WRITTEN TESTIMONY OF
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INTERNAL REVENUE
BEFORE THE
HOUSE COMMITTEE ON NATURAL RESOURCES
SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES
ON
GETTING ROYALITIES RIGHT: RECENT RECOMMENDATIONS FOR IMPROVING THE FEDERAL OIL AND GAS ROYALTY SYSTEM
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Chairman Costa, Ranking Member Pearce, and members of the Subcommittee, thank you for the opportunity to appear before you today. While the IRS has no role relative to the Federal oil and gas royalty program, it is my understanding that you want me to review for the Subcommittee IRS's compliance procedures relative to the collection of Federal income taxes.

Background

The IRS administers America's tax laws and collects the revenue that funds most federal government operations. Each year we collect more than $2 trillion, or over 96 percent of the revenues that fund the federal government each year. This revenue comes from over 144 million Federal income tax returns filed by individuals and corporations throughout the U.S. In many ways, the IRS and its employees represent the face of U.S. government to more American citizens than any other government agency.

What is perhaps most impressive about our Federal tax collection system is that it is largely self-enforcing, and yet we collect what we estimate to be approximately 85 percent of the taxes owed each year. We are able to do this by maintaining a system that balances strong taxpayer service with an equally strong compliance program.

Maintaining the Service and Enforcement Balance

Taxpayer Service

Research has shown us that the complexity of the U.S. tax code is an important factor in the ability of many taxpayers to remain compliant with tax laws. It is important for us to differentiate between this type of noncompliance and willful noncompliance where the taxpayer fully understands their obligations but refuses to pay the taxes due. The primary goal of IRS service programs for individual taxpayers is to facilitate compliance with federal tax obligations.

We attempt to assist taxpayers through three primary means: the internet, the telephone and direct contact.

- The Internet – One of the most frequently visited websites in America is IRS.gov. In FY 2007 there were more than 215 million hits on the web site, a 10-percent increase over the previous year. IRS.gov:
    - Provides taxpayers information on the economic stimulus program enacted by Congress in February;
    - Assists taxpayers in determining whether they qualify for the Earned Income Tax Credit (EITC);
    - Assists taxpayers in determining whether they are subject to the Alternative Minimum Tax (AMT);
    - Allows more than 70 percent of taxpayers the option to file their tax returns at no cost through the Free File program. Free File is a public/private partnership that allows more than 97 million taxpayers to file their returns at no cost. In 2007, approximately 4 million taxpayers took advantage of the Free File service.
    - Allows taxpayers who are expecting refunds to track the status via the "Where's My Refund?" feature; and,
    - Allows taxpayers to calculate the amount of their deduction for state sales taxes.

- Telephone – Many Americans still prefer to pick up the telephone to have their questions answered. In FY 2007 the IRS customer assistance call centers answered 33.2 million assistor telephone calls and maintained an 82.1 percent level of service on the telephone with an accuracy rate of 91.2 percent on tax law questions. The agency reached a 95 percent customer satisfaction rating for its toll-free telephone service, up from 94 percent the year before.

- Face to Face – While we attempt to direct taxpayers to less costly, and in many ways more effective, means of assistance such as the internet, we understand that there will always be a number of people who prefer direct contact with an individual to have their questions answered. We continue to meet that need through our 401 Taxpayer Assistance Centers (TACs). These TACs are scattered across the country and act as walk-in sites for millions of Americans each year. Another important element of our face-to-face contact with taxpayers is the nearly 12,000 manned volunteer sites. These volunteer sites assist in the preparation and submission of income tax returns, primarily for low-income Americans. In FY 2007, over 76,000 volunteers prepared 2.63 million returns at these sites.

The overriding strategy that guides our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July 2005 in response to a Congressional mandate to develop a five-year plan that outlines the steps we should take to improve taxpayer services. This was in recognition of the critical role that taxpayer service plays in improving compliance.

TAB represents a significant milestone in a decade-long history of service enhancements by the IRS. During this period taxpayer satisfaction with IRS services has grown significantly, due in large part to the strength of our commitment to continual improvements. Increases in electronic filing and on-line service transactions, high levels of toll-free access and accuracy, extensive stakeholder engagement, and increasingly diversified efforts to reach taxpayers through local partners and community coalitions have all led to better taxpayer understanding and participation in the tax system.

Another critical component of our compliance program is a strong customer service focus toward the business community. A key component of this has been our outreach program. In FY 2007, we:

- Maintained relationships with business industry and tax-professional organizations and coordinated or participated in events across the country, sharing education and outreach messages and information to better enable their members to comply with the law.

- Engaged practitioners and payroll providers through national and local chapters of prominent organizations such as the American Institute of Certified Public Accountants (AICPA), American Bar Association (ABA), the National Association of Enrolled Agents (NAEA), the National Payroll Consortium (NPRC), and the Independent Payroll Provider Association (IPPA).

- Maintained a close working relationship with the Internal Revenue Service Advisory Council (IRSAC) and the Information Returns Program Advisory Committee (IRPAC) to address small business issues through their Small Business/Self-Employed Sub-Working Group. Currently, both groups are working to address issues to improve voluntary compliance.

Enforcement

Through a renewed focus on improving our enforcement efforts, we have been able to increase enforcement revenue from $33.8 billion in FY 2001 to $59.2 billion in FY 2007, an increase of 75 percent. This represents a 5.6 to 1 return on investment for all IRS activities in FY 2007.

In FY 2007, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.4 million examinations of individual tax returns in FY 2007, an 8 percent increase over FY 2006. This is over three-quarters more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.6 percent in FY 2001 to 1 percent in FY 2007.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over $1 million. Audits of individuals with incomes of $1 million or more increased from 17,015 during FY 2006 to 31,382 during FY 2007, an increase of 84 percent. One out of 11 individuals with incomes of $1 million or more faced an audit in 2007. Their coverage rate has risen from 5 percent in FY 2004 to 9.25 percent in FY 2007.

In looking at our audit numbers for individual taxpayers, it is important to understand that we conduct two types of audits. The first is the traditional field audit where an auditor actually meets with the taxpayer to conduct an examination. The second is a correspondence audit. These occur in instances where we are unable to match the taxpayer's return with third-party documents that are filed with us. For example, a taxpayer's return that does not report income that is reported to us as part of an interest statement provided by the taxpayer's bank would raise a red flag. We would send a letter to the taxpayer assessing the additional tax as well as any interest and penalties that may apply. The taxpayer is then provided an opportunity to dispute this assessment if they desire or they can send the corrected assessment directly to us.

In the business arena, we attempt to allocate resource to the areas where we think they will be most effective. In FY 2007 for example, the IRS continued efforts to review more returns of flow-through entities – partnerships and S Corporations. Our business statistics reflect that we have placed more emphasis in the growing area of these flow-through returns. We also increased our focus on mid-market corporations – those with assets between $10 million and $50 million.

Operating in an environment where resources are limited, we are challenged to find ways to improve processes and increase productivity. We are doing this by continuing to improve efficiency and productivity through process changes and streamlined business practices.

A critical component in ensuring the most productive use of compliance resources is a greater reliance on information technology (IT) modernization. The IRS strategic vision includes IT systems that would allow for identification of the cases to be worked, routing of those cases to the most appropriate workstream, and the availability of cost effective technology analytics to manage cases in the stream optimally.

The National Research Project (NRP), which analyzed some 46,000 individual income tax returns from Tax Year (TY) 2001, has provided us with significant data to help us facilitate the selection of the most productive returns to examine. It is envisioned that the case selection process will be further enhanced through automated classification processes, including expert systems, electronic database analysis, and leveraging e-filed data from corporations – efforts that are currently underway. Technology enhancements are also on track for more effective and efficient workload selection models within the non-filer population.

The FY 2009 Budget for the IRS includes $51 million to expand our commitment to quality enforcement research. This enforcement initiative will support and expand ongoing research studies of filing, payment, and reporting compliance to provide a comprehensive picture of the overall taxpayer compliance level. Research allows the IRS to better target specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively to reduce the tax gap. Improved research data will refine workload election models reducing audits of compliant taxpayers.

We also use current audit information from "issue management" systems to improve case selection criteria and provide for immediate identification of emerging issues. For collection programs, we are using improved decision analytics to select cases and route them to the most appropriate collection enforcement stream. For large corporate returns, data is now available earlier due to the corporate e-file mandate, and we are using data from returns filed electronically, including the Schedule M-3, for risk assessment and issue identification.

Delivery systems are also being modified to move audit work into the system more effectively and efficiently. Return classification and delivery will be more automated and digital, eliminating the manual time-consuming and expensive process of ordering returns and sending examiners out to Campus locations for classification details. Additionally, the IRS will replace manual processes with electronic case building and instant access to multi-year tax return information.

Automated systems are also being deployed to allow more batched processing of high-volume examinations. Technology enhancements will allow employees to work cases in an online environment, where returns and case-related data can be downloaded, and actions can be tracked electronically. We will continue to link multiple internal and external databases to enhance overall effectiveness, allowing better identification, management, and performance monitoring for compliance workload. In utilizing these automated systems, IRS remains committed to protecting taxpayer data from being accessed inappropriately.

The large corporate entities monitored by the IRS are highly sophisticated, well-capitalized, well-organized, and adept at tax planning. Particularly in the case of public companies, they are driven to show high after-tax profitability to shareholders in a very competitive and complex economic environment. They have the resources and willingness to defend their reporting positions and contest proposed adjustments aggressively.

However, these taxpayers also face significant changes in corporate governance, including increased public disclosure and transparency. A number of these changes have been the result of legislative or administrative changes including:

- New requirements were imposed on corporate officers and directors by the Sarbanes-Oxley Act.

- There was increased scrutiny of outside auditors by the creation of the Public Corporation Accounting Oversight Board.

- Increased requirements of disclosure were included in the American Jobs Creation Act.

- New SEC/FASB (FIN48) rules limit the discretion companies can apply in determining their unresolved tax positions for financial accounting purposes.

For some corporations, these changes have created a desire for certainty regarding their tax liability as soon as possible. Tax certainty – or lack thereof – can have a real effect on a company's share price, because a more accurate picture of a company's finances is now required and publicly available.

We recognized long ago that our traditional approach to corporate tax administration, which centered on lengthy, detailed tax return examinations, was no longer viable. As a result, we developed a proactive approach to dealing with the challenges of effective tax administration in a global environment with an increasingly complex tax code. Overall, this strategy depends on making compliance checks, when possible, on a real-time basis, remaining current in our examinations, and having as much transparency to book-tax differences and other indicators of risk as possible. To that end, we have initiated several programs that foster transparency, currency, pre-filing compliance opportunities, and improved efficiencies in issue and risk identification.

First, to improve transparency on corporate tax returns, the IRS introduced a new Schedule M-3. The Schedule M-3 provides transaction-specific detail on book-tax differences, enabling the IRS to identify and focus more quickly and precisely on those tax returns and issues that present the highest potential compliance risk.

Second, our Large and Mid-Sized Business (LMSB) division has introduced the Compliance Assurance Program (CAP). The CAP program is designed to improve both currency and transparency. It is a real-time approach to compliance review that allows LMSB, working in conjunction with the taxpayer, to determine tax return accuracy prior to filing. CAP is more efficient than a post-filing examination, as it provides corporations certainty about their tax liability for a given year within months, rather than years, of filing a tax return. CAP is a pre-filing initiative designed to provide certainty for both the IRS and the taxpayer, that a return (in its entirety) is substantially complaint when it is filed. This win-win program greatly reduces taxpayers' compliance burden and their need for contingent book tax reserves, while increasing currency and allowing for more efficient use of IRS resources.

Third, the IRS is continuing the Pre-Filing Agreement (PFA) program to provide taxpayers an opportunity to request that revenue agents examine and resolve potential issues before tax returns are filed. This is distinguished from the CAP program as it provides certainty on a single issue(s), as opposed to certainty of a tax return (in its entirety). We continue to explore ways to improve and create additional pre-filing compliance opportunities that may limit the number of issues we need to examine in a post-filing examination.

Fourth, working with Treasury and Chief Counsel, LMSB identifies emerging high-risk issues as early as possible, issuing guidance to taxpayers and examiners on the proper treatment of these issues, and efficiently and vigorously examining those returns where taxpayers engage in that behavior.

Fifth, the IRS is mandating, in stages, the electronic filing of corporate returns *(E-Filing)* in order to improve issue identification and the selection for examination of high-risk returns. Large corporations are required now to file their tax returns electronically and this mandate will expand in future tax years. *E-filing* will provide more consistent treatment and data analysis for efficient, near real time identification of high-risk issues and taxpayers. *E-filing* and Schedule M-3 together also allow us to identify and exclude more efficiently lower-risk taxpayers from consideration for examination.

The approaches described above better position the IRS to address the rapid change of business in the domestic and global arenas in a timelier manner. The earlier we learn of emerging trends, the better positioned we will be to adjust resources to address compliance risks appropriately.

Increasing timeliness and reducing cycle time means that less time is spent on each audit. This has allowed us to continue to show improvement in enforcement results at the same time we are increasing our coverage of these taxpayers. We believe that the more compliance “touches” that occur (even if that does not include a full audit in the traditional sense), the better the direct and indirect enforcement benefits will be.

Summary

Any agency with limited resources must make difficult decisions on how to allocate those resources in the most effective way. It also must be accountable for those decisions, and so appropriate metrics must be established to measure the success or failure of the actions taken.

While we understand that we can still do some things better, we believe that our approach, which balances service and enforcement in an effort to improve compliance, is working effectively. We base that conclusion on the metrics that show how enforcement — particularly enforcement against high-income individuals and large corporations — have grown substantially in the last five years without any diminution in our taxpayer service levels.

Thank you for the opportunity to appear this morning, and I will be happy to respond to any questions.