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IRS MODERNIZATION

Continued Progress Requires Addressing Resource Management Challenges

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Highlights

Highlights of GAO-05-707T, a testimony before congressional committees

May 19, 2005

IRS MODERNIZATION

Continued Progress Requires Addressing Resource Management Challenges

Why GAO Did This Study

Since the passage of the IRS Restructuring and Reform Act of 1998 (RRA 98), the Internal Revenue Service (IRS) has faced the challenge of managing its resources to simultaneously improve service to taxpayers, assure taxpayers' compliance with the tax laws, and modernize its antiquated information systems.

As requested, this statement provides our assessment of IRS's current performance in the areas of taxpayer service, tax law enforcement, and systems modernization. Looking ahead, this statement also describes the challenges that IRS faces in addressing resource constraints as well as realizing efficiency and information systems improvements.

What GAO Recommends

GAO is not making any new recommendations, but has recommendations outstanding related to taxpayer service, tax law enforcement, Business Systems Modernization (BSM), and systems security.

IRS is in general agreement with our recommendations and is in the process of implementing many of them.

www.gao.gov/cgi-bin/getrpt?GAO-05-707T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

What GAO Found

IRS's most noticeable progress has been in IRS's taxpayer service, which has been of special concern to the Congress. Since the passage of RRA 98, improvements in access to IRS by telephone, the accuracy of answers given to taxpayer inquiries, and the growth of IRS's Web site, which now provides a variety of services, have been noteworthy accomplishments.

IRS experienced declines in enforcement staffing after 1998, but recently stopped the declines and begun to show increases. Despite this, enforcement remains a high risk area because of the continued need to improve enforcement and make progress towards reducing the tax gap.

IRS has made significant progress in establishing management controls and acquiring infrastructure as part of the BSM program, as well as significant progress in addressing financial management issues. However, BSM remains at risk because of the scope and complexity of modernization activities and the need for better management capacity to avoid repeating the program's history of schedule delays and cost overruns.

Looking ahead, continuing the progress described above depends on IRS addressing resource constraints and realizing efficiency and systems improvements. We highlight several such opportunities:

- Developing long-term goals would help IRS and Congress assess agency performance and make budget decisions.
- Considering additional funding enhancements such as user fees and private debt collection which may help mitigate budget constraints.
- Leveraging nonfederal partners such as states to assist with tax law enforcement and volunteers to help provide taxpayer service.
- Prioritizing taxpayer service activities could help IRS minimize the impact of budget cuts.
- Targeting enforcement resources could help IRS make more efficient use of available resources and help the agency make progress towards reducing the tax gap.
- Creating the necessary systems to enable IRS to develop accurate cost accounting information would help IRS make resource allocation decisions.
- Developing and using better productivity data would help IRS make productivity improvements and thereby make better use of available resources.
- Making needed management improvements would help IRS bring planned new information systems on-line in a timely and cost-effective manner.
- Making needed improvements to assure information systems security would reduce vulnerabilities.

Mr. Chairman and Members of the Committees:

Mr. Chairman, we are pleased to participate in this joint review of the Internal Revenue Service (IRS). Since passage of the IRS Restructuring and Reform Act of 1998 (RRA 98), IRS has faced the challenge of managing its resources to simultaneously improve service to taxpayers, assure taxpayers' compliance with the tax laws, and modernize its antiquated information systems. As you are well aware, making these improvements is important. IRS is responsible for collecting the roughly $2 trillion in tax revenue used to fund the government and annually touches more Americans than any other federal agency. IRS's service and enforcement efforts influence Americans' confidence in the fairness of the tax system and their perception of the effectiveness of their government.

As requested, this statement provides our assessment of IRS's current performance in all three areas. We then look ahead, describing the challenges that IRS faces in addressing resource constraints as well as realizing efficiency and information systems improvements.

Our discussion of both recent progress and challenges facing IRS is based primarily on recently issued GAO products. We used our recent reports and testimony on IRS's budget, the tax gap, filing season reviews, financial audits, systems modernization activities, Business Systems Modernization (BSM) expenditure plans, and information security. Our work was performed in accordance with generally accepted government auditing standards.

In summary, IRS has made progress in improving service and modernizing operations, but the gains have not been uniform. The most noticeable progress has been in IRS's taxpayer service, an area that has been of special concern to the Congress. Access to IRS by telephone, the accuracy of answers given to taxpayer inquiries, and the growth of IRS's Web site, which now provides a variety of services, including forms and instructions, information on the status of refunds, and answers to frequently asked questions, have been noteworthy accomplishments in the years since passage of RRA 98. With respect to tax law enforcement, IRS experienced declines in enforcement staffing after 1998 but has recently stopped the declines and begun to show increases. However, tax law enforcement remains a high-risk area because of the need to improve enforcement and make progress towards reducing the tax gap—the difference between taxes owed and taxes paid on time.[1] As for systems modernization, IRS has made significant progress in establishing long-overdue management controls and in acquiring foundational system infrastructure and applications as part of the BSM project, as well as significant progress in addressing financial management issues. However, BSM remains at risk because of the scope and complexity of modernization activities and the need for better management capacity to avoid repeating the program's history of schedule delays and cost overruns.

Looking ahead, continued progress depends on IRS addressing resource constraints and realizing efficiency and systems improvements. Long-term goals would help stakeholders, including the Congress, evaluate the adequacy of IRS's budget. Further, additional resources might be brought to bear by, perhaps, additional user fees or the leveraging of nonfederal partners beyond what is now done with states and volunteers. Efficiency gains may be possible by, for example, prioritizing taxpayer services in order to focus on those that provide greater benefit, targeting enforcement by using better data on noncompliance, collecting more accurate cost information to improve day-to-day and long-term decision making, and realizing productivity improvements. Finally, IRS needs to bring planned new systems on line in a timely and cost-effective manner while also assuring systems security. GAO has outstanding recommendations related to taxpayer service, tax law enforcement, BSM, and systems security. IRS is in general agreement with our recommendations and is in the process of implementing many of them.

[1] In April 2005, we discussed the tax gap in testimony before the Senate Committee on Finance (GAO-05-527T). In our statement, we reported that IRS recently released its tax gap estimate for tax year 2001. IRS estimated that the difference between taxes owed and taxes paid on time was between $312 billion and $353 billion. After tax law enforcement recovers a portion of the unpaid taxes, IRS estimates it will eventually recover some of this tax gap, resulting in a net tax gap of between $257 billion and $298 billion in tax year 2001.

IRS Has Improved Taxpayer Service but Enforcement and BSM Remain High Risk

IRS has made noticeable progress in improving taxpayer service since passage of RRA 98. While progress has also been made in the tax law enforcement and BSM areas, however, serious ongoing issues have kept both on our high-risk list.[2]

IRS Has Improved Taxpayer Service but Is Shifting Priorities

IRS has made meaningful progress in four key taxpayer service areas; paper and electronic processing, telephone assistance, IRS's Web site, and walk-in assistance. Table 1 shows IRS performance in these areas since 2002. While the progress is widespread, table 1 also shows that there are some areas of performance that merit attention, especially in light of current and proposed cuts to IRS's taxpayer service budget. In fiscal year 2005 and in its proposed 2006 budget, IRS is shifting priorities by reducing taxpayer service and increasing resources for enforcement.

[2] GAO, *High Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005).

Table 1: IRS Performance in the First Weeks of the Filing Season, 2002-2005

Volume in thousands				
Actual returns processed[a]	**2002**	**2003**	**2004**	**2005**
Paper	24,491	22,117	20,232	17,607
Electronic	35,067	38,627	42,988	45,848
Telephone assistance				
Total calls[b]	34,489	27,905	29,058	23,340
Answered by assistors	9,208	9,434	10,116	9,421
Answered by automation	25,281	18,471	18,942	13,919
Customer service representative level of service	62%	82%	84%	83%
Average speed of answer[c]	227 seconds	183 seconds	199 seconds	235 seconds
Accounts accuracy rate estimates[d]	88% +/- 1%	88% +/- 1%	89% +/- 1%	92% +/- 1%
Tax law accuracy rate estimates[d]	84% +/- 1%	81% +/- 1%	76% +/- 1%	87% +/- 1%
Internet assistance				
Forms and publications downloaded[e]	N/A	N/A	N/A	70,321
Refund status inquiries[f]	N/A	9,300	14,300	16,400
Walk-in assistance				
Total walk-in contacts[g]	N/A	2,740	2,433	2,163
Returns prepared at IRS walk-in sites[h]	436	291	186	145
Returns prepared at volunteer sites[i]	466	594	741	915

Source: IRS.

[a]From January 1 to March 22, 2002; March 21, 2003; March 19, 2004; and March 18, 2005.

[b]Total calls (i.e., calls answered by assistors and automation) and CSR level of service are based on actual counts from January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005. The 2002 totals include increased call demand as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16 (2001)).

[c]From January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005.

[d]Based on a representative sample estimated at the 90 percent confidence level from January to February 2002, 2003, 2004, and 2005.

[e]As of February 28, 2005.

[f]From January 1 to March 20, 2003; 2004; and 2005.

[g]From January 1 to March 15, 2003; March 13, 2004; and March 12, 2005.

[h]From January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005.

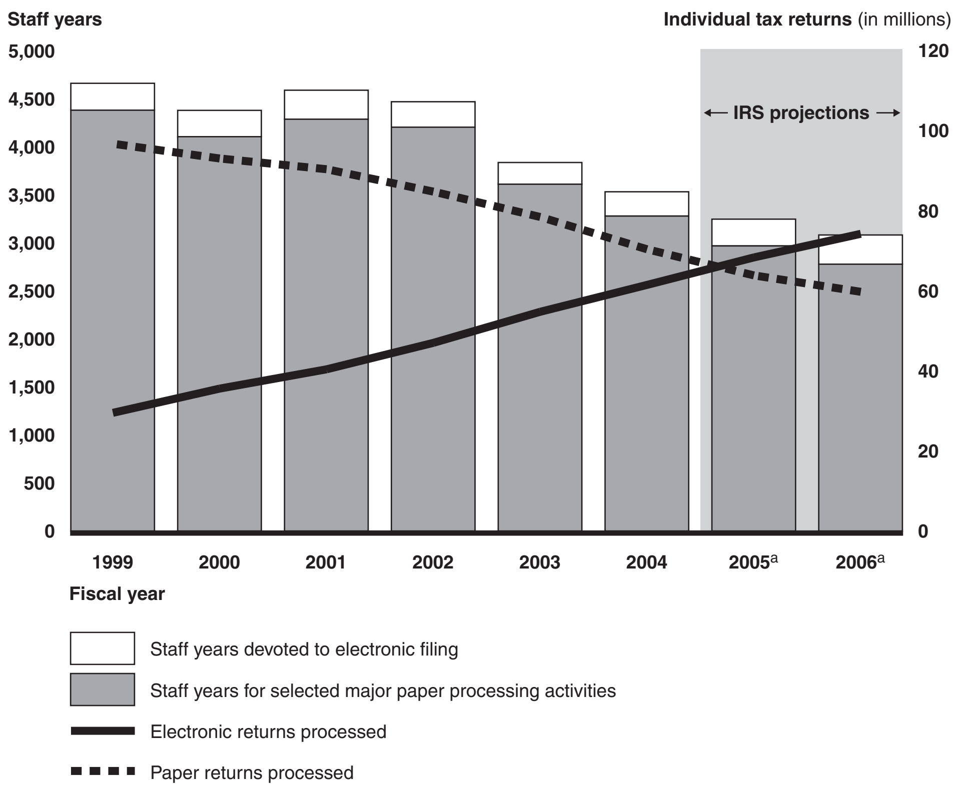
[i]From January 1 to March 9, 2002; March 8, 2003; March 13, 2004; and March 12, 2005.

Returns Processing

As shown in table 1, electronic filing has increased while paper filing has dropped. The increase in electronic filing has allowed IRS to reduce the resources devoted to processing. As shown in figure 1, IRS reduced the staff devoted to processing paper returns between 1999 and 2004 by just over 1,100 staff years. The figure also shows that as the number of e-filed returns has increased, the number of staff years used to process those returns has not increased. The decline in paper processing staff allowed IRS to close its Brookhaven processing center in 2003.[3] In addition, IRS is in the process of closing its paper processing operation in Memphis.

[3] In March 2005 we reported that IRS successfully completed the rampdown at Brookhaven without any significant disruptions in service. (GAO-05-319R)

Figure 1: Change in Methods of Tax Return Filing Since 1999



Source: GAO analysis of IRS data.

[a]Fiscal years 2005 and 2006 are IRS projections and, given the current lower e-file growth rates, the estimates may be optimistic.

In addition to saving IRS resources, electronic filing offers benefits to taxpayers in that it allows taxpayers to receive refunds faster and is less error prone. IRS employees manually transcribe paper tax return information into IRS's computer systems, which can introduce errors.

Telephone Assistance

As shown in table 1, by several measures IRS's telephone service has improved since 2002. One measure of access, the customer service representative (CSR) level of service (the percentage of taxpayers who attempted to reach CSRs and actually got through and received service) increased from 62 percent to 83 percent. Accuracy also showed some improvement; accounts accuracy (accuracy of answers to taxpayer questions about their accounts) exceeded 90 percent in 2005. However, taxpayers are waiting somewhat longer in 2005 to get answers than in 2002, 2003, and 2004.

Web Site

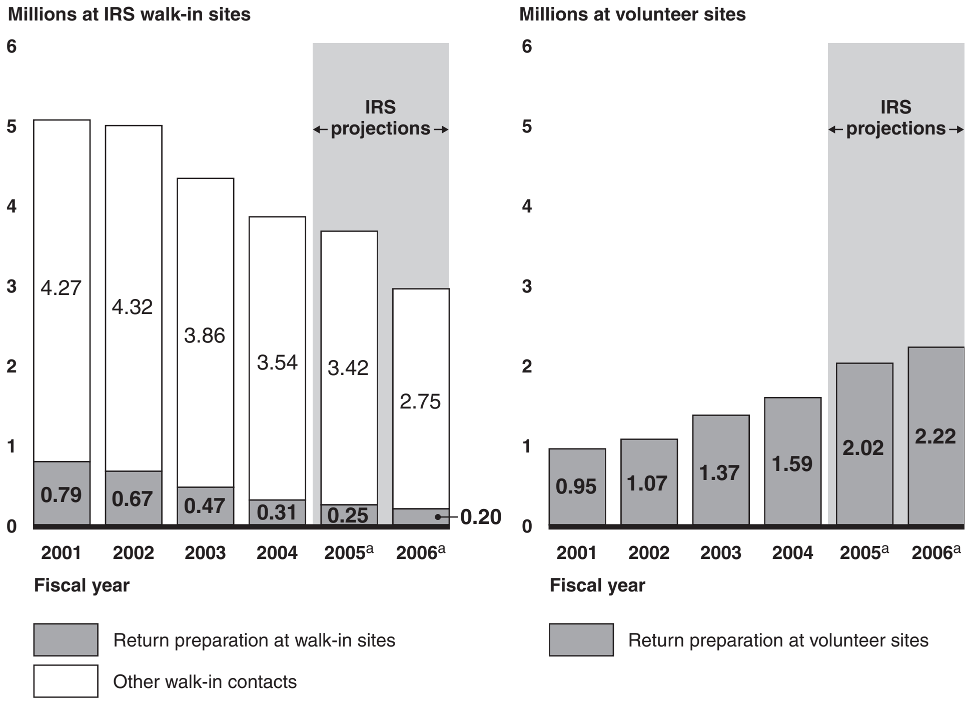
IRS's Web site is performing well. A relatively recent addition to IRS's menu of services, the Web site first became available during the 1996 filing season. We found it to be user friendly because it was readily accessible and easy to navigate. An independent weekly study ranked it in the top 4 out of 40 federal government web sites in terms of accessibility.

The site is used extensively. In the early weeks of the 2005 filing season the IRS Web site was visited about 83 million times by users who viewed about 628 million pages and downloaded about 70.3 million forms and publications. IRS's Web site continues to provide two very important tax service features: (1) "Where's My Refund," which enables taxpayers to check on the status of their refund and (2) Free File, which provides taxpayers the ability to file their tax return electronically for free. This filing season IRS provided new functionality for "Where's My Refund" whereby taxpayers whose refunds could not be delivered by the Postal Service (i.e., returned as undeliverable mail), could change their addresses on the Web site.

IRS and Volunteer Walk-in Sites

Taxpayer use of IRS's walk-in sites has decreased while use of volunteer sites has increased. As shown in figure 2, IRS projects it will see about 3.4 million visits to its 400 walk-in sites this year, down from over 3.5 million in 2004 and about 4.3 million in 2001. Over the same period, IRS expects taxpayer visits to volunteer sites to increase to just over 2 million visits in 2005; a substantial increase over about 1.6 million visits in 2004 and fewer than 1 million in 2001. IRS continues to encourage taxpayers to use volunteer sites for return preparation.

Figure 2: Assistance Provided by IRS Walk-in and Volunteer Sites, 2001-2006 Filing Seasons



Source: GAO-05-416T page p.33, and GAO of IRS data.

Note: “Other walk-in contacts” includes assistance for account notices, tax law inquiries, forms, and compliance work, but not return preparation. For the walk-in sites, the time periods covered are December 31, 2000, through April 28, 2001; December 30, 2001, through April 27, 2002; December 29, 2002, through April 26, 2003; and December 28, 2003, through April 24, 2004. For volunteer sites, the time period covered for 2001 is January 1, 2001, through April 21, 2001; all other periods are the same as those for IRS walk-in sites.

[a]Fiscal years 2005 and 2006 are IRS projections.

This shift is important because it transfers time-consuming services, particularly return preparation, to volunteers and allows IRS to concentrate on services that only it can provide, such as account assistance or compliance work. While it reduces the demand on IRS resources, the shift from IRS to volunteer sites has raised concerns about the quality of service provided. We and the Treasury Inspector General for Tax Administration (TIGTA) have called attention to the quality of service at both IRS walk-in and volunteer sites. IRS has separate quality initiatives under way at both IRS walk-in and volunteer sites, although data remain limited and cannot be compared to prior years.

Post-Filing Taxpayer Service

Another concern is post-filing service to taxpayers when IRS has undertaken compliance or collection actions. An example of this is the release of federal tax liens against taxpayers' property. IRS is required to release a federal tax lien within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax but, as have we reported for several years as part of our financial audits, most recently in November 2004, IRS has not always met this standard.[4]

IRS Has Stopped Declines In Enforcement Staffing, but Enforcement Remains High Risk

We have long been concerned about tax noncompliance and IRS efforts to address it. Collection of unpaid taxes was included in our first high-risk series report in 1990, with a focus on the backlog of uncollected debts owed by taxpayers. In 1995, we added Filing Fraud as a separate high-risk area, narrowing the focus of that high-risk area in 2001 to Earned Income Credit Noncompliance because of the particularly high incidence of fraud and other forms of noncompliance in that program. We expanded our concern about the Collection of Unpaid Taxes in our 2001 high-risk report to include not only unpaid taxes (including tax evasion and unintentional noncompliance) known to IRS, but also the broader enforcement issue of unpaid taxes that IRS has not detected. In our high-risk update that we issued in January,[5] we consolidated these areas into a single high-risk area—Enforcement of Tax Laws—because we believe the focus of concern on the enforcement of tax laws is not confined to any one segment of the taxpaying population or any single tax provision.

Tax law enforcement is a high-risk area in part because of the size of the tax gap. IRS's recent estimate of the difference between what taxpayers timely and accurately paid in taxes and what they owed ranged from $312 billion to $353 billion for tax year 2001. IRS estimates it will eventually recover some of this tax gap, resulting in a net tax gap from $257 billion to $298 billion. The tax gap arises when taxpayers fail to comply with the tax laws by underreporting tax liabilities on tax returns; underpaying taxes due from filed returns; or "nonfiling," which refers to the failure to file a required tax return altogether or in a timely manner.

[4] GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, GAO-05-103 (Washington, D.C.: Nov. 10, 2004).

[5] GAO-05-207.

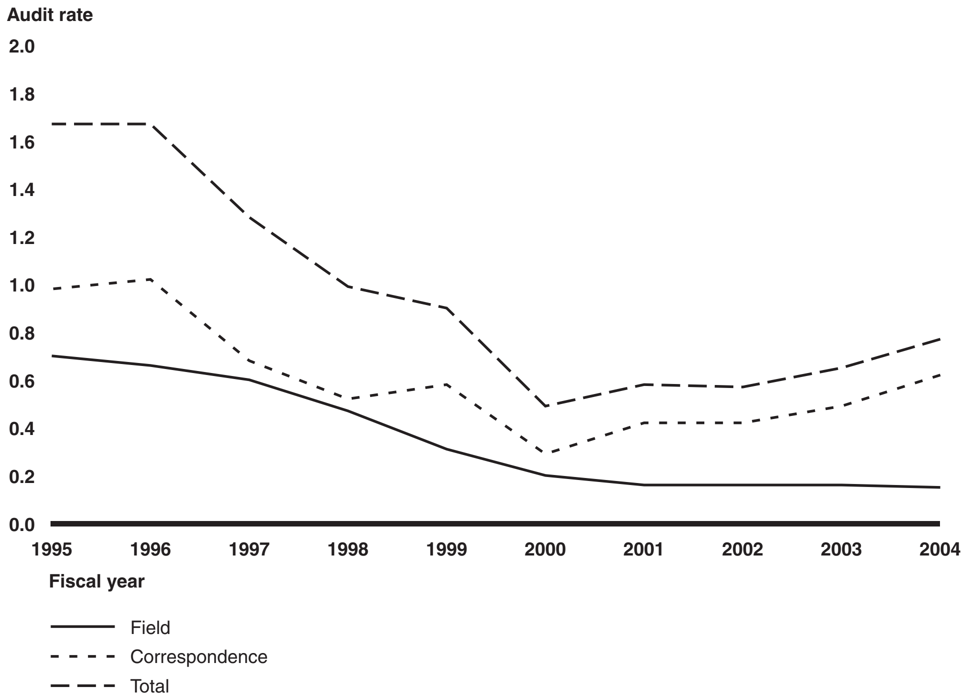
Tax law enforcement is also high risk because past declines in IRS's enforcement activities threatened to erode taxpayer compliance. In recent years, the resources IRS has been able to dedicate to enforcing the tax laws have declined. For example, the number of revenue agents (those who examine complex returns), revenue officers (those who perform field collection work), and special agents (those who perform criminal investigations) decreased over 21 percent from 1998 through 2003. However, IRS achieved some staffing gains in 2004 and expects modest gains in 2005. IRS's proposal for fiscal year 2006, if funded and implemented as planned, would return enforcement staffing in these occupations to their highest levels since 1999.[6]

Concurrently, IRS's enforcement workload—measured by the number of taxpayer returns filed—has continually increased. For example, from 1997 through 2003, the number of individual income tax returns filed increased by about 8 percent. Over the same period, returns for high-income individuals grew by about 81 percent.[7] Due to their income levels, IRS believes that these individuals present a particular compliance risk. In light of declines in enforcement staffing and the increasing number of returns filed, nearly every indicator of IRS's coverage of its enforcement workload has declined in recent years. Although in some cases workload coverage has begun to increase, overall IRS's coverage of known workload is considerably lower than it was just a few years ago. Figure 3 shows the trend in examination rates—the proportion of tax returns that IRS examines each year—for field, correspondence, and total examinations since 1995. Field examinations involve face-to-face examinations and correspondence examinations are typically less comprehensive and complex, involving communication through written notices. IRS experienced steep declines in examination rates from 1995 to 1999, but the examination rate has slowly increased since 2000. However, as the figure shows, the increase in total examination rates of individual filers has been driven mostly by correspondence examinations, while more complex field examinations continue to decline.

[6] GAO, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season*, GAO-05-416T (Washington, D.C.: Apr. 14, 2005).

[7] High-income individuals are those reporting $100,000 or more of "total positive income," which is, in general, the sum of all positive amounts shown for the various sources of income reported on individual tax returns and thus excludes net losses.

Figure 3: Audit Rate of Individual Income Tax Returns, Fiscal Years 1995-2004



Source: GAO analysis of IRS data.

Further, IRS's workload has grown ever more complex as the tax code has grown more complex. IRS is challenged to administer and explain each new provision, thus absorbing resources that otherwise might be used to enforce the tax laws. Concurrently, other areas of particularly serious noncompliance have gained the attention of IRS and the Congress, such as abusive tax shelters and schemes employed by businesses and wealthy individuals that often involve complex transactions that may span national boundaries. Given the broad declines in IRS's enforcement workforce, IRS's decreased ability to follow up on suspected noncompliance, and the emergence of sophisticated evasion concerns, IRS is challenged in attempting to ensure that taxpayers fulfill their obligations.

On the collection front, IRS's use of enforcement sanctions, such as liens, levies, and seizures, dropped precipitously during the mid and late 1990s. In fiscal year 2000, IRS's use of these three sanctions was at 38 percent, 7 percent, and 1 percent, respectively, of fiscal year 1996 levels. However, beginning in fiscal year 2001, IRS's use of liens and levies began to increase. By fiscal year 2004, IRS's use of liens, levies, and seizures reached 71 percent, 65 percent, and 4 percent of 1996 levels, respectively.

IRS is working to further improve its enforcement efforts. In addition to recent favorable trends in enforcement staffing, correspondence examinations, and the use of some enforcement sanctions, IRS has recently made progress with respect to abusive tax shelters through a number of initiatives and recent settlement offers that have resulted in billions of dollars in collected taxes, interest, and penalties. In addition, IRS is developing a centralized cost accounting system, in part to obtain better cost and benefit information on compliance activities, and is modernizing the technology that underpins many core business processes. It has also redesigned some compliance and collections processes and plans additional redesigns as technology improves. Finally, the recently completed National Research Program (NRP) study of individual taxpayers not only gives us a benchmark of the status of taxpayers' compliance but also gives IRS a better basis to target its enforcement efforts.

IRS Has Made Progress in Implementing BSM, but Program Has History of Cost Overruns and Schedule Delays and Is High Risk

IRS has long relied on obsolete automated systems for key operational and financial management functions, and its attempts to modernize these aging computer systems span several decades. Modernization has encountered a long history of continuing delays and design difficulties and the impact of these problems on IRS's operations led GAO to designate IRS's systems modernization as a high-risk area in 1995 and it remains so today.

IRS's current modernization program, BSM, is a highly complex, multibillion-dollar program that is the agency's latest attempt to modernize its systems. BSM is critical to supporting IRS's taxpayer service and enforcement goals. For example, BSM includes projects to allow taxpayers to file and retrieve information electronically and to provide technology solutions to help reduce the backlog of collections cases. BSM is also important to allow IRS to provide the reliable and timely financial management information needed to account for the nation's largest revenue stream and better enable the agency both to determine and to justify its resource allocation decisions and congressional budgetary requests.

Over the past year, IRS has deployed initial phases of several modernized systems under its BSM program. The following provides examples of the systems and functionality that IRS implemented in 2004 and the beginning of 2005.

- *Modernized e-File (MeF)*. This project is intended to provide electronic filing for large corporations, small businesses, and tax-exempt organizations. The initial releases of this project were implemented in June and December 2004, and allowed for the electronic filing of forms and schedules for the form 1120 (corporate tax return) and form 990 (tax-exempt organizations' tax return). IRS reported that, during the 2004 filing season, it accepted over 53,000 of these forms and schedules using MeF.
- *e-Services*. This project created a Web portal and provided other electronic services to promote the goal of conducting most IRS transactions with taxpayers and tax practitioners electronically. IRS implemented e-Services in May 2004. According to IRS, as of late March 2005, over 84,000 users have registered with this Web portal.
- *Customer Account Data Engine (CADE)*. CADE is intended to replace IRS's antiquated system that contains the agency's repository of taxpayer information and, therefore, is the BSM program's linchpin and highest priority project. In July 2004 and January 2005, IRS implemented the initial releases of CADE, which have been used to process filing year 2004 and 2005 1040EZ returns, respectively, for single taxpayers with refund or even-balance returns. According to IRS, as of March 16, 2005, CADE had processed over 842,000 tax returns so far this filing season.
- *Integrated Financial System (IFS)*. This system replaced aspects of IRS's core financial systems and is ultimately intended to operate as its new accounting system of record. The first release of this system became fully operational in January 2005.

In prior years, IRS deployed several systems, including (1) Customer Communications 2001, to improve telephone call management, call routing, and customer self-service applications; (2) Customer Relationship Management Examination, to provide off-the-shelf software to IRS revenue agents to allow them to accurately compute complex corporate transactions; and (3) Internet Refund/Fact of Filing, to improve taxpayer self-service by providing to taxpayers via the Internet instant refund status information and instructions for resolving refund problems.

Although IRS is to be applauded for delivering important BSM functionality, the BSM program is far from complete. Future deliveries of additional functionality of deployed systems and the implementation of other BSM projects are expected to have a significant impact on IRS's taxpayer services and enforcement capability as well as its efforts to continue to improve its financial management. For example, IRS has projected that CADE will process about 2 million returns in the 2005 filing season. However, the returns being processed in CADE are the most basic and constitute less than 1 percent of the total tax returns expected to be processed during the current filing season. IRS expects the full implementation of CADE to take several more years. Another BSM project—the Filing and Payment Compliance (F&PC) project—is expected to increase (1) IRS's capacity to treat and resolve the backlog of delinquent taxpayer cases, (2) the closure of collection cases by 10 million annually by 2014, and (3) voluntary taxpayer compliance. As part of this project, IRS plans to deliver an initial limited private debt collection capability in January 2006, with full implementation of this aspect of the F&PC project to be delivered by January 2008 and additional functionality to follow in later years. Finally, full implementation of CADE, as well as the successful implementation of future releases of IFS and efforts to address the impact of IRS's decision to discontinue the Custodial Accounting Project (CAP) will be critical to addressing many of IRS's remaining and long-standing financial management issues.

Continued Progress Depends on IRS Addressing Resource Constraints and Realizing Efficiency and Systems Improvements

For IRS to build on the gains made since passage of RRA 98, the agency must address numerous challenges related to resource management. IRS faces budgetary constraints that may be addressed in part through the development of goals for assessing performance and to help in making budget decisions, looking for opportunities to enhance its funding, and leveraging the resources of nonfederal partners. IRS also faces the challenges of improving efficiency in taxpayer service and tax law enforcement, developing useful cost accounting tools, and improving productivity. Finally, IRS faces information systems challenges in both BSM and systems security shortfalls.

Long-term Goals Would Help IRS Assess Performance and Make Budget Decisions

For IRS, the Congress, and IRS's other stakeholders, long-term goals can be used to assess performance and progress towards these goals, and determine whether budget decisions contribute to achieving those goals. Without long-term goals, the Congress and other stakeholders are hampered in evaluating whether IRS is making satisfactory long-term progress. Further, without such goals, the extent to which IRS's 2006 budget request would help IRS achieve its mission over the long term is less clear.

A recent Program Assessment Rating Tool (PART) review conducted by the Office of Management and Budget (OMB) reported that IRS lacks long-term goals.[8] As a result, IRS has been working to identify and establish long-term goals for all aspects of its operations for over a year. [9] IRS officials said these goals will be finalized and provided publicly as an update to the agency's strategic plan in the near future.

Long-term goals and results measurement are a component of the statutory strategic planning and management framework that the Congress adopted in the Government Performance and Results Act of 1993.[10] As a part of this comprehensive framework, long-term goals that are linked to annual performance measures can help guide agencies when considering organizational changes and making resource decisions. For example, long-term goals would provide IRS with a framework for assessing budgetary tradeoffs between taxpayer service and enforcement and whether IRS is making satisfactory progress towards achieving those goals. Similarly, long-term goals could help identify priorities within the taxpayer service functions (e.g., if the budget for taxpayer service were to be cut and efficiency gains did not offset the cut, long-term goals could help guide decisions about whether to make service cuts across a broad or target selected services).

Perhaps most important, long-term compliance goals coupled with periodic measurement of compliance levels would provide IRS with a better basis for determining to what extent its various day-to-day service

[8] The PART was applied during the fiscal year 2004 budget cycle to "programs" selected by OMB. The PART includes general questions in each of four broad topics to which all programs are subjected: (1) program purpose and design, (2) strategic planning, (3) program management, and (4) program results (i.e., whether a program is meeting its long-term and annual goals). OMB also makes an overall assessment on program effectiveness.

[9] IRS has one long-term goal set by the Congress in RRA 98 for IRS to have 80 percent of all individual income tax returns filed electronically.

[10] Pub. L. No. 103-62 (1993). The Government Performance and Results Act of 1993 seeks to improve the management of federal programs, as well as their effectiveness and efficiency, by requiring executive agencies to prepare multiyear strategic plans, annual performance plans, and annual performance reports. Under the act, strategic plans are the starting point for setting goals and measuring progress towards them. The act requires executive agencies to develop strategic plans that include an agency's mission statement, long-term general goals, and the strategies that the agency will use to achieve these goals. The plans should also explain the key external factors that could significantly affect achievement of these goals, and describe how long-term goals will be related to annual performance goals.

and enforcement efforts contribute to compliance in the long run. Furthermore, long-term, quantitative goals may help IRS consider new strategies to improve compliance, especially since these strategies could take several years to implement. For example, IRS's progress toward the goal of having 80 percent of all individual tax returns electronically filed by 2007 has required enhancement of its technology, development of software to support electronic filing, education of taxpayers and practitioners, and other steps that could not be completed in a short time frame. Focusing on intended results can also promote strategic and disciplined management decisions that are more likely to be effective because managers who use fact-based performance analysis are better able to target areas most in need of improvement and select appropriate interventions.

Considering Funding Enhancements Could Help Mitigate Budget Constraints

Identifying potential new sources of funds could be an opportunity for helping to mitigate IRS's budget constraints. Current examples of resource enhancers—user fees and private debt collection—may provide useful models for IRS and Congress to consider. User fees are collected from identifiable recipients of special benefits beyond those accruing to the general public. In 2004, IRS collected over $137 million in user fees for a wide range of services, including installment agreements, offers in compromise, and Freedom of Information Act (FOIA) requests.[11] In fiscal year 2004, about 82 percent of all user fees collected by IRS were for installment agreements or Employee Plans and Exempt Organizations letter rulings and determination letters.[12] The 1995 Treasury Appropriation Act specifies that IRS can keep a maximum of $119 million per year of the user fees it collects, with the rest of the user fees going into the Treasury

[11] Installment agreements are for taxpayers who cannot pay the full amount owed on their tax returns when due. IRS charges a one-time fee to these taxpayers, and allows them to make monthly installment payments. An offer in compromise (OIC) is an agreement between a taxpayer and IRS that resolves the taxpayer's tax liability for less than the full amount owed for taxes, interest, and penalties. IRS charges a one-time fee. FOIA requestors are charged a one-time fee and are provided with agency records as requested, with some exceptions.

[12] A letter ruling is a written determination issued in response to a written inquiry from an individual or an organization about its status for tax purposes or the tax effects of its acts or transactions, prior to the filing of returns or reports that are required by the revenue laws. A determination letter is a written determination that applies the principles and precedents previously announced by IRS to a specific set of facts. It is issued only when a determination can be made based on clearly established rules in a statute, a tax treaty, the regulations, a conclusion in a revenue ruling, or an opinion or court decision that represents the position of IRS.

general fund. In 2004, IRS retained about $90 million from the user fees collected (see table 2). In comparison, IRS's total spending in 2004 was $10.7 billion.

Table 2: User Fees and Reimbursable User Fees Collected by IRS, Fiscal Year 2004

Dollars in millions

Fee type	Fiscal year 2004 user fees collected	User fees to General Fund	User fees retained by IRS
Installment agreements	69.4	0.0	69.4
Offers in compromise	6.6	0.0	6.6
Employee plans and exempt organizations letter rulings and determination letters	43.1	41.2	1.9
Chief Counsel letter rulings and determination letters	9.3	5.5	3.8
Photocopy reimbursable user fees	6.4	0.0	6.4
Other	2.8	1.2	1.6
Total	**137.6**	**47.9**	**89.7**

Source: IRS officials.

In setting certain user fees, IRS must follow Internal Revenue Code (IRC) Section 7528, which authorizes user fees for letter rulings, opinion letters, determination letters, and similar requests.[13] IRC Section 7528 requires that user fees (1) vary according to categories or subcategories, (2) take into account the average time and difficulty of requests by categories or subcategories, (3) be payable in advance, and (4) be subject to appropriate exemptions and reduced fees within limits specified by Section 7528. IRS is precluded from expending any fees collected pursuant to IRC Section 7528 unless provided by an appropriations act. As mentioned earlier, the 1995 Treasury Appropriation Act specifies that IRS can keep a maximum of $119 million per year in user fee collections.

[13] Section 7528 was added to the Code by section 202 of the Temporary Assistance for Needy Families Block Grant Program, Pub. L. 108-89, and was extended to September 30, 2014, by section 690 of the American Jobs Creation Act of 2004, Pub. L. 108-357.

OMB Circular A-25, *User Charges*, establishes general federal policy for user fees assessed for government services by executive branch agencies.[14] A-25 requirements include (1) identifying services and activities that convey special benefits; (2) determining their full cost or market price, as appropriate; (3) biennial reviews of user fees for unanticipated cost or market price changes; and (4) biennial reviews of agency programs not subject to user fees to determine if such fees should be assessed.

Private debt collection provides another example of a revenue enhancement model that may be useful for IRS. The 2004 American Jobs Creation Act permitted IRS to contract with private collection agencies (PCA) to collect some federal tax debts and allows IRS to keep a portion of the funds collected by PCAs.[15] PCAs will not replace IRS's own collection resources, but will handle cases that do not require enforcement action or discretion in resolving tax liabilities. According to IRS, the private debt collection program will help reduce the significant and growing amount of uncollectable cases that are not currently collected, and enable IRS to focus existing resources to address more difficult cases. IRS will begin a limited implementation phase of the private debt collection in 2005, and full implementation is planned for 2007. The law allows IRS to retain and use up to 25 percent of any amounts collected to pay for collection services and IRS collection enforcement activities. IRS expects to retain $10 million of PCA collections in fiscal year 2007 and more in later years.

Leveraging Nonfederal Partners Is Another Way to Accomplish More

IRS has leveraged nonfederal resources to make improvements to taxpayer service and tax law enforcement. The examples below highlight the variety of such leveraging and could provide a basis for exploring whether additional such opportunities exist.

One example involving taxpayer service is the Free File Alliance. In 2003 IRS entered into a 3-year agreement with the Free File Alliance, a consortium of tax preparation companies that provides free electronic filing to taxpayers who access any of the companies via a link on IRS's

[14] Circular A-25 applies to executive branch agencies assessing charges under the general user fee statute enacted in the Independent Offices Appropriations Act of 1952 and codified at 31 U.S.C. 9701. The circular also provides guidance to agencies imposing user fees under other statutes to the extent that the circular is not inconsistent with the statute in question.

[15] The American Jobs Creation Act of 2004, P.L. 108-357.

Web site. IRS has benefited from this partnership because it encourages electronic filing of tax returns. For example, as of March 16, 2005, 3.6 million tax returns had been filed via Free File, which represents a 44 percent increase over the same time period last year.

IRS has also established partnerships with states and several cities to assist in combating abusive tax schemes.[16] In September 2003, IRS announced the establishment of a nationwide partnership to combat abusive tax avoidance. Under agreements with individual states, IRS shares information on abusive tax avoidance transactions and those taxpayers who participate in them. The agreements creating this partnership were designed to enable States and IRS to move more aggressively in addressing this tax compliance problem. The partnership also includes joint public outreach activities to more effectively counter the claims of those marketing tax schemes.

Another example of IRS's effort to leverage nonfederal resources is the over 13,500 volunteer sites run by community-based coalitions. IRS awards grants, trains and certifies volunteers, and provides reference materials, computer software and, in some cases, computers to these volunteer organizations to assist primarily low-income and elderly taxpayers prepare their returns. Since 2001, the number of taxpayers seeking return preparation assistance at volunteer sites has increased an average of 19 percent per year. During the 2004 filing season, taxpayers had over five times more returns prepared at volunteer sites than at IRS walk-in sites. This trend reflects IRS's strategy to shift return preparation to sites staffed by volunteer and community-based coalitions that are overseen by IRS. IRS has encouraged the shift by advertising the locations of these sites.

As we noted earlier, the shift of taxpayers from walk-in to volunteer sites is important because it has transferred time-consuming services, particularly return preparation, from IRS to volunteer sites and allowed IRS to concentrate on services that only it can provide, such as account assistance or compliance work. However, as we also noted earlier, there have been concerns raised about the quality of service at both walk-in and

[16] Abusive tax schemes encompass distortions of the tax system such as falsely describing the law (saying, for example, that the income tax is unconstitutional), misrepresenting facts (for instance, promoting the deduction of personal expenses as business expenses), or using trusts or offshore bank accounts to hide income.

volunteer sites. In addition, in her January 2005 report,[17] the Taxpayer Advocate expressed concern about the reduction of face-to-face services, such as those offered at walk-in sites. She stated that IRS's plan does not adequately provide for the segment of the population that continues to rely on the interaction provided by walk-in sites. Better data about the quality of service at volunteer sites would provide a baseline for making decisions about how to better manage quality.

Prioritizing Taxpayer Service Could Minimize Impacts of Budget Cuts

For at least two reasons, this is an opportune time to review the menu of taxpayer services that IRS provides. First, IRS's budget for taxpayer services was reduced in 2005 and an additional reduction is proposed for 2006. These reductions have forced IRS to propose scaling back some services, including the hours of telephone contact availability. Second, as we have reported, IRS has made significant progress in improving the quality of its taxpayer services. For example, IRS now provides many Internet services that did not exist a few years ago, and has noticeably improved the quality of telephone services. This opens up the possibility of maintaining the overall level of taxpayer service but with a different menu of service choices. Cuts in selected services could be offset by the new and improved services.

Generally, as indicated in the budget, the menu of taxpayer services that IRS provides covers assistance, outreach, and processing. Assistance includes answering taxpayer questions via telephone, correspondence, and face to face at its walk-in sites. Outreach includes educational programs and the development of partnerships. Processing includes issuing millions of tax refunds.

When considering program reductions, we support a targeted approach rather than across-the-board cuts.[18] A targeted approach helps reduce the risk that effective programs are reduced or eliminated while ineffective or lower priority programs are maintained.

With the above reasons in mind for reconsidering IRS's menu of services, we have compiled a list of options for targeted reductions in taxpayer

[17] National Taxpayer Advocate, *2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004)

[18] GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

service. The options on this list are not recommendations, but are intended to contribute to a dialogue about the tradeoffs faced when setting IRS's budget. The options presented meet at least one of the following criteria that we generally use to evaluate programs or budget requests.[19] These criteria include that the activity:

- duplicates other efforts that may be more effective and/or efficient;
- historically does not meet performance goals or provide intended results as reported by GAO, TIGTA, IRS, or others;
- experiences a continued decrease in demand;
- lacks adequate oversight, implementation and management plans, or structures and systems to be implemented effectively;
- has been the subject of actual or requested funding increases that cannot be adequately justified; or
- has the potential to make an agency more self-sustaining by charging user fees for services provided.

We recognize that the options listed below involve tradeoffs. In each case, some taxpayers would lose a service they use. However, the savings could be used to help maintain the quality of other services. We also want to give IRS credit for identifying savings, including some on this list. The options include the following:

- Closing walk-in sites. As discussed previously, taxpayer demand for walk-in services has continued to decrease and staff answer a more limited number of tax law questions in person than staff answer via telephone.
- Limiting the type of telephone questions answered by IRS assistors. IRS assistors still answer some refund status questions even though IRS provides automated answers via telephone and its Web site.
- Mandating electronic filing for some filers such as paid preparers or businesses. As noted, efficiency gains from electronic filing have enabled IRS to consolidate paper processing operations.
- Charging for services. For example, IRS provides paid preparers with information on federal debts owed by taxpayers seeking refund anticipation loans.

[19] The derivation of these criteria is detailed in our earlier testimony, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season*, GAO-05-416T (Washington, D.C.: Apr 14, 2005).

Targeting Enforcement Could Make More Efficient Use of Resources

Multiple enforcement strategies could help IRS reduce the tax gap. Given its size, even small or moderate reductions in the net tax gap could yield substantial returns. For example, based on IRS's most recent estimate, a 1 percent reduction in the net tax gap would likely yield more than $2.5 billion annually.

Although reducing the tax gap may be an attractive means to improve the nation's fiscal position, achieving this end will be a challenging task given persistent levels of noncompliance. IRS has made efforts to reduce the tax gap since the early 1980s; yet the tax gap is still large—although without these efforts it could be even larger. Also, IRS is challenged in reducing the tax gap because the tax gap is spread across the five different types of taxes that IRS administers, and a substantial portion of the tax gap is attributed to taxpayers who are not subject to withholding or information reporting requirements. Moreover, as we have reported in the past,[20] closing the entire tax gap may not be feasible or desirable, as it could entail more intrusive recordkeeping or reporting than the public is willing to accept or more resources than IRS is able to commit.

Although much of the tax gap that IRS currently recovers is through enforcement actions, a sole focus on enforcement will not likely be sufficient to further reduce the net tax gap. Rather, the tax gap must be attacked on multiple fronts and with multiple strategies on a sustained basis. For example, efforts to simplify the tax code and otherwise alter current tax policies may help reduce the tax gap by making it easier for individuals and business to understand and voluntarily comply with their tax obligations. For instance, reducing the multiple tax preferences for retirement savings or education assistance might ease taxpayers' burden in understanding and complying with the rules associated with these options. Also, simplification may reduce opportunities for tax evasion through vehicles such as abusive tax shelters. For any given set of tax policies, IRS's efforts to reduce the tax gap and ensure appropriate levels of compliance will need to be based on a balanced approach of providing service to taxpayers and enforcing the tax laws.

Furthermore, providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax

[20] GAO, *Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap*, GAO/T-GGD-97-35 (Washington, D.C.; Jan. 9, 1997).

gap. As we have reported in the past,[21] one method of improving compliance through service is to educate taxpayers about confusing or commonly misunderstood tax requirements. For example, if the forms and instructions taxpayers use to prepare their taxes are not clear, taxpayers may be confused and make unintentional errors. One method to ensure that forms and instructions are sufficiently clear is to test them before use. However, we reported in 2003 that IRS had tested revisions to only five individual forms and instructions from July 1997 through June 2002, although hundreds of forms and instructions had been revised in 2001 alone.[22]

Finally, in terms of enforcement, IRS will need to use multiple strategies and techniques to find noncompliant taxpayers and bring them into compliance. One pair of tools has been shown to lead to high levels of compliance: withholding tax from payments to taxpayers and having third parties report information to IRS and the taxpayers on income paid to taxpayers. For example, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Similarly, most wages, salaries, and tip compensation are reported by employers to employees and IRS through Form W-2. Preliminary findings from NRP indicate that more than 98.5 percent of these types of income are accurately reported on individual returns.

Regularly measuring compliance can offer many benefits, including helping IRS identify new or major types of noncompliance, identify changes in tax laws and regulations that may improve compliance, more effectively target examinations of tax returns or other enforcement programs, understand the effectiveness of its programs to promote and enforce compliance, and determine its resource needs and allocations. For example, by analyzing 1979 and 1982 compliance research data, IRS identified significant noncompliance with the number of dependents claimed on tax returns and justified a legislative change to address the noncompliance. As a result, for tax year 1987, taxpayers claimed about 5 million fewer dependents on their returns than would have been expected without the change in law. In addition, tax compliance data are

[21] GAO/T-GGD-97-35.

[22] GAO, *Tax Administration: IRS Should Reassess the Level of Resources for Testing Forms and Instructions*, GAO-03-486 (Washington, D.C.: Apr. 11, 2003).

useful outside of IRS for tax policy analysis, revenue estimating, and research.

IRS research officials have proposed a compliance measurement study that will allow IRS to update underreporting estimates involving flow-through entities. This study, which IRS intends to begin in fiscal year 2006, would take 2 to 3 years to complete. Because either individual taxpayers or corporations may be recipients of income (or losses) from flow-through entities, this study could affect IRS's estimates for the underreporting gap for individual and corporate income taxes.

While these data and methodology updates could improve the tax gap estimates, IRS has no documented plans to periodically collect more or better compliance data over the long term. Other than the proposed study of flow-through entities, IRS does not have plans to collect compliance data for other segments of the tax gap. Also, IRS has indicated that given its current research priorities, it would not begin another NRP study of individual income tax returns before 2008, if at all, and would not complete such a study until at least 2010. When IRS initially proposed the NRP study, it had planned to study individual income tax underreporting on a 3-year cycle.

According to IRS officials, IRS has not committed to regularly collecting compliance data because of the associated costs and burdens. Taxpayers whose returns are examined through compliance studies such as NRP bear costs in terms of time and money. Also, IRS incurs costs, including direct costs and opportunity costs—revenue that IRS potentially forgoes by using its resources to examine randomly selected returns, which may include returns from compliant taxpayers, as opposed to traditional examinations that focus on taxpayer returns that likely contain noncompliance and may more consistently produce additional tax assessments.

Although the costs and burdens of compliance measurement are legitimate concerns, as we have reported in the past, we believe compliance studies to be good investments. Without current compliance data, IRS is less able to determine key areas of noncompliance to address and actions to take to maximize the use of its limited resources. The lack of firm plans to continually obtain fresh compliance data is troubling because the frequency of data collection can have a large impact on the quality and utility of compliance data. As we have reported in the past, the longer the time between compliance measurement surveys, the less useful they become given changes in the economy and tax law.[23]

In designing its recently completed NRP study, IRS balanced the costs, burdens, and compliance risk of studying that area of the tax gap. Any plans for obtaining and maintaining reasonably current information on compliance levels for all portions of the tax gap would similarly need to take into account costs, burdens, and compliance risks in determining which areas of compliance to measure and the scope and frequency of such measurement.

The NRP survey had an added benefit of including the use of casebuilding to aid examiners in determining whether IRS needs to have any contact with taxpayers to verify the accuracy of information reported on their tax returns. The casebuilding tools consisted of data from both IRS and third-party sources. IRS's NRP casebuilding included return information from the prior 3 years, audit history, payment and filing history, information return data reported by third parties (banks, lending institutions, and others), and bank reports on large cash transactions. NRP casebuilding tools also included data from third-party sources, such as external public database containing real estate and other asset ownership information (e.g., motor vehicle registrations and ownership of luxury items like watercraft and aircraft). Another third-party data source was the Dependent Data Base, which is a combination of Department of Health and Human Services and Social Security Administration data. These data were used to provide custody information that can be used to help determine the validity of dependent and Earned Income Tax Credit (EITC) claims. Use of these data helped IRS enforcement staff to rule out compliance issues that could be verified without contacting taxpayers.

As IRS moves to further strengthen enforcement and introduce enforcement initiatives, one management challenge will be coordinating across IRS programs and offices. An initiative that identifies noncompliance has resource implications for downstream activities such as collections, criminal investigations, and appeals. Without appropriate, coordinated follow-up, compliance initiatives run the risk of becoming toothless. IRS has experienced this sort of imbalance in the past. For

[23] GAO, *IRS Plans to Measure Tax Compliance Can Be Improved*, GAO/GGD-93-52 (Washington, D.C.: Apr. 5, 1993).

example, in 2002 we reported on the growing backlog of collections cases generated by the upstream exam and assessment functions that the downstream collections function lacked the capacity to pursue.[24]

Accurate Cost Information Would Help IRS Make Resource Allocation Decisions

Managing a federal agency as large and complex as IRS requires managers to constantly weigh the relative costs and benefits of different approaches to achieving the goals mandated by the Congress. Management is constantly called upon to make important long-term strategic as well as daily operational decisions about how to make the most effective use of the limited resources at its disposal. As constraints on available resources increase, these decisions become correspondingly more challenging and important. In order to rise to this challenge, management needs to have at its disposal current and accurate information upon which to base its decisions, and to enable it to monitor the effectiveness of actions taken over time so that appropriate adjustments can be made as conditions change.

However, in its ongoing effort to make such increasingly difficult resource allocation decisions and defend those decisions before the Congress, IRS management has long been hampered by a lack of current and accurate information concerning the costs of the various options being considered. This has impaired management's ability to properly decide which, if any, of the options at hand are worth the cost relative to the expected benefits. For example, accurate and timely cost information may help IRS consider changes in the menu of taxpayer services that it provides by identifying and assessing the relative costs, benefits, and risks of specific projects. Without reliable cost information, IRS's ability to make such difficult choices in an informed, reasoned manner is seriously impaired. Similarly, IRS should periodically reassess the prices it charges taxpayers in user fees for various services, such as entering into installment agreements and making determinations about the tax exemption status of certain organizations. The cost of providing such services is supposed to be a major factor in setting the related fees. However, without timely and reliable cost information, the basis for the fees becomes problematic. The lack of reliable cost information also means that IRS cannot prepare cost-based performance measures to assist in measuring the effectiveness of its programs over time.

[24] *Tax Administration: Impact of Compliance and Collection Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2002).

IRS lacks reliable and timely cost information because prior to fiscal year 2005, it did not have a cost accounting system to accumulate and report the reliable cost information that managers needed to support informed decision making. Instead, management often relied on a combination of the limited existing cost information; the results of special analysis initiated to establish the full cost of a specific, narrowly defined task or item; and estimates based on the best judgment of experienced staff. In fiscal year 2005, IRS implemented a cost accounting module as part of the first release of its IFS. However, while this module has much potential and has begun accumulating cost information, management has not yet determined what the full range of its cost information needs are or how best to tailor the capabilities of this module to serve those needs. IRS has also not yet implemented a related workload management system intended to provide the cost module with detailed personnel cost information. In addition, because it generally takes several years of historical cost information to support meaningful estimates and projections, IRS cannot yet rely on this system as a significant planning tool. It will likely require several years and implementation of additional components of IFS before the full potential of IRS's cost accounting module will be realized. In the interim, IRS decision making will continue to be hampered by inadequate underlying cost information.

Productivity Improvements Could Help Offset Budget Cuts

IRS needs to make the most use of its available resources and a key to this is improved productivity. Productivity is defined as the efficiency with which inputs are used to produce outputs. It is measured as the ratio of outputs to inputs. Productivity and cost are inversely related—as productivity increases, average costs decrease. Consequently, information about productivity can inform budget debates as a factor that explains the level or changes in the cost of carrying out different types of activities. Improvements in productivity either allow more of an activity to be carried out at the same cost or the same level of activity to be carried out at a lower cost.

Sound productivity data are an important element of meaningful productivity improvement efforts. As part of our review of IRS process improvement initiatives,[25] private sector executives we met with stressed the benefits of productivity analysis. They said that an inadequate

[25] GAO, *Tax Administration: Planning for IRS's Enforcement Process Changes Include Many Key Steps But Can Be Improved*, GAO-04-287 (Washington, D.C.: Jan. 20, 2004).

understanding of productivity makes it harder to distinguish processes with a potential for improvement from those without such potential. GAO's Business Process Reengineering Assessment Guide also highlighted the importance of being able to identify processes that are in greatest need of improvement.[26]

Opportunities exist to improve enforcement productivity data and give IRS managers a more informed basis for decisions on how to make improvements. Statistical methods that are widely used in both the public and private sectors can be used to adjust productivity measures for quality and complexity. In particular, by using these methods, managers can distinguish productivity changes that represent real efficiency gains or losses from those that are due to changes in quality standards. These methods could be implemented using data currently available at IRS. The cost of implementation would be chiefly the staff time required to adapt the statistical models. Although the computations are complex, the methods can be implemented using existing software. We currently have under way a separate study that illustrates how these methods can be used to create better productivity measures at IRS.

Additional Management Improvements Needed for BSM Success

The BSM program has a long history of significant cost increases and schedule delays, which, in part, has led us to report this program as high risk since 1995.[27] In January 2005 letters to congressional appropriation committees, IRS stated that it had showed a marked improvement in significantly reducing its cost variances. In particular, IRS claimed that it reduced the variance between estimated and actual costs from 33 percent in fiscal year 2002 to 4 percent in fiscal year 2004. However, we do not agree with the methodology used in the analysis supporting this claim. Specifically, (1) the analysis did not reflect actual costs, but instead reflected changes in cost estimates (i.e., budget allocations) for various BSM projects; (2) IRS aggregated all of the changes in the estimates associated with the major activities for some projects, such as CADE, which masked that monies were shifted from future activities to cover increased costs of current activities; and (3) the calculations were based on a percentage of specific fiscal year appropriations, which does not reflect that these are multiyear projects.

[26] GAO, *Business Process Reengineering Assessment Guide*, GAO/AIMD-10.1.15 (Washington, D.C.: April 1997).

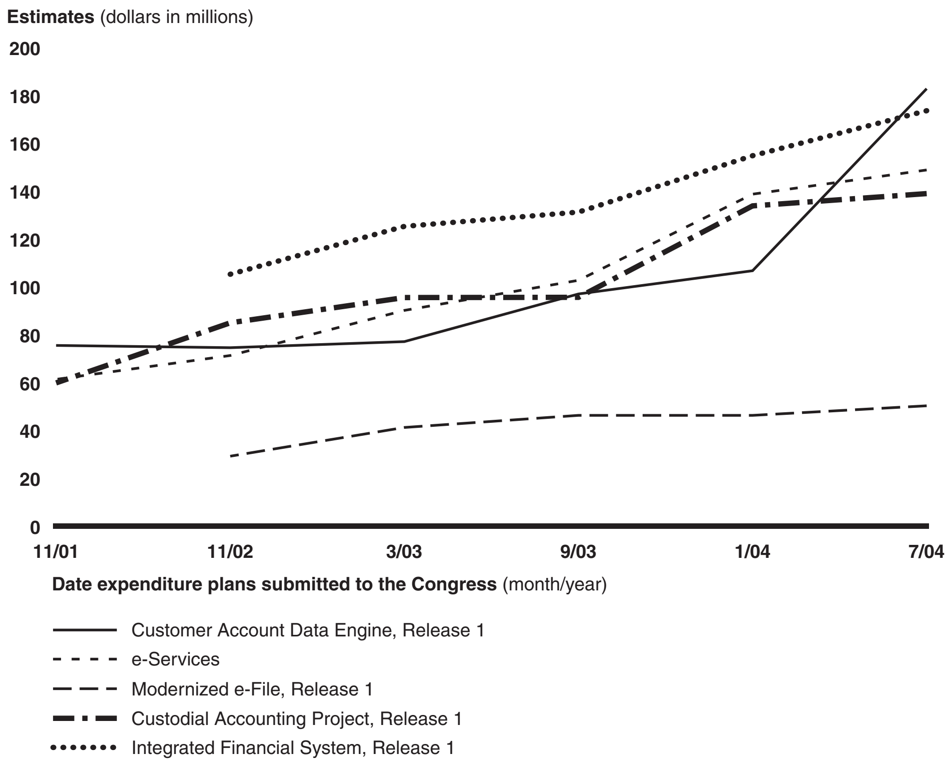
[27] GAO-05-207.

In February 2002 we expressed concern over IRS's cost and schedule estimating and made a recommendation for improvement.[28] IRS and its prime systems integration support (PRIME) contractor have taken action to improve their estimating practices, such as developing a cost and schedule estimation guidebook and developing a risk-adjustment model to include an analysis of uncertainty. These actions may ultimately result in more realistic cost and schedule estimates, but our analysis of IRS's expenditure plans[29] over the last few years shows continued increases in estimated project life-cycle costs (see fig. 4).

[28] GAO, *Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload*, GAO-02-356 (Washington, D.C.: Feb. 28, 2002).

[29] BSM funds are unavailable until the IRS submits to congressional appropriations committees for approval a modernization expenditure plan that (1) meets the OMB's capital planning and investment control review requirements; (2) complies with IRS's enterprise architecture; (3) conforms with IRS's enterprise life-cycle methodology; (4) is approved by IRS, the Department of the Treasury, and OMB; (5) is reviewed by GAO; and (6) complies with acquisition rules, requirements, guidelines, and systems acquisition management practices.

Figure 4: Life-cycle Cost Estimates for Key BSM Projects



Source: GAO analysis of IRS data.

The Assistant Chief Information Officer (CIO) for BSM stated that IRS's cost and schedule estimating has improved in the past year. Our comparison of IRS's reported project costs and milestone completion dates presented in the July 2004 and April 2005 expenditure plans shows that two BSM projects, CADE Releases 1.1 and 1.2, were delivered at the estimated cost and on or before the scheduled completion dates projected in the July 2004 expenditure plan. It is important to note that this recent success is based on project cost and schedule estimates that were re-baselined in the second quarter of fiscal year 2004 with delivery dates in late fiscal year 2004 and early fiscal year 2005. It is too early to tell whether this signals a fundamental improvement in IRS's ability to accurately forecast project costs and schedules.

The reasons for IRS's cost increases and schedule delays vary. However, we have previously reported that they are due, in part, to weaknesses in management controls and capabilities. We have previously made recommendations to improve BSM management controls, and IRS has implemented or begun to implement these recommendations. For example, in February 2002, we reported that IRS had not yet defined or implemented an information technology human capital strategy, and recommended that IRS develop plans for obtaining, developing, and retaining requisite human capital resources.[30] In August 2004, the current Associate CIO for BSM identified the completion of a human capital strategy as a high priority. Among the activities that IRS is in the process of implementing are prioritizing its BSM staffing needs and developing a recruiting plan. IRS has also identified, and is in the process of addressing, other major management challenges. For example, poorly defined requirements have been among the significant weaknesses that have been identified as contributing to project cost overruns and schedule delays. As part of addressing this problem, in March 2005, the IRS BSM office established a requirements management office, although a leader has not yet been hired.

IRS Is Adjusting the BSM Program in Response to Budget Reductions

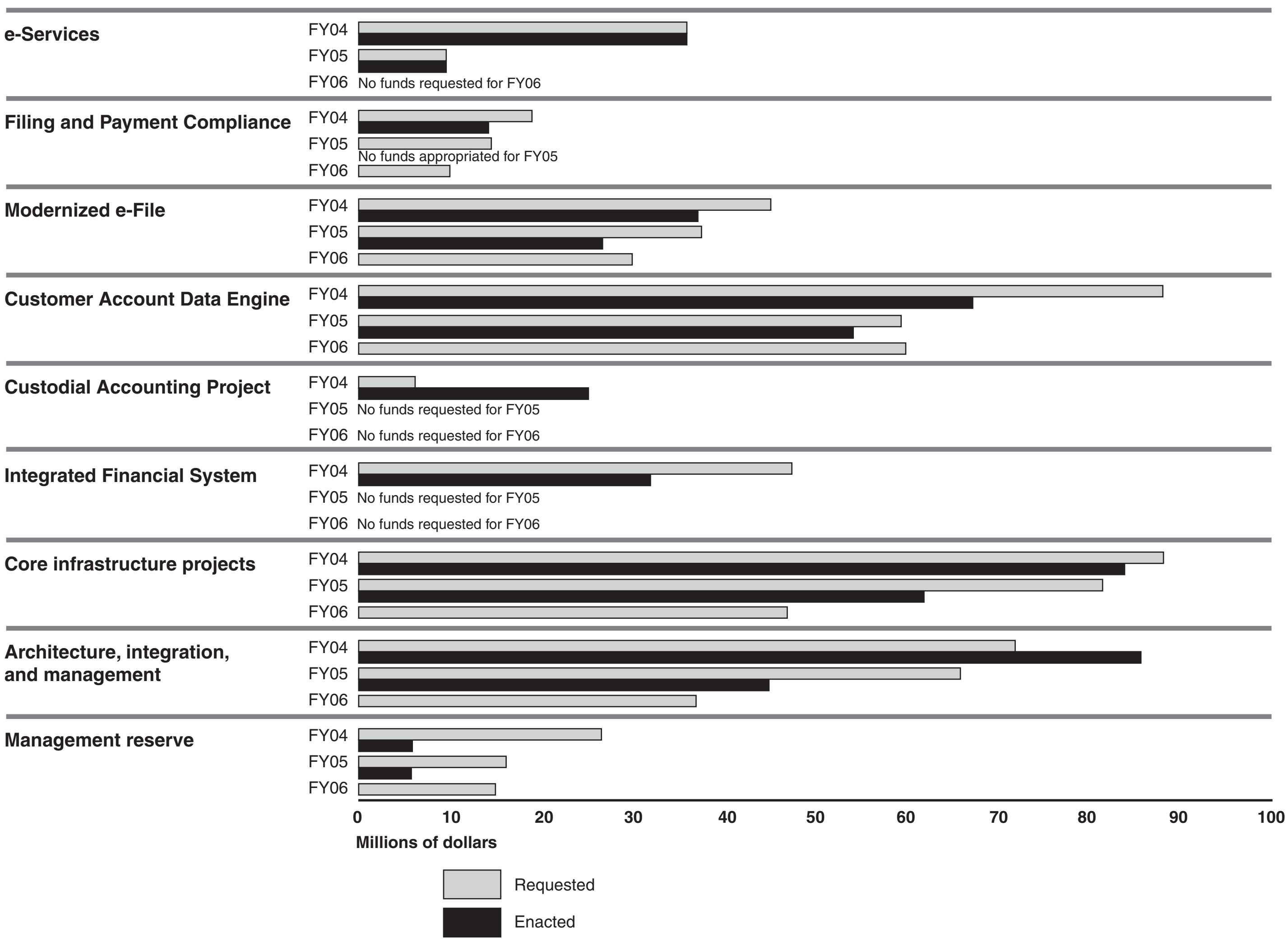
The BSM program is undergoing significant changes as it adjusts to reductions in its budget. Figure 5 illustrates the BSM program's requested and enacted budgets for fiscal years 2004 through 2006.[31] For fiscal year 2005, IRS received about 29 percent less funding than it requested (from $285 million to $203.4 million). According to the Senate report for the fiscal year 2005 Transportation, Treasury, and General Government appropriations bill, in making its recommendation to reduce BSM funding, the Senate appropriations committee was concerned about the program's cost overruns and schedule delays. In addition, the committee emphasized that in providing fewer funds, it wanted IRS to focus on its highest priority projects, particularly CADE.[32] In addition, IRS's fiscal year 2006 budget request reflects an additional reduction of about 2 percent, or about $4.4 million, from the fiscal year 2005 appropriation.

[30] GAO, *Business Systems Modernization: IRS Needs to Better Balance Capacity With Systems Acquisition Workload*, GAO-02-356 (Washington, D.C.: Feb. 28, 2002).

[31] IRS uses the appropriated funds to cover contractor costs related to the BSM program. IRS funds internal costs for managing BSM with another appropriation. These costs are not tracked separately for BSM-related activities.

[32] U.S. Senate, Senate Report 108-342.

Figure 5: Changes in the BSM budget (dollars in millions)



Source: IRS.

Note: The BSM account authorizes funds to be obligated for 3 years.

It is too early to tell what effect the budget reductions will ultimately have on the BSM program. However, the significant adjustments that IRS is making to the program to address these reductions are not without risk, could potentially impact future budget requests, and will delay the implementation of certain functionality that was intended to provide benefit to IRS operations and the taxpayer. For example,

- *Reductions in management reserve/project risk adjustments*. In response to the fiscal year 2005 budget reduction, IRS reduced the amount that it had allotted to program management reserve and project risk adjustments by about 62 percent (from about $49.1 million to about $18.6 million).[33] If BSM projects have future cost overruns that cannot be covered by the depleted reserve, this reduction could result in (1) increased budget requests in future years or (2) delays in planned future activities (e.g., delays in delivering promised functionality) to use those allocated funds to cover the overruns.
- *Shifts of BSM management responsibility from the PRIME contractor to IRS*. Due to budget reductions and IRS's assessment of the PRIME contractor's performance, IRS decided to shift significant BSM responsibilities for program management, systems engineering, and business integration from the PRIME contractor to IRS staff. For example, IRS staff are assuming responsibility for cost and schedule estimation and measurement, risk management, integration test and deployment, and transition management. There are risks associated with this decision. To successfully accomplish this transfer, IRS must have the management capability to perform this role. Although the BSM program office has been attempting to improve this capability through, for example, implementation of a new governance structure and hiring staff with specific technical and management expertise, IRS has had significant problems in the past managing this and other large development projects, and acknowledges that it has major challenges to overcome in this area.
- *Suspension of the Custodial Accounting Project (CAP)*. Although the initial release of CAP went into production in September 2004, IRS has decided not to use this system and to stop work on planned improvements due to budget constraints. According to IRS, it made this decision after it evaluated the business benefits and costs to develop and maintain CAP versus the benefits expected to be provided by other projects, such as CADE. Among the functionalities that the initial releases of CAP were expected to provide were (1) critical control and reporting capabilities

[33] We did not include in our calculations reductions to specific project risk adjustment amounts that were made for reasons other than the fiscal year 2005 budget reduction.

mandated by federal financial management laws; (2) a traceable audit trail to support financial reporting; and (3) a subsidiary ledger to accurately and promptly identify, classify, track, and report custodial revenue transactions and unpaid assessments. With the suspension of CAP, it is now unclear how IRS plans to replace the functionality this system was expected to provide, which was intended to allow the agency to make meaningful progress toward addressing long-standing financial management weaknesses. IRS is currently evaluating alternative approaches to addressing these weaknesses.

- *Reductions in planned functionality*. According to IRS, the fiscal year 2006 funding reduction will result in delays in planned functionality for some of its BSM projects. For example, IRS no longer plans to include form 1041 (the income tax return for estates and trusts) in the fourth release of Modernized e-File, which is expected to be implemented in fiscal year 2007.

The BSM program is based on visions and strategies developed in 2000 and 2001. The age of these plans, in conjunction with the significant delays already experienced by the program and the substantive changes brought on by budget reductions, indicates that it is time for IRS to revisit its long-term goals, strategy, and plans for BSM. As we have previously reported, such an assessment would include an evaluation of when significant future BSM functionality would be delivered.[34] IRS's Associate CIO for BSM has recognized that it is time to recast the agency's BSM strategy because of changes that have occurred subsequent to the development of the program's initial plans. According to this official, IRS is in the process of redefining and refocusing the BSM program, and he expects this effort to be completed by the end of this fiscal year. However, clear milestones for completing these activities have not been defined and we plan to address this in our ongoing 2005 BSM expenditure plan review for the appropriations committees.

IRS Needs to Remedy Serious Information Security Weaknesses over Taxpayer and Bank Secrecy Act Information

Information security is a critical consideration for any organization that depends on information systems and computer networks to carry out its mission or business. It is especially important for government agencies where maintaining the public's trust is essential. In December 2002, the Congress enacted the Federal Information Security Management Act of 2002 (FISMA) to strengthen security of information and systems within

[34] GAO-05-416T.

federal agencies.[35] FISMA requires each agency to develop, document, and implement an agencywide information security program to provide information security for the information and systems that support the operations and assets of the agency. IRS relies extensively on interconnected information systems to perform vital functions, such as collecting and storing taxpayer data, calculating interest and penalties, and generating refunds. In addition to processing its own financial and tax information, IRS provides information processing support to the Financial Crimes Enforcement Network (FinCEN), a Treasury bureau responsible for administering and enforcing the Bank Secrecy Act (BSA) and its implementing provisions.

While IRS has made progress in correcting or mitigating previously reported information security control weaknesses, serious control weaknesses continue to exist over key financial and tax processing information systems. For example, during our review of information security at IRS facilities in 2004,[36] we determined that IRS corrected or mitigated 32 of the 53 weaknesses that we reported as unresolved at the time of our last review in 2002. In addition to the 21 previously reported weaknesses that remained uncorrected, we identified 39 new information security control weaknesses during this review that placed sensitive taxpayer and BSA data—including information related to financial crimes, terrorist financing, money laundering, and other illicit activities—at significant risk of unauthorized disclosure, modification, and destruction. These include the following:

- Access controls over the mainframe computing environment provided no logical separation between IRS's taxpayer data and FinCEN's BSA data, allowing all 7460 mainframe users—IRS employees, non-IRS employees, and contractors—regardless of their official duties, the ability to read and modify taxpayer and BSA data, including information about citizens, law enforcement personnel, and individuals subject to investigation. Thus, IRS users could read or copy BSA information, and law enforcement users could read or copy taxpayer information.
- User accounts and passwords were not adequately controlled to ensure that only authorized individuals had access to IRS's servers and networks,

[35] FISMA was enacted as title III, E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2946 (Dec. 17, 2002).

[36] GAO, *Information Security: Internal Revenue Service Needs to Remedy Serious Weaknesses over Taxpayer and Bank Secrecy Act Data*, GAO-05-482 (Washington, D.C.: Apr. 15, 2005).

thereby increasing the risk that unauthorized users could gain authorized user ID and password combinations to claim a user identity and then use that identity to gain access to sensitive taxpayer or BSA data.

- Audit and monitoring of security-related events on IRS's servers suffered from insufficient retention of security logs, heightening the risk of unauthorized system activity going undetected.
- Security over access to sensitive areas was jeopardized due to the lack of accountability over the issuance of master keys at an IRS facility, thereby increasing the likelihood that an unauthorized person could gain possession of a master key and use it to unlock sensitive computing areas within the facility.

These information security control weaknesses exist primarily because IRS has not fully implemented an agencywide information security program to effectively protect the information and information systems that support the operations and assets of the agency. Consequently, these identified weaknesses in information security controls impair IRS's ability to ensure the confidentiality, integrity, and availability of sensitive financial, taxpayer and FinCEN's BSA data hosted at its facility.

We made recommendations to the Secretary of the Treasury to direct the IRS Commissioner to take several actions to fully implement a comprehensive agencywide information security program and to determine whether taxpayer data have been disclosed to unauthorized individuals.[37] In addition, we recommended that the Secretary of the Treasury direct the FinCEN Director to perform an assessment to determine whether BSA data have been disclosed to unauthorized individuals. The Acting Deputy Secretary of the Treasury generally agreed with the recommendations and identified specific completed and planned corrective actions, which we did not verify.

Concluding Observation

IRS is operating in a difficult budget environment. On the one hand, its workload—represented by the number of returns and the complexity of those returns—is growing. On the other hand, IRS faces pressure to hold down spending.

Addressing the resource challenges summarized in this statement can help policy makers assessing IRS's budget. Long-term goals can help determine

[37] GAO-05-482.

overall budgetary requirements. Revenue enhancements and the leveraging of nonfederal resources can help, to some extent, meet those requirements. Productivity gains and successful new investments in systems can help ensure that existing resources are used as efficiently as possible, helping minimize the need for additional funding. Addressing these resource challenges does not promise a painless way out of difficult budget decisions. However, it could provide a clearer picture of the tradeoffs involved.

Mr. Chairman, this concludes my testimony. I would be happy to answer any questions you may have at this time.

Contact and Acknowledgments

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