HEARING BEFORE THE

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON APPROPRIATIONS SUBCOMMITTEE ON TRANSPORTATION, TREASURY, AND HOUSING AND URBAN DEVELOPMENT, THE JUDICIARY, DISTRICT OF COLUMBIA, AND INDEPENDENT AGENCIES

March 29, 2006

Washington, DC

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WRITTEN STATEMENT OF
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION
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BEFORE THE COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON TRANSPORTATION, TREASURY AND HOUSING AND URBAN DEVELOPMENT, THE JUDICIARY, DISTRICT OF COLUMBIA, AND INDEPENDENT AGENCIES
U.S. HOUSE OF REPRESENTATIVES
HEARING ON THE
INTERNAL REVENUE SERVICE'S FISCAL YEAR 2007 BUDGET
MARCH 29, 2006

Introduction

Chairman Knollenberg, Ranking Member Olver, and Members of the Subcommittee, I thank you for the opportunity to testify as you consider the Fiscal Year 2007 appropriations for the Internal Revenue Service (IRS). My observations today are primarily based on the body of work my organization has developed through audits and investigations of the IRS. To assist you in your consideration of the IRS' Fiscal Year 2007 budget, I will focus on some of the major challenges facing the IRS.

While the IRS continues to face longstanding challenges, it deserves recognition for making progress in an area that will always be a challenge: providing quality customer service to the American taxpayer. Providing quality customer service is the first component of Commissioner Everson's principle for the IRS, *Service + Enforcement = Compliance*. Over the past few years, TIGTA audits have shown that the IRS has improved customer assistance in its face-to-face, toll-free telephone, tax return processing, and electronic services, including the IRS public Internet site (www.IRS.gov). The accuracy of answers assistors provide to tax law and account inquiries has improved, access to the toll-free telephone lines has increased, tax returns are being processed on schedule, and refunds are being issued more quickly. Electronically filed (*e-filed*)[1] tax returns exceeded paper-filed tax returns for the first time during the 2005 Filing Season.[2] In addition, electronic services are increasing and more information is available online at IRS.gov.

However, the IRS faces challenges in meeting several taxpayer service goals and expectations, as well as in determining and providing taxpayers the levels and types of service they want or need. The IRS is reducing face-to-face services and encouraging taxpayers to use other, less costly services, such as the toll-free telephone lines and IRS.gov. With decreasing taxpayer service budgets, it is essential that the IRS determine

[1] *E-file* is a way to electronically file a tax return with the IRS using an authorized IRS e-file provider or personal computer.
[2] The Filing Season is the period from January through mid-April when most individual income tax returns are filed.

what the right mix of services might be (e.g., face-to-face or electronic, self-help or assisted).

While providing quality customer service is the IRS' first step toward achieving compliance, the IRS has conducted only limited research on the impact of customer service on taxpayer compliance. Currently, there are not sufficient data available to measure the effect on taxpayer compliance as services are reduced or redirected. Both the National Taxpayer Advocate and the Government Accountability Office (GAO) have also expressed concerns about this lack of data. As the IRS redirects taxpayers to electronic and self-help services, it needs to know what services taxpayers most need or want and whether the anticipated cost savings and efficiencies will result in an increased burden for taxpayers trying to remain or become compliant.

It is, however, encouraging to note that the IRS took numerous actions to provide broad relief to taxpayers affected by Hurricanes Katrina and Rita. These broad relief efforts included postponing deadlines for filing and payment, providing relief from interest and penalties, and waiving some low-income housing tax credit rules. The IRS also waived the usual fees, and expedited requests for copies of previously filed tax returns for affected taxpayers who needed them to apply for benefits or file amended tax returns to claim casualty losses.[3]

IRS employees also provided tax assistance at Federal Emergency Management Agency (FEMA) disaster assistance sites in a number of locations. Additionally, the IRS assigned 5,000 employees to augment Federal Government telephone call sites and provided additional employees to assist in approximately 34 FEMA disaster recovery centers in 13 States.

Challenges Facing the IRS

Each year TIGTA provides its perspective on the top management and performance challenges facing the IRS.[4] For Fiscal Year 2006, those challenges include, among others, providing quality taxpayer service operations and tax compliance initiatives. I will address these and other challenges individually in the remaining portion of my testimony.

Providing Quality Taxpayer Service Operations

Providing quality customer service to the taxpayer is not only a primary goal of the IRS, but it is also one of its major management challenges. The Commissioner has frequently stated that service combined with enforcement will result in compliance.

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[3] *Planning for the 2006 Filing Season Is on Course, but Challenges Exist for the Toll-Free Telephone Operations* (Reference Number 2006-40-053, dated February 2006).

[4] The Reports Consolidation Act of 2000 (31 U.S.C. § 5316(d)) requires that TIGTA summarize, for inclusion in the *Department of the Treasury Accountability Report* for each fiscal year, its perspective on the most serious management and performance challenges facing the IRS.

Quality taxpayer service includes helping the taxpaying public understand their tax obligations while making it easier to participate in the tax system.

Since the passage of the IRS Restructuring and Reform Act of 1998 (RRA 98),[5] the IRS' focus on customer service has led to many improvements. One of the goals of the IRS is to improve taxpayer service by improving service options, facilitating participation in the tax system by all sectors of the public, and simplifying the tax process. Every year, the IRS helps millions of taxpayers understand their tax obligations by answering questions on its toll-free telephone lines or in person at local offices, making information available on its web site, and responding to correspondence.

IRS.gov continues to be one of the most visited web sites in the world, especially during filing seasons. The IRS now provides practitioners with online tools to provide better service to their customers, such as electronic account resolution, transcript delivery, and disclosure authorization. The Free File Program, which provides and promotes free online tax preparation and *e-filing* through commercial tax return preparation companies, can be accessed through a link on IRS.gov. For the 2005 Filing Season, the IRS had accepted 5 million Free File Program returns, an increase of 47 percent from the prior year. There have been some changes to the 2005 Free File agreement. These changes include certain limitations on who is eligible to use Free File services. We are currently evaluating the impact of the changes.

In Fiscal Year 2005, over 22 million taxpayers successfully received their refund information online, an increase of almost 50 percent for the same period in Fiscal Year 2004. More than one-half of all taxpayers—over 68 million individual income tax returns—e-filed their tax returns in 2005, an increase of 11 percent. As a result, the IRS met its Fiscal Year 2005 goals for the number and percentage of individual tax returns e-filed.[6] However, as TIGTA reported in March 2004, the current rate of e-file growth is slowing and will not enable the IRS to meet its e-file goal of 80 percent by 2007.[7]

Additionally, the IRS provided taxpayers with effective access to its toll-free telephone system and realized productivity and efficiency gains during the 2005 Filing Season. Telephone assistors answered 14.8 million calls, 4 percent more than planned, using 95 percent of the planned resources. Furthermore, assistors answered more calls per full-time equivalent[8] compared to the 2004 Filing Season. Since the 2003 Filing Season, the IRS has experienced a steady decrease in the number of full-time equivalents budgeted for the toll-free telephone program. However, over the same time period, the number of calls answered per full-time equivalent has increased.

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[5] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

[6] *Taxpayer Service Is Improving, but Challenges Continue in Meeting Expectations* (Reference Number 2006-40-052, dated February 2006).

[7] *Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-filing* (Reference Number 2004-40-076, dated March 2004).

[8] A full-time equivalent is a measure of labor hours in which 1 full-time equivalent is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year.

Our last review of the accuracy of responses provided to tax questions received via the toll-free telephone lines was during the 2004 Filing Season. This Fiscal Year we are assessing whether the data in the quality measurement system used to report toll-free accuracy are valid and reliable. For Fiscal Year 2005, the IRS reported an accuracy rate of 89 percent for tax law and 91.5 percent for tax accounts. Tax law complexity contributes to the IRS' challenges in reaching these accuracy goals, as well as to taxpayers' frustrations as they attempt to decipher the tax code.[9]

Customer satisfaction surveys continue to show positive results. Callers were able to connect with the IRS more easily and received better, quicker service. Assistor availability, which measures the amount of time that assistors are idle or available to answer calls, declined 42 percent compared to the 2004 Filing Season. When Assistor availability is low, assistors' time is being productively used and the cost of providing toll-free telephone services decreases.

Over the past seven years, the IRS has made commendable strides in customer service. However, I am concerned that the IRS does not sufficiently ensure that it uses adequate and reliable data for making decisions that impact customer service operations. Recent decisions to close Taxpayer Assistance Centers (TAC) and reduce the hours of operation for toll-free telephone service were based primarily on input from IRS functional areas and considered other factors that included internal priorities, resource demands, and shifts in the IRS' customer service perspective. However, data were not obtained from taxpayers who use these services to determine the impact of removing or reducing them.

The TACs are walk-in sites where taxpayers can receive answers to both account and tax law questions, and receive assistance preparing their returns. Over the past few years, customer service at TACs has shown improvement. Yet, in May 2005, the IRS announced plans to close 68 of its TACs nationwide. Closing the 68 TACs was expected to yield staffing and facilities cost savings of $45 million to $55 million. After the IRS' closure announcement, Congress enacted legislation to delay the closure of any TACs.[10] The IRS is prohibited from using funds provided in the Fiscal Year 2006 budget appropriation to reduce any taxpayer service function or program until TIGTA completes a study detailing the effect of the IRS' plans to reduce services relating to taxpayer compliance and taxpayer assistance.

TIGTA reviewed[11] the IRS' TAC Closure Model and data used to select the 68 centers scheduled for closure and identified that although the structure of the Model was sound, not all data used were accurate or the most currently available, and some of the data were based on estimates and projections instead of actual available data. Data discrepancies affected the scores the Model calculated for each TAC and, ultimately, the ranking and overall selection of centers for closure. In addition, data discrepancies

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[9] TIGTA did not audit toll-free accuracy. The accuracy rates noted here are from IRS Document 12325.
[10] Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006, Pub. L. No. 109-115, 119 Stat. 2396 (2005).
[11] *The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data* (Reference Number 2006-40-061, dated March 2006).

affected the IRS' ability to accurately determine cost savings. The IRS should ensure data used in any decision-making tool are accurate and reliable before using them. For the TAC Program, the IRS should include data to identify customer characteristics and capture customer input to effectively measure the impact any changes might have on taxpayer service or compliance.

The IRS had also planned to reduce the hours of its toll-free telephone operation in Fiscal Year 2006. The IRS has about 400 fewer full-time equivalents for toll-free telephone operations than it had in Fiscal Year 2005 because of plans to reduce operating hours from 15 to 12 hours per day. Congress, the Taxpayer Advocate and the National Treasury Employees Union have expressed concerns about the IRS reducing operating hours for the toll-free telephone lines. A new law enacted in November 2005 requires the IRS to consult with stakeholder organizations, including TIGTA, regarding any proposed or planned efforts to terminate or significantly reduce any taxpayer service activity.[12] Congress recently further defined a reduction of taxpayer service to include limiting available hours of telephone taxpayer assistance on a daily, weekly, and monthly basis below the levels in existence during the month of October 2005.[13] As of March 11, 2006, assistor level of service has not been negatively impacted, and the IRS reports an 84.2 percent level of service rate.

TIGTA is currently evaluating the IRS' plans to reduce operating hours for the toll-free telephone lines. Our preliminary results are that the IRS does not have documentation to support the steps it took to arrive at the final conclusion to reduce the hours of telephone operations. TIGTA is reconstructing the steps taken as part of our on-going audit work in this area.

Recently, the Senate Finance Committee directed the IRS to undertake a comprehensive review of its current portfolio of taxpayer services and develop a five-year plan that outlines the services it should provide to improve services for taxpayers. This plan should detail how the IRS will meet service needs on a geographic basis and address how it will improve taxpayer service based on reliable data on those needs. This plan should be developed in consultation with the IRS Oversight Board and the National Taxpayer Advocate and submitted to the House and Senate Appropriations Committees.[14]

In response to the Senate Finance Committee's directive, the IRS is developing its five-year Taxpayer Assistance Blueprint, which will outline what services the IRS should provide, as well as how to improve services for taxpayers by leveraging reliable data on taxpayer and partner needs and preferences. Phase One will provide a baseline of current IRS services, taxpayer and partner needs and preferences, service industry benchmarking, and strategic service directions. The IRS plans to issue its Phase One report on April 14, 2006. Phase Two will validate the service recommendations through extensive primary research with taxpayers and will identify key operational and resource delivery

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[12] The Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, Pub. L. No. 109-115, 119 Stat. 2396 (2006).
[13] Department of Defense Appropriations Act, Pub. L. No. 109-148, 119 Stat. 2680 (2006).
[14] U.S. Congress. Senate. Senate Report 109-109. *Transportation, Treasury, the Judiciary, Housing And Urban Development, And Related Agencies Appropriations Bill, 2006* 109th Cong.

requirements. The IRS plans to issue its Phase Two report by the end of Fiscal Year 2006. TIGTA plans to include the Taxpayer Assistance Blueprint in its audit risk assessment process for the Fiscal Year 2007 audit program.

Responding to Emergencies and Natural Disasters

Hurricane Katrina made landfall at the Central Gulf Coast of the United States on August 29, 2005. It caused unprecedented damage to New Orleans, Louisiana, as well as the coastal areas of Mississippi and Alabama, and became the most destructive and costliest natural disaster in United States history. Hurricane Rita followed less than one month later and further damaged New Orleans and the Gulf Coast area of Texas. The IRS had 25 offices affected by the hurricanes, many of which were closed for short durations because of sustained power outages. Five offices, however, received significant damage, which forced closure for longer periods of time.

The IRS adequately prepared for Hurricanes Katrina and Rita.[15] The IRS had sufficiently updated its Occupant Emergency Plans[16] in May 2005 and Incident Management Plans[17] in March 2004 for the offices affected by the hurricanes and conducted training sessions for its designated Incident Commanders.[18] It also took actions immediately prior to the hurricanes to enhance post-hurricane employee communications, ensure continued salary payments, and minimize computer damage in its offices affected by the hurricanes.

After the hurricanes made landfall, the IRS took appropriate actions to expeditiously locate all employees and restore computer operations in the affected offices. Emergency Operations Command Centers were established in Nashville, Tennessee, and Dallas, Texas, immediately after Hurricanes Katrina and Rita, respectively. The IRS focused its primary attention on finding all employees in affected offices. All 517 employees in those offices were accounted for within 13 days after Hurricane Katrina, and all 35 employees were accounted for within 5 days after Hurricane Rita.

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[15] Draft Audit Report -- *The Internal Revenue Service Successfully Accounted for Employees and Restored Computer Operations After Hurricanes Katrina and Rita* (Audit Number 200620036, draft dated February 28, 2006). This audit is one of several audits the Treasury Inspector General for Tax Administration is conducting to address additional tax administration issues resulting from these natural disasters.

[16] An Occupant Emergency Plan contains the procedures for employees to follow during an emergency situation.

[17] An Incident Management Plan describes the overall coordinated actions to be taken by the Incident Management team to ensure recovery and restoration of a facility when an incident occurs.

[18] An Incident Commander is directly responsible for frontline management of an incident. The Incident Commander, in conjunction with other onsite business team managers, will develop and implement response strategies and use existing disaster preparedness documents for the recovery of business operations.

As for its computer operations in the offices affected by the hurricanes, the IRS restored system access to its Integrated Collection System[19] application from the five affected offices to the Atlanta, Georgia, office within five workdays. Personnel from the IRS' Modernization and Information Technology Services[20] organization also transferred employees' work files to another network so employees in affected offices had access to them and could continue to work.

However, TIGTA was unable to definitively state that taxpayer data were protected in the wake of Hurricanes Katrina and Rita because seven computers from two offices affected by the hurricanes could not be located. TIGTA confirmed that none of the missing computers was used to access the IRS computer network after the hurricanes, thus, any loss of data would have been limited to the data on the computers. TIGTA has recommended that the IRS establish procedures to require a team of employees from the IRS and other government entities to visit an office as soon as possible, but no later than 72 hours, after a major disaster to evaluate the security of the office's perimeter and, if necessary, to take appropriate actions to either secure the perimeter or implement measures to prevent unauthorized access into the office. TIGTA has also recommended that the IRS establish procedures to conduct an inventory reconciliation of all computers at IRS facilities that suffer extensive damage after any major disaster to identify possible loss or theft of computers.

The IRS also appropriately considered Hurricanes Katrina and Rita issues when planning for the 2006 Filing Season.[21] For example, the IRS added services to help lessen taxpayer burden. Taxpayers affected by Hurricanes Katrina and Rita will be treated as meeting extreme hardship criteria, which will allow them to request and receive transcripts of prior year tax returns instead of having to order them and wait for delivery. Additionally, the IRS expanded the scope of tax law training for assistors to include questions about casualty losses. Taxpayers affected by the hurricanes will also be able to have current and prior-year tax returns prepared even though their income levels exceed the income requirement.

TIGTA is actively participating in the President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE) coordinated oversight of the multi-billion dollar Federal relief effort for Hurricanes Katrina and Rita. The PCIE and ECIE are the coordinating bodies of the Federal Inspector General community. Within days after Hurricane Katrina, the Inspectors General initiated the most aggressive, comprehensive, and well-coordinated interagency

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[19] The Integrated Collection System is a case processing application that supports IRS employees who work delinquent taxpayer cases (i.e., taxpayers who have not filed tax returns or paid tax obligations).

[20] The Modernization and Information Technology Services organization is responsible for supporting the IRS on Information Technology issues, which includes protecting and restoring computer operations and locating all computers after a disaster.

[21] Draft Audit Report -- *The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program* (Audit Number 200540037, draft dated February 21, 2006). This audit is one of several audits the Treasury Inspector General for Tax Administration is conducting to address additional tax administration issues resulting from these natural disasters.

oversight effort ever undertaken. As part of this coordinated oversight, TIGTA is conducting and plans to conduct several audits to evaluate the performance of the IRS' relief efforts for taxpayers affected by the hurricanes.

Collecting Taxes

As of September 2005, the gross accounts receivable to the IRS was $258 billion. On October 22, 2004, the President signed the American Jobs Creation Act of 2004[22] that includes a provision allowing the IRS to use Private Collection Agencies (PCA) to help collect Federal Government tax debts. The law allows PCAs to locate, contact, and request full payment from taxpayers specified by the IRS. The law also allows the IRS to retain and use an amount not in excess of 25 percent of the amount collected by the PCAs to pay for the cost of PCA services, and an amount not in excess of 25 percent collected for collection enforcement activities of the IRS. According to the IRS, the initiative to use PCAs will help reduce the significant and growing amount of tax liability deemed uncollectible because of IRS resource priorities, help maintain confidence in the tax system, and enable the IRS to focus its existing collection and enforcement resources on more difficult cases.

The provisions of the Fair Debt Collection Practices Act[23] apply to PCAs. PCAs are prohibited from committing any act or omission that employees of the IRS are prohibited from committing in the performance of similar services. The IRS requires that PCAs adhere to all taxpayer protections and PCAs are prohibited from threatening or intimidating taxpayers or otherwise suggesting that enforcement action will or may be taken if a taxpayer does not pay the liability. The PCAs must also adhere to all security and privacy regulations for systems, data, personnel, physical security, and taxpayer rights protections. To ensure compliance with these requirements, the IRS is responsible for providing oversight of PCA actions.

On March 9, 2006, the IRS announced that it awarded contracts to three firms to participate in the first phase of its private debt-collection initiative. The IRS has developed its own guidelines for the private firms, including background checks on all private-firm personnel associated with the projects as well as a mandatory, IRS-directed training program for company personnel. The IRS planned to begin delivering delinquent tax account cases to the selected PCAs by July 2006. However, on March 23, 2006, the IRS announced that it had issued stop-work orders to the three PCAs after two unsuccessful bidders filed bid protests with the GAO.

In the second phase of the private debt-collection initiative, scheduled for 2008, the IRS intends to contract with up to 10 firms. Over the course of 10 years, the IRS expects that the private firms will help it collect an additional $1.4 billion in outstanding taxes.

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[22] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[23] 15 U.S.C. § 1601 note, 1692-1920 (2000).

While the use of private collection agencies could result in significant recoveries of unpaid taxes, the potential for abuse exists. Experience at the State level demonstrates that the use of PCAs should be closely monitored. In December 2005, the State of New Jersey Commission of Investigation reported[24] that what began as an effort to privatize the collection of tax debt 12 years ago evolved into a corrupt association between high- and mid-level managers in the Divisions of Taxation and Revenue and the PCAs. The State of New Jersey may have been over-billed by more than $1 million for a five-year period.

The Commission reported that a lack of oversight and a lack of audits and quality controls directly contributed to the undetected over-billing. Additionally, the PCAs repeatedly ignored contract requirements and Taxation and Revenue officials failed to enforce them. While the Commission's report did not address this particular issue, TIGTA is also concerned about the quality of taxpayer service from PCAs during their attempts to collect outstanding taxes. Poor taxpayer service by PCAs could potentially have a negative impact on voluntary compliance.

Since the IRS is just now embarking on this initiative, TIGTA has not yet seen indications of problems with the IRS' private debt-collection initiative similar to those in New Jersey. However, a recent news story reported that a former official of one of the IRS' three selected PCAs for the first phase of this initiative was indicted for bribery of public officials to win a contract to collect unpaid fines and fees. According to the story, the official pleaded guilty to one count of conspiracy to commit bribery and one count of bank fraud in 2005, and was sentenced to 30 months in prison and a $1 million fine. This particular case and the State of New Jersey experience clearly illustrate the need for proper oversight of this important initiative. According to the IRS, it has established an oversight unit responsible for ensuring that PCAs adhere to established procedures and that a tremendous amount of rigorous oversight will be applied to the PCAs.

Overseeing the IRS' private debt-collection initiative is a top priority for TIGTA. TIGTA has coordinated with the IRS during the initial phases of implementation of this initiative by addressing security concerns with the contracts and protection of taxpayer rights and privacy, and by developing integrity and fraud awareness training for the contract employees. In April 2006, TIGTA plans to provide a presentation to IRS trainers for PCAs about TIGTA's role in the private debt-collection initiative.

TIGTA has also developed a three-phase audit strategy to monitor this initiative and provide independent oversight. In the first phase, TIGTA is reviewing the IRS' planning and initial implementation of the program. As part of the first audit phase, TIGTA reviewed the IRS' Request For Quotation (RFQ) for the private debt-collection initiative.[25] Our limited scope review did not identify any material omissions that would adversely affect the IRS' ability to effectively manage this initiative.

[24] State of New Jersey Commission of Investigation, *The Gifting of New Jersey Tax Officials* (December 2005).

[25] A RFQ is issued by the IRS' Office of Procurement and describes the requirements that prospective contractors should provide in support of needed products or services. TIGTA reviewed the RFQ dated

In the second phase, TIGTA will review the initiative after full implementation, which may not occur until Fiscal Year 2007. In the third phase, TIGTA will review the effectiveness of the program. The goal of this audit strategy is to ensure that the IRS effectively exercises its new authority to use private debt collectors, while also ensuring that taxpayers' due process and privacy rights are protected.

Preventing Erroneous and Improper Payments

One of the goals of *The President's Management Agenda* is to reduce erroneous payments.[26] Further, the Improper Payments Information Act of 2002[27] greatly expanded the Administration's efforts to identify and reduce erroneous and improper payments in Federal programs and activities. While the Administration has pushed to prevent erroneous and improper payments, stewardship over public funds remains a major challenge for IRS management.

Improper and erroneous payments include inadvertent errors, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from outright fraud and abuse by program participants or Federal employees. For the IRS, improper and erroneous payments generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors.

Some tax credits, such as the Earned Income Tax Credit (EITC), provide opportunities for taxpayer abuse. The EITC is a refundable credit available to taxpayers who do not exceed a certain amount of income per year. The EITC was intended to provide significant benefits to the working poor, but some taxpayers have abused the credit, which has resulted in a significant loss of revenue. The IRS has estimated that approximately 30 percent of all EITC claims should not have been paid, which was approximately $9 billion of the $31 billion in EITC claimed for Tax Year 1999.[28] The IRS has been developing an EITC initiative to combat the problems of fraudulent EITC claims. The initiative is focused on three concepts: certification of qualifying child residency requirements, verification of filing status, and verification of reported income. In October 2005, the IRS reported that as a result of these efforts, it had identified and prevented the payment of over $275 million in erroneous EITC claims. TIGTA has conducted an ongoing assessment of this initiative as the three concepts have been tested.[29]

April 25, 2005. *The Private Debt Collection Request for Quotation Outlines Adequate Procedures and Controls* (Reference Number 2005-10-156, dated September 2005). TIGTA is currently reviewing the revised RFQ dated October 14, 2005.

[26] *The President's Management Agenda*, announced in the summer of 2001, is the President's aggressive strategy for improving the management of the Federal Government. It focuses on five areas of management weakness across the Government where improvements should be made.

[27] Pub. L. No. 107-300, 116 Stat. 2350.

[28] IRS report, *Compliance Estimates for Earned Income Tax Credit on 1999 Returns* (dated February 2002).

[29] Audit reports previously issued: *The Earned Income Tax Credit Income Verification Test Was Properly Conducted* (Reference Number 2005-40-093, dated May 2005); *The Earned Income Credit Recertification*

The Criminal Investigation function is responsible for detecting and combating tax refund fraud through its Questionable Refund Program (QRP). TIGTA has repeatedly reported in the last six years that additional controls and procedures were necessary not only to identify additional instances of potential fraud, but also to properly and timely release refunds that are determined not to be fraudulent. Recently this latter issue has been the subject of much debate, coming on the heels of the National Taxpayer Advocate's 2005 *Annual Report to the Congress* in which the Taxpayer Advocate criticized the IRS for unnecessarily stopping refunds owed to legitimate taxpayers.

In response to the Taxpayer Advocate's concern, on February 6, 2006, the IRS announced that it is taking steps to improve the QRP and reduce the number of taxpayers subject to frozen refunds. The announced changes include: improving and refining screening procedures to reduce the number of valid refund claims held, expediting the review of tax returns which should result in earlier release of delayed refunds, and notifying all taxpayers whose refunds are frozen. Notification procedures were implemented for the 2006 Filing Season and improvements to the screening and review processes will be implemented as soon as possible.

TIGTA is extremely concerned about this issue, believing that a necessary balance must be struck between protecting the revenue by not allowing refund fraud to go unchecked, and ensuring that legitimate taxpayers receive their refunds timely or, if challenged by the IRS, are afforded notification and due process. The QRP was established to deal with the serious problem of refund fraud, which has increased significantly in recent years. According to IRS estimates, fraudulent refund claims now exceed $500 million annually. TIGTA is continuing its review of the QRP and will report on its audit work later in the year.[30]

In addition to erroneous payments of credits, contract expenditures represent a significant outlay of IRS funds and are also susceptible to mistakes or abuse. As of October 2005, the IRS was responsible for administering 553 contracts with a total systems life value of $28.2 billion. TIGTA continues to perform audits of select contracts to ensure that payments on selected vouchers are appropriate and in accordance with contract terms and conditions. TIGTA also provided the IRS with a summary report highlighting several system deficiencies identified by the Defense Contract Audit Agency in the past five years for a major IRS contractor. These deficiencies could lead to overstated and unsupported

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Program Continues to Experience Problems (Reference Number 2005-40-039, dated March 2005); *Initial Results of the Fiscal Year 2004 Earned Income Tax Credit Concept Tests Provide Insight on Ways Taxpayer Burden Can Be Reduced in Future Tests* (Reference Number 2005-40-006, dated October 2004); and *Management Controls Over the Proof of Concept Test of Earned Income Tax Credit Certification Need to Be Improved* (Reference Number: 2004-40-032, dated December 2003).

[30] Audit reports previously issued: *The Internal Revenue Service Can Improve the Effectiveness of Questionable Refund Detection Team Activities* (Reference Number 2000-40-018, dated December 1999); *Revised Questionable Refund Program Procedures Were Not Consistently Implemented* (Reference Number 2001-40-025, dated January 2001); *Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected* (Reference Number 2003-10-094, dated March 2003); and *The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners* (Reference Number 2005-10-164, dated September 2005).

labor and other costs. Although the contractor is making progress in addressing previously reported system inadequacies, TIGTA believes significant risk still remains for the IRS on this contract.

Processing Returns and Implementing Tax Law Changes During the 2006 Tax Filing Season

Each filing season tests the ability of the IRS to implement tax law changes made by Congress. It is during the filing season that most individuals file their income tax returns and call the IRS if they have questions about specific tax laws or filing procedures. Correctly implementing tax law changes is a continuing challenge because the IRS must identify the tax law changes; revise the various tax forms, instructions, and publications; and reprogram the computer systems used for processing returns.

Preparing for the 2006 Filing Season was particularly difficult because of new tax laws enacted in response to hurricanes that struck the Gulf Coast States between August and October of 2005. For example, the Katrina Emergency Tax Relief Act of 2005,[31] which was signed into law on September 23, 2005, contained $3.3 billion in estimated tax relief for Fiscal Year 2006. Overall, this year's filing season includes 24 new tax provisions created by six pieces of tax legislation that became effective in Tax Year 2005.[32] Changes to the tax law can have a major effect on how the IRS conducts its activities, how many resources are required, and how much progress can be made on strategic goals. Generally, Congress makes changes to the tax law each year, so some level of change is a normal part of the IRS environment. However, certain kinds of changes can significantly impact the IRS in terms of the quality and effectiveness of service and in how taxpayers perceive the IRS.

To date, we have seen no significant problems during the 2006 Filing Season. However, we are closely monitoring two significant areas: Disaster Relief provisions and elimination of the Telefile program. We are evaluating the impact of the Disaster Relief provisions afforded those taxpayers impacted by the hurricanes because of the number of Disaster Relief provisions passed by Congress, and because many of them were passed late in the year. Our goal is to ensure that taxpayers are receiving the benefits to which they are entitled. We are evaluating the impact of the IRS' decision to eliminate the Telefile program because this program allowed taxpayers to file Form 1040EZ[33] electronically via the telephone. We are reviewing the accounts of taxpayers who used the Telefile program in 2005 to determine whether they used another means to file electronically in 2006, or reverted to paper tax returns.

Modernizing the IRS

Modernizing the IRS' computer systems has been a challenge for many years and will likely remain a challenge for the foreseeable future. The latest effort to modernize

[31] Pub. L. No. 109-73, 119 Stat. 2016 (to be codified in scattered sections of 26 U.S.C.).
[32] On-going audit of the Tax Law Changes Impacting Tax Returns (Audit Number 200640015).
[33] Income Tax Return for Single and Joint Filers With No Dependents.

the IRS' systems, the Business Systems Modernization (BSM) program, began in Fiscal Year 1999, and is a complex effort to modernize the IRS' technology and related business processes. According to the IRS, this effort involves integrating thousands of hardware and software components. Through February 2006, the IRS has received appropriations of approximately $2 billion to support the BSM program, and the President has requested an additional $167 million for Fiscal Year 2007.

Succeeding in the modernization effort is critical—not only because of the amount of time and money at stake—but also to improve the level of service provided to taxpayers. To accomplish the modernization effort, the IRS hired the Computer Sciences Corporation (CSC) as the PRIME[34] to design, develop, and integrate the modernized computer systems. However, in January 2005, the IRS began taking over the role of systems integrator from the PRIME due to reductions in funding for the BSM program and concerns about the PRIME's performance.

The BSM program has shown progress. The IRS and its contractors have been focusing on defining and delivering smaller, incremental releases[35] of projects. For example, the IRS recently released the fourth incremental release of the Modernized e-File project. The Modernized e-File project has provided the capability for corporations, exempt organizations, governmental entities, private foundations, and trusts to file 106 tax forms electronically. In January 2006, the IRS released the fourth incremental release of the Customer Account Data Engine (CADE) project which will eventually replace the IRS' existing Master File.[36]

Although progress is being made, the modernization program is behind schedule, over budget, and is delivering less functionality than originally planned. TIGTA has identified four primary challenges that the IRS must overcome for modernization to be successful:

1) The IRS must implement planned improvements in key management processes and commit necessary resources to succeed;

2) The IRS must manage the increasing complexity and risks of the modernization program;

3) The IRS must maintain continuity of strategic direction with experienced leadership; and,

[34] The PRIME stands for Prime Systems Integration Services Contractor.
[35] A release is a specific edition of software.
[36] The Master File is the IRS database for storing taxpayer account information on individuals, businesses, employee retirement plans, and exempt organizations. The CADE will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer account and return data. In conjunction with other applications, the CADE will allow employees to post transactions and update taxpayer account and return data on-line from their desks. Updates will be immediately available to any IRS employee who accesses the data and will provide a complete, timely, and accurate account of the taxpayer's information. In contrast, the current Master File processing system can take up to two weeks to update taxpayer accounts, and IRS employees may need to access several computer systems to gather all relevant information related to a taxpayer's account.

4) The IRS must ensure contractors' performance and accountability are effectively managed.

In response to modernization challenges and reduced funding, the IRS began making dramatic changes to significant areas within the BSM program over the last year. For example, the GAO recommended and the House and Senate Appropriations Committees directed the IRS to develop a new version of the Modernization Vision and Strategy. In addition, the IRS' prior modernization approach involved a huge development effort aimed at replacing all current systems. The IRS is now focusing on using current systems to accomplish modernization. I believe these extensive changes signal the beginning of a different design and structure for the entire modernization effort.

As risks and issues are identified within the BSM program, frequent changes are often required. However, the IRS' recent and planned future changes do not eliminate the four challenges we have identified. Due to the criticality of the BSM program, the IRS must confront identified challenges and proactively address them in order to come closer to realizing expectations in this new phase of the BSM program.

Managing Human Capital

Like much of the Federal Government, managing the extensive human capital resources at the IRS remains a serious concern. Workforce issues, ranging from recruiting to training and retaining employees, have challenged Federal agencies for years. The GAO, the Office of Management and Budget, and the Office of Personnel Management have all made the strategic management of human capital a top priority. Specifically for the IRS, recent reorganization and modernization efforts, such as the focus on *e-filing*, have made many jobs dealing with processing paper tax returns redundant.

The IRS also faces personnel shortages in certain functions. The Wage and Investment Division is experiencing critical staffing shortages in its TAC program. The IRS' decision to focus more resources on compliance activities has limited available resources and the IRS' Field Assistance Office does not have the resources to offer unlimited services. Additionally, the uncertainty around the TAC closures created critical vacancies as TAC employees left for other jobs in the IRS. As of December 1, 2005, the Field Assistance Office Headquarters had identified 47 TACs with critical staffing shortages. Five vacancies are in TACs located in areas impacted by Hurricanes Katrina and Rita–three in Louisiana and two in Texas. The shortages come at a time when taxpayer visits in these areas may increase and the Field Assistance Office is adding services to help reduce the burden on taxpayers affected by the hurricanes.

During the 2006 Filing Season, the IRS has reported fewer taxpayers are seeking assistance at the TACs.[37]

The Large and Mid-Size Business Division reported in its Fiscal Year 2006 strategic assessment that it will continue to lose substantial experience in the revenue agent position through attrition. Similarly, in the Small Business/Self-Employed Division, the human capital crisis continues to intensify as employees in key occupations increasingly become eligible for retirement, are lost through attrition, or migrate to other areas. Stagnant funding allocations have impacted the ability to attract new hires and retain existing employees. Thus, potential losses in critical occupational groups, coupled with concerns regarding grade and competency gaps, further emphasize the need to strategically manage human capital. The IRS must devote significant attention to managing human capital to overcome these challenges.

Conclusions

The IRS faces a number of significant challenges. As I mentioned in my introduction, Commissioner Everson established a principle for the IRS, *Service + Enforcement = Compliance*. Maximizing compliance with finite resources requires the proper balance between *Service* and *Enforcement*. This is perhaps the most difficult challenge facing the IRS.

I hope my discussion of some of the significant challenges aids you in your consideration of the IRS' appropriation for Fiscal Year 2007. Mr. Chairman and Members of the Subcommittee, thank you for allowing me to share my views. I would be pleased to answer any questions you might have at this time.

[37] Draft Audit Report – *The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program* (Audit Number 200540037, draft issued February 21, 2006).