



Statement for the Record

Before the Subcommittee on Transportation,  
Treasury, the Judiciary, and Housing and  
Urban Development, and Related Agencies,  
Committee on Appropriations, U.S. Senate

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**INTERNAL REVENUE  
SERVICE**

**Assessment of the Interim  
Results of the 2006 Filing  
Season and Fiscal Year 2007  
Budget Request**

Statement of James R. White  
Director  
Strategic Issues

Statement of David A. Powner  
Director  
Information Technology Management Issues





# INTERNAL REVENUE SERVICE

## Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request

Highlights of [GAO-06-499T](#), a statement for the record for the Subcommittee on Transportation, Treasury, the Judiciary, and Housing and Urban Development, and Related Agencies, Committee on Appropriations, U.S. Senate

### Why GAO Did This Study

The Internal Revenue Service's (IRS) filing season performance affects tens of millions of taxpayers who expect timely refunds and accurate answers to their tax questions. IRS's budget request is a planning tool showing how it intends to provide taxpayer service and enforce the tax laws in 2007. It is also the first in a series of annual steps that will determine whether IRS meets its new long-term goals of increasing tax compliance and reducing taxpayers' acceptance of cheating on their taxes. Tax law enforcement remains on GAO's list of high-risk federal programs, in part, because of the persistence of a large tax gap. IRS recently estimated the gross tax gap, the difference between what taxpayers owe and what they voluntarily pay, to be \$345 billion for 2001.

GAO assessed (1) IRS's interim 2006 filing season performance; (2) the budget request; and (3) how the budget helps IRS achieve its long-term goals. GAO compared performance and the requested budget to previous years.

### What GAO Recommends

GAO is not making any new recommendations, but notes past recommendations and their implementation status where relevant and identifies opportunities for additional savings.

[www.gao.gov/cgi-bin/getrpt?GAO-06-499T](http://www.gao.gov/cgi-bin/getrpt?GAO-06-499T).

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](mailto:whitej@gao.gov).

### What GAO Found

IRS has improved its filing season performance so far in 2006, continuing a trend. More refunds were directly deposited, which is faster and more convenient. Electronic filing continued to grow, but at a slower rate than in previous years. IRS's two most commonly used services—telephone and Web site assistance—continued to improve. IRS estimates that the accuracy rate for its telephone answers is now at 90 percent or more. Taxpayers continued the recent pattern of using IRS's walk-in sites less and community-based volunteer sites more. While millions of taxpayers use chain paid tax preparers, taxpayers may not be receiving accurate and complete assistance, putting them at risk of owing back taxes, interest, and penalties.

The 2007 budget request of \$11 billion (a small decrease after adjusting for inflation) sets performance goals for service and enforcement that are all equal to or higher than the 2006 goals. The budget reduces funding by 15 percent for Business Systems Modernization, the ongoing effort to replace IRS's aging information systems. The reduction could impede progress delivering improvements to taxpayers. The budget request identified over \$121 million in savings; however, opportunities exist for further savings. For example, IRS officials told us IRS's 25 call centers have underutilized space. Those centers could be consolidated without affecting service to taxpayers.

Achieving IRS's long-term compliance goals will be challenging because the tax gap has persisted for many years at about its current level. In addition, because the effect of taxpayer service and enforcement on compliance has never been quantified, IRS does not have a data-based plan demonstrating how it will achieve its goals. Nor does IRS have a plan for measuring compliance by 2009, the date for achieving the goals. Reducing the tax gap will likely require new and innovative solutions such as simplifying the tax code, increasing income subject to withholding, and increasing information reporting about income.

**Changes in Funding and Full-time Equivalent (FTE) Staff for the Fiscal Year 2007 Budget Request Compared to Fiscal Year 2006 Enacted Budget**

	Fiscal year 2007 requested		Percentage change fiscal years 2006-2007	
	Dollars	FTEs	Dollars	FTEs
	Dollars in thousands			
Processing, Assistance, & Management	\$4,159,893	37,126	1.58	-4.30
Tax Law Enforcement	4,764,954	49,479	1.85	-2.14
Information Systems	1,619,834	7,351	2.33	4.54
Business Systems Modernization	167,310	0	-15.08	0.00
Health Insurance Tax Credit Administration	14,846	17	-25.80	0.00
<b>Total</b>	<b>10,726,837</b>	<b>93,973</b>	<b>1.45</b>	<b>-2.52</b>
Existing user fees and reimbursables	282,543	1,503	9.17	11.33
<b>Total program operating level</b>	<b>\$11,009,308</b>	<b>95,476</b>	<b>1.63</b>	<b>-2.33</b>

Source: GAO analysis of IRS data.

Notes: Fiscal year 2007 FTEs reflect an adjustment made after the budget was printed. Enacted FTEs differ from actual FTEs.

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Mr. Chairman and Members of the Subcommittee:

Since the passage of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98)<sup>1</sup>, IRS has made noticeable improvements to taxpayer services such as telephone assistance and delivered some modernized information systems that, among other benefits, speed up refunds to taxpayers. Increased funding financed some of the improvements, but a significant portion has been financed internally through efficiencies from increased electronic filing of tax returns and other operational improvements.

IRS has also increased revenue collected through its enforcement programs; however, tax law enforcement continues to be included on our list of high-risk federal programs.<sup>2</sup> This is due, in part, to the persistence of a large tax gap.<sup>3</sup> IRS estimated the gross tax gap to be \$345 billion for tax year 2001. After late payments by taxpayers and revenue brought in by IRS's enforcement efforts, the resulting net tax gap is estimated to be \$290 billion.<sup>4</sup> Even modest progress in reducing the tax gap would yield significant revenue; each 1 percent reduction would likely yield nearly \$3 billion annually.

If its 2007 budget request is a harbinger of longer term funding, IRS faces an era of tight budgets. Consequently, continued performance improvements will depend on the extent to which IRS can make more efficient use of limited resources to provide internal funding for the improvements. By indicating how resources are allocated to specific programs and activities within the agency, the budget request is a key planning tool showing where the agency intends to achieve additional efficiencies.

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<sup>1</sup>Pub. L. No. 105-206 (1998).

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

<sup>3</sup>The tax gap is an estimate of the difference between the taxes that should have been timely and accurately paid and what was actually paid. Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

<sup>4</sup>GAO, *Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions*, [GAO-06-453T](#) (Washington, D.C.: Feb. 15, 2006).

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The 2007 budget request is also an indication of how IRS intends to achieve longer term goals. For the first time, IRS lists two agencywide long-term goals: to increase the compliance rate and reduce the proportion of taxpayers who think it is acceptable to cheat on their taxes.<sup>5</sup> This budget can be viewed as a first step in a series of annual steps that will determine whether IRS achieves these long-term goals.

Our statement discusses IRS's 2006 filing season performance to date and fiscal year 2007 budget request. To address your request, we assessed (1) the interim results of IRS's 2006 filing season performance compared to prior years; (2) IRS's budget request compared to prior years; and (3) how the budget helps IRS achieve its long-term goals aimed at reducing the tax gap.

Our assessment of the interim results of IRS's filing season is based on comparing IRS's performance this year to prior filing seasons, monitoring various production meetings and production statistics, reviewing other IRS documents and reports, interviewing IRS and Treasury Inspector General for Tax Administration (TIGTA) officials and paid tax preparers and other external stakeholders, reviewing TIGTA and other external reports, and reviewing IRS's Web site. Our assessment of the budget request is based on a comparative analysis of IRS's fiscal year 2002 (in most cases) through 2007 budget requests, funding, expenditures, and other documentation and interviews with IRS officials. We used historical budget and performance data from reports and budget requests used by the IRS, Department of the Treasury, and Office of Management and Budget. In past work, we assessed IRS's budget and performance data. Since the data sources and procedures for producing this year's budget and performance data have not significantly changed from prior years, we determined that the data were sufficiently reliable for the purposes of this statement. We did not verify IRS's estimates for enforcement revenue and the tax gap. IRS presents tax gap information as supplemental information in its financial statements; that information is not required to be audited. However, we have been involved in tax gap methodology briefings, and the TIGTA has an ongoing review of the accuracy of IRS's tax gap estimates.

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<sup>5</sup> The Congress set one long-term goal for the IRS in RRA 98 for IRS to have 80 percent of individual returns, business returns, and information returns filed electronically by 2007. We and IRS have previously reported that IRS likely will not meet this goal for having 80 percent of all individual returns tax returns filed electronically by 2007. Also, IRS's budget describes plans to establish other agencywide goals, targets for which have not yet been established and therefore are not listed in the budget request.

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Additionally, our analysis of IRS's Business Systems Modernization (BSM) program was based primarily upon the results of our detailed review of IRS's fiscal year 2006 BSM expenditure plan that we recently reported to you.<sup>6</sup> We performed our work in Washington, D.C., and Atlanta, Georgia, from January 2006 through April 2006, in accordance with generally accepted government auditing standards.

Our statement makes these key points:

- IRS has improved its 2006 filing season performance to date in important areas compared to last year, continuing a recent trend. IRS's returns processing has gone smoothly and over 64 percent of refunds are now directly deposited to taxpayers' bank accounts, which is faster, more convenient and less costly than issuing paper checks. Electronic filing continues to grow, but at a slower rate. So far this filing season, electronic filing rate has increased 2.1 percentage points compared to an average percentage point increase of 5.1 annually for the previous two years. According to IRS officials, the slower rate of growth is due, in part, to new income limits in the Free File program, which reduced the number of taxpayers eligible to file electronically for free via IRS's Web site, and the termination of the TeleFile program, which eliminated electronic filing by phone. Telephone assistance has improved this year, in part, due to lower call volume. The percentage of taxpayers attempting to reach an IRS telephone assistor and who actually received service increased 1.6 percentage points to 83.3 percent this filing season and the length of time taxpayers waited to get their calls answered decreased from 256 seconds to 205 seconds. The accuracy of IRS's responses to tax law and account questions improved—both are now at 90 percent or more. IRS's Web site is being used more, is performing well based on third-party evaluations, and has been reconfigured with the goal of improving taxpayer service. Taxpayers continued the recent pattern of using IRS's walk-in sites less, and using sites run by community-based organizations and staffed by volunteers more. In addition to service from IRS, millions of taxpayers—particularly those with complicated returns—receive service from paid preparers.<sup>7</sup> However, we recently

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<sup>6</sup>GAO, *Business Systems Modernization: Internal Revenue Service's Fiscal Year 2006 Expenditure Plan*, GAO-06-360 (Washington, D.C.: Feb. 21, 2006).

<sup>7</sup>As noted in our report, complicated returns are defined as those using the Form 1040 as opposed to the Form 1040EZ, those claiming itemized deductions and not the standard deduction, and those claiming the Earned Income Tax Credit.

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reported<sup>8</sup> that chain paid tax preparers may not be providing accurate and complete assistance, putting taxpayers at risk of owing back taxes, interest, and penalties.

- IRS's fiscal year 2007 proposed budget is \$11 billion, which is a small decrease compared to the 2006 enacted level after adjusting for expected inflation.<sup>9</sup> For service, the budget proposes to cut staffing by 4 percent. For enforcing tax laws, the budget proposes to cut staffing by 2 percent. However, for service and enforcement, the budget sets performance goals for 2007 that are higher than or equal to those for 2006. For maintaining and operating IRS's existing information systems (IS), the 2007 budget request shows an increase in resources when compared to the 2006 enacted budget. However, when compared to the level currently assumed for 2006, the 2007 budget request leaves Full-time Equivalents (FTE)<sup>10</sup> for IS virtually constant. For the BSM program, which is the ongoing effort to replace the agency's aging information systems, the budget proposes to reduce spending by about 15 percent. This reduction could delay delivery of improved services for taxpayers. As it has in prior years, IRS's budget request identifies savings—the 2007 budget proposes to save over \$121 million and 1,424 FTEs. However, additional opportunities exist for savings. One would be to increase electronic filing by additional use of mandates. IRS currently mandates electronic filing by large corporations and 12 states currently mandate electronic filing of individual income tax returns by certain tax preparers. Another opportunity would be to consolidate IRS's 25 telephone call sites. IRS officials told us that the call sites have space that is not used for 850 staff. Call sites could be consolidated without affecting service to taxpayers. Finally, IRS has long been hampered by a lack of current and accurate cost information for making resource allocation decisions. IRS recently implemented components of a cost accounting system, but needs to continue gathering the cost data needed to make it an effective planning tool.

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<sup>8</sup>GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, [GAO-06-563T](#) (Washington, D.C.: April 4, 2006).

<sup>9</sup>The Congressional Budget Office is estimating inflation to be 1.8 percent in 2007. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016*. (Washington, D.C.: January 2006).

<sup>10</sup> According to IRS, a FTE is the equivalent of one person working full-time for one year with no overtime. A staff year includes overtime. Therefore, the cost of 1 staff year is equal to the cost of 1 FTE plus overtime.

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- IRS's budget request sets two long-term goals: increasing the rate of voluntary compliance from 83 percent to 85 percent by 2009 and reducing the percentage of taxpayers who think it is acceptable to cheat on their taxes from 10 percent to 9 percent in 2008. These goals will be challenging to meet because the tax gap has persisted at a relatively stable level of 81 to 84 percent for many years. However, because the effect of taxpayer service and enforcement on compliance has never been quantified, IRS does not have a data-based plan demonstrating how it will use its programs to achieve its goals and reduce the tax gap. Nor does IRS have a plan for measuring compliance by 2009. Reducing the tax gap will likely require new and innovative solutions such as simplifying the tax code, increasing income subject to withholding, and increasing information reporting about income. Despite these limitations, IRS's budget request includes several proposals for increasing compliance that would not require additional resources for IRS. For example, the Department of the Treasury plans to study, and we have long supported, clarifying the definition of independent contractors and requiring additional information reporting on their income, steps that could increase tax revenue by billions of dollars.

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## IRS's Filing Season Performance to Date Has Improved in Important Areas, Continuing a Recent Trend

IRS improved its 2006 filing season performance in important areas that affect large numbers of taxpayers. This continues a trend of improvement since at least 2002. Returns processing has gone smoothly and electronic filing continues to grow, although at a slower rate than in previous years. Taxpayer assistance has improved in the two most commonly used services—toll-free telephones and the Internet Web site. Fewer taxpayers visited IRS's walk-in sites, and more sought assistance at volunteer-staffed sites.

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## Return Processing Has Been Smooth and Electronic Filing Continues to Grow, Although At a Slower Rate Than Previous Years

From January 1 through April 14, 2006, IRS processed 91.8 million individual income tax returns. Of those returns, 63.4 million returns were filed electronically (up 2.3 percent) and 28.3 million returns were filed on paper (down 7.1 percent).

According to IRS data and officials, returns processing has gone smoothly so far this filing season. IRS issued 78 million refunds, 50 million, or 64 percent of which were directly deposited, up 5.4 percent over the same period as last year. Direct deposit is faster, more convenient for taxpayers, and less expensive for IRS than mailing paper checks.

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Because of the volume of tax returns, it is normal for IRS to experience some processing disruptions, although this year, disruptions have not been significant. For example, 13 different tax forms were unavailable for electronic filing until February 1 due to the late hurricane relief legislation, which caused a minor processing delay for some returns.

Furthermore, IRS officials said that the new Customer Account Data Engine (CADE), which is intended eventually to replace IRS's antiquated Master File system containing taxpayer records, processed over 6 million returns and dispersed 5.3 million refunds as of April 14, 2006 without disruptions. IRS is reporting that direct deposit refunds and paper check refunds are being issued within 4 and 6 business days, respectively, after tax returns are posted to CADE, which is faster than for returns processed by the Master File system. CADE's growth in future years will directly benefit taxpayers. Not only can it speed up refunds, but it also updates taxpayer account information quicker than the Master File system.

Representatives of the taxpayer industry corroborated IRS's view that the filing season is going smoothly. Groups and organizations that we talked to included the National Association of Enrolled Agents, the American Institute of Certified Public Accountants, and others. In addition, the TIGTA recently testified that thus far it has seen no significant problems during the filing season.<sup>11</sup>

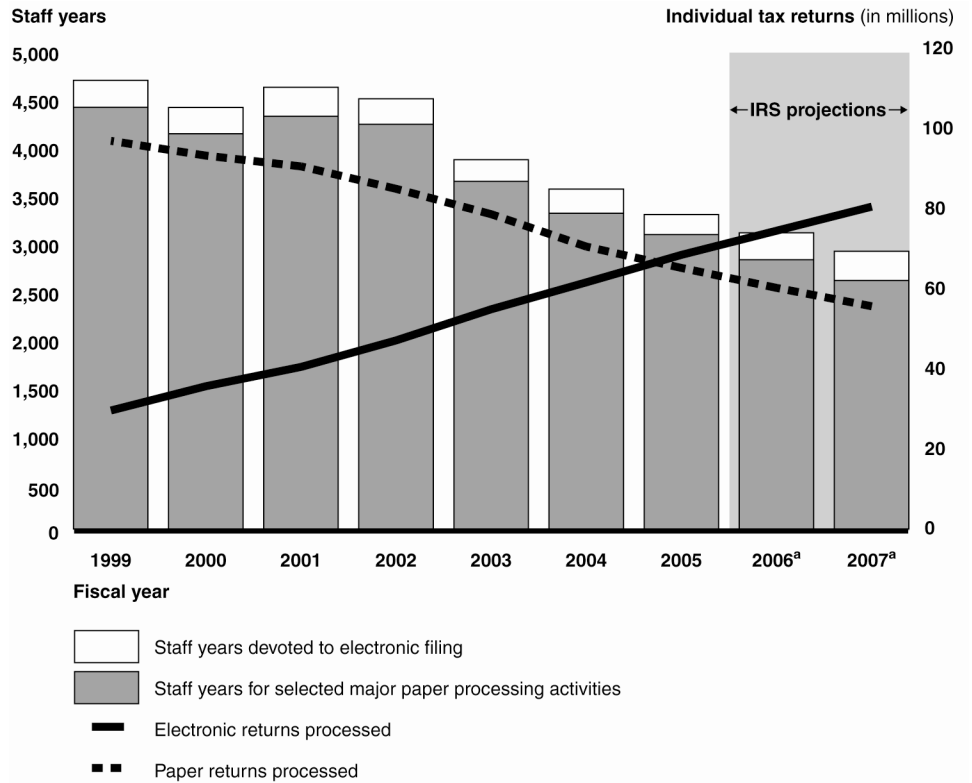
The growth of electronic filing is important, because it generates savings by reducing staff years needed for labor intensive paper processing. Between fiscal years 1999 and 2006, IRS reduced the number of staff years devoted to paper and electronic processing by 1,586, or 34 percent as shown in figure 1.

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<sup>11</sup> Written statement of Treasury Inspector General for Tax Administration, J. Russell George, before the Committee on Appropriations, Subcommittee on Transportation, Treasury and Housing and Urban Development, the Judiciary, District of Columbia, and Independent Agencies, U.S. House of Representatives, Hearing on the Internal Revenue Service's Fiscal Year 2007 Budget, Washington, D.C., Mar. 29, 2006.



**Figure 1: Number of Individual Returns and IRS Staff Years for Individual Paper and Electronic Processing, Fiscal Years 1999-2007**



Source: GAO analysis of IRS data.

<sup>a</sup>Fiscal years 2006 and 2007 are IRS projections.

Note: Staff years and FTE are units of measurement that are often used interchangeably. As noted in the figure, staff years for paper filing are for selected major activities only.

Electronic filing continues to grow but at a slower rate than previous years. This year's 2.1 percent rate of growth is less than the average annual rate of growth of 5.1 percent for each of the preceding 2 years. According to IRS officials, the slower growth in electronic filing this year is due, in part, to changes in the Free File program, which reduced the number of taxpayers eligible to file electronically for free this year and reduced publicity and advertising by companies involved in that program, and the termination of the TeleFile program, which eliminated the way for taxpayers to file their returns electronically via telephone.

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The Free File program enables taxpayers to file their returns electronically via IRS's Web site. Through IRS's Web site, taxpayers can access the Web sites of 20 companies comprising the Free File Alliance. The alliance is a consortium of tax preparation companies that agreed to offer free return preparation and electronic filing for taxpayers that meet certain criteria (see app. 1 for further detail). In an amended agreement with IRS that took effect this year, the Free File Alliance set a \$50,000 income limitation on taxpayer participation. This limit was absent last year and reduced the number of taxpayers eligible to participate in the program. As of April 13, 2006, IRS processed about 3.5 million free file returns, which is a decrease of 24 percent from the same period last year. This decline is inconsistent with IRS's projection that it would receive 6 million tax returns filed through the Free File program, almost a million more compared to last year.

For 2006, IRS terminated the TeleFile program. IRS expected that eliminating TeleFile would reduce electronic filing, but justified the decision because of declining usage and relatively high costs. The number of taxpayers using the program had been decreasing—from approximately 5.7 million in 1999 to 3.8 million in 2004. IRS estimated the cost per tax return submitted through TeleFile, typically Form 1040EZ, to have been \$2.63 versus \$1.51 for a return filed on paper, largely due to contractor, telecommunications, and other costs. Given the limitations of IRS's cost accounting system, the validity of these figures is unknown. IRS officials stated that the reason for this year's increase in the number of 1040EZ returns filed on paper is due, in part, to the elimination of TeleFile. Through April 14, 2006, the number of 1040EZ returns filed on paper has increased 20 percent from last year.

Options for increasing electronic filing, in particular mandated electronic filing, will be discussed in the budget section of this statement.

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## Telephone Access and Accuracy Improved, in Part Due to Lower Call Volume

Taxpayers' ability to access IRS's telephone assistors and the accuracy of answers provided improved compared to previous years. From January 1 through April 15, 2006, IRS answered approximately 31 million phone calls, which is about a 7 percent decline from the same period last year.<sup>12</sup> The call volume has been less than projected by IRS and less than was assumed when IRS set staffing levels for telephone assistors for the filing season. IRS officials offered several explanations for the unexpected decline in call volume. One explanation is that more taxpayers are using improved tax preparation software, which reduces their need to call IRS. Another explanation is that more taxpayers are getting through to a telephone assistor the first time they call, thus reducing the need for taxpayers to call again.

As shown in table 1, the percentage of taxpayers who attempted to reach an assistor and actually got through and received service—referred to as the level of service—is 83.3 percent so far this filing season compared to 81.7 percent over the same period last year—and greater than its 2006 fiscal year goal of 82 percent. According to IRS officials, one possible explanation for the improvement in access is the decline in overall call volume. When call volume decreases, taxpayers are likely to wait less time to speak with an IRS telephone assistor. As a result, fewer taxpayers would likely hang up, increasing the percentage of taxpayers who get through to an assistor.

IRS also reported that, so far this filing season, the average speed of answer (length of time taxpayers wait to get their calls answered) is down 51 seconds from the same time last year to 205 seconds, a decrease of about 20 percent, and significantly better than IRS's 2006 fiscal year goal of 300 seconds. IRS also reported that the rate at which taxpayers

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<sup>12</sup>Despite less demand overall, call volume increased from affected taxpayers in federally-declared disaster areas. IRS maintains a special services hotline (1-866-562-5227) to provide assistance on questions related to hurricane relief and combat zone participation. Between January 1 and April 15, 2006, the hotline answered 63,203 calls, an increase of 195 percent over the same period in 2005. According to IRS officials, the hotline received primarily combat zone calls in 2005 because there were so few federally-declared disaster areas. Therefore, IRS officials attribute the 2006 increase to the three major hurricanes in 2005.

abandoned their calls<sup>13</sup> to IRS decreased from 12 percent to 9.7 percent compared to the same period last year.

**Table 1: IRS Telephone Assistance Performance in the First Weeks of the Filing Seasons, 2002 through 2006**

	2002	2003	2004	2005	2006
<b>Telephone assistance</b>					
Total calls <sup>a</sup> (volume in thousands)	51,148	40,805	41,647	33,935	31,540
Answered by assistors	14,799	14,987	15,915	14,804	13,709
Answered by automation	36,349	25,818	25,732	19,132	17,831
Assistor level of service	66.5%	82.4%	84.7%	81.7%	83.3%
Average speed of answer <sup>b</sup>	253 seconds	175 seconds	187 seconds	256 seconds	205 seconds
Accounts customer accuracy rate estimates <sup>c</sup>	89.3%	89.1%	89.3%	91.6%	92.9%
	+/- 0.7%	+/- 0.5%	+/- 0.6%	+/- 0.5%	+/- 0.5%
Tax law customer accuracy rate estimates <sup>c</sup>	84.0%	82.0%	77.7%	88.2%	90.0%
	+/- 0.5%	+/- 0.8%	+/- 1.0%	+/- 0.8%	+/- 0.8%

Source: IRS.

<sup>a</sup>Total calls (i.e., calls answered by assistors and automation) and CSR level of service are based on actual counts from January 1 to April 20, 2002; April 19, 2003; April 17, 2004; April 16, 2005; and April 15, 2006.

<sup>b</sup>From January 1 to April 20, 2002; April 19, 2003; April 17, 2004; April 16, 2005; and April 15, 2006.

<sup>c</sup>Based on a representative sample estimated at the 90 percent confidence interval from January through March 2002, 2003, 2004, 2005, and 2006.

Using a statistical sampling process, IRS estimates that the accuracy of telephone assistors' responses to taxpayers' tax law and account questions improved compared to last year. IRS estimates its tax law accuracy rate to be 90 percent, an increase of 1.9 percentage points over the same time period last year, continuing an improvement since 2004.<sup>14</sup> Additionally, IRS estimates that the accuracy rate to taxpayers' inquiries about their

<sup>13</sup>IRS divides abandoned calls into two subsets, primary abandons and secondary abandons. Primary abandons occur when callers hang up before being put into queue to wait for an available assistor. Secondary abandons are the number of callers who hang up after being put into the queue to wait for an assistor. In November 2004, IRS established a program to help determine where primary abandons occur within the IRS scripts. According to IRS officials, looking at the number and percentage of where callers hang up highlights opportunities where IRS can improve its menu prompt phrasings in a way that would be more beneficial for callers.

<sup>14</sup>IRS's customer account and tax law accuracy rates are estimated from representative samples. Based on these estimates, accuracy rates for 2006 were statistically better than those of 2005.

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accounts, to be 92.9 percent this year compared to 91.6 percent over the same period last year, continuing an improvement since 2003. IRS officials attribute these improvements in performance to several factors, including better and more timely performance feedback for telephone assistors, increased assistor experience, better training, and increased use of the Probe and Response Guide, a script used by telephone assistors to understand and respond to tax law questions.

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### IRS's Web Site Is Being Used More, Is Performing Well, and Has Been Reconfigured with the Goal of Improving Taxpayer Service

Use of IRS's Web site has increased so far this filing season compared to prior years based on the number of visits and downloads. From January 1 through March 31, IRS's Web site was visited 95 million times by visitors who downloaded 90 million forms and publications. The number of visits reflects a 7.5 percent increase over the same period last year while the number of forms and publications downloaded has increased by 34 percent.

Further, IRS's Web site is performing well. For example,

- we found IRS's Web site to be readily accessible, easy to navigate, and easy to search,
- an independent weekly study by Keynote, a company that evaluates Web sites, reported that IRS's Web site has repeatedly ranked second out of 40 government agencies evaluated in terms of average download time. The same study also reported that IRS has repeatedly ranked first out of the most commonly accessed government related Web sites for response time and success rate, and
- the American Consumer Satisfaction Index overall customer satisfaction with IRS's Web site increased from 68 to 72 percent after IRS reconfigured the site.

IRS reconfigured its Web site for the 2006 filing season. According to IRS officials, the goal for reconfiguring the Web site was to improve overall customer service through easier navigation and a more effective search function. As a result, the number of Web site searches has decreased by 51 percent, from 108 million during the same period last year to 52.5 million this year. Typically, search functions are used when users fail to find information through links. According to IRS officials, the decrease in the number of searches indicates that users are finding the information that they need faster.

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IRS also added the following new features to its Web site this year:

- **Electronic IRS:** The Electronic IRS brand reconfigured the IRS's Web site and made it easier to locate items, as evidenced by the decline in searches;
- **Alternative Minimum Tax (AMT) Assistant:** Helps taxpayers determine if they do not owe AMT; and
- **Help for Hurricane Victims:** A special link that provides victims of the recent hurricanes information on special tax relief, assistance and how to get help with tax matters.

IRS's Web site continues to include several important features in addition to the Free File program:

- **Where's My Refund,** which allows taxpayers to check on the status of their refunds. As of April 15, 2006, 24 million taxpayers accessed the Where's My Refund feature to check on the status of their tax refunds. This was a 17 percent increase from the same period last year; and
- **Electronic Tax Law Assistance,** where taxpayers can ask IRS general tax law questions via its Web site. From January 1 through April 14, 2006, IRS received 10,160 emails requesting tax law assistance (down over 43 percent compared to last year). As of March 31, 2006, IRS estimated the accuracy rate of IRS's responses to tax law questions submitted via the Web site, to be 85 percent, similar to 2005. However, the average number of days that it took IRS to respond to tax law questions submitted via the Web site was 2.2 days, compared to 1.2 days in 2005.

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## Taxpayers Continue Their Recent Pattern of Using IRS's Walk-In Sites Less and Using Volunteer Sites More, And Information About the Quality of Service Remains Limited

Fewer taxpayers have used IRS's 400 walk-in sites so far in the 2006 filing season compared to the same period in prior years. Staff at walk-in sites provide taxpayers with information about their tax accounts and answer taxpayers' questions within a limited scope of designated tax law topics, such as those related to income, filing status, exemptions, deductions, and related credits.<sup>15</sup> Walk-in site staffs also provide need-based tax return preparation assistance, limited to taxpayers meeting certain requirements.<sup>16</sup> As of April 1, 2006, the total number of contacts at IRS's walk-in sites declined by approximately 12 percent compared to last year. The decline thus far this year is consistent with the annual trends in walk-in use shown in figure 2, including IRS's projection for 2006. The declines in the number of taxpayers using IRS's walk-in sites, including for tax return preparation, are also consistent with IRS's strategy to reduce its costly face-to-face assistance by providing taxpayers with additional options, such as IRS's toll-free telephone service, Web site, and numerous volunteer sites. It is unclear, however, whether the declining volume is an indicator of how well IRS is meeting taxpayers' demand for face-to-face assistance. For example, IRS does keep track of the number of taxpayers entering a walk-in site, taking a number to queue for service, but then leaving the site without receiving service. If a taxpayer did not take a number, IRS would have no way of counting those taxpayers.

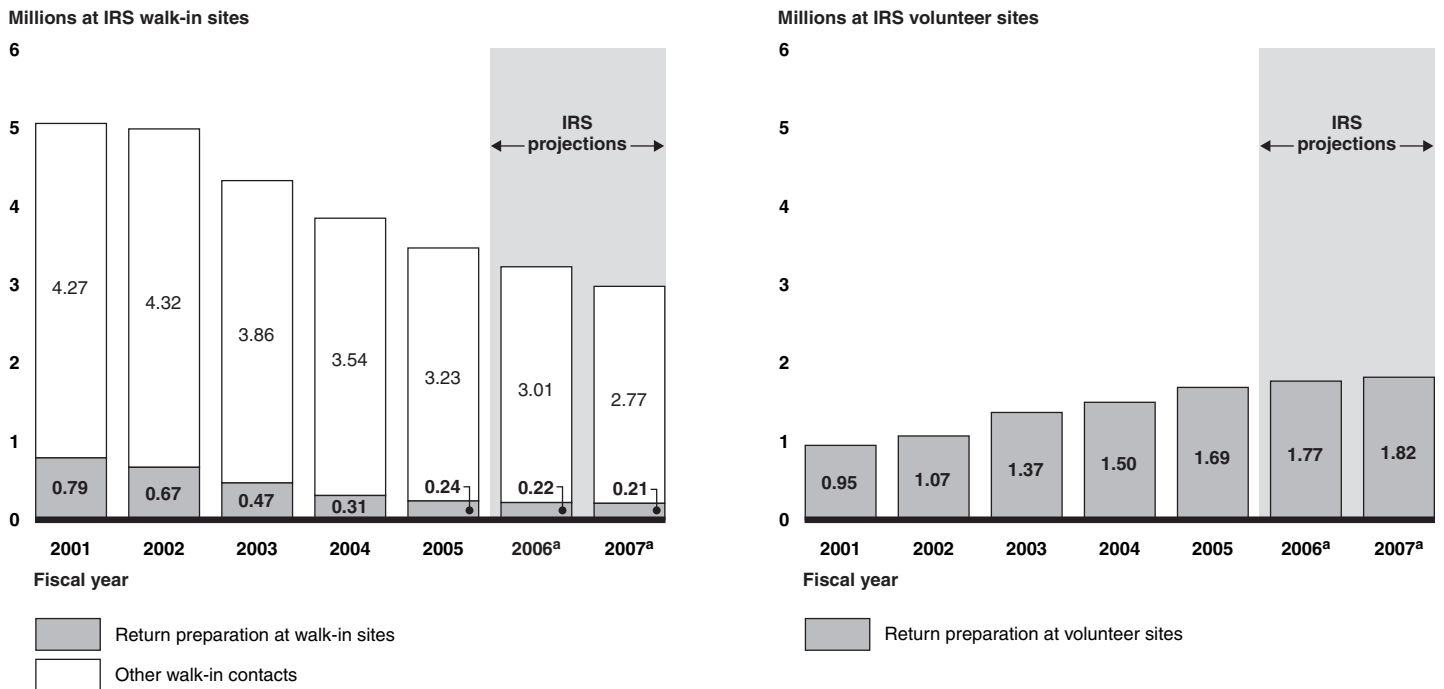
IRS officials said the types of services offered at walk-in sites remained constant for most sites from 2005 to 2006. For sites in areas with a high number of natural disaster victims, IRS expanded the types of assistance provided. For example, IRS adjusted the type of tax law questions that it would answer at walk-in sites to include casualty loss and removed income limitations for disaster victims seeking return preparation assistance at walk-in sites.

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<sup>15</sup>IRS considers some tax law questions to be out of scope related to businesses and corporations, for example. If staff cannot answer taxpayer's questions, they are required to refer taxpayers to IRS's telephone service or Web site.

<sup>16</sup>Return preparation assistance is limited to taxpayers with income of \$38,000 or less. According to IRS, this limitation approximates the amount set in the tax code for claiming the Earned Income Tax Credit. IRS has required appointments for most taxpayers seeking this assistance since 2003.

**Figure 2: Assistance Provided at IRS Walk-in Sites and Volunteer Sites, 2001 – 2006 Filing Seasons (contacts in millions)**



Source: GAO analysis 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; December 28, 2003, through April 24, 2004; and December 26, 2004, through April 23, 2005. For volunteer sites, the time period covered for 2001 is January 1, 2001, through April 21, 2001; December 30, 2001, through April 27, 2002; December 29, 2002, through April 26, 2003; December 28, 2003, through April 24, 2004; and December 26, 2004, through April 23, 2005.

<sup>a</sup>Fiscal years 2006 and 2007 are IRS projections. For walk-in sites, projections cover the time periods of December 25, 2005 through April 22, 2006, and December 31, 2006 through April 28, 2007. For volunteer sites, projections cover the time periods from January 1 through April 30, 2006 and 2007.

In contrast to IRS walk-in sites, the number of taxpayers seeking return preparation assistance at approximately 14,000 volunteer sites has increased this year by 8.7 percent, continuing the trend since 2001 (see fig. 2). These sites, often run by community-based organizations and staffed by volunteers who are trained and certified by IRS, do not offer the range of services IRS provides at walk-in sites, but instead focus on preparing tax returns primarily for low-income and elderly taxpayers and operate chiefly



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during the filing season. As we have previously reported,<sup>17</sup> the shift of taxpayers from walk-in to volunteer sites is important because it has allowed IRS to transfer time-consuming services, such as return preparation, from IRS to other less costly alternatives that can be more convenient for taxpayers.

IRS has used both walk-in and volunteer sites to provide relief efforts for federally-designated disaster zones such as in hurricane-affected areas. IRS developed a Disaster Referral Services Guide and new training materials for employees to better equip them to address disaster-related issues. In addition to the expanded services for disaster victims at IRS walk-in sites noted above, volunteer sites performed outreach within their network of partners by creating training material for tax preparers, and agreeing with two organizations to accept referrals from IRS of disaster victims needing tax return preparation assistance.

IRS continues to lack reliable data on the quality of the services provided at walk-in and volunteer sites. As in previous years, TIGTA is conducting an audit on the accuracy of some services provided at walk-in sites, although the results will not be available until after the filing season. However, TIGTA has noted problems with the quality of services provided at IRS walk-in sites in prior reports.<sup>18</sup> We have made recommendations for IRS to improve its quality measurement at walk-in sites.<sup>19</sup> At volunteer sites, IRS is conducting different types of reviews to monitor tax return preparation assistance.<sup>20</sup> According to IRS officials, the results to date show that the quality of service has improved at volunteer sites compared

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<sup>17</sup>GAO, *Tax Administration: IRS Improved Performance in the 2004 Filing Season, but Better Data on the Quality of Some Services Are Needed*, [GAO-05-67](#) (Washington, D.C.: Nov. 15, 2004).

<sup>18</sup>Treasury Inspector General for Tax Administration, *Coordination and Monitoring Are Needed for Continued Improvement in the Tax Return Preparation Process at the Taxpayer Assistance Centers*, Reference No. 2004-40-147, (Washington, D.C.: 2005), and Treasury Inspector General for Tax Administration, *Customer Accuracy at Taxpayer Assistance Centers Showed Little Improvements During the 2005 Filing Season*, Reference No. 2005-40-146, (Washington, D.C.: 2003).

<sup>19</sup>See [GAO-05-67](#) and [GAO-06-51](#).

<sup>20</sup>The different types of reviews include site reviews to measure the administrative aspects of a volunteer site such as readiness. IRS plans on conducting 825 of these site reviews. IRS also plans on conducting 2,475 return reviews, approximately 3 during each site review, which will involve on-site review of the return for accuracy and discretionary reviews for problem sites not operating in accordance with the IRS's guidelines.

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## Taxpayers Using Chain Paid Tax Preparers May Receive Incorrectly Completed Tax Returns

to previous years, but they acknowledge that challenges remain in terms of volunteers' adherence to IRS's procedures and use of IRS materials. As in previous years, TIGTA will conduct limited quality reviews at volunteer sites. While the results of those reviews are based on a judgmental sample, TIGTA has concluded in the past that, while significant improvements have been made in the oversight of volunteer sites, continued effort is needed to ensure the accuracy of tax return assistance provided.<sup>21</sup>

In addition to service from IRS, millions of taxpayers receive service, such as tax return preparation, from paid preparers. About 56 percent of about 130 million individual tax returns filed for tax year 2002 used a paid tax preparer, with higher paid preparer usage among taxpayers with more complicated returns.<sup>22</sup>

We recently reported, however, that some preparers make serious errors when completing returns. Based on our very limited sample of 19 paid tax preparers, taxpayers who rely on tax preparers to provide them with accurate, complete, and fully compliant tax returns may not get what they pay for. For example, during visits to paid preparers, tax returns prepared for GAO often varied widely from what we determined the returns should and should not include, sometimes with significant consequences. Their work resulted in unwarranted extra refunds of up to almost \$2,000 in 5 instances, while in 2 cases they cost the taxpayer over \$1,500.

Some of the most serious problems involved paid preparers:

- not reporting business income in 10 of 19 cases;
- not asking about where a child lived or ignoring GAO's answer to the question therefore allowing an ineligible child to be claimed for the Earned Income Tax Credit in 5 out of the 10 applicable cases;
- failing to take the most advantageous postsecondary education tax benefit in 3 out of the 9 applicable cases; and
- failing to itemize deductions at all or failing to claim all available deductions in 7 out of the 9 applicable cases.

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<sup>21</sup>Treasury Inspector General for Tax Administration, *Significant Improvements Have Been Made in the Oversight of the Volunteer Income Tax Assistance Program, but Continued Effort Is Needed to Ensure the Accuracy of Services Provided*, Reference No. 2006-40-004, (Washington, D.C.: 2005).

<sup>22</sup> As noted in our report, complicated returns are defined as those using the Form 1040 as opposed to the Form 1040EZ, those claiming itemized deductions and not the standard deduction, and those claiming the earned income credit.

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Many of the problems we identified put paid preparers, taxpayers, or both at risk of IRS enforcement actions. According to IRS officials, paid preparers and taxpayers risk enforcement action by filing a tax return that includes the types of misstatements or omissions we reported. According to the officials, if IRS were to uncover problems with the preparation of real tax returns similar to several that we found, the preparers would be subject to civil sanctions. If an erroneous return was prepared, in addition to paying the correct tax due and any related late payment interest, the taxpayer may also be assessed a penalty, depending on the facts and circumstances of each situation, according to IRS officials. For example, if taxpayers substantially understate income, overstate deductions, or provide other incorrect information resulting in decreased tax or improperly high refunds, they may be assessed an accuracy-related penalty. The penalty could be assessed for any failure to comply with the tax laws, including the failure to report self-employment income (further discussion on the consequences of the errors of paid tax preparers is provided in the discussion on the tax gap).

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## IRS's Budget Proposes Decreases in Staffing and Identifies Savings, but Opportunities for Additional Savings Exist

IRS's fiscal year 2007 budget request is a small decrease compared to 2006 enacted levels after adjusting for expected inflation. It proposes to reduce overall staffing levels, as well as staffing levels for taxpayer service and enforcement activities, while maintaining or improving taxpayer service and enforcement. As it has in prior years, IRS has identified some savings, but additional opportunities exist for enhancing savings.

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## IRS's Budget Proposes Decreases in Funding After Adjusting for Expected Inflation and in Staffing

IRS's proposed fiscal year 2007 budget is \$11 billion (a 1.6 percent increase), but after adjusting for expected inflation, it reflects a slight decrease over last year's enacted budget. The \$11 billion includes \$417 million from new and existing user fees and reimbursable agreements with

other federal agencies.<sup>23</sup> The 2007 budget request for IRS's appropriation accounts is shown in table 2 (see app. II for more details).<sup>24</sup>

**Table 2: IRS's Changes in Funding and FTEs for Fiscal Years 2006 through 2007**

Dollars in thousands

	Fiscal year 2007 requested including new user fee revenue		Fiscal year 2006 enacted		Percentage change fiscal year 2006–2007	
	Dollars	FTEs	Dollars	FTEs	Dollars	FTEs
Processing, Assistance, and Management (PAM)	\$4,159,893	37,126	\$4,095,212	38,796	1.58	-4.30
Tax Law Enforcement (TLE)	4,764,954	49,479	4,678,498	50,559	1.85	-2.14
IS	1,619,834	7,351	1,582,977	7,032	2.33	4.54
BSM	167,310	0	197,010	0	-15.08	0.00
Health Insurance Tax Credit Administration (HITCA)	14,846	17	20,008	17	-25.80	0.00
<b>Total</b>	<b>\$10,726,837</b>	<b>93,973</b>	<b>\$10,573,706</b>	<b>96,404</b>	<b>1.45</b>	<b>-2.52</b>
Existing user fees and reimbursables <sup>a</sup>	\$282,543	1,503	\$258,820	1,350	9.17	11.33
<b>Total program operating level</b>	<b>\$11,009,380</b>	<b>95,476</b>	<b>\$10,832,526</b>	<b>97,754</b>	<b>1.63</b>	<b>-2.33</b>

Source: GAO analysis of IRS data.

Notes: For fiscal year 2007, the figures shown for requested FTEs reflect an IRS adjustment and differ slightly from what IRS reported in its budget request. The Congressional Budget Office projects the inflation rate to be 1.8 percent in 2007; therefore, IRS's proposed increases are less than the rate of inflation.

<sup>a</sup>Reimbursables are payments IRS receives for providing services to other federal agencies and states.

The real decrease in the proposed budget can be seen in staffing. IRS proposes to fund 95,476 FTEs in fiscal year 2007, down over 2 percent from 97,754 FTEs in enacted fiscal year 2006 (see table 5 in app. II for comparisons in enacted FTE levels for fiscal years 2002 through 2007).

<sup>23</sup> According to IRS, the \$417 million estimate is based on receiving \$135 million from increasing existing user fees and establishing new ones. IRS has committed to distributing the \$135 million over its PAM, TLE, and IS accounts, exclusively for taxpayer service. The remaining user fees will be used as needed by IRS.

<sup>24</sup> The PAM appropriation account primarily funds functions related to taxpayer service which includes funding for enforcement; TLE primarily funds enforcement activities but includes funding for taxpayer services; IS funds information technology support and improvements for legacy systems which support both taxpayer services and enforcement; BSM funds the new modernized business system; and HITCA administers a refundable tax credit for health insurance for qualified individuals. We did not review the HITCA account as part of our work.

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Actual FTEs tend to be lower than enacted FTEs, in part, because of how IRS absorbs unbudgeted costs (see table 6 in app. II for actual FTEs).

The decrease in FTEs may be greater than shown in IRS's fiscal year 2007 budget request. Every year agencies, including IRS, are expected to absorb some costs that are not included in their budget requests. For fiscal year 2007, IRS officials currently anticipate having to absorb over \$117 million in costs, including about \$41 million for homeland security-related controls over physical access to government facilities. Absorbing such costs reduces the actual number of FTEs that IRS can support. For example, for fiscal year 2005, the enacted level of FTEs was 96,435 but the actual level was 94,282.

**IRS's Budget Request Proposes to Maintain or Improve Taxpayer Services with Fewer Resources**

IRS is requesting \$4.2 billion for PAM, including some user fees, which is funding primarily spent on providing service to taxpayers.<sup>25</sup> The amount requested is about a 1.6 percent increase over fiscal year 2006 enacted levels, but is a slight decrease after adjusting for expected inflation. This funding level translates into reduced staffing, down over 4 percent from an enacted level of 38,796 FTEs in fiscal year 2006 to 37,126 proposed FTEs in fiscal year 2007. Since fiscal year 2002, FTEs devoted to PAM have declined over 15 percent from an enacted level of 43,866 FTEs.

Despite the proposed inflation-adjusted decrease in funding in 2007, IRS is planning to maintain or improve taxpayer services. For every one of the major taxpayer services listed in the budget, 2007 planned performance goals are higher or equal to 2006 performance goals. These services include telephone assistance and refund issuance.

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<sup>25</sup>IRS has funding in other appropriation accounts that support its taxpayer service programs.

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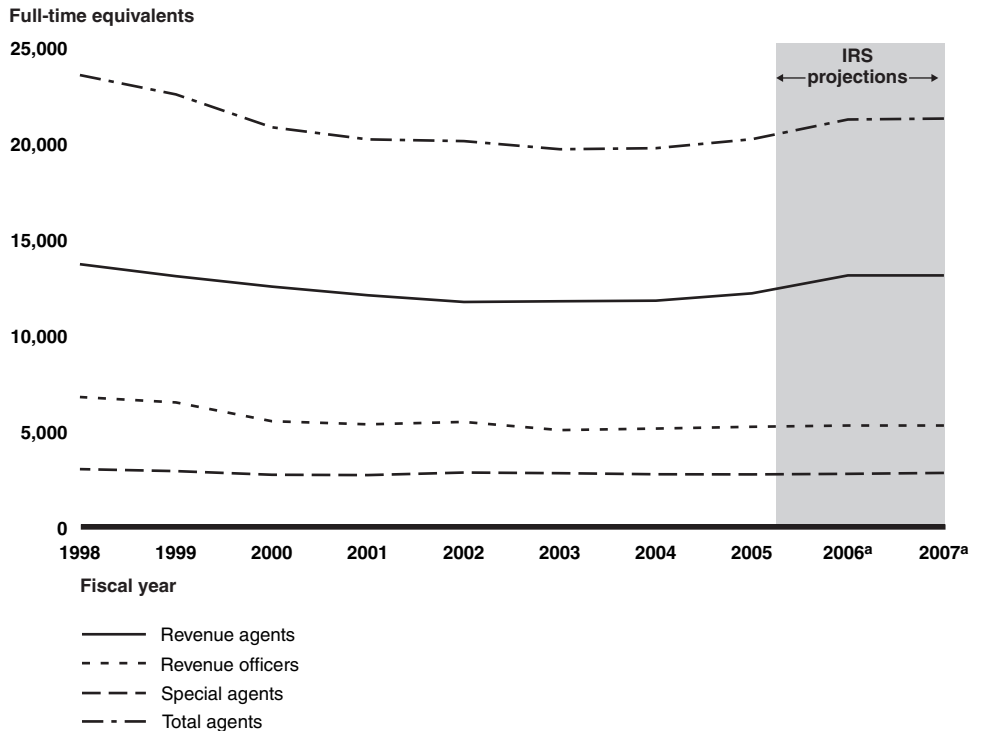
IRS's Budget Request Reduces Enforcement Staffing Slightly, While Increasing Major Enforcement Activities

IRS is requesting \$4.8 billion for TLE.<sup>26</sup> The 2007 budget request proposes an overall decrease in enforcement FTEs, down over 2 percent to a proposed 49,479 FTEs from last year's enacted level of 50,559 FTEs. For its three main categories of skilled enforcement staff, IRS is proposing a marginal increase in staffing of 0.2 percent (see fig. 3). For special agents (those who perform criminal investigations), the increase is 1.7 percent. For the other two categories—revenue agents (those who examine complex returns), revenue officers (those who perform field collection work)—IRS is proposing to keep the number of staff the same as in 2006.

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<sup>26</sup>In his recent testimony, the IRS Commissioner said that if the Congress failed to provide funding outside the program integrity cap adjustment it could potentially jeopardize past gains. This year, IRS is seeking \$137 million outside the cap.

**Figure 3: Revenue Agents, Revenue Officers, and Special Agents, Fiscal Years 1998- 2007**



Source: GAO analysis of IRS data.

Notes: Numbers for 2006 and 2007 are IRS estimates. IRS recalculated the figures since GAO reported them last year. GAO is using the new figures because IRS has validated those figures using its new cost accounting system.

Despite keeping skilled enforcement staff virtually unchanged, IRS is proposing to maintain or increase its major enforcement activities. For all the major enforcement activities listed in the budget, IRS is establishing goals in 2007 that are higher or equal to 2006 planned performance goals. Major enforcement activities include individual taxpayer examinations, collection coverage,<sup>27</sup> and criminal investigations completed. IRS officials anticipate increased revenue collected and other performance improvements as a result of using data from IRS’s most current

<sup>27</sup>The number of collection cases closed or otherwise eliminated compared to the total number of collection cases in inventory.

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Budget Request for IS Funding is Up Slightly, and IRS Has Taken Additional Steps to Improve Budgeting for IS Operations and Maintenance

compliance research effort, known as the National Research Program (NRP).<sup>28</sup>

IRS is requesting about \$1.6 billion for IS in fiscal year 2007, which is intended to fund information technology (IT) staff and related costs for activities such as information security and maintenance and operations of its current tax administration systems. Although the number of FTEs proposed in 2007 is up when enacted FTEs are considered, it is virtually the same as the operating level currently assumed in 2006 (see app. II for more details).

In 2002, we reported that the agency did not develop its fiscal year 2003 IS operations and maintenance budget request in accordance with the investment management approach used by leading organizations. We recommended that IRS prepare its future budget requests in accordance with these best practices.<sup>29</sup> To address our recommendation, IRS agreed to take a variety of actions, which it has made progress in implementing. For example, IRS planned to develop a capital planning guide to implement processes for capital planning and investment control, budget formulation and execution, business case development, and project prioritization. In August 2005, IRS issued the initial version of its IT Capital Planning and Investment Control (CPIC) Process Guide, which (1) provides executives with the framework within which to select, control, evaluate, and maintain the portfolio of IT investments to best meet IRS business goals and (2) defines the governance process that integrates the agency's IT investments with the strategic planning, budgeting, and procurement processes. According to IRS officials and documentation, the agency formulated its prioritized fiscal year 2007 IT portfolio and associated budget request, including operations and maintenance requirements, in accordance with this CPIC Process Guide. We will continue to monitor the implementation of IRS's CPIC process as its IT investment management process matures.

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<sup>28</sup> NRP replaced the Taxpayer Compliance Measurement Program, which last measured compliance for individuals for 1988 but was canceled because of concerns about costs and burdens on taxpayers. GAO, *Tax Administration: New Compliance Research Effort Is on Track, but Important Work Remains*, GAO-02-769 (Washington, D.C.: June 27, 2002) and *Tax Administration: Status of IRS' Efforts to Develop Measures of Voluntary Compliance*, GAO-01-535 (Washington, D.C.: June 18, 2001) discuss the development of the NRP study.

<sup>29</sup> GAO, *Internal Revenue Service: Improving Adequacy of Information Systems Budget Justification*, GAO-02-704 (Washington, D.C.: June 28, 2002).



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IRS's Proposed BSM Budget  
Reduction Could Impede  
Future Progress

In addition, IRS stated that it planned to develop an activity-based cost module to plan, project, and report costs for business tasks/activities funded by the IS budget. During fiscal year 2005, as part of the first release of the Integrated Financial System (IFS),<sup>30</sup> IRS implemented a cost module that is potentially capable of allocating costs by activity. However, agency officials stated that they needed to accumulate 3 years of actual costs to have the historical cost data necessary to provide a basis for meaningful future budget estimates. Since then, according to the Office of the Chief Financial Officer, IRS has (1) populated the cost module with all actual fiscal year 2005 expenses; (2) identified the data needed from IFS to support its budget requests; and (3) developed a system to capture, test, and analyze the cost data to devise a standard methodology to provide the necessary data from the cost module. IRS still expects to have the requisite 3 years of historical cost data available in time to support development of the fiscal year 2010 budget request. Although IRS has made progress in implementing best practices in developing its IS operations and maintenance budget, until IRS completes the actions necessary to fully implement the activity-based cost module, the agency will not be able to ensure that its request is adequately supported.

BSM is a high-risk, highly complex effort that involves developing and delivering a new set of information systems that are intended to replace the agency's aging tax processing and business systems. The program 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. It also helps IRS considerably in providing the reliable and timely financial management information needed to account for the nation's largest revenue stream and better enable the agency to both determine and justify its resource allocation decisions and budget requests.

IRS's fiscal year 2007 budget request of \$167.3 million for the BSM program reflects a reduction of about 15 percent (and even greater when adjusted for expected inflation), or about \$30 million, from the enacted fiscal year 2006 budget of \$197 million.

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<sup>30</sup>IFS replaces 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.

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Over the past year, IRS has made further progress in implementing BSM, although some key projects did not meet short-term cost and schedule commitments. During 2005 and the beginning of 2006, IRS deployed additional releases of several modernized systems that have delivered benefits to taxpayers and the agency, including CADE, e-Services (a new Web portal and electronic services for paid tax preparers), and Modernized e-File (a new electronic filing system). While three BSM project releases were delivered within the cost and/or schedule commitments presented in the fiscal year 2005 expenditure plan, others experienced cost increases or schedule delays. For example, two IFS and Modernized e-File project release segments experienced cost increases of 93 percent<sup>31</sup> and 29 percent, respectively. As we have previously reported,<sup>32</sup> the BSM program has had a history of cost increases and schedule delays that have been due, at least in part, to deficiencies in various management controls and capabilities that have not yet been fully corrected. IRS is in the process of implementing our prior recommendations to correct these deficiencies.

IRS has identified significant risks and issues that confront future planned system deliveries. For example, according to IRS, schedule delays and contention for key resources between multiple releases of CADE necessitated the deferral of some functionality. This deferral, in conjunction with additional recently reported risks and issues, may negatively impact the cost, schedule, and functionality for future CADE releases. The agency recognizes the potential impact of these project risks and has developed mitigation strategies to address them. We will, however, continue to monitor the various risks IRS identifies and the agency's strategies to address them and will report any concerns.

IRS also has made additional progress in addressing high-priority BSM program improvement initiatives during the past year, including initiatives related to shifting the role of systems integrator from the prime contractor to IRS and establishing requirements management standards—an initiative on which we recently issued a report to you, Mr. Chairman, and made a

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<sup>31</sup>IRS recently reported that it plans to redirect about \$5 million of unobligated funding from the IFS project to program management reserve, which would reduce this cost overrun.

<sup>32</sup>For example, see GAO, *Business Systems Modernization: Internal Revenue Service's Fiscal Year 2005 Expenditure Plan*, [GAO-05-774](#) (Washington, D.C.: July 22, 2005).

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number of recommendations for improvement.<sup>33</sup> IRS's program improvement process appears to be an effective means of assessing, prioritizing, and addressing BSM issues and challenges. However, much more work remains for the agency to fully address these issues and challenges.

In addition, in response to our prior recommendation, IRS is developing a new Modernization Vision and Strategy to address BSM program changes and provide a modernization roadmap. According to the Associate Chief Information Officer for BSM, the agency's new strategy focuses on promoting investments that provide value in smaller, incremental releases that are delivered more frequently, with the goal of increasing business value. IRS is currently finalizing a high-level vision and strategy as well as a more detailed 5-year plan for the BSM program. We believe these actions represent sound steps toward addressing our prior recommendation to fully revisit the vision and strategy and develop a new set of long-term goals, strategies, and plans consistent with the budgetary outlook and with IRS's management capabilities. Further, this strategy is important because it will describe how and when IRS will receive the full benefits from its modernization efforts, such as when CADE will be able to replace the Individual Master File.

While the requested fiscal year 2007 BSM budget will allow IRS to continue the development and deployment of the CADE, Modernized e-File, and Filing and Payment Compliance (F&PC)<sup>34</sup> projects, the proposed reduced funding level would likely affect the agency's ability to deliver the functionality planned for the fiscal year and could result in project delays and/or scope reductions. This could, in turn, impact the long-term pace and cost of modernizing tax systems and of ultimately improving taxpayer service and strengthening enforcement. For example, according to IRS documents, the agency had planned to spend \$85 million in fiscal year 2007 to develop and deploy additional CADE releases that would enable the system to process up to 50 million individual tax returns by the 2008 filing season and issue associated refunds faster. However, with a

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<sup>33</sup>GAO, *Business Systems Modernization: IRS Needs to Complete Recent Efforts to Develop Policies and Procedures to Guide Requirements Development and Management*, GAO-06-310 (Washington, D.C.: Mar. 20, 2006).

<sup>34</sup>F&PC is a series of projects expected to provide support for detecting, scoring, and working nonfiler (filing compliance) and delinquency (payment compliance) cases. The first phase of F&PC is Private Debt Collection, which will use advanced software to analyze tax collection cases and divide them into the complex cases requiring IRS involvement and the less complex (balance due) cases that can be handled by private collection agencies.

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proposed budget of \$58.5 million—over 30 percent less than anticipated—IRS would likely have to scale back its planned near-term work on this project. In addition, the reductions to the planned budgets for the Modernized e-File and F&PC projects may also result in IRS having to redefine the scope and/or reassess schedule commitments for future project releases.

The proposed BSM budget reduction would also significantly reduce the amount allotted to program management reserve by about 82 percent (from \$13 million in fiscal year 2006 to \$2.3 million in fiscal year 2007). If BSM projects have future cost overruns that cannot be covered by the depleted reserve, this reduction could result in increased budget requests in future years or delays in planned future activities.

While the BSM program still faces challenges, IRS has recently made progress in delivering benefits and addressing project and program-level risks and issues. Reducing BSM funds at a time when benefits to taxpayers and the agency are being delivered could adversely impact the momentum gained from recent progress and result in delays in the delivery of future benefits. However, until IRS addresses our prior recommendation by clearly defining its future goals for the BSM program as well as the impact of various funding scenarios on meeting these goals in its new Modernization Vision and Strategy, the long-term impact of the proposed budget reduction is unclear.

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### IRS's Budget Request Identified Some Savings, but Opportunities Exist for Enhancing Savings

In its 2007 budget request, IRS identified savings as it has done in prior years and plans to redirect some of those savings to front-line taxpayer service and enforcement activities. IRS is proposing to save over \$121 million and 1,424 FTEs by, for example, automating the process of providing an individual taxpayer identification number to those taxpayers ineligible for a Social Security number and improving data collection techniques and work processes for enforcement activities through increased financial reporting requirements and scanning and imaging techniques.

IRS's history of realizing savings proposed in past budget requests provides some confidence that the agency will be able to achieve savings in fiscal year 2007. For example, IRS reported it realized 88 percent of the anticipated dollar savings and 86 percent of the anticipated staff savings identified in the fiscal year 2004 budget request. IRS also reported exceeding the savings targets in the fiscal year 2005 budget request (see app. III).

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In addition to the areas identified by IRS in its budget request, there may be additional opportunities for efficiency gains.

- **Increasing electronic filing:** In an era of tight budgets, continued growth in electronic filing may be necessary to help fund future performance improvements. One proposal for continuing to increase electronic filing is additional use of electronic filing mandates. Currently, IRS mandates electronic filing for large corporations. The 2007 budget request proposes a legislative change that would expand its authority to require electronic filing for businesses. Moreover, 12 states now mandate electronic filing for certain classes of tax preparers (see app. IV for more information on state mandates). As we have reported,<sup>35</sup> although there are costs and burdens likely to be associated with electronic filing mandates for paid tax preparers and taxpayers, state mandates have generated significant increases in electronic filing. IRS has an electronic filing strategy, which the agency is updating.
- **Changing the menu of taxpayer services:** IRS currently lacks a comprehensive strategy explaining how its various taxpayer services (including its telephone, walk-in, volunteer, and Web site assistance) will collectively meet taxpayer needs. In response to a Congressional directive,<sup>36</sup> IRS is developing such a strategy. The strategy is important because some taxpayers may not be well served by the current service offerings. IRS's attempts to reduce some taxpayer services, namely reducing the hours of telephone operations and closing some walk-in sites, have met with resistance from the Congress. Although

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<sup>35</sup>[GAO-06-51](#).

<sup>36</sup>In the H.R. Conf. Rep. No. 109-307 (2005), the Congress directed the IRS, in conjunction with the IRS Oversight Board and the National Taxpayer Advocate, to develop a 5-year plan for taxpayer service activities and report to the House and Senate Committees on Appropriations by April 14, 2006. According to IRS officials, the Department of the Treasury has reviewed an initial report; that report is now under review at the Office of Management and Budget, prior to being submitted to the Congress.

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Accurate Cost Information  
Would Help IRS Make  
Resource Allocation Decisions,  
and Help Provide Some  
Information about the Return  
on Investment for its Programs

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congressional directives to study the impact of IRS's actions exist,<sup>37</sup> we still believe there may be opportunities to adjust IRS's menu of services to reduce costs, without affecting IRS's ability to meet taxpayers' needs.

- Consolidating telephone call sites: IRS operates 25 call sites throughout the country. Consistent with earlier plans, IRS closed two of its smallest call sites—Chicago and Houston—in March 2006, to realize savings in its toll-free telephone operations. Also, IRS has gained efficiencies from using a centralized call router located in Atlanta. As a result, there are currently more than 850 workstations that are not being used; consequently, IRS may have the potential to close several additional call sites. Consolidations would not affect telephone service and would be invisible from the taxpayer's perspective.

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 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.

In its ongoing effort to make such increasingly difficult resource allocation decisions and defend those decisions before the Congress, IRS has long been hampered by a lack of current and accurate information concerning

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<sup>37</sup>In Pub. L. No. 109-115, § 205, (Nov. 30, 2005), the Congress directed the IRS not to reduce taxpayer services as the IRS proposed in fiscal year 2006 until TIGTA completed a study on the impact of such reductions on taxpayer compliance and services. Further, IRS was directed, to consult with stakeholder organizations, including, but not limited to, the IRS Oversight Board, National Taxpayer Advocate, TIGTA and Internal Revenue employees with respect to any efforts by the IRS to terminate or reduce significantly any taxpayer service activity. Pub. L. No. 109-148, § 5021 (Dec. 30, 2005) extends above provisions to include any reduction in available hours of telephone taxpayer assistance below the levels in existence during the month of October 2005. In March 2006, TIGTA released its study on IRS's plans to close 68 of its 400 walk-in sites, concluding that in IRS's plan was based on inaccurate data (see Treasury Inspector General for Tax Administration, *The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data*, Reference No. 2006-40-061 (Washington, D.C.: 2005)).

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the costs of the various options being considered. Instead, management often has 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. This has impaired IRS'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 manner is seriously impaired and IRS cannot prepare cost-based performance measures to assist in measuring the effectiveness of its programs over time.

Further, IRS does not have the capability to develop reliable information on the return on investment for each category of taxpayer service and enforcement. IRS lacks reliable information on both the return from services (the additional revenue collected by helping taxpayers understand their tax obligations) and the investment or cost of the services. While developing return on investment information is difficult, the cost component of that equation may be the least complex to develop. Having such cost information is a building block for developing return on investment estimates. For its enforcement programs, IRS has developed a rough measure of return on investment in terms of tax revenue that is directly assessed from uncovering noncompliance. Continuing to develop return on investment measures could help officials make more informed decisions about allocating resources.<sup>38</sup> Even without return on investment information, cost information can help IRS determine if, for example, IRS should change the menu of services provided.

As discussed in the BSM section, in fiscal year 2005, IRS implemented a cost accounting module as part of IFS. However, while this module has much potential and has begun accumulating cost information, IRS 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. Also, IRS does not have an integrated workload management system which would provide the cost module with detailed allocation of

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<sup>38</sup>Developing such measures is difficult because of incomplete information on all the costs and all the tax revenue ultimately collected from specific enforcement efforts, as well as incomplete information on the indirect tax revenues generated when current enforcement actions prompt voluntary compliance improvements in the future.

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personnel cost information.<sup>39</sup> In addition, as noted in developing its IS budget, because it generally takes several years of historical cost information to support meaningful estimates and projections, IRS cannot yet rely on IFS as a significant planning tool. It will likely require several years, implementation of additional components of IFS, and integration of IFS with IRS's tax administration activities before the full potential of IFS's cost accounting module will be realized. Furthermore, IRS's fiscal year 2007 BSM budget request does not include funding for additional releases of IFS. In the interim, IRS decision making will continue to be hampered by inadequate underlying cost information.

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## IRS Sets Long-Term Goals, but Lacks a Data-Based Plan for Achieving the Goals, and Addressing the Tax Gap Requires Solutions Beyond Funding and Staffing for IRS

For the first time, IRS's budget request sets long-term goals aimed at reducing the tax gap, although IRS does not have a data-based plan for achieving the goals. However, because of its persistence, reducing the tax gap requires solutions which go beyond funding and staffing for IRS.

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## IRS's Budget Proposes Long-Term Goals, but Lacks a Data-Based Plan for Achieving Them

IRS established two agencywide, long-term performance goals, as shown in table 3. IRS plans to improve voluntary compliance from 83 percent in 2005 to 85 percent by 2009, and reduce the number of taxpayers who think it is acceptable to cheat on their taxes from 10 percent in 2005 to less than 9 percent in 2010. According to IRS, these are the first in a series of quantitative goals that will link to its three strategic goals—improve taxpayer service, enhance tax law enforcement, and modernize IRS through technology and processes.

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<sup>39</sup> IRS had planned to develop a workload management system, but has postponed this project indefinitely, due to budget constraints.



**Table 3: IRS Agencywide Goals for Fiscal years 2004 through 2010**

Performance level	Fiscal year 2004 actual performance	Fiscal year 2005 actual performance	Fiscal year 2006 planned performance	Fiscal year 2007 planned performance	Fiscal year 2008 planned performance	Fiscal year 2009 planned performance	Fiscal year 2010 planned performance
Improve voluntary compliance	N/A	83.0%	N/A	N/A	N/A	85.0%	N/A
Reduce the percentage of taxpayers who think it is acceptable to cheat on their taxes	12.0%	10.0%	10.0%	10.0%	9.0%	<9.0%	<9.0%

Source: IRS.

These goals will be challenging to meet, because for three decades, IRS has consistently reported a persistent, relatively stable tax gap. Although IRS has made a number of changes in its methodologies for measuring the tax gap, which makes comparisons difficult, regardless of methodology used, the voluntary compliance rate that underpins the gap has tended to range from around 81 percent to around 84 percent.

Because of a lack of quantitative estimates of how changes to its service and enforcement programs affect compliance, IRS is unable to show in a data-based plan how it will use those programs to reach the two long-term goals shown in table 3. If IRS could quantify the impact of its service and enforcement programs on the compliance rate or attitudes towards cheating, it could use the information to show the kinds of changes to the programs needed to achieve the long-term goals and how best to direct resources towards achieving those goals. Unfortunately, quantifying the impact of IRS's service and enforcement programs on compliance or cheating is very challenging. The type of data needed to make such a link does not currently exist, and may not be easy to collect.

Lacking such quantitative estimates, IRS must take a more qualitative approach in its plans for increasing compliance, which would likely also involve changing attitudes towards cheating. IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. We recently reported that IRS has

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taken a number of steps that may improve its ability to reduce the tax gap.<sup>40</sup> Favorable trends in staffing of IRS enforcement personnel; examinations performed through correspondence, as opposed to more complex face-to-face examinations; and the use of some enforcement sanctions such as liens and levies are encouraging. Also, IRS has 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. Finally, IRS has continually improved taxpayer service by increasing, for example, the accuracy of responses to tax law questions.

The effect of this overall approach and the 2007 budget proposal will have on voluntary compliance has not been quantified by IRS. Therefore, the Congress will have to rely on the IRS Commissioner for qualitative explanations, of why, in his judgment, IRS's mix of taxpayer service and enforcement and overall approach for reducing the tax gap, including the 2007 budget proposal, will be sufficient to start IRS on a path towards achieving its long-term goals. More specifically, such explanations could include a clear statement of which service and enforcement programs have priorities for expansion because they are expected to contribute the most to increasing the compliance rate and the evidence that supports that judgment.

In addition, IRS lacks a plan for measuring progress towards one goal—improving voluntary compliance. IRS plans to measure progress towards the second goal—reducing the percentage of taxpayers who think it is acceptable to cheat—via the IRS Oversight Board's annual Taxpayer Attitude Survey.

Nevertheless, IRS recently estimated voluntary compliance as part of the NRP study, which reviewed the compliance of a random sample of individual taxpayers and used those results to estimate compliance for the population of all taxpayers. The study took several years to plan and execute. In addition to providing an estimate of the compliance rate, the study's results will be used to better target IRS's audits of potentially non-compliant taxpayers. Better targeting reduces the burden on taxpayers because IRS is better able to avoid auditing compliant taxpayers.

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<sup>40</sup>[GAO-06-453T](#).

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At this time, however, IRS has not made plans to repeat the study in time to measure compliance by 2009. Furthermore, doing compliance studies once every few years does not give IRS or others information about what is happening in the intervening years. Annual estimating of the compliance rate could provide information that would enable IRS management to adjust plans as necessary to help achieve the goal in 2009. One option that would not increase the cost of estimating compliance would be to use a rolling sample. IRS Oversight Board officials and we agree that instead of sampling, for example, once every 5 years, one-fifth of the sample could be collected every year. The total sample could include 5 years worth of data—with each passing year the oldest year would be dropped from the sample and the latest year added. The availability of current research data would allow IRS to more effectively focus its service and compliance efforts.

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## Addressing the Tax Gap Requires Solutions Beyond Funding and Staffing for IRS

For years, we have reported that tax law enforcement is a high-risk area, in part because of the size of the gross estimated tax gap, which IRS most recently estimated to be \$345 billion for tax year 2001. IRS estimated it would recover around \$55 billion through late payments and enforcement revenue, resulting in a net tax gap of around \$290 billion.<sup>41</sup> Reducing the tax gap would yield significant revenue and even modest progress, such as a 1 percent reduction, would likely yield nearly \$3 billion annually. In recent years, IRS reported increases in enforcement revenue—revenue brought in as a result of IRS taking enforcement action. Between fiscal years 2003 and 2005, IRS reported that enforcement revenue grew from \$37.6 billion to \$47.3 billion, with a level of \$48.1 billion estimated for 2006. However, the voluntary compliance rate has persisted at a relatively stable level.

Further, GAO recently reported that tax returns prepared by paid tax preparers often contained errors such as unwarranted extra refunds and underreported income. These findings are consistent with NRP data which indicate that tax returns prepared by paid preparers contained a significant level of errors. These errors, whether they are the fault of the preparer or the result of taxpayers providing incomplete or inaccurate information, contribute to the tax gap.

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<sup>41</sup>[GAO-06-453T](#).

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We have reported that significant reductions in the tax gap will likely require exploring new and innovative solutions.<sup>42</sup> Such solutions that may not require significant additional IRS resources, but are nonetheless difficult to achieve, include

- simplifying the tax code to make it easier for individuals and businesses to understand and comply with their tax obligations;
- increasing tax withholding for income currently not subject to withholding;
- improving information reporting; and
- leveraging technology to improve IRS's capacity to receive and process tax returns.

IRS's 2007 budget request includes five new legislative proposals to address some of these solutions to reduce the tax gap, along with a proposal to study independent contractor compliance that would not require additional resources. In recent testimony, the IRS Commissioner stated that the amount of enforcement revenue IRS expects from the legislative proposals will be \$3.6 billion over the next 10 years (about 0.1 percent of the tax gap). However, the proposals should also increase revenue voluntarily paid without any IRS enforcement actions. The amount of that revenue is uncertain. The IRS Commissioner recognizes the implications of the tax gap and states in the budget that addressing it is a top priority. Although IRS's 2007 budget request does not propose allocating IRS resources to new initiatives to reduce the tax gap, according to IRS officials, they plan to continue initiatives identified in prior budgets. For example, IRS has two ongoing BSM projects—F&PC and Modernized e-File—which, according to IRS's Associate Chief Information Officer for BSM, could help reduce the tax gap. F&PC is expected to increase IRS's capacity to resolve the growing backlog of delinquent taxpayer cases and increase collections, while Modernized e-File is expected to help make it easier for IRS to process tax returns, look for irregularities, and track down unpaid taxes.

The budget request states that the administration will study the standards used to distinguish between employees and independent contractors for

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<sup>42</sup>[GAO-06-453T](#).

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purposes of paying and withholding income taxes. We have long supported efforts aimed at improving independent contractor compliance.<sup>43</sup> Past IRS data have shown that independent contractors report 97 percent of the income that is reported on information returns to IRS, while contractors that do not receive these information returns report only 83 percent of income. We have also identified other options for improving information reporting by independent contractors, including increasing penalties for failing to file required information returns, lowering the \$600 threshold for requiring such returns, and requiring businesses to separately report on their tax returns the total amount of payments to independent contractors.<sup>44</sup> We previously reported that clarifying the definition of independent contractors and extending reporting requirements for those contractors could possibly increase tax revenue by billions of dollars.<sup>45</sup>

Two of the legislative proposals call for more information reporting on payment card transactions from certain businesses and on payments by federal, state, and local governments to businesses. Information reporting has been shown to significantly reduce noncompliance. Although information reporting is highly effective in encouraging compliance, such reporting imposes costs and burdens on the businesses that implement it. However, information reporting is a way to significantly increase voluntary compliance without increasing IRS's budget.

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Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other members of the subcommittee may have at this time.

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## Contacts and Acknowledgments

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<sup>43</sup>GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance*, [GAO/GGD-92-108](#) (Washington, D.C.: July 23, 1992).

<sup>44</sup>[GAO-06-453T](#).

<sup>45</sup>GAO, *Opportunities for Congressional Oversight and Improved Use of Taxpayer Funds*, [GAO-04-659](#) (Washington, D.C.: May 7, 2004).

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# Appendix I: Differences Between the 2002 and 2005 Free File Agreements

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In 2002, Internal Revenue Service (IRS) entered into a 3-year agreement with the Free File Alliance, a consortium of 20 tax preparation companies to provide free electronic filing to taxpayers who access any of the companies via a link on IRS's Web site. The 2002 Free File Agreement stated that as part of the agreement, IRS would not compete with the Consortium in providing free, online tax return preparation and filing services to taxpayers.

IRS and the Consortium amended the agreement in 2005. Key differences between the two agreements are: the new income limitation of \$50,000 and new language in the amendment that states the Alliance members must disclose early on if state tax return services are available, and if so, whether a fee will be charged for such services; and provide the necessary support to accomplish a customer satisfaction survey. It also added language pertaining to the marketing and offering of Refund Anticipation Loans (RALs)<sup>1</sup> whereby:

- No offer of free return preparation and filing of an electronic return in the free file program shall be conditioned on the purchase of a RAL; and
- RALs will be offered with clear language indicating, for example, that RALs are loans, not a faster way of receiving an IRS refund; must be repaid even if the IRS does not issue a full refund; are short-term loans interest rates may be higher and customers may wish to consider using other forms of credit; and may be offered but not promoted.

IRS tests each Consortium member's software to ensure it is in accordance with the Free File provisions, including those cited previously, before allowing a link to IRS's Web site. In addition, IRS officials monitor complaints about the Free File program received via IRS.gov, including allegations regarding false, deceptive, or misleading information or advertising. While IRS does not track the number of complaints it receives, according to IRS officials, most of the complaints received thus far were a result of the taxpayer either not carefully reading or following instructions, or incorrectly entering information. GAO conducted limited testing of the Free File program and found that the Consortium members were complying with the terms outlined in the amended Free File agreement pertaining to RALs.

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<sup>1</sup> Refund Anticipation Loans are very short-term loans issued while taxpayers wait for their refunds.

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The amended Free File agreement contains provisions that enable IRS to monitor taxpayer participation beginning in the 2006 filing season, unlike prior years where Free File Alliance members self-reported filing figures. IRS also tracks the number of free file users who are accepting any financial products, such as RALs. As of April 17, IRS reported that 207,814 free file returns accepted financial products. This represents about 5 percent of all returns filed through the Free File program.

The number of taxpayers using free file to electronically file their individual income tax returns has increased steadily from 2.8 million in 2003, to 3.5 million in 2004, to 5.1 million in 2005. The substantial growth between 2004 and 2005 was due to, in part, several Consortium members offering free filing to all taxpayers through the free file program regardless of their income in 2005. However, according to IRS officials, the lack of income limitation created conflict among Consortium members as it put pressure on all Alliance members to offer free service, which may not have been economically feasible for some, threatening competition if members were to drop out of the Alliance.

IRS projected that 6.1 million taxpayers would use free file in 2006. However, this projection may be optimistic, because between January 1 and April 13, IRS has reported receiving only 3.5 million free file returns compared to 4.6 million during the same period last year, a decline of 24 percent. According to IRS officials, contributing factors to this decline are, in part, due to decreased press attention and advertising by the participating companies and the income limitation. The income limitation provides coverage to 70 percent of the nation's taxpayers, or more than 92 million people. This coverage includes taxpayers with an adjusted gross income of \$50,000 or less.



# Appendix II: Comparison of IRS's Actual and Enacted Funding and Full-Time Equivalents, Fiscal Years 2002 through 2007

For fiscal year 2007, the Internal Revenue Service (IRS) has requested \$10.7 billion in its appropriation accounts. This request consists of \$10.6 billion in direct appropriations and \$135 million in revenue from new user fees, which IRS will commit to taxpayer service activities in its Processing, Assistance, and Management (PAM), Tax Law Enforcement (TLE), and Information System (IS) accounts. In addition, IRS is projecting to collect and use \$282 million from existing user fees and reimbursable agreements with states and other federal agencies. This brings IRS's proposed fiscal year 2007 budget to approximately \$11 billion (a 1.6 percent increase over fiscal year 2006). After adjusting for expected inflation, IRS's \$11 billion budget request reflects a slight decrease from last year's enacted budget.

IRS's enacted budgets for its appropriation accounts from fiscal years 2002 through 2007 are shown in table 4. IRS's enacted budget has increased almost 8 percent since fiscal year 2002. By far, the biggest percentage increase has been in TLE—almost 21 percent—and is reflective of the shift in resources devoted to TLE from PAM during this period. The biggest percentage decrease was in the Business Systems Modernization (BSM) program, down almost 58 percent.

**Table 4: IRS's Funding for Fiscal Years 2002 through 2007**

Dollars in thousands

	Fiscal year 2007	Fiscal year 2006	Fiscal year 2005	Fiscal year 2004	Fiscal year 2003	Fiscal year 2002	Fiscal year 2002 - 2007
	Requested including new user fees	Enacted	Enacted	Enacted	Enacted	Enacted	Percentage change
PAM	\$4,159,893	\$4,095,212	\$4,056,857	\$4,009,205	\$3,930,064	\$3,982,971	4.44
TLE	4,764,954	4,678,499	4,363,539	4,171,244	3,849,884	3,940,741	20.92
IS	1,619,834	1,582,977	1,577,768	1,581,575	1,621,834	1,620,905	-0.07
BSM	167,310	197,010	203,360	387,699	363,621	391,593	-57.27
HITCA	14,846	20,008	34,562	34,794	69,545	NA	NA
<b>Total appropriations requested</b>	<b>\$10,726,837</b>	<b>\$10,573,706</b>	<b>\$10,236,087</b>	<b>\$10,184,517</b>	<b>\$9,834,948</b>	<b>\$9,936,210</b>	<b>7.96</b>

Source: GAO analysis of IRS data.

Notes: Numbers may not add due to rounding. Fiscal year 2007 includes \$135 million in new user fee revenue distributed in PAM, TLE, and IS accounts. Without user fees, IRS is requesting \$4,045,122 for PAM, \$4,762,327 for TLE, and \$1,602,232 for IS.

Tables 5 and 6 show IRS's enacted and actual Full-time Equivalents (FTEs) for fiscal years 2002 through 2007. Overall, actual FTEs tend to be lower

than enacted FTEs due in part to the way IRS funds its unbudgeted costs. When both enacted and actual FTEs are considered, FTEs for PAM have steadily decreased and, for the most part, FTEs for TLE have increased since fiscal year 2002. However, steady trends are not apparent when comparing enacted and actual FTEs in IRS's IS account. For example, when enacted FTEs are considered, IS staffing appears to fluctuate up and down between fiscal years 2002 through 2007; yet, when actual FTEs are considered, IS staffing decreased from fiscal year 2002 through 2005 and increased from fiscal years 2005 to 2006. IRS officials attribute these fluctuations in FTEs to reorganizations and other factors.

Tables 5 and 6 also show significant differences in percentage changes between enacted and actual FTEs in some of IRS's appropriations accounts from fiscal years 2006 to 2007. The enacted level of FTEs is the number IRS projected it could support given the level of funding the Congress enacted. According to IRS officials, enacted levels tend to be overstated compared to actual FTEs for several reasons. First, IRS, like most federal agencies, does not receive its budgets when expected and cannot fill all positions. Also, as the costs of maintaining current FTE levels increase annually, IRS is not able to realize all of the FTEs it projects to fund with the appropriations the Congress enacts.

**Table 5: IRS's Enacted FTEs for Fiscal Years 2002 through 2007**

	Fiscal year 2007	Fiscal year 2006	Fiscal year 2005	Fiscal year 2004	Fiscal year 2003	Fiscal year 2002	Fiscal year 2006 - 2007	Fiscal year 2002 - 2007
	Requested	Enacted	Enacted	Enacted	Enacted	Enacted	Percentage change	Percentage change
PAM	37,126	38,796	39,901	42,332	43,452	43,774	-4.30	-15.19
TLE	49,479	50,559	49,132	49,147	47,478	48,628	-2.14	1.75
IS	7,351	7,032	7,385	7,559	7,445	7,499	4.54	-1.97
BSM	0	0	0	0	0	NA	0.00	NA
HITCA	17	17	17	17	6	NA	0.00	NA
<b>Total</b>	<b>93,973</b>	<b>96,404</b>	<b>96,435</b>	<b>99,055</b>	<b>98,381</b>	<b>99,901</b>	<b>-2.52</b>	<b>-5.93</b>

Source: GAO analysis of IRS data.

Notes: Fiscal year 2007 requested FTEs reflect an adjustment after the budget was printed. Also, we are not reporting FTEs for user fees and reimbursable as shown in an earlier section of this statement, because we were unable to obtain this information for all years in time for this statement.

**Table 6: IRS's Actual FTEs from Fiscal Years 2002 through 2007**

	Fiscal year 2007	Fiscal year 2006	Fiscal year 2005	Fiscal year 2004	Fiscal year 2003	Fiscal year 2002	Fiscal year 2006 - 2007	Fiscal year 2002 - 2007
	Requested	Operating Level	Actual	Actual	Actual	Actual	Percentage change	Percentage change
PAM	37,126	38,308	38,710	41,436	43,452	44,191	-3.09	-15.99
TLE	49,479	49,721	48,544	47,704	47,478	48,238	-0.49	2.57
IS	7,351	7,340	7,015	7,279	7,445	7,773	0.15	-5.43
BSM	0	0	0	0	0	NA	0.00	NA
HITCA	17	17	13	12	6	NA	0.00	NA
<b>Total</b>	<b>93,973</b>	<b>95,386</b>	<b>94,282</b>	<b>96,431</b>	<b>98,381</b>	<b>100,202</b>	<b>-1.48</b>	<b>-6.22</b>

Source: GAO analysis of IRS data.

Notes: Fiscal year 2007 requested FTEs reflect an adjustment after the budget was printed. Also, we are not reporting FTEs for user fees and reimbursable as shown in an earlier section of this statement, because we were unable to obtain this information for all years in time for this statement.

In its fiscal year 2006 budget request, IRS showed its budget distributed by taxpayer services and enforcement, including IS funding for those areas, because the agency's current appropriation accounts are not divided clearly between taxpayer service and enforcement. As table 7 shows, funding for enforcement increased 15 percent between fiscal years 2004 and 2007 to \$6.96 billion, while funding for taxpayer service declined over 3 percent to almost \$3.6 billion.

**Table 7: IRS's Funding for Taxpayer Service and Enforcement for Fiscal Years 2004 through 2007**

Dollars in Millions

	Fiscal year 2007 requested	Fiscal year 2006 enacted	Fiscal year 2005 enacted	Fiscal year 2004 enacted	Percentage change 2004-2007
Taxpayer Service	\$3,583	\$3,533	\$3,606	\$3,710	-3.4
Enforcement	\$6,961	\$6,824	\$6,392	\$6,052	15.0

Source: GAO analysis of IRS data.

Note: IRS's taxpayer service and enforcement programs are funded through its PAM, TLE, and IS accounts.

# Appendix III: IRS's Estimated and Actual Savings and Reinvestments

In its 2007 budget request, the Internal Revenue Service (IRS) is proposing to save over \$121 million and 1,424 Full-time Equivalents (FTEs) and reinvest over \$12 million and 11 FTEs. Based on IRS's ability to achieve prior year savings and reinvestments as shown in table 8, we have a basis to believe that IRS will achieve most, if not all, of these savings. For example, IRS reported it realized 88 percent of its anticipated budget savings and 86 percent of its anticipated staff savings for savings identified in its fiscal year 2004 budget request, and IRS reported exceeding savings targets in fiscal year 2005.

**Table 8: IRS's Estimated and Actual Savings and Reinvestments for Fiscal years 2004 through 2007**

Dollars in Thousands

	Fiscal year 2004 actual		Fiscal year 2005 actual		Fiscal year 2006 estimate		Fiscal year 2007 estimate	
	Dollars	FTEs	Dollars	FTEs	Dollars	FTEs	Dollars	FTEs
<b>Savings<sup>a</sup></b>								
Budgeted	\$160,872	1,993	\$110,841	1,442	\$230,096	2,230	\$121,596	1,424
Actual	\$141,142	1,711	\$127,239	1,628	\$226,908	2,230	NA	NA
Percentage realized between Budgeted and Actual <sup>b</sup>	88	86	115	113	99	100	NA	NA
<b>Reinvestments<sup>a</sup></b>								
Budgeted	\$141,419	602	\$66,343	359	\$95,893	805	\$12,237	11
Actual	\$118,330	313	\$96,481	958	\$92,030	805	NA	NA
Percentage realized between Budgeted and Actual <sup>b</sup>	84	52	145	267	96	100	NA	NA

Source: GAO analysis of IRS data.

Note: Fiscal year 2007 FTE savings reflect an adjustment after the budget was printed.

<sup>a</sup>IRS considers savings to be gained through process or systems improvements and reinvestments to be those savings that were realized and available for other purposes.

<sup>b</sup>IRS reported actuals for 2004 and 2005, and year-end projections for 2006.

# Appendix IV: State Mandates

Of the 50 states, 12 have electronic filing mandates for tax preparers in effect for the 2006 filing season (see fig. 4). The mandates differ in their implementation dates and schedules, thresholds for filing, and penalties. The differences between mandates may affect the magnitude of electronic filing increases in each state.

**Figure 4: States with Electronic Filing Mandates for Tax Preparers**



Sources: GAO analysis; Copyright © Corel Corp. All rights reserved (map).

We recently reported that state mandates encourage electronic filing of federal tax returns and recommended that IRS develop better information about the costs to paid tax preparers and taxpayers of mandatory electronic filing of tax returns for certain categories of tax preparers.<sup>1</sup>

<sup>1</sup>GAO-06-51.

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These mandates require tax practitioners who meet certain criteria, such as filing 100 individual state tax returns or more, to file individual state returns electronically.

Between tax years 2001 and 2004, electronic filing had grown in the 9 states with mandates from an average of 36.7 percent to 56.8 percent, or an increase of over 20 percentage points, compared to an increase of 14 percentage points for the 41 non mandated states over the same time period. We expect this trend to continue as 3 additional states—New York, Utah and Connecticut—implemented mandates in time for the 2006 filing season. Of these 3 states, New York may have the most to gain because it currently has the lowest rate of electronic filing rate, with fewer than 38 percent of its nearly 9 million federal individual income tax returns electronically filed last year.

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