HEARING BEFORE THE U.S. SENATE COMMITTEE ON APPROPRIATIONS SUBCOMMITTEE ON TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES

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HEARING ON THE
INTERNAL REVENUE SERVICE'S FISCAL YEAR 2007 BUDGET
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Introduction

Chairman Bond, Ranking Member Murray, 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). It was just over one year ago that I appeared before you to testify on the IRS' Fiscal Year 2006 appropriations. Since my prior testimony, significant events have affected tax administration including Hurricanes Katrina and Rita, which impacted thousands of taxpayers and required rapid responses from many departments and agencies, including the IRS.

When I testified before the Subcommittee last year, I had only served as the Treasury Inspector General for Tax Administration (TIGTA) for a few short months. As I testify before the subcommittee today, I have been the TIGTA for 17 months. My four priorities as the TIGTA are to maintain our focus on IRS efforts to modernize its technology, enhance our ability to protect tax administration from corruption, assist the IRS with improving tax compliance initiatives, and monitor the IRS' use of private debt collection agencies. As the TIGTA, my observations 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 the 2006 Filing Season, electronic filing, the tax gap, customer service, the IRS' Private Debt Collection initiative and other major challenges facing the IRS.

The 2006 Filing Season

Preparing for the Filing Season

Planning for the 2006 Filing Season was difficult for the IRS because of many tax law changes enacted late last year in response to unprecedented natural disasters. Disaster relief provisions were enacted into law for taxpayers affected by Hurricanes Katrina, Rita, and Wilma, and were intended to provide relief to over 11 million taxpayers who lived in the affected areas of the Gulf Coast, as well as to others who may have been adversely impacted by these storms.

This year, TIGTA reviewed 28 new tax law provisions and is also closely monitoring the implemented changes that are intended to assist taxpayers adversely affected by the 2005 hurricanes. New tax law provisions were included in the Katrina Emergency Tax Relief Act of 2005,[1] the Gulf Opportunity Zone Act of 2005,[2] and also in

[1] Pub. L. No. 109-73, 119 Stat. 2016 (to be codified in scattered sections of 26 U.S.C.).

the Working Families Tax Relief Act of 2004[3] and the American Jobs Creation Act of 2004,[4] all of which became effective in 2005. The latest legislation, the Gulf Opportunity Zone Act of 2005, was signed into law on December 21, 2005.

TIGTA reviewed the IRS' preparation for the 2006 Filing Season and determined that the IRS accurately updated its tax products and computer programming to incorporate the tax law changes that became effective in 2005. TIGTA reviewed 42 tax forms, publications, and instructions that required updating, and determined that they were accurately updated. The IRS also accurately updated its computer programming and returns processing programs for the new tax law provisions and other adjustments or changes.[5] TIGTA is continuing to monitor the IRS' processing of income tax returns during the 2006 Filing Season and will report its results later this year.

While planning for the 2006 Filing Season, the IRS considered the impact of Hurricanes Katrina and Rita. Specifically, the IRS accounted for all employees affected by the hurricanes and located alternate office space in affected areas. All Taxpayer Assistance Centers (TAC) in impacted areas were open and operational for the 2006 Filing Season. The IRS also added services to help lessen taxpayer burden, including tax return preparation for taxpayers affected by the hurricanes regardless of the income guidelines. Additionally, the scope of tax law topics in which assistors are trained was expanded to provide assistance to taxpayers with questions about casualty losses. Furthermore, the IRS will treat taxpayers affected by Hurricanes Katrina and Rita as meeting extreme hardship criteria. That designation allows affected taxpayers to request and immediately receive transcripts of prior year tax returns instead of having to order them and wait for delivery.

Processing Tax Returns

During the 2006 Filing Season, the IRS expected to process an estimated 135 million individual returns. So far, TIGTA has not identified any significant problems with the IRS' processing of individual tax returns. As of April 8, 2006, the IRS has received over 87.7 million returns. Of those, 57.7 million were filed electronically (an increase of 3.5 percent from this time last year), and 29.9 million were filed on paper (a decrease of 7.1 percent from 2005). Additionally, $164.5 billion in refunds have been timely issued. Of this amount, $124.3 billion were directly deposited to taxpayer bank accounts, an increase of 9.3 percent compared to last year.

Providing Quality Customer Service

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

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[2] Pub. L. No. 109-135, 199 Stat. 2577 (2005).
[3] Pub. L. No. 108-311, 118 Stat. 1166 (2004).
[4] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[5] Draft Report *Tax Products and Computer Programs for Individual Income Tax Returns Were Accurately Updated for the 2006 Filing Season* (Audit #200640015, date April 24, 2006).

processing, and electronic services, including the IRS public Internet site (www.IRS.gov).

Furthermore, it is 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 that need them to apply for benefits or file amended tax returns to claim casualty losses.[6]

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.

IRS.gov

IRS.gov continues to be one of the most visited Internet sites in the world, especially during filing seasons. As of the week ending April 8, 2006, the IRS reported a 6.46 percent increase in the number of visits to IRS.gov over the same period during the last filing season. 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. As of the week ending April 8, 2006, the IRS also reported a 17.02 percent increase in taxpayers obtaining their refund information online via the "Where's My Refund" option found on the Internet site.

Toll-Free Telephone Operations

The 2006 Filing Season presented unique challenges for the IRS toll-free operations. The IRS had also planned to reduce the hours of its toll-free telephone operation in Fiscal Year 2006. The IRS had about 400 fewer Full-Time Equivalents[7] for toll-free telephone operations than it had in Fiscal Year 2005 because of plans to reduce operating hours from 15 to 12 per day. Congress, the Taxpayer Advocate and the National Treasury Employees Union 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.[8] 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. TIGTA is

[6] *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).
[7] 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. For FY 2005, 1 Full-Time Equivalent was equal to 2,088 hours.
[8] 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).

currently assessing the IRS' plans to reduce operating hours and will report its results later this year.

As of April 8, 2006, assistor level of service had not been negatively impacted, with an IRS-reported level of service rate of 83.8 percent.[9] In addition, about 6.49 percent fewer assistor calls were answered, but the number of taxpayers who hung up prior to reaching an IRS assistor was up 10.9 percent. The average speed of answer was about 66 percent of the time planned, so those taxpayers who called and spoke with an assistor did not experience longer wait times.

In planning for Fiscal Year 2006, IRS management expected fewer calls program-wide, even after taking into consideration taxpayers affected by Hurricanes Katrina and Rita. IRS management believed that most taxpayers needing disaster relief assistance obtained it during the latter part of 2005. Prior to the start of the filing season, TIGTA brought to IRS management's attention our concern that more taxpayers than expected could call the help line with questions due to the effects of Hurricanes Katrina and Rita.

After we shared this concern, IRS management raised the estimated volume of services to these telephone lines by about 78,000 services, from approximately 27,000 to about 105,000. The estimate is for services from January through June 2006, a 365.1 percent increase over the total Fiscal Year 2005 services provided on those telephone lines.[10] For the 2006 Filing Season it appears that the calls to these telephone lines were higher than anticipated. For example, the IRS had planned 77,235 services for one of its applications devoted to assisting disaster victims; however, through April 8, 2006, the IRS has already provided 136,552 services.

Taxpayer Assistance Centers

2006 Filing Season Services

The TACs are walk-in sites where taxpayers can receive answers to both account and tax law questions, as well as receive assistance preparing their returns. The IRS acknowledged that staffing would be a challenge during the 2006 Filing Season since not all TACs would be fully staffed and not all TACs would provide standard services or standard hours of operation (from 8:30 a.m. to 4:30 p.m., Monday through Friday). As of December 1, 2005, the IRS identified 47 TACs with critical staffing shortages (a critical vacancy is one that must be filled to ensure that a TAC remains open).

The IRS took actions to minimize the impact of the staffing shortages. As of January 31, 2006, the IRS had hired additional frontline technical employees, recalled intermittent employees back to work, detailed former TAC employees from their current positions in other IRS functions back to the TACs, and made plans to have some employees travel between TACs to ensure that all TACs remained open daily. The IRS' decision to focus more resources on compliance activities, however, further limited resources available for the TAC Program. As a result, the IRS limited some assistance

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[9] Level of Service is the primary measure of providing service to taxpayers. It is the relative success rate of taxpayers that call for services on the IRS' toll-free telephone lines.

[10] A service is defined when a call is answered by an assistor. When the assistor answers the caller's question, a service is provided. If the same caller has an additional question or issue and is transferred to another area or assistor, an additional service is provided.

services and not all TACs were open during standard operating hours. As of the week ending April 8, 2006, the IRS reported a 12.5 percent reduction in TAC contacts with taxpayers.

Although the IRS publicized when TAC operating hours were limited, it did not publicize when TACs would only provide limited services. When notified by TIGTA, the IRS implemented changes and standardized the list of services offered at each TAC. Furthermore, the IRS modified its Internet site, IRS.gov, to indicate when TACs would provide limited services.

TIGTA made anonymous visits to 50 TACs and asked 200 questions to determine if taxpayers received quality service, including correct answers to their questions. Assistors correctly answered 73 percent of the questions compared to 66 percent during the 2005 Filing Season. TIGTA visited an additional 20 TACs and asked 80 tax law questions specifically related to the Katrina Emergency Tax Relief Act of 2005. Assistors answered 75 percent of those questions correctly. IRS assistors should have been trained to answer these questions. TIGTA's observations were that assistors sometimes inappropriately referred taxpayers to publications to conduct their own research, or responded to tax law questions without following required procedures, such as using the publication method guide that requires them to ask probing questions.

Closure

Over the past few years, customer service at TACs has shown improvement. 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.[11] 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 completed its study in March.

TIGTA reviewed[12] 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 current 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 affected the IRS' ability to accurately determine cost savings. The IRS should ensure that 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.

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. The decision

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[11] 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).

[12] *The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data* (Reference Number 2006-40-061, dated March 2006).

to close TACs was 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.

Volunteer Income Tax Assistance (VITA) Program

The VITA Program plays an increasingly important role in IRS' efforts to improve taxpayer service and facilitate participation in the tax system. The VITA Program provides no-cost Federal tax return preparation and electronic filing to underserved taxpayer segments, including low income, elderly, disabled, and limited-English-proficient taxpayers. These taxpayers are frequently involved in complex family situations that make it difficult to correctly understand and apply tax law.

TIGTA visited VITA sites to determine if taxpayers received quality service, including the accurate preparation of their individual income tax returns. TIGTA developed scenarios designed to present volunteers with a wide range of tax law topics that taxpayers may have needed assistance with when preparing their tax returns. These scenarios included the characteristics (e.g., income level, credits claimed, etc.) of tax returns typically prepared by the VITA Program volunteers based on an analysis of the Tax Year 2004 VITA-prepared tax returns. TIGTA had 36 tax returns prepared with a 39 percent accuracy rate, comparable to the 34 percent accuracy rate reported for the 2005 Filing Season. TIGTA's observations were that volunteers did not always use the tools and information available when preparing returns. TIGTA will report its final results later this year.

The Tax Gap

In an April 2004 U.S. Senate Committee on Finance news release, Senator Max Baucus called for 90 percent voluntary tax compliance by 2010. Senator Baucus stated, in part, that "Today, I'm calling on the IRS to achieve a 90 percent voluntary compliance rate by the end of the decade, which would raise at least an additional $100 billion each year without raising taxes." Perhaps the greatest challenge facing the IRS is finding ways to improve the voluntary compliance rate.

Using different terms, Senator Baucus challenged the IRS to reduce what is commonly known as the tax gap. The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. In February 2006, the IRS estimated the gross tax gap at $345 billion for Tax Year 2001.

TIGTA evaluated the reliability of the IRS-developed tax gap figures and concluded that the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and voluntary compliance.[13] The IRS has significant challenges in both obtaining complete and timely data and developing the methods for interpreting the data.

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[13] *Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections* (Reference Number 2006-50-077, dated April 2006).

A reliable estimate of the overall tax gap and its components is important to tax administration and tax policy decision-makers. Without a reliable estimate, inappropriate decisions may be made on how to address the tax gap. If we assume that the total tax liability in Tax Year 2010 is the same as it was in Tax Year 2001, noncompliant taxpayers would have to pay timely and voluntarily an additional $134 billion to achieve Senator Baucus' challenge to reach a 90 percent voluntary compliance rate by 2010.

Despite the significant efforts undertaken in conducting the individual taxpayer National Research Program (NRP)[14] for underreporting, the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and the voluntary compliance rate. TIGTA's primary concerns are described in the following areas of nonfiling, reporting compliance, and payments collected.

Nonfiling

Prior to the NRP, the IRS' estimate of the nonfiling gap was $30.1 billion, consisting of $28.1 billion for individual income taxes and $2 billion for estate taxes. In February 2006, the IRS updated this estimate to $25 billion for individuals. Supplementary data, however, suggest that substantial amounts are not included in the estimates provided in the tax gap projections. The IRS describes the nonfiling estimate as reasonable despite the missing segments of corporate income, employment, and excise taxes. These facts suggest the nonfiler estimate is incomplete and likely inaccurate.[15]

Reporting Compliance

At an estimated $285 billion, underreporting is by far the largest identified portion of the tax gap. Yet, this estimate may not be complete since there are at least four areas that suggest substantial amounts are not included in the tax gap estimates.

- The effect that the current NRP on Subchapter S corporations will have on individual taxpayer compliance estimates could be substantial, as well as the effect on employment tax estimates. [16]
- The $5 billion underreporting estimate for small corporations and the $25 billion estimate for large corporations date back to the 1980s and, according to the IRS, are considered weak.
- The estimate for estate taxes was not updated during the current NRP, and no estimate has been made for excise taxes.
- The dated estimate for the Federal Insurance Contributions Act taxes and unemployment taxes are considered weak by the IRS.

Payments Collected

The IRS estimates that it recovers about $55 billion of the annual tax gap through enforced collections and other late payments.[17] This figure does not represent an actual

[14] The NRP was a study designed to accurately measure reporting compliance of individual taxpayers while minimizing the burden on taxpayers during the process.
[15] There are no plans to update the estate tax segment or to estimate the corporate, employment, and excise tax nonfiler segment.
[16] This study is expected to take 2 years to 3 years to complete from its inception in October 2005.

amount but is an estimate based on formulas devised from historical analyses. The actual basis of these formulas seems to be very limited, as well as dated. Furthermore, these collections have two basic parts – voluntary payments received by the IRS and payments that result from some type of IRS intervention.[18] The IRS does not currently correlate either type of payment to the applicable tax year and thus does not determine actual collections.

Measuring Noncompliance

TIGTA attempted to determine whether the IRS' tax gap estimates coincide with estimates developed by independent sources. Although some independent studies exist, none provided sufficient information to allow close comparisons. One possible source of comparison was the annual Bureau of Economic Analysis estimate of the difference between its personal income figures and the IRS' measure of Adjusted Gross Income to derive what is called an Adjusted Gross Income Gap. IRS Office of Research officials suggested that this is a narrow definition of tax noncompliance based, in part, on IRS estimates. For Tax Year 2001, the Bureau of Economic Analysis reported an Adjusted Gross Income Gap of $834.4 billion.[19]

The private sector has also developed some estimates of the tax gap. For example, in January 2005, financial analysts calculated the number of illegal immigrants in the United States at more than double the United States Census Bureau's estimated 9 million. These undocumented workers may hold as many as 15 million jobs, with perhaps 5 million collecting untaxed cash wages, costing the Federal Government an estimated $35 billion yearly.[20]

Performing a compliance measurement program is expensive and time consuming. The estimated cost for performing the TY 2001 individual taxpayer NRP was approximately $150 million. The IRS Office of Research staff explained that resource constraints are a major driver in NRP studies and will affect how often the NRP is updated. From FYs 1995 through 2004, the revenue agent workforce declined by nearly 30 percent while the number of returns filed grew by over 9 percent. Additionally, operational priorities must be balanced against research needs. This shortfall in examiner resources makes conducting large-scale research studies problematic.

The IRS' budget submission to the Department of the Treasury (Treasury) for FY 2007 requests funding to support ongoing NRP reporting compliance studies. It requests funding for 268 Full-Time Equivalents and $45.9 million that will include 26 analytical and technical positions to estimate reporting compliance for new segments of taxpayers (such as S corporations, partnerships, and other business entities) and to update estimates of reporting compliance for other segments. It also requests 510 additional revenue

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[17] According to one IRS representative, these collections can take up to 10 years because of appeals and court decisions.

[18] Voluntary late payments are generally those remittances received after their due dates but before collection notices were sent or other collection actions were taken.

[19] This number is an income gap rather than a tax gap. Thus, it would have to be multiplied by a tax rate to determine the associated tax gap. Similarly, the $35 billion stated in the following paragraph could be significantly smaller, depending on whether some of these workers have actual filing obligations. Neither the BEA nor the IRS assumes a tax rate to calculate a tax gap estimate based on this income gap.

[20] Bear Stearns, *The Underground Labor Force Is Rising To The Surface.*

agents to conduct reporting compliance research examinations. The initiative seeks to provide a foundation for conducting compliance studies and to limit the diversion of resources to research audits from operational priorities. The IRS Oversight Board supports ongoing dedicated funding for compliance research. Unfortunately, funding for those resources in previous fiscal years did not materialize. Without a resource commitment to continually update the studies, the information will continue to be stale and less useful in improving voluntary compliance.

TIGTA's review of the tax gap concluded that a determination cannot be made about the IRS' ability to meet Senator Baucus' challenge of 90 percent voluntary compliance by 2010 with the information currently available. Regardless of whether a 90 percent voluntary compliance rate can be achieved, the IRS faces formidable challenges in completely and accurately estimating the tax gap and finding effective ways to increase voluntary compliance.

Electronic Filing

The IRS has seen a steady growth in electronic filing (e-file) of income tax returns over the past several years. In Calendar Year 2002, 35.9 percent of the 130.3 million individual income tax returns received by the IRS were e-filed. Last year, the percentage of e-filed returns increased to 51.7 percent of the total individual income tax returns received. The number of e-filed returns increased 46.2 percent over the three-year span. While the IRS will not meet its goal of having 80 percent of all tax returns e-filed by 2007, it does expect to see continued growth in electronic filing, although at a somewhat diminished growth rate from year to year. For example, the IRS expects the e-file percentage to reach 54.1 percent this year, 57.7 percent in 2007, and 60.6 percent in 2008.

Although e-filing continues to increase overall, TIGTA found some indications that taxpayers are shifting between the various types of e-filed returns, and some segments of e-filed returns are starting to show a decrease in the numbers filed. E-filed returns are generated from three basic sources – paid preparers who transmit their clients' tax returns, taxpayers who purchase tax-preparation software and file their own returns via the Internet from their personal computers, and taxpayers who take advantage of free e-filing options, such as the Free File Program, or in previous years via the TeleFile Program.

Overall, as of April 8, 2006, e-filing has increased 3.5 percent compared to the same period in 2005, which is significantly less than the 6 percent increase the IRS expected. While the number of taxpayers e-filing from their home computers is up 16.6 percent this Filing Season, the number of taxpayers taking advantage of free online filing is down 22 percent below last year. I am concerned that more taxpayers are not using the free e-filing services offered by the IRS.

Free File Program

Background

The IRS Restructuring and Reform Act of 1998 (RRA 98)[21] established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. It also required the IRS to work with private industry to increase electronic filing.

In February 2002, President Bush established the President's Management Agenda to improve the overall management of the Federal Government. One of the five initiatives in the President's Agenda is E-Government. The goal of this initiative is to make it easier for citizens and businesses to interact with the government, save taxpayer dollars and streamline citizen-to-government transactions. In response to the President's E-Government initiative, the Office of Management and Budget (OMB) developed the EZ Tax Filing Initiative. EZ Tax Filing was intended to make it easier for citizens to file taxes in an Internet-enabled environment. Citizens would no longer have to pay for basic, automated tax preparation. The goal of this initiative was to increase the number of citizens who filed their tax returns electronically.

In response to this requirement and the statutory requirement of RRA 98, in 2003 the Treasury, the OMB and the IRS launched the Free File Program featuring private-sector partners that allow qualifying taxpayers to prepare and file their taxes online for free. The Treasury, OMB and IRS made this possible through a public-private partnership with a consortium of tax software companies, the Free File Alliance, LLC (Alliance).

The Free File Program provides taxpayers with access to free online tax preparation and e-filing services made possible through a partnership agreement between the IRS and the tax software industry. Eligible taxpayers may prepare and e-file their Federal income tax returns using commercial online software provided by Alliance members. After the IRS and Alliance entered into a Free File Agreement, the Free File Program debuted in January 2003. According to statistics provided by the Alliance, more than 2.79 million taxpayers used the program in its first year. In subsequent years, use of the Free File Program increased significantly to about 3.51 million taxpayers in 2004 and 5.12 million taxpayers in 2005.

The Amended Free File Alliance Agreement and Its Potential Impact on Electronic Filing

After the 2005 Filing Season, the IRS and the Alliance amended their agreement to continue the Free File Program through October 2009. With the amended agreement, the overall focus of the Free File Program changed significantly. While the amended agreement still contributes to the original goal of increasing the number of citizens who electronically file their tax returns, new limits effectively changed the intent of the Free File Program. The original intent of the program was to provide free tax preparation and electronic filing services to all taxpayers. The revised intent is to assist lower income and underserved taxpayers.

[21] 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.).

The original 2002 agreement between the IRS and the Alliance established a minimum number of taxpayers who should be served by the Free File Program and was more in line with the intent of the EZ Tax Filing Initiative. There is, however, some support in Congress for the shift in the program's focus to lower income and underserved taxpayers. For example, according to the House Appropriations Committee Report accompanying the IRS' FY 2005 Budget Appropriations, the Committee reaffirmed its position that the Alliance is first and foremost intended to provide electronic Federal tax return preparation and e-filing services at no cost to the working poor and other disadvantaged and underserved taxpayers.

As part of the amended agreement, new limits were set for participation in the Free File Program. The new limits stem, in part, from the differing objectives of the IRS and the Alliance members. One of the IRS' principal purposes for establishing the program was to add another avenue for electronic filing with the intent of increasing electronic filing overall. However, Alliance members are businesses that incur a cost to provide free services. According to representatives of Alliance member companies who TIGTA interviewed, their primary goal is to keep the Federal Government from entering the tax preparation business.[22] A secondary benefit of their participation in the program is the opportunity to market their other products for free. Taxpayers opting to use these services provide additional revenues to Alliance members.

Per the initial agreement, a minimum of 60 percent of all taxpayers (approximately 78 million) were eligible for the Free File Program. Last year, the Alliance opened the program up to almost 130 million taxpayers. However, only 5.12 million taxpayers took advantage of it. The amended agreement now limits the program's availability to 70 percent of taxpayers (approximately 93 million). For Tax Year 2005, this limitation equates to an Adjusted Gross Income (AGI) of $50,000 or less. The maximum AGI to achieve the 70 percent limit, however, may vary from year to year. The net impact of this new limit is that during the 2006 Filing Season approximately 40 million taxpayers were no longer offered free filing services through the program.

As mentioned earlier, online filing on home computers is up 16.6 percent this Filing Season. This increase, however, appears to be the result of an increase in the number of taxpayers who paid for online filing services. As of April 8, 2006, paid online filing is up 33.7 percent while free online filing is down 22 percent. Two possible explanations for the growth in online filing from home computers and the decline in free online filing are: 1) taxpayers who filed electronically through a practitioner last year may have decided to purchase software and file online this year; and 2) taxpayers who filed through the program last year do not qualify this year and therefore purchased software to file online.

Another factor that appears to have contributed to the decline in free online filing is elimination of the IRS' TeleFile Program. The IRS and the Alliance had hoped that many of the 3.3 million taxpayers who used TeleFile in 2005 would migrate to the Free File Program. However, current Filing Season statistics indicate that many former TeleFilers are no longer filing electronically and instead are filing their returns on paper.

[22] TIGTA interviewed a sample of 6 of the 20 Alliance member companies.

Positive Provisions of the New Free File Alliance Agreement

Although the changes in the amended Free File Agreement limit the number of taxpayers offered free tax return preparation and filing services, several other changes enhance the quality of the program. Under the amended agreement, Alliance members must adhere to more stringent disclosure of the nature, costs, and alternative methods of receiving refunds faster. In addition, not all taxpayers will be offered a Refund Anticipation Loan (RAL). There is some controversy over RALs because of the high fees and rates sometimes associated with those loans. Starting in 2006, the agreement guarantees that some taxpayers using the Free File Program will have the option to prepare and file their tax return without being offered a RAL. The decision of whether or not to accept an RAL lies with the taxpayer; however, these new provisions make the choice more clear. If taxpayers choose to apply for an RAL, all terms of the loans must be fully disclosed.

The amended agreement also increased security requirements and added performance measures for the individual Alliance members. Alliance members must have third-party security assessments to ensure that taxpayer information is adequately protected. Also, performance standards require a 60 percent acceptance rate[23] for providers who e-file returns through the program. This acceptance rate will be gradually increased in future years.

Under the amended agreement, Alliance members also agreed for the first time to provide the IRS with an indicator that identifies those taxpayers who use the Free File Program. Prior to the amendment, the IRS had no way to independently determine how many taxpayers participated in the program, or which taxpayers were using it. Previously, individual Alliance members reported data on participation in the program, and the IRS lacked a method to monitor participation. This significantly hampered the IRS' ability to evaluate the program's success or the effects of changes to the program.

Difficulties Using the Free File Program

Although the Free File Program offers some taxpayers the option to prepare and file their tax return for free, the program may not be accessible to all who are eligible for it, and it is not necessarily easy to use. The Free File Internet site readily allows taxpayers to determine whether they qualify for the program, but finding the best software provider for their needs is time consuming and may be difficult for less savvy computer users.

Taxpayers must access the Free File Program through the IRS' Internet site at IRS.gov. The Internet site clearly identifies the basic requirements for participation in the program and provides a tool that guides taxpayers to free filing providers. This tool presents taxpayers with a number of providers from which to choose based on some basic information that taxpayers provide. Although this tool guides taxpayers to the providers they qualify to use, the tool does not assist taxpayers in determining which of those providers best meets their needs.

Taxpayers must access each provider's Internet site to determine the services offered and must then compare the services offered and select the provider that is the best

[23] The percentage of returns an individual provider must transmit to the IRS error free.

for them. Additionally, each Alliance member company sets taxpayer eligibility requirements for its own program. These requirements may differ from company to company. Generally, eligibility is based on such factors such as age, adjusted gross income, State residency, military status or eligibility for the Earned Income Tax Credit.

Although the Free File Program is currently focused on low-income taxpayers, many of these taxpayers do not have access to the tools to use it. For example, taxpayers who speak limited English have not been provided access to all of the filing options offered. Only two providers offer services in Spanish and neither of them offer free electronic filing of Form 4868, Automatic Extension of Time to File.

The Free File Program also requires taxpayers to have access to a computer and the Internet. Taxpayers who have access to the necessary technology must also be savvy enough to navigate the IRS' and the Alliance members' Internet sites. The focus of the program on lower-income taxpayers may be at odds with their ability to participate in it. In her 2004 Report to the Congress, the National Taxpayer Advocate wrote that in 2001 approximately 50 percent of low-income families[24] used a computer and only 38 percent had access to the Internet. Furthermore, access to a computer or the Internet does not necessarily indicate that a person has the ability to navigate the Internet or use tax preparation software.[25]

The IRS offers free assistance to taxpayers with tax preparation and filing through its Taxpayer Assistance Centers, Voluntary Income Tax Assistance, and Tax-Aide Programs as well as through the Free File Program. Similar to the Free File Program, taxpayers must meet certain requirements in order to receive assistance from those other programs. The Free File Program, however, is the only free filing option that taxpayers may use from their homes. Taxpayers must bring their tax documentation to an assistance site to take advantage of the other free tax return preparation and filing services.

The addition of the RAL provisions, increased security, and added performance measures to the agreement are important provisions to further promote public confidence in the Free File Program. Adding the electronic indicator to returns filed through the program will provide the IRS with information to measure the program's success. However, limiting the scope of the program to 70 percent of taxpayers has impacted the use of the program. Based on the statistics Alliance members provided in previous years, the new limits in the amended agreement appear to be substantially reducing participation in the program. Furthermore, the AGI limit also keeps the program from achieving the full intent of the EZ Tax Filing Initiative, which never specified any such limits for access to free, basic, automated tax return preparation and electronic filing. Not yet known, however, is whether the IRS' ability to better understand who is using and who is not using the program could help the IRS better market the program and expand its usage despite the new limits. The answer to that question may ultimately have a significant effect on the overall growth rate of electronic filing.

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[24] Income of less than $25,000.

[25] *National Taxpayer Advocate 2004 Annual Report to the Congress, Volume 1* December 2004.

Elimination of the TeleFile Program

As mentioned earlier in my statement, one factor that appears to have negatively impacted the Free File Program is the elimination of the TeleFile Program. The IRS discontinued this program for individual taxpayers in August 2005. The TeleFile Program allowed taxpayers with the simplest tax returns[26] to file their returns by telephone. The pilot TeleFile Program was launched on a limited basis in 1992, and the program became available nationally in 1997. The RRA 98 included the expectation that the IRS would continue to offer and improve TeleFile and make a similar program available on the Internet.

Despite its initial success, use of the TeleFile Program began to decrease in 1999. According to IRS electronic filing statistics as of April 17, 2005, approximately 3.3 million filers used TeleFile in 2005, a 12.7 percent decline from the previous year. Until the IRS eliminated the TeleFile Program last year, participation in the program had declined every year since 1999 when 5.2 million filers used it.

Declining use was one factor the IRS considered when deciding whether or not to end the TeleFile Program. Other contributing factors included the increasing cost of maintaining an aging TeleFile system, declining and discontinued State TeleFile programs, and the growing use of other electronic filing alternatives, such as the Free File Program.

According to the IRS, taxpayers who previously used TeleFile may continue to file electronically using one of the following five methods:

1. Tax preparers;
2. Personal computers with Internet access and tax preparation software;
3. IRS' Free File Program;
4. Free tax assistance sites, such as the Voluntary Income Tax Assistance and Tax-Aide Programs; and
5. IRS Taxpayer Assistance Centers.

However, two of the five alternatives require the taxpayer to pay for tax preparation and filing services that were previously free, and two other options require taxpayers to have access to computers and the Internet. Consequently, in many cases, the most cost-effective avenue for the taxpayer is to file a paper tax return. According to initial IRS statistics, a significant number of former TeleFile users are reverting to filing paper returns this year. As of April 8, 2006, the number of paper Form 1040EZ returns filed has increased 19.2 percent compared to this time last year (5.9 million in 2006 compared to 4.9 million in 2005), and there has been a corresponding decrease in electronically filed Forms 1040EZ (6.7 million in 2006 vs. 8.4 million in 2005).

TIGTA will further evaluate the impact of the elimination of the TeleFile Program on taxpayers and the IRS' efforts to increase electronic filing, and will report the results later this year.

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[26] Forms 1040EZ.

Private Debt Collection

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[27] that included 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, will help maintain confidence in the tax system, and will enable the IRS to focus its existing collection and enforcement resources on more difficult cases.

The provisions of the Fair Debt Collection Practices Act[28] 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. PCAs are also 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.

The IRS issued a detailed Request For Quotation[29] (RFQ) for solicitation of debt collection services in support of the Private Debt Collection program on April 25, 2005. However, this RFQ was canceled after the United States Court of Federal Claims filed an order on July 25, 2005, informing the IRS it intended to enjoin the solicitation. The order ruled that the IRS' restriction of the solicitation only to vendors with current Federal Government debt collection task orders was arbitrary and capricious. The IRS subsequently revised the RFQ and reissued it on October 14, 2005.

TIGTA reviewed the revised RFQ and determined that it adequately addressed the deficiencies cited by the United States Court of Federal Claims. The IRS deleted the requirement that PCAs must have a current Federal Government debt collection task order to be eligible for the solicitation. TIGTA did not identify any other restrictions in the RFQ which would have unnecessarily limited the procurement process. Further, the revised RFQ was reviewed by the IRS' Office of Procurement Policy Quality Assurance Branch and General Legal Services as required by IRS procurement procedures.

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[27] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[28] 15 U.S.C. § 1601 note, 1692-1920 (2000).
[29] An 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 April 25, 2005. *The Private Debt Collection Request for Quotation Outlines Adequate Procedures and Controls* (Reference Number 2005-10-156, dated September 2005). TIGTA will soon report on its review of the revised RFQ dated October 14, 2005.

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 Government Accountability Office (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.

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 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.[30] 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

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

contract employees. 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 mentioned previously, our limited scope reviews of the original and revised RFQs did not identify any material omissions that would adversely affect the IRS' ability to manage this initiative effectively. Additionally, TIGTA recently reported that overall, the IRS has taken positive steps to effectively plan and implement certain aspects of the Private Debt Collection program. For example, the IRS has developed a draft letter and a related publication with pertinent information to notify taxpayers when their accounts are transferred to PCAs.

While the IRS has taken positive steps to implement the Private Debt Collection program, TIGTA noted that approximately 72 percent of the IRS' original inventory of cases available for placement in the program had balances due[31] that were over 2 years old. The IRS is now considering a revision to its case selection criteria that will increase the balance-due age even further. IRS management indicated that there is a long-term strategy in place to include more current cases in the program. However, the new Filing and Payment Compliance project[32] currently limits their ability to accomplish this strategy.

For the initial phase of the program, the IRS plans to place simpler cases with PCAs, such as those in which the taxpayer has filed all tax returns due. TIGTA determined, however, that contrary to IRS intentions, the case selection criteria the IRS had established would have allowed certain nonfiler cases to be assigned to the PCAs. The IRS subsequently agreed to review nonfiler conditions and determine whether the nonfiler cases should be excluded from inventory.

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.

Other Major Challenges Facing the IRS

Despite the overall progress in customer service and the broad relief provided to Hurricane victims, improvements need to be made in customer service and other areas in which the IRS faces significant challenges in accomplishing its mission. TIGTA has identified the following additional management and performance challenges that confront the IRS:

- Modernization of the IRS;
- Security of the IRS;

[31] A balance due represents an unpaid assessment for which a taxpayer owes the IRS.
[32] The Filing and Payment Compliance project was initiated to address the inventory of delinquent tax debt that is not actively being collected by the IRS due to limited resources.

- Complexity of the Tax Law;
- Using Performance and Financial Information for Program and Budget Decisions;
- Erroneous and Improper Payments;
- Taxpayer Protection and Rights;
- Managing Human Capital.

Each of the above presents its own unique challenges, which I will address individually in the remaining portion of my testimony.

Modernization of 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 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[33] 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 of projects.[34] For example, the IRS recently issued 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.[35]

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[33] The PRIME is an acronym for Prime Systems Integration Services Contractor.

[34] A release is a specific edition of software.

[35] 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 online 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.

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
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 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.

Security of the IRS

Millions of taxpayers entrust the IRS with sensitive financial and personal data, which are stored and processed by IRS computer systems. The risk of sensitive data being compromised has increased over the last few years because of the increased threat of identity theft. According to the Social Security Administration, identity theft is one of the fastest growing crimes in the United States. The Department of Commerce estimates that more than 50 million identities were compromised in 2005. The sensitivity of taxpayers' information stored by the IRS and the IRS' use of the Social Security Number as a taxpayer identifier on its computer systems add to the risks the IRS must address.

As the nation's primary revenue collector, the IRS may also be a prime target for attacks on its computer systems by anti-government protestors, international terrorists, and disgruntled employees. In addition to identity theft concerns, computer attacks can cause the loss of revenue and productivity by disrupting computer operations. Although many steps have been taken to limit risks, IRS systems and taxpayer information remain susceptible to threats that could impact the confidentiality, integrity, and availability of data and information systems.

The IRS has focused on technical solutions to protect its computer systems and data, and has established reasonable technical controls to prevent intruders from entering the IRS network. However, managerial and operational controls have not been adequately emphasized, leading TIGTA to conclude that systems and data remain vulnerable. In the past, the IRS relied mainly upon the Chief Information Officer and Chief, Mission Assurance and Security Services, to provide security controls. The IRS has recently increased business unit involvement to ensure adequate security and has added security responsibilities to executives' position descriptions. These changes are critical but will take time to improve the security posture of the IRS.

The IRS has improved its processes and devoted additional resources for certifying and accrediting its systems; however, only 35 percent of its systems had been certified and accredited as of September 2005. Annual testing had not been conducted on a majority of its systems. In addition, only 300 of its 2,737 employees with key security responsibilities had received any specialized training in the last fiscal year. We have attributed several security weaknesses in the past to the lack of training for these employees and expect these weaknesses will persist until specialized training is given more emphasis. In addition, contractors and States who use taxpayer information to administer their States' tax laws have not been given sufficient oversight.

Hurricanes Katrina and Rita affected 25 IRS offices. By adequately planning and taking aggressive actions after the hurricanes hit, the IRS was able to locate its employees and restore its computer operations to continue tax administration activities in the Gulf Coast area. However, disaster recovery plans for the IRS' large computing centers and campuses require additional development, testing, or personnel training to ensure that the IRS can quickly recover in the event of a disaster.

For the IRS to make the largest strides in improving computer security at a relatively low cost, managers and employees must be aware of the security risks inherent in their positions and consider security implications in their day-to-day activities. IRS business unit managers should be held accountable for the security of their systems and key security employees should be adequately trained to carry out their responsibilities. It is also vital that the IRS continues to refine its plans and capabilities to manage emergency situations in a manner that protects employees and allows restoration of business operations in a timely manner.

Complexity of the Tax Law

The scope and complexity of the United States tax code make it virtually certain that taxpayers will face procedural, technical, and bureaucratic obstacles before meeting their tax obligations. The IRS has consistently sought to ease the process for all taxpayers. But each tax season brings new challenges, and old problems sometimes resist solution.

According to the November 2005 Report of the President's Advisory Panel on Tax Reform, last year Americans spent more than 3.5 billion hours doing their taxes, the equivalent of hiring almost two million new IRS employees—more than 20 times the IRS' current workforce. About $140 billion is spent annually on tax preparation and compliance—about $1,000 per family.

The Joint Committee on Taxation conducted a study in 2001 that demonstrates the vastness of the tax code. The study found that, in 2001, the tax code consisted of nearly 1.4 million words. There were 693 sections of the code applicable to individuals, 1,501 sections applicable to businesses, and 445 sections applicable to tax exempt organizations, employee plans, and governments.[36]

The complexity of the code hampers the ability of the IRS to administer the nation's tax system and confuses most taxpayers. The IRS has attempted to provide assistance to taxpayers with questions about the tax code through toll-free telephone lines, TACs, kiosks, and the IRS Internet site. TIGTA has performed numerous audits of the accuracy of IRS responses to taxpayer questions submitted via these methods and found that even some IRS employees cannot apply the tax code correctly.

Tax law complexity contributes to the IRS' challenges in reaching accuracy goals to tax law questions, as well as to taxpayer frustration with attempting to decipher the tax code. For example, assistors are trained and expected to be knowledgeable in 318 tax law topics with 395 subtopics. Additionally, they are expected to be able to respond to taxpayer issues for the current and prior tax years.

In part because of the tax law complexity, taxpayers are continuing to receive inaccurate answers to their tax law questions. TIGTA's results for the 2006 Filing Season show that assistors provided accurate answers to 73 percent of the tax law questions asked at the TACs. Although this is an improvement from the accuracy rate of 66 percent TIGTA reported for the 2005 Filing Season,[37] taxpayers are still receiving incorrect answers to 27 percent of their questions asked at the TACs. Using its own methodology to calculate the accuracy rate, however, the IRS did meet its accuracy rate goal of 80 percent for the 2006 Filing Season.

As well as adding to the burden on the taxpayer and the IRS, tax law complexity also may inadvertently contribute to the tax gap. Complexity has given rise to the latest generation of abusive tax avoidance transactions, with taxpayers attempting to take advantage of the tax code's length and complexity by devising intricate schemes to illegally shelter income from taxation. The Son of Boss (Bond and Option Sales Strategies) is one such abusive tax shelter.[38] Other than generating tax benefits, the IRS determined it lacked a business purpose.

Overall, the IRS estimated the Son of Boss abusive tax shelter understated tax liabilities in excess of $6 billion. The IRS describes the Son of Boss abusive tax shelter as a highly sophisticated, technically complex, no-risk scheme designed to generate tax losses without corresponding economic risks, which was promoted by some prominent firms in the financial services industry to investors seeking to shelter large gains from the sale of a business or capital asset.

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[36] *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Staff of the Joint Committee on Taxation, JCS-3-01 (Apr. 2001).

[37] *Customer Accuracy at Taxpayer Assistance Centers Showed Little Improvement During the 2005 Filing Season* (Reference Number 2005-40-146, date September 2005).

[38] IRS Notice 99-59 issued in December 1999 described Boss transactions as certain losses involving partnerships and foreign corporations that would not be allowed for tax purposes.

The scheme used flow-through entities, such as partnerships, and various financial products[39] to add steps and complexity to transactions that had little or no relationship to the investor's business or the asset sale creating the sheltered gain. Additionally, the losses generated from the transactions were often reported among other "legitimate" items in several parts of the income tax return. Some losses from the Son of Boss abusive tax shelter, for example, were reported as a reduction to gross sales, cost of goods sold, or capital gains.

Taken together, these characteristics, especially the use of flow-through entities, made it very difficult for the IRS to detect the Son of Boss abusive tax shelter through its traditional process of screening returns individually for questionable items.[40] Administering such a complex tax code makes the job of pursuing abusive tax avoidance schemes, such as the Son of Boss, challenging and costly to the IRS.

As part of its goal to improve service to taxpayers, the IRS includes simplifying the tax process as an objective in its Strategic Plan. Simplification could incorporate a range of actions from developing legislative recommendations to clarifying tax instructions or forms. Changing tax laws, however, can be a lengthy process since the IRS only administers the tax code that is passed by Congress. Thus, the IRS must work extensively with its stakeholders, as well as the Department of the Treasury, to identify and develop legislative recommendations that would reduce tax law complexity and taxpayer burden.

Using Performance and Financial Information for Program and Budget Decisions

The President's Management Agenda aims to place a greater focus on performance by formally integrating it with budget decisions. In addition, without accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people. The IRS has made some progress. However, integrating performance and financial management remains a major challenge.

The IRS has achieved mixed success in establishing long-term goals to integrate performance and financial management. During the Fiscal Year 2005 budget formulation process, the IRS took the important step of aligning performance and resources requested. The IRS also modified its budget and performance plans to include more customer-focused and "end result" measures. However, TIGTA believes that the IRS must continue to integrate performance into its decision-making and resource allocation processes to completely achieve an integrated performance budget.

The IRS also continues to analyze the critical data needed to develop long-term enforcement outcome measures. For example, the IRS released the first results from its NRP, which provided fresh data on taxpayer voluntary compliance levels – the first in more than a decade. Such data are essential to establishing enforcement measures and effectively allocating resources to related activities. The IRS, however,

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[39] The IRS defines financial products as instruments used in the global marketplace and include, among others, stocks, bonds, foreign currencies, mortgages, commodities, and derivatives.

[40] *The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters* (Reference Number 2006-30-065, dated March 2006).

needs to develop a more strategic approach to the entire tax administration system. Such an effort would better identify the characteristics of an effective and efficient tax administration system, would help pinpoint desired outcomes, and would create a road map for the next decade that would complement the IRS' strategic, budget, and annual performance plans.

This past year TIGTA reported on two circumstances that highlight the need for more integration of performance and budget data. The Federal Workforce Flexibility Act of 2004[41] requires agencies to regularly assess their training efforts to determine whether their training is contributing to the successful completion of the agencies' missions. However, the IRS was not able to assess how effectively the approximately $100 million spent on training enhanced its ability to fulfill its mission.[42] Additionally, the IRS could better manage its facilities and office space. TIGTA determined that the lack of appropriate performance data prevents the IRS from cataloging office space freed up by employees who regularly participate in the IRS' telecommuting program. This lack of performance data prevented the IRS from freeing up underutilized space with an estimated annual cost of $18 million.[43]

The IRS has reported a yield of more than $4 in direct revenue from IRS enforcement efforts for every $1 invested in the IRS' total budget. However, we do not believe there is an adequate basis to use the total IRS budget to determine a return on investment for enforcement activities. Enforcement is only one component of the IRS that collects revenue. Enforcement revenue ($43.1 billion in Fiscal Year 2004) compared to the enforcement costs ($6.1 billion in Fiscal Year 2004) actually equates to an overall return on investment for enforcement activities of 7 to 1. The IRS also provided estimates that it would eventually achieve approximately $1.17 billion in additional revenues for its proposed Fiscal Year 2006 enforcement initiatives. This would equate to a 4.4 to 1 return on investment. However, our analysis indicates the revenue estimate may be too high. Furthermore, the IRS currently does not have a methodology to measure the revenue resulting from any initiatives that it implements.[44]

The IRS' financial statements and related activities also continue to be of concern to IRS stakeholders. The GAO audits the IRS' financial statements annually. The audit determines whether the IRS (1) prepared reliable financial statements, (2) maintained effective internal controls, and (3) complied with selected provisions of significant laws and regulations, including compliance of its financial systems with the Federal Financial Management Improvement Act of 1996.[45]

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[41] Public Law 108-411 [S. 129] (2004).
[42] *The Internal Revenue Service Does Not Adequately Assess the Effectiveness of Its Training* (Reference Number 2005-10-149, dated September 2005).
[43] *The Internal Revenue Service Faces Significant Challenges to Reduce Underused Office Space Costing $84 Million Annually* (Reference Number 2004-10-182, dated September 2004).
[44] *A Better Model is Needed to Project the Return on Additional Investments in Tax Enforcement* (Reference Number 2005-10-159, dated September 2005).
[45] Pub. L. No. 104-208, 110 Stat. 3009.

In audits of the IRS' financial statements, the GAO has concluded that the statements were fairly presented in all material respects.[46] The GAO, however, identified some continuing serious deficiencies in the IRS' financial systems, including control weaknesses and system deficiencies affecting financial reporting, unpaid tax assessments, tax revenue and refunds, and computer security. Also, the IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements. Without a financial management system that can produce timely, accurate, and useful information needed for day-to-day decisions, the IRS' financial stewardship responsibilities continue to be one of the largest challenges facing IRS management.

During Fiscal Year 2004, the IRS collected over $2 trillion in Federal tax revenue, which constituted approximately 95 percent of all Federal revenue. However, as reported by the GAO for the last several years, the systems used to account for these revenues do not meet current Federal financial management guidelines. For example, the IRS' Federal tax revenue financial management systems lack adequate audit trails, cannot readily produce reliable information regarding unpaid assessments at interim periods, and cannot readily generate custodial financial information needed for year-end reporting.

To address these weaknesses, the IRS is developing the Custodial Detail Database (the Database). The purpose of the Database is to provide sub-ledgers for the custodial financial activities of the IRS. The IRS also plans to use the Database to track unpaid assessments throughout the year and to help support the lengthy extraction, reconciliation, and summarization process needed to produce the IRS' annual financial custodial statements. TIGTA's preliminary assessment indicates that the IRS faces a number of significant challenges in meeting these objectives, especially the development of a system that would support the production of current and reliable information regarding tax receivables throughout the year.

To provide useful information on tax receivables at interim periods, the Database will also need to address collectibility issues, and accurately account for and eliminate duplicate assessments. Furthermore, the IRS continues to be unable to determine the specific amount of revenue it actually collects for three of the Federal Government's four largest revenue sources, primarily because the accounting information needed to validate and record payments to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. The IRS has to use statistical methods to estimate the amounts of these taxes.[47]

Preventing Erroneous and Improper Payments

One of the goals of *The President's Management Agenda* is to reduce erroneous payments.[48] Further, the Improper Payments Information Act of 2002[49] greatly expanded

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[46] *Financial Audit: IRS's Fiscal Years 2005 and 2004 Financial Statement* (GAO-06-137, dated November 2005).
[47] The three revenue sources cited are Social Security, hospital insurance, and individual income taxes. *The Custodial Detail Database Should Help Improve Accountability; However, Significant Financial Management Issues Still Need to Be Addressed* (Reference Number 2006-10-029, dated December 2005).
[48] *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.
[49] Pub. L. No. 107-300, 116 Stat. 2350.

the Administration's efforts to identify and reduce erroneous and improper payments in government 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.[50] 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.[51]

The Criminal Investigation function of the IRS is responsible for detecting and combating tax refund fraud, through its Questionable Refund Program (QRP). TIGTA has repeatedly reported over the last six years that additional controls and procedures were necessary to not only identify additional instances of potential fraud, but also to properly and timely release refunds that are later determined not to be fraudulent. This latter issue recently 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.

TIGTA previously reported in March 2003 that there were unnecessary delays issuing legitimate, non-fraudulent refunds.[52] That same audit, however, identified expired statutory periods for making civil assessments of tax, thereby preventing recovery of

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

[51] 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 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).

[52] *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).

erroneously refunded monies through an examination of income or expense items on the tax returns.

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 due process and notification. TIGTA is continuing its review of the IRS QRP and will report on its audit work later in the year.[53]

Additionally, at the request of the House Committee on Ways and Means, TIGTA initiated an audit of the Electronic Fraud Detection System (EFDS). EFDS was designed to identify potentially fraudulent tax returns. We plan to report our results later in the year.

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 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 (DCAA) in the past five years for a major IRS contractor. These deficiencies could lead to overstated and unsupported 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.

Taxpayer Protection and Rights

Congress realized the importance of protecting taxpayers and taxpayer rights when it passed the RRA 98. This legislation required the IRS to devote significant attention and resources to protecting taxpayer rights. The RRA 98 and other legislation require TIGTA to review IRS compliance with taxpayer rights provisions. Our most recent audit results on some of these taxpayer rights provisions are:

- *Notice of Levy* – TIGTA reports have recognized that the IRS has implemented tighter controls over the issuance of systemically generated levies, and TIGTA testing of these controls indicated that they continue to function effectively. In addition, revenue officers who manually issued levies properly notified taxpayers of their appeal rights.[54]
- *Restrictions on the Use of Enforcement Statistics to Evaluate Employees* – The IRS is complying with the law. A sample review of employee performance and related

[53] 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).

[54] *Taxpayer Rights Are Being Protected When Levies Are Issued* (Reference Number 2005-30-072, dated June 2005).

supervisory documentation revealed no instances of tax enforcement results, production quotas, or goals being used to evaluate employee performance.[55]

- *Notice of Lien* – The IRS did not completely comply with the law. For example, the IRS did not always timely mail lien notices. In other cases, the IRS could not provide proof of mailing. In addition, the IRS did not always follow its guidelines for notifying taxpayer representatives and resending notices when they are returned as undeliverable.[56]
- *Seizures* – The IRS did not comply with all legal and internal guidelines when conducting seizures. TIGTA's review did not identify any instances in which taxpayers were adversely affected, but not following legal and internal guidelines could result in abuses of taxpayer rights.[57]
- *Illegal Tax Protestor Designations* – The IRS is prohibited by law from designating taxpayers as "illegal tax protestors" but may refer to taxpayers as "nonfilers." TIGTA has reviewed the Master File[58] for illegal tax protestor designations. We found that the IRS has not reintroduced such designations on the Master File and formally coded illegal tax protestor accounts have not been assigned similar Master File designations. In addition, the IRS does not have any current publications with illegal tax protestor references and has initiated actions to remove references from various forms of the Internal Revenue Manual. However, a few illegal tax protestor references still exist in isolated case files.[59]
- *Denials of Requests for Information* – The IRS improperly withheld information from requesters in 7.1 percent of the Freedom of Information Act and Privacy Act of 1974 requests, and 3.1 percent of the 26 U.S.C. § 6103 requests reviewed.[60]
- *Collection Due Process* – A significant portion of the Appeals Collection Due Process and Equivalent Hearings closed case files requested could not be located or did not contain sufficient documentation. As a result, TIGTA could not determine if the IRS complied with legal guidelines and required procedures to protect taxpayer rights. Moreover, some Appeals determination letters did not contain clear and detailed explanations of the basis for the hearing officers' decisions and did not adequately communicate the results of the hearings to taxpayers. Some

[55] *Fiscal Year 2005 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results* (Reference Number 2005-40-157, dated September 2005).
[56] *Fiscal Year 52004 Statutory Review of Compliance With Lien Due Process Procedures* (Reference Number 2005-30-095, dated June 2005).
[57] *Fiscal Year 2005 Review of Compliance With Legal Guidelines When Conducting Seizures of Taxpayers' Property* (Reference Number 2005-30-091, dated June 2005).
[58] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[59] *Fiscal Year 2005 Statutory Audit of Compliance With Legal Guidelines Prohibiting the Use of Illegal Tax Protester and Similar Designations* (Reference Number 2005-40-104, dated July 2005).
[60] *Some Improvements Have Been Made to Better Comply With the Freedom of Information Act Requirements* (Reference Number 2005-10-089, dated May 2005).

determination letters did not address the specific issues raised or tax periods discussed by the taxpayers in their hearing requests.[61]

Neither TIGTA nor the IRS could evaluate the IRS' compliance with three RRA 98 provisions since IRS information systems do not track specific cases. These three provisions relate to: restrictions on directly contacting taxpayers instead of authorized representatives, taxpayer complaints, and separated or divorced joint filer requests.

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 OMB, 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. These 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. As noted earlier, the IRS has reported fewer taxpayers are seeking assistance at the TACs.[62]

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 IRS' 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 the 10 challenges discussed in this testimony.

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[61] *The Office of Appeals Should Strengthen and Reinforce Procedures for Collection Due Process Cases* (Reference Number 2005-10-138, dated September 2005).
[62] *The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program* (Reference Number 2006-40-067, dated March 2006).

Conclusions

While the 2006 Filing Season appears to have been successful based on TIGTA's preliminary results, I am concerned about some of the challenges the IRS faces. In particular, it appears that changes in the Free File Agreement as well as the elimination of the TeleFile Program may have contributed to a significant slowing of the growth in electronic filing this year. This slowed growth comes at a time when the IRS is still far from reaching Congress' goal of 80 percent electronic filing by 2007. This slower growth will defer the efficiency gains for the IRS that result from electronic filing.

Also, without reliable estimates of the tax gap, IRS' compliance and customer service efforts may not be as effective as necessary to improve the voluntary compliance rate and reduce the tax gap. Additionally, reductions in customer services, such as TAC closures, the elimination of the TeleFile Program, and a reduction in toll-free telephone hours of operation, to gain resource efficiencies must be carefully considered before any further decisions are made. TIGTA continues to be concerned that the IRS does not ensure that it has adequate and reliable data prior to making decisions that impact customer service operations. Before proceeding with these efforts, the IRS needs to better understand the impact of such changes on taxpayers as well as taxpayers' abilities to obtain these services through alternative means.

I hope my discussion of the 2006 Filing Season and some of the significant challenges facing the IRS will assist you with your consideration of the IRS' Fiscal Year 2007 appropriations. 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 may have.