. And they do not work cheaply.

Ms. OLSON. Right.

Senator ALLARD. So it seems to me like somehow or the other it would be appropriate if we could give—if they have to hire professional help, for example, are they allowed to write that off as an expense or not?

Ms. OLSON. It would probably be for an individual a miscellaneous itemized deduction. I do not know how identity theft would come up in a business, but it could be a business expense.

RELIEF FROM ID THEFT EXPENSES

Senator ALLARD. That is what I am trying to figure out, if there is—maybe we need some legislation that would give those kind of individuals some relief.

Ms. OLSON. I think something that is very important that the IRS is working on is, once we know that somebody's number has been compromised we put an indicator on our accounts for future years, because often once the number is out there we are going to see W–2s coming——

Senator ALLARD. Yes, you are going to see more coming through.

Mr. GEORGE. Then we could at least, instead of sending an auditor out to that person or a letter out saying, you owe us money, saying we are seeing this happen again. I think we need legislative authority for that, to communicate in that way. But we can at least know internally that that taxpayer is not earning that money.

Senator ALLARD. I might have my staff work with you on that. That might be some common sense legislation that we can work on and maybe help those that are suffering from this crisis that occurs with identity theft if we can help them out.

I see my time just expired.

ELECTRONIC FRAUD DETECTION SYSTEM

Senator DURBIN. I would like to ask one last question. Mr. Brown, it appears that there was some lapse in terms of the systems that were being used, the electronic systems being used, and according to the inspector general $318 million in fraudulent refunds were issued in May of last year. Could you tell us what you are doing to recover that money?

Mr. BROWN. Well, we are not going to be able to recover the majority of that money. What you are referring to is the electronic fraud detection system that stops fraudulent refunds, what we deem fraudulent refunds, from going out. And once the money is out, it is extremely difficult to recover.

That system did not come up. We had a mistake there that should not have occurred and we have taken action both with the contractor and with our employees to make sure that does not happen again. The system did come up on schedule this year and it is functioning properly this year.

Senator DURBIN. But no effort was made to recover the money?

Mr. BROWN. There has been some effort, but it is extremely difficult to recover the money once it is gone.

Senator DURBIN. There was also the hiring of some consultants, as I understand it, to—perhaps the inspector general can comment on this. Are you familiar with it?

Mr. GEORGE. Not about the hiring of consultants, except for MITRE Corp., to look at what occurred in the past and to look at what they were attempting to do to remedy the situation.

But Mr. Chairman, this is symptomatic of a problem that has historically troubled the IRS. Most of their purchases and efforts to modernize their systems have been behind schedule, have cost more than were contracted for, and have failed to deliver what was promised. This, the EFDS, as they call it, electronic fraud detection system, was certainly an example of that.

Senator DURBIN. Mr. Powner, you have not had a chance to speak and I think this is your area of expertise. What would you say?

Mr. POWNER. Well, if you look at the EFDS system and what happened with that, it was a little bit different. We oversee the

business system modernization program for this committee and if you look at how this business systems modernizations are overseen from a project management and governance perspective, there is a lot of oversight that occurs. EFDS was actually flying under the oversight radar screen, so executives were not engaged on this system.

A couple things happened incorrectly. One is the system did not work when they deployed it, but you could not reactivate the legacy system. That is also a basic 101 misstep when you are deploying a new system. So there are several missteps that occurred here, not only with deploying the new one, but they could not reactivate the old system.

TECHNOLOGY IMPROVEMENTS AT THE IRS

Senator DURBIN. So step back from this particular case and tell me what your general impression is of the technology improvements at IRS?

Mr. POWNER. Well, in terms of the business systems modernization, that is an area where IRS has improved significantly over the years. Now, are there still concerns there? Yes, absolutely. If you look at the latest release of the CADE, which is really the linchpin for the modernization, we were late, the IRS was late on that, and there are cost overruns and schedule slippages that are still ongoing.

If you compare that historically, though, they have improved dramatically over the years. Now, are we still concerned going forward? Yes, we are concerned because there still is not the basic internal management capacity to manage the modernization effort that you would like to see, and the complexity is only going to increase over time.

Senator DURBIN. Mr. Brown, would you like to have the last word on that?

Mr. BROWN. I think the assessment is accurate. We have done a much better job over the years, but we have occasional slip-ups. This was one where we did not exercise proper management.

Senator DURBIN. Well, thank you for your testimony and your candor on that.

Do you have another question?

COLLECTION NOTICES FOR DELINQUENT DEBT OF $100 OR LESS

Senator ALLARD. Yes, Mr. Chairman, I have just one issue I would like to follow up on. This is the amount of collections where you send out notices where the amount owed is $100 or less. I think we sent you a request on this earlier and you said that was impossible to determine. Well, do you not have a computer that is capable of sorting out due amounts of $100 and less? Can you get us a total number on that?

Mr. BROWN. Yes. It is roughly 5.2 million notices were sent out last year for less than $100.

Senator ALLARD. 5.2 million, okay. Then what do you do with the $100 or less? Do you—these get turned over to collectors? Is that what they do? You send out a notice, I am assuming you send out a notice, and then how many respond on those?

Mr. BROWN. I do not have the precise numbers. We are not able to tell you how many dollars come in, but the vast majority. And remember, it is not——

Senator ALLARD. Most of them respond?

Mr. BROWN. Most, the vast majority respond. If they do not respond, if they are getting a refund in the following year, we would offset the refund. There are other ways to get the money.

Senator ALLARD. I see. Okay. Well, here is one of the things that I have had explained as a frustration. I have had taxpayers say, well, we—they claimed we owed a certain amount, it was under $100, it was $50 or $75, and to go to our accountant and have him hassle with the IRS just costs us money or it costs us to deal with it, so we are just going to pay it.

So there is, somehow or the other there is a balance there. I am trying to figure out where you feel that balance is.

Mr. BROWN. Many of the notices are generated by things like math errors. You simply added up the columns incorrectly. You added it, it came to $600 of income and the math actually should be $800 of income, and therefore you owe us another $50. So they are relatively straightforward things and most taxpayers I think see that and just comply.

Senator ALLARD. The more of them that use these computer programs, I would think math errors are less.

Mr. BROWN. We are very much in favor of those automated programs.

Senator ALLARD. Turbotax is not too difficult to use.

Mr. BROWN. They take the error rate down to——

Senator ALLARD. Maybe you need Turbotax, Mr. Chairman.

But those type of programs, yes.

Well, I am interested in knowing some statistics about how many you send out and how many respond on the first notice and what percent then—of those that are left, what happens to that after that.

Mr. BROWN. We will get you those, sir.

Senator ALLARD. Very good.

Mr. Chairman, thank you.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. Thank you very much, Senator Allard.

Thanks to all the members of the panel. The record will be open for a week. There may be some questions submitted to you. I appreciate your testimony.

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

QUESTIONS SUBMITTED TO KEVIN BROWN

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

TAXPAYER ASSISTANCE BLUEPRINT

Question. Improving taxpayer service is an important part of a comprehensive strategy to reduce the "tax gap" by helping taxpayers understand and meet their tax obligations.

On April 11, 2007, the Taxpayer Assistance Blueprint, Phase 2 was published. This Blueprint is the joint response of the IRS, the IRS Oversight Board and the

National Taxpayer Advocate to comply with a Congressional mandate for the development of a five-year strategic plan for the delivery of taxpayer service.

The Senate Report that established the five-year strategic plan directive for taxpayer service delivery provides detailed requirements for the content of the plan, including a strong urging that the IRS use innovative approaches to taxpayer services including mobile units and virtual technology.

Does the Blueprint include proposals for activities such as these?

Answer. The Taxpayer Assistance Blueprint (TAB) recommendations are grounded in extensive research regarding taxpayer needs, preferences, and behaviors. Factors that influence taxpayer's choice of service delivery channels include: the specific type of service sought, demographic characteristics, awareness of channels, access to channels, habit, and channel performance. TAB research indicates that taxpayers generally prefer self-assisted services, such as those found on the IRS website, most often for transactional tasks like obtaining a form or making a refund inquiry. Taxpayers prefer assisted services, such as those available through telephones or Taxpayer Assistance Centers, most often for more complex interactive tasks, like responding to a notice. Telephone lines and the IRS website account for approximately 85 percent of all channel contacts for the common service tasks surveyed. Investments that respond to this differentiated service approach in the two primary delivery channels will increase both taxpayer defined preference and value, and government value with efficiency gains. In contrast, the IRS Oversight Board 2006 Taxpayer Attitude Survey indicated that in response to the question "how likely would you be to use each of the following services for help with a tax issue?" 24 percent of taxpayers indicated that it was "very likely" that they would use a tax assistance van, compared to 58 percent for toll free telephone services and 51 percent for the web channels.

In view of this research, the TAB Strategic Plan focuses on enhancing the IRS website so it becomes the first choice of more taxpayers, while improving telephone service performance, increasing assistance to external partners (the source of the majority of prefiling and filing services), enhancing outreach and education to targeted populations, and improving the marketing of channel alternatives—specifically the electronic channel.

As noted below, virtual technology will play an increasingly important role in service delivery. The TAB envisions continued research on taxpayer expectations for and interest in virtual service delivery channels such as Voice over Internet Protocol and Text Messaging. Also, in recognition of the unique challenges presented by the face-to-face service environment, the TAB Strategic Plan recommends development of a Facilitated Self-assistance Model to provide taxpayers coming to a Taxpayer Assistance Center (TAC) the option of using self-assistance workstations to resolve their tax issues. The TAB Strategic Plan also calls for a TAC Geographic Footprint Initiative that includes a detailed process to analyze existing TAC locations for effectiveness in meeting service demands and using the process to make future investment decisions, including the relative value of mobile units or other alternative service delivery options.

Question. Please share some examples of innovative approaches the IRS is currently using or developing to meet taxpayer service needs.

Answer. The IRS has developed an effective business model for alternate service delivery to individuals challenged by income, language, age, or disability to meet their Federal tax obligations. The Stakeholder Partnerships, Education and Communication (SPEC) function supports over 300 community-based coalitions and thousands of local partnerships to extend outreach and assistance services. As a measure of this model's success, the United Way of America recently announced they were investing $1.5 billion over five years in this partner-based initiative. Virtual technology will play an increasingly important role in service delivery. TAB included a prospective virtual technology application, interactive web services, in its conjoint or "trade off" research. The Taxpayer Services Program Management Office, the function tasked with facilitating the implementation of TAB recommendations, will continue research on taxpayer expectations for and interest in virtual service delivery channels such as Voice over Internet Protocol and Text Messaging. In addition, TAB recommends enhanced alternate service delivery capabilities through increased support to its extensive community-based partner network and exploration of greater Federal Agency partnering and coordination to create shared service infrastructure.

DELIVERY OF INTERACTIVE TAXPAYER ASSISTANCE

Question. As an element of the Taxpayer Assistance Blueprint, the IRS recommended a migration strategy to move taxpayers away from Taxpayer Assistance

Centers (TACs) and toward electronic, self-assisted services. I understand the IRS plans to implement these Facilitated Self-Assistance Models in 15 selected sites, including two locations in my home State of Illinois. Under the model, taxpayers who come to the TACs for in-person help will be directed to in-house telephones and computers where they can access both the IRS website and phone assistors.

The National Taxpayer Advocate's Report to Congress for 2006 provides some data drawn from the IRS Oversight Board's 2006 Service Channel Survey. I think it elucidates the concern that migrating away from Taxpayer Assistance Centers (TACs) may be problematic. It states:

"Nearly 25 percent of taxpayers do not have Internet access, with more than twice as many taxpayers over 60 not having Internet access as those 60 or younger. Approximately 75 percent stated they were not secure sharing personal information via the Internet. Among taxpayers who have used IRS services in the last two years, about 45 percent of those who called IRS and more than 75 percent of those who visited the IRS stated that they would not use the IRS website."

How do you respond to concerns that migrating to self-assisted center may be laying the groundwork for an expanded effort to move persons away from face-to-face interactive contact and toward telephone and Internet access?

Answer. The Taxpayer Assistance Blueprint (TAB) recommendations are grounded in extensive research regarding taxpayer needs, preferences, and behaviors. TAB research indicates that taxpayers generally prefer self-assisted services, such as those found on the IRS Web site, most often for transactional tasks like obtaining a form or making a refund inquiry. Taxpayers prefer assisted services, such as those available through telephones or Taxpayer Assistance Centers (TACs), most often for complex interactive tasks like responding to a notice. Telephone lines and the IRS website account for approximately 85 percent of all channel contacts for the common service tasks surveyed. The TAB recommendation is to differentiate transactional and interactive service tasks within the TAC and satisfy them with effective, but different resources.

Question. Wouldn't a plan to scale back the number of TACs or replace them with self-help centers be an unwise cutback in customer service and a step backwards in achieving the goal of increasing compliance and shrinking the tax gap?

Answer. Rather than "self-help" centers, TACs would become portals where skilled and expensive staff resources would be applied to complex service issues and transactional tasks would be satisfied by effective, but less costly, web or phone applications. This differentiated approach conforms to growing private and public sector practices, responds to taxpayer defined value, addresses service performance in areas such as wait and service times and first contact issue resolution, increases service efficiencies, and has a potential positive impact on compliance.

The IRS plans to implement a limited deployment of the Facilitated Self-assistance Model at 15 locations in 2007 that will allow us to assess the effectiveness of this service delivery model. Adequate staffing, space, and technological infrastructure were considered in selecting these initial 15 locations. Demographic and geographic diversity were also analyzed to ensure adequate sampling for research and data gathering.

PRIVATE DEBT COLLECTION

Question. Is the private tax debt collection initiative generating greater returns at a lower total cost than the alternative of providing the IRS the additional resources it would need to collect the same tax debt on its own?

Answer. Overall, the IRS's Return on Investment (ROI) is about 4 to 1. ROI resulting from IRS enforcement programs ranges from $3 to $14 for every additional $1 invested, depending on the type of enforcement activity. For example, labor-intensive activities such as the Collection Field Function have lower ROIs, and automated activities such as Automated Underreporter have high ROIs.

We are performing a cost effectiveness study as recommended by GAO and in cooperation with the Taxpayer Advocate Service (TAS) in order to evaluate the program's impact on the collection of delinquent taxes and to serve as a comparison for program alternatives. We will issue the report from this study to GAO in August 2008. We project that the Private Debt Collection (PDC) ROI will range from 3.2:1 to 3.6:1 in fiscal year 2007 and from 4.0:1 to 4.3:1 in fiscal year 2008.

Question. If the initiative were eliminated, what steps could the IRS take to collect the tax debt that the private collection agencies were pursuing under their contracts and would sufficient resources be available to allow the IRS to take any (or all) of these steps?

Answer. If the program were eliminated, the IRS would continue to apply available resources to the highest priority work. Since these cases have already been through lower cost methods of collections at the IRS, they would remain unworked. The IRS would need a significant influx of resources over a number of years to be able to work enough inventory to get to these lower priority cases currently eligible for PCA placement. The President's Fiscal Year 2008 Budget request does not include funds to hire IRS workers to replace Private Collection Agency (PCA) employees should the Congress eliminate the program.

Question. What is the cost to the IRS of managing the initiative and processing cases that the private collection agencies cannot handle?

Answer. The projected fiscal year 2008 cost for administration of the PDC program is $7.35 million. We project that PDC will breakeven in April of 2008, including all start up costs. Of the $7.35 million, $5.84 million is for managing the initiative and consists of costs for the Referral Unit, Oversight Unit, Project Office, and Project Office contractors. The remaining $1.51 million is for IT costs.

The PCAs are not assigned cases that meet criteria outside of their authority. These cases have already been through lower cost methods of collections at the IRS, and would remain unworked and uncollected if not assigned to the PCAs. However, there may be instances where the taxpayers make a decision about their account that causes the return of the case to the IRS (e.g., Offer in Compromise, Innocent Spouse status, Insolvency, Disaster relief) and the IRS works on a case originally assigned to a PCA. In these instances, the returned PCA cases are processed according to IRM procedures in the appropriate function of the IRS. There are other situations where the IRS Referral Unit (RU) must work an account because the taxpayer opted out of working with the PCA or entered into an installment agreement that was beyond the PCA's authority to monitor. As of the end of April 2007, 37,689 cases were assigned to the PCAs and approximately 220 (0.6 percent) requested to opt out of the program or entered into an installment agreement beyond PCA authority. Given the small number of these requests, no additional costs are required beyond what has already been budgeted for the RU.

ELECTRONIC FILING

Question. Section 2001 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law105–206), specifies that it is the policy of Congress that paperless filing should be the preferred and most convenient means of filing Federal tax and information returns, it should be the goal of the Internal Revenue Service to have at least 80 percent of all such returns filed electronically by the year 2007, and the Internal Revenue Service should cooperate with and encourage the private sector by encouraging competition to increase electronic filing of such returns.

It is now 2007. What are the experiences with e-filing?

Answer. Based on the July 2006 results of our market research study called Findings From the 2006 Taxpayer Satisfaction Study for 1040 e-file conducted by Russell Research:

—Practitioner e-file is the term used for taxpayers who e-file their tax returns electronically through an IRS-authorized Electronic Return Originator. Online filing is the term used for taxpayers who e-file their returns online via their home computers either by using an online company or with software through a third party transmitter. Practitioner e-file and Online filing with software are maintaining high levels of satisfaction (82 percent and 83 percent respectively), but online filing with an online company is trending downward (from 83 percent to 74 percent).

—Three of the products (Practitioner e-file, online filing with an online company, online filing with software) continue to have a high number of user suggested improvements (simplify it and lower the costs).

—Non-user interest in practitioner e-file, the online filing products and Free File showed little year-to-year change, but long-term trend data indicates a hardening of non-user resistance to products and suggests that future usage gains may come in small increments.

—Non-users who were most resistant to adoption had generally negative impressions of the products in terms of their being better than other filing methods, being private and secure, being easy to use and being accurate.

—A gap analysis of attitudes toward e-file in general continues to show that lack of belief in e-file is clearly playing a role in its non-adoption among non-triers and even lapsed users. These segments do not accept e-file's benefits of accuracy, privacy/security or ease of use, and these are the attributes of a tax filing method that they value most.

—Another persistent barrier to the adoption of e-file is that not all practitioners offer or advocate the use of e-file at the same rate.

The Free File program is a free federal tax preparation and electronic filing program for eligible taxpayers developed through a partnership between the Internal Revenue Service and the Free File Alliance LLC—a group of private sector tax software companies. Free File is an online option available through the irs.gov website. Based on the July 2006 results of our Free File research study called Report of Findings From the 2006 Free File Cognitive and Behavioral Research conducted by Russell Research:

—Overall, users seem satisfied with Free File, with high intent to re-use (94 percent) and recommend (97 percent), high ratings of overall ease of use (94 percent) and low suggested improvements (30 percent).

—Free File's convenience appeals to them most with cost being the secondary driver.

—Other Free File program diagnostics results tell us that the site is generally easy to navigate (96 percent), that users have confidence in the security of their tax information (96 percent), and that it's easy to select a company at the site (94 percent) with high intent to use the same company next year (91 percent).

Question. What percentage of taxpayers in this filing season are submitting returns electronically?

Answer. Per IRS's Research, Analysis, and Statistics (RAS) Weekly Tracking Report for individual income tax returns for the week ending May 4, 2007, of the 127.3 million total individual returns filed, electronic filing (e-file) represented 76.7 million returns (60 percent) and paper represented 50.6 million returns (40 percent). Of the 76.7 million electronically filed returns, 54.7 million (71 percent) were e-filed by practitioners and 22.0 million (29 percent) were e-filed online. Of the approximately 95 million taxpayers who are eligible to use the Free File program in the 2007 filing season, 3.8 million actually used it. Numerous studies show taxpayers select a tax preparation "channel" (e.g. self-prepared, paid prepared, etc.) based on personal preferences and won't change. The current e-file rate of 60 percent is 3 percentage points higher than last year, at this point in time. The relative proportion of e-file returns is expected to drop to 58 percent by the end of the year as more returns with extensions are filed on paper.

Question. What efforts can be taken to increase the level of electronic filing?

Answer. The IRS's e-Strategy for Growth outlines plans to reduce taxpayer burden and continuously grow the e-file program. Key strategies include:

—Make electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer them to calling and mailing.

—Substantially increase taxpayer access to electronic filing, payment, and communication products and services.

—Aggressively protect transaction integrity and internal processing accuracy.

—Deliver the highest quality products and services as promised.

—Partner with states and other governmental entities to maximize opportunities to reduce burden for our common-customer base.

—Encourage private-sector innovation and competition.

Question. What are the impediments that have hindered attaining the goal set nine years ago?

Answer. In their 2005 annual report to Congress, the Electronic Tax Administration Advisory Committee has identified three major barriers to increasing electronic filing:

—Electronic filing must be faster, easier, and more accurate than paper filing and the initial experience must be positive.

—Electronic payments must be faster, easier, and more foolproof than paying by paper check and the first experience needs to be positive.

—Electronic services offered by the IRS must be faster, easier, and more efficient than paper, telephone or fax-based communications.

MANDATORY E-FILING BY CHARITABLE ORGANIZATIONS

Question. The IRS recently implemented measures requiring that certain tax-exempt organizations electronically file their annual returns, and many nonprofits recommend amending federal laws to require mandatory e-filing of all charitable organizations that annually file with the IRS. In particular, the Panel on the Nonprofit Sector, an independent group of nonprofit leaders convened at the encouragement of the Senate Finance Committee to make recommendations to Congress, recommended that tax laws be amended to enable the IRS to move forward with mandatory e-filing for all charitable organizations and that funding be authorized to support implementation of the initiative, and encourage more complete filings by

nonprofits and better oversight by the IRS. Organizations now required to file their returns electronically have needed to adjust from attaching documents to their returns to completing sections on the electronic returns.

What challenges has the IRS experienced in implementing e-filing, particularly from organizations accustomed to attaching documents to their returns?

What would the IRS need to do to implement broader e-filing requirements?

Would the funding levels proposed by the President for fiscal year 2008 permit the IRS to adequately serve groups now required to e-file and to move toward more extensive e-filing if approved by Congress?

Answer. The IRS worked closely with stakeholders and filers to communicate the business rules with regard to attachments in advance of the implementation of e-filing. Recognizing that our filer community often chooses to include "unrequested" information about their organization and program services, we worked with the software development community to ensure the creation of "General Explanation" pages that allow filers to include additional information that they believe is important. Moreover, the IRS has broadened the kinds of items that can be attached to e-filed returns to include such things as revised Organizing Documents and Articles of Dissolution.

The primary limitation on proposing a broader e-filing mandate is statutory. Section 6011(e) of the tax code provides that IRS can require e-filing only if the taxpayer is required to file at least 250 returns during the year. (This mandated threshold is for charitable organizations. Corporate taxpayers and partnership taxpayers have a different mandate.) The budget contains a proposal that all corporations and partnerships required to file Schedule M–3 would be required to file their income tax returns electronically. In the case of large taxpayers not required to file Schedule M–3 (such as exempt organizations), the Budget contains a provision to expand the regulatory authority to require electronic filing beyond the current 250-return minimum. That provision would reduce the legal barriers (the 250-return rule) that prevent enhanced e-filing.

The President's fiscal year 2008 budget request provides adequate funding for the IRS to serve groups now required to e-file. In addition, the budget requests funding for developing and deploying the capability for the modernized electronic filing application to accept and process a subset of the 1040 family of forms. The funding would also allow a significant advancement toward establishing the capability to accept and process all 1040-related forms in multiple phases as the IRS works to retire the legacy e-file system. The IRS's modernized electronic filing application has been designed and built to be scalable for additional volumes resulting from increased e-filings due to new and/or changed mandatory thresholds.

BUSINESS SYSTEMS MODERNIZATION

Question. During fiscal year 2006, the IRS developed a new IT Modernization Vision and Strategy for the Business Systems Modernization (BSM) program along with a 5-year plan to guide IT investment decisions through 2011. While this presents a positive first step towards defining the agency's future plans for the modernization program, it does not fully address GAO's recommendation to develop a long-term vision and strategy for completing BSM.

When does IRS anticipate completing this strategy, including establishing time frames for consolidating and retiring legacy systems?

Answer. Building a credible and comprehensive long-term vision and strategy to modernize the information technology of the largest and most complex tax administration system in the world is an iterative process that we are developing, institutionalizing and maturing over time in lockstep with our business partners. Our goals as part of our Modernization Vision & Strategy (MV&S) effort are to provide the vision, creativity, and a repeatable process to rationalize our investments in a way that we are now aligning with OMB's recommendations for Segment Architecture (Domain Architecture). In fiscal year 2005, our first year of this effort, we accomplished many foundational activities, and selected an integrated set of IT investments using sound investment processes across the primary tax administration domains (submission processing, manage taxpayers accounts, customer service, reporting compliance, filing and payment compliance, and criminal investigation).

During this past year, fiscal year 2006, the IRS improved and built additional capabilities to institutionalize the MV&S investment processes. We applied lessons learned to improve our development of technical solution concepts, added additional layers of functional and technical integration and sharpened our cost-estimation processes. In addition to covering the domains of tax administration, we added in a domain for IT security as well as a domain to cover our Internal Management Systems (to include our financial, human resource, and asset management applica-

tions). In parallel, we have been maturing our IT governance structure, and we have brought our governance committees into the MV&S process to oversee and approve the strategies, project proposals and prioritize at the domain level.

This year we are expanding the depth and breadth of our MV&S processes. A new functional area domain is being added to cover the provision of IT infrastructure products and services. In addition, we plan to complete a comprehensive architecture and strategy for one of the primary tax administration domains. This process will entail a comprehensive analysis of current processes and systems, target processes and systems over the next five years, transition strategies to achieve the targets and performance measures to be achieved. This initiative will address plans for consolidating and retiring legacy systems within that domain which you asked about in your question above. We then plan to complete the comprehensive architecture work for the remaining domains during fiscal year 2008.

It takes time and is very challenging to develop, communicate, and achieve organizational commitment to a vision and strategy for modernization that (1) addresses consolidation, transformation and retirement of hundreds of interrelated legacy systems; (2) incorporates modernized capabilities from new systems; and, (3) allows IRS to continue to provide systems for end-to-end tax administration that incorporate each years' new tax laws and policy. Previously the IRS has focused its IT modernization plans on dealing with the replacement of just key systems (e.g., CADE replacing the master files, the implementation of modernized e-file to both replace the legacy e-file system and handle additional forms types). The MV&S is about building the proper modernization plan for all of the IRS's IT, dealing with the more than 450 systems that support tax administration. The long-term goal is not to replace most of these systems, but, through concepts such as service-oriented architecture (SOA), to transform and streamline our IT environment over time while still being able to address new business needs that are identified through the MV&S process. Doing this right entails changes in a management paradigm that requires significant involvement from hundreds of people across the organization, entails embracing architectural and engineering concepts that have never been introduced in the past, and given the complexities, entails the use of an incremental approach. In addition, we must build and institutionalize capabilities within the IRS to make sound investment choices along the way so we can use our resources prudently. The good news is that the first two years of embarking on this effort have forged a much better working relationship between the business units of the IRS and MITS.

Even as we formalize and drive these plans ever deeper across the domains, one must realize that the plans must also be flexible to support significant change. Business requirements, tax laws and tax administration policy can change radically over time. One example would be in submissions processing and, in particular, e-file. We have a roadmap for implementing Modernized e-file (MeF) that has the IRS implementing MeF for all major form types by 2014. However, if the IRS is directed to implement a direct-file option for individual filers, it will significantly change the implementation approach and direction for MeF. Whether direct filing with the IRS should be done is a policy issue, but a decision such as that would have major impacts on our modernization strategy.

Lastly, your question addresses timeframes for consolidating and retiring legacy systems. These comprehensive architecture and strategies that we are developing for each domain will address timing.

I understand that the latest release of the Customer Account Data Engine (CADE), the system that is intended to replace the antiquated Master File processing system, was put into production in March, about two months later than planned.

Question. What was the impact of the delay on 2007 filing season processing?

Answer. Prior to CADE's deployment, we executed what is known as our Technical Backout Plan in which we automatically routed and timely processed tax returns for CADE-eligible accounts in the legacy master-file cycle. Since CADE is not a customer facing system, this recovery maneuver is not evident to the taxpayer, so this action does not increase processing time and the taxpayer received the same service this year that they have received in past years under the legacy master-file cycle. That said, unfortunately, there were approximately 20 million CADE-eligible taxpayers this year who could have received their refunds a few days earlier based on CADE-reduced cycle times had CADE been in production at the time they submitted their returns. There are no other effects to the taxpayer.

Question. What, if any, impact has the delayed release had on the planned functionality of CADE and on future releases of CADE?

Answer. The delay in delivering CADE Release 2.2 is having an effect on Release 3. While we have not completely finalized the changes in scope for the two sub-releases in Release 3, we are scaling back some of the functionality.

The priorities for Release 3 will be to maintain the functionality to enable the capabilities to be delivered in conjunction with Account Management Services (AMS), update CADE with any necessary filing season changes, address some technical upgrades and design issues that have been uncovered as we have run CADE in operation, and add functionality that will enable CADE to process additional tax returns (in particular, we will be adding capabilities for CADE to process returns with Math Errors and Disaster Area Designations).

While there will undoubtedly be less functionality increase in CADE Release 3 than originally planned, we believe that these steps we are taking to address the issues on CADE performance will enable us to "catch up" over the next few years, so we do not anticipate changing our planned retirement date of the individual master file in 2012.

Question. How does this year's delay, and possible delays in future releases of CADE affect other systems, including the Accounts Management System?

Answer. Based on our Technical Backout capability in CADE, this year's delay did not have any effect on other systems.

As your question notes, possible delays in future releases of CADE can affect other systems, most notably Account Management Services (AMS). We view maintaining alignment between the CADE and AMS programs a central challenge and source of risk for the BSM Program going forward. Development of these two major modernization initiatives requires a level of coordination and cooperative execution that is higher than the IRS has required so far in our modernization efforts. We recognized this challenge in our initial planning for the AMS program and have taken a number of steps to put in place the organizational structure, resources and approaches needed to assure that CADE and AMS are successfully delivered as a coherent set of capabilities.

For the Release 3 sub-releases of CADE (those that will be released in calendar year 2007), we have taken steps to ensure that functionality in CADE required for proper functioning of AMS is of high priority and will be delivered in those sub-releases. In particular, CADE is slated to deliver functionality that will support online address change in Releases 3.1 and functionality to support basic notices generation in Release 3.2. We do not anticipate any significant issues in delivering this functionality as part of these releases.

IRS WORKFORCE

Question. According to IRS data, while the number of employees at the IRS has decreased by almost 20,000 since 1995, the number of managers who supervise these employees has increased over this same period. During the period between 2000 and 2005, the number of frontline bargaining unit employees, decreased by 4,756, a decrease of 5.1 percent. During that same time, the number of managers and management officials increased from 12,514 to 12,684, an increase of 170.

Why does the IRS need more managers today than it needed six years ago when it now has 4,700 fewer front-line employees?

How many enforcement dollars and impact could 170 managers generate if they were assigned inventories?

Has the IRS considered returning any managers to front-line work?

Answer. A review of IRS staffing for January of each year shows that while there was an increase in the number of managers and management officials between 2001 and 2002, since 2002 the number of employees in this category has steadily decreased. An updated snapshot of the IRS staffing shows a 5.4 percent decrease in the number of managers/management officials from January 2001 to January 2006. The current alignment of managers and employees has provided the appropriate focus to allow for increased enforcement revenues of nearly 40 percent from $33.8 billion in 2001 to $47.3 billion in 2005. Audits of high-income taxpayers—those earning $100,000 or more—topped 221,000 in fiscal year 2005, the highest number in the past 10 years. Total audits of all taxpayers topped 1.2 million last year—a 20 percent jump from the prior year.

NARROWING THE "TAX GAP" AND MISCLASSIFICATION

Question. I am concerned about the misclassification of workers in certain industries as independent contractors. Many of these workers should be correctly classified as employees and income reported on W–2 forms, not 1099 forms. This misclassification leads to the underreporting of self-employment taxes, which the IRS estimates accounts for $148 billion per year and 43 percent of the gross tax gap. Last year, the Senate Appropriations Committee, in S. Rept. 109–293, strongly urged the IRS to provide increased tax enforcement in industries where misclassification of employees is widespread. In 1984, the IRS reported that at least

15 percent of employers misclassified about 3.4 million workers as independent contractors with higher rates in several industries including construction.

Is it your sense that the practice of misclassifying workers as independent contractors has increased since then?

Answer. While we have not conducted a recent study, the Government Accountability Office (GAO) looked at this issue in its 2006 report, GAO–06–656, entitled, Employment Arrangements—Improved Outreach Could Help Ensure Proper Worker Classification. In this report, the GAO stated the number of independent contractors increased from 6.7 percent to 7.4 percent of the workforce from 1995 to 2005, and the number of independent contractors in the contingent workforce population rose from 8.3 to 10.3 million. The report also states that many workers are misclassified as independent contractors; however, no updated data was provided. Additionally, we have seen an increase in misclassification through our examination process and increased filings of Form SS–8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. If the taxpayer accurately reports income received, whether as employee or an independent contractor, there is little consequence for the Social Security trust funds. The tax rates on wages and salaries, on the one hand, and self-employment income, on the other hand, are virtually identical. For self-employment taxes, however, work-related expenses incurred by the worker are deductible whereas similar expenses are not deductible by an employee.

Question. Has the IRS prepared an updated estimate?

Answer. We have not prepared an updated estimate. We are in the process of considering the possibility of undertaking the necessary research.

Question. What enforcement resources are being devoted now or are planned in fiscal year 2008 to address this issue?

Answer. The IRS office with primary responsibility for employment tax noncompliance devoted 9 percent of its fiscal year 2007 workplan to worker misclassification and plans to increase examinations of misclassification issues to 34 percent of its overall audit plan in fiscal year 2008.

Question. You have described the 16 legislative proposals and 4 administrative proposals for closing the tax gap. Is this issue a component of those? If not, why not?

Answer. This issue was not included in these 16 legislative proposals or the 4 administrative proposals. However, the Administration's fiscal year 2007 revenue proposals did address the issue. In addition to 5 tax gap proposals, it provided for the Treasury Department to study the standards used to distinguish between employees and independent contractors for purposes of withholding and paying Federal employment taxes.

Question. Where does addressing this problem fit within your strategy for narrowing the tax gap?

Answer. In conjunction with the Treasury Department's tax gap strategy issued in September 2006, the IRS is developing a comprehensive strategy to address employment tax issues. This strategy will include the issue of misclassification of workers as independent contractors. However, the prohibition on general guidance on classification issues contained in section 530 of the Revenue Act of 1978 limits the Treasury's ability to provide guidance in this area.

SAFE HARBOR AND MISCLASSIFICATION

Question. Under Section 530 of the Revenue Act of 1978, the "safe harbor" provision, employers who "reasonably" misclassify their workers as independent contractors are protected against any liability for employment tax purposes. This includes any employer who can show that more than 25 percent of his industry classifies workers as independent contractors.

I understand that once an employer is covered by the safe harbor provision, the IRS cannot pursue the employer for unpaid employment taxes even in the future as long as the situation has not changed in their industry, even if they are actually misclassifying.

What is the impact of the "safe harbor provision" including the number of employers who qualify, the particular industries, the number of workers that represents, and the loss of revenue to the Federal treasury in the form of past and future liability?

Answer. While we are unable to quantify the exact impact of the "safe harbor provision," we know that employers that claim safe harbor provisions of Section 530 represent a subset of all worker misclassification. Section 530 applies not only to past years but also future years as long as the taxpayer continues to report the income to the workers as required and treat the workers consistently as independent

contractors. Increasing noncompliance in an industry has the effect of increasing the possibility that most taxpayers in the industry will qualify for the safe harbor provision. GAO conducted the last study in this area in 1989. In this study they reviewed a sample of IRS worker reclassification examinations and determined that 40 percent of the tax could not be assessed due to the safe harbor provision.

RECRUITMENT AND RETENTION: STUDENT LOAN REPAYMENT

Question. One of the biggest challenges facing Federal agencies is attracting and retaining well-qualified, high-performing employees. Student loan repayments are a valuable management tool to help agencies recruit highly qualified candidates into Federal service and keep talented employees in the Federal workforce.

Federal law (5 U.S.C. § 5379) provides agencies with discretion to establish and tailor a student loan repayment programs. Recently, OPM issued its annual report on the use of the tool across the Federal government last year. With each passing year, the use of this program continues to grow dramatically.

In fiscal year 2006, 34 Federal agencies provided 5,755 employees with a total of nearly $36 million in student loan repayment benefits. This represents a 31 percent increase over fiscal year 2005 in the number of employees receiving student loan repayment benefits and a 28 percent increase in agencies' overall financial investment in this valuable incentive. When compared to fiscal year 2002, agencies invested more than 11 times as much funding on student loan repayments in fiscal year 2006.

How many IRS employees are currently benefiting from the student loan repayment program?

What portion of the IRS' fiscal year 2008 budget proposal would be devoted to initiatives such as those suggested by Columbia Law School Dean David Schizer in his op-ed published in the New York Times on April 16, 2007? Are you willing to give serious consideration to his recommendations and provide a written evaluation to the subcommittee on the feasibility and cost of implementing these suggestions? By what date could that assessment be accomplished?

Answer. While the IRS has not yet implemented a Student Loan Repayment Program, we have found thus far that the lack thereof has not hindered our ability to attract well qualified, highly motivated employees through the use of various student employment programs. In fiscal year 2006, 93 percent of these student program hires were to front-line positions.

The Office of Chief Counsel, which hires the majority of the attorneys in the IRS, revamped its recruitment program a couple of years ago by conducting on-campus interviews at law schools throughout the country and increasing its visibility by having executives visit top schools. As a result, it has been very successful in recruiting law students for entry-level and summer-internship positions. This past year Counsel hired 36 entry-level attorneys and 25 summer legal interns. Over 3,000 law students and recent graduates applied for these positions. The applicants were highly qualified—over 70 percent of those hired last fall were in the top 30 percent of their class.

NONPROFIT ELECTION-RELATED ACTIVITY

Question. 501(c)(3) organizations are permitted to engage in voter education and outreach activities, but are strictly prohibited from promoting or opposing any candidate for federal office. I understand that during the 2004 presidential campaign season, the IRS examined more than 100 charities and churches, questioning whether they had engaged in prohibited, partisan political activities. As a result of the investigations, the IRS sought to ensure that the nonprofit community engaged in legitimate election-related activities. Concerns have been expressed that the timing of the IRS's investigation discouraged legitimate voter education and registration efforts. There were also allegations that the investigations were provoked by politically motivated complaints.

How does the IRS evaluate whether a complaint is legitimate or motivated by partisan politics?

Is it possible for the IRS to expedite investigations to ensure they do not have a chilling effect on legitimate election-related activities?

Looking ahead to the 2008 elections, what additional resources will the IRS need to ensure that charitable organizations understand and comply with restrictions on election-related activities?

Answer. In both the 2004 and 2006 Political Activity Compliance Initiatives (PACI), the IRS endeavored to intercede quickly in instances of alleged prohibited political activity and to educate the organizations to prevent potential future violations. As we noted in our report on the 2004 initiative, the PACI Referral Com-

mittee, comprised of three career civil servant employees with extensive Exempt Organization tax law experience, determined whether the information the IRS received as part of a complaint supported a reasonable belief that the organization may have violated the political campaign prohibition of section 501(c)(3) and, therefore, warranted further IRS action. While these procedures are designed to weed out those complaints that are not legitimate, oftentimes it is only after examination that the validity of the complaint can be determined with certainty. We also note that a complaint from a partisan source may nonetheless be valid.

The 2006 PACI included expedited timeframes for classification and case assignment. Because of the sensitivity of these cases and their highly factual nature, as well as procedural prerequisites (e.g., the church tax inquiry procedures), and in some cases the lack of cooperation from the taxpayer, it is not always possible to ensure the swift completion of these examinations.

On June 1, 2007, the IRS released two documents to help tax-exempt organizations avoid prohibited political campaign intervention activities that can result in the loss of their tax-exempt status. Revenue Ruling 2007–41 sets out 21 factual situations involving tax-exempt organizations, including churches, and various activities that may or may not constitute prohibited political intervention. Second, the IRS released its Report on the Political Activity Compliance Initiative for the 2006 election cycle. The 2006 report details the types and numbers of allegations, which are roughly equivalent to those found in the 2004 cycle.

In terms of funding, we believe the Administration's fiscal year 2008 budget request for the IRS, which includes a $15 million increase for Tax-Exempt Entity Compliance, will allow us to effectively serve the public, including in the area of prohibited political activity, and we respectfully request your support for it.

IMPLEMENTATION OF NEW NONPROFIT LAWS

Question. The Pension Protection Act of 2006, enacted last August, included what has been called the most sweeping legislation affecting tax-exempt laws since 1969. The IRS has already issued some guidance reflecting changes in the law; however, several aspects require additional guidance. Increased outreach and education will also be necessary to ensure that charities, many of which rely on voluntary staff and do not have tax professionals, are aware of the changes.

What additional resources will be required to develop and issue needed guidance and web-based tools, educate IRS staff about the new rules, and ensure that individual taxpayers and charitable organizations have the necessary information to comply with the new rules?

Answer. The IRS has been extremely proactive in its guidance and outreach efforts related to the implementation of the charitable provisions of the Pension Protection Act of 2006 (PPA). We have updated our webpage continuously to reflect the latest developments. We explained the PPA changes affecting exempt organizations and their contributors on a Tax Talk Today web cast; over 6,100 individuals viewed it. We continue to speak at numerous other outreach events for organizations involving the PPA changes. We educated our staff and the telephone call sites on the PPA changes so they can respond to taxpayer inquiries. We have begun to roll out a massive publicity campaign, directed especially to small organizations, concerning the new annual notice filing requirement, which is applicable to all small organizations that did not previously have a filing requirement.

We made numerous changes to the 2006 Form 990 to implement PPA changes. We conducted two phone forums to explain these changes. The phone forums were open to all, and over 500 practitioners participated; we subsequently posted the script on our website, along with frequently asked questions. We issued guidance immediately following PPA's enactment addressing issues of critical importance regarding donor advised funds, supporting organizations, and procedures for being recognized as a publicly supported organization. We recently issued guidance on the procedures for section 501(c)(3) organizations to make their Forms 990–T available for public inspection. We will issue additional PPA guidance and outreach in the near future. We also will assist the Treasury Department on PPA mandated studies.

Implementation of the PPA is important. We have devoted the resources required to issue all needed guidance in a timely fashion, and we intend to continue to do so until the act is fully implemented.

We believe the Administration's fiscal year 2008 budget request for the IRS, which calls for a $15 million increase for Tax-Exempt Entity Compliance, will enable us to effectively serve the public, including in the area of prohibited political activity, and we respectfully request your support for it.

EFFECT OF NEW NON-CASH CHARITABLE CONTRIBUTION RULES

Question. In 2004, Congress enacted new restrictions on charitable contributions of vehicles. Most recently, in 2006, Congress enacted new restrictions and reporting requirements on charitable contributions of clothing and household items as part of the Pension Protection Act.

Has the IRS seen any changes in the amount and/or type of deductions being claimed since passage of these new rules?

Answer. Internal Revenue Code § 170(f)(12) went into effect for vehicle donations after December 31, 2004. Our Statistics of Income Division (SOI) collects this type of data. However, data for the 2005 tax year (the first tax year where the change applied) has not yet been analyzed.

Question. Has the volume of taxpayer queries increased since enactment of the rules?

Answer. The Accounts Management Toll Free function experienced a 23 percent increase in inquiries on deductions in fiscal 2005 compared to fiscal 2004. Questions received on deductions cover over 26 topics including contributions. The data we collect does not allow us to provide specific evidence on whether the increase was attributable to vehicle donations. In fiscal year 2006 the deduction queries returned to a level comparable to fiscal years before 2005.

QUESTIONS SUBMITTED BY SENATOR BEN NELSON

Question. Do you support including a preference for companies willing to hire disabled veterans and other individuals with disabilities within the IRS Private Debt Collection (PDC) program?

Answer. The IRS is considering a strategy that would give a preference to Private Collection Agencies (PCAs) that employ disabled veterans and individuals with disabilities.

Question. Do you support an across-the-board hiring target for collection agencies within the PDC to create jobs for veterans and other persons with disabilities?

Answer. In the short term, it may be difficult for the IRS to achieve an across-the-board hiring target for all collection agencies within the PDC program. Setting a predetermined target could jeopardize the program. If we were unable to find a contractor who meets the requirements, we could not enter into any qualified tax collection contract. PDC companies are often located in rural areas where there is a population base that allows them to employ highly qualified people at a low cost. These same rural areas may not have a large enough population of severely disabled and veterans to draw upon to achieve a set goal.

Nonetheless, the IRS is considering an alternative strategy that could give a preference to PCAs that employ the severely disabled and veterans. We intend to revise our contract award determinations to provide incentives. The IRS intends to offer extra evaluation points for PCAs that employ a specified percentage of the severely disabled or veterans. We are still in the process of finalizing the Request for Quotations for the next contract and have not yet determined the required percentages or extra evaluation points. We believe that this will encourage the PCAs to hire the severely disabled and veterans to work IRS accounts without jeopardizing the PDC program.

Question. What obstacles exist which prevent the IRS from developing a veterans/disability preference program for the PDC?

Answer. The obstacle to a disability preference program based on a hiring target arises after the contract is awarded. The PDC program requires the use of long-term contracts with the PCAs. Preparing the PCA to process IRS cases requires a significant amount of time and resources by both the PCA and the IRS. The contract period must be of sufficient time to allow the PCA and IRS to recover their expenses. We have determined one year to be the minimum time period for a contract to be cost effective.

The IRS implied obligation under a preference program would be to terminate a contract with disability preference if the contractor failed to meet the agreed upon condition. If after contract award, a contractor, otherwise qualified, is unable to fulfill the agreement to hire the required quota of severely disabled for positions to provide contract services, the contract would have to be terminated for breach of contract. The cost to cancel a contract after 90 days would dramatically increase the cost of administering the PDC program. We believe that an incentive as described above will encourage the PCAs to hire the severely disabled and veterans to work IRS accounts without jeopardizing the PDC program.

Question. What amount of the fiscal year 2008 appropriation does the IRS plan to devote to the PDC program? (Or, as fiscal year 2008 appropriations are as-of-yet

unknown, how much has the IRS budgeted for administration of the PDC program in fiscal year 2008?)

Answer. The current projected fiscal year 2008 cost for administration of the PDC program is $7.35 million. We project that PDC will breakeven in April of 2008, including all start up costs. Of the $7.35 million, $5.84 million is for managing the initiative and consists of costs for the Referral Unit, Oversight Unit, Project Office, and Project Office contractors. The remaining $1.51 million is for IT costs.

Based on conservative projections for revenue, the program is expected to recoup all costs in fiscal year 2008 and is projected to generate between $1.5 billion and $2.2 billion in revenue over 10 years. In fiscal year 2008, we expect the PDC ROI will be between 4.0 to 1 and 4.3 to 1, once the program is in steady state.

Question. If the IRS is prevented from using any appropriated funds to administer the program, how will the IRS allocate the appropriations which otherwise would have gone to the PDC program?

Answer. If the IRS is prevented from using funds to administer the program, we would need to determine alternative applications for the funding. The staff in the Referral Unit, Oversight Unit, and Project Office would be absorbed into other collection activities. The remaining non-labor funds would be reprioritized against all agency requirements. The IRS will work with the Office of Management and Budget (OMB) to determine the most appropriate allocation of resources.

It is also important to note that if the program is eliminated, the IRS would continue to apply available resources to the highest priority collection work. Since the cases assigned to the PDC program have already been through lower cost methods of collections at the IRS, they would remain unworked. The President's fiscal year 2008 budget request does not include funds to hire IRS workers to replace Private Collection Agency (PCA) employees should the Congress eliminate the program. The IRS would need a significant influx of resources over a number of years to be able to work enough inventory to get to these lower priority cases currently eligible for PCA placement.

In addition, sec. 6306 of Title 26 (The Internal Revenue Code) allows the Secretary to retain and use up to 25 percent of the collections for collection enforcement activities of the Internal Revenue Service. Termination of the contracts would also cut off continued accumulation of the retained funds which can be used to fund other Tax Law Enforcement activities. The projected revenue, between $1.5 billion and $2.2 billion over ten years, would also be lost.

Question. If the PDC were repealed or de-funded, is there a detailed proposal, including cost and timeline estimates, to replicate the PDC within the IRS, or an alterative plan to collect the "inventory" of cases or the debt currently slated to be collected via the PDC?

Answer. No. The types of cases currently assigned to the PCAs would not be actively worked by the IRS if the PDC program were repealed or de-funded and funding for any alternatives are not assumed in the budget request. Due to the volume of higher priority work, there is no plan to replicate PDC within the IRS. These lower priority cases would remain unassigned.

QUESTIONS SUBMITTED TO NINA E. OLSON

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

Question. Improving taxpayer service is an important part of a comprehensive strategy to reduce the "tax gap" by helping taxpayers understand and meet their tax obligations.

On April 11, the Taxpayer Assistance Blueprint, Phase 2 was published. This Blueprint is the joint response of the IRS, the IRS Oversight Board and the National Taxpayer Advocate to comply with a congressional mandate for the development of a five-year strategic plan for the delivery of taxpayer service.

The plan includes a variety of specific recommendations to expand, simplify, standardize and automate services, and to improve and expand technology infrastructure. It also includes recommendations for increasing education and outreach to taxpayers, partners and IRS employees, and incorporating feedback into future service decisions.

When the recent Blueprint was issued, you labeled it a "much-needed first step to delivering this service in ways that meet taxpayer needs."

Where does it fall short? What additional steps do you consider critical to meeting taxpayer needs?

Answer. The Taxpayer Assistance Blueprint (TAB) lays out a comprehensive, laudable plan to improve taxpayer service over the next five years. Now, the critical

issue is how the IRS implements the plan. I believe the TAB is only a "first step" because the TAB report alone will not ensure that the IRS delivers service in ways that meet taxpayer needs. To improve taxpayer service, the IRS must maintain a commitment to improving assistance to taxpayers both now and in the future, and must be given the resources necessary to make the needed improvements.

The TAB also is just a "first step" because it focuses solely on individual taxpayers. The IRS should expand its focus to more comprehensively consider the needs of all taxpayers. For example, the IRS should use the TAB as a starting point and engage in similar efforts to improve services for Schedule C filers, large and small businesses, and tax-exempt organizations. Additionally, the IRS should begin to look at other areas that affect taxpayer service, including return preparers, submission processing, and the content of notices and publications.

The IRS also should continue the research efforts it began in preparing the TAB. The taxpaying population will continue to change and so will taxpayer needs. The IRS should commit to ongoing research related to issues such as taxpayer needs, the link between service and compliance, and barriers taxpayers face to using certain IRS services.

Question. I understand that the Blueprint was a product of a collaborative effort. Were there any aspects upon which you could not reach consensus that, as a result, were not incorporated in the publication?

Answer. The TAB was designed to reflect the collaborative efforts of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate. Throughout the development of the TAB, I personally participated in the TAB Executive Steering Committee meetings and decisions. I met personally with the members of the TAB team to discuss with them my views on the TAB and taxpayer service in general. I reviewed drafts of the TAB report and provided comments and feedback to the TAB team. Members of my staff worked closely with the TAB team both in monitoring the research and in drafting the report.

Throughout the TAB process, disagreements occasionally arose over the direction of the TAB report. These issues were discussed among the Executive Steering Committee members in order to reach an agreement. I worked tirelessly to ensure that the TAB report would reflect a taxpayer-centric perspective and that taxpayer needs would not be unduly sacrificed for the sake of administrative convenience. I also wanted to ensure that given the time allotted, the TAB report would not come to any conclusion on reducing or eliminating taxpayer services. Instead, I urged that the TAB propose a methodology to evaluate current services and make improvements to meet taxpayer needs based on the data collected through the TAB research efforts, while not reducing the services currently available. For the most part, I believe the TAB report reflects this approach.

As the IRS begins to realize cost savings as a result of providing more efficient and effective taxpayer service, I believe strongly that any savings resulting from those efficiencies should be reinvested in taxpayer service and not shifted to compliance. I also believe that the IRS should maintain its commitment to providing face-to-face services in the future, as stated in the TAB Guiding Principles.

Question. As an element of the Taxpayer Assistance Blueprint, the IRS recommended a migration strategy to move taxpayers away from Taxpayer Assistance Centers (TACs) and toward electronic, self-assisted services. I understand the IRS plans to implement Facilitated Self-Assistance Models in 15 selected sites, including two locations in my home State of Illinois. Under the model, taxpayers who come to the TACs for in-person help will be directed to in-house telephones and computers where they can access both the IRS website and phone assistors.

The National Taxpayer Advocate's Report to Congress for 2006 provides some data drawn from the IRS Oversight Board's 2006 Service Channel Survey. I think it elucidates the concern that migrating away from Taxpayer Assistance Centers (TACs) may be problematic. It states:

"Nearly 25 percent of taxpayers do not have Internet access, with more than twice as many taxpayers over 60 not having Internet access as those 60 or younger. Approximately 75 percent stated they were not secure sharing personal information via the Internet. Among taxpayers who have used IRS services in the last two years, about 45 percent of those who called IRS and more than 75 percent of those who visited the IRS stated that they would not use the IRS website."

How do you respond to concerns that migrating to self-assisted centers may be laying the groundwork for an expanded effort to move persons away from face-to-face interactive contacts and toward telephone and Internet access?

Answer. Throughout the development of the TAB, I advocated strongly to ensure that, as the IRS moves increasingly toward the electronic delivery of services, the Service remains aware of the needs of those taxpayers who may be unable or unwill-

ing to use self-assisted services. Many taxpayers face barriers in receiving assistance, particularly in using the Internet, and the IRS has an obligation to provide service to these taxpayers, including face-to-face service, as well as to help these taxpayers overcome the barriers.

The IRS is making an effort to move taxpayers away from face-to-face interaction and toward telephone and Internet services. This approach is appropriate for many taxpayers who are comfortable handling financial transactions by phone or over the Internet. However, the TAB's research studies showed that a certain percentage of taxpayers will continue to need face-to-face services. Therefore, I will continue to advocate that, even as many taxpayers move to electronic service options, the IRS must maintain face-to-face services as long as there is a segment of the population that still needs them.

Question. Wouldn't a plan to scale back the number of TACs or replace them with self-help centers be an unwise cutback in customer service and a step backwards in achieving the goal of increasing compliance and shrinking the tax gap?

Answer. At this point, I believe the IRS lacks the data necessary to determine whether it should reduce the number of TACs or replace existing TACs with self-help centers. Although the TAB report contains a significant amount of information regarding taxpayer needs and preferences, the IRS still has not completed enough research to evaluate the existing TACs.

An ongoing survey of taxpayers who visit TACs conducted by the Taxpayer Advocacy Panel, an advisory panel that operates pursuant to the Federal Advisory Committee Act, should provide valuable information regarding whether TACs are meeting taxpayer needs. This is the first survey that asks taxpayers who were turned away from the TACs what assistance they were seeking, and asks taxpayers who were served by the TACs whether they received the service they sought. With this data, the IRS can begin to determine whether it is offering sufficient assistance or whether it needs to expand both the nature and amount of its service offerings to meet taxpayer needs.

My goal is to work with the IRS as it evaluates the current placement of the TACs. The IRS needs to ensure that TACs are located in areas where taxpayers need and can use the services offered. By evaluating the location of the current 401 TACs, the IRS can identify areas in which moving a TAC may make it more convenient for taxpayers. Additionally, we may identify areas where the IRS should consider adding a TAC.

The Facilitated Self-Assistance Model (FSM) represents an important step forward as the IRS expands its efforts to deliver services electronically. FSM is designed to assist taxpayers who have indicated a willingness to use alternate service channels, such as the Internet and the telephone. If a taxpayer comes into a TAC to obtain a form and the TAC does not have the form in stock, FSM will allow the taxpayer to use one of the computer terminals provided and, with the assistance of a TAC employee, to print out the form he needs. In the future, the same taxpayer may wish to return to the TAC to obtain a form, or he may now feel comfortable navigating irs.gov to print out a copy of the form on his own. FSM will also provide additional information about taxpayer needs. In addition to conducting surveys of taxpayers who use the FSM work stations, the IRS will be able to monitor taxpayers as they navigate irs.gov. This information will identify areas where the website can be improved to make it easier for taxpayers to use. This type of real world testing is critical to improving irs.gov and making it more taxpayer-friendly.

I do not view FSM as a replacement for traditional face-to-face services provided in a TAC. Rather, I view FSM as a complement to existing TAC services. If the FSM pilot proves successful and the IRS is given the additional taxpayer service funding it needs, I am hopeful that workstations will be installed in all TAC offices. By rolling out FSM, our goal is to help some taxpayers become more comfortable using online and telephone alternatives. FSM has the potential to save both taxpayers and the IRS time and costs.

Question. As your report observes, "Until [these] barriers to Internet access can be addressed, eliminating the option of being able to call or visit the IRS means that these taxpayers would not be able to use the IRS website for the service they received, increasing the burden for these taxpayers to comply with their tax obligations." How serious is your concern? What are the implications?

Answer. My concerns are very serious. As I have stated previously, the overriding mission of the IRS should be to increase voluntary compliance. The IRS should make it as easy as possible for taxpayers to comply with the tax laws. As the IRS looks to move more taxpayers toward using electronic service delivery options such as the Internet, the IRS must consider why some taxpayers cannot use the Internet. One way this can be accomplished is through the current Facilitated Self Assistance pilot in the TACs. By observing how taxpayers use irs.gov to obtain needed services,

the IRS can potentially identify barriers to using the Internet and modify irs.gov in order to help taxpayers overcome these barriers.

While continued research into the barriers to using electronic services is necessary, it is also critical that the IRS continue to maintain telephone and face-to-face services for taxpayers who are unable or unwilling to use electronic services. The IRS cannot reduce or eliminate existing service delivery methods until research demonstrates that the available services are meeting the needs of all taxpayers. Moreover, it is my belief that there are many tax issues that cannot be resolved through electronic communication. That is, the conversation between the IRS employee and the taxpayer, whether on the phone or in person, is part of the resolution process. Thus, I cannot now envision a time when it would be appropriate for the IRS to eliminate or sharply curtail the availability of face-to-face services for taxpayers who seek them.

QUESTIONS SUBMITTED BY SENATOR BEN NELSON

Question. What amount of the fiscal year 2008 appropriation does the IRS plan to devote to the PDC program? (Or, as fiscal year 2008 appropriations are as-of-yet unknown, how much has the IRS budgeted for administration of the PDC program in fiscal year 2008?)

Answer. The IRS estimates that the PDC initiative will cost $7.35 million in fiscal year 2008.[1] However, this number does not include indirect costs such as the staffing the Taxpayer Advocate Service is devoting to oversight and casework arising from the PDC initiative. Moreover, the IRS reports that it will have spent about $71 million in startup and maintenance costs by the end of fiscal year 2007, again excluding indirect costs. As a result, the IRS projects that the initiative at this point has lost money and will not break even until April 2008.[2] It is not clear why the IRS is investing so much in an initiative that promises to return relatively little and that raises so many concerns regarding taxpayer rights, especially when the IRS could invest the same amount of money in its Automated Collection System (ACS) and generate a greater return on its investment.

Question. If the IRS is prevented from using any appropriated funds to administer the program, how will the IRS allocate the appropriations which otherwise would have gone to the PDC program?

Answer. If Congress prohibits the IRS from administering the PDC initiative, the IRS could apply its resources to ACS, whose employees perform work most analogous to the PDCs. In fact, ACS would likely generate a much greater return than the PDC initiative if provided the additional funding. For instance, it is estimated that the PDC initiative will cost $71 million on startup and ongoing maintenance expenses through fiscal year 2007.[3] If this $71 million were allocated to ACS, the Office of the Taxpayer Advocate has estimated that the IRS could bring in $1.4 billion, as compared to the $19.5 million brought in by the PDC initiative to date.[4] Even if the cost of the PDC initiative significantly decreases, as the IRS projects, the IRS would still likely be better off spending the PDC program costs on hiring more collection personnel. For example, if the IRS applied the $7.35 million (which is the PDC initiative's estimated cost for the referral unit, oversight unit, program office, contractors, and MITS for fiscal year 2008) to ACS, the IRS could collect about $146 million.[5] By contrast, the IRS PDC initiative is projected to bring in $88 million in gross revenue for fiscal year 2008.

Question. What is the estimate of the return on investment in terms of revenue collected from the alternative use of appropriated funds as mentioned in question

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[1] Internal Revenue Service, Filing and Payment Compliance Advisory Council (May 1, 2007) at 15.

[2] Data furnished by the IRS Filing and Payment Compliance Modernization Project Office (June 2007).

[3] Internal Revenue Service, Filing and Payment Compliance Advisory Council (May 1, 2007) at 15. These estimated costs include startup and ongoing maintenance from the PDC Project Office, oversight, administration, and IT costs from fiscal year 2004 projected through fiscal year 2007. These estimated costs do not include infrastructure assessments for any MITS costs or costs associated with TAS oversight or casework arising from the PDC initiative.

[4] The dollars spent on the PDC initiative could instead have been used to fund new ACS employees. We computed the fully loaded cost of an average ACS employee at about $75,000 (assuming GS–8, step 5). Based on IRS expenditures of $71 million, the number of new ACS employees that could have been funded by the PDC initiative (about 942) was multiplied by the current average dollars collected by an ACS employee per year (about $1.49 million) to estimate the revenue that could be collected by ACS in one year.

[5] Internal Revenue Service, Filing and Payment Compliance Advisory Council (May 1, 2007) at 15.

1 above? How does this compare to projections for fiscal year 2008 collections under the PDC program?

Answer. It is clear that the IRS can collect these liabilities more efficiently and effectively. In fact, the IRS openly acknowledges it can do better.[6] The Private Collection Agencies (PCAs) get a four dollar return for every one dollar IRS invests.[7] By contrast, IRS ACS personnel obtain an average return of $20 for every one dollar IRS invests in collecting tax liabilities. From the September 2006 inception of the PDC program through April 19, 2007, the PCAs collected $19.5 million in gross revenue. As noted, however, if the $71 million invested in the PDC initiative were instead invested in ACS, the IRS could bring in about $1.4 billion. Not only can the IRS get a better return, but IRS employees, although not perfect, receive significantly more training concerning taxpayer rights and are better equipped to work with taxpayers on resolving their tax debts.[8]

Question. If the PDC were repealed or de-funded, is there a detailed proposal, including cost and timeline estimates, to replicate the PDC within the IRS, or an alterative plan to collect the "inventory" of cases or the debt currently slated to be collected via the PDC?

Answer. If the PDC initiative is repealed, there are a variety of areas in which the IRS could invest that would generate a better return and benefit taxpayers. For example, the IRS could invest in ACS, including retraining some submission-processing employees whose positions are being eliminated due to the expansion of electronic filing and the consequent reduction in the need for manual entry of data from paper-filed returns. Those employees could work PCA-type cases as a stepping stone to more complex collection work. The IRS could design a system that would effectively identify the "next best case" to work and should invest in modernizing its technology. The IRS could use the funding to revise or develop collection measures, which will accurately identify the true age of its accounts receivable; develop realistic measures of collection "yields" that accurately identify recovery of potentially lost revenue; and improve communication to delinquent taxpayers concerning the accrual of penalties and interest on collection cases.[9]

In addition to funding ACS, there are several alternative areas in which the IRS could invest the funds currently being used to oversee the PDC initiative. For instance, the IRS has failed to fund the other two components of its Filing and Payment Compliance Project (F&PC). These components include plans to conduct analysis on a given collection case and allow it to be officially routed to the appropriate collection unit, whether the IRS automated call sites, IRS campuses, or the IRS collection field function. The full impact of this initiative is unclear since only the PDC component is funded. But I believe there are multiple superior uses for these funds that would produce better returns on investment at less risk to taxpayer rights.

Question. What is the estimate of the return on investment in terms of revenue collected from the alternative use of appropriated funds as mentioned in question 1a above? How does this compare to projections for fiscal year 2008 collections under the PDC program?

Answer. Overall, the IRS Return on Investment (ROI) is about 4 to 1. ROI resulting from IRS enforcement programs ranges from $3 to $14 for every additional $1 invested, depending on the type of enforcement activity. For example, labor-intensive activities such as the Collection Field Function have lower ROIs, and automated activities such as Automated Underreporter have high ROIs. It would be expected that the ROI for an "alternative use of funds" initiative would be consistent with that for enforcement programs and range from 3:1 to 14:1.

In fiscal year 2008, we expect the PDC ROI will be between 4.0 to 1 and 4.3 to 1, once the program is in steady state. We base this estimate on fiscal year 2008 gross revenue projections of $86 million to $127 million compared to operating costs

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[6] Testimony of Commissioner of Internal Revenue, Mark W. Everson, House Committee on Appropriations: Subcommittee on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, Fiscal Year 2007 Appropriations for the Internal Revenue Service (March 29, 2006).

[7] Testimony of United States Treasury Secretary, John Snow, in an exchange with Senator Robert C. Byrd, Senate Committee on Appropriations: Subcommittee on Transportation, Treasury and General Government, Hearing on Fiscal Year 2004 Appropriations for the Treasury Department, May 20, 2003.

[8] TAS also produced video training, including a 20-minute presentation by the National Taxpayer Advocate and a two-hour discussion by TAS personnel, that is required to be taken by all PCA employees about TAS, taxpayer rights, low income taxpayer clinics (LITCs), and procedures for referring TAS cases.

[9] For an in-depth analysis of current IRS collection strategy and recommendations for improvement, see National Taxpayer Advocate 2006 Annual Report to Congress at 80–82.

of approximately $5.84 million[10] in IRS costs and the average 18.5 percent payments to the PCAs.

ADDITIONAL STATEMENT FOR THE RECORD

Senator DURBIN. The statement from Colleen Kelley, referred to earlier, will be inserted into the record at this point.

[The statement follows:]

PREPARED STATEMENT OF COLLEEN M. KELLEY, PRESIDENT, NATIONAL TREASURY EMPLOYEES UNION

Chairman Durbin, Ranking Member Brownback, and distinguished members of the Subcommittee, I would like to thank you for allowing me to provide comments on the Administration's fiscal year 2008 budget request for the Internal Revenue Service (IRS). As President of the National Treasury Employees Union (NTEU), I have the honor of representing over 150,000 federal workers in 30 agencies including the men and women at the IRS.

IRS FISCAL YEAR 2008 BUDGET REQUEST

Mr. Chairman, as you know, the IRS budget forms the foundation for what the IRS can provide to taxpayers in terms of customer service and how the agency can best fulfill its tax enforcement mission. Without an adequate budget, the IRS cannot expect continued improvement in customer service performance ratings and will be hampered in its effort to enhance taxpayer compliance. I would like to applaud the Administration for acknowledging in its Fiscal Year 2008 Budget in Brief (page 65) that "assisting the public to understand their tax reporting and payment obligations is the cornerstone of taxpayer compliance and is vital for maintaining public confidence in the tax system." However, I was disappointed in the Administration for failing to request a budget for fiscal year 2008 that meets the needs of the Agency to meet its customer service and enforcement challenges. In fact, the President's budget anticipates a "savings" equal to nearly 1,200 full-time equivalent positions, including 1,147 in enforcement and taxpayer service programs.

Although it's widely recognized that additional funding for enforcement provides a great return on the investment, the Administration seems reluctant to request an adequate budget for the IRS. In addition, despite citing a lack of resources as the primary rationale for contracting out a number of inherently governmental activities, such as the collection of taxes, the Commissioner of the IRS has told Congress that the IRS does not need any additional funding above the President' budget request.

NTEU believes that Congress must provide the IRS with a budget that will allow the Service to replenish the depleted workforce, particularly with respect to enforcement personnel.

History has shown that the IRS has the expertise to improve taxpayer compliance but lacks the necessary personnel and resources. The President's own fiscal 2008 budget proposal trumpets the increased tax collections produced by IRS's own employees and cites the increased collections of delinquent tax debt from $34 billion in 2002 to $49 billion in 2006, an increase of 44 percent. Unfortunately, instead of providing additional resources to hire more enforcement staff, IRS personnel resources have been slashed in recent years resulting in a 36 percent decline in combined collection and examination function enforcement staff between 1996 and 2003. In addition, these staffing cuts have come at a time when the IRS workload has dramatically increased.

According to IRS's own annual reports and data, taxpayers filed 114.6 million returns in 1995. After a steady annual climb, eleven years later, the Service saw more than 132 million returns filed. Yet, between 1995 and 2005, total numbers of IRS employees shrunk from 114,000 to 94,000. Even more alarming is that during that period, revenue officers and revenue agents—two groups critical to IRS enforcement and compliance efforts—shrunk by 32 and 23 percent respectively. Revenue officers who collect large delinquent accounts went from 8,139 to 5,462 and revenue agents who do audits fell from 16,078 to 12,355. Unfortunately, instead of reversing this trend, the IRS has continued efforts to reduce its workforce and has moved forward

[10] Due to fluctuating costs, there may be additional costs incurred that would result in the actual ROI being closer to the low end of the range. The $5.84 million does not include MITS Maintenance costs which were included in fiscal year 2008 costs ($7.35 million) on a prior page.

with downsizing in several different areas which have targeted some of the service's most productive employees.

These include last year's reorganization of the Estate and Gift Tax Program which sought the elimination of 157 of the agency's 345 estate and gift tax attorneys—almost half of the agency's estate tax lawyers—who audit some of the wealthiest Americans. The Service pursued this drastic course of action despite internal data showing that estate and gift attorneys are among the most productive enforcement personnel at the IRS, collecting $2,200 in taxes for each hour of work.

The IRS decision to drastically reduce the number of attorneys in the estate and gift tax area flies in the face of several reports made to Congress by Treasury and IRS officials over the past few years, indicating that tax evasion and cheating among the highest-income Americans is a serious and growing problem. In fact, an IRS study found that in 1999, more than 80 percent of the 1,651 tax returns reporting gifts of $1 million or more that were audited that year understated the value of the gift. The study found that the average understatement was about $303,000, on which about $167,000 in additional gift taxes was due. This alone cost the government about $275 million. Consequently, it is difficult to understand why the IRS sought the elimination of key workforce positions in an area that could produce significant revenue to the general treasury.

In addition, the Service continues to move forward with its plan to close five of its ten paper tax return submission facilities by 2011. The IRS originally sought the closings of the five paper return submission centers due to the rise in the use of electronic filing (e-filing) and in order to comply with the IRS Restructuring and Reform Act of 1998 (RRA 98) which established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. But in their recent report to Congress on e-filing, the IRS Oversight Board noted that the IRS will fall well short of the 80 percent goal and urged Congress to extend the deadline to 2012. The report noted that in 2006 just 54 percent of individuals e-filed their returns, well short of the 80 percent goal. Furthermore, the report cited a decline in 2006 in the number of e-file returns received from individual taxpayers who self-prepared their taxes. And finally a recent GAO report on the 2006 filing season noted the year over year percentage growth in individual e-filing slowed to a level lower than any of the previous three years.

While overall use of e-filing may be on the rise, the number of taxpayers opting to use this type of return is not increasing as rapidly as the IRS had originally projected. Combined with the fact that almost a third of American taxpayers do not even have internet access and changes to the IRS Free File Program that are expected to increase the number of paper filing returns, it is clear that paper submission processing facilities are still necessary and that serious thought and consideration must be given before any additional closings are undertaken.

Mr. Chairman, it is clear that drastic reductions in some of the agency's most productive tax law enforcement employees directly contradict the Service's stated enforcement priority to discourage and deter non-compliance, particularly among high-income individuals. In addition, we believe these staffing cuts have greatly undermined agency efforts to close the tax gap which the IRS recently estimated at $345 billion. As Nina Olson, the National Taxpayer Advocate noted, this amounts to a per-taxpayer "surtax" of some $2,600 per year to subsidize noncompliance. And while the agency has made small inroads and the overall compliance rate through the voluntary compliance system remains high, much more can and should be done. NTEU believes that in order to close the tax gap, the IRS needs additional employees on the frontlines of tax compliance and customer service. In addition, we believe Congress should establish a dedicated funding stream to provide adequate resources for those employees.

NTEU STAFFING PROPOSAL

In order to address the staffing shortage at the IRS, NTEU supports a two percent annual net increase in staffing (roughly 1,885 positions per year) over a five-year period to gradually rebuild the depleted IRS workforce to pre-1998 levels. A similar idea was proposed by former IRS Commissioner Charles Rossotti in a 2002 report to the IRS Oversight Board. In the report, Rossotti quantified the workload gap in non-compliance, that is, the number of cases that should have been, but could not be acted upon because of resource limitations. Rossotti pointed out that in the area of known tax debts, assigning additional employees to collection work could bring in roughly $30 for every $1 spent. The Rossotti report recognized the importance of increased IRS staffing noting that due to the continued growth in IRS' workload (averaging about 1.5 to 2.0 percent per year) and the large accumulated increase in work that should be done but could not be, even aggressive productivity

growth could not possibly close the compliance gap. Rossotti also recognized that for this approach to work, the budget must provide for a net increase in staffing on a sustained yearly basis and not take a "one time approach."

Although this would require a substantial financial commitment, the potential for increasing revenues, enhancing compliance and shrinking the tax gap makes it very sound budget policy. One option for funding a new staffing initiative would be to allow the IRS to hire personnel off-budget, or outside of the ordinary budget process. This is not unprecedented. In fact, Congress took exactly the same approach to funding in 1994 when Congress provided funding for the Administration's IRS Tax Compliance Initiative which sought the addition of 5,000 compliance positions for the IRS. The initiative was expected to generate in excess of $9 billion in new revenue over five years while spending only about $2 billion during the same period. Because of the initiative's potential to dramatically increase federal revenue, spending for the positions was not considered in calculating appropriations that must come within annual caps.

A second option for providing funding to hire additional IRS personnel outside the ordinary budget process could be to allow IRS to retain a small portion of the revenue it collects. The statute that gives the IRS the authority to use private collection companies to collect taxes allows 25 percent of collected revenue to be returned to the companies as payment, thereby circumventing the appropriations process altogether. Clearly, there is nothing magical about revenues collected by private collection companies. If those revenues can be dedicated directly to contract payments, there is no reason some small portion of other revenues collected by the IRS could not be dedicated to funding additional staff positions to strengthen enforcement.

While NTEU agrees with IRS' stated goal of enhancing tax compliance and enforcement, we don't agree with the approach of sacrificing taxpayer service in order to pay for additional compliance efforts. That is why we were disappointed to see that the President's proposed budget calls for the elimination of 527 taxpayer services positions. NTEU believes providing quality services to taxpayers is an important part of any overall strategy to improve compliance and that reducing the number of employees dedicated to assisting taxpayers meet their obligations will only those efforts. The Administration's own budget proposal for 2008 notes that in fiscal year 2006, IRS' customer assistance centers answered almost 33 million assistor telephone calls and met the 82 percent level of service goal, with an accuracy rate of 91 percent for tax law questions. In addition, a recent study commissioned by the Oversight Board found that more than 80 percent of taxpayers contacted said that IRS service was better than or equal to service from other government agencies. And while these numbers show that IRS taxpayer services are being effective, more can and should be done.

Mr. Chairman, in order to continue to make improvements in taxpayer services while simultaneously processing a growing number of tax returns and stabilizing collections and examinations of cases, it is imperative to reverse the severe cuts in IRS staffing levels and begin providing adequate resources to meet these challenges. With the future workload expected to continue to rise, the IRS will be under a great deal of pressure to improve customer service standards while simultaneously enforcing the nation's tax laws. NTEU strongly believes that providing additional staffing resources would permit IRS to meet the rising workload level, stabilize and strengthen tax compliance and customer service programs and allow the Service to address the tax gap in a serious and meaningful way.

SPAN OF CONTROL

And while it is imperative that Congress provide the IRS with sufficient staffing resources, we also believe that the IRS should look at the management to bargaining unit employee ratio to find additional resources for increased frontline tax compliance efforts. As noted previously, while the number of employees at the IRS has decreased by almost 20,000 since 1995, the number of managers who supervise these employees has increased over this same period. If we just look at the period between 2000 and 2005, we see that the number of bargaining unit employees, the frontline employees who do the work, decreased by 4,756, a decrease of 5.1 percent. During that same time, the number of managers and management officials increased by 170, an increase of 1 percent. If the IRS decreased the number of managers and management officials at the same rate as it decreased its rank and file employees during that period, there would be 5.1 percent fewer managers and management officials or a savings of 808 Full time Equivalents (FTE's) that could be saved and redirected to the frontlines. While the IRS has previously cited concerns about the number of employees that would have to be taken offline to train additional frontline employees, we believe this training could be done with minimal dis-

ruption to current operations. One possibility would be to use the increasing number of managers and management officials to do the training. This would ensure that these employees are afforded the best possible training while allowing current operations to continue to run efficiently.

PRIVATE TAX COLLECTION

Mr. Chairman, as stated previously, if provided the necessary resources, IRS employees have the expertise and knowledge to ensure taxpayers are complying with their tax obligations. That is why NTEU continues to strongly oppose the Administration's private tax collection program, which began in September of last year. Under the program, the IRS is permitted to hire private sector tax collectors to collect delinquent tax debt from taxpayers and pay them a bounty of up to 25 percent of the money they collect. NTEU believes this misguided proposal is a waste of taxpayer's dollars, invites overly aggressive collection techniques, jeopardizes the financial privacy of American taxpayers and may ultimately serve to undermine efforts to close the tax gap.

NTEU strongly believes the collection of taxes is an inherently governmental function that should be restricted to properly trained and proficient IRS personnel. When supported with the tools and resources they need to do their jobs, there is no one who is more reliable and who can do the work of the IRS better than IRS employees.

As you may know, under current contracts, private collection firms are eligible to retain 21 percent to 24 percent of what they collect, depending on the size of the case. In testimony before Congress, former IRS Commissioner Mark Everson repeatedly acknowledged that using private collection companies to collect federal taxes will be more expensive than having the IRS do the work itself. The Commissioner's admission directly contradicts one the Administration's central justifications for using private collection agencies—that the use of private collectors is cost efficient and effective.

In addition to being fiscally unsound, the idea of allowing private collection agencies to collect tax debt on a commission basis also flies in the face of the tenets of the IRS Restructuring and Reform Act of 1998. Section 1204 of the law specifically prevents employees or supervisors at the IRS from being evaluated on the amount of collections they bring in. But now, the IRS has agreed to pay private collection agencies out of their tax collection proceeds, which will clearly encourage overly aggressive tax collection techniques, the exact dynamic the 1998 law sought to avoid. Furthermore, the IRS is turning over tax collection responsibilities to an industry that has a long record of abuse. For example, in 2006, consumer complaints about third-party debt collectors increased both in absolute terms and as a percentage of all complaints that consumers filed with the Federal Trade Commission (FTC). Last year the FTC received 69,204 consumer complaints about debt collection agencies—giving debt collectors the impressive title of the FTC's most complained about industry.

NTEU believes that a better option would be to provide the IRS with the resources and staffing it needs. There is no doubt that IRS employees are—by far—the most reliable, cost-effective means for collecting federal income taxes. As noted previously, the former IRS Commissioner himself has admitted that using IRS employees to collect unpaid tax debts is more efficient than using private collectors. In addition, the 2002 budget report submitted to the IRS Oversight Board, former Commissioner Charles Rossotti made clear that with more resources to increase IRS staffing, the IRS would be able to close the compliance gap.

This is not the first time the IRS has tried this flawed program. Two pilot projects were authorized by Congress to test private collection of tax debt for 1996 and 1997. The 1996 pilot was so unsuccessful it was cancelled after 12 months, despite the fact it was authorized and scheduled to operate for two years. A subsequent review by the IRS Office of Inspector General found that contractors participating in the pilot programs regularly violated the Fair Debt Collection Practices Act, did not adequately protect the security of personal taxpayer information, and even failed to bring in a net increase in revenue. In fact, a 1997 GAO report found that private companies did not bring in anywhere near the dollars projected, and the pilot caused a $17 million net loss.

Despite IRS assurances that it has learned from its past mistakes, two recent reports indicate otherwise. A March 2004 report by the Treasury Inspector General for Tax Administration raised a number of questions about IRS' contract administration and oversight of contractors. The report found that "a contractor's employees committed numerous security violations that placed IRS equipment and taxpayer data at risk" and in some cases, "contractors blatantly circumvented IRS policies

and procedures even when security personnel identified inappropriate practices." (TIGTA Audit #200320010). The proliferation of security breaches at a number of government agencies that put personal information at risk further argue against this proposal. These security breaches illustrate not only the risks associated with collecting and disseminating large amounts of electronic personal information, but the risk of harm or injury to consumers from identity theft crimes.

In addition, a September 2006 examination of the IRS private collection program by the Government Accountability Office (GAO) reveals that like the 1996 pilot, the program may actually lose money by the scheduled conclusion of the program's initial phase in December 2007. The report cited preliminary IRS data showing that the agency expects to collect as little as $56 million through the end of 2007, while initial program costs are expected to surpass $61 million. What's more, the projected costs do not even include the 21–24 percent commission fees paid to the collection agencies directly from the taxes they collect.

In addition to the direct costs of the program, I am greatly concerned about the potential negative effect that the private tax collection program will have on our tax administration system. In her recent report to Congress, the National Taxpayer Advocate voiced similar concern about the unintended consequences of privatizing tax collection. Olson cited a number of "hidden costs" that private tax collection has on the tax system including reduced transparency of IRS tax collection operations, inconsistent treatment for similarly situated taxpayers, and reduced tax compliance. Clearly the negative effects of contracting out tax collection to private collectors hampers the agency's ability to improve taxpayer compliance and will only serve to undermine future efforts to close the tax gap.

NTEU is not alone in its opposition to the IRS' plan. Similar proposals allowing private collection agencies to collect taxes on a commission basis have been around for a long time and have consistently been opposed by both parties. In fact, the Reagan Administration strongly opposed the concept of privatizing tax collections warning of a considerable adverse public reaction to such a plan, and emphasizing the importance of not compromising the integrity of the tax system. (Treasury Dept. Statement to House Judiciary Comm. 8/8/86). More recently, opposition to the private tax collection program has been voiced by a growing number of members of Congress, major public interest groups, tax experts, as well as the Taxpayer Advocacy Panel, a volunteer federal advisory group—whose members are appointed by the IRS and the Treasury Department. In addition, the National Taxpayer Advocate, an independent official within the IRS recently identified the IRS private tax collection initiative as one of the most serious problems facing taxpayers and called on Congress to immediately repeal the IRS' authority to outsource tax collection work to private debt collectors (National Taxpayer Advocate 2006 Report to Congress).

Instead of rushing to privatize tax collection functions which jeopardizes taxpayer information, reduces potential revenue for the federal government and undermine efforts to close the tax gap, the IRS should increase compliance staffing levels at the IRS to ensure that the collection of taxes is restricted to properly trained and proficient IRS personnel.

IRS AUDITS OF HIGH-INCOME INDIVIDUALS AND LARGE BUSINESSES AND CORPORATIONS

Mr. Chairman, the final issue that I would like to discuss is IRS enforcement efforts with regard to high-income individuals and large businesses and corporations. I previously noted the drastic staff reductions in the estate and gift tax division that occurred last year and will obviously hamper the Service's ability to achieve greater compliance from the wealthiest Americans. In addition, recent IRS data shows that IRS audits of high-income individuals have dropped dramatically over the past decade. The audit rate for face-to-face audits fell from 2.9 percent of high-income tax filers in fiscal year 1992 to 0.38 percent in fiscal year 2001 and then drifted down to 0.35 percent in fiscal year 2004. While the audit rate has rebounded somewhat in the last two years, it is still far below the level of the mid-1990's. These facts seem to directly contradict claims by the IRS that the Service's first enforcement priority is to discourage and deter non-compliance, with an emphasis on high-income individuals.

We are seeing similar troubling trends with respect to large corporations. While this issue has just started receiving public attention in recent weeks, it has long been of concern to IRS employees that believe recent IRS currency and cycle time initiatives are resulting in the premature closing of audits of large companies, possibly leaving hundreds of millions of dollars of taxes owed on the table. IRS data shows the thoroughness of IRS enforcement efforts for the nation's largest corporations—measured by the number of hours devoted to each audit—has substantially

declined since fiscal year 2002. IRS data also show that the annual audit rates for these corporations, all with assets of $250 million or more, while increasing in fiscal year 2004 and 2005, receded in 2006 to about the level it was in 2002 and is much lower than levels that prevailed a decade or more ago.

Although the number of the largest corporations is small, they are a very significant presence in the American economy. In fiscal year 2002, the largest corporations were responsible for almost 75 percent of all additional taxes the IRS auditors said were owed the government. By comparison, low and middle income taxpayers in the same year were responsible for less than 10 percent of the total.

Agency data shows that audit attention given those corporations with $250 million or more in assets has substantially declined in the last five years. In 2002, an average of 1,210 hours were devoted to each of the audits of the corporations in this category. The time devoted to each audit dropped sharply in 2004 and by 2006 the number of hours per audit remained 20 percent below what it was in 2002.

But what may be most disturbing is that according to IRS' own data, while the coverage rate of large corporation returns (identified as those with assets of $10 million and higher) increased in fiscal year 2004 and 2005, the number of audits for these corporations actually decreased in 2006. Clearly, the rationale the IRS is using to justify a reduction in time and scope of large corporation audits, that is, to allow for expanding the total number of companies audited is not working.

IRS officials have continued to point to a rise in additional tax recommended for each hour of audit as a sign that the policy is working, but most auditors know that this rise can be primarily attributed to the proliferation of illegal tax shelters which makes it easier to find additional taxes due.

Warnings about the potential negative consequences of such policy decisions were made by a number of IRS employees in a recent New York Times article and are not new. In fact, when the IRS first began limiting the time and scope of business audits through implementation of the Limited Issue Focused Examination (LIFE) process in 2002, the former chief counsel of the IRS said that the IRS' proposed reductions in cycle time of corporate audits would "virtually guarantee that IRS auditors would miss tax dodges, fail to explore suspicious transactions, or even walk away from audits that are on the verge of finding wrongdoing."

In addition, IRS employees have raised concerns about this shift in approach to the auditing of business tax returns since its implementation several years ago. Their concerns are multi-fold. Primarily, employees' feel that their experience and professional judgment is being ignored when the scope of audits is limited and cycle times are reduced. Revenue agents need flexibility to determine the scope of an audit and need the ability to expand the examination time when necessary. The men and women of the IRS that perform these audits are highly experienced employees who know which issues to examine and when more time is necessary on a case. But under current IRS policies, this is just not the case.

Mr. Chairman, we have heard directly from a number of our members about the detrimental effect this policy has had not just on efforts to ensure corporations are in full compliance, but also how this misguided policy is damaging employee morale. In one instance, an IRS agent with 29 years of experience, including 19 as an international specialist examining tax returns of large, multinational corporations was given an unreasonably short period of time to examine three tax years of a very large company. The agent reported being constantly harassed for refusing to further limit the scope of the examination beyond that which was set at the beginning of the audit, even though he had successfully completed two prior examinations of the same taxpayer in a timely manner. The employee knew the issues and how to examine them but also knew they would need more than the allotted time to complete his part of the examination. But, despite past successes, management refused to provide the employee with additional time to complete his portion of the audit and labeled the employee as uncooperative and not a "team player." Although the employee refused to compromise, he believed that other members of the examination team had been pressured into dropping issues which likely would have resulted in additional tax.

Mr. Chairman, in the face of a rising tax gap and exploding federal deficits, it is imperative that the agency is provided with the necessary resources to allow IRS professionals to pursue each and every dollar of the taxes owed by large businesses and corporations. Allowing these corporations to pay just a fraction of what they owe in taxes greatly hinders efforts to close the tax gap and is fundamentally unfair to the millions of ordinary taxpayers that dutifully pay their taxes. Only by increasing the overall number of IRS employees that do this work can the Service ensure that businesses and large corporations are complying with their tax obligations and that the tax gap is being closed.

CONCLUSION

It is an indisputable fact that the IRS workforce is getting mixed signals regarding its value to the mission of the Service and the level of workforce investment the Service is willing to make. NTEU believes that the drastic reductions of some of the IRS's most productive employees, reliance on outside contractors to handle inherently governmental activities such as the collection of taxes, and a shift in philosophy which focuses enforcement efforts too much on wage earners and not enough on high-income individuals and large businesses and corporations, only serve to undermine the agency's ability to fulfill its tax enforcement mission and hamper efforts to close the tax gap.

SUBCOMMITTEE RECESS

Senator DURBIN. The subcommittee stands recessed.

[Whereupon, at 4:17 p.m., Wednesday, May 9, the subcommittee was recessed, to reconvene subject to the call of the Chair.]