IRS

INTERNAL
REVENUE
SERVICE

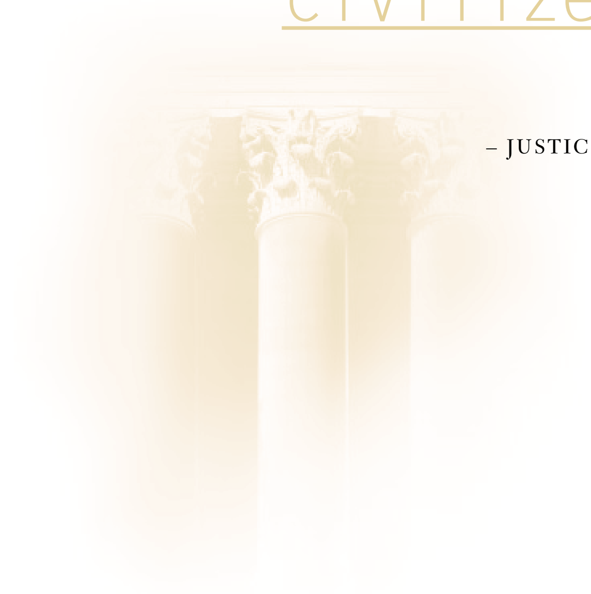
Progress Report

From the Commissioner of the Internal Revenue Service

DECEMBER 2001

Taxes are what we pay for civilized society.

– JUSTICE OLIVER WENDELL HOLMES JR.



Both progress and promise marked this past fiscal year.

MANY YEARS AGO WHEN I BEGAN WORKING in the private sector, a very smart man told me, "If you ever find yourself in a hole, stop digging."

Before the passage of the IRS Restructuring and Reform Act of 1998, the Internal Revenue Service was in a deep hole and seemed to be digging deeper.

Basic taxpayer services had plummeted. The Tax Systems Modernization project was declared a failure after billions were spent. Taxpayer rights were not always being respected. America's taxpayers gave the IRS its lowest rating on record.

We stopped digging. The National Commission on Restructuring the IRS took a long, hard look at the agency. It came up with a new direction for the IRS, the essence of which was incorporated a year later in the landmark Restructuring Act.

At the most fundamental level, Congress directed the IRS to be more effective in meeting taxpayer needs as well as collecting the revenue. We developed and are carrying out a modernization program of short- and long-term improvements designed to achieve the overall objectives of improved service, better treatment of taxpayers, more efficient and effective compliance and greater overall efficiency. In other words, we aren't just moving an imaginary pendulum one way or the other. We are improving the entire way the IRS works.

Thanks to our employees, we've made progress on our goals. Although we have no shortage of problems at the IRS, we have an abundance of dedicated, talented and hardworking individuals who achieve a great deal with very little. Not the least of their accomplishments is working to modernize the IRS while still administering the world's largest and most complex tax system.

Both progress and promise marked this past fiscal year. Returns, payments and refunds were efficiently processed. The telephones were better answered. We tore down more barriers and added more incentives to electronic filing of returns and payment of taxes. And some have joked that our Web site is very un-IRS like because it is so popular, easy to use and helpful. More taxpayer problems are being solved in a telephone call or visit. We simplified some forms and regulations. We better administered the new taxpayer rights. We stabilized some key compliance activities. We worked to ease the burden of those affected by the September 11 terrorist attacks.

However, if we look back on the progress we made in FY 2001, we also clearly see how far we still have to go.

We are still not providing service at a level that taxpayers expect or deserve. We are still not ensuring that everyone's neighbor or competitor is complying with the tax law and paying what they owe. We have many jobs that we must perform at higher quality and efficiency.

There are no shortcuts to achieving our goals. The IRS' problems developed over a long period and are too widespread, deep and complex to yield to simple, quick remedies. We must carefully lay a foundation that will allow us to succeed in our rebuilding efforts. The early successes we have enjoyed are stepping-stones on a much longer journey to reach a higher level of performance.

We have now restructured our organization, reducing management layers and achieving more customer focus and greater management accountability. We have developed and implemented a new set of balanced performance measures.

Our biggest remaining task is to modernize all of our business processes with the enabling technology. The real tangible benefits of modernization will materialize over the remainder of this decade in carefully planned and executed projects. The first of these were delivered this past year; taxpayers will see more in 2002.

Combined with effective operational management and a clear strategic plan, these modernization efforts will continue to move the IRS solidly, year after year, toward full achievement of our goals.

So, what must we do to ensure the success of IRS modernization for next year and the years beyond? I believe that we must stay focused and committed to the intent of the Restructuring Act, making adjustments as necessary, but not losing sight of the goal. If we do, I am convinced we will succeed.

Sincerely,

Charles O. Rossotti

Charles O. Rossotti
Commissioner of Internal Revenue

December 31, 2001

There are no shortcuts

3 GOALS

WE WILL FULFILL OUR MISSION BY REACHING THREE GOALS:

1- TOP-QUALITY SERVICE TO EACH TAXPAYER IN EVERY INTERACTION

2- TOP-QUALITY SERVICE TO ALL TAXPAYERS THROUGH FAIR AND UNIFORM APPLICATION OF THE LAW

3- PRODUCTIVITY THROUGH A QUALITY WORK ENVIRONMENT.

EXECUTIVE SUMMARY

The IRS Restructuring and Reform Act of 1998 (RRA 98) gave us a clear mandate—do a better job meeting the needs of taxpayers as well as collecting the revenues. We expressed this direction in a new IRS mission statement:

"PROVIDE 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."

It is equally important that we define the specific goals and objectives needed to achieve our mission. They are top-quality service to each taxpayer in every interaction, top-quality service to all taxpayers through fair and uniform application of the law, and productivity through a quality work environment. If progress is made on all three of these goals, we can be confident that we are moving toward achieving our mission and meeting the public's expectations.

GOAL 1 TOP-QUALITY SERVICE TO EACH TAXPAYER IN EVERY INTERACTION

We want to improve the entire way the IRS serves taxpayers—from filing and paying taxes to getting information and assistance to protecting their rights. More than the sum of its parts, the highly successful 2001 filing season continued to demonstrate how we can build on positive trends in service to taxpayers, especially as our major technology and organizational initiatives take effect.

A prominent annual government-wide survey released in December 2001 indicated that the IRS has significantly improved customer satisfaction among individual taxpayers.

Forty million taxpayers filed electronically in 2001—a 13 percent rise from last year. Since 1997, e-filing increased by 110 percent, and on-line filing grew by 1,700 percent. However, achieving the congressionally mandated goal of 80 percent of returns filed electronically by 2007 will be very difficult. But by working with taxpayers and practitioners, we are tearing down the barriers to e-filing.

For the 2001 filing season, we added 23 additional forms to the 1040 *e-file* program. And we will achieve a major milestone in 2002—virtually all 1040 forms and schedules can be filed electronically and no paper signature document is required. We also introduced EFTPS OnLine, which allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet.

Last year, taxpayer use of our Web site smashed all records—2.6 billion hits with more than 317 million forms and publications downloaded. In 2001, we also launched the Small Business and Self-Employed Community Web page. And in 2002, we will unveil a revamped IRS Web site designed to be a world-class transaction-based gateway.

Many taxpayers prefer telephoning the IRS. Today, nearly all callers have almost immediate access to automated services. In 2001, the IRS toll-free lines answered 108 million calls through a combination of automated and assistor service. However, in the 2001 filing season, taxpayers who wanted to reach an assistor were successful only 63.9 percent of the time. Although this was an improvement, we need to reduce wait time and make service more accessible, consistently accurate and responsive.

We are also working to provide immediate and far-reaching burden relief. For example, in FY 2001, we overhauled the old, complicated rules governing the required minimum distributions from individual retirement accounts. Also, millions of taxpayers are no longer required to file the 54-line Schedule D, “Capital Gains and Losses.” The “checkbox” burden reduction initiative, which enables taxpayers to authorize the IRS to discuss their returns with their paid preparers, also made a very strong showing in its inaugural year. And

OUR STRIDES

SINCE 1997, E-FILING INCREASED BY 110 PERCENT, AND ON-LINE FILING GREW BY 1,700 PERCENT.

we provided burden relief to small businesses through a number of initiatives, including permitting many of them to use the cash method of accounting.

Last year, the concept of service to taxpayers also went far beyond what is normally expected of the IRS. Two events—the issuance of millions of advance refund checks and providing administrative relief to the victims of the September 11 terrorist attacks—demonstrated how we could provide service to taxpayers under extraordinary circumstances.

In spite of the short-term gains we achieved, we are still not providing service to taxpayers at a level that they expect and deserve. However, our Strategic Plan squarely addresses these challenges. It is based upon improving our quality and productivity through the modernization and reengineering of our technology and business practices with limited increases in resources.

GOAL 2 TOP-QUALITY SERVICE TO ALL TAXPAYERS THROUGH FAIR AND UNIFORM APPLICATION OF THE LAW

Our tax system depends on each person who is voluntarily meeting his or her tax obligation having confidence that his or her neighbor or competitor is also complying. Service to all taxpayers means applying the tax law fairly and uniformly. Therefore, when taxpayers do not voluntarily meet their tax obligations, the IRS must use its enforcement powers to collect the taxes that are due.

However, we simply do not have the resources to attack every case of non-compliance. We must apply our resources to where non-compliance is greatest while still maintaining adequate coverage of all other areas. Our near term goal in 2001 was to stabilize the level of our key compliance activities while beginning to focus on the areas of greatest risk to our nation's tax system.

After careful study, we identified and are addressing four important areas of systematic non-compliance. They are: misuse of devices such as trusts and passthroughs to hide income; use of complex and abusive corporate tax shelters to reduce taxes improperly; failure to file and pay large accumulations of employment taxes; and erroneous refund claims.

Although major and systematic areas of non-compliance are our top priority, it is also important that we use all available tools to detect, correct and deter non-compliance of all kinds. For example, in 2002, the IRS will begin processing and matching K-1s reporting almost $700 million of income and, importantly, reporting losses on trusts and passthroughs.

However, no matter how effectively we use our resources and new techniques to identify and prevent problems, some cases require intervention by IRS compliance personnel. Although 80 percent of individual income is reported by third parties, the remaining 20 percent, mainly business income, is not reported and often requires in-person auditing to verify. Also, business income, including that by passthrough corporations, partnerships and trusts, can only be verified through auditing.

In FY 2001, we achieved most of our specific compliance activity goals. Collection activities finally stabilized in FY 2001, and the number of liens filed and levies issued increased by 49 percent and 103 percent respectively over the previous year. Large corporate examinations and returns examined by correspondence increased by 27 percent and 65 percent respectively. We also made 10 percent more determinations for innocent spouse cases and processed 40 percent more offers in compromise.

The exception to achieving our compliance goals was our in-person examination rate, which declined about 20 percent. In-person examinations of individuals and corporations are the area that takes longest to turn around because of the length of time it takes to train people and to complete cases even after they are initiated.

GOAL 3 PRODUCTIVITY THROUGH A QUALITY WORK ENVIRONMENT

Following RRA 98's directions, we designed and made substantial progress in implementing a new modernized IRS organized around customers with similar needs. The new organization focuses on providing service in three key program areas: pre-filing, filing, and compliance. The modernized IRS organization was officially inaugurated, or "stood up," on October 1, 2000. The final stages of implementation, including the redistribution of workload, will require another year through FY 2002.

Employee satisfaction is also a key component of our third strategic goal, productivity through a quality work environment. New survey techniques suggested by the Gallup organization, which better measure employee satisfaction with their jobs, showed a 9 percent decline from 2000-2001. However, much of this drop can be attributed to the uncertainty and change that naturally arise from any reorganization of this magnitude. As a result of feedback from our survey and other channels, we are responding to the problems that our employees brought to our attention.

On January 30, 2001, the IRS Oversight Board approved the IRS Strategic Plan. It lays out how we will use our limited resources to achieve the greatest benefits in performance. Moreover, we will meet these goals while continuing to shrink in size relative to the economy. Indeed, we are planning most of our performance improvement from internal management improvements and modernization, not increased resources. By the end of 2001, balanced measures in line with our strategic plan were rolled out to most of the new organization.

Our business systems modernization (BSM) effort is the largest ever undertaken in the public or private sector. And more than updating our antiquated technology, the modernization program changes the entire way the IRS interacts and conducts business with taxpayers and stakeholders.

Key to BSM's success is the Tax Administration/Internal Management Vision and Strategy (TAVS/IMVS).

The new modernized IRS organization focuses on providing service in three key program areas: pre-filing, filing, and compliance.

It provides a clear, integrated view of how the agency should work in the future. Earlier this fiscal year, the IRS Executive Steering Committee also approved the Enterprise Architecture—a strategic view of the initiatives that are managed by BSM. It will enable us to design and build new business and technology projects that will be the backbone of the modernized IRS.

The BSM program was officially inaugurated on June 28, 1999. In two years, we graduated from strategic planning and systems design to business results. In FY 2001, we put two projects into production, including the Customer Communications FY 2001 Project that greatly improves the efficiency and effectiveness of our systems for receiving, routing, and responding to millions of taxpayer calls.

FY 2002 will mark the first major move away from the 1960s technologies for managing taxpayer data. Through a secure Internet portal, authorized practitioners will be able to access automated self-service applications for services such as requesting account transcripts, resolving certain account issues, and authorizing disclosure of sensitive account information. We will also implement the first stages of the Customer Account Data Engine that will give us access to timely, consistent, and centralized data.

Due to its enormous size, complexity and sensitivity, the BSM program involves considerable risk. However, the fact that risk exists does not mean that the program will fail. It means that the program could fail if the risks are not adequately identified and appropriate action taken to address them on a timely basis.

We are actively identifying and managing the risks in BSM, and we have not hesitated to make changes in programs when necessary. There is a critical point to understand about managing risks in this program: making constant adjustments to plans is an indication that they are being addressed and managed. It is one of the hallmarks of a successful systems program.

Resources and Stewardship

America's taxpayers, the Congress and the Administration expect us to be able to properly account for their money and property. Last year, the General Accounting Office rendered an "unqualified," or clean, opinion on the IRS' FY 2000 Financial Statement for both the Revenue and Administrative accounts. This means that the IRS could properly account for $8.3 billion in appropriated funds, over $2 trillion in revenues collected, and over $190 billion in refunds.

In spite of some long-standing inadequacies in our financial reporting systems that will be addressed through the broader modernization efforts, all of the revenue that comes into the IRS is honestly accounted for and provided to the Treasury. Having a tax agency that performs this task honestly and accurately is an enormous asset to our nation. As demonstrated earlier this year, when the Mellon Bank Pittsburgh Lockbox site lost thousands of taxpayer checks, specific violations or errors were found and corrected.

As we look back on the progress
we made in FY 2001, we also clearly
see how far we still have to go.

Toward Our Mission and Goals: Our Strides, Our Challenges

IT IS A NEW ERA FOR THE IRS. The IRS Restructuring and Reform Act of 1998 (RRA 98) gave us a clear mandate—do a better job meeting the needs of taxpayers as well as collecting the money. We expressed this direction in a new IRS mission statement:

"Provide 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."

Our mission statement accurately describes our role, as well as the public's expectation as to how we should perform it. In the United States, the Congress passes tax laws and requires taxpayers to comply with them. The taxpayers' role is to understand and meet their tax obligations. And most do, since roughly 98 percent of the taxes collected are paid without active intervention by the IRS.

Our role is to help the large majority of taxpayers who are willing to comply with the tax law, while seeing to it that the minority who are unwilling to comply are not allowed to burden their fellow taxpayers. We recognize that we must meet the highest of standards in performing this role, which means that all of our services should be seen by the people who receive them as comparable in quality to the best they get elsewhere.

Just as the best companies produce excellent shareholder returns by providing high-quality products and services, we expect that successful execution of our new mission will produce tax revenues for the Treasury, in accordance with the tax law and without political or corrupt influence. This mission does not, in any sense, negate the intent of the previous one; rather, it builds upon it and sets a broader and higher performance standard.

While a new mission statement and clarification of the public's expectations are fundamentally important, it is equally important that we define the specific goals and objectives needed to achieve our mission. These goals and objectives represent what we are striving to achieve and how we will judge our success, both qualitatively and quantitatively.

The IRS has formulated three strategic goals. They are top-quality service to each taxpayer in every interaction, top-quality service to all taxpayers through fair and uniform application of the law, and productivity through a quality work environment. If we make progress on all three of these goals, we can be confident that we are moving toward achieving our mission and meeting the public's expectations.

GOAL 1

Top-Quality Service to Each Taxpayer in Every Interaction

TOP-QUALITY SERVICE TO EACH TAXPAYER IN EVERY INTERACTION

This is our first strategic goal. We interact with taxpayers millions of times each year on issues both simple and complex. And throughout these interactions, we should give taxpayers top-quality service and treatment that is helpful based on their particular situation and need. The ultimate measure of success in our first strategic goal is whether our customers, America's taxpayers, believe we are meeting their expectations.

We must improve the entire way the IRS serves taxpayers—from filing and paying taxes to getting information and assistance. We have made significant improvements in some key areas, such as electronic filing, telephone service and taxpayer rights.

Indeed, a government-wide survey released in December 2001 demonstrated improved customer satisfaction among individual taxpayers, especially among those who file their returns electronically. The IRS posted an 11 percent increase in satisfaction among all individual tax filers since 2000 and a 22 percent increase since 1999. It was the largest favorable gain of the 30 federal agencies surveyed by the American Customer Satisfaction Index (ACSI).

Although we are on the right road, many problems remain. We have laid out a clear path to our goal and are progressing steadily toward it.

The 2001 Filing Season

The majority of individual taxpayers interact with the IRS during the filing season—that period between January and June when millions of returns, both electronic and paper, are filed and processed, payments are made, and refunds issued. It is also during this critical time that we as an organization are called upon to provide an extensive menu of critical services to America's taxpayers.

To meet this demand, we offer filing, payment, refund and tax law information through a variety of channels and at times and locations convenient to taxpayers. These include both our automated and customer assistance toll-free telephone lines, the IRS' Web site, faxes, CD-ROMS and face-to-face help at our taxpayer assistance centers.

In 2001, the IRS delivered on a successful filing season. We collected $1.9 trillion. We processed over 130 million individual returns and issued over 92 million refunds. IRS representatives met with 7.4 million taxpayers, and we answered 108 million telephone calls during the fiscal year and responded to 19.2 million letters. The sheer size of the numbers is just one indicator of the complexity and magnitude of our task.

The General Accounting Office observed, "This accomplishment is a proud testament to the dedication and abilities of IRS employees who meet this critical responsibility despite shortcomings in information

Number of Individual Income Tax Returns Filed Electronically Since 1995

	Number of Returns in Thousands	Increase	Percentage Increase
1995	11,807		
1996	14,968	3,161	26.8
1997	19,136	4,168	27.8
1998	24,580	5,444	28.4
1999	29,349	4,769	19.4
2000	35,394	6,045	20.6
2001	40,245	4,851	13.7
Cumulative Increase		**28,438**	**240.9**

systems and the challenge of working in a rapidly changing environment."

More than the sum of its parts, the 2001 filing season continues to demonstrate how we can build on positive trends in service to taxpayers, especially as our major technology and organizational initiatives take effect. We are making progress on a number of key service projects that will help taxpayers, not only during the filing season but also throughout the year.

Electronic Tax Administration

Prior to the passage of the Restructuring Act, electronic tax administration (ETA) was still in its infancy. Today, we are weaving it into the fabric of virtually every part of our tax administration system.

In 2001, a little more than 40 million taxpayers filed electronically—a 13 percent rise from last year. Since 1997, e-filing increased by 110 percent, and on-line filing grew by a staggering 1,700 percent. Clearly, the value taxpayers receive from all of our e-programs is one reason behind the growth. Faster refunds, positive acknowledgement of receipt, and fewer errors that require time-consuming letters and telephone calls to correct are key benefits to taxpayers.

One of the important reasons for the strong showing in the ACSI survey was the very high satisfaction rate among electronic filers. It was 77.2 points—higher than the previous year and nearly seven points higher than the national score for private sector services. It was the third year in a row that taxpayers using IRS *e-file* expressed increased satisfaction.

However, achieving the congressionally-mandated goal of 80 percent of returns filed electronically by 2007 will be very difficult. But, by working with taxpayers and practitioners, we are tearing down the barriers to e-filing and making electronic transactions more attractive for all types of taxpayers.

For the 2001 filing season, we added 23 additional forms to the 1040 *e-file* program. And we will achieve a major milestone in the 2002 filing season—virtually all 1040 forms and schedules can be filed electronically and no paper signature document is required. We will also expand the electronic payment options available to taxpayers by accepting credit cards to pay

OUR TASK

IN 2001, THE IRS COLLECTED $1.9 TRILLION, PROCESSED OVER 130 MILLION INDIVIDUAL RETURNS, AND ISSUED OVER 92 MILLION REFUNDS.

IRS REPRESENTATIVES ALSO MET WITH 7.4 MILLION TAXPAYERS, ANSWERED 108 MILLION TELEPHONE CALLS AND RESPONDED TO 19.2 MILLION LETTERS.

installment agreements and delinquent taxes. In addition, we will repeat a popular option from the 2001 filing season. Taxpayers who need a filing extension can get one automatically by making a simple phone call.

In 2001, we also better served the business community's ETA needs. In September, we introduced EFTPS OnLine, which allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. And businesses can now file on-line their Form 941 (Employer's Quarterly Federal Tax Return), as well as Form 1065 (U.S. Return of Partnership Income) and Form 940 (Employer's Annual Federal Unemployment [FUTA] Tax Return). Individual taxpayers who make quarterly estimated tax payments could also use the system, eliminating paper forms and receiving on-line access to payment history.

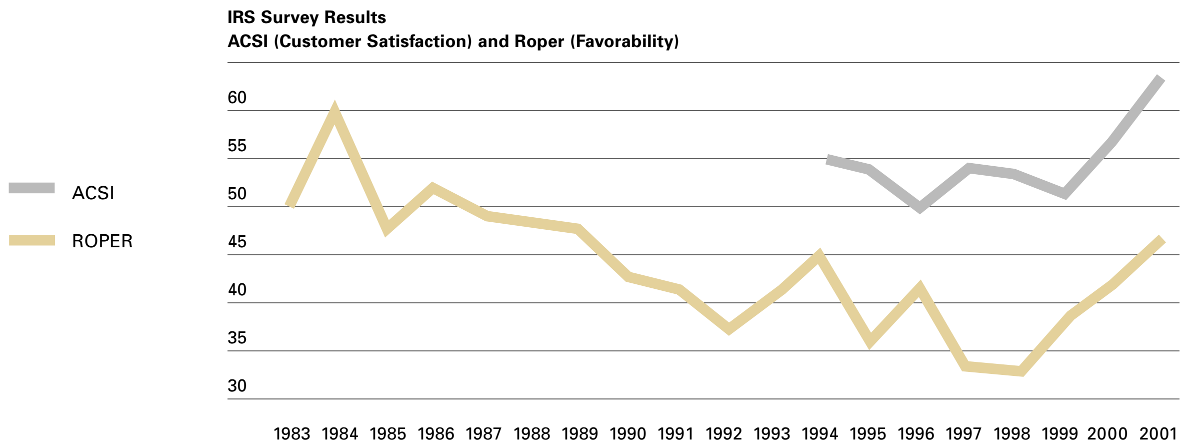
The Internet proved as well to be an enormous growth area for ETA. Taxpayer use of our Web site smashed all records. Four years ago, *irs.gov* received 260 million hits. This year, we estimate that it will post 2.6 billion hits with more than 317 million forms and publications downloaded. In 2001, we also launched the Small Business and Self-Employed Community Web page. It is devoted to the needs of this important group of taxpayers who often confront more complex tax issues than those who have their taxes withheld by an employer. And in 2002, we will unveil a revamped IRS Web site that takes us from being an information-only portal to a world-class transaction-based gateway.

Telephone Service

Many taxpayers prefer telephoning the IRS, and our inability to deliver this basic service contributed significantly to the public's lack of confidence in the IRS in the 1990s. During that time, up to 80 percent of taxpayer calls were met with a busy signal, and according to Roper Surveys, the public's rating of the IRS declined to an all-time low in 1998.

Since 1998, we have provided extended hours of telephone service during the filing season. We also put on more assistors at peak hours, rather than just during normal business hours. Almost 108 million taxpayers called on one of our toll-free lines during FY 2001. We received 76 million automated and TeleTax calls, and our live assistors handled 32 million taxpayer calls. Our San Patricio Puerto Rico call site became fully operational in 2001 and will greatly assist us in providing better access and service to Spanish-speaking taxpayers.

Nearly all callers now have almost immediate access to automated services, although some callers are forced to wait longer to receive assistor service. For taxpayers who wanted to reach an assistor in the 2001 filing season, the overall wait time was 5 minutes and they reached an assistor 63.9 percent of the time, which often required them to call back. Although this was an improvement over the previous year, this level of service is still unacceptable to both taxpayers and the IRS. We are using every method at our disposal, including modern technology, to improve access.



OUR SUCCESS

A GOVERNMENT-WIDE SURVEY RELEASED IN DECEMBER 2001 DEMONSTRATED IMPROVED CUSTOMER SATISFACTION AMONG INDIVIDUAL TAXPAYERS, ESPECIALLY AMONG THOSE WHO FILE THEIR RETURNS ELECTRONICALLY. THE IRS POSTED AN 11 PERCENT INCREASE IN SATISFACTION SINCE 2000 AND A 22 PERCENT INCREASE SINCE 1999, THE LARGEST FAVORABLE GAIN OF THE 30 FEDERAL AGENCIES SURVEYED.

Once connected, taxpayers must get prompt, accurate and courteous answers to their account and tax questions. Here, too, we have made substantial progress toward providing better service to taxpayers. The telephone quality rates for tax law and tax account questions showed a marked improvement in FY 2001. They were up to 75 percent and 69 percent respectively as compared to 73 percent and 60 percent over the same period last year. Although we would agree with the GAO's assessment that we have not yet attained a world-class customer service level, we believe that we are on the right track to achieving that goal.

To increase productivity and quality of service, we must give our employees the technology and tools they need to do their jobs at a high level. In this regard, our Business Systems Modernization (BSM) program is delivering both short- and long-term improvements.

The first of the BSM projects, Customer Communications 2001, was deployed in July 2001 and helped us increase the total number of calls answered, which surged by 32 percent over the past year due in large measure to the advance tax refund. We must also give our assistors specialized knowledge so they can better answer taxpayer questions about a very complex, difficult and changing tax code. Our new technology will allow us to route calls more precisely to assistors with the necessary expertise.

Assistance in Person

For those taxpayers who prefer to visit an IRS office, service is available at more than 400 locations nationwide. At many sites, in-person service is offered on Saturdays during the filing season.

In the past, the IRS did not place a high priority on what were called "walk-in" sites. The services offered at them were limited and often of poor quality. However, under our new field assistance concept of operations, we will better serve taxpayers at our taxpayer assistance centers. We will help them meet their filing and paying responsibilities, including answering their tax law questions and providing forms and limited, courtesy return preparation.

Throughout the year, and at a variety of locations, we also schedule the highly acclaimed Problem

Solving Days to resolve long-standing taxpayer issues for those who cannot take advantage of weekday problem solving services.

Problem Solving Days have an excellent track record. But we must bring what we learn from them to our daily operations. Every day should be problem solving day at the IRS, not just three or four times a year. That means using a cross-functional approach to resolve most tax account issues with a single visit or phone call at any time throughout the year.

To help us meet this need, we created a new job at the IRS, "Tax Resolution Representative." These IRS employees will receive the training and authority to provide "one-stop service" for a broad range of issues ranging from answering tax questions to resolving payment problems.

The Stakeholder Partnership, Education and Communication (SPEC) branch of our Wage and Investment Division is also working to energize the VITA (Volunteer Income Tax Assistance) return preparation program. Last year, we worked with more than 18,000 volunteer sites across the country to assist an estimated 4.3 million taxpayers wanting this service.

Working hand-in-hand with SPEC to help taxpayers understand their obligations is the Taxpayer Education and Communication (TEC) function of the Small Business/Self-Employed Division. Once fully realized, their education and pre-filing services will greatly benefit both taxpayers and our tax administration system in two ways.

First, if we can eliminate confusion, errors and mistakes before a return or form is ever filed, America's taxpayers will be spared countless numbers of notices and communications with the IRS.

Better pre-filing services can reduce the need to fix a problem after it has occurred or to take enforcement actions. Both are more time consuming and costly for the taxpayer and the IRS. This approach promises to be particularly helpful for America's small businesses, especially start-up businesses, which are confronted with a dizzying array of new tax and filing requirements.

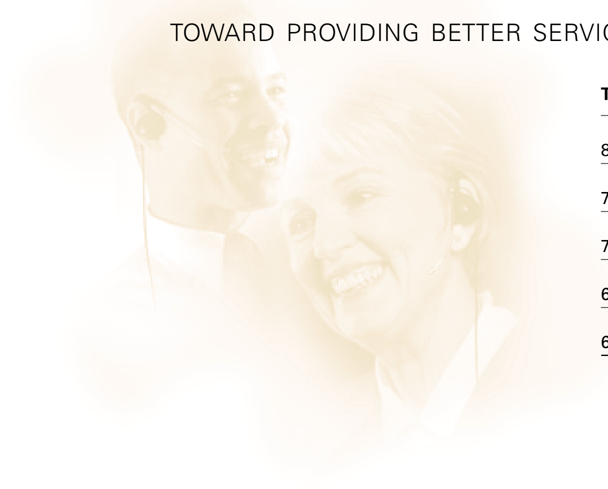
Second, by helping taxpayers better understand their tax filing, payment and reporting requirements, and by giving them the information and tools they need, voluntary compliance should increase markedly. Approximately 98 percent of tax revenues come voluntarily into the Treasury. Therefore, an increase of one percent in voluntary compliance roughly translates to a 50 percent increase in enforcement revenues.

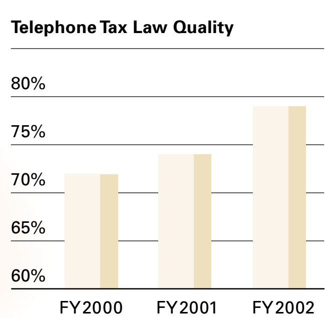
Burden Reduction

One of the ten major strategies included in the IRS Strategic Plan is "reduce taxpayer burden." Through our dual approach of short- and long-term improvements, we are working to provide taxpayers with both immediate and far-reaching burden relief. Our short-term efforts include reducing the number of taxpayers who must file specific forms. We are also simplifying or eliminating forms and notices altogether and making it easier through electronic means to file and pay.

OUR STRIDES

ONCE CONNECTED, TAXPAYERS MUST GET PROMPT, ACCURATE AND COURTEOUS ANSWERS TO THEIR ACCOUNT AND TAX QUESTIONS. HERE, TOO, WE HAVE MADE SUBSTANTIAL PROGRESS TOWARD PROVIDING BETTER SERVICE TO TAXPAYERS.





For example, in FY 2001, we completely overhauled the rules governing the required minimum distributions from individual retirement accounts. The old IRA rules were confusing and onerous to most taxpayers. So, we made the process easier for retirees to determine how much money they must withdraw from their accounts.

Millions of taxpayers are no longer required to file the 54-line Schedule D, "Capital Gains and Losses." They can now use a shorter and simpler form, dramatically easing their burden. We estimate that, in 2002, only 650,000 taxpayers will have to use the long form.

In 2000, we also increased the threshold from $500 to $1,000 for required tax deposits. The change meant that almost one-third of the nation's 6.2 million small business employers does not have to deposit employment taxes.

And in 2001, we provided even more burden relief to small businesses, raising the threshold yet again from $1,000 to less than $2,500 in quarterly employment taxes. This affected about one million small businesses. Through our continued efforts, we estimate that between 70-80 percent of them can be relieved of the burden of making as many as 12 deposits annually, the most frequent transaction of small businesses with the IRS.

In April 2000, the IRS and Treasury Department also issued a revenue procedure that permits qualifying small business taxpayers with average annual gross receipts of $1 million or less to use the cash method of accounting. And in December 2001, the IRS and Treasury Department announced that they would allow certain small businesses with gross receipts up to $10 million or less to use this accounting method.

The new procedure has an enormous impact on easing their tax accounting burden. By our calculations, the overwhelming majority of these taxpayers, who otherwise would have been forced to use the accrual method, are now allowed to use the much simpler and easier-to-understand cash method of accounting.

The "checkbox" burden reduction initiative, which enables taxpayers to authorize the IRS to discuss their returns with their paid preparers, made a very strong showing in its inaugural year. Almost 21 million individual taxpayers marked the checkbox in 2001. We project that number will almost double in 2002.

We are also revising most business income tax returns with a "checkbox" to allow the designation of the paid preparer. For the major employment and excise tax returns, which do not have the box, we are adding a section to allow taxpayers to designate either their paid preparer or an employee. We estimate that 32 percent of these filers will use the checkbox.

However, burden reduction goes beyond filing and payment issues. It also means helping taxpayers with the sometimes complex RRA 98 taxpayer rights provisions, such as the innocent spouse and offers in compromise programs and enhanced due process rules.

We are still working very hard to administer these provisions at a higher level. However, along with some remaining management challenges, there have also been some successes.

Faced with a mounting backlog of 40,000 innocent spouse claims, we took several steps to promote greater efficiency. The innocent spouse program was centralized at one location in Cincinnati. We provided the necessary staff to dig out from the backlog. Today, most new cases can and will be resolved at the Cincinnati Service Center or one of our taxpayer assistance centers. We predict that claims received after January 2001 will soon be processed without significant delays on our part.

Burden reduction also means communicating with taxpayers in plain English. As part of our continuing effort to improve our correspondence to taxpayers, and following RRA 98's directions, the IRS began sending out this year six redesigned notices, including those dealing with math errors, balance due, overpayments and offsets. These notices affect both individual and business taxpayers. The new notices should reduce the number of times taxpayers need to contact the IRS, be easier to understand, and help resolve inquiries. We continue to redesign 24 additional notices. We plan to release four of them in January 2002, seven in July 2002 and the remaining 13 in January 2003.

For many taxpayers, burden reduction is synonymous with problem solving. The Restructuring Act created the Taxpayer Advocate Service—an independent problem-solving function within the IRS. The Taxpayer Advocate Service has more than a proven record of solving taxpayers' long-standing problems with the IRS. It also has the authority to identify and bring to the surface systemic problems, such as burden reduction, and to propose administrative and legislative changes to Congress.

We are certainly making burden reduction gains, but the potential is greater. With business systems modernization and a new customer-focused organization, we can provide meaningful burden reduction for all types of taxpayers—far beyond what is available today.

Advance Refund and September 11th

Last year, the concept of service to taxpayers went far beyond what is normally expected of the IRS. Two events—the issuance of millions of advance refund checks and our response to the tragic events of September 11—demonstrated how we could provide service to taxpayers under extraordinary circumstances.

Just six weeks after President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001, we delivered for taxpayers by getting their checks in the mail. To put in place the $36 billion advance payment provision, we began work weeks earlier so that we would be prepared to handle the first rebate in a quarter century.

The IRS coordinated an unprecedented outreach to America's taxpayers, an intricate computer programming project, a flurry of news releases, an updated irs.gov Web site and additional assistors to handle record call volumes.

Over Memorial Day weekend, Congress gave final approval to the 2001 tax bill, which included the advance payment. The provision set a maximum amount of $300 for an individual, $500 for head of household or $600 for married couples filing jointly. The checks were an advance of a 2001 rate reduction credit and were subject, as most tax provisions are, to various exceptions and limitations.

The Department of Treasury estimated it would issue over 90 million checks, worth approximately $36 billion, over a 10-week period. The checks began arriving in mailboxes on July 23 and no checks were issued after December 31, 2001.

We decided to issue notices to all taxpayers, both those who qualified and those who did not. The notices, issued prior to the checks, helped to answer taxpayers' questions and reduce the number of telephone calls. We contracted with a private vendor to print notices for 130 million people—nearly half the population of the United States.

This is not to say the process was problem free. In July, a computer glitch caused almost a half-million taxpayers to receive notices with inaccurate amounts of their checks. However, the error was identified and those taxpayers were sent a second notice with the corrected amount. In addition, our telephone systems were overwhelmed and many taxpayers could not at first get through to us. Here, too, the IRS responded by retaining our seasonal workers and applying additional resources to address the crunch. All told, we answered 21.8 million taxpayer calls on the advance refund.

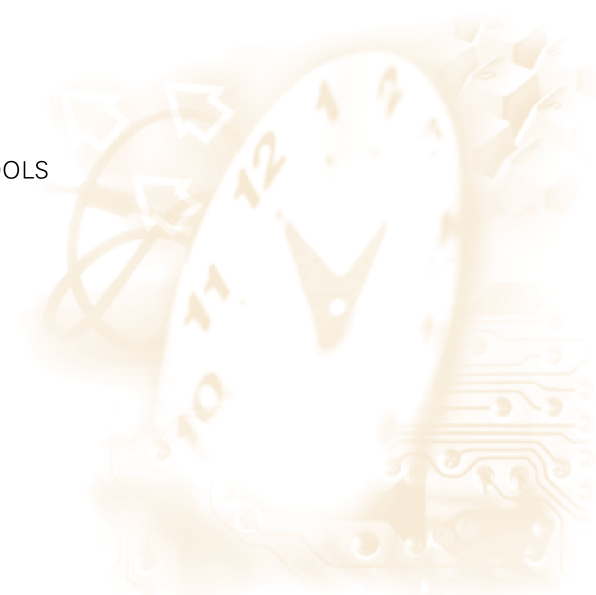
Following the September 11 national tragedy, IRS and Treasury Department employees did their best to minimize the distraction of tax issues for the victims. By September 14, three days after the attack, we provided administrative relief to the victims in the form of extensions to file returns and pay taxes. We also suspended for six months many enforcement actions for the affected taxpayers. In addition, we established special toll-free numbers to answer any questions, and we set up a special disaster relief page on our Web site.

To complement these efforts, we published a brochure, "Help from the Internal Revenue Service for Those Affected by the Terrorist Attacks on America," that explains the tax relief we are providing. To reach the largest possible audience, we also placed public service advertisements in *USA Today*, *Sports Illustrated* and *Business Week*. However, our efforts did not end there.

Our Large and Mid-Size Business Division (LMSB) worked closely with airline industries on the Air Transportation Safety and System Stabilization Act legislation. It allowed for extension of due dates for deposits and clarification that federal loans are included in the airlines' income. LMSB also held an intensive, two-day technical meeting to discuss issues with the principal industries located in the World Trade Center.

OUR CHALLENGE

TO INCREASE PRODUCTIVITY AND QUALITY OF SERVICE,
WE MUST GIVE OUR EMPLOYEES THE TECHNOLOGY AND TOOLS
THEY NEED TO DO THEIR JOBS AT A HIGH LEVEL.



On the law enforcement side, we are providing expertise on money laundering. We are a key part of Operation Green Quest, the new multi-agency initiative targeting funding sources for terrorist organizations.

Before and after the terrorist attacks, the IRS' Tax Exempt/Government Entities (TE/GE) Division also helped educate the public on the legal requirements organizations must meet to qualify for tax-exempt charitable status.

On September 18, we placed a new, easy-to-understand publication on our Web site that provided information to assist the public to make use of charitable organizations. We also announced that we would speed processing of requests for tax-exempt status from new charities formed to assist the victims. Although we expedited the process, we did not lower our standards for new organizations applying for the tax-exempt status.

In addition, we worked with the September 11 charities in getting donations to the victims' families. On November 16, we issued interim guidance that recognized the unique circumstances caused by the tragedy. The notice stated that the charities will not put their exemptions at risk by making payments to the victims and their families without first proving they are in financial need. We wanted to send a clear message that charitable groups that act in a reasonable and good-faith manner to help the victims would not endanger their tax-exempt status.

Challenges Remain to Quality Service

The IRS Oversight Board stated that "service to taxpayers is inadequate" and we do not take issue with their position. In spite of the short-term gains we have achieved, we are still not providing service to taxpayers at a level that they expect and deserve. The facts speak for themselves.

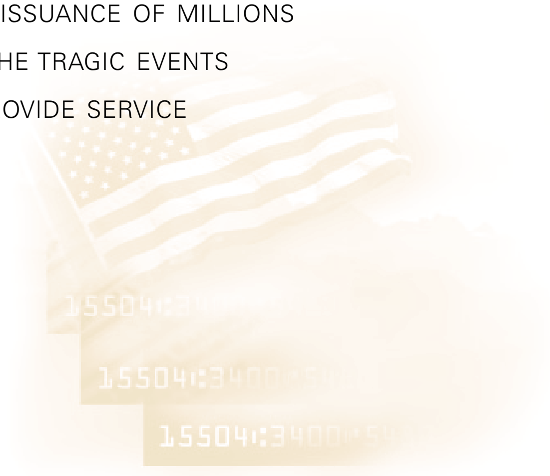
We received 108 million telephone calls on our telephone lines, covering a very wide range of subject matter. The quality of that telephone service—while improving—is still not on a level with what taxpayers receive in the private sector. Treasury Secretary Paul O'Neill characterized it as "unacceptable." He is correct.

Not only must we continue to improve taxpayer access to our toll-free lines, we must improve the accuracy of the response we give to tax law and account questions. Unfortunately, this problem is not confined to telephone assistance. We also have a steep learning curve at our taxpayer assistance centers. The GAO testified in April 2001 that "walk-in sites are continuing to provide poor tax law assistance."

Although we are updating our communications technology to improve access and routing, two factors make it especially challenging to provide high quality service on our telephone lines. First, is the highly peaked and seasonal nature of telephone service that requires answering as many calls during just the filing season as for the rest of the year.

OUR STRIDES

LAST YEAR, THE CONCEPT OF SERVICE TO TAXPAYERS WENT FAR BEYOND WHAT IS NORMALLY EXPECTED OF THE IRS. TWO EVENTS—THE ISSUANCE OF MILLIONS OF ADVANCE REFUND CHECKS AND OUR RESPONSE TO THE TRAGIC EVENTS OF SEPTEMBER 11—DEMONSTRATED HOW WE COULD PROVIDE SERVICE TO TAXPAYERS UNDER EXTRAORDINARY CIRCUMSTANCES.



Second, is the subject matter's complex range and changing scope. For example, between January and April, calls about tax law, which can be extremely complex, make up 38 percent of the calls, while for the rest of the year, they can be as low as 18 percent.

In order to improve service, we will design and implement a major and comprehensive set of changes to the whole telephone program. We will organize our 8,000 assistors into specialized units with expertise on specific subject matter and then use technology to direct calls to the right groups.

We are providing poor service in other areas. For example, employers, particularly first-time employers, are often discouraged by the delays and difficulties in obtaining an Employer Identification Number (EIN). Employers can now go to our new Small Business and Self-Employed Community Web page where they can answer a series of questions to help determine their requirements and what to do if they do not receive their EIN.

As previously noted, we are now administering the Restructuring Act's 71 new taxpayer rights provisions. Many of the provisions, such as innocent spouse protection, due process in collections and offers in compromise, would individually be considered major projects. Collectively, they represent a challenge of learning new ways of doing business for nearly every one of our 100,000 employees. And during this process, we encountered a number of problems and demands that we are still addressing.

The Restructuring Act added requirements that lengthened the offer-in-compromise (OIC) process. Over the past few years, the OIC program's over-age inventory continued to grow in spite of applying more resources. To improve quality, timeliness and efficiency, we centralized OIC processing at our Memphis and Brookhaven Service Centers. By using revised procedures at the new consolidated sites, we hope to streamline the processing of over 120,000 applications submitted each year. This centralization should allow our revenue officers to concentrate on collecting overdue accounts while improving the timeliness of processing OICs.

RRA 98's collection due process provisions also presented new challenges and have resulted in a backlog of cases. However, through the training of additional appeals officers in collection processes and procedures, we believe we will be able to clear up the case backlog in 2002. Improved resource allocations, case development practices, better management, communications and technology should also provide for more efficiency, greater productivity and better results.

It will take time, resources and management attention to solve the challenges that RRA 98 presents. However, our Strategic Plan squarely addresses these issues. More importantly, it improves our quality and productivity through modernization and reengineering of our technology and business practices with minimal increases in resources.

GOAL 2

Top-Quality Service to All Taxpayers Through Fair and Uniform Application of the Law

There is another service that the IRS provides to all taxpayers. And we supply it even if a taxpayer never dials our toll-free numbers or visits our Web site. It is providing top-quality service to all taxpayers through fair and uniform application of the law. Putting it another way, we cannot allow those taxpayers who do not comply to place a burden on those who do. Our tax system has a simple and time-honored premise: each person who is voluntarily meeting his or her tax obligation having confidence that his or her neighbor is also complying.

However, over the past four years, there have been some major declines in many of the activities that the IRS uses to assure compliance with the tax law. At risk are protecting revenues flowing to the Treasury as well as taxpayer confidence in the fairness of our tax administration system. Our near term goal in 2001 was to stabilize the level of our key compliance activities while beginning to focus on the areas of greatest risk to our nation's tax system.

Areas of Systematic Non-Compliance

We do not have the resources to attack every case of non-compliance. Therefore, we must apply our resources to where non-compliance is greatest while still maintaining adequate coverage of all other areas. No taxpayer should ever believe that he or she could ignore the tax law and get away with it.

After careful study, we identified four important areas of systematic non-compliance. They are misuse of devices such as trusts and passthroughs to hide or improperly reduce income; use of complex and abusive corporate tax shelters to reduce taxes improperly; failure to file and pay large accumulations of employment taxes; and erroneous refund claims. However, there is one common element in all four. These schemes are organized and actively promoted.

Abusive trusts are particularly troubling. Experts estimate that the revenue loss to our nation could run into the tens of billions of dollars. Aimed at upper-income taxpayers, these packages use a flurry of paperwork involving domestic and offshore trusts and foreign bank accounts. They appear to move income into tax-free countries or legal vehicles, while taxpayers still maintain effective control over their funds.

With our new IRS organization and Strategic Plan in place, we are able to combat the threat of abusive trusts much more effectively. We have a coordinated strategy involving a full range of tools, from public education to civil and criminal enforcement against both promoters and participants.

Since 1997, IRS Criminal Investigation obtained 154 convictions of individuals for illegal trust schemes. In 2001 alone, it had 301 open investigations, including 125 of promoters. Our commitment to attack this problem is visible for all to see.

In late 2000, a federal judge issued a pair of John Doe summons seeking credit card receipts relating to offshore banking. On February 28, 2001, we conducted the largest and most extensive enforcement action in the IRS' history, carrying out three dozen search warrants simultaneously in a series of related investigations of suspected promoters of fraudulent trust schemes. Law enforcement authorities also made arrests as part of a series of investigations of alleged illegal offshore trust programs.

Civil and criminal penalties are stiff for convicted investors and promoters. Civil fraud can include a penalty of up to 75 percent of the underpayment of the tax that is attributed to the fraud, in addition to the taxes owed. Judges have recently imposed lengthy prison sentences, including one of 11 years, and steep fines against promoters.

We developed specialized training programs and trained 160 agents and attorneys on these trust-related topics. On the civil side, our agents are currently auditing 57 promoters and evaluating several hundred abusive schemes for possible examination or injunctive action. During the past year, these audits resulted in three permanent injunctions and, in one case, a $1.25 million penalty.

Abusive corporate tax shelters are the second major compliance problem. In February 2000, the LMSB Office of Tax Shelter Analysis (OTSA) was established as the focal point for tax shelter compliance initiatives. OTSA is responsible for coordinating and planning tax shelter initiatives and supporting IRS examiners working abusive tax shelter issues. It also serves as a clearinghouse for information provided to us on potentially improper tax shelter activity by corporate and non-corporate taxpayers.

Disclosure is key to addressing and discouraging the spread of abusive corporate tax shelters. In 2000, we issued new regulations requiring corporate taxpayers to disclose more information on these shelters to the IRS. Early disclosure of tax shelters has two advantages. One, it gives us the information we need to better focus our resources. And two, it accelerates what has been a very slow process of finding and winnowing out these tax shelters one at a time. In 2001, we also issued proposed regulations to revise Circular 230, which sets standards for professionals practicing before the IRS. Our goal was to modernize standards of opinions rendered by tax practitioners regarding the kinds of tax shelters prevalent today.

In August 2001, we also reached an agreement with Merrill Lynch resolving issues relating to tax shelter registration penalties. Under the terms of the agreement, Merrill Lynch agreed to make a substantial payment to the IRS. In addition, it implemented a general tax review for investment vehicles it markets. The review process is intended to assure compliance with tax shelter registration and listing requirements under federal tax laws.

Employment tax fraud is also a serious threat to the fairness of the tax administration system. In 2001, we issued a special consumer alert on the employment tax fraud problem. IRS Criminal Investigation is working closely with all parts of the agency to investigate and refer for prosecution individuals and companies that willfully failed to file or pay employment taxes. We are

OUR FOCUS

WE DO NOT HAVE THE RESOURCES TO ATTACK EVERY CASE OF NON-COMPLIANCE. THEREFORE, WE MUST APPLY OUR RESOURCES TO WHERE NON-COMPLIANCE IS GREATEST WHILE STILL MAINTAINING ADEQUATE COVERAGE OF ALL OTHER AREAS.

making solid progress on this front: case openings increased by 75 percent this year. And many of those who bought into these schemes soon discovered that they had embarked on a perilous legal and financial path.

In the past three years, 127 individuals were sent to federal prison, a halfway house or home detention on employment tax issues. Nearly 86 percent of those sentenced for evading employment taxes served an average of 17 months in confinement and were ordered to make restitution to the government for the taxes evaded plus interest and penalties.

On November 15, 2001, the Justice Department filed lawsuits in federal courts in three states to crack down on one of these frivolous and bogus scams that claimed that Section 861 of the tax code exempts from taxation all domestic income earned by U.S. citizens.

Our fourth area of systematic non-compliance involves false refund schemes and Earned Income Tax Credit (EITC) fraud. In 2001, the IRS issued two nationwide alerts warning taxpayers not to fall victim to them. We also established a Web section designed to alert taxpayers and practitioners to fraud and tax schemes that seem "to good to be true." They range from tax credits or refunds related to reparations for slavery to illegal ways to "untax" yourself.

In addition, we will continue to emphasize improved compliance with the EITC provisions of the tax code. Key to our efforts is the use of the Dependent Database (DDB). Using data provided by the Department of Health and Human Services and Social Security Administration, it is designed to identify potential non-compliant returns during returns processing.

For example, when a child's Social Security number was used on multiple returns, the database helps determine which taxpayer was likely to be erroneously claiming tax benefits on behalf of that child. We have moved beyond testing to using the DDB application nationwide as part of our examination program and for the identification of non-compliant taxpayers and paid preparers.

Detecting and Deterring Non-compliance

All taxpayers must comply with the law. "A little cheating here and a little cheating there" is not okay; it is unacceptable. Although major and systematic areas of non-compliance are our top priority, it is also important that we use all available tools to detect, correct and deter non-compliance of all kinds. Compliance is an IRS-wide program requiring that all parts of the agency work together and contribute to our strategic goal.

One of the most powerful tools that we use to ensure compliance is matching information received from employers, financial institutions and other businesses with information reported by taxpayers. In fact, third parties report approximately 80 percent of the personal income received by taxpayers. An important compliance strategy is to use this data as effectively as possible.

We have identified four important areas of systematic non-compliance. The one common element in all four is that these schemes are organized and actively promoted.

For example, this year, the IRS began capturing data from 16.8 million K-1 forms. In 2002, the IRS will change its processing procedures and begin processing and matching K-1s reporting almost $700 million of income and also, importantly, reporting losses on trusts and passthroughs. This will help us to find potential problem cases and to follow up, when necessary, with audits.

In addition, our operating divisions' performance plans reflect the new compliance strategy in examination and collection. SB/SE will focus more on business tax cases, such as those involving unpaid, in-trust taxes, including employment and withholding taxes. We are also instituting new collection processes to select cases and to realign our case inventories based on the compliance risks we identified.

In FY 2001, we implemented the first phase of a multi-year Collection Re-engineering Program. It modifies our Inventory Delivery System to ensure that we promptly assign business tax cases to revenue officers. The Electronic Fraud Detection System is also being enhanced to include selected Business Master File data that will permit research, analysis and evaluation of fraud detection scenarios for business returns.

Finally, we are reinvigorating the fraud referral program so that when our examiners and revenue officers find serious cases of non-compliance from any source, the taxpayers will be referred for criminal investigation. Our Criminal Investigation division is developing training material for the Small Business/Self-Employed fraud referral specialists. The number of fraud referrals has increased by more than 15 percent when compared to last fiscal year.

No matter how effectively we bring our resources to bear and new techniques to prevent problems, some cases will still require audits by IRS compliance personnel. Although 80 percent of the individual income is reported by third parties, the remaining 20 percent, mainly business income, is not reported and often requires in-person auditing to verify. Business income, including that by passthrough corporations, partnerships and trusts, can only be verified through auditing.

Document matching is not useful for verifying business income, gain or loss on asset sales, or most itemized deductions. We estimate that the total personal income that cannot be verified by document matching was about $1.2 trillion in FY 1998, or 19.7 percent of total reported personal income. An important role of audits is to verify these major categories of income and deductions.

Equally important, with respect to both tax revenues and fairness, is the income reported by corporations and partnerships. While the IRS continues to audit the 1,100 largest corporations every year, the audit rate for all other corporations declined from 3 percent in 1992 to 1.1 percent today.

A particular source of concern is the growing number of entities, such as partnerships, trusts and

S-corporations, that pay no income tax at the business level, but pass on their net income to their shareholders or partners.

In 2000, these “passthrough” entities filed 7.4 million returns, reported $5 trillion of gross revenues and $680 billion of income. However, the IRS audited only 29,057 of them, or only one of every 256 returns—the equivalent of 0.39 percent. Even our new K-1 matching program will not provide any verification of the income reported by the business entity itself; this still requires an audit.

Compliance Activity in FY 2001

As previously discussed, our goal in 2001 was to stop the long-term decline in our compliance activities while beginning to focus effectively and efficiently on the key areas of non-compliance previously described.

In most areas, we did achieve this goal. For example, enforcement revenue in FY 2001 was about level with FY 2000, stemming the decline of the past several years. Large corporate examinations and returns examined by correspondence increased by 27 percent and 65 percent respectively. We also made 10 percent more determinations for innocent spouse cases and processed 40 percent more offers in compromise.

Collection activity also stabilized. The number of cases closed by telephone and in the field was about level with 2000. It is also important that when necessary, the IRS take direct enforcement action to collect amounts due. In this regard, it is noteworthy that the number of liens filed and levies issued increased by 49 percent and 103 percent respectively over the previous year.

The significant exception to achieving our compliance goals was our in-person examination rate, which declined about 20 percent. In-person examinations of individuals and corporations are the area that takes longest to turn around because of the length of time it takes to train people and to complete cases even after they are initiated.

By stabilizing the number of compliance personnel, reengineering processes and setting clear goals, we believe that compliance activity levels will increase over the next three years. We will also be able to better identify and focus on key compliance problem areas. Research and other programs will support compliance operations. Taxpayer education, published guidance and pre-filing agreements will help us prevent compliance problems in the first place. However, compliance operations will not yet rise to the desired level of efficiency and effectiveness.

In the long term, we will rely on our Business Systems Modernization (BSM) program to increase the effectiveness and efficiency of these activities. BSM will enable us to increase coverage from audits and other income verification techniques with only modest increases in staff. We also have the opportunity to allocate our compliance resources more efficiently, both in specific cases and around patterns of noncompliance. And when intervention is necessary, we can use analytically-based techniques to assist in determining the appropriate action.

OUR STRIDES

ENFORCEMENT REVENUE IN FY 2001 WAS ABOUT LEVEL WITH FY 2000, STEMMING THE DECLINE OF THE PAST SEVERAL YEARS. LARGE CORPORATE EXAMINATIONS AND RETURNS EXAMINED BY CORRESPONDENCE INCREASED BY 27 PERCENT AND 65 PERCENT RESPECTIVELY.

GOAL 3

Productivity Through A Quality Work Environment

MODERNIZATION AND INCREASED PRODUCTIVITY

The improvements we made since the passage of RRA 98 are significant. However, these short-term initiatives were never intended to create a tax agency of and for the 21st century. To reach that goal and to carry out the Restructuring Act's broad mandates and, most importantly, its intent, we must rely on our long-term modernization program.

We know how to modernize the IRS. Our course is clearly laid out in our Strategic Plan and we are making important progress to achieve our strategic goals. However, the path is neither short, nor easy.

As the Oversight Board correctly observed, "Accomplishing this plan will be a long and difficult process. It will require significant work by the IRS and its advisors and contractors. As importantly, it will require the continuous oversight and support of the many stakeholders that are impacted by and work with the IRS, in particular the Administration and Congress."

Organizational Modernization

Following RRA 98's directions, we designed and made substantial progress in implementing a new modernized organizational structure. It closely resembles the private sector model of organizing around customers with similar needs.

The IRS created four customer-focused operating divisions (ODs) to best serve taxpayers: Wage and Investment, Small Business and Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. There are also a number of functional units, including Appeals, the Taxpayer Advocate Service, Criminal Investigation, and Communications and Liaison. In addition, Chief Counsel established a senior attorney as the Division Counsel for each of the operating divisions; they will fully participate in the OD's plans and activities.

Internally, the Modernization and Information Technology Services organization, which includes the Business Systems Modernization Office, and the Agency-Wide Shared Services unit provide information technology and administrative support, respectively, to all divisions.

The new organization focuses on providing service to each set of taxpayers in three key program areas: pre-filing, filing, and compliance. And to succeed individually and collectively, all programs and organizational units must deliver top-quality services to taxpayers through these three programs.

The modernized IRS organization was officially inaugurated, or "stood up," on October 1, 2000. A top management team is in place for each of the ODs and business units and has clear, end-to-end responsibility and authority to serve a taxpayer segment. This is a huge break from past practices.

Prior to the reorganization, we had a district director responsible for every part of the tax code, from taxpayers who came into one of our "walk-in" centers to large international corporations wrestling with incredibly complex tax issues.

Now, in LMSB, for example, we have five industry groups and entire teams of revenue agents focused on understanding the taxpayer's business problems, which can greatly vary from the financial services industry to retailing and manufacturing. We also have specific industry advisors who bring private sector experience on a broad spectrum of industry issues.

However, many challenges and much hard work remain as the different parts of the new organization are staffed and trained. The final stages of implementation, including the redistribution of workload, will require another year through FY 2002.

In the short term, the reorganization should be largely invisible to taxpayers and tax practitioners. But in the long term, they will see the positive changes that modernization is intended to produce.

Employee Satisfaction

Employee satisfaction is a key component of our third strategic goal, productivity through a quality work environment. New survey techniques suggested by the Gallup organization better measure employee satisfaction with their jobs. Although measurements are not completely comparable to those of prior surveys, they did indicate a decline in FY 2001. Much of this drop can be attributed to the uncertainty and change that naturally come from any reorganization of this magnitude.

More importantly, we are responding to the problems that our employees brought to our attention through the survey and other channels. Last summer, after reviewing the survey results, we acted on a number of the growing pains that arose from the reorganization. For example, we are providing better tools and internal service to our employees, such as through our new employee resource center. We are lessening the administrative burden on front-line managers and we are working and communicating better across organizational lines, which is critical to delivering a successful filing season.

Strategic Plan and Balanced Measures

On January 30, 2001, the IRS Oversight Board approved the IRS Strategic Plan. It follows closely the letter and spirit of RRA 98 and reflects the new and modernized IRS.

The Strategic Plan lays out how we will use our limited resources to achieve the greatest benefits in performance. Moreover, we will meet these goals while continuing to shrink in size relative to the economy. Indeed, we are planning most of our performance improvement from internal management improvements and modernization, not increased resources.

Taken as whole, the Strategic Plan means that there is one very important difference between the IRS' situation today and that of even a year ago: the uncertainty about the future is greatly reduced. We still have much to do, but we know better how to do it and have put in place the foundation for achieving it.

All federal agencies must also have appropriate quantitative performance measures. They are required by the Government Performance and Results Act (GPRA) and are essential to any large organization's proper operation. An integral part of our overall

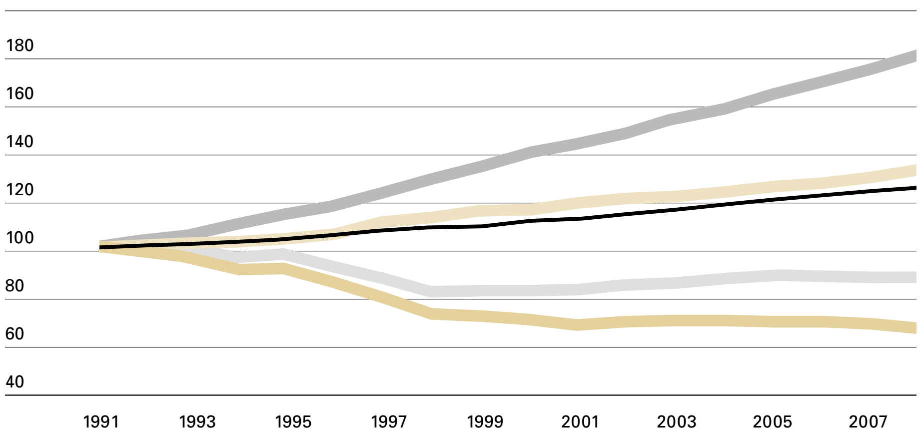
OUR TASK

WE KNOW HOW TO MODERNIZE THE IRS. OUR COURSE IS CLEARLY LAID OUT IN OUR STRATEGIC PLAN AND WE ARE MAKING IMPORTANT PROGRESS TO ACHIEVE OUR STRATEGIC GOALS. HOWEVER, THE PATH IS NEITHER SHORT, NOR EASY.

OUR CHALLENGE

FROM 1993 THROUGH 1999, THE NUMBER OF IRS EMPLOYEES DECREASED 15 PERCENT, FROM 115,000 TO 98,000, WHILE THE ECONOMY GREW IN REAL TERMS BY 23 PERCENT AND THE NUMBER OF TAX RETURNS PROCESSED GREW BY 8.7 PERCENT.

IRS Resources have been Shrinking as a Fraction of the Economy



Notes:

1991 to 2000 real GDP data from the Bureau of Economic Analysis are in chained 1996 dollars. 2001 to 2008 GDP reflect economic assumptions from the Budget of the United States Government, OMB, FY 2002, Mid-Session Review.

FTE data from IRS CFO. 1991 to 1999 FTE levels exclude inspection. 1997 to 2008 exclude EITC staffing. FTE data for FY 2004 and beyond reflect revised assumptions on out-year staffing per CFO.

Returns filed from IRS Document 6186, Calendar Year Returns Projections for the United States and IRS Centers: 2000-2008.

"Workload" data from IRS CFO. "Workload" represents a weighted average of returns processed by exam class.

modernization program is establishing balanced performance measures that support and reinforce our mission and strategic goals.

By the end of 2001, balanced measures in line with our strategic plan rolled out to most of the new organization. For FY 2002, we will expand our number of critical measures. We will deploy balanced measures to the territory, or equivalent level, for purposes of setting performance targets for field offices.

However, we still have work to do. Development of the balanced measurement system and, even more so, learning the new ways of working will take years. By focusing our attention on what is important for achieving our strategic goals, we will stay on the right path and continue our progress.

Resources

The IRS is shrinking when compared to the economy and to our growing workload. But as laid out in our Strategic Plan, we can build productivity by slightly increasing our workforce while at the same time handling the greater workload from a growing economy and improving performance on our service goals. Indeed, should we succeed, we will increase productivity at a rate greater than the private financial sector and continue to shrink the size of the agency significantly in relation to the size of the economy.

It is important to understand the historical context that surrounds our efforts. From 1993 through 1999, the number of IRS employees decreased 15 percent, from 115,000 to 98,000, while the economy grew in real terms by 23 percent and the number of tax returns processed grew by 8.7 percent. Looking solely at gross numbers, one might assume that the IRS succeeded in recent years in achieving higher productivity. However, the facts tell a different story. The reduction in number of IRS employees was achieved only in part by an increase in real productivity. Instead the decline in resources imposed a burden on taxpayers who failed to receive the service they expect.

Today, with our Strategic Plan in place, we believe we can achieve the goals, mandates and, most importantly, RRA 98's intent as to how the IRS should perform its mission, with only limited increases in resources. We do not need large additional funding for staffing. Rather, we must have sustained attention to carrying out RRA 98 by modernizing all aspects of the

IRS. This requires limited, but consistent, increases in operational resources and sustained funding of the modernization program.

Stewardship

The IRS is the steward of massive taxpayer revenue, budget and financial resources. America's taxpayers, the Congress and the Administration expect us to be able to properly account for their money and property. For the past four years, we have received an "unqualified" or clean opinion on IRS' Financial Statement for the $2 trillion collected in Revenue Accounts. Last year, the General Accounting Office rendered an unqualified opinion on the IRS' FY 2000 Financial Statement for both the Revenue and Administrative accounts.

The GAO's opinion means that the IRS could properly account for $8.3 billion in appropriated funds, over $2 trillion in revenues collected, and over $190 billion in refunds. This success can be greatly attributed to the hard work and dedication of the IRS staff, the significant improvements made to IRS' internal controls, and management focus placed on the financial audits.

Certainly, many material weaknesses were identified in the audits and they must and will be addressed through the broader efforts to modernize the IRS' systems and organization as mandated by the Restructuring Act. One of the key requirements for better financial management at the IRS is improved technology.

However, in spite of these weaknesses, one fact emerges. All of the revenue that comes into the IRS from millions of taxpayers and businesses is honestly accounted for and provided to the Treasury. It is an enormous asset to our nation that it has a tax agency, which regardless of its limitations and weaknesses, performs this task honestly and accurately. As demonstrated earlier this year, specific violations or errors are found and corrected.

Over the past eight years, the IRS oversaw 500 million remittances without a major problem. However, in 2001, more than 70,000 taxpayer checks valued at $1.2 billion were determined to be missing at the Mellon Bank Pittsburgh Lockbox site. The Lockbox Program is a network of financial institutions that process taxpayer remittances for the IRS. Operated through an agreement with the Department of Treasury's Financial Management Service, the system helps accelerate the flow of funds to the Treasury.

Once detected, we took swift action to alert potentially affected taxpayers to the problems. More importantly, these taxpayers will not be penalized by what occurred. They will be made whole, and the Treasury will receive its funds. The incident, although isolated, will be used to improve procedures and prevent any such problem in the future.

It bears mentioning that all of the IRS' operations are transparent to Congress and our auditors, including the GAO and the Treasury Inspector General for Tax Administration (TIGTA). These audits point out problems and identify useful ways we can improve the entire spectrum of taxpayer services. In FY 2001, we received 149 TIGTA audit reports and 42 GAO reports containing 569 specific recommendations for changes and improvements. In addition, 104 TIGTA and 37 GAO audits are underway.

Today, with our Strategic Plan in place, we believe we can achieve our mission with only limited increases in resources.

BUSINESS SYSTEMS MODERNIZATION

The IRS is saddled with a collection of obsolete and inefficient computer systems developed over a 35-year period. The most important ones that maintain all taxpayer records were developed in the 1960s and 1970s. Virtually every one of our 100,000 employees depends on these antiquated and inconsistent systems to perform his or her job.

The effect of this obsolete technology on service to taxpayers and productivity cannot be disputed. As compared to what the private sector offers, the IRS' services are deficient, and the lack of modern computer systems is one of the fundamental obstacles to providing consistent, top-quality service.

Our modernization program is one of the largest and most complex business systems modernization efforts ever undertaken in the public or private sector. And more than updating our antiquated technology, the modernization program changes the entire way the IRS interacts and conducts business with taxpayers and stakeholders. Indeed, we do not view systems modernization as a separate entity, but rather as one of the major ways we can achieve all of RRA 98's goals within realistic budget resources.

Our biggest challenge is to implement this massive change while still running the largest tax administration system in the world, collecting about $2 trillion per year from 130 million individuals and six million businesses.

A Vision of How the IRS Should Work

Key to BSM's success is the Tax Administration/Internal Management Vision and Strategy (TAVS/IMVS). It provides a clear, integrated view of how the agency should work in the future. As seen through its lens, taxpayers will reap the benefits from BSM in a number of key areas, such as speed, access and accuracy.

Of course, it will take nearly a decade to achieve all of these benefits. But once fully realized, nearly all taxpayers will be able to file and pay electronically, regardless of the type of form or tax. They will also be able to review their tax accounts on-line in a secure manner. Taxpayers filing electronically and having correct returns can expect to receive refunds to their bank accounts within two to three days.

The level of telephone service is also expected to increase to 90 percent. We will expand Web-based services to include exchange of information and resolution of accounts; first-time resolution of account inquiries should increase to 80 percent.

The effect of BSM on our compliance activities will also be profound. Third party matching data will be made available earlier. Assembling all available data about a taxpayer case for our employees will avoid the need to get duplicate data from taxpayers. The collection time for outstanding balances will be reduced to an average of six months. Improved systems will allow us to identify more quickly which taxpayer accounts need attention from either telephone or in-person collectors. BSM will also provide complete and accurate information to the collectors before they even deal with the taxpayer, and computer tools will assist them in closing cases.

Enterprise Architecture

Earlier this fiscal year, the IRS Executive Steering Committee approved the Enterprise Architecture (Version 1.0). This is a strategic view of the six change initiatives that are managed by BSM: process, organization, location, data, application and technology.

The approval of the architecture marked a major milestone in our progress toward BSM's goals and will enable us to design and build new business and technology projects that will be the backbone of the modernized IRS. Indeed, this represents the first time in the IRS' history that we have a comprehensive view of the planned evolution of both business processes and supporting technology.

The importance of completing a useable and comprehensive version of this enterprise vision and architecture cannot be overstated. The lack of one contributed significantly to the failure of previous IRS modernization programs.

FY 2001: From Planning to Delivery

The BSM program was officially inaugurated on June 28, 1999, with the first release of funding from the Information Technology Investment Account. In two years, we have graduated from strategic planning and systems design to business results. In FY 2001, we put two projects into production.

On July 27, 2001, the Customer Communications FY 2001 Project was placed into operation. CCO1 greatly improves the efficiency and effectiveness of our systems for receiving, routing and responding to millions of taxpayer calls on our telephone lines each year.

The project went "live" just in time for the issuance of the advance tax refund notices and the onslaught of telephone calls that ensued. We successfully handled over 39,000 of these calls during CCO1's busiest hour on the first day of the job. This new capability also helped us better route callers to our 9/11-disaster hotline.

In FY 2001, we also deployed a commercial tax computation software package, the Customer Relationship Management Exam. The package was sent to over 500 revenue agents in LMSB, with copies to be delivered to the rest of the LMSB agents by the end of FY 2002. The CRM Exam software allows agents to calculate accurate tax assessments for complex tax calculations including carryback/carryforward, Alternative Minimum Tax, and Foreign Tax Credit. BSM will also deploy the system to some SB/SE agents next year.

FY 2002: More Service and Support

FY 2002 will mark the first major move away from the 1960s technologies for managing taxpayer data that have held the IRS back from providing quality service to taxpayers. The infrastructure deployed in 2002 will enable secure and private access over the Internet to taxpayer and tax practitioner information. It is the foundation for all future business enhancements and new services to taxpayers.

In FY 2002, we will implement the first stages of the Customer Account Data Engine (CADE). Access to timely, consistent, and centralized corporate data is the key to modernization; CADE is the implementation vehicle. Due to the size and complexity of the software that analyzes and posts data onto the Master Files, and to minimize the risk of potential problems, we will first move simple accounts onto the CADE database, beginning with a subset of Form 1040EZ filers.

Because of the enhancements to the security and telecommunications infrastructures, the e-Services Project can begin to use effectively the power of the Internet to benefit customers and employees. Through a secure portal, authorized practitioners can access automated self-service applications for new account and non-account-related services, such as requesting account transcripts, resolving certain account issues, and authorizing disclosure of sensitive account information.

The Customer Communications Internet Refund, Fact of Filing (IR/FoF) will deliver a self-service Internet application to allow individual taxpayers to

OUR CHALLENGE

THE EFFECT OF OUR OBSOLETE TECHNOLOGY ON SERVICE TO TAXPAYERS AND PRODUCTIVITY CANNOT BE DISPUTED. AS COMPARED TO WHAT THE PRIVATE SECTOR OFFERS, THE IRS' SERVICES ARE DEFICIENT, AND THE LACK OF MODERN COMPUTER SYSTEMS IS ONE OF THE FUNDAMENTAL OBSTACLES TO PROVIDING CONSISTENT, TOP-QUALITY SERVICE.

check on the status of their income tax return posting (fact-of-filing) and their refund, 24 hours a day, 7 days a week.

Some slippage occurred for the projects slated for initial implementation in 2001 and 2002. However, these schedule adjustments are well within normal tolerances for major systems programs.

Building Management Capability

A major program, such as BSM, requires a highly-developed management capability. It must include highly-qualified individuals, well-developed processes and practical experience in applying them to the program's real work. Such a capability cannot be instituted immediately in any organization, but must mature over time.

In the two years since the BSM program began, management processes have greatly matured and will continue to show progress as more experience is gained. We built a much strengthened management team in both the IRS and the PRIME contractor (Computer Sciences Corporation) and their alliance partners. We now have a seasoned management team blending IRS and private sector experience.

Also, with the appointment in March of a new Deputy Commissioner for Modernization and Information Technology Services (MITS) and Chief Information Officer, we took a key step to better synchronize the transition of BSM from design orientation to delivery.

During the past year, we also made significant progress in a number of areas to improve the program's overall management. The first was configuration management. During FY 2001, we defined a baseline process for each project. It spells out and helps us measure all of the different projects' functions, requirements and capabilities, technology, schedules and costs. Configuration management prevents the BSM program's complexity and the number of moving pieces from overwhelming us.

Closely related to configuration management is release management. This is the process of coordinating and managing the activities by which we plan, test and implement all BSM project releases. Release management is critical to a business systems plan as large as ours, as one release can have ripple effects throughout the larger universe of projects.

On May 8, 2001, in partnership with the PRIME, we also formally established a Release Management Board to manage all of the FY 2002 and subsequent releases. We now have a detailed quarterly plan that shows the sequencing and interdependencies of all of the different BSM projects.

Managing Risk

Due to its enormous size, complexity and sensitivity, the BSM program involves considerable risk. However, risk in this context is often misunderstood. The fact that risk exists does not mean that the program will fail. It means that the program could fail if the risks are not adequately identified and appropriate action taken to address them on a timely basis.

We are actively identifying and managing the risks in BSM, and we have not hesitated to make changes in the program when necessary. Since April 2000, many serious program risks were reduced or eliminated, and new risks are constantly being identified. There is a critical point to understand about managing risks in this program: making constant adjustments to plans is an indication that they are being addressed and managed. It is one of the hallmarks of a successful systems program.

WORKING IN A POST 9/11 ENVIRONMENT

In the weeks following the September 11 terrorist attacks, we conducted a security assessment of all IRS facilities. Aided by security experts, we determined what immediate steps needed to be taken, such as screening and guard services. In addition, we will establish a consistent security standard for key areas such as screening employees, identification badges and parking access.

Given the enormous volume of mail that the IRS handles, we are concerned too about hazardous materials threats. As recommended by the Centers for Disease Control, we arranged for all employees throughout the country who handle mail to have available masks and gloves that meet or exceed recommended standards. In addition, we are taking measures to limit employees' exposure to any hazardous substances and, in the event that a hazardous substance is suspected or identified, contain it in one place. We are committed to taking whatever actions are necessary to protect our employees' health and safety as well as the integrity of our tax administration system, especially during the 2002 filing season.

APPENDIX A: PERFORMANCE MEASURES

The following charts present the performance goals that the IRS set for its primary programs for FY 2001. This was a first for the IRS. Never before had the Agency attempted to lay out and quantify goals across the broad spectrum of services and activities that the IRS provides and performs.

When the FY 2002 IRS Annual Performance Plan was finalized in April 2001, we projected that the performance goals for almost all programs would significantly increase in FY 2001. These were highly aggressive goals that depended on many assumptions. While we were reasonably confident of the overall positive trend, we also realized that some of the targets would not be achieved during the projected time frame. The charts indicate where we did not meet the set goals and provide an explanation of the factors behind any shortfall of 10 percent or more.

AGENCY-WIDE OPERATIONAL PERFORMANCE MEASURES

	FY 2000	FY 2001	FY2001 Targets	% Change from FY 2000	% Change from FY2001 Target
Pre-Filing Programs — Assisting Taxpayers in Understanding their Tax Responsibilities and Preparing Accurate Returns					
1. Education and Outreach Staff-Years	1,082	**1,224**	1,768	13%	-31%
Volunteers Helping Taxpayers					
2. Volunteer Hours Reported	2,274,732	**2,790,245**	2,297,700	23%	21%
3. Number Volunteer Locations	18,147	18,238	17,472	1%	4%
4. Small Business Products Disseminated (Workshops)	2,200	**1,181**	371	-46%	218%
Rulings and Agreements					
5. EP/EO Determination Letters	109,461	**109,326**	121,000	-0.1%	-10%
6. Private Letter Rulings Completed	1,913	**2,428**	1,920	27%	26%
7. APAs and Pre-Filing Agreements	67	**73**	165	9%	-56%
8. Small Business Agreements	2,700	3,104	3,000	15%	3%
9. Electronic Tax Law Questions Received	303,758	**264,448**	310,050	-13%	-15%
10. Taxpayer Advocacy Projects	88	92	88	5%	5%
Filing and Account Assistance Programs – Assisting Taxpayers in Filing Returns, Receiving Refunds, Making Payments, Resolving Questions					
Returns Processing:					
Paper Primary Returns Filed					
11. Individual 1040 Series (millions)	92.30	90.59	87.87	-2%	3%
12. Business Returns (millions)	81.59	83.15	81.47	2%	2%
Electronic Primary Returns Filed					
13. Individual 1040 Series (millions)	35.37	40.22	42.34	14%	-5%
14. Business Returns (millions)	3.22	**6.26**	3.72	94%	68%
15. Total Primary Returns Filed (millions)	212.48	220.22	215.39	4%	2%
Electronic Tax Administration					
16. Percent Individual Returns Filed Electronically	27.8%	30.7%	32.6%	10%	-6%
Number Taxpayers Paying Electronically					
17. Debit/Credit Card Transactions	456,300	**648,413**	1,000,200	42%	-35%
18. Elect Fed Tax Payments System (millions of transactions)	63.38	64.37	67.5	2%	-5%
19. Number of Web Site Hits (billions)	1.56	**2.60**	2.00	67%	30%
20. Customer Account Correspondence	18,795,551	**19,183,250**	17,100,000	2%	12%
Toll-Free Telephone Service Workload					
21. TeleTax and Toll-Free Automated Calls (millions)[1]	49.70	**76.12**	67.79	53%	12%
22. Assistor Calls Answered (millions)[2]	32.32	32.09	32.68	-1%	-2%

[1] *FY 01 Rebate calls = 18.5 million*

[2] *Additional assistor calls answered: 10.1 million (calls other than 3 major product lines)*

KEY:

2001 Results above or below 10% of Target shown in **bold.**

AGENCY-WIDE OPERATIONAL PERFORMANCE MEASURES

	FY 2000	FY 2001	FY2001 Targets	% Change from FY 2000	% Change from FY2001 Target
Filing and Account Assistance Programs – Assisting Taxpayers in Filing Returns, Receiving Refunds, Making Payments, Resolving Questions					
Toll-Free Telephone Service Effectiveness					
23. Customer Satisfaction (4 point scale W&I/SBSE)	3.46	3.45	3.58	-0.3%	-4%
24. Assistor Level of Service (Full Year)	59%	**56%**	63%	-5%	-12%
24.a. Assistor Level of Service (Filing Season)	61%	64%	N/A	4.8%	_
25. Tax Law Quality	73%	75%	74%	4%	2%
26. Account Quality	60%	**69%**	63%	15%	10%
Local In-Person Assistance to Taxpayers					
27. Customer Satisfaction (7 point scale)	6.48	6.40	6.50	-1%	-2%
28. Returns Prepared	1,092,691	1,009,390	1,114,080	-8%	-9%
29. Geographic Coverage	70%	**82%**	72%	17%	14%
Post-Filing Compliance Services: — Bringing Taxpayers into Compliance with the Law					
Addressing Taxpayer Payment and Filing Obligations					
Collection by Telephone and Correspondence					
30. Customer Satisfaction (4 point scale SBSE/W&I)	3.41	3.46	3.50	1%	-1%
31. Delinquent Accounts Closed (Entities)	1,052,221	1,006,600	1,087,400	-4%	-7%
32. Delinquent Investigations Closed	412,150	**297,791**	400,376	-28%	-26%
33. Telephone Level of Service	79%	77%	80%	-2%	-3%
In Person Collection					
34. Customer Satisfaction (7 point scale)	4.45	5.01	4.94	13%	1%
35. Delinquent Accounts Closed (Modules)	771,455	**757,392**	846,800	-2%	-11%
36. Delinquent Investigations Closed	144,764	**119,451**	146,211	-17%	-18%
37. Quality of Cases Handled in Person	84%	84%	86.4%	-1%	-3%
38. Offers in Compromise Processed	69,514	**97,013**	73,068	40%	33%
Post-Filing Compliance Services: — Bringing Taxpayers into Compliance with the Law					
Addressing Taxpayer Reporting Obligations					
Cases of Under or Over Reporting Identified Through Document Matching					
39. Number of Cases Closed	2,888,900	**2,511,424**	2,859,000	-13%	-12%
40. Case Quality Score	93%	95%	94%	2%	1%
Examination of Returns Through Correspondence and Telephone					
41. Customer Satisfaction (7 point scale)	4.04	4.18	4.30	3%	-3%
42. Number of Returns Examined	394,754	**650,376**	558,655	65%	16%
43. Case Quality Score	70%	71%	72%	1%	-2%

KEY:

2001 Results above or below 10% of Target shown in **bold.**

AGENCY-WIDE OPERATIONAL PERFORMANCE MEASURES

	FY 2000	FY 2001	FY 2001 Targets	% Change from FY2000	% Change from FY2001Target
Post-Filing Compliance Services: — Bringing Taxpayers into Compliance with the Law					
Examination of Returns in Person					
Individual Returns					
44. Customer Satisfaction (7 point scale)	4.41	4.65	4.60	5%	1%
45. Number of Individual Returns > $100,000[3]	63,217	**50,827**	113,699	-20%	-55%
46. Number of Individual Returns < $100,000[3]	187,891	145,144	152,964	-23%	-5%
47. Total Number of Individual Returns[3]	251,108	**195,971**	266,663	-22%	-27%
48. Case Quality Score	58%	**70%**	60%	20%	16%
Corporate Returns					
49. Number of Business Returns Examined[4]	103,112	**84,748**	142,441	-18%	-41%
50. Number of Cases Examined (Large Case)[5]	369	**417**	475	13%	-12%
51. Number of Returns Closed (Large Case)	3,096	3,710	3,831	20%	-3%
Post-Filing Compliance Services: — Bringing Taxpayers into Compliance with the Law					
Employee Plans and Exempt Organizations					
52. Customer Satisfaction (7 point scale) (AVG EP & EO)	5.71	5.70	5.70	-0.1%	0%
53. Number of Examinations	19,080	**15,988**	19,300	-16%	-17%
54. Case Quality Score (AVG EP & EO SCORES)	83%	**73%**	83%	-12%	-13%
Compliance Services					
55. Innocent Spouse Determinations Made and Claimant Notified	55,698	61,011	57,659	10%	6%
56. Appeals Cases Closed	54,986	**54,748**	73,013	-0.4%	-25%
57. Criminal Investigations Initiated	3,372	3,284	3,320	-3%	-1%
58. Total Tax Court Cases (Beginning Inventory & Receipt)	35,962	31,883	33,400	-11%	-5%
Taxpayer Advocate Service					
59. Number of Cases Closed	237,885	248,011	244,941	4%	1%
60. Casework Quality Index	65%	72%	68%	10%	5%
Other					
61. Total Enforcement Revenue (billions)	33.80	33.78	34.00	-0.1%	-1%
62. Agency-Wide Employee Satisfaction	59%	**51%**	60%	-14%	-15%
63. Number of FTEs (w/ EITC)	97,074	97,938	99,509	1%	-2%
64. Number of FTEs in Taxpayer Contact Programs (w/EITC)	65,415	65,730	67,852	0.5%	-3%
65. FTE per Billion $ Real GDP	10.57	10.26	10.42	-3%	-2%

[3] *Individual Returns Examined – This data reflects only Small Business/ Self-Employed In Person Examination closures.*

[4] *Number of Business Returns Examined – This data includes SB/SE Business Return closures, and all LMSB Industry and associated Individual Return closures.*

[5] *FY 2000 Actual adjusted to reflect updated information.*

KEY:

2001 Results above or below 10% of Target shown in **bold.**

FY 2001 PERFORMANCE SUMMARY
EXPLANATIONS FOR VARIANCE IN MEETING/EXCEEDING PERFORMANCE GOALS (+/- 10%)

2. Volunteer Hours Reported – The increase in the hours reported by IRS volunteers is attributed to an increased focus placed on providing additional services to taxpayers as well as increased publicity to solicit volunteers to staff new volunteer locations in FY 2001. In addition, some adjustments were made to hours reported in FY 2001 to account for reporting shortfalls that occurred in FY 2000.

4. Small Business Products Disseminated – The increase in the number of products provided to the small business taxpayer resulted from a change in the definition to now report the number of products provided at a workshop versus the number of workshops held. In addition, the target was established absent the availability of accurate historical data.

5. EP/EO Determination Letters – The planned number of determination case disposals was predicated on the projected volume of application receipts. The shortfall was primarily due to an unexpected shortfall in receipts for plan amendments under new pension laws. Those receipts are expected in the first quarter of FY 2002 and will increase both receipts and cases closed for FY 2002. Determination closures were slightly (less than 2%) below plan due to an increase in time applied per case associated with new agent hires.

6. Private Letter Rulings Completed – Increases in rulings of this type continue to remain a popular customer-service mechanism for taxpayers to seek resolution of issues in pre-filing stages. Another factor contributing to the increase is the gross income threshold changes for companies that reduced filing fees to an affordable level.

7. APA's and Pre-Filing Agreements – The announcement opening the Pre-Filing Agreement program to all (Rev. Proc. 2001-22) was not issued until January 22, 2001 - later than expected. The late opening of the program combined with significantly less taxpayer interest than expected caused delivery of only 5% of target.

9. Electronic Tax Law Questions Received – Approximately 85% of planned receipts were realized. The addition of a "Frequently Asked Question" feature to the Electronic Tax Law Assistance Web site in January 2001 had an impact on receipts. This feature is a self-service application based on questions (received and answered) in ETLA in prior years. Taxpayers are able to search for their question (and answer) without having to contact the IRS. Also, a limited number of tax law changes occurred in FY 2001 and advertising of this service was kept to a minimum due to limited resources.

14. Business Returns – The increase in electronic filing for business returns can be attributed to an increase in filing options that are available to taxpayers and Reporting Agents. These options include 940 e-file, 941 e-file, and 941 On-Line Filing and the 1065 e-file. Also available are integrated payment options (EFTPS, Direct Deposit) for the 941 e-file and 941 On-Line Filing programs, all contributors to more business taxpayers taking advantage of the simpler filing through electronic media.

17. Debit/Credit Card Transactions – The target was a mathematical projection based on accelerated growth in electronic payment activity with limited historical data and no precedent to use as a basis. Although the target was not achieved, debit/credit card transactions increased by 43% over last year. Some reasons for this increase include:

- perceptions by taxpayers that options are safe (2 years, no major problems);
- expanded information in IRS publications and on the Digital Daily, and promotion by practitioners, credit card companies and credit card processors; and
- improved training of Customer Service Representatives about the payment options.

19. Number of Web Site Hits – Successful marketing of the Web site is the primary reason for the increase. More people are also becoming aware of the site from a variety of sources and recognize the value of being able to access the information they need themselves rather than waiting for service on the telephone, in an office, or through the mail. This awareness, combined with the increased number of people who own computers and have access to the Internet, are other primary contributors to the increase in hits.

20. Customer Account Correspondence – Volume increased slightly compared to FY 2000. The increase relative to the target was the result of miscalculation of the target going into FY 2001 (closures for the first quarter of FY 2000 were not considered in the calculation of the FY 2001 target).

21. TeleTax and Toll-Free Automated Calls – Newer technology and newer scripts enabled us to move more calls to automated services providing the means to accomplish goals in this area. The ability to move many of the rebate calls and answer related questions without using assistor resources was also a major contributor to the successful achievement for this measure. Calls related to special advance refund in FY 2001 totaled 18.5 million.

24. Assistor Level of Service – The assistor level of service for the full fiscal year was significantly affected by the large volume of calls during July, August, and September due to the special advance refund, resulting in longer wait times and a lower than planned assistor level of service despite answering approximately the planned number of assistor calls. During the filing season period, which ended before the special refund calls began to come in, assistor level of service was at 64%, an increase of 5.13 percent from the 2000 filing season level. The fiscal year variance from target was caused primarily by longer handle times for account calls, which in turn is partly due to the diversion of more simple calls to automated services.

26. Account Quality – Increased attention placed on quality, and an increase in the knowledge and experience of the Customer Account Representatives as the year progressed were factors in the significant increases in work quality in the account area.

29. Geographic Coverage – The original target was a mathematical projection calculated using little if any historical information. There is no one item that can be associated with achievement of this target and the data obtained is of little value to the service. This measure will be deleted from the critical measures in FY 2002.

32. ACS Closures – Taxpayer Delinquent Investigation (TDI) – The target was determined to be flawed after identification of a systemic problem inflating the base used to develop the FY 2001 goals. In addition, the need to provide staff to answer the increased call volumes was a primary contributing factor to the missed target as were delays in hiring and greater focus placed on working the delinquent account inventory.

35. & 36. Field Collection TDA & TDI Closures – The top priority was to stem the long-term decline in the TDA (Taxpayer Delinquent Account) closures, which were approximately level with closures in FY 2000. The number of closures were impacted by a resource shift to work Offer In Compromise cases, increased complexity of SB/SE inventory, Collection Due Process procedures and additional process steps still in place from the Restructuring and Reform Act of 1998

38. Offers In Compromise Processed – Establishment of management controls over the escalating inventory caused an increase in assigned resources and productivity, and resulted in a reduction in inventory levels. However, the additional resources added to OICs had a negative effect on TDA closures.

39. Automated Underreporter Closures – A delay in starting the Tax Year 1999 inventory due to systemic problems, coupled with a reduction in the number of immediate closures screened out on the front end of the process (29% versus the planned 40%) contributed to an inventory shift to more complex SB/SE cases and were direct contributors in failure to meet the target.

42. Number of Returns Examined – A decision by management to redirect resources to work through the backlog of inventory in the Earned Income Tax Credit (EITC) area was successful. The additional resources and the less complex examination of an EITC return caused an increase in productivity and subsequently, results over the planned target.

45. & 47. Number of Individual Returns > $100K and Total Number of Individual Returns – The original plan assumed increases in resources; percentages of direct time applied, and reduction in the time per return. These improvements were not realized resulting in fewer returns closed. Immediate emphasis has been placed on building and maintaining optimal inventory levels, case management and issuance of revised program guidance.

48. Case Quality Score – The apparent increase in case quality score in FY 2001 is due to changes in the case quality point scale and number of standards measured, as compared to FY 2000.

49. Number of Returns Examined (General Industry) – The FY 2001 planning assumptions were made with limited historical information. Also, there was a larger than expected expenditure of time in areas that do not ordinarily result in a closed case. Accordingly, the number of returns that were planned did not materialize.

50. Number of Cases Examined (Large Case) – The increase in cases examined in FY 2001, as compared to FY 2000, is attributed to a large number of staff re-directed to case examination. In FY 2000, a large number of staff within LMSB was engaged in design team activities focused on organization and stand up.

53. EP/EO Examinations Closed – A surge in determination receipts was expected and inventories of open examination cases were kept low in order to ensure a smooth transition of agents from working examinations to determinations. When the anticipated volume of determination receipts did not materialize, additional returns were placed in process. Many of the additional returns were larger plans that require longer processing time and resulted in fewer returns closed than expected.

54. EP/EO Examination Quality – The overall decline in quality was primarily attributed to the Examination Planning and Workpaper standards, which were found to be inconsistent with current work processes and required modification. These quality standards were addressed through targeted training sessions in FY 2001 and emphasis on quality will continue during regular training for all agents.

56. Appeals Cases Closed – The Appeals workload continued to shift from examination to predominantly collection-type work, including Collection Due Process. Resources were diverted to accommodate the dramatic increase in Collection work and a comprehensive training program of retraining and mentoring existing personnel to handle this new source of work was initiated. The impact of diverting resources and retraining existing personnel to accommodate the shift in workload contributed to an increase in cycle time and subsequently, lower than planned productivity.

62. Agency-Wide Employee Satisfaction – The measurement definition was changed from FY 2000 to FY 2001 so results are not fully comparable. Nevertheless, the numbers show a decline in FY 2001, which can be attributed to the effects of the reorganization, which are also showing up as negative results in the Climate Survey. The IRS Commissioner has made improving employee satisfaction results the responsibility of each individual manager (an element in each manager's performance plan) and every Operating and Functional Division (OD and FD). Divisions are now analyzing their census survey results in light of their Climate Survey data to determine what (if any) additional Division-level responses are needed.

APPENDIX B: COMPLIANCE ACTIVITIES

EXAMINATION STAFFING

Fiscal Year Staffing – Full Time Equivalents (FTEs)

(Whole numbers only—totals may not add due to rounding)

	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001
Field Professionals							
Revenue Agents (RAs)	15,772	15,083	14,399	13,647	13,061	12,550	11,598
Tax Auditors (TAs)	2,632	2,485	2,318	2,113	1,930	1,702	1,420
Total	**18,404**	**17,568**	**16,717**	**15,760**	**14,991**	**14,252**	**13,018**
Change from prior year		*-4.54%*	*-4.84%*	*-5.72%*	*-4.88%*	*-4.93%*	*-8.66%*
Field FTEs not spent on Examinations							
Training	1,973	842	718	846	1,167	1,142	862
Customer Service	240	183	269	451	601	758	397
Other Details	549	481	477	443	446	471	433
Total	**2,762**	**1,505**	**1,464**	**1,741**	**2,214**	**2,371**	**1,692**
Innocent Spouse work							
RA/TA FTEs only					241 (est)	560	259

EXAMINATION COVERAGE

Examination coverage—commonly known as the "audit rate"—is figured by dividing the number of returns examined by the total number of returns filed the previous calendar year.

This chart shows the coverage portions attributed to "Field" examinations, which are "in-person" at either an IRS office or the taxpayer's place of business, and "Correspondence" examinations. It also gives the coverage for "High Income" taxpayers, i.e., those with incomes of $100,000 and higher.

Examination Coverage – Individual Returns

(Totals may not add due to rounding)

	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001
All Individuals							
Field	0.70%	0.66%	0.60%	0.47%	0.31%	0.20%	0.16%
Correspondence	0.98%	1.02%	0.68%	0.52%	0.58%	0.29%	0.42%
Total	1.67%	1.67%	1.28%	0.99%	0.90%	0.49%	0.58%
High Income ($100K + Up)							
Field	1.87%	2.08%	1.98%	1.53%	1.03%	0.61%	0.48%
Correspondence	1.10%	1.12%	0.76%	0.49%	0.37%	0.35%	0.31%
Total	2.97%	3.21%	2.74%	2.01%	1.40%	0.96%	0.79%

EXAMINATIONS – FISCAL YEAR TOTALS

	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001
Individuals – Income under $100K							
Field	684,395	625,430	571,201	443,220	289,725	187,891	146,671
Correspondence	1,055,171	1,106,084	747,972	585,246	682,150	330,327	493,535
Total	**1,739,566**	**1,731,514**	**1,319,173**	**1,028,466**	**971,875**	**518,218**	**640,206**
Returns Filed - Prior CY*	108,625,300	109,513,000	111,060,700	112,185,800	113,368,900	114,518,500	115,486,900
Coverage	***1.60%***	***1.58%***	***1.19%***	***0.92%***	***0.86%***	***0.45%***	***0.55%***
Individuals – Income $100K + Up							
Field	113,090	136,420	144,414	124,539	94,759	63,217	55,844
Correspondence	66,781	73,612	55,656	39,775	33,639	36,330	35,706
Total	**179,871**	**210,032**	**200,070**	**164,314**	**128,398**	**99,547**	**91,550**
Returns Filed – Prior CY*	6,058,100	6,546,700	7,301,900	8,156,600	9,178,000	10,368,600	11,610,500
Coverage	***2.97%***	***3.21%***	***2.74%***	***2.01%***	***1.40%***	***0.96%***	***0.79%***
Total Individuals							
Field	797,485	761,850	715,615	567,759	384,484	251,108	202,515
Correspondence	1,121,952	1,179,696	803,628	625,021	715,789	366,657	529,241
Total	**1,919,437**	**1,941,546**	**1,519,243**	**1,192,780**	**1,100,273**	**617,765**	**731,756**
Returns Filed – Prior CY*	114,683,400	116,059,700	118,362,600	120,342,400	122,546,900	124,887,100	127,097,400
Coverage	***1.67%***	***1.67%***	***1.28%***	***0.99%***	***0.90%***	***0.49%***	***0.58%***
Corps. W/ Assets Less Than $10M							
Field	36,803	45,091	55,021	40,735	27,484	17,580	13,169
Correspondence	1,900	1,477	1,302	1,083	784	1,043	1,163
Total	**38,703**	**46,568**	**56,323**	**41,818**	**28,268**	**18,623**	**14,332**
Returns Filed – Prior CY*	2,460,500	2,482,700	2,534,700	2,508,700	2,446,200	2,430,000	2,372,900
Coverage	***1.57%***	***1.88%***	***2.22%***	***1.67%***	***1.16%***	***0.77%***	***0.60%***
Corps. W/ Assets $10M & Over							
Field	12,374	12,586	12,706	11,464	10,287	8,978	8,465
Correspondence	306	305	266	366	250	234	253
Total	**12,680**	**12,891**	**12,972**	**11,830**	**10,537**	**9,212**	**8,718**
Returns Filed – Prior CY*	49,200	50,900	53,400	55,200	55,300	56,500	57,800
Coverage	***25.77%***	***25.33%***	***24.29%***	***21.43%***	***19.05%***	***16.30%***	***15.08%***

** CY = Calendar Year*

COLLECTION

ACTIVITY (ALL $ IN BILLIONS)

	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001
Yield							
Total Yield	$25.150	$29.776	$29.913	$29.907	$29.167	$29.936	$32.187
TDA* Yield	$7.419	$8.432	$8.653	$7.817	$6.455	$6.757	$7.542

**Taxpayer Delinquent Accounts – those not voluntarily resolved during the Notice process*

	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001
Enforcement Actions							
Levies	2,721,823	3,108,926	3,659,417	2,503,409	504,403	219,778	447,201
Liens	798,677	750,225	543,613	382,755	167,867	287,517	428,376
Seizures	10,707	10,449	10,090	2,307	161	174	255
Installment Agreements (IAs)							
# of IAs (000s)	2,502	2,671	2,816	2,828	2,431	2,243	2,147
Total $s to IAs	$9.004	$9.900	$10.840	$10.752	$8.415	$8.321	$8.638

COLLECTION FIELD FUNCTION STAFFING

Item	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001
# of Revenue Officers	5,908	5,537	5,439	4,989	4,354	3,601	3,792
Detail-out hrs*	608,755	632,439	546,552	789,480	1,202,857	1,316,468	405,764
Training hrs*	1,127,985	470,752	701,444	861,252	1,320,569	1,167,530	628,074
Offer-in-Compromise staffhours	885,464	794,931	727,682	741,143	860,125	1,287,046	1,600,074

** ROs, plus paraprofessional, managerial and clerical positions*

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