

Testimony before the
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Good afternoon. I am Mary Jane Egr, commissioner of the Nebraska Department of Revenue and president of the Federation of Tax Administrators. The Federation is an association of the tax agencies in the 50 states, D.C. and New York City. Its principal missions include improvement of tax administration through coordination of shared efforts with the Internal Revenue Service, training and education, research, and development of harmonized approaches to tax administration that benefit tax agencies, tax professionals and taxpayers alike.

I am pleased to represent the FTA today in sharing the states' thoughts on administrative simplification and streamlining options for the IRS that will improve tax compliance.

History of partnership

The state tax agencies and the IRS have a long history of shared or coordinated activities that improve the tax administration process. We have jointly educated taxpayers, shared training, coordinated policies, collected one another's debts, shared knowledge and expertise in audit situations, designed our e-file systems to operate as a single process to the extent possible, shared large volumes of taxpayer data in a fully safeguarded – and increasingly efficient – manner, coordinated our technologies and standards, worked as a team to tackle large, interstate compliance issues such as motor fuel tax evasion, and held forth to one another our best ideas, our hottest technologies and our most insightful lessons learned.

Let me start with just a few simple examples of how states and the IRS have recently leveraged their resources through this partnership:

-- When states have tax amnesties, as a dozen or so have done in the past few years, they share information on the amnesty applications with the IRS. Similarly, upon request states have provided IRS with data from their sales tax files or on all income tax filers, so the IRS can make sure that those on state tax rolls are also filing returns with the federal government.

-- The IRS provides the states with large volumes of data each year, and works closely them to ensure the data is properly secured and used only for its intended purposes. Of special note are recent modernization projects that have improved the efficiency of some of these data exchanges. One in particular allows states to receive IRS audit reports in a far more timely manner and in an electronic format. Another will be fully functional within a few months and will for the first time automate the process by which the IRS responds to specific requests for data, such as a certain schedule or individual address. This project – the Transcript Delivery System -- stands to save the IRS incalculable human resources and will speed the delivery of this critical data. Information that used to take months to obtain will soon be available almost instantaneously.

-- From time to time we have undertaken projects for the joint collection of federal and state taxes owed by a taxpayer, for coordination of payment agreements, and for shared audits. No government wants to put effort into working a case that has already been worked by another government; no taxpayer wants to deal with one tax administrator, then turn around and have to repeat the process with another. But these have been some

of the most difficult projects we've undertaken together, and we have learned much from each one. In particular, we are learning that on a day-to-day basis, the legal and policy constraints of this type of joint activity can be daunting and even prohibitive, no matter how desirable the outcome. However, in narrow circumstances or special cases, such as a special banking audit project undertaken by the IRS, New York State and New York City, the benefits can be well worth the effort to government and taxpayers alike. Some targeted thinking on other shared enforcement opportunities would seem to be of benefit.

-- Along similar lines, the federal and state governments and the motor fuel industry have worked in close harmony for a number of years to develop policies, processes and technologies that allow the tracking of taxed and untaxed motor fuel across the country. Through a combination of structural changes, uniformity efforts and improved technology, the burden imposed on taxpayers has been reduced and the opportunities for evasion reduced. We now face two challenges in this area: (1) implementation of a new federal electronic reporting requirement in a timely, effective fashion; and (2) leveraging the commonalities of the state and federal fuel tax systems into a more seamless, cooperative administration system.

These are only a few examples of the types of activities the state tax agencies and the IRS have undertaken together for their mutual benefit and for the benefit of taxpayers. There are more ongoing projects than can be listed in one source, and we have more ideas percolating up from state and IRS personnel than ever can be executed. These examples, however, should be more than sufficient to demonstrate that federal-state cooperative efforts can improve compliance directly and can also reduce taxpayer burden, which will have indirect benefits for compliance.

Recommendation for systematic approach

What we have learned from these efforts is that we need to be doing more, and we should be seeking out these new opportunities in a more systematic manner.

We have seen firsthand the benefits of tackling a shared problem in a systematic manner. Both federal and state governments have suffered incalculable revenue losses from both individual and corporate use of tax minimization strategies that, in many cases and in the final analysis, do not meet the requirements of the Internal Revenue Code, or of state tax codes. The IRS recognized the growing use of these strategies and aggressively challenged their use in the court system. It also poured significant audit and legal resources into tracking down those who tried to hide their untaxed earnings in offshore banks.

Clearly there was more than enough work to go around, and the Service determined early in the process that part of its strategy in tackling this problem would be to partner effectively with states. The IRS shared its planned approaches with the states from the earliest stages and we were able to identify ways to work more effectively together. We developed a Memorandum of Agreement (MoA) for Abusive Transactions that created a structure for our activities.

As the Agreement itself spelled out: “By coordinating audit programs and enforcement activities, participating agencies will be better equipped to mitigate the impacts of abusive tax avoidance transactions on states’ tax revenues. This coordinated effort will identify those taxpayers, promoters, organizers and accommodators who participate in and promote ATAT. “ It went on to specifically outline the tasks and actions expected from both states and the IRS.

The overall IRS strategy included sharing all results from all its cases. Where the Service turned up more cases than it could work, it shared its workload with the respective states, giving the state an opportunity to track down taxpayers – for the benefit of both governments – who might otherwise have gotten away with an illegal activity. The IRS also has generously shared its knowledge and expertise through a variety of training vehicles.

The states in return shared their technological resources with the Service, providing information that helped produce a final identification of the individuals in question, among other benefits. The states also have been sharing the results of their own sheltering compliance projects. In particular, California and New York were among the first to give the IRS invaluable data from state-instigated compliance programs.

This is clearly an example of a situation where, if we did not stand together, we would surely fail separately. And none of us could afford to fail with this task.

Likewise, I would take this opportunity to challenge the states to more systematically identify the ways in which their lessons learned can be shared with the Service. For all our differences, we are substantially alike, in our missions, our challenges, our constraints and especially in our shared community of taxpayers and tax professionals.

Our members have long enjoyed the advantage of having 52 laboratories that are exploring, discovering, trying, refining, and sometimes even rejecting new ways to streamline tax administration. Yet we have not done our best to share these ideas and lessons with our federal counterparts. We have not reached out to the IRS in a high-level or systematic manner to include them in our training workshops, or in identifying to the appropriate executives where we have had breakthrough successes.

For instance, the states have been using 2-D bar codes to speed a large number of administrative tasks, in particular the processing of paper tax returns. The bar code can be read quickly and accurately by either hand-held or high speed scanners. While not as efficient from a processing standpoint as electronic returns, bar code returns substantially reduce the resources required for income tax return data capture.

The IRS did initially track the state experiences with bar codes. When states began to save millions of dollars by marketing and in some cases even mandating the use of 2-D barcodes on returns, the IRS decided to adopt the technology for the Form 1065 partnership return. But we do not have any process in place for reporting back on states’ historical experiences with the special bar code on individual income tax returns – our volume has been growing exponentially even as our e-file volume has grown

exponentially, and states are now seeing success with mandating the use of the bar codes. Now that there is a well-proven track record, the IRS may wish to reconsider the use of bar codes on the 1040 returns.

But even more importantly, we have no process in place for showing the IRS the many new uses of these bar codes outside of the filing arena. States now use them for everything from speeding up taxpayer walk-in assistance to streamlining the process for handling undeliverable refund checks. The technology is simple, inexpensive and adaptable to dozens of time-consuming, expensive activities.

Likewise, there are good, worthy activities, in particular some data exchanges, that have not been systematically incorporated into the business process. As a result, when there is a personnel change at the IRS or a restructuring, the historical knowledge of the activity and its benefits may be lost, in some cases we have identified for a decade or more. Again, a systematic process of identifying, analyzing, prioritizing, establishing protocols *and cataloging* our shared activities seems to us to be a critical missing link in our goal of simplifying and streamlining tax administration.

What we are recommending, again for the mutual benefit of both governments and the citizenry, is that the IRS and states follow the example set by the IRS Abusive Transactions strategy and take a more systematic approach to identifying where are greatest needs are, where the greatest opportunities exist, and where we should – and equally importantly, should not – be launching new efforts together.

To expand briefly on this last point, deciding where not to partner together can be a trickier business than deciding where to work in concert. The danger of tackling every good idea, or in choosing projects based on the power and effectiveness of its champions, is that resources can be wasted when a project must be scrapped to deal with a more pressing priority, or a project fails halfway through because it did not fit properly with other technologies or policies in use within the Service.

Our specific recommendation on how to promote streamlined tax administration and more effective compliance is that the IRS and states should:

(a) Catalog and systematically review cooperative activities and activities from which they could benefit. The ATAT MoU may provide a useful model. In particular, there should be a focus on debt collection and the utility of either joint or shared audits in particular areas.

(b) There should also be a systematic evaluation of data that can be provided by the states to assist with IRS compliance activities. The IRS has reported to us that, for instance, it has found value in state sales tax data and in data it has received from state Voluntary Compliance Initiatives and similar abusive transaction activities. It is likely that there are many more types of data that the states can provide that would bolster IRS compliance work.

(c) Examine on an ongoing basis both the value of data being provided and the technology and process by which the data is provided.

Recommendation for expanding joint e-filing

By now we all know the extraordinary benefits of e-filing. You get it once and you get it right. Data is accurate, data processing is quick, taxpayer burden is reduced in a number of ways. There's plenty here for tax administrators to like, and plenty for taxpayers to love. Indeed, I would argue that the introduction of electronic filing and its sister technologies, Internet filing and 2-D barcodes, have done more to streamline and improve the taxpayers' interaction with government than any other single action ever taken by a tax administrator.

Therefore, anything we can do to encourage and improve the use of this technology deserves consideration.

The IRS has worked closely with states (and the tax preparation community) to develop a process for joint electronic filing of tax returns. The success in individual income tax filing is well known. The focus more recently has turned to the joint filing of the Form 1120 corporate tax return and the joint filing of employment tax returns.

In a time of limited resources and an ever-growing list of competing priorities, the IRS recognized the value of this partnership to tax administration generally and to taxpayers in particular, and worked hard to keep these two new programs on track. This project will be implemented in a year, and it remains on schedule only because of dedicated work by both state and IRS personnel. It stands as one of the brightest examples of the good that can come of working together in a concerted fashion.

We are recommending that the IRS:

- (a) continue their development of the joint e-file 1120 project and with a similar program to make 1065 data available to states in an electronic format;
- (b) implement the federal Motor Fuel e-file mandate in a fashion that is consistent with state e-filing programs; and
- (c) work with states in a concerted effort to develop joint e-file efforts in all types of taxes.

This partnership would require the Service to continue its willingness to include states in the earliest stages of the development phase, as was done with the 1120 and employment tax returns. It would also require the Service to recognize the necessity for constancy. Once a joint project is fully committed to and an approach is finalized, making fundamental changes leads to a waste of resources and could jeopardize the partnership in this arena.

Recommendation for implementing mandates

And, as a member of the IRS Electronic Tax Administration Advisory Committee (ETAAC), I have a dual interest in calling your attention to another change that would promote e-filing.

The ETAAC's recent report encouraged the IRS to go beyond simply adopting the technology and "begin to think of itself as an electronic tax administration agency that is a communicator, transmitter, receiver and repository of e-information rather than as a paper handler."

To make this vision a reality, we proposed several policy points to Congress, the most critical of which, in my own estimation, is that Congress should support mandated e-filing by paid preparers. Our reasoning was based on our belief that the increase in federal electronically filed returns is now directly related to mandates created by states for e-filing. State e-filing mandates are a growing policy, and seem to be having an effect on overall numbers.

In fact, the report goes so far as to say, "Federal e-file growth may now be entirely dependent on what states may be doing rather than because of incentives offered by the IRS."

Results can be seen in overall numbers. This past year saw 42 percent of state income returns received in non-paper form, up from 35 percent the previous season. These numbers reflect the implementation of mandates across the nation. By 2004, five states – California, Michigan, Minnesota, Oklahoma and Wisconsin – had mandate programs in place. (In 2005, Alabama, New Jersey and Virginia will roll out their respective mandate programs.)

Regardless of the data set one looks at -- state e-file returns only, federal e-filed returns from practitioners only or federal returns from both practitioners and online -- about one-half of the increased volume of federal e-file returns this year came from the states of California and Michigan. California alone saw an increase of 86 percent (3.2 million) in its electronic return volume. Michigan received 900,000 more e-file returns.

In total, these states received roughly 4 million more e-filed returns than in 2003. Without California and Michigan, the growth rate in practitioner-filed federal returns would have dropped from 16 percent to 9 percent and the growth in state e-filed returns (other than TeleFile) would have dropped from 25 percent to 12 percent. IRS estimates it received an additional 2.46 million returns as a direct result of the California and Michigan electronic filing mandates, with the bulk received due to California's mandate. IRS estimates this resulted in a savings of about \$5.3 million in direct processing costs.

ETAAC also concluded that "[a] mandate will likely encourage development of consistencies in the processing of tax returns, which will in turn lead to increased efficiency and, eventually, cost savings."

The IRS may also find it instructive to look beyond the traditional mandates for e-filing by tax professionals. Massachusetts and Rhode Island have requirements that computer-prepared returns be filed either electronically or with a 2-D bar code, allowing rapid capture of return data in every case. Massachusetts received nearly 85 percent of all returns with easy-capture bar code technology attached. [Source: FTA bulletin B-28/04].

Summary

In summary, FTA's recommendations to the Oversight Committee is that:

-- the IRS work with states to create a systematic process for the consideration and development of joint projects and joint sharing of data, and that the IRS be encouraged to take greater advantage of the communication, training and sharing afforded their state counterparts;

-- the IRS and states need to launch a concerted effort to develop joint e-file efforts in all types of taxes; and

-- again in my role as a member of ETAAC, I recommend further consideration of the ETAAC report that says federal policymakers should implement mandates for e-filing and even bar-code use on federal returns.

Thank you for your consideration of these thoughts. I welcome any questions.