DEPARTMENT OF THE TREASURY

Treasury Inspector General for Tax Administration

TESTIMONY

IMPLEMENTATION OF THE IRS RESTRUCTURING AND REFORM ACT OF 1998

JOINT HEARING BEFORE COMMITTEES OF THE

UNITED STATES SENATE

AND

UNITED STATES HOUSE OF REPRESENTATIVES

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STATEMENT FOR THE RECORD

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Mr. Chairman and distinguished members of the House and Senate Committees, I appreciate this opportunity to appear before you to discuss the progress the Internal Revenue Service (IRS) has made in implementing the IRS Restructuring and Reform Act of 1998 (RRA 98). In last year's testimony, I committed my organization to timely and accurately reporting on the IRS reforms and making recommendations to improve the direction and pace of progress. Today, I will report to you on the results of our work.

Internal Revenue Service Challenges and Accomplishments

Three of the more significant challenges for the IRS involve restructuring the organization, modernizing computer systems, and improving customer service. The RRA 98 requires the IRS Commissioner to reorganize the IRS around groups of taxpayers with similar needs and to plac a greater emphasis on serving taxpayers and meeting their needs. The IRS' modernization process includes both restructuring the organization to better meet taxpayer needs and developing new technology to replace deficient and obsolete systems. Although this is a long-term effort, there is broad consensus for the IRS' plan to transform itself, while continuing to implement tax law changes, collect approximately $2.1 trillion in tax revenue, and improve customer service.

Since July 1998 when the RRA 98 was enacted, the IRS has involved itself deeply in modernizing its operations and procedures and has made progress in its restructuring efforts. For example, as of October 1, 2000, the IRS substantially completed the stand-up of its four customer-focused business units. In addition, considerable emphasis has been given to protecting taxpayers' rights and, as a result, the IRS is either in full compliance or is taking action to become compliant in the specific taxpayer rights provisions that the Treasury Inspecto General for Tax Administration (TIGTA) is required to report on annually.

In the RRA 98, the Congress stated that the IRS should have a plan to increase electronic filing and also established a goal that at least 80 percent of all federal tax and information returns should be filed electronically by 2007. To help achieve this goal, the IRS continues to increase the number of tax forms that taxpayers can file electronically. More than 20 new forms (for electronic filing) were added in 2001, with an additional 38 to be added in 2002. The number of returns filed electronically and refunds deposited directly into back accounts have both increased during the 2001 filing season. In addition, the IRS began accepting electronic partnership returns in February 2001.

Although the number of electronic returns filed continues to increase, the IRS faces a significar challenge to meet the goal of 80 percent electronic filing by 2007. To achieve this goal, the IRS must increase the use of electronic filing an average of 19 percent per year for individual returr over the next several years. Despite IRS efforts to increase the number of returns filed electronically, the IRS is projecting annual increases ranging from only 7.4 to 2.8 percent for years 2004 through 2007.

The IRS must continue to address these challenges as well as other issues that surface in its organizational restructuring to provide first-rate customer service and ensure compliance with the tax laws.

Organizational Restructuring

As stated previously, on October 1, 2000, the IRS achieved a significant milestone toward modernization by putting into effect (or standing up) a new organizational structure. The four major components of the new IRS are the Wage and Investment (W&I) Division, the Small Business/Self-Employed (SB/SE) Division, the Large and Mid-Size Business (LMSB) Division and the Tax Exempt and Government Entities (TE/GE) Division.

The stand-up of the new business unit structure was an important step in the IRS' restructuring though it is far from the last step of this long-term endeavor. The next phase must continue to address management and operational issues surrounding its organizational restructuring, such as revised management information systems designed to support the new organizational structure; taxpayer access to walk-in and toll-free telephone services; accuracy of responses provided to taxpayers; the ability to hire, train, and retain a qualified workforce; and the decline in enforcement rates.

TIGTA audits showed that all four business units substantially completed the five critical elements needed for standing up. Specifically, most key management positions were filled, mo employees were realigned, finance offices and budgets were established, many delegations of authority were revised, and detailed plans of workarounds were developed. However, additiona actions were needed in the area of staffing unfilled positions in the W&I Division, enhancing the TE/GE Division's oversight and control of its modernization initiatives, and coordinating a long-term strategy to place remaining SB/SE Division's transition employees in permanent positions

In addition to these four new operating divisions, the IRS' Criminal Investigation (CI) function substantially completed the requirements for operation when it stood up on July 2, 2000. The C function has also made significant progress in completing the recommendations in the report o Judge William Webster's Review of the Criminal Investigation Division (Webster Review). However, the CI function still needs to take additional steps to ensure all Webster Review initiatives are implemented, that special agent search warrant activities are appropriately monitored, and resources are effectively shifted to legal source tax violations (as opposed to illegal source violations, such as narcotics).

The IRS' Taxpayer Advocate Service, which assists taxpayers in resolving problems with the IRS that cannot be resolved through normal systemic processes, stood up on March 12, 2000. Local taxpayer advocates now report directly to the National Taxpayer Advocate and are independent of any local IRS official. In January 2001, the IRS expanded caseworkers' delegated authorities to include account adjustments, which should enable them to resolve issues rather than referring such matters to other functions in the IRS.

The IRS Appeals function, which is the alternative dispute resolution program for taxpayers contesting a compliance action taken by the IRS, stood up on August 13, 2000. The Appeals function reorganized its staffing into operating units that align with the larger IRS operating divisions.

Despite the successful stand-up, the transition to the new operating divisions and the process changes required to implement certain taxpayer rights provisions of the RRA 98 have adversel impacted the IRS. For example, for the taxpayer rights provisions we reviewed, new procedure were written, new forms and notices were prepared, and training provided, often extending pas the effective date of the provisions. The average Internal Revenue Manual change took over 9 months. In the interim, some employees did not have adequate procedures to follow to ensure compliance with the law. Additionally, new procedures were not always adequately tested with field personnel before implementation to determine the impact on casework processing. These problems caused confusion and delayed processing.

In addition, the transition to the new operating divisions and the implementation of the required process changes delayed some enforcement actions. The overall decline in enforcement actions has been primarily attributed to a long-term decline in enforcement staffing, to redirection of the staff to customer service functions during the filing season, and to IRS employees' concerns over the mandatory termination provision in Section 1203 of the RRA 98.

Moreover, current information technology systems have not been reprogrammed to provide IR executives the management information they need to make decisions in the IRS' new operatin environment, which focuses on serving distinct taxpayer market segments. For example, IRS compliance management information systems will not fully reflect the new organizational structure in the SB/SE Division until at least early in 2002. The IRS' Master File does not segment tax account data by operating division, nor will this capability be provided in the foreseeable future. Executives rely on the information generated from these systems to plan, execute, and evaluate programs. Until this realignment of management information is achieved executives may not have all the data they need to effectively manage resources and evaluate whether taxpayers are receiving the best service possible.

Systems Modernization

The IRS' modernization concept and plans are heavily dependent on new technology to update its computer systems. The IRS has made significant progress towards establishing its governance structure and processes to support and oversee the modernization of its computer systems. The Business Systems Modernization Office was created to manage modernization efforts and the risks inherent with an undertaking of this size and complexity. Although there were initial difficulties, the IRS has addressed them by clarifying the roles and responsibilities f both the IRS and the PRIME contractor. The IRS is primarily responsible for acquisition and oversight of the contractor, and the PRIME contractor is responsible for building and delivering the systems that meet the IRS' needs and requirements. The IRS also adopted a performance-based contracting process, which includes plans to provide incentives for the contractor to deliver quality products on time and within budget.

Another major accomplishment is the completion of the first version of the enterprise architecture, known as Blueprint 2000. The purpose of the enterprise vision and of the architecture is to set forth a high-level, complete picture of how the future business systems wil operate and how they will fit together. The IRS also finalized a disciplined process to be followe in developing modernized systems, called the Enterprise Life Cycle (ELC). The definition of the future architecture (Blueprint) and the ELC processes are essential if the IRS is to fully succeec in modernizing its systems.

To further enhance IRS operations, TIGTA has recommended to IRS management the need fo all systems development activities to be consolidated and monitored under the Chief Informatic Officer (CIO). TIGTA believes that managing systems development initiatives outside the CIO's organization increases the risk of inconsistent and ineffective project management processes and fragmented systems modernization initiatives, which could lead to delays, cost overruns, and rework. The IRS has stated that the consolidation of all systems staff in the field under the CIO is scheduled for completion by October 1, 2001.

About $400 million has been spent on the current systems modernization initiative since it began about 2 years ago. While significant progress has been made, thus far, most of the ongoing systems modernization projects have taken longer and cost more than originally planned. Some contributing factors are that the IRS is in a steep learning curve in its systems modernization effort and that the roles and responsibilities of the IRS and the PRIME contracto were inadequately defined during the early phases of the modernization.

Because of these delays, the intended benefits to taxpayers have yet to be realized. For example, the IRS plans to dramatically improve the volume and routing of telephone calls received on its toll-free telephone service and to provide Internet access to determine refund and filing status. These benefits were originally scheduled to be implemented for the 2001 filinç season. However, they will not be fully implemented until the 2002 filing season or later. To meet the revised implementation dates, the IRS must define and complete a substantial amour of critical design requirements and development work.

The IRS will continue to face risks throughout the life of its technology modernization projects, and TIGTA will continue to assess the IRS' efforts. Thus far, TIGTA has identified six areas of concern that could have serious implications on the success of computer modernization efforts if they are not properly managed. These areas are:

- Potential funding problems.
- Problems implementing key systems development processes, such as the ELC, project management, configuration management, and risk management.
- Inappropriate sequencing of projects, e.g., projects are progressing towards developmen without having key foundational development efforts established to provide needed direction.
- Projects being over budget and behind schedule.
- Business needs not always being well defined.
- A lack of substantial tangible benefits delivered to taxpayers.

An example of a project that has experienced delays is the Customer Account Data Engine (CADE) project. The CADE project will incrementally replace the IRS' current taxpayer databases with new technology, applications, and databases. The new "data engine" provided by the CADE will lay a foundation for modernizing IRS systems and business processes. The CADE will allow employees to post transactions and update taxpayer account and return data from their desks. Updates will be immediately available to anyone who accesses data, which should enable the system to provide a complete, timely, and accurate account of the taxpayer's information.

The CADE project team was initially supposed to complete its planning phases in December 2000 for the initial release of the CADE project, which will store simple individual tax returns. This was later moved to March 2001, and has recently been moved again to an estimated completion date of May 15, 2001. As a result, this project will likely be delayed beyond the scheduled January 2002 release date.

Computer Security

The IRS maintains a significant amount of valuable and sensitive information. As such, computer security will continue to be a risk for the IRS. There are risks from within (e.g., unethical employees who have improperly viewed and manipulated taxpayer records) as well a external threats (e.g., potential incidents such as defacement of public web pages, manipulatio of computer software coding, and the theft of taxpayer account information). In response to these risks, TIGTA maintains an approach to overseeing the IRS' computer security efforts tha addresses detection and prevention activities.

Over the past several years, TIGTA has recommended that the IRS improve controls in its computer systems to safeguard confidential taxpayer information from unauthorized employee accesses because the IRS continues to have difficulty protecting such information from misuse Recent TIGTA audits have identified significant security weaknesses in other areas, such as:

- Intrusion detection.
- Disaster recovery.
- Physical security of facilities and systems.
- Certification of security controls for sensitive systems.

To address unauthorized access to taxpayer information by employees, TIGTA uses computer technology and forensic data analysis techniques to investigate unauthorized access leads identified by detection criteria and complaints received by field special agents. Since 1997, the number of unauthorized access to tax information (UNAX) violations identified and investigated has continued to remain relatively constant, although the number of resignations and terminations has increased each year. TIGTA has initiated 1,546 investigations since 1997 for apparent UNAX violations, which have resulted in 448 resignations or removals and 74 successful criminal prosecutions.

TIGTA is also working closely with the IRS to develop a cadre of computer specialists and criminal investigators who will rapidly respond to computer intrusion incidents, investigate IRS network problems when indicators of intentional disruption are present, and conduct recurring systems penetration tests to detect new vulnerabilities.

2001 Filing Season

The filing season impacts every American taxpayer and is, therefore, always a highly critical program for the IRS. Many programs, activities, and resources have to be planned and managed effectively for the filing season to be successful. The processing changes for the 200 filing season included the Third Party Authorization Initiative, which provides a checkbox on individual returns to allow the designation of limited power of attorney.

Through April 27, 2001, the IRS has had a successful 2001 filing season. As of this date, approximately 118 million individual income tax returns were filed, and over 88 million of those were processed. Approximately 39.6 million (34 percent) of these returns were filed electronically, which is a 13 percent increase from last year. While this represents a significant increase, the IRS did not achieve its goal of 19.5 percent for this filing season. The average dollar amount of refunds issued was $1,711, up from an average refund of $1,624 last year. In addition, the number of refunds deposited directly into taxpayers' bank accounts increased by almost 15 percent from last year.

Customer Service and Tax Compliance

Providing top quality service to every taxpayer is integral to the IRS' modernization plans and strategic goals. There are many ways in which the IRS provides customer service, including tol free telephone service, electronic customer service, written communications to taxpayers, and walk-in service. Each of these services affects a taxpayer's ability to voluntarily comply with the tax laws. The IRS has also developed a web site that provides taxpayers with convenient access to tax forms and information. The web site recorded over 1.5 billion accesses during the 2001 filing season. The IRS anticipates 2.5 billion accesses to its web site in Fiscal Year (FY) 2002.

A great deal of work is needed to achieve the IRS' primary goal of providing quality customer service as a key to improving tax compliance. The underlying theory of much of the IRS' modernization is that the overall rate of voluntary compliance with the tax laws will increase if the IRS provides the right mix of education, support, and up-front problem solving to taxpayers. Through its modernization efforts, the IRS has embarked on a course to reengineer its busines processes and technology to focus on improving service to taxpayers, including processing returns and issuing refunds more quickly. In addition, telephone and Internet technology afford the IRS many opportunities to dramatically improve its customer service.

Although the IRS has made some strides in its use of technology, factors such as inadequate systems design and planning and human capital issues hinder some of the IRS' efforts to improve customer service. For example, the Electronic Tax Law Administration Program is intended to give taxpayers another way to communicate with the IRS. However, significant improvements are needed to raise the quality of answers. In a limited test during the 2000 filing season, the IRS responded correctly to 27 of the 50 SB/SE Division questions TIGTA submitte through the Digital Daily. Commercial web sites offering free tax advice provided correct answers only 47 percent of the time. Our analysis of response times showed that the commercial web sites provide responses faster than the IRS, although taxpayers were generall satisfied with the IRS' response times.

During our 2001 filing season audits, we identified the need for the IRS to improve the quality o answers to taxpayers. In a current review of the Tax Assistance Centers (i.e., walk-in sites) ove a 2-week period, 90 contacts were made with IRS assistors. In seven of these instances, service was denied to our reviewers (e.g., reviewers were merely provided forms or instructions or told no one was available to answer their questions). When service was provided, incorrect answers were provided 49 percent of the time, and insufficient answers were provided 24 percent of the time. Similarly, during a current review of the toll-free telephone system over a 4- day period, our reviewers were unable to talk with an IRS assistor 37 percent of the time and, when we did reach an assistor, we did not receive the service requested 47 percent of the time (e.g., reviewers were sometimes provided inaccurate or insufficient information, referred to publications or the IRS' Internet site without receiving an answer to the original question, or tolc an assistor was not available to answer a particular type of question).

Because the IRS has not conducted a Taxpayer Compliance Measurement Program audit sinc 1992, it currently has no reliable method to measure voluntary compliance or the effect that increased customer service and the diversion of compliance resources are having on voluntary compliance. However, one general indicator of voluntary compliance is revenue collected. IRS reports reflect that revenue receipts increased from $1.5 trillion in FY 1996 to $2.1 trillion in FY 2000. Despite this increase, revenue collected as a result of compliance activity decreased by $4.2 billion to $33.8 billion, and unpaid assessments have increased by 22 percent during this period. IRS management and many stakeholders have been concerned about the reductio in resources allocated to compliance activities and the related decrease in business results. To help address this issue, Treasury's FY 2001 budget submission included a request for 2,800 new positions over the next 2 fiscal years. These additional resources would be dedicated to enforcing tax laws and improving service to taxpayers.

Decreased enforcement has also been attributed to IRS employees' concerns over the mandatory termination provision in Section 1203 of the RRA 98. To help address these concerns, TIGTA has continued to brief the IRS staff on investigations related to Section 1203 violations. Also, TIGTA continues to be dedicated and involved with the IRS' efforts to comply with the legislative changes required by the RRA 98 through representation on an IRS task forc with the focus on Section 1203 processes.

Revenue Protection

The IRS must continually seek opportunities to protect revenue and minimize tax-filing fraud in its programs and operations. To meet this challenge, it has launched promising new complianc initiatives. One initiative involves a partnership with the Department of Health and Human Services (HHS) that will allow the IRS to periodically receive information contained in the HHS Federal Case Registry regarding child support. Another initiative involves a partnership with the Social Security Administration (SSA) to provide the IRS with Social Security Numbers (SSN) fo parents and individuals younger than 18 years old who have applied for a SSN. As a result of these partnerships, the IRS will be able to cross-check information regarding how the child is related to the taxpayer, the age of the child, and whether the taxpayer is the child's custodial parent.

In 2001, the IRS began checking all secondary SSNs, in addition to primary and qualifying chilc SSNs, on Earned Income Credit (EIC) returns. The IRS rejects returns if the names and numbers do not match SSA records. In a limited test of cases, the IRS had incorrectly disallowed the personal exemption and/or EIC in approximately 15 percent of the cases. The IRS immediately addressed this by revising its processing procedures for researching the taxpayer accounts before disallowing the exemptions or the EIC.

Despite its efforts to address EIC compliance, the EIC Program is a continuing concern for the IRS. An August 2000 IRS EIC compliance study reported that the amount of overclaims submitted was approximately $9.3 billion, or 31 percent of the amount claimed. The IRS' weaknesses related to the EIC are in three primary areas:

- Achieving full participation by eligible taxpayers.
- Ensuring compliance through verification of taxpayers' eligibility.
- Reducing inherent vulnerabilities (multiple use of dependent SSNs).

Despite extensive IRS programs and efforts to address certain refund schemes, relatively little effort has been made to systematically identify those schemes involving business returns and associated credits. A few business schemes have been identified, but it has generally been through labor intensive manual procedures. The IRS is concerned that fraudulent refund claims may be expanding to include business returns and that scheme perpetrators may be using the Internet or other means to promote and advertise their schemes.

Another area in which the IRS needs to significantly improve its compliance efforts is in the international taxpayer segment. The General Accounting Office and TIGTA have previously reported internal control and systemic weaknesses in the IRS' administration of its internationa programs. Improvements are needed in international compliance programs to focus on nonfilin transfers of assets by United States citizens to foreign trusts, foreign tax credit claims, and foreign-sourced income. A recent TIGTA audit found that the IRS is in no better position to determine taxpayers' compliance levels in reporting foreign-sourced income than it was in 1997

Taxpayer Protection and Rights

Although the IRS is not yet fully compliant with all of the RRA 98 taxpayer rights provisions that TIGTA has reviewed, it has made progress. Our audit work found that the IRS was fully or substantially compliant with the provisions involving seizures and notification requirements for levies. For other provisions, the IRS was continuing to take corrective actions to increase compliance with the RRA 98, including:

- Providing proper and timely notices for all federal tax liens.
- Timely consideration of innocent spouse relief claims.
- Fully eliminating the use of illegal tax protester designations.

The RRA 98 also placed restrictions on the IRS' use of enforcement statistics to evaluate employees or suggest production quotas or goals. TIGTA reported that most employee evaluations and management documents did not contain tax enforcement results and did not impose production quotas or goals; however, there were some instances in which these types enforcement statistics were used.

The IRS determined that it would not be able to comply with some deadlines imposed by the RRA 98 relating to the requirements to provide certain types of notices to taxpayers and asked the Congress for an extension. These requirements included detailed notices of interest assessed, penalties imposed, and annual statements for taxpayers with installment agreement The effective dates were extended by the Community Renewal Tax Relief Act of 2000 to June 30, 2001, for these notices and September 1, 2001, for the annual installment agreement statements. TIGTA is in the process of evaluating the actions taken by the IRS for these provisions.

Based upon TIGTA's statutory requirement to review determinations made by the IRS to deny Freedom of Information Act and Privacy Act requests, we determined that the IRS improperly withheld information from requesters in 10.7 percent of cases that were denied, partially deniec or categorized as no responsive record. The IRS did not respond timely in 20.1 percent of the cases reviewed. In addition, denied requests that were appealed were not always timely worked.

Regarding Collection due process, Appeals employees complied with legal requirements to protect taxpayers' rights when taxpayers appealed a lien or levy action taken by the IRS. However, we found that Appeals can improve customer service by timely contacting taxpayers and fully explaining the basis for the appeals determinations when responding to taxpayers on their requests for due process hearings.

TIGTA also assists in the protection of taxpayers and their rights by investigating allegations of misconduct by IRS employees. Since the passage of the RRA 98, TIGTA has received 1,152 complaints alleging Section 1203 violations. Shortly after Section 1203 became effective, there was an initial surge in what both the public and IRS employees thought were valid Section 120 violations but which did not meet the requirements of Section 1203. The IRS has provided both public and employee education in Section 1203 requirements. As a result, TIGTA is currently noticing a decline in the number of complaints it receives.

Consistently, since the enactment of the statute, the vast majority of Section 1203 complaints received by TIGTA have alleged an IRS employee violated a provision of the Internal Revenue Manual or Internal Revenue Code in order to retaliate against, or harass someone. The seconc category, by volume, involves constitutional and civil rights/Equal Employment Opportunity violations.

In addition to those received and investigated by TIGTA, the IRS also receives and adjudicates numerous Section 1203 allegations where no investigation is needed.

Strategic Planning and Budgeting

Within the last 2 years, the IRS has developed a Strategic Plan and provided budget justifications that include the Annual Performance Plan(s). Collectively, these documents satisf major requirements of the Government Performance and Results Act of 1993 (GPRA) by identifying the IRS' mission, strategic objectives, goals, and strategies. The documents also describe the IRS' priorities for the next 6 years and the key performance indicators (measures) used in assessing achievement of those goals.

The IRS Commissioner has indicated that it will take years to achieve a fully acceptable set of balanced measures that can be used at all levels of the organization. While the new operating units concentrate on implementing the new organizational structure, performance measures may not be a high priority. Based on our audits to date, TIGTA believes that the IRS can improve its measures, the data quality of its measures, and its reporting of annual accomplishments.

As part of its balanced measurement system, the IRS conducts surveys of taxpayers to gauge their satisfaction with various IRS customer services. The results of these surveys are also use for GPRA reporting purposes. The IRS conducted surveys in various functions, including the toll-free telephone, walk-in, collection, examination, and appeals operations. Our reviews of the controls and processes used in conducting these surveys indicated that survey data may not b statistically reliable. Specifically, the surveys did not always include all taxpayer interactions, th sampling methodologies did not ensure equal and unbiased opportunities for taxpayer participation, and the survey response rates were too low, thereby increasing the risk that the results may not be representative of the overall population.

In closing, it may be some time before we have conclusive evidence on the totality of the IRS' efforts to better protect taxpayer rights, modernize its systems and organization, and achieve a higher level of customer service. In this regard, my office will continue to review the progress made and problems encountered in implementing RRA 98 as part of our overall effort to promote economy, efficiency, and effectiveness in tax administration; detect and deter fraud ar abuse in IRS programs and operations; and, protect the IRS against external attempts to corru or threaten its employees.

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