

IRS Oversight Board



**Statement of the Honorable Raymond T. Wagner, Jr.
Chairman, IRS Oversight Board**

**Testimony Before the Subcommittee on
Transportation, Treasury, the Judiciary, Housing and Urban
Development, and Related Agencies**

Of the Senate Committee on Appropriations

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INTRODUCTION AND OVERVIEW

Mr. Chairman, thank you for this opportunity to present the Oversight Board's views on the Administration's FY2007 IRS budget request. I will explain in my testimony why the Board believes its proposed budget is needed to meet the needs of the country and of taxpayers. In developing these recommendations, the Board has applied its own judgment but has also drawn on the collective wisdom of others in the tax administration community, including the IRS, Government Accountability Office (GAO), the Treasury Inspector General for Tax Administration (TIGTA), National Taxpayer Advocate, and Congress.

In fulfilling its responsibilities, the Board must ensure that the IRS' budget and the related performance expectations contained in the performance budget support the annual and long-ranges plans of the IRS, support the IRS mission, are consistent with the IRS goals, objectives and strategies and ensure the proper alignment of IRS strategies and plans. In addition to my statement today, the Board is developing a formal report in which it will explain why it has recommended this budget for the IRS.

Now is a fiscally challenging time for our nation. Defense and homeland security needs coupled with rebuilding efforts along the hurricane-ravaged Gulf Coast have placed an enormous strain on the federal budget.

In addition to our fiscal challenges, taxpayers are expected to comply with an increasingly complex tax code which places heavy burdens on honest taxpayers who wish to comply and offers untold opportunities for mischief by those who do not.

Against this backdrop, it is imperative that government work better and smarter and get the most out of every taxpayer dollar. But there is also a drain on the Treasury that undermines our country's tax revenues and threatens the integrity of our tax administration system — the tax gap.

The IRS recently disclosed that the nation's annual tax gap — the difference between what is owed and what is collected annually — stands at \$345 billion, and some experts believe it could be even more. The Board considers the existence of such a large tax gap to be an affront to honest taxpayers, and is pleased with the attention that Congress has focused on the tax gap in the last year, especially with the release of the IRS' latest tax gap estimates. The Board, along with many other members of the tax administration community, believe that reducing the tax gap requires a comprehensive, multi-faceted plan with action on many fronts— from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

Such an approach needs to be more thoughtful and comprehensive than merely increasing IRS resources and expecting that the gap will shrink. However, increased IRS resources are certainly a part of the solution. A successful strategy will encompass several separate but interrelated approaches that will reinforce each other to produce the desired result. In the Board's opinion, a number of actions that can be taken will require additional IRS resources.

The Oversight Board recommends an integrated set of strategies to close the tax gap: (1) tax code simplification; (2) improved information reporting and enforcement tools related to the cash economy; (3) improved customer service to make taxpayers aware of their obligations and modern technology to ease their burdens; (4) greater focus on research; (5) more productive partnerships between the IRS and tax professionals; and (6) and more emphasis on personal integrity.

There can be no doubt that in the last five years the agency has achieved significant progress in all dimensions of its mission. Customer service has rebounded from the lows of the 1990s and through targeted investments and greater management focus, IRS enforcement has also turned the corner.

This across-the-board improved performance has not gone unnoticed — especially among taxpayers. According to the 2005 American Customer Service Index, overall satisfaction among individual tax filers with the Internal Revenue Service remains stable at 64 percent; it is even higher among e-filers. The IRS Oversight Board 2005 Annual Survey also found that American taxpayer support for overall compliance reached an all-time high. However, the IRS's job is far from complete and it must close the tax gap while achieving balance in other parts of its critical mission.

The Board recommends budget increases in four IRS program areas in FY2007: customer service, enforcement, Business Systems Modernization, and infrastructure and management tools.

To achieve balance and ultimately compliance, the Board recommends two modest investments in customer service to ensure that there is no slippage in hard won gains. For example, the toll-free telephone level of service is slightly down and wait times have increased compared to FY2004. The Board proposes restoring customer service to FY2003/4 levels and investing in telephone infrastructure. It is far less expensive to prevent or solve a problem early on than let it grow.

The Board proposes a modest increase in resources for virtually all IRS enforcement activities. This is money well-spent and there is a growing recognition of the positive return on money invested in the IRS. The Board strongly believes that the enforcement increase includes a significant investment in research to better understand enforcement and customer service needs and the impact of customer service on voluntary compliance. The Board's recommended budget puts the IRS on track to make the National Research Program (NRP) permanent and produce annual tax gap estimates. The Board further recommends that the IRS consider developing a long-term strategic plan for research.

Business Systems Modernization is also a priority and the Board advocates a larger investment in information technology to improve IRS productivity and reduce taxpayer burden. Despite productivity improvements in recent years, the IRS is still hampered in its efforts to modernize because of its reliance on a forty-year-old information system for its central recording-keeping functions, which limit the IRS to weekly updates of its central taxpayer records. No modern financial institution in the private sector could survive under these conditions and eliminating these limitations is key to making the IRS an efficient and effective modern financial institution.

Lastly, the Board recommends a number of management increases that will help the IRS cope with unfunded mandates, implement BSM projects, and restore leadership training to FY2003

levels, which has become especially critical during a period in which over 50 percent of IRS managers are eligible to retire.

Overall, the Oversight Board proposes a budget that is good for the country, good for taxpayers, and allows the IRS to achieve its strategic goals and objectives in an efficient and effective manner. It calls for \$11.3 billion funding for FY2007, a 6.9 percent increase over last year's appropriation.

The Board has also voiced concern that two items in the Administration's proposed FY2007 budget for the IRS pose significant risks. First, the budget proposes \$84 million in savings from program efficiencies. The Oversight Board believes there is a risk that these reductions will decrease performance. Second, last December the IRS announced that it would dramatically raise fees for certain services and the President's budget assumes that the IRS will receive an additional \$135 million in fee revenue. Although the IRS has expressed confidence it would receive this amount in additional fees based on its estimates, there is still some risk whether the estimated fee revenue can be achieved. In addition, external stakeholders have expressed concern that the additional fees could have an unintended negative impact on taxpayer compliance.

In conclusion, the Board believes that it has constructed a fiscally responsible and realistic budget for the IRS that meets national needs and priorities. It would help shrink the tax gap while providing taxpayers with a level of service they rightly deserve and need. It would speed the modernization of the IRS' antiquated technology and give it the research tools to better understand current and developing trends. Most importantly, it would maintain that delicate but critical balance between enforcement and customer service that America's taxpayers have said time and again they want, and which has been validated through the Board's Taxpayer Attitude Survey. The IRS is now solidly on the right track and is making progress, but we must give it the resources to do its job. It is the right investment for this and future generations of taxpayers.

Recommended IRS Oversight Budget in Brief

The IRS Oversight Board recommends an FY2007 IRS budget of \$11.31 billion, an increase of \$732 million over the enacted FY2006 budget.¹ This recommendation compares to the President's budget request for the IRS of \$10.59 billion in direct appropriations. The two budgets share the following characteristics:

- Both reflect the same adjustments for inflation, \$272 million
- Both show a savings and reinvestment of \$121.6 million
- Both are supplemented by \$135 million in increased user fees to achieve a higher operating level

The Board's budget, however, proposes program increases of \$705 million compared to a proposed program decrease of nearly \$9 million in the President's budget, as shown in the following table.

Comparison of Board and President's Program Increases
(all dollars in thousands)

Function	Oversight Board Recommendation	President's Request
Taxpayer Service	\$43,637	\$0
Enforcement	\$367,768	\$0
Infrastructure and Mgt Modernization	\$104,715	\$20,900
Business Systems Modernization	\$188,600	(\$29,700)
Total Program Increases (Decreases)	\$704,720	(\$8,800)

Recommended initiatives for enforcement, customer service, infrastructure and management and Business Systems Modernization can be found in the individual sections of this statement and Appendices 2 through 5.

IRS Performance from FY2001 to FY2005

The agency, which had become synonymous with poor customer service in the late 1990s, has demonstrated a remarkable performance improvement in the last five years. Toll-free telephone level of service has steadily increased from 56 percent in FY2001 to a high of 87 percent in FY2004. (In FY2005, there was a slight three percent drop which the IRS attributes to reduced funding for taxpayer services.) Toll-free tax law accuracy also rose from 82 percent in FY2003 to an impressive 88 percent in FY2005.

Perhaps the most important and notable gain recorded over the past five years is the percent of individuals filing electronically — 31 percent in FY2001 to 51 percent in FY2005.² And although it will miss the 2007 deadline, the IRS is making steady progress in closing in on the 80 percent e-file goal established by the IRS Restructuring and Reform Act of 1998.

Through targeted investments and greater management focus, IRS enforcement has also turned the corner. Enforcement revenue rebounded from \$33.8 billion in FY2001 to \$44.1 billion in FY2005. Audit rates also steadily increased. For high-income individuals they rose from 0.79 percent in FY2001 to 1.61 percent in FY2005. Over the same time period, corporate and small business audits increased respectively from 13.5 percent to 16.9 percent and 0.88 percent to 1.32 percent.

Taxpayers Respond to Better Performance but Problems Remain

This across-the-board improved performance has not gone unnoticed — especially among taxpayers. According to the 2005 American Customer Service Index, overall satisfaction among individual tax filers with the IRS remains stable at 64 percent. However, the number is much higher among e-filers who had an ACSI score of 77 percent.³ By way of comparison, the IRS received a 51 percent score in 1998. Taxpayer attitudes have also improved. Since 2002, the IRS Oversight Board has conducted an annual survey to gain a deeper understanding of taxpayers' attitudes. Of great concern was the growing number of individuals who thought it acceptable to cheat on their taxes.

In 2003, twelve percent of respondents thought it acceptable to cheat a “little here and there” on their taxes, and five percent would cheat as much as possible. However, two years later those numbers have dropped to seven and three percent respectively and public support for tax compliance is at an all-time high. Moreover, the 2005 survey found that 82 percent of respondents say that their own personal integrity has the greatest influence on whether or not they report and pay their taxes honestly — double the number who cite any other factor. Significantly, the survey also found two out of three surveyed expressed continued support for additional funding for both IRS assistance and enforcement.⁴ America’s taxpayers want a balanced tax administration system.

However, as welcome as the news may be, it cannot disguise the hard fact that the tax gap has remained unacceptably high. In testimony before the Senate Budget Committee, Comptroller General David Walker stated that the \$345 billion tax gap estimated by the IRS could indeed be greater: “IRS has concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data and IRS has no estimates for other areas of the tax gap. For example, IRS used data from the 1970s and 1980s to estimate underreporting of corporate income taxes and employer-withheld employment taxes.”⁵

The tax gap is more than an abstract number. According to National Taxpayer Advocate Nina Olson, it hurts taxpayers in a very concrete way:

The collective failure by certain taxpayers to pay their taxes imposes greater burdens on other taxpayers. The IRS receives approximately 130 million individual income tax returns each year. Given the size of the net tax gap, the average tax return includes a “surtax” of about \$2,000 to make up for tax revenues lost to noncompliance. The tax gap may also impose significant costs on businesses in the form of unfair competition by noncompliant competitors who can pass along a portion of their tax “savings” to customers by charging lower prices.

Most importantly, the tax gap can erode the level of confidence that taxpayers have in the government, thereby reducing federal revenue and increasing the need for more examination and collection actions. The tax gap, then, can produce a vicious cycle of increased noncompliance and increased enforcement.⁶

The IRS Oversight Board believes that its FY2007 IRS budget recommendations are part of the solution to reversing this corrosive trend.

Budget Environment Should Not Discourage Investment

The IRS does not operate in a vacuum and the Oversight Board recognizes that the current budget environment stresses fiscal restraint and austerity. However, at the same time, we should not throw up our hands in defeat and say we can do no more to improve tax administration. We should look at the larger picture.

Unlike other government agencies, there is a positive return on money invested in the IRS. Senate Budget Committee Chairman Judd Gregg agrees. He observed at a recent hearing on the tax gap, “We’ve got to talk to the CBO about scoring on that [investing in IRS enforcement], clearly there’s a return on that money.”⁷

The Board would welcome such a change but also recognizes that this is a problem that has plagued the IRS for decades. Former IRS Commissioner Charles O. Rossotti wrote:

When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of job, by far, was dealing with the IRS budget. The reaction was usually, “Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn’t you be able to get it?”⁸

Indeed, this lack of recognition of a direct return on investment has left many puzzled. In his April 14, 2004 column, *Washington Post* financial writer Al Crenshaw wondered why the Administration and Congress “aren’t falling over themselves to give the IRS more money. Tax Enforcement pays for itself many times over, and it would be a good way to cut the deficit.”⁹

In its FY2007 budget recommendation, the Board calls for increases in enforcement that would result in a real return on investment, ranging from three to six dollars on every dollar spent, resulting in \$730 million revenue by FY2009 on a \$242 million investment.

The Oversight Board urges Congress to adopt the Board’s budget recommendations and invest in more effective tax administration.

SIX STRATEGIES TO REDUCE THE TAX GAP

The Board considers the existence of such a large tax gap to be an affront to honest taxpayers, and is pleased with the attention that Congress has focused on the tax gap in the last year, especially with the release of IRS latest tax gap estimates. The Board, along with many other members of the tax administration community, believe that reducing the tax gap requires a comprehensive, multi-faceted plan with action on many fronts — from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

Such an approach needs to be more thoughtful and comprehensive than merely increasing IRS resources and expecting that the gap will shrink. That being said, however, increased IRS resources are a part of the solution. A successful strategy will encompass several separate but interrelated approaches that will reinforce each other to produce the desired result. In the Board’s opinion, a number of actions that can be taken will require additional IRS resources.

The Board supports six strategies that it believes would constitute an over-arching plan to reduce the tax gap. This information is presented here only to provide some additional background to understand the Board’s FY2007 budget recommendations, so that these recommendations can be understood in the context of an overall approach where the individual elements reinforce each other.

The first is a simplified tax code. Our complex and ever changing tax code not only confounds honest taxpayers who want to comply with their obligations under the law, but provides ample opportunity for those who exploit its complexity to cheat. The President’s Advisory Panel on Federal Tax Reform observed:

Since the last major reform effort in 1986, there have been more than 14,000 changes to the tax code, many adding special provisions and targeted tax benefits, some of which expire after only a few years. These myriad changes decrease the stability, consistency, and transparency of our current tax system while making it drastically more complicated, unfair, and economically wasteful. Today, our tax system falls well short of the expectations of Americans that revenues needed for government should be raised in a manner that is simple, efficient, and fair.¹⁰

Second, the Oversight Board recommends improved information reporting and enforcement tools to address large areas of the tax gap related to what has been called the cash economy. Although the Board is prohibited by statute from endorsing any specific proposal, we note that in its FY2007 budget submission for the IRS, the Administration makes five legislative recommendations to close the tax gap that include: (1) increasing information reporting on payment card transactions; and (2) expanding information reporting to certain payments made by federal, state and local governments to procure property and services. They certainly merit congressional discussion and consideration.

The National Taxpayer Advocate also recommended in her 2005 Annual Report to Congress that the IRS create a cash economy program office, similar to the Earned Income Tax Credit program office. The Board is pleased that the IRS Small Business/Self-Employed Operating Division Commissioner has agreed to establish a task force on the cash economy that will seek to determine the feasibility of this and other recommendations.

In testimony before the Senate Budget Committee, the National Taxpayer Advocate further recommended that to address the tax gap “we should begin by identifying various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose.”¹¹ The Board supports such analysis.

Third, the Board believes that the IRS must improve customer service to make taxpayers aware of their legal obligations and ease taxpayer burden through modernization. Indeed, not all non-compliance is willful; a significant amount of is due to the complexity of the tax laws that results in errors. IRS Commissioner Mark Everson recently testified:

[T]he tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, though, at this point, we do not have sufficiently good data to help us know how much arises from willfulness as opposed to innocent mistakes. This is an area where we expect future research to improve our understanding.¹²

Fourth, there should be a much greater emphasis and focus on research so the IRS can more effectively target areas of major non-compliance. It bears mentioning that a lack of research in the 1990s contributed in part to the IRS’ failure to detect the emergence and subsequent epidemic of illegal tax avoidance schemes. The Board recommends an additional \$60 million in funding for research. The IRS needs to know much more about non-compliance than it currently does to mount a successful campaign against the tax gap.

Fifth, the Board urges a more productive partnership between IRS and the tax administration community. At the Board’s 2006 open meeting, the AICPA supported the IRS’ efforts to partner with professional organizations in the area of *pro bono* tax assistance, noting that such a synergy provides the IRS with the opportunity to leverage precious resources and increase customer service at the same time. The Board would add that such a partnership also contributes directly to compliance.

Sixth, there must be more emphasis on personal integrity in making tax decisions. The Board has found that the vast majority of taxpayers state that their personal integrity is a very important factor in influencing their tax compliance. In the Board’s most recent Taxpayer Attitude Survey,

82 percent of taxpayers cite personal integrity as the principal factor for reporting and paying their taxes honestly. Commissioner Everson also testified at the Senate Budget Committee tax gap hearing:

[A]nother enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures.¹³

Our tax administration system should challenge taxpayers to be conscious of the need for integrity when making tax decisions.

The Oversight Board recognizes that no single initiative or program will solve the tax gap—a multi-faceted effort must be taken to shrink it. The plan must be more comprehensive than just applying additional resources to do more of what is being done today. Indeed as Commissioner Everson told the Senate Budget Committee, a combination of appropriate funding, legislative changes, new enforcement tools, tax simplification and auditing and taxpayer service improvements, will allow the IRS to collect an additional \$50-100 billion.¹⁴ The \$705 million in additional funding recommended by Board to help in this effort is dwarfed in comparison to this estimate of new revenues collected.

COMPARING THE PRESIDENT’S AND BOARD’S FY2007 BUDGET RECOMMENDATIONS

The size of the tax gap should be a clarion call for our nation to examine the tax administration system and invest time, energy, and resources to making it better.

This is not the time to stand still but to move forward in a comprehensive and unified way to build on what has already been accomplished and give America’s taxpayers a better, more efficient and fair system in return — what the President’s tax reform panel suggested. The Oversight Board’s FY2007 budget recommendations focus on the IRS resources needed to move forward in FY2007, but much more needs to be done.

To this end, the Board recommends additional investments in better service, enforcement, infrastructure and management, and BSM in the following amounts:

▪ Taxpayer Service	\$43,637
▪ Enforcement	\$367,768
▪ Infrastructure and Management	\$104,715
▪ BSM	\$188,600

Additionally, the Oversight Board has identified two areas of significant risk in the IRS’ FY2007 budget request. First, the IRS budget justification includes \$84.1 million in savings coming from program efficiencies. The Board is concerned that the IRS may not be able to achieve these efficiencies without decreasing performance.

Second, the proposed IRS budget for FY2007 in direct appropriations is supplemented by \$135 million in increased user fees. The IRS announced last December that it would charge taxpayers for receiving advance assurance from the IRS about the tax consequences of certain

transactions. For example, the fee for IRS Chief Counsel private letter rulings will increase from \$7,000 to \$10,000.¹⁵

The Oversight Board believes that there is risk in assuming that this revenue stream will be available without a proven record of collecting fees at this level, especially since the IRS could not present the Board with FY2006 data to confirm the realism of the proposed FY2007 revenue stream. The Board recommends that Congress evaluate actual FY2006 fee collection data to evaluate the validity of the proposed FY2007 revenue expected from increased fees.

The Board is also concerned about the negative impact these fees might have on taxpayer compliance. Testifying at the Board's annual public meeting, the AICPA was also apprehensive that these increases will result in a substantial reduction in general taxpayer use of critical IRS programs:

These programs for the most part encourage taxpayers to seek advance assurance from the IRS that the tax consequences of their proposed actions will be treated consistently by both the taxpayer and the IRS. Actions by the IRS that discourage use of programs, such as private letter ruling requests, could result in greater compliance costs for taxpayers and enforcement costs for the IRS.¹⁶

Customer Service: What Is “Good Enough?”

Good customer service leads to fully informed and satisfied taxpayers who understand their tax obligations and experience few problems in interacting with the IRS. Clearly, there is a linkage between customer service and compliance. Speaking at the Board's 2006 open meeting, Diana Leyden, Associate Clinical Professor of Law, University of Connecticut School of Law Tax Clinic said:

Customer service at the Internal Revenue Service has a direct impact on voluntary compliance and ultimately on the tax gap. For example: (1) making it easier for taxpayers to get their returns prepared free of charge and quickly encourages taxpayers to become compliant; (2) providing face-to-face interaction with IRS employees helps taxpayers get advice in 'real time' and usually reduces the time for resolution of problems.¹⁷

At the April 14, 2005 Senate Finance Committee hearing on closing the tax gap, Ranking Member Max Baucus similarly observed:

The IRS cannot close the tax gap simply by increasing enforcement. Issuing more liens. Conducting more seizures. Levying more bank accounts. We do need targeted, appropriate enforcement. If, however, the IRS lets taxpayer service slide – if the IRS diminishes the access and accuracy of taxpayer service – including the essential need for face-to-face taxpayer service – then we fail to help taxpayers comply with the law on the front end. Ensuring up front quality is more efficient than back end enforcement.¹⁸

However, efforts to provide quality customer service are hindered by the fact that there is no consensus among the tax administration community on desired customer service standards of performance, which makes informed decision-making about desired levels of service very difficult. Achieving such a consensus among the executive and legislative branches and external stakeholder organizations would allow customer service requirements to influence budget decisions rather than having budget decisions set service levels.

The drive for improved customer service is further aggravated by the lack of data on the impact that service levels have on taxpayer compliance. Such data could be used to make a stronger case to policy makers about the importance of customer services. We should not retreat from the high customer service levels previously achieved during FY2003/2004. Two initiatives contained in the Board's budget are designed to prevent such a reduction.

First, although significant progress has been made during the past five years, toll-free telephone level of service is slightly down from FY2004 and call wait-time on hold has increased. To restore the level of service, the Oversight Board proposes an initiative to restore the toll-free telephone service to FY2003/2004 levels. Although the cost is \$35 million, the Board believes that this level of service should be provided to taxpayers. The potential impact of lower service is that taxpayers will not get the assistance they need, hurting compliance, and creating a need for additional enforcement. As Senator Baucus rightly observed, preventing problems is more cost-effective than the price of future corrections, such as collection.

Second, the Board also recommends an \$8.7 million investment in telephone infrastructure to expand services to callers and provide telephone representatives with a more state-of-the-art call center environment. The IRS predicts this investment would result in lower queue times across the enterprise for all applications and would counter a negative trend in telephone service. (Wait time on hold for taxpayers has been increasing in the last three years. It has gone from 158 seconds in FY2004 to 258 seconds in FY2005, and the FY2006 target is 300 seconds.)

Enforcement Must Continue to Improve; More Research Needed

As noted earlier in this report, the IRS has boosted its enforcement activity, and enforcement revenue has increased during the last two years. The IRS is working smarter and it needs to continue to improve and build on this important trend.

However, it should be noted that despite these positive results, it is difficult to evaluate the impact that increased enforcement activity has had on overall taxpayer compliance.

Absent this information, the Oversight Board still believes that one important element of the campaign to reduce the tax gap should be increasing IRS enforcement resources, especially since the application of additional resources has a positive return on investment. The Board recommends a modest increase in enforcement resources in virtually all IRS enforcement activities, including:

1. **Combat Egregious Non-Compliance and Prevent Tax Gap Growth** (+\$136 million)
Add 748 FTEs to enhance coverage of high-risk compliance areas and address the tax gap associated with small business and self-employed taxpayers.
2. **Intensify Tax Enforcement** (+\$28 million)
Add 86 FTEs to curtail non-compliance in abusive schemes, corporate fraud, non-filers, employment tax and Bank Secrecy Act
3. **Attack Fraudulent Payments** (+\$27 million)
Add 62 FTEs to address fraudulent payments made through the EITC program.

The IRS must also do a better job of identifying where non-compliance is occurring. For example, IRS data indicates impressive results on abusive, high-profile tax shelters, such as Son-of-BOSS. However, the most recent research indicates that a majority of the tax gap is the result of underreporting of income in areas where there is little third-party reporting.

According to the IRS' National Research Program, half (\$109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent (\$56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining \$32 billion came from overstated subtractions from income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits.

Given this situation, the Oversight Board believes that special attention should be placed on the National Research Program and additional research be conducted on customer service and its relation to compliance. Indeed, the National Taxpayer Advocate "recommends that the IRS undertake a research-driven needs-assessment, from the taxpayers' perspective, to help identify what services taxpayers need and want and how best to deliver them."¹⁹ These efforts are necessary to improve tax administration to the point where the effects of IRS activities on taxpayer compliance can be better understood. To this end, the Board proposes two research initiatives: (1) Improve Tax Gap Estimates (+\$46 million); and (2) Additional Customer Service Research (+\$15 million).

The first of these two initiatives, Improve Tax Gap Estimates, will establish permanent staffing for the NRP program and put the IRS on a path to conducting research annually. The Oversight Board recommends that the NRP be made a permanent program. The NRP is now reporting estimates of the tax gap based on 2001 tax returns. Prior estimates were based on extrapolations of 1988 data. It is time to progress from "catching up" to making current research the normal and preferred way of doing business.

The Board also proposes that the IRS consider developing a long-range strategic plan for research that goes beyond the current 2009 end date for the IRS Strategic Plan, and covers approximately a decade. In such a plan, the IRS should describe how it will bring its research on all taxpayer segments up to date, and perform a limited sample every year so that its research on all segments will be as current as possible.

The Board believes the availability of up-to-date research data will allow the IRS to more effectively focus its service and enforcement programs on areas that have the greatest impact on taxpayer compliance, and use the changes in taxpayer compliance rates as feedback to evaluate the effectiveness of IRS' service and enforcement program on actual taxpayer compliance. Achieving such a capability will be a vast improvement over the current situation in which the lack of data makes it virtually impossible to evaluate the effectiveness of IRS activity on taxpayer compliance and make informed decisions.

The second research initiative recommended by the Board is to add \$15 million to begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers. The need for such research is also consistent with recommendations made by Treasury Inspector General for Tax Administration and the National Taxpayer Advocate in testimony last year to the Senate Appropriations Committee on the closing of a number of Taxpayer Assistance Centers. (The committee has also requested TIGTA to evaluate the connection between service and compliance in its study of TAC closings, but TIGTA was unable to find much existing research.)

However, the IRS has told the Oversight Board that it could extend and update research efforts in two major areas: evaluating the service needs of taxpayers and estimating the effect of customer service on taxpayer compliance. Additional resources in FY2007 would be used to

further evaluate the service needs of taxpayers and to scope and design the data gathering and analysis capability to estimate the effect of customer service on taxpayer compliance.

A modest initial effort should include identifying promising areas of research and determining data needs. If the initial efforts are promising, this could be expanded in future years. Due to the long-term nature of these studies, resources should be provided on a multi-year basis.

Modernizing Infrastructure and Management

The Oversight Board is pleased that the IRS is developing an IRS Infrastructure Roadmap. It is a detailed plan for replacing the agency's aging IT equipment in an orderly and cost-effective manner. Rather than replacing outdated equipment on a one-for-one basis, the roadmap will identify and prioritize opportunities to consolidate equipment, retire redundant and low-demand infrastructure components, and replace old equipment with new technology that is cheaper to maintain and use. Because the IRS fully anticipates that the Infrastructure Roadmap will identify new strategies for IT infrastructure delivery that will mitigate the cost of replacing old IT equipment while assuring a sound IRS IT infrastructure, the Board is deferring any recommendations on modernizing IT infrastructure until FY2008.

The Oversight Board does recommend funding infrastructure and management initiatives that will assist the IRS to cope with unfunded mandates, implement BSM projects, and restore its capacity for leadership development training to FY2003 levels:

1. Fund Business Unit IT Solutions (Non-Major Investments)
2. Implement e-Travel
3. Fund HR Connect
4. Consolidate Philadelphia Campus (included in the President's budget)
5. Restoration of Leadership Development Training to FY2003 levels (Board-initiated)

The Board notes that a lack of leadership training capacity at the IRS is especially critical during a period in which approximately 50 percent of IRS managers are eligible for retirement. The Board recommends a consistent budget base to allow planning for these anticipated leadership development training needs.

The requested funds would enable the IRS to: (1) eliminate the backlog of untrained leaders at all levels by the end of FY2007; (2) ensure enough capacity to train new managers upon selection in all Business Units; (3) improve and expand readiness programs to provide a cadre of manager candidates to step up to management positions; (4) revise the management curriculum to incorporate more e-learning and promote continuous learning; and (5) evaluate the effectiveness and impact of the leadership development training program.

Funding Leadership Development Training at FY2003 levels will also assist in meeting the objectives of the President's Management Agenda, which in turn will improve performance and the IRS' objectives of enhanced employee engagement, employee satisfaction and customer satisfaction.

Business Systems Modernization

The Board is pleased that the IRS' once-troubled BSM program experienced better performance in FY2005. In a recent report submitted to Congress on the BSM FY 2006 expenditure plan, the Government Accountability Office offered these positive comments:

IRS has made further progress in implementing BSM...Future BSM project deliveries face significant risks and issues which IRS is addressing....IRS has made additional progress in addressing high-priority BSM program improvement initiatives. [They] appear to be an effective means of assessing, prioritizing, and addressing BSM issues and challenges...In response to our prior recommendations, IRS reports having efforts under way to develop a new Modernization Vision and Strategy to address a new modernization roadmap.²⁰

GAO also had some criticism of the IRS and BSM, but improved management focus over the past few years has helped the BSM program deliver within cost and budget targets important technology projects that will generate greater efficiencies throughout the agency and real world benefits for taxpayers.

The first taxpayers have already been moved to a modernized data base known as the Customer Account Data Engine (CADE) and corporate taxpayers are now able to file their income tax returns with the IRS electronically using the Modernized e-File system. Indeed, CADE will process more than 30 million returns in 2007 and will process 70 million by 2009. Daily updates by CADE will allow taxpayers to receive their refund in just a few days.

Future BSM deliverables are also critical to improved customer service and enforcement. The IRS does not yet offer products and services familiar to customers of many financial institutions, such as daily updating of accounts, electronic access by customers to account records, and a full range of electronic transactions. However, with the help of modern technology, the IRS can close this gap.

If the IRS can continue to demonstrate improvement, it would seem desirable and logical to increase BSM's pace and program funding in FY2007, especially as BSM funding levels were severely reduced in the last several years: from \$388 million in FY2004 to \$203 million in FY2005, and a requested \$199 million in FY2006. In addition to the base, the Board would fund:

1. Web-based Self-service (+\$24 million)
2. Filing and Payment Compliance (+\$30 million)
3. Modernized e-Filing (+\$70 million)
4. Customer Account Date Engine (+\$25 million)
5. Core Infrastructure (+\$18 million)
6. Architecture, Integration, and Management (+\$13 million)
7. Management Reserve (+\$9 million)

Therefore, the Board recommends that the BSM program move forward at an accelerated pace. Not only will this allow the IRS to operate more efficiently and effectively, it will strengthen the agency's efforts to enforce the tax law and improve customer service. Despite productivity improvements in recent years, the IRS is still hampered in its efforts to modernize because of its reliance on a forty-year-old information system for its central recording-keeping functions, which limit the IRS to weekly updates of its central taxpayer records. No modern financial institution in the private sector could survive under these conditions, and eliminating these limitations is key to making the IRS an efficient and effective modern financial institution.

We would like to make one last point on modernization. Both GAO and TIGTA have reported on the cost overruns and delays the BSM program has experienced. However, one cost you will

not hear about is the significant cost to the taxpayers of delaying the benefits of a modernized IRS.

Professor Joel Slemrod of the University of Michigan testified to the President's Advisory Panel on Federal Tax Reform that individual taxpayers spend approximately \$85 billion a year complying with the tax code.²¹ If a modernized IRS makes taxpayers only five percent more efficient, that would still save taxpayers over \$4 billion a year.

CONCLUSION

The IRS Oversight Board believes that it has constructed a fiscally responsible and realistic budget for the IRS that meets national needs and priorities. It would help shrink the tax gap while providing taxpayers with a level of service they rightly deserve and need. It would speed the modernization of the IRS' antiquated technology and give it the research tools to better understand current and developing trends. Most importantly, it would maintain that delicate but critical balance between enforcement and customer service that America's taxpayers have said time and again they want. The IRS is now solidly on the right track and is making progress but we must give it the resources to do its job. It is an investment we must make for this and future generations of taxpayers.

Appendices:

- 1. Comparison of the Administration's IRS FY2007 Budget Request and IRS Oversight Board Recommendation**
- 2. Recommended FY2007 Program Increases: Enforcement**
- 3. Recommended FY2007 Program Increases: Taxpayer Service**
- 4. Recommended FY2007 Program Increases: Infrastructure and Management Modernization**
- 5. Recommended FY2007 Program Increases: Business Systems Modernization**
- 6. Explanation for Difference in IRS Oversight Board Budget in the Administration's FY2007 Budget Request and this Recommendation**

Appendix 1:
Comparison of the Administration's IRS FY2007 Budget Request and IRS Oversight Board Recommendation

Final Board Budget	Board's budget	President's Budget	Difference
	(all dollars in thousands)		
FY2006 Enacted budget (with 1% rescission)	\$10,573,706	\$10,573,706	\$0
FY2007 Maintaining Current Levels (MCLs) Adjustments (includes HITCA)			
Labor Annualization	\$61,994	\$61,994	\$0
Labor MCL (2.7 %)	\$149,819	\$149,819	\$0
Non-Labor MCL (1.5 %)	\$60,418	\$60,418	\$0
Total MCL Adjustments	\$272,231	\$272,231	\$0
Base Reinvestment			
Increase Returns processing efficiencies	\$12,237	\$12,237	\$0
Program Cost Savings			
E-file savings	(\$6,760)	(\$6,760)	\$0
Improvement project savings	(\$8,215)	(\$8,215)	\$0
competitive sourcing savings	(\$17,000)	(\$17,000)	\$0
program efficiencies	(\$84,121)	(\$84,121)	\$0
HITCA program efficiency	(\$5,500)	(\$5,500)	\$0
Total Savings and Reinvestments	(\$121,596)	(\$121,596)	\$0
Transfer Out to TIGTA	(\$941)	(\$941)	\$0
Total, FY2007 Current Service Level	\$10,735,637	\$10,735,637	\$0
Program Increases			
Tax Administration Operations			
Taxpayer Service	\$43,637	\$0	\$43,637
Enforcement	\$367,768	\$0	\$367,768
Infrastructure and Mgt Modernization	\$104,715	\$20,900	\$83,815
Business Systems Modernization	\$188,600	(\$29,700)	\$218,300
Total, Program Increases Above FY2006 Current Service Level	\$704,720	(\$8,800)	\$713,520
Total, FY2007 Operating Level	\$11,440,357	\$10,726,837	\$713,520
Fee Adjustment	(\$135,000)	(\$135,000)	
FY2007 Budget Appropriation Request	\$11,305,357	\$10,591,837	\$713,520
Growth Over FY2006 Enacted Budget	\$731,651	\$18,131	\$713,520
Percent Growth	6.9%	0.2%	

Appendix 2:
Recommended FY2007 Program Increases: Enforcement
(In \$/thousands)

Enforcement Program Increases	Total	Enforcement-Related	Service-Related
Combat Egregious Non-Compliance and Prevent Tax Gap Growth This initiative provides an increase of 748 FTE and \$135.5 million to enhance coverage of high-risk compliance areas as well as address the tax gap associated with small business and self-employed taxpayers.	\$135,518	\$132,696	\$2,822
Increase Individual Taxpayer Filing and Payment Compliance The initiative provides 84 FTE (87 positions) and \$8 million to support the IRS' enforcement presence through contracts with Private Collection Agencies (PCAs) for Qualified Tax Collection Contracts.	\$7,773	\$6,968	\$805
Detect and Deter Non-Compliant Enterprise Structures This initiative provides an increase of 200 FTE (400 positions) and \$37 million to increase the coverage of the flow-through population, including examination of controlling enterprise entities, that are posing significant compliance risks.	\$37,008	\$37,008	
Increase Individual Taxpayer Reporting Compliance This initiative provides an increase of 100 FTE (125 positions) and \$10.8 million to enable the Automated Underreporter (AUR) program to address reporting compliance in a program that is effective, efficient, less labor intensive and less costly.	\$10,821	\$8,808	\$2,013
Enhance Enforcement in the Tax-Exempt and Governmental Sectors This initiative requests an additional 69 FTE (138 positions) and \$12,940,668 to improve detection of compliance risks, accelerate enforcement actions, and balance the pursuit of critical enforcement initiatives while maintaining adequate coverage of the exempt community.	\$12,941	\$12,941	
Intensify Tax Enforcement This initiative requests an increase of 86 FTE (172 positions) and \$27.6 million to curtail non-compliance in the following areas: abusive schemes, corporate fraud, non-filers, employment tax and Bank Secrecy Act (BSA).	\$27,570	\$27,570	
Attack Fraudulent Payments This initiative, which provides an increase of 62 FTE (123 positions) and \$27 million, relates directly to the President's Management Agenda Program Initiative "Eliminating Improper Payments," and also supports the IRS' strategies for addressing erroneous payments and non-compliance involving Earned Income Tax Credits (EITC).	\$26,998	\$26,837	\$161
Improve Compliance With the Bank Secrecy and PATRIOT Acts This initiative provides an increase of 124 FTE (248 positions) and \$25.9 million to improve the Bank Secrecy Act (BSA) compliance program.	\$25,858	\$25,858	
Strengthen Regulatory Compliance This initiative provides an increase of 38 FTE (76 positions) and \$6.6 million to strengthen regulatory compliance activities to deter fraud, abuse, and terrorist financing in the tax exempt and governmental entities community.	\$6,616	\$6,376	\$241
Improve Enforcement of Circular 230 This initiative provides an increase of 8 FTE (16 positions) and \$4.1 million to detect and address tax practitioner misconduct. The IRS, Treasury, and Congress are placing increased	\$4,104	\$4,104	

emphasis on practitioner misconduct by providing new statutory and regulatory tools to address abusive behavior.			
Improve Tax Gap Estimates, Measurement and Detection of Non-Compliance Supports 268 FTE (536 positions) and \$45.9 million to fund and support ongoing Reporting Compliance Studies through the National Research Program.	\$45,942	\$45,942	
Study EITC Compliance This initiative provides an increase of 49 FTE (65 positions) and \$6.8 million to develop estimates of Earned Income Tax Credit compliance.	\$6,822	\$6,822	
Improve Compliance Through Data-Driven Workload Identification This initiative provides an increase of 67.5 FTE (90 positions) and \$4.8 million to develop and test decision analytical tools and models for improved identification of high-risk filers.	\$4,796		\$4,796
Customer Service Research Begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers.	\$15,000	\$15,000	
Subtotal Enforcement	\$367,768	\$356,931	\$10,837

Appendix 3:
Recommended FY2007 Program Increases: Taxpayer Service
(In \$/thousands)

Taxpayer Service Program Increases	Total	Enforcement-Related	Service-Related
Increase Accounts Management Efficiencies Provides funding to improve the telephone infrastructure, e.g., Compliance Services and Accounts Management call centers, by expanding services to customers and providing telephone representatives with a more state-of-the-art center environment and providing taxpayers with improved service through multiple access channels. Enterprise queuing will eliminate the queuing of calls at the local level and be queued at the enterprise level, reducing taxpayer wait times.	\$8,657		\$8,657
Restore Customer Service to FY2004 levels Supports 450 FTE from W&I to restore telephone level of service back to 87.3 percent achieved in FY2004 rather than the current 82 percent target. Improves TE/GE service measures for EP and EO determination timeliness, CAS toll-free level of service, correspondence timeliness measures to FY2004 levels.	\$34,980		\$34,980
Subtotal: Taxpayer Service	\$43,647		\$43,647

Appendix 4:
Recommended FY2007 Program Increases: Infrastructure and Management Modernization
(In \$/thousands)

Infrastructure and Mgt Modernization Program Increases	Total	Enforcement-Related	Service-Related
Expand IT Security - Personal Identity Verification This initiative requests an increase of \$20 million to ensure IRS' compliance with Homeland Security Policy Directive -12 (HSPD-12) and Federal Information Processing Standards-201 (FIPS-201).	\$20,000	\$12,576	\$7,424
Close Financial Management Material Weaknesses - Custodial Detail Data Base This initiative provides \$4.7 million to develop the CFO Custodial Detail Data Base (CDDDB) which will establish the foundation for building an IRS-modernized custodial financial management system.	\$4,743	\$2,982	\$1,761
Fund Modernization Information Systems (Major Investments) O&M This initiative will result in modernized information systems to improve enforcement activities.	\$15,000	\$9,432	\$5,568
Fund Business Unit IT Solutions (Non-Major Investments) O&M This initiative provides an increase of \$15 million for the successful transition of Business Systems Modernization (BSM) projects to the Current Production Environment (CPE), funding their operations and maintenance as they move to full production.	\$9,972	\$7,121	\$2,851
Implement e-Travel Treasury has mandated that IRS must implement eTravel by October 1, 2006.	\$10,000	\$6,288	\$3,712
Fund HR Connect The initiative requests \$11.9 million in FY 2007 to fully fund the additional Operations and Maintenance cost associated with the HR Connect system that the IRS has implemented and is billed through the Treasury's Working Capital Fund.	\$11,900	\$7,482	\$4,418
Consolidate Philadelphia Campus	\$20,900	\$14,215	\$6,685
Restoration of Leadership Training to FY2003 levels The requested funds would enable the IRS to: (1) eliminate the backlog of untrained leaders at all levels by the end of FY2007; (2) ensure enough capacity to train new managers upon selection in all Business Units; (3) improve and expand readiness programs to provide a cadre of manager candidates to step in to management positions; (4) revise the management curriculum to incorporate more e-learning and promote continuous learning; and (5) evaluate the effectiveness and impact of the leadership training program.	\$12,200	\$7,564	\$4,636
Subtotal Modernization	\$104,715	\$67,660	\$37,055

Appendix 5:
Recommended FY2007 Program Increases: Business Systems Modernization
(In \$/thousands)

Business Systems Modernization Program Increases	Total
Web-based Self Service Identify and design initial set of internet self-service applications.	\$24,200
Filing & Payment Compliance (F&PC) Completes delivery of full capability needed to support Private Collection Agencies.	\$30,000
Modernized e-file (MeF) Funds development, testing and deployment of modernized electronic filing for Form 1040.	\$70,200
Customer Account Data Engine (CADE) Process 33 million returns for the FY2007 filing season.	\$25,000
Core Infrastructure Projects Improve the facilities which allow pre-deployment testing and integration of modernized systems, which help ensure modernized systems will operate as needed when they are deployed.	\$17,900
Architecture, Integration & Management Ongoing support and improvements to BSM's program with planning, engineering, and management activities.	\$12,800
Management Reserve	\$8,500
Subtotal BSM	\$188,600

Appendix 6:

Explanation for Difference in IRS Oversight Board Budget in the Administration's FY2007 Budget Request and this Recommendation

After the Board-approved budget is submitted to the Department of Treasury, it is reviewed and modified by both the Treasury Department and the Office of Management and Budget (OMB) before being incorporated into the President's budget. During the first several years of IRS Oversight Board operation, the Treasury Department would inform the Oversight Board of changes as the IRS budget progressed through the formulation process. However, for the past two years, the Treasury Department has taken the position that although RRA98 provides the Oversight Board with the responsibility of reviewing and approving the budget request prepared by the Commissioner and submitted to the Department of the Treasury, this authority does not include participating in subsequent budget decision adjustments and formulation of the President's Budget.

Consequently, changes in IRS requirements that occur after the Board approves the IRS budget are not provided to the Board, and can only be considered by the Board when the President's budget is made available to the public. The Board adjusted its previously approved budget to account for the following circumstances:

- The Board's initial FY2007 budget was based on the FY2006 President's request, not the enacted appropriation, and is adjusted to use the FY2005 enacted level as the base.
- The inflation factors for labor and non-pay inflation were not known to the Board when it first approved the IRS budget, and are adjusted to reflect the lower base as well as changes in rates.
- The IRS budget submitted to the Board identified approximately \$15 million in savings, which the Board approved. During subsequent reviews with the Treasury Department and OMB, the IRS identified an additional \$106 million in savings, for a total savings of \$121 million. The Board's budget is adjusted to reflect these additional savings, despite the Board's assessment that they may represent some risk.
- The IRS budget submitted to the Board did not identify any fee offsets, which were not yet authorized by Congress. The Board's budget is adjusted to reflect these offsets.
- The budget is adjusted to reflect the development of an IRS Infrastructure Blueprint to define a cost-effective approach to meeting IRS infrastructure needs and the elimination of the need to fund Kansas City growth in FY2007.

Endnotes

- ¹ The President's budget includes on pages IRS-127 to IRS-129 of the Congressional Justification, as required by law, a copy of the FY2007 IRS budget the Oversight Board approved and submitted to the Department of the Treasury. The Board's recommended budget, as show on these pages, is higher than the request shown above; Appendix 6 provides an explanation of the differences.
- ² Statistics provided to the Oversight Board by the IRS.
- ³ Professor Claes Fornell, "ACSI Commentary: Federal Government Scores", December 15, 2005.
- ⁴ IRS Oversight Board, 2005 Taxpayer Attitude Survey.
- ⁵ Comptroller General David Walker, Testimony Before the Senate Budget Committee, "Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions," February 15, 2006, GAO-06-453T.
- ⁶ Nina E. Olson, National Taxpayer Advocate, Testimony Before the Senate Subcommittee on Federal Financial Management, Government Information, and International Security Committee on Homeland Security and Governmental Affairs, October 26, 2005
- ⁷ Tax Notes, February 16, 2006
- ⁸ Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America*, Harvard University Press, 2005. p. 278.
- ⁹ Al Crenshaw, "Letting Cheaters Prosper," *Washington Post*, April 14, 2004.
- ¹⁰ Statement by the Members of the President's Advisory Panel on Federal Tax Reform, "America Needs a Better Tax System," April 13, 2005.
- ¹¹ National Taxpayer Advocate, "Testimony Before the Senate Budget Committee, Causes and Solutions to the Federal Tax Gap," February 15, 2006.
- ¹² IRS Commissioner Mark Everson, Testimony Before the Senate Budget Committee, February 15, 2006
- ¹³ Everson, *op.cit.*
- ¹⁴ Tax Notes, *Everson Says IRS Could Collect Up To \$100 Billion More Per Year*, February 16, 2006
- ¹⁵ IRS Press Release, "IRS to Raise Some User Fees in 2006," IR-2005-144, December 19, 2005.
- ¹⁶ AICPA, "Statement Presented to the IRS Oversight Board, "Meeting the Customer Service Needs of Taxpayers and the Importance of Measures", February 8, 2006.
- ¹⁷ Statement of Diana Leyden, Associate Clinical Professor of Law, University of Connecticut School of Law Tax Clinic Before the IRS Oversight Board, February 8, 2006.
- ¹⁸ Senator Max Baucus, Opening Statement, Senate Finance Committee, Hearing, April 14, 2005.
- ¹⁹ The National Taxpayer Advocate, 2005 Annual Report to Congress, Executive Summary, p. I-1.
- ²⁰ General Accountability Office, Report to Congress, "Business Systems Modernization: Internal Revenue Service's Fiscal Year 2006 Expenditure Plan," February 2006, GAO-06-360, pp. 2-3.
- ²¹ Statement of Professor Joel Slemrod, University of Michigan Ross School of Business, before the President's Advisory Panel on Federal Tax Reform, March 3, 2005.