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2004 TAX RETURN FILING SEASON AND THE IRS BUDGET FOR FISCAL YEAR 2005

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

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2004 TAX RETURN FILING SEASON AND THE IRS BUDGET FOR FISCAL YEAR 2005

TUESDAY, MARCH 30, 2004

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 3:04 p.m., in room 1100, Longworth House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
March 23, 2004
OV–12

CONTACT: (202) 225–7601

Houghton Announces Hearing on 2004 Tax Return Filing Season and the IRS Budget for Fiscal Year 2005

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the 2004 tax return filing season and the Internal Revenue Service (IRS) budget for fiscal year 2005. **The hearing will take place on Tuesday, March 30, 2004, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 3:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include IRS Commissioner Everson, and representatives of the U.S. General Accounting Office (GAO), the IRS Oversight Board, the tax section of the American Bar Association (ABA), the American Institute of Certified Public Accountants (AICPA), Tax Executives Institute, Inc. (TEI), and the National Association of Enrolled Agents (NAEA).

BACKGROUND:

The 2004 tax return filing season refers to the period from January 1st to April 15th when U.S. taxpayers will file more than 130 million tax returns, including more than 50 million e-filed returns. During this period the IRS is expected to issue more than 105.7 million tax refunds, answer nearly 36.8million telephone calls from taxpayers asking for assistance, and its homepage is projected to receive more than 4.8 billion hits.

The Administration's budget requests $10.67 billion to fund the IRS for fiscal year 2005. This level of funding will support approximately 101,272 employees who will collect an estimated $1.716 trillion in taxes (net of refunds), according to Administration estimates. Beyond supporting the traditional activities of the filing season, the fiscal year 2005 budget request addresses the Administration's key strategic goals for the IRS.

In announcing the hearing, Chairman Houghton stated, "During the next 3 weeks, tens of millions of Americans will perform a key duty of citizenship. They will file their federal income tax return. Also, millions of aspiring citizens and residents will file faithfully."

"This is a great country for many reasons, not the least being our sense of honesty and decency. For most, rather than gaming the system on April 15th, they try to uphold it. Maybe this is one of the sacred strengths of our country. I applaud the efforts of IRS Commissioner Everson and the Bush Administration in upholding our standards."

FOCUS OF THE HEARING:

The hearing will focus on the 2004 tax return filing season and the IRS budget for fiscal year 2005.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person or organization wishing to submit written comments for the record must send it electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, by close of business Tuesday, April 13, 2004. In the immediate future, the Committee website will allow for electronic submissions to be included in the printed record. Before submitting your comments, check to see if this function is available. Finally,due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, in WordPerfect or MS Word format and **MUST NOT** exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman HOUGHTON. Good afternoon, ladies and gentlemen. We are delighted to have you here. I am going to make an opening statement, and then I will ask the Democratic leader of this Committee, Mr. Pomeroy, to make his statement. Nice to see you here, Mr. Portman.

Mr. PORTMAN. Good morning, Mr. Chairman.

Chairman HOUGHTON. Nice to see you here. Commissioner, we are obviously honored that you are going to be here expressing your views and giving us your wisdom. During the next 3 weeks, as most people know, tens of millions of Americans will perform a key duty of citizenship. They are going to be filing their Federal income tax returns. Millions of aspiring citizens and residents will also file. As we all know, this is a great country for a variety of reasons, not the least of which is our sense of honesty and decency. For most, rather than gaming the system on April 15th, they will try to uphold it. I don't think there is another Nation in the world that does this as well. It is for the benefit of the vast majority of

law-abiding taxpayers that we are holding this hearing today. We owe it to these honest and decent taxpayers to see that we are served by a Federal tax agency that treats all taxpayers with dignity and respect and one that is both efficient and strong enough to deter cheating and bring the others to justice.

Appearing before us today, is Internal Revenue Service (IRS) Commissioner Mark Everson, who has made it one of his key priorities to reverse the decline in voluntary compliance consistent with taxpayer rights. On the next panel, we are going to have representatives from the IRS Oversight Board and the U.S. General Accounting Office (GAO). Finally, we have a distinguished panel of practitioners who represent some of the organizations that have helped the IRS and Congress to shape tax policy and tax administration in the past. I welcome you all and look forward to your testimony, all of the witnesses, and I am now pleased to yield to our Ranking Democrat, Mr. Pomeroy.

Mr. POMEROY. I thank the Chairman. I thank him for his leadership of this Committee, for convening this meeting and for being my friend. An important function of the Subcommittee on Oversight is to keep an evaluation of how the tax-filing season is proceeding. We are aware that there will be 130 million tax returns filed during this filing season which ends in about 2 weeks. During this time, we will have received over 50 million e-filed returns, issued over 100 million tax refunds and answered nearly 40 million telephone calls from taxpayers seeking assistance. The reports indicate that the 2003 tax return filing season is progressing smoothly, and we certainly look forward to your further testimony on that. I must say that I am concerned about the Washington Post story. I will just read you the lead paragraph:

"President Bush's 2005 budget request for the IRS would seriously shortchange the Agency's tax-collection activities, leaving half a million tax accounts uncollected, 15 million service calls unanswered and nearly 46,000 audits unscheduled, according to the President's own IRS Oversight Board." So, as we look at the performance of the IRS relative to this tax-filing season, I would also like to have one eye down the road where we will be in 1 year, if we cannot adequately fund these essential collection activities the statutes direct the IRS to perform. I would cite this article that is in today's paper to everyone to really look at the daunting issues before the IRS relative to performing activities.

Congress has to understand—I think Congress may have a tendency to note problems in the field, haul in the Commissioner or other representatives of the IRS, rail indignantly about the administrative failings relative to the tax season and never accept any responsibility for the fact that we have never given you the resources you need to do the job. I hope if nothing else could come from this hearing, Mr. Chairman, it would represent a bit of Congress owning up to its own responsibilities to giving you the resources so that the job can done in the first place. There is a specific item of concern that I have asked to be addressed in the course of this hearing, and I am very pleased that among the practitioner panel, Allen Orwick, a constituent of mine from North Dakota, will be on the panel.

He will be presenting testimony concerning the recent e-file program and also talk about a recent ruling by the IRS regarding the Conservation Reserve Program CRP), a recent Chief Counsel's letter ruling that now appears to change what has been longstanding practice relative to the treatment of CRP rent to retired farmers as active income from the farm requiring the self-employment tax to be administered. This is different than it has been in the past, has caused a lot of concern in farm country, can be clarified in ways that I will suggest in the course of this hearing. Thank you for, even while we talk about the macro issues, allowing the discussion of this particular issue, so important not just to North Dakota, but all of farm country. Mr. Chairman, thank you, and I look forward to this hearing.

Chairman HOUGHTON. Thank you very much. We are going to try to move this thing along pretty fast. Unless anybody has an opening statement, we are going to go right to Mr. Everson. There are going to be votes. I do not know when they are going to be. They may be at 3:30 p.m. We are going to do the best we can, and we will roll this thing as fast as we can, and then we will have to just stop until we have the votes, and then we will be coming back. I would like to introduce, once again, the Honorable Mark Everson, Commissioner of the IRS. Thanks for being here.

STATEMENT OF THE HONORABLE MARK W. EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. EVERSON. Thank you, Mr. Chairman, Ranking Member Pomeroy, and Members of the Subcommittee. I appreciate the opportunity to testify this afternoon on the President's 2005 budget request for the IRS and the 2004 tax filing season. At the onset, let me indicate how much I appreciate the Subcommittee's ongoing support for the IRS. In particular, I am very thankful for your efforts to secure adequate budgetary resources for the IRS.

Mr. Chairman, Ranking Member Pomeroy, and Congressman Portman, in your March 24th letter to Chairman Istook and Ranking Member Olver of the Appropriations Subcommittee, with jurisdiction over the IRS, you wrote: "we hope you will fully fund the President's budget, and in particular the 10.7-percent increase in enforcement funding." You went on to write that the "new moneys for enforcement will allow the IRS to make up ground in compliance that was lost while the IRS conducted the IRS restructuring." Thank you.

As you know, my working equation for the IRS is service "plus" enforcement equals compliance not service "or" enforcement. The IRS must do both. We must run a balanced system of tax administration based on a foundation of taxpayer rights. Earlier this month, we released our enforcement statistics for fiscal year 2003. They demonstrate that we have arrested the enforcement decline which began in the nineties and worsened with the implementation of Restructuring and Reform Act 1998 (RRA 98). Audits, criminal investigations and moneys collected were all up. In particular—and you can see the chart over on the easel—when compared with the fiscal year which started October 1, 2000, audits of taxpayers with incomes over $100,000 were up by over 50 percent.

[The charts are being retained in the Committee files.]

The President's 2005 budget request for the IRS will continue to rebuild our enforcement activities. I would note that two-thirds of the new moneys will be devoted to enhancing our compliance efforts in the high-income and corporate arenas, as well as increasing our criminal investigations. These incremental resources will help us address the tax gap—the difference between what is owed and what is paid, due to nonfiling, underreporting, and underpayment—and secure billions of extra dollars for the Department of the Treasury.

Furthermore, over a 4-year period, we have seen an increase in the percentage of Americans who think it is okay to cheat on their taxes from 11 percent to 17 percent. I find this alarming, as do you. I believe, however, that enhanced enforcement efforts will improve attitudes concerning compliance by reassuring the average American, who pays his or her taxes, that when he or she pays, neighbors and competitors will do the same. I am convinced we can augment our enforcement activities without diminishing our commitment to service. Our filing season results thus far in 2004 show that we can. Through last Friday, returns filed have increased almost 2 percent, but our electronically filed returns are up 12 percent from last year. Electronic filing is more reliable, both for the taxpayer and the IRS, and it is faster, allowing the IRS to issue refunds in half the time.

Also, noteworthy is that the Free File Initiative, which helps low—and middle-income taxpayers, has grown in volume by over 24 percent from last year. Our other IRS indicators, for the most part, also show improvement. We have handled increased call volumes with stable resources and bettered our level of service, and there is increased usage of automated services both on the phone and the Internet. While we made some changes to improve tax law accuracy and had some startup problems earlier in the season, in recent weeks, our tax law accuracy results have recovered. While we have 2 weeks yet to go, I expect good results through the remainder of the filing season. Thank you.

[The prepared statement of Mr. Everson follows:]

House Committee on Ways and Means

Statement of The Honorable Mark Everson, Commissioner, Internal Revenue Service

INTRODUCTION

Chairman Houghton, Ranking Member Pomeroy, and Members of the Subcommittee, thank you for the opportunity to testify today on the 2004 tax filing season, our FY 2005 budget request and the progress that the Internal Revenue Service is making in the fair and efficient administration of taxes.

Our working equation at the IRS is service plus enforcement equals compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he or she owes.

This is not an issue of service OR enforcement, but service AND enforcement. As you know, IRS service lagged in the 1990s. In response, we took important and necessary steps to upgrade service—we significantly improved the answering of taxpayer telephone inquiries and electronic filing to name just a couple areas.

Unfortunately, improvement in service coincided with a drop in enforcement of the tax law. Since 1996, the number of IRS revenue agents, officers, and criminal investigators has dropped by over 25 percent.

We currently have a serious tax gap—the difference between what taxpayers are supposed to pay and what is actually paid—in this country. By our best estimates, we lose a quarter trillion dollars each year due to non-filing, under-reporting, and underpayment. (This is a rough estimate based largely upon data from our old Tax-

payer Compliance Measurement Program, most of which was collected in the 1980s. Our estimates have been updated to reflect changes in the economy during the intervening years, but a key assumption is that compliance behavior has remained largely unchanged. If taxpayer compliance has changed in the last 15 years, the tax gap could well be much different than our estimate suggests.)

In addition, over the last four years, the number of Americans saying it is OK to cheat on taxes rose from 11 to 17 percent. Sixty percent of Americans believe that people are more likely to cheat on taxes and take a chance on being audited. (See Roper ASW, 2003 IRS Oversight Board Annual Survey on Taxpayer Attitudes, September 2003.)

We must restore the balance between service and enforcement, but that will not come at the expense of continued improvements to taxpayer service. In recent years, we have begun to attack these declines by revitalizing our investigations, audits and prosecutions against those who do not pay their taxes. The President's FY 2005 budget—if approved by Congress—will help with our efforts to boost enforcement while maintaining our levels of service. The submission requests an additional $300 million for enforcement activities over the FY 2004 consolidated appropriations level.

In a moment, I will talk much more about service and enforcement and the President's budget request. But first, let me give you an update on the 2004 filing season and what we are doing to make the tax season easier and more convenient for the American taxpayer.

2004 FILING SEASON

Mr. Chairman, I have been on the job for not quite a year so I am still going through my first filing season. Each year at the IRS, we process billions of tax-related documents. We process well over one hundred million taxpayer returns. We send out about one hundred million refunds. And we do a lot of other things as well.

It all peaks, of course, on April 15, a little more than two weeks away.

Here are some highlights as of March 19th (unless otherwise indicated):

Return Receipts

The IRS has received 68 million total individual returns. 25 million returns (36.86%) are paper and 43 million (63.14%) are e-file. Total returns have increased 1.2 million from last year, a 1.81% growth.

- The number of online returns is at 9.88 million, a 22.9% increase from last year.
- Through **March 17h**, 2.46 million Free File returns have been accepted, an increase of **24%** from last year (1.98 million).

Funds

Refund measures continue to show an increase over 2003. Total refunds are up from 2003 by 4.6%. Total dollars paid are 9.77% higher than last year, with an average refund of $2,128 paid.

Telephone Measures

Assistor level of service, at 84%, is up 1.9% compared to last year. Assistors have answered approximately 731,000 more calls than they did during the same period in 2003.

Automated calls completed are 304,000 more than the same period in 2003. A major contributor to this increase is Advanced Child Tax Credit (ACTC) related calls.

We created automated ACTC applications for use in providing taxpayers the correct amount of ACTC to report on their 2003 tax return. These applications are available through telephone automation and interactive web applications.

Telephone Quality Rates

We measure telephone quality two ways, 1) customer account accuracy and 2) tax law accuracy. While our customer account accuracy estimates are 89.75%, up slightly over the previous two years, our tax law accuracy has declined from 84% in 2002 to 75.79% thus far in 2004.

FY 2004 Quality Review results indicate that two of our most frequent tax law defects are: Incomplete Research and Applying Tax Law Incorrectly.

We are undertaking the following efforts to improve performance:

- Identifying root cause of performance deficiencies and implementing corrective initiatives through analysis;
- Establishing Quality Review Improvement Teams to determine the drivers of Customer Accuracy rates and to establish resolution priorities as needed; and

- Strengthening accountability to the frontline managerial level to facilitate improvement in services provided.

Taxpayer Assistance Sites (TACS)

The number of taxpayers walking into a TAC for assistance has decreased as a result of streamlined services in the TACs and initiatives to educate taxpayers on alternate methods of obtaining services generally requiring a face-to-face contact. The advent of technological advances in irs.gov services such as "Free File" and "Where's My Refund", and the accessibility of forms online have all contributed to the decline in the number of customers walking into a TAC.

IMPROVING SERVICE

As this snapshot of the filing season makes clear, we are improving service to the taxpayer. Let me give a broader picture of service and compliance, and how the President's budget will lead to more effective and fair collection of taxes.

It was not long ago that IRS service was not all that it should be—some would even say it was poor. In many areas the service level we provided, or more accurately stated, failed to provide, frustrated taxpayers in their effort to understand and comply with the tax law.

Regardless of the merits of some of the allegations directed against the IRS in the mid-1990s, there was a significant gap between the quality of service that the IRS was providing taxpayers and the quality of service that the public had a right to expect. This shortfall in services clearly warranted the fundamental improvements and reorganization established under the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).

The reorganization of the IRS along customer lines of business and the other changes brought about by RRA 98 were, taken as a whole, sound reforms. The twin themes of the legislation were improvement of service and protection of taxpayer rights.

Through an almost single-minded focus on RRA 98 implementation, the IRS has demonstrated unmistakable progress in improving customer service and increasing its recognition of, and respect for, taxpayer rights. While we still aim to reach a higher level of customer service, our improvement and commitment with respect to these core goals is measurable.

Last year 53 million individuals filed their returns electronically. Thus far this year, nearly 2 weeks away from "tax day", electronic filing is up again, by about 11 percent. Electronic filing is more reliable, both for the taxpayer and the IRS. And it is faster. Over three-quarters of Americans get refunds, and we issue the refund in about half the time when a taxpayer files electronically.

Another challenge in the 1990s was getting through to the IRS at all. We now have a world-class telephone call routing system. A call is directed to the right person, someone who knows something about charitable contributions or IRAs—whatever the subject may be—and the system balances workforce planning against predictable workload patterns to reduce waiting time. Busy signals—the crudest indication of service failure—decreased from 400 million in 1995 to 600 thousand in 2003.

All told, we have reduced taxpayer call-waiting time in half, reduced the number of abandoned calls by 50%, and doubled the number of refund inquiries from our Spanish-speaking taxpayers.

Meanwhile, we have delivered other applications that provide tangible benefits to taxpayers and improve the efficiency and effectiveness of our tax administration system. They include:

- *Where's My Refund?/Where's My Advance Child Tax Credit?,* which gives taxpayers instant updates on the status of their tax refunds and advance child tax credits. These applications have received over 40 million requests since the beginning of the year. By shifting a significant volume of customer demand to the Internet, we have seen a measurable improvement in service to taxpayers who still choose to call.
- *e-Services,* which includes preparer tax identification number (TIN) applications with instant delivery, individual TIN matching for 3rd party payers, on-line registration for electronic e-Services, and on-line initiation of the electronic originator application (currently released to a controlled segment of external users). I am pleased to announce that we recently made the first part of e-Services available on our public web site. The remaining parts will come out over the next several months.
- *Internet EIN,* which permits small businesses to apply for, and receive, an Employer Identification Number on-line.
- *HR Connect,* which allows IRS users to perform many personnel actions on-line. This technological advance will enable the Service to redirect hundreds of posi-

tions to enforcement activities by the time it is fully deployed, which we have planned for October 2005.

Are we where we need to be on service? Not yet. As you know, I have been emphasizing enforcement, but I do not want this subcommittee or anyone to think the IRS will walk away from service. We still continue to maintain and improve service.

Our objectives for improved taxpayer service are three-fold:

- First, to improve and increase service options for the tax-paying public;
- Second, to facilitate participation in the tax system by all sectors of the public; and
- Third, to simplify the tax process.

These are service objectives that recognize the dynamics of a rapidly changing world, one in which the Internet will be the dominant communications tool. Yet we realize there will remain a wide range of computer and technological literacy among individual taxpayers, and we must not fail to provide the same level of service to all taxpayers regardless of their technological sophistication. Our objectives also recognize an America with an increasingly diverse population, and that diversity will create challenges for us as tax administrators. Nevertheless, we are confident that we can and will serve all American effectively.

Continued changes in traditional media will make it harder to cover the waterfront as we seek to educate taxpayers. Moreover, the complexity of our tax laws, along with the frequency of changes to these laws, is not only a challenge to taxpayers trying to comply with the tax laws, but a basis of cynicism about complying with the tax laws. The Administration is committed to addressing this complexity. While it remains, we have an obligation to help taxpayers navigate these laws and make it as easy as possible for them to comply.

In a world increasingly impatient for prompt and reliable information and transaction processing, all of these factors pose significant challenges to the IRS as it strives to improve the level of service provided to the American taxpayer.

A good example of the challenges we will face is reconciling our desire to standardize our processes through electronic filing with the reality that some groups, such as immigrants and the elderly, will need different, targeted services. Electronic filing is important to the IRS and to taxpayers, but we cannot overemphasize it to the detriment of services to taxpayer groups who will not utilize it. Addressing competing priorities on the service side of the IRS will not be easy, but we will work diligently to provide a balanced, effective program.

EFFECTIVE ENFORCEMENT

Our focus on the strong mandate of RRA 98 to improve IRS services to the taxpaying public made it difficult for us to balance both the service and enforcement elements that are so necessary to the success of our tax system. Improved taxpayer service enhances compliance and respect for our laws among the vast majority of Americans who do their best to pay their fair share. Improved taxpayer service also may help discourage those who might not otherwise do what is necessary to comply with our tax laws. Taxpayer service, however, does not address those who actively seek to avoid paying their fair share. I believe most people would agree that we achieved improvement of IRS taxpayer services in large part at the expense of needed enforcement activities.

Over a five-year period beginning in 1997, the IRS refocused its enforcement resources significantly. The number of revenue agents (those who conduct audits), the number of revenue officers (those who collect monies due), and the number of criminal investigators (those who prepare cases for possible prosecution by the Justice Department) each declined by over a quarter.

In essence, we did not observe the wise admonition of President John F. Kennedy that "Large continued avoidance of tax on the part of some has a steadily demoralizing effect on the compliance of others."

We are correcting our course and re-centering the agency. We are strengthening the IRS enforcement of the tax laws in a balanced, responsible fashion. And we will do so without compromising taxpayer rights. As the IRS enhances enforcement, we have four priorities:

First, we are working to discourage and deter non-compliance, with emphasis on corrosive activity by corporations and high-income individuals. Attacking abusive tax shelters is the centerpiece of this effort. What is at stake is greater than many billions of dollars of lost tax revenues. Our surveys indicate that 80 percent of Americans believe it is very important for the IRS to enforce the law as applied to corporations and high-income individuals. Enforcing compliance in these sectors is critical to maintaining Americans' faith that our system is fair. The abuses of recent years have to a very real degree strained the credibility of our tax administration system.

The IRS is moving aggressively to attack these transactions. Working with our partners in the Treasury Department, we have accelerated the issuance of guidance identifying abusive and potentially abusive transactions and improved disclosure requirements to provide greater transparency—sorely needed in today's complex world. And we have over 100 promoter audits underway, not to mention thousands of audits of high-income individuals and corporations who have entered into potentially abusive transactions. Where necessary, the Treasury Department, on behalf of the Administration, has proposed legislation that would stop abusive transactions that we may not be able to fully or quickly address under existing law.

But we need to do better. We need to do more, and we particularly need to do it faster. The length of time it takes us to complete the audit of a large, complex corporation is five years from the date the return is filed, which in most cases is already eight and one-half months after year end. And these figures don't include the appeals process, which runs another two years before the matter is settled or goes to court. That means that half of our current inventory of large cases is from the mid 1990s or the early 1990s. In today's rapidly changing world, we might as well be looking at transactions from the Civil War.

Simply stated, the IRS did not detect and deter the abusive transactions that spread during the 1990s on an adequate or timely basis because we did not have an informed view of current taxpayer behavior, only an historical understanding of events long past. And the challenge is becoming greater every day, as promoters of abusive tax transactions operate globally, without regard to national boundaries.

The lessons we have learned make it imperative to get current in our audits, to identify transactions and shorten the feedback loop so that abusive transactions can be shut down promptly. I am convinced we can do it. Technology will help. Right now it takes two years on average before complicated corporate returns find their way into the hands of the assigned examiner. We are addressing this issue. Electronic filing by corporations will facilitate our analysis of data and help us calibrate risk. Through speedier audits we will provide better service to the compliant taxpayer by resolving ambiguity earlier, and hold accountable those who seek to game the system. And we are creating a web of disclosure, registration and maintenance of investor lists that will provide information about abusive transactions.

Second, we are working to ensure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law. In recent decades, with an accelerated slide in the nineties, the model for accountants and attorneys changed. The focus shifted from independent audit and tax functions, premised on keeping the client out of trouble, to value creation and risk management. The tax shelter industry had a corrupting influence. It got so bad that in some instances blue-chip professionals actually treated compliance with the law—in this case IRS registration and list maintenance requirements—as a business decision. They weighed potential fees for promoting shelters but not following the law against the risk of IRS detection and the size of our penalties.

Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are honest and scrupulous, but even they suffered from the erosion of ethics by being subjected to untoward competitive pressures. The IRS is acting. We have augmented our Office of Professional Responsibility by doubling its size and appointing as its director a tough, no nonsense, former prosecutor; we are tightening the regulatory scheme; and we are receiving excellent support from the Justice Department in our promoter and associated investigations. But we need the Congress to enact the tougher penalties proposed by the Administration for those promoters who have not yet gotten the message.

Third, we must detect and deter domestic and offshore-based criminal tax activity, our traditional area of emphasis, and financial criminal activity. Our Criminal Investigation Division is a storied and proud law enforcement agency. Their expertise comprises not just criminal tax matters but other financial crimes. Our investigators are the best in law enforcement at tracking and documenting the flow of funds. In addition to our tax investigations, the IRS has over one hundred agents assigned on an ongoing basis to support the President's Corporate Fraud Task Force. We will continue and intensify these important efforts.

Two factors account in significant part for America's great economic vigor and success. They are our pervasive culture of entrepreneurship, on the one hand, and the stability and transparency of our markets on the other. The reputation and attractiveness of our markets have been compromised by the scandals of recent years. The President's Corporate Fraud Task Force and the President and Congress with Sarbanes-Oxley have taken important steps to restore confidence. Through these three enforcement initiatives, the IRS will do its part so that sound tax administration contributes to public confidence in our economic system.

We have one more enforcement priority. The stakes for America in this area are also important. We will discourage and deter non-compliance within tax exempt and government entities, and the misuse of such entities by third parties for tax avoidance or other unintended purposes. Non-compliance involving tax-exempt entities is especially disturbing because it involves organizations that are supposed to be carrying out some special or beneficial public purpose. Enforcement in this area has suffered as IRS staffing in the exempt organizations area fell from 1996 through 2003. Enactment of the President's budget would allow us to gradually build up staffing in this important area and step up enforcement.

If we do not act to guarantee the integrity of our charities, there is a risk that Americans will lose faith in and reduce their support more broadly for charitable organizations, damaging a unique and vital part of our nation's social fabric.

A case in point is credit-counseling agencies. These organizations have been granted tax-exempt status because they are supposed to be educating and assisting people who are experiencing credit or cash flow problems. Based on the information we have reviewed, we believe that a troubling number of these organizations, however, instead are operating for the benefit of insiders or in league with profit-making companies, such as loan companies, to generate income from lending to these distressed individuals and families. We are taking a close look at these organizations to ensure that they are operating within the bounds of the law.

It is, of course, imperative as we reinvigorate the enforcement program that IRS employees maintain their respect for and diligence to all taxpayer due process rights and protections.

We are making progress in our effort to reduce the annual tax gap. Our enforcement statistics for Fiscal 2003, released in early March, demonstrate that we have arrested the enforcement decline that began in the 1990s and worsened with the implementation of RRA 98. Audits, criminal investigations and monies collected were all up. In particular, the number of high-income taxpayer audits again increased by 24 percent. Moreover, audits of taxpayers with income over $100,000 were up over 50 percent from two years ago. Overall audits of all taxpayers increased to 849,296, an increase of 14 percent from 2002.

BUSINESS SYSTEMS MODERNIZATION AT THE IRS

While not as publicly visible as service or enforcement, modernization of IRS information technology is also a high priority. This effort is often referred to as Business Systems Modernization or BSM. Most of our tax administration systems are very old and difficult to keep current with today's fast paced environment—they must be modernized.

We are committed to resizing our modernization efforts to allow greater management capacity and to focus on the most critical projects and initiatives. Last summer, we used comprehensive studies to help us identify opportunities to improve management, re-engineer business processes and implement some new systems and technology.

As I have noted, the IRS has made progress on applications such as improved telephone service, electronic filing, and a suite of e-services to tax practitioners. But we have failed thus far to deliver several important projects with which taxpayers are not directly involved.

The projects include replacing our master file system, implementing the on-line security features, and building the modernized technological infrastructure on which all of our future modernization applications will depend.

Four studies completed last year consistently identified the following problems in delivering the large information technology efforts:

- Insufficient participation in the technology program by IRS business units;
- An overly ambitious portfolio;
- Inadequate performance by the contractor.

The IRS is responding by to this challenge by:

- Increasing business unit ownership of projects;
- Resizing the project portfolio and reducing the modernization program from $388 million this year to $285 million in the President's FY 2005 request;
- And revising our relationships with the contractor and ensuring joint accountability.

While we have much work to do on modernization, I can assure you that it is one of my top priorities as Commissioner. We need to put in place the foundation upon which the tax system will build and rely for decades to come.

PRESIDENT'S FY 2005 BUDGET SEEKS INCREASE IN ENFORCEMENT

The President has asked for an IRS fiscal year 2005 budget of $10.674 billion, a 4.8 percent increase over the fiscal year 2004 consolidated appropriations level for the IRS.

This budget includes the goals of customer service, infrastructure/modernization and enforcement. After a period of declining enforcement resources, the IRS has stabilized and increased the amount of resources dedicated to enforcement.

This budget has an increase of $300 million for a more vigorous enforcement of the tax laws. This strong commitment to tax administration will provide a significant augmentation of our enforcement resources.

The additional $300 million will increase enforcement in several key ways:

- Discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individual taxpayers and other contributors to the tax gap;
- Assure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law;
- Detect and deter domestic and off-shored based tax and financial criminal activity;
- Discourage and deter non-compliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance or other unintended purposes.

Let me now provide more details on the broad categories of the budget request for the IRS.

PROCESSING, ASSISTANCE, AND MANAGEMENT

We are seeking $4,148,403,000 for processing, assistance and management. This includes necessary expenses for prefiling taxpayer assistance and education, filing and account services, shared services support, and general management and administration. Up to $4.1 million of the $4.1 billion total will be for the Tax Counseling for the Elderly Program and $7.5 million of the total will be available for low-income taxpayer clinic grants.

The Processing, Assistance, and Management (PAM) appropriation handles all functions related to processing tax returns, including both manual and electronic submissions, and provides assistance and education to taxpayers to enable them to file accurate returns. The PAM appropriation issues refunds, maintains taxpayer accounts, and provides tax law assistance that includes tax law interpretation and rulings and agreements related to tax law issues. This appropriation is responsible for IRS personnel, facilities, and procurement services.

The IRS will continue to focus on pre-filing services and is requesting funding for taxpayer communication and education to help all taxpayers comply with tax laws and assume their fair share of the tax burden. Funding is being requested for resources to warn taxpayers of abusive tax schemes and improve compliance by preventing fraud and abuse. The IRS is redirecting funding to enhance customer service by reengineering processes to complement new technology and to develop an outreach strategy for the Child Tax Credit.

The IRS is reinvesting resources for filing and account services by providing funding for field assistance to reduce filing season details of compliance staff, funding the Business Master File workload increase, improving the level of telephone service to taxpayers, and updating processes to complement technology.

As part of the shared services program, the IRS will reinvest resources in new training and training delivery methods to develop and to improve expert consultative skills. This effort will significantly improve administrative and resource management decisions that will enhance delivery of compliance initiatives. Additional resource reinvestments will be used to defer rent annualization costs (based on partial year costs extrapolated annually for approved FY 2003 space expansion projects) to fulfill the IRS' operational mission objectives. Shared services will implement HR Connect, the integrated Human Resources Management System over the next two years. This system will seamlessly link multiple Human Resource applications that should result in significant program efficiencies.

The OMB Program Assessment Rating Tool (PART) review of Submissions Processing recommends that IRS successfully implement the Modernized E–File IT projects. IRS is enabling e-file growth by increasing the numbers of returns eligible to be electronically filed. In FY 2005, the IRS plans to complete the architecture and engineering analysis required to develop and deploy functionality, allowing taxpayers to electronically file Forms 1065, 990T, and 1041.

TAX LAW ENFORCEMENT

For enforcement, we are requesting $4,564,350,000. This appropriation ensures IRS' ability to: provide equitable and appropriate enforcement of the tax laws, identify possible non-filers for examination, investigate violations of criminal statutes, support the Statistics of Income program, conduct research to identify compliance issues and support the national effort to combat domestic and international terrorism.

The resources in the Tax Law Enforcement (TLE) Appropriation provide service to taxpayers after a return is filed and support activities such as research to identify compliance and tax administration problems, as well as tabulation and publication of statistics related to tax filing. In FY 2001, Tax Law Enforcement was realigned and redefined as mandated by RRA 98 to better serve the needs of taxpayers. The modernized IRS structure is similar to those widely used in the private sector: organized around customers' needs, in this case taxpayers. The IRS has set up four operating divisions to service the four major categories of taxpayers; Wage and Investment Income (W&I), Small Business and Self-Employed (SBSE), Tax Exempt and Government Entities (TEGE) and Large and Mid-Sized Business (LMSB). Each of these business units has substantial operations within the Tax Law Enforcement appropriation. The Criminal Investigation (CI) business unit investigates criminal violations of the Internal Revenue Code and also supports the National effort to combat terrorist financing by integrating CI special agents into the Joint Terrorism Task Forces and other anti-terrorism task forces. CI has the largest part of its operation within the Tax Law Enforcement appropriation.

The TLE appropriation is the primary source of funding for the compliance functions of the IRS, including: (1) automated, in-person and correspondence collection of delinquent taxpayer liabilities, (2) the matching of reporting documents with taxpayer returns, to insure reporting compliance, (3) face-to-face examination to determine taxpayers' correct income levels and corresponding tax liabilities, (4) service center support of the field examination function and correspondence with taxpayers regarding tax issues, (5) investigation of criminal violations of the tax laws, (6) processing of currency transaction reports over $10,000, (7) tax litigation, (8) acting as an advocate to provide prompt resolution of taxpayer problems and (9) a general counsel function to offer legal advice and guidance to all components of the IRS.

The functions in TLE are essential to accomplishing the primary goals of the FY 2005 Budget Request. To accomplish this goal, the IRS must restore the strength of the compliance function. Staffing devoted to compliance and enforcement operations has declined in recent years. Annual growth in return filings and additional work related to RRA 98 have contributed to a steady decline in enforcement presence, audit coverage and case closures in front-line compliance programs.

The FY 2004 Appropriations Act merged the Earned Income Tax Credit (EITC) Appropriation with the TLE Appropriation. The merge of EITC into the TLE appropriation will provide for customer service and public outreach programs, strengthened enforcement activities and enhanced research efforts to reduce over claims and erroneous filings associated with the Earned Income Tax Credit (EITC) compliance initiative.

Customer service for the EITC initiative includes dedicated toll-free telephone assistance, community-based tax preparation sites and a coordinated marketing and educational effort (including paid advertising and direct mailings) to assist low—income taxpayers in determining their eligibility for EITC. Improved compliance activities include increased staff and systemic improvements in submission processing, examination, and criminal investigation programs. Increased examination coverage, prior to issuance of refunds, reduces overpayments and encourages compliance in subsequent filing periods; in addition, post-refund correspondence audits by service center staff aid in the recovery of erroneous refunds. Criminal investigation activities target individuals and practitioners involved in fraudulent refund schemes and generate referrals of suspicious returns for follow-up examination. Examination staff assigned to district offices audit return preparers and may apply penalties for non-compliance with "due diligence requirements."

OMB Program Assessment Rating Tool (PART) observations concluded that the IRS does not work enough collection cases with its current resources, work processes and technology to ensure fair tax enforcement. Each year IRS fails to work billions of dollars worth of collection cases. Consequently, the Budget includes a legislative proposal to allow IRS to hire private collection contractors to assist the IRS in addressing a significant number of cases. In addition to the increased resources requested, the IRS is making internal process improvements, including: developing models to better identify high priority work, better use of the predictive dialer, realigning the workforce to core hours and creating a performance support tool to provide employees with technical guidance while handling calls. The PART review also

determined that IRS financial management systems remain weak. In response, the IRS plans to modernize its' collection technology to improve effectiveness. New technology tools will be developed to collection employees, (e.g., eACS, contact recording, and desktop integration), which will improve program efficiency.

HEALTH INSURANCE TAX CREDIT ADMINISTRATION

We are requesting $34,841,000for expenses necessary to implement the health insurance tax credit included in the Trade Act of 2002. This appropriation provides operating funding to administer the advance payment feature of the Trade Adjustment Assistance health insurance tax credit program to assist dislocated workers with their health insurance premiums. The Trade Act of 2002 created the tax credit program and it became effective in August of 2003.

INFORMATION SYSTEMS

We are requesting $1,641,768,000 for information systems. This appropriation is for necessary expenses of the Internal Revenue Service for information systems and telecommunications support, including developmental information systems and operational information systems.

It provides for IRS information systems operations and maintenance, investments to enhance or develop business applications for the IRS Business Units and staff support for the Service's Modernization program.

The appropriation includes staffing, telecommunications, hardware and software (including commercial-off-the-shelf), and contractual services. It also provides for Servicewide Information Systems (IS) operations, IRS staff costs for support and management of the Business Systems Modernization effort, and investments to support the information systems requirements of the IRS business units. It includes staffing, telecommunications, hardware and software (including commercial-off-the-shelf software), and contractual services.

Staffing in this activity develops and maintains the millions of lines of programming code supporting all aspects of the tax-processing pipeline as well as operating and administering the Service's hardware infrastructure mainframes, minicomputers, personal computers, networks, and a variety of management information systems.

In addition, the Information Systems "Tier B" modernization initiatives fund projects that modify or enhance existing IRS systems or processes, provide changes in systemic functionality, and establish bridges between current production systems and the new modernization architecture being developed as part of the Servicewide Business Systems Modernization efforts. Investment activities also include improvements or enhancements to business applications that support requirements unique to one of the IRS business units. These Tier B projects yield increased efficiency and allow the Service to progressively improve the quality of its interactions with the taxpaying public and its many other internal and external customers.

BUSINESS SYSTEMS MODERNIZATION

We are seeking $285,000,000, for our Business Systems Modernization (BSM) efforts. This request is based upon the resizing efforts we began following the various internal and external reviews of BSM.

This appropriation provides for the planning and capital asset acquisition of information technology systems, including related contractual costs of such acquisition and contractual costs associated with operations authorized by 5 U.S.C. 3109, to modernize IRS' antiquated business systems.

The IRS collects $1.7 trillion in revenues annually through an assortment of computer systems developed over a 40-year period. The IRS developed the most important systems that maintain all taxpayer records in the 1960s and 1970s. These outdated systems do not allow the IRS to meet today's taxpayer and business needs. Failure to modernize IRS's tax administration business systems will result in a significant increase in resources required to maintain legacy systems—systems that no longer efficiently or effectively serve America's taxpayers.

The BSM Appropriation provides for revamping business practices and acquiring new technology. The IRS is using a formal methodology to prioritize, approve, fund and evaluate its portfolio of BSM investments across the IRS Business Units and Modernization and Information Technology Services (MITS). This methodology enforces a documented, repeatable and measurable process for managing investments throughout their life cycle. The MITS Enterprise Governance (MEG) Committee, which includes the Chief Information Officer and other senior MITS executives, the Chief Financial Officer, and the heads of the Business Operating Divisions, approves investment decisions. This executive-level oversight ensures that products and projects delivered under the Business Systems Modernization program are fully integrated into IRS Business Units. The Department of the Treasury Investment

Review Board also reviews the BSM expenditure Plan once the IRS executive-level oversight board approves the investment decisions. The plan is then cleared through OMB and submitted through the Appropriations Committees.

The IRS has undergone an intensive servicewide portfolio prioritization effort, leading to a long-term modernization plan identifying selected modernization projects, a release sequence for each project, and estimated costs for each project. The effort is based on vision and strategy initiatives that created an enterprise-wide view, which unified the needs of the IRS Business Units. FY 2005 resources will fund the infrastructure, program management, and releases of business applications to support the successful delivery of a modernized tax administration system. More complete details are provided in the BSM Expenditure Plan.

A partial FY 2004 BSM Expenditure Plan was submitted by the Department of Treasury for Congressional approval in January 2004, and the full-year revision incorporating current project information should be completed by this spring.

PROGRAM PERFORMANCE

The IRS expects to achieve the following levels of performance after attaining full performance of the requested FY 2005 initiatives:

- Examine an additional 30,000 investor returns in the Small Business and Self-Employed(SB/SE) business unit and increase coverage of high-income taxpayers, generating an additional $170 million in FY 2006. SB/SE also anticipates closing an additional 50,000 taxpayer delinquent accounts, resulting in an estimated $215 million in additional revenue.
- Hire and train over 2,000 new staff in the Examination, Collection and Document Matching programs. These increases will generate some $2.8 billion in direct enforcement revenue through FY 2007. Additional audits of investor returns and high-income taxpayers, together with 55,000 correspondence examinations, will yield more than $1.0 billion during that same period and help to maintain an overall audit coverage rate of 0.57%. Collection closures will increase by 240,000 and taxpayer contacts through the Automated Underreporter Program by some 300,000 through FY 2007—generating an additional $1.8 billion.
- Increase the overall audit coverage rate in the Large and Mid-Sized (LMSB) business unit from 5.1% in FY 2004 to 9.6% in FY 2007 and increase projected return closures by 63% from 16,067 returns in FY 2004 to 26,193 returns in FY 2007. Enforcement revenue recommended for the three years FY 2005 through FY 2007 should increase by over $3 billion.
- Complete 229 significant Corporate Fraud investigations through FY 2007. Tax-related completed investigations will increase by approximately 20 percent over the FY 2003 level by FY 2007. In addition, CI is striving to reduce elapsed time on completed investigations by 30 percent from FY 2002 levels.

CONCLUSION

The IRS has lagged behind, for reasons that are understandable, in tax enforcement. But that is changing. We will continue to improve service and respect taxpayer rights. But we will also enforce the law. We won't relax until taxpayers who are unwilling to pay their fair share see that that is not a worthwhile course to follow.

Mr. Chairman, the great majority of Americans honestly and accurately pay their taxes. Average Americans deserve to feel confident that, when they pay their taxes, their neighbors and competitors are doing the same.

The President's budget request will help us enforce the tax law more fairly and efficiently. I am most grateful for your support of increased enforcement, and I look forward to working with you on this important budget request.

Thank you very much. I'd be happy to take your questions.

Chairman HOUGHTON. Thank you very much. I would just like to ask one question to kick this off, and then I am sure that others would like to ask some questions. What is the relationship between the number of audits and the increase in revenues?

Mr. EVERSON. There are two components, I would say, Mr. Chairman. When you address audits or any of our enforcement activities, there is a direct relationship to revenues, which is to say that through an audit or through a criminal investigation or any

enforcement action, you secure the incremental dollars for the Treasury, and then there is what some call a spillover effect, which is to say changes in behavior more broadly. If you are sitting at the country club and down in the locker 5 yards away you hear somebody saying, "Geez, I never should have gotten into that abusive shelter. I was audited by the IRS, and now I have got to pay the moneys due, interest and penalties," well, not only have we recovered money from that audit, but we have had a change in behaviors that we believe takes place when that fellow who overheard that conversation is a little more conservative and reluctant to engage in a pattern or practice of abuse.

Chairman HOUGHTON. When you take a look at the audits of $100,000-taxpayers on the rise, does it give you the feeling that we are regaining the sense of trust that we so desperately have held onto for so many years?

Mr. EVERSON. I think that one component of this erosion in the attitudes toward compliance was a feeling on the part of many that others were getting away with something they should not be getting away with. So, clearly, we needed to augment the audits. I cannot tell you a magic number as to where those ought to be, frankly, Mr. Chairman. I think we need to do more, particularly in the high income. We need to do audits responsibly, though, in a way that treats people fairly and does not, in any way, intimidate folks as we go through the process.

Chairman HOUGHTON. Mr. Pomeroy?

Mr. POMEROY. I think that that chart is interesting and alarming. It shows to me how quickly things can come apart in terms of a national mores that you better pay what you owe. I believe that we have got a period of about 6 years there of declining audits, and ultimately a substantially fewer set of audits at the bottom of the trough than at the beginning of the decline. You indicate national statistics showing that those who believe you can cheat on your taxes has gone from 11 percent to 17 percent. I suspect, just from anecdotally, it might even be higher. After all, who is going to respond to a pollster, "do you think it is okay to cheat on your taxes or not?" I believe there will be people that will never fess up to such a thing, but would do it in a heartbeat if they had the chance.

That is why I believe that Congress, in administering, as the ultimate authority on our Nation's revenue collection system, has to be very careful. We cannot go off on some kind of ideological lark/funding on compliance because we are mad at taxes and basically try to make ideological statements about the role and function of government based upon whether you can do the job that you are statutorily required to do. We can fight tax rates, tax levels, we can fight role of government. Those are stand-alone questions that need their own fighting, but we can't fight them by proxy by trying to hurt and cripple the IRS from doing the job it is supposed to do.

I will read to you a statement from the Chair of your Oversight Board, which was presented in testimony yesterday, and ask whether you agree or disagree with the statement. Admittedly, this is from Nancy Killefer, the Chair, not your words, but the statement, "the IRS is doing a better job of identifying egregious noncompliance. Now, it needs the resources to fight back. In the past

2 years, IRS has sharpened its compliance focus to identify and pursue promoters and participants of abusive tax shelters and tax evasion schemes. For example, the agency is now targeting its resources on promoters of illegal tax schemes that are often marketed to high-income individuals, but are also finding their way to middle-market businesses. Despite this focus, enforcement activities are still at an unacceptable level simply because the IRS does not have the resources needed to accomplish its mission. It continues to be outmanned and outgunned. In fiscal year 2003, the agency was able to pursue only 18 percent of known cases of abusive devices designed to hide income, leaving an estimated $447 million uncollected, and that is from known cases. We knew $447 million was out there. We knew it was illegally withheld from tax payment, but we didn't have the resources to go and get it." Do you ascribe to the statements made by the Chair? Let me put it differently. Do those statements made by the IRS Oversight Board Chairman accurately reflect the situation?

Mr. EVERSON. I agree that the IRS needs more resources to combat compliance issues. I believe that the President has made a very strong commitment to improved tax administration, through the 5 percent budget increase. The increase is over 10 percent, as you know, in the enforcement funding for the IRS. I think that coupled with our own emphasis on improving our business processes on the enforcement side, much as the IRS has done on the service side over the last several years, we will further improve our compliance and enforcement efforts, and bring in more moneys, bring up the audits and increase the investigations and the criminal prosecutions. There will be more to do, undoubtedly. I will continue to look at the funding levels on an ongoing basis and discuss, within the Treasury Department and with Office of Management and Budget (OMB), what I believe is necessary to run a balanced program.

What I want to emphasize at this point is my principal goal to make sure that we do secure 100 percent of the President's request. That is the real key for me, if you will, because, as you have indicated, in the past, on average, over the last 10 years, there has been a 3-percent shortfall between what President Clinton or President Bush has requested and what ultimately the Congress has provided. So, I would like to first secure the full funding of the President's request this year, which would be a departure from the past. If we need more from there, I will take that up in the 2006 budget process within the Administration.

Mr. POMEROY. Mr. Chairman, if I might have a couple of more minutes' leave. I will pursue quickly. When we have some of the major accounting firms in this country marketing these shady or illegal tax-dodge schemes, I think it goes to show you the impunity with which noncompliance has become socially acceptable. Are the major accounting firms out of that business?

Mr. EVERSON. I think we are seeing changes in what I would call the larger accounting firms and the larger blue-chip corporations. Our concern has been, though, that as we clamp down in one area, we continue to see issues in mid-size businesses or also on a continued basis with wealthy individuals. We have a great partnership with the Department of Justice on this issue. They are sup-

porting us in litigation with the accounting firms and the law firms. As you know, first time ever where we have litigated against law firms, in terms of those who are acting as promoters, so that they are handled as promoters.

There are matters before the Justice Department now that include criminal investigations that will send a real signal through the professions, and I do expect that this will continue to receive a lot of attention on an ongoing basis. I was at the President's Corporate Fraud Task Force meeting just a week ago, and this was emphasized to all, not just by myself, but by the leader of the task force, the Deputy Attorney General, that combatting abusive tax shelters are part of the effort to clean up corporate governance and should receive top priority.

Mr. POMEROY. Thank you.

Chairman HOUGHTON. Mr. Portman?

Mr. PORTMAN. I thank you, Mr. Chairman. Commissioner, thank you for being here today. It is timely to talk about the filing season, but also to go over some of these budget issues with regard to 2005. I will say that, as I read this, your budget request this year is a 4.8-percent increase over the enacted amount from 2004.

Mr. EVERSON. Correct.

Mr. PORTMAN. This is a substantial increase. I just did the math, which may be wrong, but it seems to me that from 2002 to now we have a 13.5-percent increase during this Administration. I sometimes fight for more than that, as do my two colleagues on the left. They happen to be to my left right now.

[Laughter.]

We have had substantial increases at a time when, frankly, we are looking at practically a freeze in your budget for the non-defense and non-homeland security domestic discretionary spending, and so I am pleased that we had the 4.8 percent. I appreciate your comment that a lot of this is about allocation. In fact, when I look—and I know Ms. Killefer is going to testify later, and I look forward to her testimony, although I need to run out to another meeting, and I will try to come back—but Congress has funded, since 1998, all but about 1 percent of what the IRS has requested, and we have increased funding every year. Again, I would like to see more sometimes. There is a sense out there somehow that Congress has cut funding. We have not.

There have been allocation of those resources, as you say, during the restructuring more toward customer service and less toward enforcement, and I think that is now being corrected, and I think appropriately so. I couldn't agree with you more that they are not inconsistent with one another. I will also say that we were 2.6-percent below the request from the Oversight Board in the past 3 years.

This year, it looks like we will be more below, but I think that request is about 5 percent above yours. So, these are not big numbers as compared to the overall budget, and although I would like to see more funding into enforcement, I think it would be wrong to leave the impression that somehow Congress has been reducing this funding. We fight for it for every year, and we will fight for it again this year, to be sure that the IRS gets additional funding which is needed. Three other quick questions if I could. One on

simplification. You have indicated in your statement and elsewhere that simplification would help you, particularly the Sub S filings have increased. Do you have any advice for us, as Congress, as to how we could help you to enforce this Tax Code?

Mr. EVERSON. I think simplification is critical because there really are two components to compliance: One is the service side, and by service we mean helping taxpayers understand their filing obligation and facilitating their participation. Clearly, there is a very real drag on understanding obligations and on facilitating participation in the system that occurs from the increasing complexity of the Tax Code. Some people just throw up their hands, increasing errors that are made. So, anything that we can do on simplification in terms of the Tax Code is important.

The other point I would make is that, as you and I have discussed, as you add more missions to the IRS, you also put further stresses on the tax administration system. When you get a new responsibility to embed a benefits program, say, in the IRS, you have to devote adequate management, and technical, and human resource talents to achieving that new program. It makes it more complicated to administer the Tax Code and diverts our attention from other normal activities.

Mr. PORTMAN. Those are key points I hope we will always keep in mind. That is really where the Commission ended up was, yes, we need a change at the IRS, but ultimately the Tax Code itself was one of the major problems, and this Subcommittee has been focused on the simplification issue, but it is as to compliance, as you say, but also as to cost——

Mr. EVERSON. Yes.

Mr. PORTMAN. What your costs are increase. This goes to the next question I have, which is training. Are you putting adequate resources against training, and could we put more resources against training, which would then lead to having better audits, more targeted audits and perhaps less resources over time in enforcement?

Mr. EVERSON. I think we are carefully looking at our training, particularly in what we will need to do as we augment the enforcement resources, because we are not going to just hire several thousand more Revenue agents, Revenue officers and criminal investigators. We also have a very seasoned work force, and we are going to have a lot of turnover, particularly in our people who do the corporate returns or in appeals. It is critical, therefore, that as we add new people and as we ask others to step up to greater responsibility, that we do our training. We are trying to benchmark now against the corporations as to how they train their work force, but I think this is an area where we are going to have to devote a lot of attention. I do not think our plans are yet fully crystallized, but they need to be.

Mr. PORTMAN. We would like to work with you on that training. Final question, quickly. You talked about increased audits of those making over $100,000 a year. How about your audits of corporations, where are they, and does it concern you that audits are off on corporations, if I understand that to be the case?

Mr. EVERSON. I think that we will see, when we look at corporate audits for 2004 versus 2003, that we have arrested what

was a decline that was much like the decline in individual audits. Part of the most recent decrease was really related to the fact that as we have worked on these abusive shelters, and as we have devoted more resources to promoters, we did draw down a bit some of the numbers of the audits we were doing. So, I think that this was, in fact, at least in fiscal year 2003, a wise decision, and it was one that was based on a risk assessment as to where the real problems were. I would note that part of the President's budget request, for instance, it will double audit rates for corporations between $10—and $250 million of assets. Right now, the audit rate is about 5 percent or so. It will double it to 10 percent. That is an important step, and it is why we need the money.

Mr. PORTMAN. Thank you, Commissioner. Thanks for your good work.

Mr. EVERSON. Thank you.

Chairman HOUGHTON. Mr. Ryan?

Mr. RYAN. Thank you, Mr. Chairman. Thank you, Mr. Everson, for being here. I have two very specific questions. My first question is in regard to child tax credit overpayments as a result of the child tax credit advance payments that were sent out last year. I can go through the whole scenario, but the sense basically where you have divorced couples, you have this anomaly where they take every other year, they claim their children as a dependent. So, what you had in this last year, with an advance payment on the child tax credit, was in 2002 spouse, ex-spouse claimed the dependent, and in 2003 they got the advance payment. Whereas, the other spouse takes the credit of the child as a dependent in 2003, and according to your rules, it is my understanding, they will get the full tax credit. What is the estimate of the difference? It is also my understanding that you will not claw back or require a repayment from the other spouse who doesn't legitimately claim the dependent in 2003. What is the measurement of those overpayments of child tax credits?

Mr. EVERSON. I am going to have to supply——

Mr. RYAN. Could you look into that for me.

Mr. EVERSON. Supply that for you for the record. I will say this, that——

Mr. RYAN. I just wanted to make sure I was clear on how I——

Mr. EVERSON. I think that is a question I cannot answer directly. I will say this, that the most common problem we have seen so far in the filing season is accounting correctly for the child credit. It accounts for about two-thirds of the errors that we are seeing. We automatically correct for the calculation, but I am not sure that our corrections would run to the matching that you are talking about in this instance.

Mr. RYAN. Let me just make sure I can clarify your policy, which is you will not require a repayment by a spouse who gets the advance credit from having their child as a dependent on 2002, even though, in 2003, they will not have that person as a dependent, and you will give that 2003 parent who claims them that year as a dependent the full tax credit; is that correct?

Mr. EVERSON. I want to make sure that I have a correct understanding of that. We will give you a complete answer to that.

Mr. RYAN. If you could, and I would like to just see an estimate if I could.

Mr. EVERSON. Certainly.

Mr. RYAN. My second question is with the The Federal Tax Refund Offset Program (TOPS) program. It allows government agencies to submit to the IRS claims for delinquent debts up to 10 years old. The State of Wisconsin is currently participating in this, and it is for the purpose of recovering State-owed debts. Right now, local municipalities are not permitted to participate in the TOPS program to include debts owed to local and municipal agencies. Do you believe that the current system could accommodate local municipalities to participate in TOPS? If not, what would your position be on allowing them to do so?

Mr. EVERSON. I am going to want to take a look at this because we are working very actively with the States in a whole variety of ways. You may know recently we signed an agreement, and we are implementing it, cooperating with 46 different States on the abusive tax shelter transactions.

Mr. RYAN. Right.

Mr. EVERSON. We are working everywhere we can to help the States. As to whether there is additional capacity in this question, I will come back to you on that.

Mr. RYAN. Could you get back to me in writing. Specifically, you will find, as you look into this, that a lot of States already have agreements with the State government, where their local municipalities and counties can work together to reclaim debts. Does the current statute allow you to give that same participation that you are giving right now to States to municipalities and county governments or does it not, and what is your position if it does?

Mr. EVERSON. I will take a look at that and make sure we come back to you.

Mr. RYAN. That would be great. Thank you.

Mr. EVERSON. Thank you, sir.

Chairman HOUGHTON. Thanks, Mr. Ryan. Mr. Johnson?

Mr. JOHNSON. Thank you, Mr. Chairman. Good evening.

Mr. EVERSON. Good afternoon.

Mr. JOHNSON. Glad to see you. Let me ask you a technical question, if I might. Is there ever a time when you would have tax people walk up to somebody's door unannounced?

Mr. EVERSON. Unannounced, in the sense of just launching an audit or a criminal investigation?

Mr. JOHNSON. I am a guy in a house, and I am sort of, I have got a case in mind, and I will talk to you about it privately, but where the wife is at home, in a residential area, good housing, and two people walk up to the door and say, "You did not file your tax returns."

Mr. EVERSON. I do not think that is our normal procedure. What we would tend to do is contact someone, initially by a letter, indicating that we would like to—we are initiating an audit. We do audits that are either correspondence audits, which is a big block of the work, or else field audits, where we would visit a taxpayer.

Mr. JOHNSON. Yes, but not without notice.

Mr. EVERSON. I would imagine that this was an exceptional circumstance. I would like to understand what the circumstances were.

Mr. JOHNSON. Well, you are not denying that it never happens, then.

Mr. EVERSON. I do not know that it has happened, but you seem to know more than I do about a specific case, so——

Mr. JOHNSON. No, I am trying to solve the problem, if I could.

Mr. EVERSON. Right.

Mr. JOHNSON. If you do not have enough people, and you need more money, blah, blah, blah, and yet you have got people running out there being accusatory without first warning the people that they are going to, I do not think that is right.

Mr. EVERSON. We have, and we do follow very specifically, procedures that were put into place about notices on collections, and there were changes in the new law, as you know, from 1998. If our people are violating those procedures, they are held accountable. So, if you could tell me about the case, I would be happy to take a look at it, and if there has been some irregularity that is improper, I will make sure that we deal with it.

Mr. JOHNSON. Well, and I know that you have people in there that you can talk to, too, about those sorts of things, but I have never encountered you being heavy-handed like that before, and I will talk to you separately about it. One of the proposals in this year's budget would make changes in 1203, called, "The 10 Deadly Sins" provision. Can you explain why those changes are necessary and important?

Mr. EVERSON. I think that if you go back to the hearings that took place in the mid and late nineties, clearly, I agree with the substance of the reforms, taken as a whole, that came out of RRA 98. There was a big gap between the service level that Americans had every right to expect of the IRS and what we were actually delivering or failing to deliver.

At the same time, I think there was a climate that was a difficult climate. Some charges were made against IRS employees which, as you would remember, were subsequently found to be unproven or slightly exaggerated. The folks who have worked in the Agency inform me that all of this had a real overhang, in terms of for a while a reluctance to pursue the enforcement activities. To some degree, that clearly contributed to the decline in actions. In terms of these "deadly sins," I think that what we are trying to get at there is simply to allow more discretion to the Commissioner to mitigate some of these areas of problems if, on a balanced basis, that seems warranted. It doesn't make it in any way automatic. It just says that there should be more discretion in some cases if it is warranted.

Mr. JOHNSON. Thank you very much. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you. Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman. I have been looking with great interest at a couple of these charts that you brought along. I'm wondering if you could put up the enforcement chart, just to show you the pattern that we have followed. It tracks very closely this audit history. Then, after that, Commissioner, if you

don't mind, if you would pull up the exempt organizations and just give us as brief read on that one.

Mr. EVERSON. This simply says that over a period of years we have kept the resources stable in terms of manpower on the service side, the infrastructure side of the IRS. We brought down year after year the enforcement personnel. That red line is the number of revenue agents, revenue officers and criminal investigators. Those are the people who develop cases for potential prosecution by Justice. We brought that back up, and it will go up further with the President's 2005 request, if we get the funding. So, we're bringing it back up.

I would say it's not only about money, but it's also about bettering our procedures and also about prioritization, because it comes back to the Chairman's question on what is the effect of the audits. You don't only have a direct effect; you have the indirect effect, too. So, it's not only about augmenting resources. Just to zoom in on something that this Committee has had an interest in, which is credit counseling and sureties, you had a hearing when I was here last November looking at credit counseling organizations. The challenge, as you know, one of our enforcement priorities is to discourage, deter abuses within tax-exempt entities.

Mr. POMEROY. Just to refresh the audience's memory on this one, if I recall, now we see omnipresent debt counseling ads everywhere you turn. Some of the main entities involved in that, as we looked in the course of this hearing, basically operating under the guise of being nonprofits, had extremely highly paid founders or Presidents. It was in the millions in terms of wages, something that would certainly raise all kinds of questions about whether they are actually operating appropriately in a tax-exempt structure, and whether the value of what they offer to the consumer comports with what they say it does.

Mr. EVERSON. That's correct. In fact, I indicated last week that I expected, as a result of ongoing audits that we have underway, we will be lifting tax-exemption status for some of these entities and may, in fact, also end up making criminal referrals. So, this is a very serious area of focus for us. All this does is it zooms into that tax-exempt area and says that, over time, you had a real increase in total assets, you've had an increase in the returns filed, and now, after years of the staffing going down, we're bringing the staffing back up.

To show you just what has to be done here, we are also harnessing technology, again improving procedures. So, I would hasten to add that I don't expect that you need to take these lines up as high as the increases in the activity, but clearly, you can't continue on this trajectory that we've been on. We have arrested it and we're bringing it back up. I think you see from the budget request that we've got new moneys and new personnel coming into this tax-exempt area. This is not just credit counseling; this is the whole tax-exempt sector.

Mr. POMEROY. I would just note that I had hoped our hearing might have some positive effect in terms of diminishing that blatant and what I find to be offensive practice of their solicitations. It seems as though they have redoubled their efforts. So, I'm looking forward to this getting out of the private matter of internal IRS

auditing and into the much more publicized criminal arena, because I believe many of their activities are criminal. If we hang one or two from the yardarm, maybe it will have some positive effect in terms of their activities in the future.

Mr. EVERSON. That may very well happen. What I suggested, Congressman, last week on the Senate side—they had a hearing on this, the Levin/Coleman permanent Subcommittee. As we went through this, I was shocked, because I found that the schemes of the interlocking relationships between the charity and the related profit-making entities, they rivaled the complexity of the interlocking network of reinforcing relationships that you see in the tax shelter area. That is all the more disturbing because these aren't people out there just trying to make money; these are folks who are supposedly serving the public good. Yet they have become equally sophisticated in some instances and equally, I would say, hardened toward their true mission.

Mr. POMEROY. I totally agree with that. A final question. The CRP payments to retired farmers has since the 1988 letter ruling largely been viewed as not subject to self-employment tax. A letter ruling issued in May of 2003 was written broadly enough so that it appears to apply now to retired farmers with CRP income. This would be very much unlike other rental income they would be receiving.

We learned in a meeting with IRS staff in North Dakota last Friday that that letter ruling was not drafted with contemplation of the circumstance of retired farmers. The result of it has been to put a big question mark on the shoulders of taxpayers and retired farmers alike about what to do with this income. Needless to say, it represents a very substantial new tax obligation to people living on fixed incomes, especially when they all had available the option of renting the land in the first place, which would carry no self-employment tax.

I will hand you a copy and put into the record a treatise by Dr. Neil Harl, who is a tax expert operating out of Iowa, on the question of the tax status of this income for retired farmers. He recommends withdrawal of the letter ruling of 2003, sorting this out in a more comprehensive way and dealing with it going forward, based on a more comprehensive resolution but lifting the cloud that affects this tax filing season.

[The information follows:]

Self-employment Tax Aspects of the Conservation Reserve Program*
by Neil E. Harl**

I. The Food Security Act 1985 instituted a 10-year conservation reserve program (CRP) under which the Secretary of Agriculture entered into contracts with owners and operators of highly erodible cropland to take such cropland out of crop production and place it in conservation and soil and water improving use in exchange for payments of cash and commodities. *16 U.S.C.* § 3831, added by Pub. L. No. 99–198, Sec. 1231, 99 Stat. 1508 (1985). Final regulations were issued in 1987 implementing the program. *7 C.F.R. Pt. 704, 52 Fed. Reg. 4,269 (1987).*

II. The self-employment tax treatment of CRP payments

* Presented at a conference, Washington, D.C., sponsored by Cong. Earl Pomeroy, June 8, 2004.

**Charles F. Curtis Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University, Ames, Iowa; Member of the Iowa Bar.

A. Initially, tax practitioners relied on prior authority drawn from other settings. E.g., *Rev. Rul. 60–32, 1960–1 C.B. 23* (payments under soil bank program includible as self-employment income of owner-operator).

B. The Associate Chief Counsel, Technical, of IRS, stated in 1987, that where the farm operator or owner is materially participating in the farm operation, CRP payments constitute receipts from farm operations includible in net earnings from self-employment. *Letter from Peter K. Scott, Associate Chief Counsel, Technical, March 10, 1987.* The Commissioner of Social Security agreed.

C. In 1988, the Internal Revenue Service, in a letter ruling, indicated that, for a retired taxpayer who is not materially participating, payments received under the federal Conservation Reserve Program would not be considered net income from self-employment. *Ltr. Rul. 8822064, March 7, 1988* (no tenant involved; landowner's activities under CRP did not constitute material participation).

D. In a 1996 Tax Court case, *Ray v. Commissioner, T.C. Memo. 1996–436,* the Tax Court held that, for taxpayers who materially participate in the operation, CRP payments are to be reported as self-employment income if the CRP land had a "direct nexus" with the farming business. The Tax Court found that a direct nexus in that case existed where the CRP land was in the same general vicinity as the farming operation, the CRP seeding was maintained with equipment used in the farming operation and the farmer admitted that, at the termination of the CRP contract, the land involved would be used in the farm business.

E. A 1996 letter ruling involving a husband and wife as directors and officers of a family ranch corporation held that they had materially participated in the overall operation. *Ltr. Rul. 9637004, May 1, 1996.*

F. In 1998, the Tax Court held that CRP payments were "rents" and, therefore, not subject to self-employment tax by virtue of I.R.C. § 1402(a)(1). *Wuebker v. Commissioner, 110 T.C. 431 (1998).* The Tax Court said the primary purpose of the CRP contract was to achieve specified environmental benefits by converting highly erodible cropland to soil conserving use. Thus, the contract payments represented compensation from the use restrictions on the land rather than remuneration for the taxpayer's labor. However, that case was reversed on appeal in 2000 by the Sixth Circuit Court of Appeal. *Commissioner v. Wuebker, 205 F.3d 897 (6th Cir. 2000).*

G. Legislation was first introduced in April of 2000 to treat CRP payments as rent for self-employment tax purposes and reintroduced in 2001 and 2003. *S. 2422, S. 2344, H.R. 4212, 106th Cong., 2d Sess. (2000); S. 315, 107th Cong., 1st Sess. (2001); S. 665, S. 1316, 108th Cong., 1st Sess. (2003).*

H. In a Chief Counsel's Letter Ruling dated May 29, 2003, IRS took the position that a landowner's activities under a CRP contract amounted to material participation and the payments should be reported on Schedule F, not Schedule E or Form 4835. *CCA Ltr. Rul. 200325002, May 29, 2003I.* The letter ruling did not except retired landowners (taxpayer B is an individual not engaged in the trade or business of farming) and so the 2003 CCA Letter Ruling was counter to *Ltr. Rul. 8822064, March 7, 1988.*

The text of the CCA Letter Ruling, *CCA Ltr. Rul. 200325002, May 29, 2003,* is included in full in Appendix A hereto.

III. In summary, before the issuance of *CCA Ltr. Rul. 200325002, May 29, 2003,* landowners could be separated into four categories with respect to liability for SE tax on CRP payments.

A. Landowners who were retired when the land was bid into CRP and were not materially participating in retirement were not liable for SE tax on the CRP payments. *Ltr. Rul. 8822064, March 7, 1988.*

B. For landowners who were not carrying on the trade or business of farming and there was no direct nexus between the CRP land and a farming business (or landowners who were carrying on the trade or business of farming but there was no direct nexus between the CRP land and the farming business), the landowner was not liable for SE tax on the CRP payments. See *Ray v. Commissioner, T.C. Memo. 1996–436.*

C. For landowners who were carrying on the trade or business of farming and there was a direct nexus between the CRP land and a farming business, the individual or individuals were liable for SE tax on the CRP payments.

D. For landowners who retired after the land was bid into the CRP program, and who were liable for SE tax on CRP payments before retirement, there were conflicting authorities≤

1. Some authorities have focused on the taxpayer's status at the time the agreement was entered into and that status prevailed for the duration of the contract. *Notice 87–26, 1987–1 C.B. 470* (dairy termination payments); *Rev. Rul. 60–32, 1960–1 C.B. 23* (soil bank payments).

2. Other authorities suggested that it is the taxpayer's status at the time payment is received that determines liability for SE tax. *Soc. Sec. Rul. 67–42* (cropland adjustment income; dictum).

IV. Recommendations

A. Withdrawal of *CCA Ltr. Rul. 200325002, May 29, 2003,* or reissuance with a narrowing of the ruling to harmonize with *Ltr. Rul. 8822064, March 7, 1988,* would remove much of the current confusion.

B. The CCA Ltr. Rul. seems to apply to all Federal conservation programs also. It would be helpful to know whether that was intended.

C. Guidance on the matter of SE tax liability for those who retire during the term of the CRP contract would be helpful.

APPENDIX A

CCA Ltr. Rul. 200325002, May 29, 2003.

TO: Virginia E. Cochran, Deputy Area Counsel (Great Lakes & Gulf Coast Area), Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities), CC:TEGE:GLGC:DAL

FROM: Michael A. Swim, Senior Technician Reviewer, Employment Tax Branch 1, Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities), CC:TEGE:EOEG:ET1

SUBJECT: Conservation Reserve Program & SECA

This Chief Counsel Advice responds to your request for advice regarding the Conservation Reserve Program (CRP) of the United States Department of Agriculture (USDA) and Self-Employment Contributions Act (SECA) tax. In accordance with *section 6110(k)(3)* of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Whether annual "rental" payments received by Taxpayer A, who is an individual, for land enrolled in the CRP constitute self-employment income to Taxpayer A that is subject to SECA tax where Taxpayer A was engaged in the trade or business of farming prior to enrolling the land in the CRP and Taxpayer A personally fulfilled her CRP contractual obligations.

2. Whether annual "rental" payments received by Taxpayer B, who is an individual, for newly acquired land, that had been enrolled in the CRP by the land's previous owner and the enrollment is continued by the Taxpayer B, constitute self-employment income to Taxpayer B subject to SECA tax where Taxpayer B was not engaged in the trade or business of farming prior to acquiring the land but Taxpayer B personally fulfilled his CRP contractual obligations.

3. Whether the annual "rental" payments respectively received by Taxpayer A and Taxpayer B under the CRP should be reported (i) on Schedule F (Form 1040), Profit or Loss from Farming, as farming income from a trade or business, (ii) on a Schedule E (Form 1040), Supplemental Income and Loss, as rental income from real estate, or (iii) on a Form 4835, Farm Rental Income and Expenses, as rental income from crop or livestock production.

CONCLUSIONS

1. The annual "rental" payments received by Taxpayer A for land enrolled in the CRP constitute self-employment income to Taxpayer A that is subject to SECA tax where Taxpayer A was engaged in the trade or business of farming prior to enrolling the land in the CRP and Taxpayer A personally fulfilled her CRP contractual obligations.

2. The annual "rental" payments received by Taxpayer B for newly acquired land, that had been enrolled in the CRP by the land's previous owner and the enrollment is continued by Taxpayer B, constitute self-employment income to Taxpayer B subject to SECA tax where Taxpayer B was not engaged in the trade or business of farming prior to acquiring the land but Taxpayer B personally fulfilled his CRP contractual obligations.

3. The annual "rental" payments respectively received by Taxpayer A and Taxpayer B under the CRP constitute self-employment income to the recipient taxpayer that is subject to SECA tax and is not rental income that is excludible under the rentals-for-real-estate exclusion. The respective payments received by each recipient taxpayer must be reported on a Schedule F and Schedule SE (Form 1040), Self-Employment Tax, filed by that taxpayer with that taxpayer's Form 1040, U.S. Individual Income Tax Return. The use of Schedule E or Form 4835 is not allowed.

FACTS

The CRP, 16 U.S.C. §§ 3801, 3831–36, is a USDA voluntary conservation reserve program under which land is enrolled through the use of contracts. The program generally assists owners and operators of land to conserve and improve the soil, water, and wildlife resources of such land. The CRP offers, among other things, annual "rental" payments to owners and operators for converting highly erodible cropland normally devoted to the production of an agricultural commodity to less intensive use. In general, the durations of contracts are from 10 to 15 years. The Farm Security and Rural Investment Act of 2002, Pub. L. No. 107–171, provides that up to 39.2 million acres can be enrolled in CRP at any one time during the 2002 through 2007 calendar years.

No specific taxpayer or detailed factual situation was provided in regards to the requested advice. Accordingly, we address two hypothetical situations.

Taxpayer A was a farmer who owned highly erodible cropland. After planting crops on the land for 6 years, Taxpayer A decided to enroll Taxpayer A's cropland into the CRP and entered into a CRP contract with the USDA.

Under the CRP contract, Taxpayer A agreed to certain terms and conditions as to the cropland under contract. Among the terms and conditions, Taxpayer A Agreed to: (1) implement a conservation plan for converting the land normally devoted to the production of an agricultural commodity on the farm to a less intensive use, such as pasture, permanent grass, legumes, shrubs, or trees; (2) not to use the land for agricultural purposes except as permitted by the USDA; (3) establish approved vegetative cover or maintain existing cover on the land; and (4) not engage in or allow grazing, harvesting, or other commercial use of the land, except with USDA's permission (e.g., harvesting and grazing in response to a drought or other emergency).

Taxpayer B purchased highly erodible cropland that had been enrolled in the CRP by its previous owner. As the new owner, Taxpayer B executed an agreement to continue and assume all obligations of the CRP contract under the same terms and conditions as the original owner. These terms and conditions were identical to those in Taxpayer A's CRP contract. Taxpayer B was not engaged in the trade or business of farming prior to acquiring the cropland that was and continues to be subject to a CRP contract.

Taxpayer A and Taxpayer B each personally fulfilled their duties under their respective CRP contracts and received annual "rental" payments. Neither Taxpayer A nor Taxpayer B disputed the taxability of the CRP payments as includible in gross income under *section 61.* However, both taxpayers reported the payments as rental income not subject to SECA tax. Taxpayer A reported the amounts received as rental income from real estate on Schedule E. Taxpayer B reported the amounts as rental income from farm production and crop shares on Form 4835.

LAW AND ANALYSIS

Section 1401 imposes SECA tax on the self-employment income of every individual. SECA tax consists of the Old-Age, Survivors and Disability Insurance tax (OASDI tax which is commonly referred to as Social Security tax) and the Hospital Insurance tax (HI tax which is commonly referred to as Medicare tax).

Section 1402(b), in pertinent part, defines "self-employment income" as the net earnings from self-employment derived by an individual (other than a nonresident alien individual, except as provided by an agreement under section 233 of the Social Security Act) during any taxable year; except that such term shall not include:

(1) in the case of the OASDI tax imposed by *section 1401(a),* that part of the net earnings from self-employment which is in excess of (i) an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which such taxable year begins, minus (ii) the amount of the wages paid to such individual during such taxable years; or

(2) the net earnings from self-employment, if such net earnings for the taxable year are less than $400.

Section 1402(a) defines the term "net earnings from self-employment" as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by subtitle A which are attributable to such trade or business, plus the individual's distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which the individual is a member, with certain enumerated exceptions.

Section 1402(a)(1) generally excludes from the computation of "net earnings from self-employment" rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deduc-

tions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer, with an exception. Under this exception, any income derived by the owner or tenant of land must be included in the computation of "net earnings from self-employment" if:

(A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and furbearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and

(B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity.

See also, Income Tax *Reg.* § *1.1402(a)–4.*

Section 1402(c) provides that the term "trade or business" when used with reference to self-employment income or net earnings from self-employment shall have the same meaning as when used in *section 162* (relating to trade or business expenses), with certain enumerated exceptions. In order for an individual to have net earnings from self-employment, the individual must carry on a trade or business, either as an individual or as a member of a partnership. Whether or not the individual is engaged in carrying on a trade or business will be dependent upon all of the facts and circumstances in the particular case. *See also,* Income Tax Reg. § 1.1402(c)–1.

In considering whether an individual is engaged in a trade or business, the U.S. Supreme Court has stated that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity—does not qualify." *Commissioner v. Groetzinger,* 480 U.S. 23, 35 (1987) [*87–1 USTC ¶9191].* The question of whether a taxpayer is engaged in a trade or business requires an examination of the relevant facts in each case. *Id.* at 36.

In order for income received by an individual to be taxable as self-employment income, not only must the income in question derive from a trade or business carried on by the individual, but there must be a nexus between the income and the trade or business. *Newberry v. Commissioner,* 76 T.C. 441, 444 (1981) [*CCH Dec. 37,756*]. The income "must arise from some actual (whether present, past, or future) income-producing activity of the taxpayer." *Id.* at 446.

In determining what income is includible in self-employment income, *sections 1401* and *1402* are to be broadly construed to favor coverage for Social Security purposes. *Braddock v. Commissioner,* 95 T.C. 639, 644 (1990) [*CCH Dec. 47,046*]. In order to achieve this end, the rental exclusion under *section 1402(a)(1)* is "narrowly construed." *Johnson v. Commissioner,* 60 T.C. 829, 833 (1973) [*CCH Dec. 32,117*], *see also Delno v. Celebrezze,* 347 F.2d 159, 165 (9th Cir. 1965) (noting that a parallel provision of the Social Security Act relates Congress' specific intent for the "rental exclusion to be narrowly restricted to payments for occupancy only").

In *Wuebker v. Commissioner,* 205 F.3d 897 (6th Cir. 2000) [2000–1 USTC ¶50,254], the Sixth Circuit reversed a Tax Court decision that CRP payments received by Frederick and Ruth Wuebker (taxpayers) were excludible from their self-employment income as rentals from real estate. The Sixth Circuit held that CRP payments received by a farmer in exchange for the farmer's implementation of a conservation plan were includible in self-employment income from the trade or business of farming that were subject to SECA tax pursuant to section 1401.

In *Wuebker,* the taxpayers had been farming for approximately twenty years when they enrolled a portion of their farmland into the CRP. The Sixth Circuit held that because the taxpayers were "engaged in the business of farming prior to and during the term of their CRP contract" and their "agreement . . . required them to perform several ongoing tasks with respect to the land enrolled in the CRP, the very land they already owned and had previously farmed," the CRP payments "were 'in connection with' and had a 'direct nexus to' their ongoing trade or business." Id. at 902. The Sixth Circuit noted that the taxpayers were required under the CRP contract to perform tasks that are intrinsic to the farming trade or business (*e.g.,* tilling, seeding, fertilizing, and weed control) that required the use of their farming equipment. *Id.* at 903.

The Sixth Circuit found that the taxpayers' contention that their involvement with the CRP land was insufficient to constitute "material participation" within the meaning of *section 1402(a)(1)* had no bearing on whether the CRP payments constituted rentals from real estate. The issue of material participation arises only

when there is an arrangement between an owner or tenant and another individual whereby the other individual is to produce agricultural or horticultural commodities on the land. No such arrangement was present in *Wuebker.*

In addition, because of the narrow construction required of the exclusion for rentals from real estate, the Sixth Circuit held that the CRP payments were not true rental payments for the use or occupancy of property. The essence of the CRP program is to prevent participants from farming of the property and to require the participants to perform various activities in connection with the land continuously throughout the life of the contract with the government's access limited to inspection. *Id.* at 904. Furthermore, the Sixth Circuit looked to the "substance, rather than the form, of the transaction"[1] in determining that the income derived from the CRP contract is includible in self-employment income earned in lieu of farm income, for which SECA tax was due.

The CRP payments are not excludible per se as rentals from real estate. Rent is defined as "consideration paid—for the use or occupancy of property (esp. real property)." *Id.* at 904 citing Black's Law Dictionary 1299 (7th ed. 1999). Under a CRP contract, the USDA does not obtain the right to "occupy" the land enrolled in the CRP. The government's access is limited to inspecting the property and determining whether the recipients of the CRP payments are in compliance with the CRP contract. *See id.* at 904.

In *Hasbrouck v. Commissioner,* T.C. Memo. 1998–249 [*CCH Dec. 52,783(M)*], taxpayers purchased land that had already been enrolled in the CRP. The taxpayers, who fulfilled their obligations under the terms and conditions of the CRP contract, considered themselves engaged in the trade or business of farming and reported their CRP income and expenses on Schedule F. Prior to the purchase, the taxpayers were not engaged in the trade or business of farming. The Service initially reclassified the income and expenses as rentals from real estate on the basis that the taxpayers were not engaged in the trade or business of farming when they acquired the land. The Service, however, following the decision in *Ray v. Commissioner,* T.C. Memo 1996–436 [*CCH Dec. 51,573(M)*], reconsidered its position, and conceded the case.

In *Ray,* the Tax Court found that payments received under a CRP contract were includible in self-employment income. In this case, the taxpayers were engaged in the business of farming and cattle grazing and had acquired additional land that had been previously enrolled in the CRP. The Tax Court held that there was a sufficient nexus between the CRP payments received and the taxpayer's trade or business of farming to support the finding that the payments were includible in self-employment income subject to SECA tax.

In *Rev. Rul. 60–32,* 1960–1 C.B. 23, the Service held that annual payments received under the Soil Bank Act[2], an earlier acreage reserve program of the USDA, were includible in determining the recipient's net earnings from self-employment, if the recipient operated his farm personally or through agents or employees. The Service reasoned that the payments were in the nature of receipts from farm operations in that they replaced income which producers could have expected to realize from the normal use of the land devoted to the program. This was also true if the recipient's farm was operated by others and he participated materially in the production of commodities, or management of such production, within the meaning of *section 1402(a)(1).* However, if the recipient did not so operate or materially participate, payments received were not to be included in determining net earnings from self-employment.

In *Rev. Rul. 65–149,* 1965–1 C.B. 434, the Service addressed whether grain storage fees paid to a farm operator under the price support loan program of the Commodity Credit Corporation are to be regarded as attributable to the operator's trade or business of farming and considered in computing the operator's self-employment income. The Service argued that income derived from the operation of a farm, regardless of the form of the income (cash sales, Commodity Credit Corporation loans, government subsidies, including soil bank payments, conservation reserve pay-

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[1] Although the CRP contract referred to the payments as annual "rental" payments, such reference does not compel the conclusion that they should fall within the rentals-from-real estate conclusion. *Wuebker* 904; *citing Cline v. Commissioner,* 617 F.2d 192, 195 (6th Cir. 1980) [*80–1 USTC* ¶*9315*] ("Courts must look to the substance, rather than the form, of the transactions—").

[2] Soil Bank Act, Title I of the Agricultural Act 1956, 7 U.S.C. 1801–37 (repealed 1965). Under § *103(a)* of the Act, the Secretary of Agriculture is authorized and directed to carry out an acreage reserve program from the crops of specified commodities. Producers participating in the program are compensated for reducing their acreage of a commodity below their farm acreage allotments or their farm base acreage, whichever may be applicable. Producers must enter into a contract where they agree to perform various activities in connection with the land.

ments, and so forth.), should be treated in a manner consistent with the position set forth in *Rev. Rul. 60–32.* That is to say, if this income is received by a farm operator, or a landlord who materially participates, it should be treated as self-employment income. If it is received by a landlord who does not materially participate, it should be treated as rental income and excluded from net earnings from self-employment.

More recently, in *Announcement 83–43,* 1983–10 I.R.B. 29, the Service concluded that if a farmer participates in the Payment-in-Kind (PIK), or any other land diversion program sponsored by the USDA, and receives cash or a payment in kind from the USDA with respect to the diverted acres, the farmer is liable for SECA tax on the cash or payment in kind received. The announcement further provided that, for estate tax purposes (*sections 2032A* and *6166*), land diverted from the production of an agricultural commodity under a USDA land diversion program will be treated as being used as a farm for farming purposes and in the active conduct of a farming business.

Furthermore, participation in a USDA land diversion program and in the devotion of such land to conservation purposes under such programs will be treated as material participation in the operation of a farm with respect to the diverted acres.

As to reporting requirements, *section 6017* provides that every individual (other than a nonresident alien) having net earnings from self-employment of $400 or more for the taxable year shall make a return with respect to SECA tax. Income Tax *Reg.* § *1.6017–1(a)(2)* provides that the return required by *section 6017* for SECA tax shall be Form 1040.

Schedule SE is the form used to report net earning from self-employment and SECA tax. *See* 2002 Instructions for Schedule SE, Self-Employment Tax.

Schedule F is the form used to report farm income and expenses. *See* 2002 Instructions for Schedule F, Profit or Loss From Farming.

Schedule E is the form used to report income and expenses for rentals of real estate (including personal property leased with real estate) and royalty income and expenses. *See* 2002 Instructions for Schedule E, Supplemental Income and Loss.

Form 4835 is the form used by landlords or sub-lessors to report farm rental income and expenses based on the crops or livestock produced by the tenant where the landlord or sub-lessor did not materially participate (for SECA tax purposes) in the operation or management of the farm. The use of Form 4835 only applies to those circumstances where there is an arrangement between an owner or tenant and another individual whereby the other individual is to produce agricultural or horticultural commodities on the land. *See* General Instructions for Form 4835.

In each case, the annual "rental" payments that Taxpayer A and Taxpayer B individually receive for land enrolled in the CRP are in the nature of receipts from farm operations earned in lieu of income that each taxpayer could have expected to realize from the normal use of their respective cropland, if they had not enrolled the cropland in the CRP. *See Rev. Rul. 60–32.*

Pursuant to the terms of the CRP contract, each taxpayer is required to engage in soil conservation practices, to establish or maintain approved vegetative cover on the cropland, to not use the land for agricultural purposes except as permitted by USDA, and to not conduct any harvesting or grazing on the cropland. The income is derived from the income-producing activity of the taxpayers in performing under the CRP contract. The CRP contracts require Taxpayer A and Taxpayer B to perform tasks that are intrinsic to the farming trade or business. The fact that Taxpayer A was previously engaged in the trade or business of farming prior to enrolling Taxpayer A's land in the CRP is an additional fact that helps establish that Taxpayer A is continuing to be engaged in the trade or business of farming. However, Taxpayer B, who was not engaged in farming prior to the purchase of land subject to a CRP contract, becomes engaged in trade or business of farming in personally fulfilling Taxpayer B's obligations under the terms and conditions of the CRP contract. *See Hasbrouck.* As long as Taxpayer A and Taxpayer B are actively fulfilling their respective obligations under their respective CRP contracts, they will both individually be considered to be engaged in the trade or business of farming.

The CRP payments are in connection with and have a direct nexus to the taxpayer's ongoing business of farming. *See Wuebker; see also Ray.*

Although the payments are labeled as "rental" payments for purposes of the CRP, the narrow-construction placed on the *section 1402(a)(1)* exclusion for rentals from real estate eliminates these payments from its provisions. *See Wuebker.* Further, under our facts, neither Taxpayer A nor Taxpayer B leased the land to a third

party, such as another individual, on a rental basis. Thus, the test regarding material participation by the owner of rented land to a third party is irrelevant.[3]

The income derived from the CRP contract is includible in self-employment income subject to SECA tax. Taxpayer A must report the CRP payments as self-employment income from farming subject to SECA tax. Similarly, Taxpayer B must report the CRP payments as self-employment income from farming subject to SECA tax.

After having concluded that CRP payments are includible in self-employment income from farming, such CRP payments should be reported on Schedule F, filed with Form 1040. See Pub 225, Farmer's Tax Guide; and Instructions for Schedule F; *Cf. Hasbrouck*. Any profit or loss from farming should then be reported on a Schedule SE for SECA tax purposes pursuant to form instructions. *See* 2002 Instructions for Schedule F, Profit or Loss From Farming.

CRP payments are not considered rental income from real estate nor are they rental income from farm production or crop shares.[4] Accordingly, the use of Schedule E or Form 4835, under our facts, is not allowed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This memorandum does not address cost-share assistance.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

APPENDIX B

Ltr. Rul. 8822064, March 7, 1988.

Under the Food Security Act 1985, the Secretary of Agriculture instituted a 10-year conservation acreage reserve program under which the Secretary enters into contracts with owners and operators of highly erodible cropland to take the cropland out of production of intertilled crops and place the land in conservation and soil and water conserving uses. Those bidding their lands into a CRP program are compensated on a pre-acre basis in cash or, occasionally, commodities. Not more than 25 percent of the acreage in a county may be placed in the reserve, unless the Secretary of Agriculture determines that additional acres in the program in that county will not affect adversely the local economy.

Approximately 34 million acres are presently enrolled in the CRP program. Periodically, the Secretary of Agriculture announces that, for a designated time, owners wanting to enroll land in the Conservation Reserve Program can make an offer in bid form to idle the land in exchange for the bid price per acre. In accepting bids, the Secretary of Agriculture is to take into consideration the extent of erosion on and the productivity of the land involved; accept offers that provide for permanently vegetated stream borders and filter strips; establish criteria for different regions of the country; and give priority to owners and operators under the greatest economic stress.

The amount of rental payments made to a "person" may not exceed $50,000 per year, which is in addition to payments that can be received under any other agricultural commodity program.

Under a CRP contract, the owner or operator must agree to:

1. implement a plan approved by the local conservation district to convert highly erodible crop land to less intensive use, including pasture, grass, legumes, forbs, shrubs or trees;
2. place the highly erodible land specified in the contract in reserve so as not to be used for agricultural purposes except as permitted by the Secretary of Agriculture;
3. establish vegetative cover on the land;

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[3] Under the rentals-from-real estate exception, the owner of a farm operated on a rental basis must include the rental income in determining net earnings if (1) such income is derived under an arrangement between the owner and another individual which provides that there be material participation by the owner in the production or the management of the production of such commodities, and (2) there is material participation by the owner with respect to such commodity.

[4] An arrangement for the production of agriculture or horticulture commodities is not present under the CRP contract for either Taxpayer A or Taxpayer B.

4. forfeit all rights to rental and cost sharing payments and refund any rental and cost sharing payments received under the contract, with interest, upon termination of the contract resulting from a violation of the terms of the contract;
5. refund to the Secretary of Agriculture or accept adjustments to the rental and cost sharing payments provided to the owner for violation of the terms of the contract which does not cause termination of the contract;
6. forfeit all rights to rental and cost sharing payments under the contract upon transfer of the land, unless the transferee of the land agrees to assume all obligations of the contract;
7. refund rental and cost sharing payments or accept adjustments in the rental and cost sharing payments, unless the transferee of the land agrees to assume all obligations of the contract;
8. not make any commercial use, such as harvesting or grazing, of the forage on the contract land, unless permitted by the Secretary of Agriculture in case of drought or other emergency;
9. not plant trees on the contract land unless permitted by the contract, except that customary forestry practices may be allowed on land converted to forestry use;
10. not adopt any practice specified in the contract which may defeat the purposes of the program; and
11. comply with any additional contract provisions.

Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University, Ames, Iowa. Member of the Iowa Bar.

Mr. POMEROY. I don't expect necessarily that you can speak to what might be under contemplation at the IRS, but I would like your attention to those recommendations, and as quickly as possible, because people literally have dozens, if not hundreds, of tax filings and a questioned status in their offices, not knowing how to treat this new development.

Mr. EVERSON. I had a discussion on this before the hearing today with some of my folks who were familiar with the meeting that I think you held last week on this.

Mr. POMEROY. Yes.

Mr. EVERSON. As we indicated in the early conversation, this is a discussion that has broad ramifications, particularly as the country moves to a model where there are more individuals who are self-employed or running small businesses. We need to tread very carefully as we look at this. I give you my commitment that we will look at this very carefully.

Mr. POMEROY. Mr. Commissioner, can we expect to have any guidance from the IRS prior to the filing date for this tax season?

Mr. EVERSON. I don't know the answer to that. I would imagine that would be quite expedited, since we're only a couple of weeks away from April 15th. I will ask that specific question. It is not one that we discussed or had an expectation of something that rapid in the conversation I had, in fact, earlier today on this subject. I will check.

Mr. POMEROY. To sharpen the point to you, by acknowledgement of the IRS, the letter ruling—which is private and nonbinding, but nonetheless stands with some authority about what the tax treatment might be in this area—was prepared without contemplation of retired farmers but the wording of it is broad enough to sweep them in. It leaves people in a very difficult position on whether to ignore it, as has been the treatment of this matter since 1988, or whether you change based on the IRS wording

that was put out not in contemplation of this specific issue. So, some clarification I believe in this instance would be appropriate. Again, we're not asking the IRS not to—what we want them to do is lift the confusion by basically lifting the letter ruling as it applies to retired farmers, and then come forward with a more definitive statement with the contemplation of this particular set of circumstances, going forward for future guidance. I thank the Commissioner.

Chairman HOUGHTON. Thanks very much, Mr. Pomeroy. Well, thank you, Mr. Commissioner. We appreciate your testimony.

Mr. EVERSON. Thank you, sir.

Chairman HOUGHTON. Now we've got a time problem. I'm going to ask Mr. White, who is Director of Tax Issues for the GAO, and also Nancy Killefer, Chairman of the IRS Oversight Board, if you be willing to maybe squeeze in your testimony in maybe 3 minutes apiece in order that we can get through your testimony. Then when we come back from these three votes, we can get right into the questions. Is that all right with you, Ms. Killefer?

Ms. KILLEFER. Absolutely.

Chairman HOUGHTON. Good. Thanks very much. Okay, Mr. White.

STATEMENT OF JAMES R. WHITE, DIRECTOR, TAX ISSUES, U.S. GENERAL ACCOUNTING OFFICE

Mr. WHITE. Mr. Chairman and Members of the Committee, we are pleased to be here. For several years, we have reported on the opposing trends in taxpayer service and enforcement that we've heard discussed already. IRS' 2005 budget addresses both enforcement and systems modernization.

One point I want to make about the budget request for 2005 is that this is not IRS' first request for additional enforcement staff. It follows similar requests in IRS' past five budgets. You can see what actually has happened in figure 1 on page 8 of my statement. Staffing in three key enforcement occupations—revenue agents, revenue officers and special agents—declined by over 21 percent between 1998 and 2003. These declines occurred, even though IRS' budget requests were almost fully funded and IRS did realize some savings. IRS funded other priorities, such as unbudgeted cost and improvements to taxpayer services.

Switching quickly to systems modernization, as you are aware, some projects have been completed but many of the projects that have not been completed are over cost and behind schedule. The point I want to make here is that this impacts taxpayers. The customer account data engine, for example, is intended to facilitate faster refund processing and better answers to taxpayer questions. IRS, in response to these problems, has reduced its modernization budget request to focus on fewer projects and is implementing action plans to correct deficiencies.

Turning to the 2004 filing season, IRS is continuing to improve most but not all taxpayer services, and we see this as a payoff from the completed modernization projects. I have some examples in my statement but I will skip most of those. Another point to make related to customer service and IRS' budget both has to do with elec-

tronic filing. Electronic filing is continuing to grow, but it is not growing at the rate that would meet either IRS' 80 percent goal but, in fact, is growing at a slower rate each year. This continues a trend that we have seen over time.

Electronic filing is important because it's a way to gain efficiencies. It's much cheaper to process electronically filed returns than to process paper filed returns, which is a very labor-intensive process. An example of the consequence of the growth of electronic filing that we've seen is that IRS has been able to reduce processing staff. In 2003, for example, about 1,000 full time equivalents in the processing area of IRS was the size of the decline there. So, it's a significant saving in that area.

Mr. Chairman, my three themes—declines in enforcement staff, systems modernization, and improved service—are related. Recent history causes us to question whether IRS will be able to increase enforcement staffing as much as proposed in the 2005 budget. IRS already expects some unbudgeted costs. If all IRS's planned savings are not realized, then funds for enforcement could be further reduced. One near term option for increasing enforcement staff is to reconsider the level and types of services IRS provides. For example, the improvements in phone and Internet service raise a question about whether IRS needs to operate as many walk-in sites. Longer term systems modernization, if successful, could generate efficiencies and increase e-filing which would allow IRS to do more with less.

I want to make a final point on enforcement staffing. As noted, many fear that declines could be reducing taxpayers' incentives to voluntarily comply. However, IRS currently does not have a measure of voluntary compliance. IRS is working to develop a measure, but won't have results until 2005. Those results could impact future IRS budgets. If compliance is stable or has improved, the pressure to increase IRS' enforcement staff might diminish in the future. If, however, compliance is down, the pressure on IRS' budget will likely increase in the future. Thank you, Mr. Chairman.

[The prepared statement of Mr. White follows:]

Statement of James R. White, Director of Tax Issues, U.S. General Accounting Office

Mr. Chairman and Members of the Subcommittee:

We are pleased to participate in the Subcommittee's hearing on the Internal Revenue Service's (IRS) fiscal year 2005 budget request and its performance to date during the 2004 tax filing season.

Effective tax administration requires a combination of quality taxpayer service to help those who want to comply, and effective enforcement measures against those who do not. Although tax administrators continually debate the proper balance between taxpayer service and enforcement, the ultimate goal is to assure a high level of voluntary compliance. Currently, about 98 percent of the money IRS collects is received voluntarily—without any IRS enforcement action.

For the last few years, we have been reporting on trends in taxpayer service and enforcement. During this period, IRS has noticeably improved the quality of service to taxpayers. At the same time, there have been declines in many of IRS's enforcement programs and in the numbers of the most skilled enforcement staff. Many inside and outside IRS have become concerned that the declines in enforcement efforts have reduced taxpayers' incentive to voluntarily comply with the tax laws. While the actual impact on voluntary compliance is unknown, because IRS does not have a reliable current estimate of the overall compliance rate, the fear is that taxpayers could lose confidence in IRS's ability to ensure that all taxpayers pay what they should. If taxpayers ever lose confidence that their friends, neighbors, and business

competitors are paying their fair share of taxes, then they could become less willing to pay themselves.

One key to improving taxpayer service and enforcement is IRS's Business Systems Modernization (BSM) effort, now in its 6th year. If successful, BSM is expected to allow IRS to better serve taxpayers and enforce the tax laws without a major increase in staffing and other resources. However, we continue to report that modernization is a high-risk area, the scope and complexity of BSM is growing, and BSM projects are experiencing additional costs and delays.

As you requested, our statement discusses both IRS's 2005 budget request and its 2004 filing season performance to date. With respect to the budget, we assessed the likelihood that (1) IRS will be able to allocate more resources to enforcement, and (2) BSM and other technology efforts will deliver cost savings and efficiencies in the immediate future. With respect to the filing season, we assessed IRS's performance in processing returns and providing assistance to taxpayers.

Our assessment of the budget request and BSM is based on a comparative analysis of IRS's fiscal year 2002 through 2005 budget requests, funding, and expenditures, supporting documentation, and interviews with IRS officials. Our assessment of the filing season is based on a comparison of IRS's performance this year to the previous two filing seasons, site visits to an IRS processing center and walk-in sites, monitoring processing status meetings, interviews with IRS and Treasury Inspector General for Tax Administration (TIGTA) officials and other external stakeholders, reviews of TIGTA and other external reports, and reviews of IRS's Web site. We used historical budget and performance data including filing season performance data from reports and budget requests used by the IRS, Department of Treasury, and Office of Management and Budget (OMB). Although we have not verified the accuracy of the most recent data, in past reports we have assessed IRS's budget and performance data.[1] As a result, we considered the data to be sufficiently reliable for purposes of this testimony. The budget and performance projections for fiscal years 2004 and 2005 are subject to change. Also, we did not independently validate planned BSM projects' cost estimates or confirm, through system and project management documentation, the validity of IRS-provided information on the projects' content and progress. We performed our work in Washington, D.C. and Atlanta, Ga. from December 2003 through March 2004, in accordance with generally accepted government auditing standards.

In summary, our assessment of IRS's 2005 budget request shows that:

- IRS is requesting $10.7 billion, an increase of $489.8 million over fiscal year 2004. The 2005 budget proposes $377.3 million to fund new initiatives, primarily increases in enforcement staff, and $373 million to cover the increased costs, such as salary increases, of maintaining current programs. IRS plans to fund the additional spending from three sources—the budget increase, program reductions ($149.7 million) and internal savings ($110.8 million). IRS has made increasing enforcement staff a priority in its last five budget requests. However, despite getting its requests almost fully funded and despite realizing some savings—although not all that were projected—IRS did not achieve increases in enforcement staff. Staffing in three key enforcement occupations—revenue agents, revenue officers, and special agents—declined by over 21 percent between 1998 and 2003. IRS funded other priorities such as unbudgeted expenses and improvements to taxpayer service. This raises several questions and concerns. One is whether IRS will be able to increase enforcement staff as planned in 2005. Another is whether the declines in enforcement staff, and the resulting declines in statistics related to IRS's enforcement programs, are eroding taxpayers' incentive to voluntarily comply with the tax laws.
- Included in IRS's budget request is about $1.93 billion (including 7,385 staff years) in information technology resources. This includes (1) $285 million for the agency's multiyear capital account that funds contractor costs for the BSM program and (2) about $1.64 billion for information systems, of which $1.55 billion is for operations and maintenance. The BSM request has been developed consistent with federal guidance on budget preparation. While BSM management controls have improved, some weaknesses, such as cost and schedule estimating, still remain. Most BSM projects have experienced cost overruns and schedule delays that have postponed the delivery of benefits to taxpayers and IRS operations. In an effort to better ensure that projects are delivered within

[1] U.S. General Accounting Office, Tax Administration: IRS Needs to Further Refine Its Tax Filing Season Performance Measures, GAO–03–143 (Washington, D.C.: Nov. 22, 2002) and U.S. General Accounting Office, Financial Audit: IRS's Fiscal Years 2003 and 2002 Financial Statements, GAO–04–126 (Washington, D.C.: Nov. 13, 2003)

budget and on schedule, IRS has reduced its BSM budget request to focus on a smaller modernization project portfolio and is implementing action plans to respond to deficiencies noted in several recent assessments of the BSM program. In addition, with respect to its information systems budget request, IRS has made progress in implementing investment management best practices for developing and supporting it. However, until IRS fully implements planned process improvements, its ability to develop supportable information systems operations and maintenance budget requests will remain limited.

Our assessment of the 2004 filing season to date shows that:

- IRS's performance during the 2004 filing season has improved in most areas compared to this time last year and the year before, based on the data we reviewed on key filing season activities—paper and electronic processing, telephone assistance, IRS's Web site and walk-in assistance. In particular, access to IRS's telephone assistors has improved and Web site usage has increased. However, the accuracy of responses to tax law questions provided by telephone assistors declined the last two years. Additionally, the number of taxpayers seeking assistance at IRS's walk-in sites continued to decline and IRS is shifting work from its walk-in sites to alternative means of providing assistance, such as its volunteer organizations and its Web site. Although it cannot be quantified, the improvements overall in the 2004 filing season performance appear to represent a payoff from IRS's modernization and increased emphasis on service since 1998.

Enhancing Enforcement Is A Key Priority But Devoting More Resources To Enforcement May Be Difficult

The fiscal year 2005 budget is the fifth consecutive budget request where IRS is proposing increased staffing for enforcement and the third where it has identified internally-generated savings to help fund the increase. The 2005 budget proposes that, of the $377.3 million for new initiatives to be paid for either through new funding and reinvested savings, $315.2 million or 84 percent go to enforcement. In the past, IRS has not been able to realize all the projected savings intended to help fund enforcement staffing increases. In addition, other priorities, including unbudgeted expenses and taxpayer service, have consumed budget increases and internally-generated savings. This raises the question about IRS's ability to increase enforcement staffing as planned in 2005.

IRS is Asking For Significantly More For Enforcement in 2005

IRS's fiscal year 2005 budget request is $10.7 billion, up $489.8 million or 4.8 percent from the amount appropriated for fiscal year 2004. IRS's request identifies a total of $750.3 million of new proposed spending—$377.3 million for new initiatives, primarily enforcement, and $373 million to maintain current operations (such as salary increases included in the budget). IRS plans to fund the additional spending from three sources—budget increases, program reductions, and internal savings. IRS is proposing to receive $489.8 million in budget increases, gain $149.7 million from program reductions, primarily from reducing the amount for BSM, and save $110.8 million from process improvements. For context about IRS's staff resources, we provide information about how IRS allocated those resources in fiscal year 2003 to various functions including returns processing, taxpayers service and enforcement in appendix I.

In its 2005 budget request, IRS makes increasing enforcement staffing its priority. IRS identified its priority enforcement areas as:

- promoters of tax schemes,
- misuses of offshore transactions,
- uses of corporate tax avoidance transactions,
- underreporting of income by higher income taxpayers, and
- failures to file and pay large amounts of employment taxes.

IRS is proposing to spend $377.3 million on new initiatives; $315.2 million, or 84 percent is slated for enforcement initiatives. The rest is for infrastructure projects to, for example, consolidate paper processing operations. The major enforcement initiatives include:

- $90.2 million and 874 Full Time Equivalents (FTEs) to target noncompliance by small business and self-employed taxpayers by hiring field examination and collection, automated collection and service center-based compliance staff;
- $65 million and 260 FTEs for additional criminal investigation resources to combat corporate fraud, increase tax enforcement, and enhance criminal investigation capabilities by hiring additional criminal investigators and special

agents to focus on corporate financial fraud, general tax enforcement, improve forensic electronic evidence capabilities and increase special agent support staff;
- $36 million and 207 FTEs to combat corporate abusive tax shelters by devoting more resources to reviewing offshore transactions;
- $15.5 million and 175 FTEs to increase individual taxpayer compliance by focusing on the full spectrum of individual taxpayer noncompliance, including nonfilers, nonpayers of tax owed, and more tax assessments on underreported income; and
- $15.1 million and 144 FTEs to combat diversions of charitable assets and stop abusive transactions in the tax-exempt area by focusing on terrorism funding and civil fraud by charities, and targeting tax avoidance strategies by charities.

IRS is proposing to spend $373 million to maintain current operations, which would cover increased costs of continuing current operations. The increased costs include $133 million for salary increases assumed in IRS's budget. IRS's 2005 budget assumes a federal salary increase of 1.5 percent. If the actual federal salary increase is higher than 1.5 percent, IRS will have to cover the unbudgeted portion of the increase.

For 2005, IRS has identified $110.8 million in savings to be generated from process and system improvements. Key savings initiatives include:

- $34.0 million and 408 FTEs from a reorganization of the information systems function that will consolidate three parallel organizations, and reduce staff, to improve operations and support to IRS customers;
- $15.7 million and 220 FTEs from consolidating insolvency and exam/collection field support from over 80 to 5 or fewer locations;
- $14.9 million and 167 FTEs from the termination of transition employees who could not be placed when offices closed and jobs shifted when IRS's reorganization into business units; and
- $5.1 million and 130 FTEs due to more electronic filing.

In addition to the savings, IRS has identified $149.7 million in program reductions to help fund its 2005 spending priorities. The reductions include $102.7 million due to reductions in the scope of certain BSM projects (discussed later in more detail) and $18 million in overhead reductions.

Recent History Suggests Increasing Enforcement Staffing May Be Difficult

In its last five budget requests, IRS has asked for more enforcement staff, to be funded partly by budget increases and partly through internal savings. Despite budget requests that were almost fully funded and despite achieving some savings, the number of skilled enforcement staff actually declined. The budget increases and savings were consumed by other priorities including unbudgeted expenses.

IRS's Recent Budget Requests Were Almost Fully Funded, and Some Savings Were Achieved

Table 1 shows that IRS has received almost 98 percent or more of its budget requests since fiscal year 2002.

Table 1: IRS's requested and approved budget for fiscal years 2002 through 2005 (in millions)

	Fiscal Year 2002 (Actual)	Fiscal Year 2003 (Actual)	Fiscal Year 2004 (est.)	Fiscal Year 2005 (Requested)
Requested budget	$9,422	$9,916	$10,437	$10,674
Budget approved	9,437	9,835	10,185	

Source: IRS data.

Table 2 shows that in 2003 IRS realized about 34 percent of its anticipated budget savings and about 41 percent of its anticipated staff savings. In 2004, IRS officials believe they did a better job in both estimating and tracking the savings and estimate they will be able to reinvest 77 percent of the anticipated budget savings and 53 percent of the anticipated staff savings.[2]

[2] Although IRS officials were able to produce more complete supporting documentation on cost estimates and savings justifications than for fiscal year 2004, we were unable to verify actual IRS claims on savings and reinvestments. IRS's budget office generally accepts the savings and reinvestment data claimed by various IRS operating divisions, and reduces the budget allocation of the unit that identified the savings. If expected savings do not materialize, the operating divi-

Continued

Table 2: IRS's reported actual and estimated savings and reinvestments for fiscal year 2003 and 2004 (In millions)

	Fiscal Year 2003		Fiscal Year 2004		Fiscal Year 2005 (est)	
	Dollars	Staff Levels	Dollars	Staff Levels	Dollars	Staff Levels
Savings[a]						
Budgeted	157.8	2,287	166.5	2,145	110.8	1,442
Actual	53.4	944	113.0	1,120		
Percentage of actual[b]	34%	41%	68%	53%		
Reinvestments[a]						
Projected	157.8	1,830	166.5	649	110.8	712
Actual	47.4	2 39	99.5	259		
Percentage of actual[b]	30%	13%	77%	53%		

Source: GAO analysis of IRS data.
[a] IRS considers savings to be gained through process or systems improvements and reinvestments to be those savings that were realized and available for other purposes.
[b] IRS reported actuals for 2003 and end of year projections for 2004.

IRS should be commended for identifying saving and reinvestment opportunities in its budget request. While IRS has been unable to achieve its savings targets, we recognize that budget preparation begins about 18 months before the beginning of the fiscal year, making it difficult to accurately predict future savings. IRS officials believe they are doing a better job both estimating and tracking savings. Nevertheless, IRS's history raises questions about its ability to achieve the 2005 savings targets.

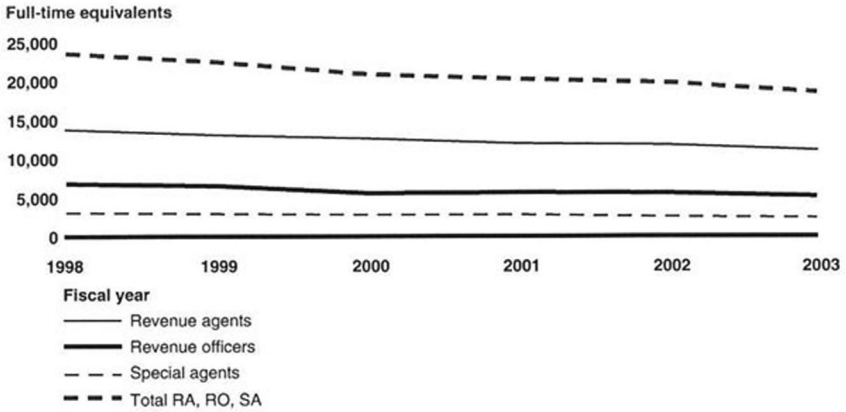
IRS Has Been Unable to Achieve Increases In Enforcement Staffing in Recent Years

Despite budget requests that were almost fully funded, and despite realizing some savings, IRS has been unable to achieve the enforcement staffing increases projected in its recent budgets.

As shown in figure 1, the number of revenue agents (those who audit complex returns), revenue officers, (those who do field collection work), and special agents (those who performed criminal investigations) has decreased over 21 percent between 1998 and 2003.

sion must either find a way to make up the savings elsewhere with new efficiencies, reduce expected expenditures, or petition for additional resources from other parts of the organization.

Figure 1: Revenue agents, revenue officers, and special agents, fiscal years 1998–2003



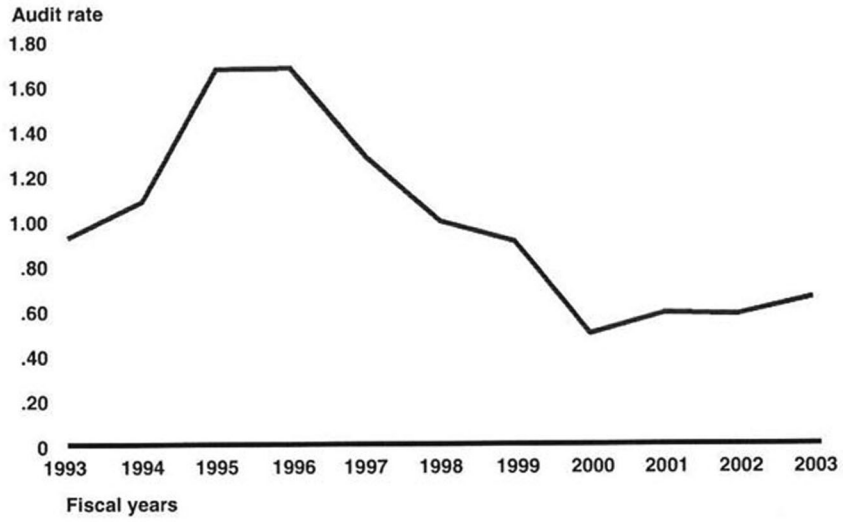
Source: IRS.

The Large—and Mid-size Business (LMSB) operating division, responsible for combating abusive corporate tax shelters and assuring that large businesses are in compliance with the tax laws, is an example of these staffing trends. According to LMSB officials, at the beginning of fiscal year 2002, they had 5,047 revenue agents on board. This was reduced to 4,431 at the beginning of fiscal year 2004—a 12 percent reduction—due to attrition and the inability to hire.

The declines in enforcement staff have been associated with declines in enforcement efforts. For example, audit rates are below the levels of the mid-1990s, even after accounting for recent increases. Figure 2 shows the trend in total audits of individual taxpayers since 1993. Total audits includes both face-to-face audits and less complex correspondence audits. IRS and GAO have reported[3] that IRS has experienced steep declines in audit rates since 1996, although the audit rate has slowly increased since 2000.

[3] U.S. General Accounting Office, Tax Administration: IRS Should Continue to Expand Reporting on Its Enforcement Efforts, GAO–03–378, (Washington, D.C.: Jan. 31, 2003).

Figure 2: Audit rate individual income tax returns, fiscal year 1993–2003



Source: IRS.

The link between the decline in enforcement staff and the decline in enforcement actions, such as audit rates, is complicated by other factors, such as changes over time in the mix of complex and simple enforcement actions. However, IRS officials have stated that the decline in enforcement staff has restricted their enforcement efforts. For example, LMSB officials stated that they hired about 200 fewer revenue agents than planned in fiscal year 2003 and expect to hire about 95 fewer in fiscal year 2004 because of budget constraints. They estimated that had this hiring occurred as planned, LMSB could have examined an additional 505 returns and 1,877 returns in fiscal years 2003 and 2004 respectively. In addition, the 2005 budget request attributes the decline in enforcement actions to the decline in enforcement staff.

The impact of the recent declines in enforcement staffing and enforcement actions on taxpayers' rate of voluntary compliance is not known. This leaves open the question of whether these declines are eroding taxpayers' incentives to voluntarily comply. As we have reported,[4] the IRS's National Research Program (NRP), which is developing new estimates of taxpayer compliance, is underway. These estimates will be the first based on data more recent than 1988, when IRS last measured voluntary compliance. According to IRS officials the new estimates should be available in 2005. Until the NRP estimates are available, IRS lacks current data on compliance including changes in taxpayers' compliance rate.

NRP is important for several reasons beyond measuring compliance. It is intended to help IRS better target its enforcement actions, such as audits, on non-compliant taxpayers, and minimize audits of compliant taxpayers. It could also help IRS better understand the impact of taxpayer service on compliance.

Other IRS Priorities Have Consumed Recent Budget Increases and Savings

Priorities other than enforcement, including unbudgeted expenses and taxpayer service, have consumed IRS's budget increases and savings over the last few years. Unbudgeted expenses include unfunded portions of the annual pay increases, that can be substantial given IRS's large workforce, and other costs, such as postage increases and higher-than-budgeted rent increases. According to IRS officials, these unbudgeted expenses accounted for

- $154 million of IRS's budget in 2002;
- $311 million of IRS's budget in 2003; and
- $169 million of IRS's budget in 2004.

[4] U.S. General Accounting Office, Tax Administration: IRS is Implementing the National Research Program as Planned, GAO–03–614, (Washington, D.C.: June 16, 2003).

IRS officials also told us that they anticipate having to cover unbudgeted expenses in 2005. As of March 2004, they were projecting unbudgeted salary increases for fiscal year 2005 of at least $100 million. This projection could change since the actual federal salary increase for 2005 has not been finalized.

Another reason for the reduction in enforcement staff has been IRS's emphasis on improving service to taxpayers. According to IRS officials, much of this improvement has been at the expense of additional resources for enforcement and has resulted in less hiring of new staff for enforcement activities.

IRS's Information Technology Budget Includes Funding For BSM and Information Systems

IRS is requesting about $1.93 billion (including 7,385 staff years) in information technology (IT) resources for fiscal year 2005. This includes (1) $285 million for the agency's multiyear capital account that funds contractor costs for the Business Systems Modernization (BSM) program and (2) about $1.64 billion for information systems, of which $1.55 billion (including 7,137 staff years) are for operations and maintenance. BSM is important for IRS's future because it has the potential for long-term efficiency gains without major increases in staffing or other resources.

Fiscal Year 2005 BSM Request Developed Consistent with Federal Guidance

Consistent with the Clinger-Cohen Act of 1996[5] and the Government Performance and Results Act of 1993,[6] OMB guidance on budget preparation and submission[7] require that, before requesting multiyear funding for capital asset acquisitions, agencies develop sufficient justification for these investments. The guidance requires that agencies implement key IT management practices, including an integrated IT architecture and a process for managing information systems projects as investments. In addition, agencies are to prepare business cases that reasonably demonstrate how proposed investments support agency missions and operations, and provide positive business value in terms of expected costs, benefits, and risks.

Beginning in 1995, when IRS was involved in an earlier attempt to modernize its tax processing systems, and continuing since then, we have made recommendations[8] that IRS implement fundamental modernization management capabilities before acquiring new systems. We recommended, among other things, that IRS (1) put in place an enterprise architecture[9] (modernization blueprint) to guide and constrain its business system investments, and (2) implement disciplined processes for investment decision management and system development management.

In response to our recommendations, IRS developed and is using an enterprise architecture, which describes IRS's current and target business and technology environments, and the associated high-level transition strategy that identifies and conceptually justifies needed investments to guide the agency's transition over many years from its current to its target architectural state. In addition, IRS also implemented a capital planning and investment control process for developing business cases and managing BSM projects as part of an investment portfolio, as well as a systems life cycle management methodology, which IRS refers to as the enterprise life cycle.

IRS's $285 million request for the BSM account for fiscal year 2005 is based on its enterprise architecture as well as its related investment management process and life cycle management methodology. IRS's BSM budget request constitutes a reduction of greater than 25 percent from the planned fiscal year 2004 spending level

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[5] This fiscal year 1997 Omnibus Consolidated Appropriations Act, Pub. L. 104–208, renamed both Division D (the Federal Acquisition Reform Act) and E (the Information Technology Management Reform Act) of the 1996 Department of Defense Authorization Act, Pub. L. 104–106, as the Clinger Cohen Act of 1996.

[6] P.L. 103–62.

[7] See, for example, Office of Management and Budget, Preparing, Submitting, and Executing the Budget, Circular No. A–11 (Washington, D.C.: July 25, 2003).

[8] See U.S. General Accounting Office, Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed, GAO/AIMD–95–156 (Washington, D.C.: July 26, 1995); Tax Administration: IRS' Fiscal Year 1997 Spending, 1997 Filing Season, and Fiscal 1998 Budget Request, GAO/T–GGD/AIMD–97–66 (Washington, D.C.: March 18, 1997); Tax Systems Modernization: Blueprint is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems, GAO/AIMD/GGD–98–54 (Washington, D.C.: February 24, 1998); and Tax Administration: IRS' 2000 Tax Filing Season and Fiscal Year 2001 Budget Request, GAO/T–GGD/AIMD–00–133 (Washington, D.C.: March 28, 2000).

[9] An enterprise architecture provides an institutional "blueprint" for defining how an organization operates today (baseline environment) in both business and technological terms, and how it wants to operate in the future (target environment). It also includes a sequencing plan that provides a road map for transitioning between these environments.

of $388 million, and reflects the agency's decision, in light of ongoing project delays, to focus on a smaller modernization project portfolio in an effort to better ensure cost targets are maintained, project schedules are met, and the promised projects are delivered.

BSM Management Controls Improved, But Weaknesses Remain

Pursuant to statute,[10] funds from the BSM account are not available for obligation until IRS submits to the congressional appropriations committees for approval an expenditure plan that meets certain conditions.[11] In January 2004, IRS submitted an expenditure plan seeking approval to obligate funds from the BSM account for its planned fiscal year 2004 projects and program-level initiatives. IRS's fiscal year 2004 plan reported the deployment of modernization projects during fiscal year 2003 that have benefited taxpayers and the agency, including an application that provides refund status for the advanced child tax credit and the first release of a new human resources system, HR Connect, which has now been delivered to 73,000 IRS employees.

In our briefing to the staff of the relevant appropriations subcommittees on the results of our review of the fiscal year 2004 expenditure plan, we reported that IRS has made progress in implementing our prior recommendations to improve its modernization management controls and capabilities. However, certain of these controls and capabilities related to configuration management, human capital management, cost and schedule estimating, and contract management have not yet been fully implemented or institutionalized. Our analysis has shown that weaknesses in these controls and capabilities have contributed, at least in part, to cost and schedule shortfalls experienced by most BSM projects. In the absence of appropriate management controls, systems modernization projects will likely be hampered by additional costs and schedule shortfalls. The reasons are twofold: the tasks associated with those projects that are moving beyond design and into development are, by their nature, more complex and risky. Also, the fiscal year 2004 expenditure plan supports progress toward the later, more complex phases of key projects as well as continued development of other projects.

BSM Projects Continue to Incur Cost Increases and Schedule Delays

Based on IRS's expenditure plans, BSM projects have consistently cost more and taken longer to complete than originally estimated. In its fiscal year 2004 plan, IRS disclosed that key BSM projects have continued to experience cost and schedule shortfalls against prior commitments. Table 4 shows the life cycle variance in cost and schedule estimates for completed and ongoing BSM projects. These variances are based on a comparison of IRS's initial and revised cost and schedule estimates to complete initial operation[12] or full deployment[13] of the projects. We did not independently validate planned projects' cost estimates or confirm, through system and project management documentation, the validity of IRS-provided information on the projects' content and progress.

Table 4: IRS BSM project life cycle cost/schedule variance and benefits summary for completed and on-going projects

Project	Cost variance (in thousands)	Reported/revised estimated cost (in thousands)	Schedule variance (in months)	Reported/revised estimated completion date	Reported IRS/taxpayer benefits
Completed Projects					

[10] P.L. 108–199, Div. F, Title II, Jan. 23, 2004.

[11] IRS's BSM expenditure plans are required to (1) meet the capital planning and investment control review requirements established by OMB, (2) comply with IRS's enterprise architecture, (3) conform with IRS's enterprise life cycle methodology, (4) be approved by IRS, Treasury, and OMB, (5) be reviewed by GAO, and (6) comply with federal acquisition rules, requirements, guidelines, and systems acquisition management practices.

[12] Initial operation refers to the point at which a project is authorized to begin enterprisewide deployment.

[13] Full deployment refers to the point at which enterprisewide deployment has been completed and a project is transitioned to operations and support.

Table 4: IRS BSM project life cycle cost/schedule variance and benefits summary for completed and on-going projects—Continued

Project	Cost variance (in thousands)	Reported/revised estimated cost (in thousands)	Schedule variance (in months)	Reported/revised estimated completion date	Reported IRS/taxpayer benefits
Security and Technology Infrastructure Release 1.	+$7,553	$41,287	+5	1/31/02 (initial operation).	Provides infrastructure for secure telephony and electronic interaction among IRS employees, tax practitioners, and taxpayers..
Customer Communications 2001.	+5,310	46,420	+9	2/26/02 (full deployment).	Improves telecommunications infrastructure, including telephone call management, call routing, and customer self-service applications..
Customer Relationship Management Exam.	−1,938	7,375	+3	9/30/02 (full deployment).	Provides commercial-off-the-shelf software to IRS revenue agents to allow them to accurately compute complex corporate transactions..
Human Resources ConnectRelease 1.	+200	10,200	0	12/31/02 (initial operation).	Allows IRS employees to access and manage their human resources information online..
Internet Refund/Fact of Filing.	+12,923	26,432	+14	9/26/03 (full deployment).	Provides instant refund status information and instructions for resolving refund problems to taxpayers with Internet access..
Ongoing Projects[a]					
Modernizede-File Release 1.	+17,057	46,303	+4.5	3/31/04[b] (initial operation).	Provides a single standard for filing electronic tax returns..

Table 4: IRS BSM project life cycle cost/schedule variance and benefits summary for completed and on-going projects—Continued

Project	Cost variance (in thousands)	Reported/revised estimated cost (in thousands)	Schedule variance (in months)	Reported/revised estimated completion date	Reported IRS/taxpayer benefits
e-Services	+86,236	130,281	+18	4/30/05 (full deployment).	Provides a Web portal and other e-Services to promote the goal of conducting most IRS transactions with taxpayers and tax practitioners electronically..
Customer Account Data Engine—Individual Master File Release 1.	+36,760	97,905	+30[c]	6/30/05[c] (full deployment).	Provides the modernized database foundation to eventually replace the existing individual master file processing systems. Facilitates faster refund processing and more timely response to taxpayer inquiries for Form 1040EZ filers..
Integrated Financial System Release 1.	+53,916	153,786	TBD[c]	TBD[c] (full deployment).	Provides a single general ledger for custodial and financial data and a platform to integrate core financial data with budget, performance, and cost accounting data..
Custodial Accounting Project Release 1.	+72,058	119,219	TBD[c]	TBD[c] (full deployment).	Provides integrated tax operations and internal management information to support evolving decision analytics, performance measurement, and management information needs..

Source: GAO analysis of data contained in IRS's BSM expenditure plans. [a] Projects ongoing as of 9/30/03. [b] IRS subsequently reported that Modernized e-File began initial operation on 2/23/04. [c] Project schedules for the Customer Account Data Engine, the Integrated Financial System, and the Custodial Accounting Project are currently under review.

As the table indicates, the cost and schedule estimates for full deployment of the e-Services project have increased by just over $86 million and 18 months, respectively, which included a significant expansion from the initial project scope. In addition, the estimated cost for the full deployment of Customer Account Data Engine (CADE) Release 1 has increased by almost $37 million, and project completion has been delayed by 30 months. In addition to the modernization management control shortcomings discussed above, our work has shown that the increases and delays were caused, in part, by

- inadequate definitions of systems requirements. As a result, additional requirements have been incorporated into ongoing projects.
- increases in project scope. For example, the e-Services project has changed significantly since the original design. The scope was broadened by IRS to provide additional benefits to internal and external customers.
- underestimating project complexity. This factor has contributed directly to the significant delays in the CADE release 1 schedule.
- competing demands of projects for test facilities. Testing infrastructure capacity is insufficient to accommodate multiple projects when testing schedules overlap.
- project interdependencies. Delays with one project have had a cascading effect and have caused delays in related projects.

These cost overruns and schedule delays impair IRS's ability to make appropriate decisions about investing in new projects, delay delivery of benefits to taxpayers, and postpone resolution of material weaknesses affecting other program areas.

Producing reliable estimates of expected costs and schedules is essential to determining a project's cost-effectiveness. In addition, it is critical for budgeting, management, and oversight. Without this information, the likelihood of poor investment decisions is increased.

Schedule slippages delay the provision of modernized systems' direct benefits to the public. For example, as table 4 shows, slippages in CADE will delay IRS's ability to provide faster refunds and respond to taxpayer inquiries on a timely basis.

Delays in the delivery of modernized systems also affect the remediation of material internal management weaknesses. For example, the Custodial Accounting Project is intended to address a material weakness in IRS's financial reporting process and provide a mechanism for tracking and summarizing individual taxpayer transactions. This release has yet to be implemented, and a revised schedule has not yet been determined. In addition, the Integrated Financial System is intended to address financial management reporting weaknesses. When IRS submitted its fiscal year 2003 BSM expenditure plan, Release 1 of the Integrated Financial System was scheduled for delivery on October 1, 2003. However, it has yet to be implemented, and additional cost increases are expected.

IRS Is Acting to Resolve Issues Identified in Recent BSM Assessments

Given the continued cost overruns and schedule delays experienced by these BSM projects, IRS and the prime systems integration support (PRIME) contractor, Computer Sciences Corporation (CSC), initiated and recently completed several in-depth and more comprehensive assessments of BSM. These assessments revealed several significant weaknesses that have driven project cost overruns and schedule delays and also provided a number of recommendations for IRS and CSC to address the identified weaknesses and reduce the risk to BSM. The deficiencies identified are consistent with our prior findings. IRS developed a BSM action plan to address the findings and recommendations resulting from these assessments. IRS expects to complete implementation of its actions by the end of the calendar year. Because of the significant risks associated with the findings of these various assessments, continued monitoring by IRS and validation of the effectiveness of corrective actions is critical to reducing the likelihood of additional cost overruns and schedule delays.

It will be important for IRS to continue its efforts to balance the scope and pace of the program with the agency's capacity to handle the workload, and to institutionalize the management processes and controls necessary to resolve the deficiencies identified by our reviews and the recent program assessments. Meeting these challenges and improving performance are essential if IRS and the PRIME contractor are to successfully deliver the BSM program.

Continued Efforts Needed to Strengthen Information Systems Budget Request Development Process

The Paperwork Reduction Act (PRA)[14] requires federal agencies to be accountable for their IT investments and responsible for maximizing the value and managing the risks of their major information systems initiatives. The Clinger-Cohen Act of 1996[15] establishes a more definitive framework for implementing the PRA's requirements for IT investment management. It requires federal agencies to focus more on the results they have achieved and introduces more rigor and structure into how agencies are to select and manage IT projects.

Leading private—and public-sector organizations have taken a project—or system-centric approach to managing not only new investments but also operations and maintenance of existing systems. As such, these organizations

[14] 44 U.S.C. § 3506(h).
[15] P.L. 104–106.

- identify operations and maintenance projects and systems for inclusion in budget requests;
- assess these projects or systems on the basis of expected costs, benefits and risks to the organization;
- analyze these projects as a portfolio of competing funding options; and
- use this information to develop and support budget requests.

This focus on projects, their outcomes, and risks as the basic elements of analysis and decision-making is incorporated in the IT investment management approach that is recommended by OMB and GAO.[16] By using these proven investment management approaches for budget formulation, agencies have a systematic method, on the basis of risk and return on investment, to justify what are typically very substantial information systems operations and maintenance budget requests.

In our assessment of IRS's fiscal year 2003 budget request, we reported that the agency did not develop its information systems operations and maintenance request in accordance with the investment management approach used by leading organizations. We recommended that IRS prepare its future budget requests in accordance with these best practices.[17] To address our recommendation, IRS agreed to take the following actions:

- develop an activity-based cost model to plan, project, and report costs for business tasks/activities funded by the information systems budget;
- develop a capital planning guide to implement processes for capital planning and investment control, budget formulation and execution, business case development, and project prioritization; and
- implement a process for managing all information systems investments as a portfolio, patterned after the BSM program.

IRS has made progress in implementing investment management best practices in developing and supporting its information systems budget request. IRS officials reported that the agency is managing all information systems funding requirements as a portfolio within Treasury's IT investment portfolio system, and preparing business cases for many of its operational program activities, as required by OMB. According to IRS, these business cases are updated on a periodic basis and are evaluated within the context of the agency's overall IT funding portfolio. IRS plans to align this portfolio management process with the capital planning and investment control system now being implemented to provide a uniform process to select, manage, and control all IT investments, including modernization, enhancements, and sustaining operations.

Although progress has been made, IRS has not yet completed all of its planned actions to implement our prior recommendation. Completion of IRS's capital planning and investment control guide has been delayed due to changing roles and responsibilities within the Modernization and Information Technology Services organization, and thus was not used in preparing the fiscal year 2005 information systems budget request. According to IRS, the capital planning guidance will not be completed until September 2004. In addition, as of March 2004, IRS has not yet developed an activity-based cost accounting system to enable it to account for the full cost of operations and maintenance projects and determine how effectively IRS projects are achieving program goals and mission needs. This cost model, which is being developed in conjunction with the Integrated Financial System modernization project, has been delayed, and due to Integrated Financial System schedule delays, will not be available until the fiscal year 2008 budget formulation cycle. Until IRS implements the capital planning and investment control guidance and the activity-based cost model and incorporates them into the preparation of its information systems budget request, the agency will not be able to ensure that the information systems operations and maintenance request is adequately supported.

Interim Results Of IRS's 2004 Filing Season Show Improvement Except In Telephone Accuracy

IRS's filing season performance through mid-March has improved in most areas compared to recent years, based on data we reviewed on five key filing season activities—paper and electronic processing, telephone assistance, IRS's Web site, and

[16] See, for example, U.S. General Accounting Office, Information Technology Investment Management: A Framework for Assessing and Improving Process Maturity, GAO–04–394G (Washington, D.C.: March 2004, Version 1.1).

[17] U.S. General Accounting Office, Internal Revenue Service: Assessment of Budget Request for Fiscal Year 2003 and Interim Results of 2002 Tax Filing Season, GAO–02–580T (Washington, D.C.: Apr. 9, 2002) and Internal Revenue Service: Improving Adequacy of Information Systems Budget Justification, GAO–02–704 (Washington, D.C.: June 28, 2002).

walk-in assistance. However, the accuracy of tax law answers provided by IRS telephone staff declined. Although we cannot quantify the connection between these improvements and IRS's actions, they appear to represent a payoff from IRS's modernization and an increased emphasis on service since the IRS Restructuring and Reform Act of 1998.[18]

Table 5 summarizes IRS's filing season performance so far this year compared to recent years. The following sections will address IRS's specific performance in key areas.

Table 5: IRS performance in the first weeks of the 2002 through 2004 filing seasons

Volume in thousands	2002	2003	2004
Actual returns processed[a]			
Paper	24,491	22,117	20,232
Electronic	35,067	38,627	42,988
Telephone assistance			
Total calls[b]	34,489	27,905	29,058
Answered by assistors	9,208	9,434	10,116
Answered by automation	25,281	18,471	18,942
Customer service representative level of service	62%	82%	84%
Accounts customer accuracy rate estimates[c]	88% +/− 1%	88% +/− 1%	89% +/− 1%
Tax law customer accuracy rate estimates[c]	84% +/− 1%	81% +/− 1%	76% +/− 1%
Internet assistance			
Forms and publications downloaded[d]	158,000	195,000	205,000
Refund status inquiries[e]	N/A	9,300	14,300
Child Tax Credit inquiries[f]	N/A	N/A	8,500
Walk-in assistance			
Total Walk-in Contacts[g]	N/A	2,740	2,433
Returns prepared at IRS walk-in sites[h]	436	291	186
Returns prepared at volunteer sites[j]	466	594	737

Source: IRS Data.

[a] From January 1 to March 22, 2002, January 1 to March 21, 2003, and January 1 to March 19, 2004.

[b] Total calls, calls answered by assistors and automation, and CSR level of service are based on actual counts from January 1 to March 16, 2002, January 1 to March 15, 2003, and January 1 to March 13, 2004. 2002 totals include increased call demand as a result of the Economic Growth and Tax Relief and Reconciliation Act of 2001 (P.L.107–16). Employer Identification Number data has been added to 2002 and 2003 to ensure valid data comparisons can be made to 2004 which includes Employer Identification Numbers.

[c] Based on a representative sample estimated at the 90 percent confidence level from January to February 2002, 2003 and 2004.

[d] From January 1 to February 28, 2002, January 1 to February 28, 2003, and January 1 to February 29, 2004.

[e] From January 1 to March 20, 2003, and January 1 to March 20, 2004.

[f] From January 1 to March 21, 2004.

[g] From January 1 to March 15, 2003, and January 1 to March 13, 2004.

[h] From January 1 to March 16, 2002, January 1 to March 15, 2003, and January 1 to March 13, 2004.

[i] From January 1 to March 9, 2002, January 1 to March 8, 2003, and January 1 to March 6, 2004.

IRS's Processing Operations Have Gone Smoothly, and Electronic Filing Continues to Grow, But Not at Rate to Meet 2007 Goal

According to IRS officials, tax industry representatives and data reviewed, the 2004 filing season is progressing smoothly (meaning without disruptions in IRS computer systems used in processing that would have a negative impact on tax-

[18] P.L. 105–206.

payers) and IRS is either meeting or exceeding its goals for the number of days to process an individual income tax returns, depending on the type of return. As table 5 shows, through March 19, 2004, IRS has processed about 63 million individual tax returns—of which 43 million were received electronically, which is about 4.4 million more electronically filed returns than this time last year. IRS officials have attributed this year's performance, in part, to having planned appropriately for issues such as correcting errors related to the advanced child tax credit. Through March 12, 2004, IRS had identified about 2.7 million individual tax returns with errors, with approximately 1.6 million related to the advanced child tax credit.[19]

Electronic filing has grown from the same time last year. It has also grown by about 250 percent overall—from about 15 million returns in 1996 to about 53 million in 2003. Although electronic filing continues to grow, IRS is not on track to reach the long-term electronic filing goal of 80 percent by 2007 set by Congress in the IRS Restructuring and Reform Act of 1998.[20] IRS officials recognizes that they will not achieve the goal of having 80 percent of all individual income tax returns filed electronically by 2007. However, IRS officials told us they will continue to strive to achieve that goal in the future. Moreover, as we reported last year,[21] the growth rate from 1996 through 2003 has been generally decreasing, with the 13 percent growth rate in 2003 representing the smallest percentage increase in the number of individual tax returns filed electronically since 1996.[22] Although the current growth rate is about 11 percent, according to IRS officials, the number of electronic filings is ahead of their estimates at this time. Consequently, IRS officials believe IRS will meet and might exceed the annual growth rate goal of 12 percent by the year's end.

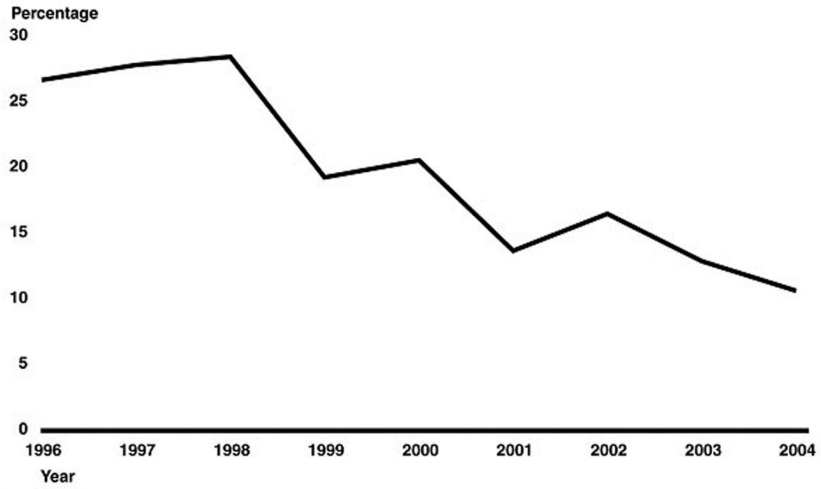
[19] In 2003, the IRS, through Financial Management Service, issued advanced child tax credit payments to more than 25 million taxpayers in a manner similar to the 86 million advance refund checks issued in 2001. See U.S. General Accounting Office, Tax Administration: IRS Issued Advance Child Tax Credit Payments on Time, but Should Study Lessons Learned, GAO–04–372 (Washington, D.C.: Feb. 17, 2004).

[20] P.L. 105–206.

[21] U.S. General Accounting Office, Internal Revenue Service: Assessment of Fiscal Year 2004 Budget Request and 2003 Filing Season Performance to Date, GAO–03–641T (Washington, D.C.: Apr. 8, 2003).

[22] Some slowing of the growth rate might be expected because, for example, taxpayers most easily attracted to electronic filing have already been converted.

Figure 3: Growth rate in the number of individual income tax returns filed electronically 1996—2004



Source: GAO.

Note: For 2004, the growth rate compares to the number of returns filed electronically as of March 12, 2004 to the same period in 2003.

Growth in electronic filing remains a key part of IRS's modernization strategy. Electronic filing has allowed IRS to reduce resources devoted to processing (discussed in appendix I) and begin consolidating paper processing centers. It also reduces errors because IRS would not have to transcribe tax returns information and some up-front checks are built into electronic filing. Finally, taxpayers get refunds quicker with electronic filing—IRS's goal for refunds for electronically filed returns is about half the 40 days that IRS allows for refunds for returns filed on paper.

IRS has implemented numerous initiatives over the years intended to increase electronic filing usage. IRS's new major electronic filing initiatives this year are related to business not individual income tax returns. They are modernized E–File, which allows the electronic filing of corporate income tax form 1120 and E–Services, which is a suite of Internet services offered to tax practitioners such as electronic account resolution and transcript delivery. IRS officials do not expect these initiatives to dramatically increase electronic filing of individual tax returns this year, because taxpayers and practitioners will need to adjust their behavior and take advantage of the new services. However, these initiatives are important, because they should increase the willingness of tax practitioners to file both corporate and individual tax returns electronically in future filing seasons, which can currently be done only on a limited basis for corporate returns.

IRS made some changes to improve the Free File Alliance[23] program, which began last year to promote electronic filing of individual income tax returns. As of March 7, 2004, IRS had received almost 2.5 million free file tax returns compared to 2.0 million for the same time last year—an increase of 24 percent. One issue with the Free File program is that IRS cannot determine how many of the Free File users are new electronic filers. We plan to follow up on this issue as part of our annual filing season report.

[23] In 2003 IRS entered into a 3-year-agreement with the Free File Alliance, a consortium of tax preparation companies, to provide free electronic filing to taxpayers that access any of the companies via a link from the IRS Web site. IRS is in the second year of its initiative with the Free File Alliance, and there are currently 17 companies that are offering free filing via IRS's Web site.

Telephone Access Improved Over Last Two Years, While Tax Law Accuracy Declined

Access to IRS's toll-free telephone lines has improved over the last two years, although account accuracy (the accuracy of answers to questions from taxpayers about the status of their accounts) has stabilized and tax law accuracy declined. As table 5 shows, as of March 13, 2004, IRS had received 29 million telephone calls. The percentage of taxpayers that attempted to reach an assistor and actually got through and received service—referred to as the Customer Service Representative (CSR) level of service—increased to 84 percent, which is 2 percentage points over the same period last year and 22 percentage points over the same period in 2002. According to IRS officials, the gains in CSR level of service are largely due to continued improvements resulting from increased specialization, improved technology, and continued focus on maintaining telephone staffing.

IRS estimates that accounts accuracy is essentially the same this year as for the last two years at this time. As shown in table 5, taxpayers who called about their accounts received correct information an estimated 89 percent of the time in 2004. IRS officials said that accounts accuracy rates remained stable, because the accounts workload has remained relatively stable.

At the same time, table 5 shows that IRS estimates that tax law accuracy declined from 84 percent in 2002 and 81 percent last year to 76 percent so this year. IRS officials said that tax law accuracy rates declined because formatting changes made in 2003 to the guide CSRs use to help them answer questions have not enhanced the usability as IRS anticipated. According to IRS, although training was provided to the staff for the changes to their assigned subjects, IRS underestimated the impact these changes would have on overall quality. Also, IRS officials said they have begun redesigning the CSRs' guide and are continuing to conduct detailed analysis of quality data to identify immediate opportunities to improve the accuracy of service.

Web Site Usage is Increasing, But Concerns About Usability Still Exist

IRS's Web site use has increased over the last 2 years as shown in table 6. Also, an independent Web site rater reported that, for 7 of out 10 weeks of the filing season, IRS's Web Site has ranked in the top 10 out of 40 in a government Web site index for time it took to download information.

Over the last 2 years, IRS has added two features to assist taxpayers, which likely contributed to the increased usage of IRS Web site. In fiscal year 2003, IRS added the "Where's My Refund?" and in 2004 added "Remember Your Advanced Child Tax Credit" features. The "Where's My Refund?" feature enables taxpayers to access IRS's Web site to determine if IRS received their tax return, whether their refund was processed, and if processed, when approximately to expect the refund. Table 5 shows that as of March 20, 2004, the use of this feature was up by 53 percent from last year, from about 9.3 million attempts to about 14.3 million. The "Remember Your Advanced Child Tax Credit" enables a person to access IRS's Web site to determine the amount of the advanced child tax credit they received. As of March 21, 2004, about 8.5 million accesses have been made to the "Remember Your Child Tax Credit" feature.

Overall we found that IRS's Web site continues to improve when it comes to providing services to taxpayers. However, we continue to have concerns about the forms and publication search function. We found that the forms and publication search function still does not always make the most pertinent information readily available. For example, when we typed, "earned income tax credit" into the forms and publication search function, Publication 596—the primary publication on the earned income tax credit—was the 79th item on the list and we had to scroll through eight pages to find it.

Use of IRS's Walk-in Assistance Sites Continues to Decline

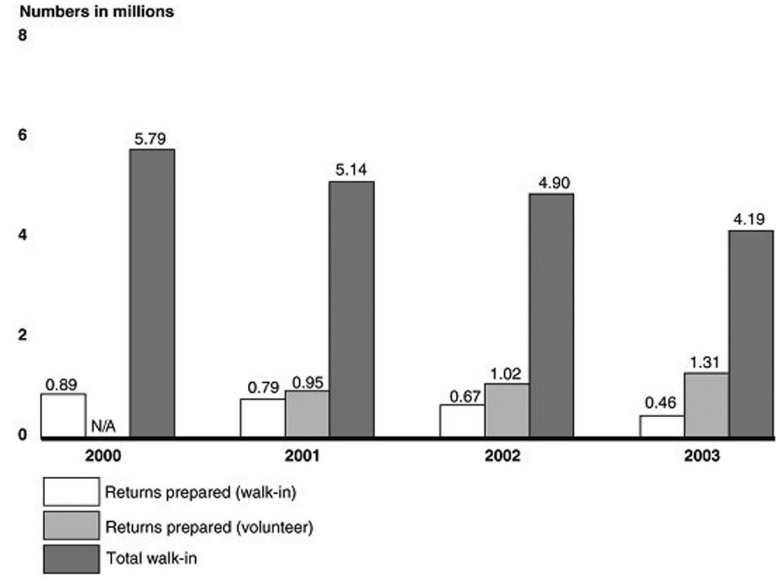
The number of taxpayers receiving assistance at IRS walk-in sites continued to decline. At any one of IRS's over 400 walk-in sites, taxpayers get various types of assistance, including answers to tax law questions, assistance with their accounts, and return preparation assistance (generally for low income taxpayers).

The number of people who received assistance at an IRS walk-in site declined by 11 percent compared to the same period last year. IRS continues to restrict free tax preparation services to, for example, taxpayers with an annual gross income level of $35,000 or less, because of the labor intensive nature of that work and to enable staff to concentrate on other services that only IRS can provide such as account assistance. IRS reduced the number of staff available for return preparation by 20 percent from 2003. As the data in table 5 indicate, the number of returns being pre-

pared has decreased by about 36 percent over this time last year. These trends are consistent with ones we have previously reported for recent filing seasons.[24]

Figure 4 shows a downward trend in the overall assistance provided and in the return preparation at the walk-in sites.

Figure 4: Assistance provided by IRS walk-in and volunteer sites, 2000–2003 filing seasons



Source: IRS.

Notes: Total walk-in figures shows all IRS face-to-face assistance, including return preparation, account services, and tax law assistance. It does not include the number of taxpayers assisted by walk-in employees via telephone or correspondence, which ranged from about 96,000 in 2000 to over 150,000 in 2003. Total figures do not include returns prepared at volunteer sites. The number of returns prepared at volunteer sites was not available for the 2000 filing season. The time periods covered by this figure each began on January 1 and ended on April 22, 2000; April 21, 2001; April 20, 2002; and April 19, 2003.

Sites staffed by volunteers certified by IRS do not provide the range of services IRS provides, such as account assistance, and operate primarily during the filing season. IRS is promoting these as alternatives to its walk-in assistance sites for certain types of service. IRS works to ensure that walk-in sites have a listing of services, hours, and locations of the volunteer sites in their area. As of March 2004, there are approximate 11,600 volunteer sites. IRS also promotes its telephone operations and Web site at its walk-in sites as well.

The quality of tax law assistance[25] provided at IRS's walk-in sites in 2004 was comparable to the same period last year. This conclusion is based on TIGTA reviews[26] through February 2004.

Concluding Observations

Congress has been supportive of IRS's efforts to improve service to taxpayers and increase enforcement staff and IRS has succeeded at the former. However, despite

[24] GAO–04–84.

[25] IRS determines the quality of account assistance after the filing season. Only tax law assistance is evaluated during the filing season.

[26] TIGTA determines tax law accuracy by measuring the percentage of correct answers to questions asked during anonymous visits to a sample of walk-in sites. Questions were designed by TIGTA to cover a range of tax law topics and assess whether taxpayers were receiving correct answers to questions that a taxpayer might ask when visiting a walk-in site. The TIGTA are statistically valid only for the times and the locations within which respondents were surveyed.

budgets that were almost fully funded and realizing savings through efficiency gains, IRS has not been able to increase enforcement staff. In fact, staffing of key enforcement occupations has declined. The declines in IRS's enforcement staff and the related declines in its enforcement efforts raise concerns that taxpayers' incentives to voluntarily comply with their tax obligations could be eroding.

Strengthening enforcement programs by increasing staffing while providing a high level of taxpayer service will continue to be a challenge for IRS. Unbudgeted costs are expected to compete for the funds IRS has allocated in its 2005 budget request for new spending including the enforcement initiatives. If, as has been the case in recent years, IRS fails to realize all expected savings then the funds available for new spending would be further reduced.

One option for increasing enforcement staff in the near-term is to reconsider the level and types of service IRS provides to taxpayers. Taxpayer services are much improved raising a question about the appropriate balance to strike between investing in further service improvements and enforcement. At the same time, the use of IRS's walk-in assistance sites is declining. The improvements in telephone service, increased Web site use, and the availability of volunteer sites raise a question about whether IRS should continue to operate as many walk-in sites. Reconsidering the level and types of service is an option—but not a recommendation—to be considered by IRS management and the Congress.

The challenge of increasing IRS's enforcement staff highlights the importance of succeeding with NRP and BSM. NRP should, if completed successfully, provide the first new data to estimate the voluntary compliance rate since IRS last estimated the compliance rate using 1988 data. The new estimates could have implications for future IRS budgets. If compliance rates are comparable to those estimated using 1988 data, the pressure to increase IRS' s enforcement staff would likely diminish. If, however, compliance rates are down, the pressure to increase enforcement staff and the pressure on IRS's budget could increase.

BSM and related initiatives such as electronic filing hold the long-term promise of efficiency gains that could allow IRS to improve both taxpayer service and enforcement without budget increases. However, cost overruns and schedule delays associated with on-going BSM projects, along with planned reductions in the BSM project portfolio mean, that many of these benefits will not be realized in the short term. As we have recommended, various management controls and capabilities need to be fully implemented and institutionalized. Otherwise the projects will likely encounter additional cost and schedule shortfalls.

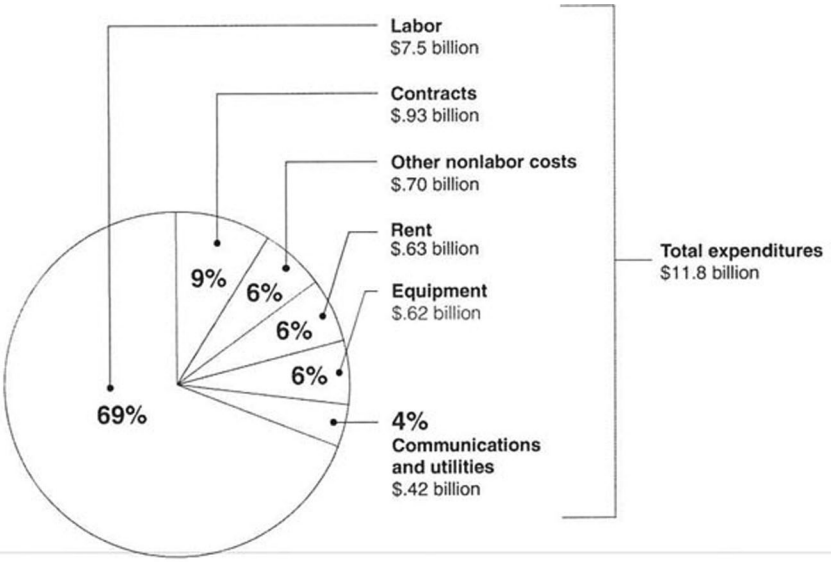
Appendix I: How IRS Aoolcated Expenditures and Staff Resources in Fiscal Year 2003

In our review of IRS's 2004 budget request, we provided figures showing IRS's expenditures and staff allocations in fiscal year 2002.[27] Figures 5 and 6 illustrate how the Internal Revenue Service (IRS) allocated expenditures and staff in fiscal year 2003.

Figure 5 shows that total expenditures increased from $10.4 billion in 2002 to $11.8 billion in 2003. While the division of expenditures across categories has generally remained the same as 2002 allocations, equipment increased from 4 to 6 percent of total expenditures from 2002 to 2003.

[27] GAO–03–641T.

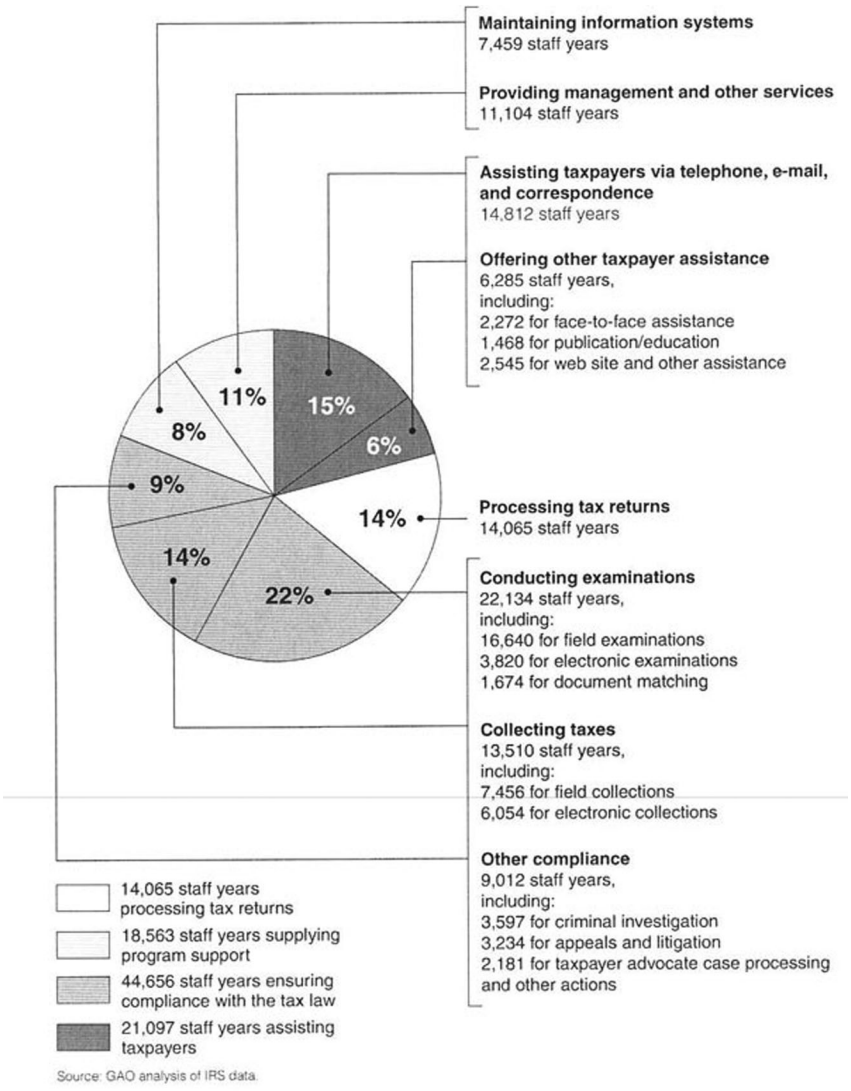
Figure 5: IRS's expenditures in fiscal year 2003



Source: GAO analysis of IRS data.

Figure 6 shows IRS's total staff resources have decreased slightly from 99,180 in 2002 to 98,381 in 2003. IRS's allocation of staffing resources remained largely similar, but with a 1 percentage point decrease in the percent of staff years processing tax returns. The boundaries between the categories presented in these figures may not be well defined. For example, staff categorized under providing management and other services could also be considered under taxpayer service, processing, or compliance. Therefore, the figures are meant to provide a summary of how IRS uses its resources and should be interpreted with caution. However, the 1 percentage point decrease in staff years devoted to processing tax returns is important because it represents a cumulative payoff from electronic filing and shows the potential for shifting IRS resources from one area to another.

Figure 6: How IRS spent its 98,381 staff years in fiscal year 2003



Chairman HOUGHTON. Thank you very much. We're just going to have to stop now. Miss Killefer, I'm sorry about this. We will just suspend the hearing until we come back from the votes. We'll be back as fast as we can. Thank you very much.

[Recess.]

Could we re-commence the hearing, please? Ms. Killefer, thanks very much.

STATEMENT OF NANCY KILLEFER, CHAIR, INTERNAL REVENUE SERVICE OVERSIGHT BOARD

Ms. KILLEFER. Mr. Chairman, thank you for inviting us here to testify. The Board believes that the IRS Budget is more than dollars or cents. It is really about the choices we as a nation make about the future of our tax administration system, and how we help over 100 million American taxpayers deal with, unfortunately, an increasingly complex Tax Code and ensure that every American citizen pays his or her fair share of their taxes. We strongly believe that this is a critical time in our tax system's history, and it is a time to strengthen it, not merely to maintain it. As we all know, billions of dollars in uncollected taxes are left on the table because the IRS simply does not have the resources to do the job, and with each passing year, as the Board has done in its own research with the Roper Survey, we know that more Americans believe that it is more acceptable to cheat. This is particularly true of young Americans, and that is a very disturbing trend.

In crafting our budget to present to Congress, the Board addressed the concerns head on by reinvesting in the IRS to produce tangible increases in enforcement while maintaining the high level of customer service that we have achieved through the implementation of RRA 98. The Board is calling for a 10 percent increase in funding which should result in an increase of over 3,000 enforcement personnel, which would allow the IRS to improve its enforcement while maintaining customer service, and we also call for an increase in the budget for modernization versus the administration.

While we applaud the Administration, and particularly Secretary Snow, for requesting a funding increase for the IRS, we feel there is a fatal flaw in the budget and it comes because left uncorrected are the lack of funding for what we believe will be pay parity between the civilian and military budgets, an issue that you are grappling with here on the Hill, as well as unfunded costs in areas such as rent, postage, that have gone on for the 3 years preceding this. What this problem ends up with is the IRS has never been able to hire the FTEs that it projects. Each year for the past 4 years, and perhaps before, those increases have been eaten up by pay parity that was unfunded in the President's budget, as well as other unfunded liabilities. In an organization like the IRS that it 80 percent people, there is no choice but to hold back on hiring.

Our concern with the Administration's budget is that if you believe that pay parity will happen yet again, and that many of the increases that we know will already be there from GSA in terms of rent increases, and so forth, you will not be able to hire any of the additional people that the Administration recommends. We feel, as private sector members of the Board, that we cannot let this trend go on. It simply will lead to once again with increasing tax load from both more taxpayers filing as well as more schemes out there, that their enforcement will become hollow, and we think that is a terribly disturbing trend.

What we are recommending therefore is a 10-percent increase which would assume the funding of, if you will, a parity pay increase as well as full funding of rent increases that are already on the table from GSA, and other increases we anticipate, and then allow for the hiring of over 3,000 additional enforcement personnel,

which we feel are badly needed, and which I think in fact the Commissioner and GAO absolutely support. One last point I would like to make from the Board's perspective is RRA 98 gave us, in fact demanded, that we submit a budget to you directly that represented our best judgment about the requirements of the IRS to fulfill its strategic mission.

From our collective expertise and familiarity with the private sector and best practices on the IRS' problems, we believe that these investments in enforcement pay for themselves many times over, not only in the revenue dollars that are directly collected through these enforcement activities, but by also reinforcing our voluntary tax system through the belief that every person is paying his or her fair share, and that is the fundamental strength of our tax system. Thank you.

[The prepared statement of Ms. Killefer follows:]

Statement of Nancy Killefer, Chair, IRS Oversight Board

Introduction

Mr. Chairman, thank you for the opportunity to testify before the House Ways and Means Subcommittee on Oversight. The Internal Revenue Service (IRS) Oversight Board is required by 26 U.S.C. Section 7802(d) to review and approve the budget request prepared by the IRS, submit a request to Treasury, and ensure that the approved budget supports the annual and long-range strategic plans of the IRS.

This year, the IRS drafted a special report presenting its recommended FY2005 IRS budget, comparing it to the Administration's request, and explaining why the Board believes its recommended budget is needed to support the annual and long-term needs of the IRS. My testimony today will discuss that report. The complete version is available on the Board's web site at www.irsoversightboard.treas.gov.

The IRS Oversight Board Budget Recommendation

Mr. Chairman, the IRS budget is more than dollars and cents. It represents the choices that we as a nation make about the future of our tax administration system and how we help over 100 million American taxpayers deal with an increasingly complex tax code while ensuring that everyone pays his or her fair share of taxes.

The IRS Oversight Board acknowledges that the IRS's budget has increased in each year of President Bush's Administration, and that the Administration's request for FY2005 is significant against other non-defense, non-homeland security discretionary funding. That commitment is commendable, and the Board recognizes and thanks Secretary Snow for his efforts, especially at a time when the nation must balance many important and competing priorities.

However, the Board believes that now is a critical time for our tax system to be strengthened, not merely maintained at current levels. Enforcement activities are still at unacceptable levels. Our nation's tax gap is estimated at $311 billion,[1] leaving billions of dollars on the table simply because the IRS does not have the resources to do its job.[2]

The Board's own research shows that each year, more Americans believe it is acceptable to cheat on their taxes. At the same time, our already complex tax code continues to be a changing, tangled mystery to most honest taxpayers—and an asset to those intent on skirting the law. Every effort must be made to provide quality service to honest taxpayers who want to comply with the law.

In crafting its FY2005 budget for the IRS, the Board addressed these concerns head on by reinvesting in the IRS to produce tangible benefits and results for America's taxpayers and our nation. It is a sensible and pragmatic budget that reflects the real world in which the IRS must operate and be funded.

The Board recommends a 10 percent increase in funding from FY2004 to $11.204 billion, with a significant increase of 3,315 full-time equivalents (FTEs) to boost enforcement efforts. If enacted, the Board's budget would increase our nation's revenue

[1] Nina Olson, National Taxpayer Advocate's 2003 Annual Report to Congress, (Washington, DC: December 31, 2003) p. 20–21. This is based on a July 2001 IRS Office of Research report.

[2] Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System (Washington, DC: September 2002), p. 16.

by approximately $5 billion each year once the IRS has hired and trained additional enforcement personnel.[3]

Under the Board's budget, the IRS would have the additional resources to:

- Close over an additional 1,000 cases involving high risk/high-income taxpayers and promoters who avoid paying income taxes by using offshore credit cards and abusive trusts and shelters.
- Boost audit rates by 42 percent from FY2004 to examine companies that use aggressive tax avoidance tactics, such as offshore transactions and flow-through entities.
- Contact an additional 200,000 taxpayers who fail to file or pay taxes due; a 40 percent boost from FY2004 and a 27 percent increase from the Administration's request. This alone will allow the IRS to collect $84 million more in revenue owed than the Administration's request would allow.
- Sustain the one-on-one assistance that millions of Americans rely on at tax time. The Board's budget will ensure that the IRS will be able to maintain its improved service to taxpayers by answering eight out of ten phone calls.

IRS Must Stay the Course on Customer Service

Mr. Chairman, the vast majority of Americans want to file their returns and pay their fair share, yet our nation's tax code continues to become more complex. Resources must be available so the IRS can answer taxpayers' questions and promptly and accurately, whether it is over the phone, through the IRS web site, by mail, or at walk-in center.

Under the board's proposed budget, customer service funding will remain at about the same level as FY2004; however, service should improve due to the deployment of self-service technology.

For taxpayers, that means eight out of ten phone calls will be answered. For tax practitioners calling the IRS toll-free hotline to resolve problems regarding clients' accounts, hold-time will remain at current levels.

The IRS call-routing systems as well as web-site applications that allow taxpayers to check the status of their tax refunds have already shown dramatic benefits in speeding service to taxpayers. New systems, such as e-Services, will soon be available, providing additional automated services to tax practitioners.

Clearly, service to taxpayers has improved in the past five years. Such improvements make it all the more imperative that we sustain them and not allow this positive trend to languish, or worse, decline. The agency must stay the course.

Days of "Outmanned and Outgunned" IRS Must End

The IRS is doing a better job of identifying egregious noncompliance—now it needs the resources to fight back. In the past two years, the IRS sharpened its compliance focus to identify and pursue promoters and participants of abusive tax shelters and tax evasion schemes. For example, the agency is now targeting its resources on promoters of illegal tax schemes that are often marketed to high-income individuals, but are also finding their way to middle-market businesses.

Despite this focus, enforcement activities are still at an unacceptable level simply because the IRS does not have the resources needed to accomplish its mission. It continues to be outmanned and outgunned. In FY2003, the agency was able to pursue only 18 percent of known cases of abusive devices designed to hide income, leaving an estimated $447 million uncollected.[4]

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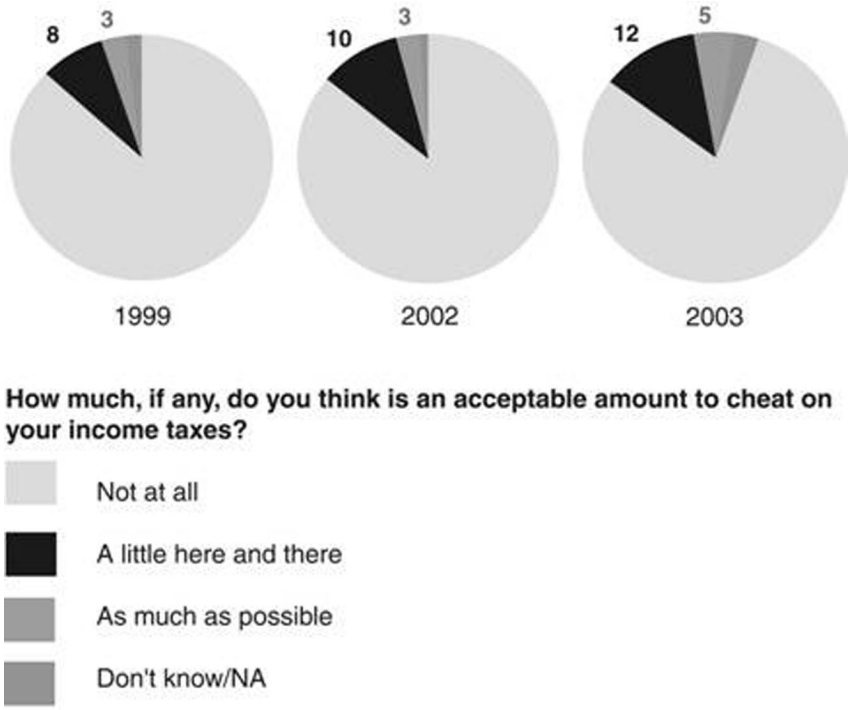
[3] These estimates are based upon the projected revenue anticipated by hiring and training full-time employees who would audit or collect owed taxes in known cases of taxpayers who did not file or pay, or who substantially underreported their taxes, as described in former IRS Commissioner Charles O. Rossotti's Report to the IRS Oversight Board: Assessment of the IRS and the Tax System, p. 16.

[4] Rossotti, p. 16.

Tax Cheating: Alarming Trends



Public attitudes towards tax cheating show some alarming trends, particularly among young Americans. The Board's 2003 Survey on Taxpayer Attitudes found that support for total tax compliance diminished by four points over the previous year to 81 percent. In other words, nearly one out of five Americans now believe that it is acceptable to cheat at least a little on their taxes. Almost one-third (30%) of young adults age 18–24 age are among those most likely to feel that any amount of cheating is acceptable, an increase of six points since last year. Yet ironically, "fear of being audited" has the greatest impact on these non-compliers at a time when actually being audited is near historic lows.[5]

The IRS must prove to the public that it can and will identify and pursue those who show contempt for the tax code. The Board's proposed budget allows the IRS to begin to reverse this disturbing trend.

The Board's recommendation would increase our nation's revenue by almost $5 billion each year once the IRS has hired and trained additional enforcement personnel. The Board believes the additional revenue achieved makes a strong business case for the recommended additional enforcement resources. While this is a modest boost in closing our compliance gap, it will also send a message to those contemplating tax avoidance: the IRS' hands are no longer tied.

Modernization Critical to Tax Administration

In December 2003, the Oversight Board released an independent analysis of the IRS Business Systems Modernization (BSM) program. The Board called for nine specific recommendations for turning around the critical but troubled program that has experienced significant and unacceptable delays and cost overruns.

However, the Board still believes that the overall Modernization plan is sound and well-designed. Moreover, it is critical to the future of tax administration. As a nation, we must remain committed to the IRS' computer modernization program.

[5] Roper ASW, 2003 IRS Oversight Board Annual Survey on Taxpayer Attitudes, September 2003, p.17.

The Board testified before the House Ways & Means Subcommittee on Oversight on Feb 12, 2004:

The IRS Oversight Board firmly believes that the IRS Modernization program cannot be allowed to fail. The IRS cannot continue to operate with the outmoded and inefficient systems and processes it uses today. Over time, the existing systems will become impossible to maintain and at that point, the ability to administer our country's tax system will be in grave danger. Such a risk to our nation is unacceptable. We remain convinced that the overall Modernization plan is sound and well-designed. The challenge is executing that plan. The IRS and the Prime must get it right this time.[6]

The Board's proposed budget provides the stable resources needed to focus and stabilize the steady stream of funding for the IRS' computer modernization initiative. Special controls are in place to ensure that no funding in this account is spent until the IRS has the capability to spend it effectively. If the IRS does not correct the weaknesses in the BSM program by FY2005, the Board advocates that the funds earmarked for modernization should not be spent. However, the Board does not believe the IRS should plan for failure. The agency must be poised to move forward with BSM once it has demonstrated that it has corrected the program's weaknesses. The funding level recommended by the Board sets the foundation for genuine progress for the program in FY2005.

The Board expects that the Customer Account Data Engine (CADE) Release 1 will occur in 2004. Over the next year, the IRS will test and build upon that system. The IRS should continue to strengthen its ability to manage the program and the Prime to deliver projects on budget and on time. By the end of FY2005 and early FY2006, the IRS should be able to proceed with the remaining releases of CADE as quickly as possible. This will minimize future risk and the long-term cost of modernization while providing a basis to deliver tangible results for taxpayers.

If the IRS' FY2005 BSM funding is reduced to $285 million, as it is in the Administration's budget, future funding likely will be adversely affected. If that happens, the projects will drag on, risk will increase, and ultimately, the program will cost taxpayers much more.

For that reason, the Board believes FY2005 BSM funding should be set at $400 million, with only $285 million put into the FY2005 spend plan. This will allow the IRS' Business Systems Modernization fund to operate like a multi-year fund, as originally envisioned by Congress and as the Board has recommended each year since its inception.

Further, as its archaic, tape-based computers begin to give way to modern business systems, the IRS must plan for a smooth transition. The Board's budget recognizes that need. As new systems are incorporated, the IRS must plan to operate both the old and new systems in parallel for some time. The IRS must also retain employees with critical skills while training existing and new employees to use new systems. This will allow the IRS to reduce the risk of a catastrophic disruption to the system.

In addition, the Board believes that the transition to modernization is a real cost that must be incurred. There are no short cuts to successful modernization—the IRS' budget must reflect the real cost of maintaining legacy systems while simultaneously supporting modernized systems. Accordingly, the Board recommends an additional $25 million to cover these costs. The Administration's budget fails to acknowledge them.

The Administration's FY2005 Budget Request

By comparison, the Board believes the Administration's FY2005 budget cannot achieve its stated goal to add almost 2,000 personnel to bolster the IRS' enforcement efforts, and will threaten hard-earned improvements in customer service. This year's request will lead to a $230 million shortfall in the IRS budget because it fails to budget adequately for the anticipated $130 million of congressionally-mandated civilian pay raises, rent increases, and at least $100 million of unfunded expenses.

In its FY2005 budget recommendation, the Board anticipates a 3.5 percent pay raise for civilian employees, which achieves parity with the Administration's call for a 3.5 percent military pay raise. The Administration, but contrast, calls for a 1.5 percent civilian pay raise. While discussions are now underway in Congress regarding parity, the Board believes that the 1.5 percent civilian pay increase fails to recognize recent history.

In fact, FY2005 is the fourth year in a row in which the Administration has called for IRS staff increases, while not covering pay raises or required expenses.

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[6] Larry R. Levitan, IRS Oversight Board Testimony before House Ways and Means Oversight Subcommittee Hearing on IRS BSM Program, February 10, 2004.

As a result, the Administration's proposed increase in the IRS' FY2005 budget will erode before new employees can be hired, more taxpayer phone calls can be answered, or new audits of possible tax cheats can be conducted.

Impact of $230 Million Budget Shortfall on Three Major IRS Functions

Function	Performance Measure	FY2005 performance goal	Revised goal after $230M cut
Field Collection	# of tax delinquent account cases resolved	981,000	463,000
Toll-free Telephone Level of Service	Calls answered	32 million	17 million
Field Exam	Exams of individual taxpayers <$100K AGI	118,840	73,000

Board Cites Complexity as Fundamental Flaw

The IRS Oversight Board is precluded by law from addressing tax policy issues, but it would be remiss not to address the cost of our nation's complex tax system; a cost ultimately borne by taxpayers and the IRS. The Administration's legislative proposals contained in its budget request only begin to address the problems caused by complexity. The approach so far to tax simplification fails to address a fundamental flaw in our tax system: its costly, confusing, and debilitating complexity. The Administration has, however, requested that Congress provide some relief in FY2005 on the Alternative Minimum Tax, but has not yet identified a long-term solution.[7] In her annual report, IRS National Taxpayer Advocate Nina Olson recommended repeal of the AMT, saying:

The AMT is extremely and unnecessarily complex and results in inconsistent and unintended impact on taxpayers. . . . [T]he AMT is bad policy, and its repeal would simplify the Internal Revenue Code, provide more uniform treatment for all taxpayers, and eliminate the oddity of dual tax systems. AMT repeal would also allow the IRS to realign compliance resources to facilitate more efficient overall administration of the tax code.[8]

The Board fully concurs with her assessment, and urges the Administration and Congress to consider accepting this recommendation in future legislation.

Conclusion

The Board was established to bring to bear its collective expertise and familiarity with private sector best practices on the IRS' problems. To the private-life Board members, investments in enforcement pay for themselves many times over, not only in revenue dollars but by the deterrence value of reinforcing the belief that all taxpayers are paying their fair share. A strong business case can be made for providing the IRS with several hundred million dollars so it can collect billions in revenue. At a time when federal revenue as a percentage of the economy has shrunk to 1950s levels and we face a $500 billion deficit, the Board believes it imperative that we strengthen our tax collection system.

For that reason, the Board recommends that both Congress and the Administration reevaluate their methodology by including the revenue value to the country

[8] Recent public remarks by Treasury Secretary Bodman noted that the President's budget extends through 2005 the temporary increase in the AMT exemption and the provision that allows certain personal credits to offset the AMT. These temporary provisions will keep the number of taxpayers affected by the AMT from rising significantly in the near-term. More importantly, they will allow the Treasury Department the time necessary to develop a comprehensive set of proposals to deal with the AMT in the long-term. Treasury Press Release JS–1250 contains the full statement of his remarks.

[8] Olson, p. 16.

when estimating budget requests for the IRS. Indeed, considering the positive impact of additional resources provides a better framework for making informed decisions and will lead to a more effective IRS.

In conclusion, the Board calls for Congress to stay the course it set more than five years ago with the passage of the IRS Restructuring and Reform Act. The IRS has made progress in carrying out the spirit and letter of the Act; we must now give it the resources to finish the job.

IRS Oversight Board FY2005 IRS Budget Recommendation and Administration Request: Program Summary Comparison

Administration FY2005 Budget Request Preogram Summary

(dollars in millions)

Appropriation Title	FY2004 Enacted	FY2005 OB request	Increase	
			$millions	Percent
Processing, Administration and Management	$4,009	$4,148	$139	3.5%
Tax Law Enforcement	$4,171	$4,564	$393	9.4%
Information Systems	$1,582	$1,642	$60	3.8%
Business Systems Modernization	$388	$285	−$103	−26.5%
Health Insurance Tax Credit Administration	$35	$35	$0	0.0%
Appropriation	**$10,185**	**$10,674**	**$490**	**4.8%**

IRS Oversight Board FY2005 Budget Request Program Summary

(dollars in millions)

Appropriation Title	FY2004 Enacted	FY2005 OB request	Increase	
			$millions	Percent
Processing, Administration and Management	$4,009	$4,291	$282	7.0%
Tax Law Enforcement	$4,171	$4,770	$598	14.3%
Information Systems	$1,582	$1,708	$126	8.0%
Business Systems Modernization	$388	$400	$12	3.1%
Health Insurance Tax Credit Administration	$35	$35	$0	0.3%
Appropriation	**$10,185**	**$11,204**	**$1,019**	**10.0%**

Unfunded IRS Costs, FY 2002–2004

(in millions, rounded)

Detail	FY 2002	FY 2003	FY 2004
Labor Inflation			
Unfunded Pay Raise Increase (President's Request to Congressional Action)	$42.3	$128	
	$42.30	**$128**	
Non-Labor Inflation			
Rent Shortfall	$32	$54.0	

Unfunded IRS Costs, FY 2002–2004—Continued

(in millions, rounded)

Detail	FY 2002	FY 2003	FY 2004
Postage	$16	$53.0	
Corporate & Electronic Contracts		$23	
Health Service Contract	$3	$2	
Interpreter's Contract	$0.5	$0.3	
Child Care Subsidy	$1		
Increased Department of Labor EFAST Contract Processing Costs	$2		
	$55	**$132.00**	
Added Requirements			
Background Investigations		$4	
Increase Cash Awards from 1.24% to 1.42%	$8	$16	
Competitive Sourcing		$8	
Campus Security Response	$15		
Congressional Mandates	$5		
Guard Services	$20	$16	
Public Transportation Subsidy	$9		
	$56	**$44**	
Total	**$153**	**$304**	
Total less pay raise and rent	**$79**	**$122**	

Where the Additional Enforcement Resources Are Applied

(in thousands rounded)

Enforcement Initiatives	Oversight Board Recommendation		Administration Recommendation		Difference	
	Budget	FTE	Budget	FTE	Budget	FTE
SBSE–2 Curb Egregious Non-Compliance	159,264	1,408	90,161	874	$69,103	534
SBSE–3 Select High-Risk Cases for Examination	5,500	0	0	0	$5,500	0
SBSE–7 Savings through Consolidation—Case Processing	16,085	200	14,469	144	$1,616	56

Where the Additional Enforcement Resources Are Applied—Continued

(in thousands rounded)

Enforcement Initiatives	Oversight Board Recommendation		Administration Recommendation		Difference	
	Budget	FTE	Budget	FTE	Budget	FTE
SBSE–8 Savings through Consolidation—Insolvency Processing	7,656	69	5,531	65	$2,125	4
WAGE–2 Increase Individual Taxpayer Compliance	46,406	521	15,469	175	$30,937	346
WAGE–9 Improve ITIN Application Process	15,484	50	0	0	$15,484	50
WAGE–10 Eliminate Erroneous EITC Payments	18,000	0	0	0	$18,000	0
LMSB–1 Combat Corporate Abusive Tax Schemes	60,017	394	36,100	207	$23,917	187
TEGE–1 Combat Diversion of Charitable Assets	3,914	44	3,914	44	$0	0
TEGE–5 Stop Abusive Transactions in the TEGE Community	11,140	100	11,140	100	$0	0
CI–1 Combat Financial Fraud in the Corporate Sector	25,600	98	25,600	98	$0	0
CI–2 Dismantle International and Domestic Terrorist Financing	12,208	80	0	0	$12,208	80
CI–3 Reinforce Core Mission Tax Enforcement Resources	34,086	130	34,086	130	$0	0
CI–7 Forensic Electronic Evidence Acquisition and Analysis	3,104	4	3,104	4	$0	0
CI–10 Leverage/Enhance Special Agent Productivity	2,500	28	2,500	28	$0	0
APPEALS–1 Resolve Appeals	13,945	112	7,000	56	$6,945	56
COUNSEL–1 Combat Abusive Tax Avoidance	10,852	75	5,426	38	$5,426	37

Where the Additional Enforcement Resources Are Applied—Continued

(in thousands rounded)

Enforcement Initiatives	Oversight Board Recommendation		Administration Recommendation		Difference	
	Budget	FTE	Budget	FTE	Budget	FTE
NHQ–2 Deliver Strategic Compliance Data	2,712	2	0	0	$2,712	2
FY2005 Enforcement Increases	*448,472*	*3,315*	*254,500*	*1,963*	*$193,972*	*1,352*

Chairman HOUGHTON. Let me ask Mr. White a question, and then we will come back to you, Ms. Killefer. Mr. White, the Commissioner showed us a chart showing the audit rates of those making over $100,000 and they are increasing. The GAO has done previous work on the ways the IRS assures compliance through other means, such as document matching. Do you think the IRS has taken the right steps to make sure all taxpayers are paying what they owe?

Mr. WHITE. I would make several points, Mr. Chairman. It is true that there are substitutes for certain types of audits. There may not be substitutes for the more complex face-to-face types of audits. Another point I would make though is that right now IRS does not know the size of the compliance problem. They do not have a current measure of the compliance rate. The last time they measured the compliance rate was using 1988 tax return data. So, they are in the process of developing a new measure, but it is not going to be available for at least another year, so we do not know the size of the problem.

In terms of steps that IRS can take to actually increase enforcement, there are several things they can do. One is to use their existing enforcement resources more efficiently. Their efforts to measure compliance should help them better target pockets of noncompliance, and therefore better allocate their existing resources. Right now they are sort of flying blind when it comes to allocating resources because it has been so long since they researched where noncompliance is. Another thing they need to do to use the existing enforcement resources more efficiently is make sure the business systems modernization is successful. They need to bring the new systems online. That will help.

Finally, something else they can do is free up resources from other parts of IRS and transfer those resources, reallocate those resources into enforcement work. One example is e-filing. I said in my statement that e-filing has now started to result in decreases in the number of processing staff at IRS. In 2003 they reduced the number of processing FTEs by about 1,000. They can also reconsider the level and types of services that they offer. Now the telephone service is so much improved, now that the Internet provides options that didn't exist even a couple of years ago, maybe it is time to raise the question of whether as many walk-in sites are needed at IRS. In fact, taxpayers are already making this decision.

The number of taxpayers who use walk-in sites has been steadily declining at IRS. So, there are some opportunities to free resources from other parts of IRS and shift them into enforcement.

Chairman HOUGHTON. It seems almost impossible for me to believe that they do not know the size of the problem. Break that down a little bit.

Mr. WHITE. The last time they measured compliance, the rate at which taxpayers are paying what they know—this gets back to the measure of the tax gap which is the difference between what people ought to owe and what they are actually paying. The last time they estimated that compliance rate with a statistically valid approach was based on 1988 tax return data. Since then we have had tremendous changes in the economy. They now have their National Research Program to come up with a new measure of the compliance rate, but as I said, those results will not be available for another year.

Chairman HOUGHTON. What about the chart that the Commissioner used in terms of the enforcement resources that have been halted, and the effort remains below what is needed? There has got to be some relationship to the resources put in and to the people that are not complying or they don't think are complying.

Mr. WHITE. That is the fear that many people have, that because of the decline in those enforcement resources and what that has meant for their ability to conduct enforcement, that people's willingness to voluntarily comply may be going down. They have less incentive to comply than they did before, that they view IRS as less of a credible enforcement threat. The way I often think about this is from the point of view of honest taxpayers. Those taxpayers—and I think you raised this issue yourself—the system depends on trust. The confidence that honest taxpayers have that their friends, neighbors and business competitors are paying their fair share of the taxes, and if we ever lose that, then the compliance rate will suffer.

Chairman HOUGHTON. Ms. Killefer, I would like to go back to some of your statements. I suppose the law which created the Oversight Board gave you the proper authority and the resources to do your job. Is that right?

Ms. KILLEFER. In many ways, yes. I think we have learned over the course of the first three plus years of the Oversight Board we have a couple of things that were not foreseen. For example, as you all know, the nomination process is a lengthy one, and we currently have two vacant Board seats. We will have a couple more coming up. It is very difficult to conceive of the Board operating without a full membership as it was conceived. So, there are some things that we are learning as we go. Indeed, we were given the authority to submit a budget, but we have learned that we have become a footnote in the President's budget. Hence, we have started to issue our own report and appreciate the opportunity to testify here to be clear about what we think are the necessary resources.

Chairman HOUGHTON. I am sure you are very worried about the expense to revenue ratio. Whether this is going to turn around overnight or not, I have no idea. Probably not. The nonmilitary discretionary account, which is now about one-sixth of the overall budget, is getting squeezed all the time. I think it is a good idea.

We are in a national crisis. We have to support our troops abroad. Hopefully it will not be as much in the future as it has been the last 2 years, but we have to do our bit here. If you look at a budget of an agency that is $10.7 billion, you have to believe that there is some opportunity for maneuvering, and I know it is not what you want, and I know you have suggested other resources, and I know there are other things as far as compliance that are important. Isn't there an opportunity with that size budget to do some of the things, particularly since we are in such a cost crunch in the country?

Ms. KILLEFER. Chairman, what I would say is from a private sector point of view it is unfortunate that the Federal budget views this as a cost center and fails to be able to recognize its revenue potential. If you had a company—and I know you have—and had the opportunity to invest in growth and revenue, would you do it? I know the answer is yes. That is what we are facing here. When you talk about the IRS, and it is 100,000 people, recognize that the sheer processing of returns, which has gone up every year and become more complex every year, and the answering of the phone calls, right, the very basic processing simply needs to get done. That is what has driven down the enforcement resources. It has not been a desire to do less enforcement. It has been the problem of with a fixed amount of resource—you have seen they have not gone up—the number of returns has gone up, the complexity of the returns has gone up, so you have an increasing workload with a fixed amount of resources, and what you have to do is process basic returns, answer the phone calls, put out the tax forms, and the discretionary becomes enforcement.

Chairman HOUGHTON. Yes, but there was a seismic shift in the structure of the IRS that took away from some of the enforcement capabilities, but now, getting back into balance, I would imagine that that would be lightened a bit.

Ms. KILLEFER. If you call it a seismic shift to take the phone service from less than 50 percent to now currently 80 percent, it was. If you consider that you want to go back to 50 percent so that you can fund enforcement? I think that is a promise that we would disagree with as a Board. We believe that——

Chairman HOUGHTON. That is not my process.

Ms. KILLEFER. Why did we put——

Chairman HOUGHTON. My question is this: you have $11.7 billion. Why can't you work something in terms of the things you think are important within that overall figure?

Ms. KILLEFER. Chairman, there have been productivity improvements at the IRS, in fact, completely in line with the financial sector of this country. So, they have achieved productivity. As Jim pointed out, we have gotten more electronic returns. The Brookhaven Center has shut down. We are shutting down another center. There will be another coming. Productivity improvements have occurred, but what you have here is an increasing workload at the same time, and we are off base—and I think a false base—of an unacceptable level of service, and we don't know whether it was the right level of enforcement. So, the premise that we started out with an adequate base and therefore can achieve productivity and redeploy, I think is a false premise. We were at an unaccept-

able level. I think if you go back and look over history, there are times that the IRS was funded at a much greater level, in the mid nineties. It is simply, if you just run the workload numbers, you cannot do the work that needs to get done and support an enhancement of the enforcement efforts.

Chairman HOUGHTON. Mr. Pomeroy.

Mr. POMEROY. That was a very interesting exchange and I agree with both perspectives that were voiced. I think the Chairman raises a good point, that we want to capture all efficiencies and the savings flowing from them, and redirect them to agency priorities, and that would certainly be enforcement. At the same time I think you have been such an advocate, Ms. Killefer, I am making certain we understand enforcement takes funding. Failure to fund enforcement means people don't pay their taxes and you leave revenue uncollected, revenue that is owed under the law, revenue that most law-abiding taxpayers are paying, but some who are breaking the law are not paying. It is indeed a revenue center. Do you have any ball-park notion of for every dollar spent on enforcement, what you might collect in revenues?

Ms. KILLEFER. As Jim said, there are no recent calculations. The old numbers were approximately 10 or $11 per dollar spent, but those are very, very old, and I would not suggest that those are correct today.

Mr. POMEROY. When I was in the State legislature we enacted a program called Catch the Tax Cheater Program, and for every dollar expended we got $10 in revenue. I would believe, in fact, when we look at the demise of collections, driven by demise of audits, we might even do better than 10 to 1 in this environment. Mr. White, do you have any notions in that regard?

Mr. WHITE. We don't have any independent estimates. IRS has done some very crude guesstimates on it which suggest that you could bring in more than a dollar that you spend. They don't have a very good database for making those estimates, however.

Mr. POMEROY. I think that in helping Congress understand that funding IRS is in part a revenue center, not a cost center, some greater quantification of this would be helpful.

Ms. KILLEFER. Absolutely.

Mr. POMEROY. I hope we can work toward getting some better figure here. Let me turn to the back part of your testimony, Ms. Killefer, which talks about specifically enforcement activities requested but not collected. We spent an awful lot of time talking about abusive corporate tax shelters. I note that the funding requested by the Oversight Board was almost double what was funded by the Administration. Funding was reduced $23 million, 187 positions. Is that correct?

Ms. KILLEFER. That is correct.

Mr. POMEROY. Is it your belief that there will therefore be abusive corporate tax shelters that will not be caught, and there will be tax revenues owed but not paid because of these abusive corporate tax shelters and our somewhat limited ability to catch and deal with them?

Ms. KILLEFER. We do have that concern, and history would suggest that that is true.

Mr. POMEROY. There is another line item that is even more stark in terms of positions requested by the Oversight Board but not funded, and this is dismantling international and domestic terrorist financing. You request $12 million, 80 positions. Nothing was granted, no positions, no dollars to this request for dismantling international and domestic terrorist financing. Can you give us some background on that?

Ms. KILLEFER. The IRS I think traditionally over time has played an important role beyond sheer tax collection, be it the old Al Capone case. We feel that it really has the ability and the talent from its financial actuarial skills actually to play a great service to the country. So, we felt it was worthy to fund. I am not sure what the Administration is thinking. I am sure that they share our intent. I just think that that is the way the dollars fell out.

Mr. POMEROY. We have been working for some years to try and get at the financial underpinnings of international terrorism. Is the IRS without the capability to participate in that effort?

Ms. KILLEFER. I am not sure how they will actually end up allocating resources when they finally get their budget.

Mr. POMEROY. The Oversight Board came to the conclusion that we need to play a more robust role in attacking the international financing of terrorist, and 80 positions ought to be committed in this regard. None were allowed by the Administration.

Ms. KILLEFER. That is correct.

Mr. POMEROY. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thanks, Mr. Pomeroy. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. I would like to hear the Administration's response to that 80 positions. I would imagine that they have allocated resources through some means, and I hope we can get that in writing from the Administration.

Ms. Killefer, I thank you very much for not just being here today, but for the work you do on the Board, and as you know, I think the Board is critically important, and when we created the Board we gave the Board a few very important responsibilities that were in the area of approval and not just review and oversight, and one was in preparing a budget which would go to the Secretary, to the President and then require it to be submitted to the Hill. This year your budget, as I read it, is about 5 percent greater than the Administration's request, last years, about 2.7 percent.

This is, frankly, what we expected to have happen. You indicated that back in the nineties the IRS was funded better. I assume you mean that in relative terms because in the mid nineties you referred to, we went from 7.4 billion down to 7.3 billion, down to 7.2 billion by 1997, and in 1998, when we issued our Restructuring and Reform Commission Report and then legislated, we went back up to 7.8 billion, and since then we have gone up. Earlier we said this proposal the Administration has before us is for a 4.8 percent budget increase. Remembering that there will be, in the congressional, budgeting process, I believe, a freeze on all non-security domestic discretionary spending, which includes the IRS, the Administration had less than a 1-percent increase, so the IRS did relatively well compared to other agencies and Departments.

Given what our deficit is and given where we are as a country right now, in fighting the war on terrorism, that is a fairly healthy

increase. So, I just want to put that in some perspective to make sure we are not leaving the impression with those who might be listening that somehow we are terribly shortchanging the agency. In fact, in the Bush years, we have gone up almost 14 percent in spending for the IRS. It is tough. Every year this Subcommittee or at least some of its membership takes into account what the Oversight Board tells us, and our own independent analysis, and we fight with the appropriations process to try to be sure that there is adequate funding. The IRS is not always the most popular agency to fund. This year I think a 4.8-percent increase, again, is generous, and that is why we wrote a letter, the three of us, to the appropriators asking that that be fully funded. We are not suggesting how that is allocated between various enforcement and taxpayer service accounts, but we believe that at a minimum we ought to have this rather substantial increase in funding, again, relative to other agencies and Departments.

So, having said all that, I very much appreciate your budget and I appreciate the fact that you have laid out for us what you think the priorities are. I do think it is a little dangerous to get into saying, gee, because the Oversight Board has said specifically there ought to be 80 positions here, that if the budget of the Administration doesn't fund those, that that function somehow isn't accommodated—I don't know if it is or not—but that wasn't really the purpose of the Board, to get into that kind of micro management. It was the purpose to give us your unvarnished view of what you think the needs really are within a realistic framework, and I think you have done that. One quick question for you. The Oversight Board, as you know, is currently being reviewed as well, and as a strong supporter of the Board and someone who believes that it has met its intended purpose to provide oversight, do you think the Board itself is being given adequate support and adequate resources to do its job?

Ms. KILLEFER. That was a question that Chairman Houghton asked before, and I said we have learned through this first 3 plus years of the Board that there are some things that were not foreseen. As you know, having spent time with us, we actually are short two members and the nomination process has proved quite lengthy, and that has left us understaffed from a member standpoint. We also have some issues about continuity of our Board staff that concern us, and so we actually would suggest there may be some changes that we all want to make in the interest of ensuring the Board actually fulfills its intent over time, and having the strength of a full membership at all time and continuity in its staff support.

Mr. PORTMAN. That would be sensible since one of the main reasons for the Board was to provide continuity as well as expertise and accountability, and I think those are functions that have been performed very well. This hearing today is an example of that. I would just again say we need to keep it in perspective, that the Administration is proposing a substantial increase. The Commissioner, as you testified earlier, is focusing that increase where it needs to go right now, which is on enforcement, at the same time recognizing that we should never sacrifice the service gains we have made. We cannot allow this pendulum to swing, and that is

where the Board provides an invaluable break on what might otherwise be the tendency in government to swing from one, in this case, enforcement, away from taxpayer service. They are consistent with one another I believe, and we will have that theory tested I suppose over the next couple of years as we try to do both. Thank you, Ms. Killefer.

Chairman HOUGHTON. Thank you, Mr. Portman. Mr. Pomeroy.

Mr. POMEROY. Ms. Killefer, I would like to come back to these positions in the international and domestic terrorist budget request. Can you tell us a little bit about the activities that you envisioned this corps doing? If you are not prepared to speak to it, I will certainly request some follow up writing regarding this matter, but it really does jump out as a pretty serious difference of opinion between the Oversight Board and the Administration. Can you give us information on it?

Ms. KILLEFER. Let me say that I don't know that it is as serious a disagreement as it would appear. I think what we reviewed as a Board in putting together the budget is where we felt there were initiatives that required increased resources. That was one of them you see among many in the enforcement arena. I am not sure the thinking that went on in the Administration as they tried to generate a budget that fit into the total budget, but they clearly brought down their request that both the IRS and we submitted. In doing that they made some choice. I am not sure that they are the ultimate choices that they will actually make when they receive a budget level. How they allocate resources post getting a budget among initiatives, I am not sure what they will do. I would be happy to provide you with detail around that initiative to give you some sense of why we approved it.

Mr. POMEROY. I would very much like that information, and I believe you have been kind in your characterization. You requested 80 positions. They did not give you any positions. This isn't just kind of differing at the edges of this proposal. It seems as though you believe that within the IRS structure and competencies, tracking the international flow of money to finance terrorism is something you would have very substantial enforcement powers to move out. I believe that most Americans think we need all hands on deck on this one, and if IRS can play a role along with the major criminal investigatory powers of this country, and whatever resources are being brought to bear, it would in all likelihood be a very helpful addition. So, I am going to want to pursue this and get some answers.

Ms. KILLEFER. We certainly do believe they can play a meaningful role in this, given their skills.

Mr. POMEROY. Then I would certainly like to know where specifically you see that and then engage the OMB in some discussions as to why they so completely disagreed and eliminated you from participating in this area. I thank the Chair and look forward to receiving the information from the witness. Thank you.

Chairman HOUGHTON. Mr. Portman.

Mr. PORTMAN. I should probably stop here, but I just have to say to my friend, Mr. Pomeroy, and to my friend, Nancy Killefer, I do think the Oversight Board has incredible expertise and specifically under law you are supposed to have expertise in manage-

ment, which you do, and information technology, as Larry does, and in reorganization of large corporations and even small business expertise. We did not select you for your expertise on terrorism. So, I would hope that those who are listening, again, would not assume that this Oversight Board has the ability to decide how our government should be drying up resources to terrorists. That is not a function we looked for you to perform, and I am frankly disappointed that the Oversight Board is making recommendations about where they think terrorism ought to be approached within the IRS budget. That was not the idea. We do respect your budget, and I am again delighted to have it, but I would hope that we would understand that this Board—and this was a very controversial Board to set up—was put in place with some very specific constraints and very specifically looking for expertise in the areas where the IRS was most lacking, and that was in management, information technology and small business, and taxpayer sensitivity, and not, as important as it is, in fighting the war against terrorism. Thank you, Mr. Chairman.

Mr. POMEROY. You know the depth of my regard for my colleague, Rob Portman, and there has not been a legislator of the 435 of us more committed over the long haul to making sure the IRS is focusing on the right priorities and has the resources to do it, and he is in the weeds in technical competencies and he has worked it over time with great conscientiousness, and I admire his work in this area a great deal. I want to take a little issue with what he was just talking about in this area. Ms Killefer, you, as one Board Member, do have some background in international finance; is that correct?

Ms. KILLEFER. Yes, sir, some.

Mr. POMEROY. You are in fact a senior partner at McKenzie and Company, and indeed have a specific expertise within that company in international management consulting; is that correct?

Ms. KILLEFER. It is an international management consulting company.

Mr. POMEROY. You have held a variety of positions, public and private, relating not just to the flow of finance domestically, but internationally; is that correct?

Ms. KILLEFER. To some extent. I would say what—just to clarify for both of you—that what the Board does when it construct its budget—is work very closely with the IRS and look at a series of initiatives that we don't propose, that they propose to us as ones that would meet their mission. It is through that process that among other things this was one of their initiatives. So, we did not propose it, nor would we expect to propose initiatives to them.

Mr. POMEROY. Many illegal conspiracies have ultimately been brought down by investigators following the flow of money. Following the flow of money is something the IRS is pretty good at, isn't it?

Ms. KILLEFER. I would think so. There are other elements of government that do the same.

Mr. POMEROY. Undoubtedly, and there have been no discussions this afternoon about taking all other investigative areas here and stripping it from those agencies and putting it in the IRS. That is not what we are talking about at all, but we are talking about

being able to tap some of the extraordinary institutional potential in the agency that through history has been in charge of basically following the money, finding out what is owed to our government, collecting it, including not just taxpayers at the H&R Block Office this afternoon, but very sophisticated international enterprises. That some of this in-house expertise, if augmented with appropriate resources, could have played a very interesting additional role perhaps in back-stopping these other agencies. So, as the Board, with all of its tremendous sophistication in international finance, evaluated this proposal from the IRS, it isn't as though you are without expertise, without competence to have an informed opinion on this matter, in my belief, and that is why I look forward very much to receiving this additional information from you. I thank the Chair. I yield back.

Chairman HOUGHTON. I feel like I have been at a tennis match here.

[Laughter.]

Mr. White, you and I ought to have our own session here. Anyway, I thank you very much for your testimony. I appreciate the work. You are great citizens. I think we will now move on to our next panel. Mr. Orwick, who is the President and Owner of the LFS Professional IRSs; Richard Shaw, Chair of the Tax section, American Bar Association, Robert Zarzar, who is Chairman of the Tax Executive Committee at the American Institute of Certified Public Accountants, James Leimbach, Enrolled Agent, National Association of Enrolled Agents, and Timothy McCormally, Executive Director of the Tax Executives Institute. Now, Mr. Pomeroy, would you like to introduce the invited witness, Mr. Orwick?

Mr. POMEROY. I would be delighted. Allen Orwick is President and Owner of LFS Professional IRSs, a tax accounting and property management company located in Lakota, North Dakota, where he prepares income tax returns on more than 500 filers. He has done this for 23 years.

We have had some exposure, Mr. Chairman, to some of the fanciest firms out there in terms of financial consulting and tax preparation. In my view, none exceed the professional integrity that Mr. Orwick brings to bear on behalf of his clients. He is not trying to stretch the law. He is trying to understand it, and he is trying to, therefore, give his advice to his taxpayer clients in terms of what they owe and what they do not owe. There is a significant issue that has come up relative to a major part of his work, and that is servicing retired farmers, and so we will hear from him on this question in the course of this panel.

I thank the Chairman, but I most particularly thank Mr. Orwick. I would just note as an aside, he is also the Mayor of Michigan, North Dakota. So, while he is in the depth of filing season, he is out here testifying, and, by the way, Michigan, North Dakota, is having significant flooding, which he is also dealing with at the same time. So, this is a man of many hats, but we are glad he is bringing his tax preparer hat to this table this afternoon. Thank you.

Chairman HOUGHTON. Well, Mr. Orwick, we are going to give you a chance to prove that you are as good as Mr. Pomeroy says you are.

[Laughter.]

So, thank you very much. Would you give your testimony?

STATEMENT OF ALLEN I. ORWICK, PRESIDENT AND OWNER, LFS PROFESSIONAL SERVICES, INC., LAKOTA, NORTH DAKOTA

Mr. ORWICK. Thank you, Mr. Chairman and Mr. Pomeroy. I appreciate the opportunity to be here today. I am not so sure that I can live up to that billing, but I will do my best. Just to revisit, I have a tax practice located in Lakota, North Dakota. It is the northeastern part of the State, very agriculturally involved, also a county that has an aged population. So, the various issues that Mr. Pomeroy alluded to earlier are big, big issues in our home area. Overall, I would say our tax season is going very well. The day-to-day workings of the complex tax law, of course, seem to put more and more hours on myself and my staff every year. If I were to wish for one thing, I guess it would be simplification, like everybody else.

We have had various contacts with State agencies and the IRS and feel very fortunate to work with such high-quality people, and the courtesy and help that they have given us throughout the season are appreciated. Since 1997, we have been very involved in the e-file program, and as of last Sunday, when I tallied it up, we had utilized the e-file program for 99.2 percent of the qualified tax returns. Of those that we did transmit, 98.4 percent were approved on the first transmission, which is something that we are very proud of. We are a big believer in the program and recommend use of the program to our peers.

In regard to the situation of the CRP, prior to the letter ruling that Mr. Pomeroy referred to earlier that was issued last May, it has been our understanding that CRP is to be reported as self-employment income for those who are actively farming, and rental income for those who are not. With this recent ruling, it has really thrown everybody into a frenzy as to whether or not that is the correct process or not. I participated in a meeting last Friday, put together by Congressman Pomeroy in Bismarck, North Dakota, and we had members of the IRS, myself, Dr. Harl, and our State Agriculture Commissioner there. During that meeting, there were a lot of different thoughts brought forward, but what we did notice is no resolution.

It is a huge item to a retired person, and it looks as though about 10 percent of my clientele could be adversely affected by this ruling if that is the case, with an average cost of $1,200 per taxpayer, which out of my firm alone is $60,000. This is money that the taxpayers did not count on paying when they walked into my office. It was something that I had to inform them of possibly being out there. My clients are very conservative, and they are law-abiding citizens, and they want to do what is right. The problem we have today is that we don't know what is right because of the situation with this recent ruling.

I would like to mention Dr. Harl's recommendations at that meeting, one of which was the withdrawal of CCA Letter Ruling 200325002 or reissue it and bring it into harmony with Private Letter Ruling 8822064 and giving us some time to go through and sort this matter out. I would hope that the IRS would look upon

these recommendations and adopt them so that we can bring some certainty and closure to this matter. I would also like to mention that I support legislation that is being offered by Congressman Pomeroy and others to completely exempt CRP payments from self-employment tax. I want to thank you for the opportunity to be here today. I will answer any questions that you may have.

[The prepared statement of Mr. Orwick follows:]

Statement of Allen I. Orwick, President and Owner, LFS Professional Services, Inc., Lakota, North Dakota

I am Allen Orwick, President and owner of LFS Professional Services, Inc., a tax accounting and property management company located in Lakota, North Dakota. I have been preparing income tax returns professionally for twenty-three years, owning my own practice since 1984. LFS Professional Services, Inc. specializes in the preparation of income tax returns for active and retired farmers in northeastern North Dakota, preparing approximately five hundred returns annually.

We have been very active in the Internal Revenue Service *e-file* program, first using the system to *e-file* 1997 tax returns. In 1999, the Internal Revenue Service chose LFS Professional Services, Inc. as an Exemplary Electronic Return Originator.

During the current tax season we have utilized the IRS *e-file* program for 99.2% of qualified returns. As of March 28, 2004, 98.4% of our transmitted returns were accepted the first time. We are very proud of our accomplishments in the *e-file* program and promote its use among our peers at every opportunity.

The current filing season has gone quite well. Our contacts with both federal and state agencies have been very positive experiences. Dealing with the complexity of the tax law is not always an easy task, my firm works very hard everyday to provide a high quality, professional service to our clients. The main area of concern this tax season has been Conservation Reserve Program payments and the manner in which they are to be taxed for retired taxpayers.

Many of our clients have some involvement with the Conservation Reserve Program. Prior to this year we have reported CRP payments based on previous Internal Revenue Service guidelines and court cases indicating that CRP payments received by an active farmer were subject to self-employment tax and those received by retired farmers were generally considered rental payments and exempt from self-employment taxes.

On June 23, 2003, the Internal Revenue Service released a Chief Counsel's letter ruling on the taxability of CRP payments for self-employment tax purposes. In CCA Ltr. Rul. 200325002 (May 29, 2003), the IRS took the position, one which appears to be directly contrary to Priv. Ltr. Rul. 8822064 (March 7, 1998), that a landowner's activities under a CRP contract amount to material participation and the payments should be reported on Schedule F, not Schedule E or Form 4835. In other words, even retired farmers must now pay self-employment taxes on CRP rental payments.

The ruling dealt with two fact situations involving CRP payments. In the first fact situation the taxpayer was engaged in the trade or business of farming and bid land into the Conservation Reserve Program. The second situation was of a taxpayer, not involved in the trade or business of farming, who acquired land that had already been bid into CRP. This ruling stated the CRP payments in both fact situations should have been reported on Schedule F and were liable for self-employment tax.

This latest CCA ruling on the second fact situation is at variance with prior Private Letter rulings and commentary issued with Tax Court decisions. It has created great concern and much confusion on how CRP proceeds are to be reported for retired landowners.

I participated in a panel discussion on this issue in Bismarck, North Dakota on March 26, 2004. At this meeting John Schmittdiel, an IRS Associate Area Counsel for the SB/SE division of Chief Counsel in St. Paul, Minnesota stated that CCA Lrt. Rul. 200325002 and Priv. Ltr. Rul. 8822064 were issued in response to single cases and were not meant to set a precedent. Another member of the panel, Dr. Neil E. Harl, the Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics at Iowa State University, and one of the country's most respected agricultural tax scholars, stated that without clarification from Congress or specific rulings from the IRS, tax practitioners had to rely on what guidance is available including the two previously noted rulings on this matter.

The 2003 Internal Revenue Service Publication 225 (Farmer's Tax Guide) instructs taxpayers that "Under, the Conservation Reserve Program (CRP), if you own

or operate highly erodible or other specified cropland, you may enter into a long-term contract with the USDA, agreeing to convert to a less intensive use of the cropland. You must include the annual rental payments and any one-time incentive payment you receive under the program on lines 6a and 6b of Schedule F. Cost-share payments you receive may qualify for the cost-sharing exclusion. CRP payments are reported to you on Form CCC–1099–G."

It is ironic that the instructions refer to these payments as "annual rental payments". While rental payments a landlord might receive are not generally subject to the self-employment tax, rental payments under the CRP program are now subject to the self-employment tax. The USDA Farm Service Agency also uses the term "rent" when reporting CRP payments on Form CCC–1099–G. If it is truly "rental income" it should not be subject to self-employment taxes.

Legislation to exempt all CRP payments from self-employment tax was introduced for consideration in legislative bills of 2000, 2001 and 2003. Many tax professionals feel legislative action is necessary to clearly define the Congress's intent relative to the circumstances when, if ever, CRP and other similar land idling program payments will be subject to or exempt from self-employment tax.

My clients are surprised to learn that self-employment taxes may apply to their CRP income while they are retired. There has been very little publicity on this subject in farm publications and local newspapers. Because of the IRS' recent ruling, tax preparers and retired landowners participating in the CRP program are unsure of how to file their income tax returns for 2003. Tax practitioners range from being unaware of the ruling to believing that CCA Ltr. Rul. 200325002 is the most recent authority and must be followed. Others believe the recent ruling will be overturned or that it does not really apply to retired farmers based on previous authority. Unfortunately, this ruling does not address prior rulings and case law and the IRS has not issued any additional guidance.

It is my firm's opinion that each client must choose between two alternatives when filing their 2003 income tax return. The first choice is to pay the additional tax and hope for future relief, either from the IRS or Congress. The second choice is to prepare the return in the same manner as in previous years and disclose to the IRS that they are filing contrary to CCA Ltr. Rul. 200325002. If retired farmers are required to pay self-employment tax on their CRP income it will make a large difference on the total taxes they will be required to pay.

Based on all of the clients I have met with so far this tax season, approximately ten percent will be adversely affected by this recent IRS ruling, and all of the retired farmers owning CRP are affected. The average additional cost to those taxpayers is about $1,200. This equates to an additional $60,000 of self-employment taxes being paid by my clients alone. Most of these taxpayers are elderly and living a very moderate lifestyle. These are not private landowners who have never farmed and are looking at the CRP program as easy money or an investment, but instead are people who have generally farmed the same land for much of their lives and CRP payments are a significant source of their retirement income. This additional tax is a severe financial burden for them.

My clients are all law-abiding citizens and they want to do what is right. At this point I can not tell them what is right, because I do not know. My clients are conservative and tend to select the option that they feel has the least risk. A majority are choosing to pay the self-employment tax and hope that additional clarification will allow them an opportunity to amended their return and apply for a refund.

During the aforementioned March 26, 2004 panel discussion, Dr. Harl made the following recommendations:

1. Withdrawal of CCA Ltr. Rul. 200325002, May 29, 2003, or reissuance with a narrowing of the ruling to harmonize with Ltr. Rul. 8822064, March 7, 1988, this would remove much of the current confusion.
2. The CCA Ltr. Rul. seems to apply to all federal conservation programs payments. It would be helpful to know whether that was intended.
3. Have the IRS give guidance on the matter of SE tax liability for those who retire during the term of the CRP contract bringing clarification to this question.

I agree with Dr. Harl's recommendations. In addition, I believe that Congress should pass legislation to clear up once and for all it's intent on the tax treatment of Conservation Reserve Payments. It is very important to taxpayers and tax professionals that certainty and closure be brought to this issue. It is my hope that common sense will prevail and that at least those whom are retired, will not be subject to the self-employment tax.

Thank you for your consideration.

Chairman HOUGHTON. Well, I thank you very much for that. Also, I thank you for coming in under your time limit. That is very helpful.

Mr. Shaw.

STATEMENT OF RICHARD A. SHAW, CHAIR, TAX SECTION, AMERICAN BAR ASSOCIATION

Mr. SHAW. Good afternoon, Mr. Chairman and Mr. Pomeroy. Thank you. My name is Richard Shaw. I am Chair of the American Bar Association (ABA) section of Taxation. This testimony is presented on behalf of the 400,000 members of the American Bar Association and the 20,000 members of the section of Taxation. We appear before you today to specifically talk about one primary subject, and that is the subject of simplification. We want to emphasize it today. The ABA and the section of Taxation have long been advocates of simplification of the Tax Code. Last month, the Board of Governors and the House of Delegates of the Bar Association adopted a resolution which treats simplification as one of 12 of the highest priority legislative areas where we believe emphasis needs to be placed. We believe that complexity is at the root of many of the significant obstacles to efficient and effective administration of the tax laws. Let's talk first about complexity creates controversy.

As the National Tax Advocate and others have well documented, the scope and complexity of the tax laws make it virtually certain that taxpayers will face procedural, technical, and bureaucratic obstacles in trying to meet their tax obligations. This not only creates problems on the front end, when they are trying to prepare their returns, but when errors appear it appears at the back end, where it results in complexity and litigation and controversy that should not have to take place. Second, let's consider the problem of fairness. Complexity has materially reduced the taxpayers' perceptions of fairness of the Federal tax system by creating disparate treatment of similarly placed and situated taxpayers. It is hard to imagine how taxpayers and Congress can see the IRS as an efficient, modern service or agency when the taxpayer cannot perceive the tax system as even being fair.

Finally, let's evaluate the manipulation. Tax law complexity creates opportunities for technical manipulation of the tax laws, often in ways not contemplated by Congress. Aggressive exploitation of ambiguities in the laws not only further aggravates the perception problem but it forces the IRS, the IRS, to divert resources from working with compliant taxpayers to having to interpret and aggressively avoid the problem of—or the ability to deal with aggressive noncompliant. We would prefer that they be able to deal with the voluntary taxpayers, but recognize the need for dealing with noncompliance as well.

What we are saying is that legislation on simplification is necessary. It results in difficult choices. The political realities of seeking a fiscal balance limits the ability to seek simplification. We know that. Simplification necessitates a willingness to embrace objective standards without dealing with passionate and political constituencies. Simplification requires that you avoid popular proposals and deal with realistic ones that avoid complexity. The code is replete with burdens where there are complexity, and these bur-

dens are greater than the benefits that are obtained by engaging in simplification. Frequently, taxpayers have to engage in torturous struggles between a maze of cross-references and inconsistent definitions in order to examine an issue and then determine finally that it is not even relevant.

There is a problem of deadwood where we have many statutes that were fair and applicable when they were first enacted, but because of changes are no longer relevant. I want to draw attention to several just quick examples where we believe simplification is helpful. It is necessary and appropriate that we deal with a phase-out of tax benefits. The Joint Committee on Taxation has sought that they be phased out. The child definition creates problems. There are at least five different definitions. When the taxpayers find that one works, they tend to think that it works for all. This results in complexity and it interferes with efficiency of the system. We think that there is a need for the elimination of the alternative minimum tax. It has created complexity that is unnecessary. The capital gains provisions apply several definitions and notes. Schedule D is almost impossible to complete.

The foreign tax rules need to be modified. In a true sense, we believe that simplification must be dealt with at this time. We also touch on the fact that regulatory simplification should be dealt with. We recognize that Congress prepares and enacts the law. We also think that Congress needs to oversee the IRS in a way that will assure that there is more efficient administration that will provide guidance for taxpayers so that they are able to comply properly with the tax laws and satisfy their obligations.

I have cut my comments very short, but I would like to summarize by simply stating that our primary message is the need for Congress to devote its energy and its resources to promote changes in the tax laws that will result in greater simplification. It is difficult to expect taxpayers to have confidence in taxes imposed under current laws when even experienced tax return preparers consistently get different results on similar data because of the complexity of the tax laws. The integrity, the fairness, and the equity of the tax system required and do require a concerned effort to obtain simplification now and not 10 years from now.

[The prepared statement of Mr. Shaw follows:]

Statement of Richard Shaw, Chair, Tax Section, American Bar Association

Thank you, Mr. Chairman. My name is Richard A. Shaw. I am Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the American Bar Association.

The American Bar Association appreciates the opportunity to appear before the Subcommittee on Oversight (the "Subcommittee") today to discuss the critical need for simplification of the federal tax laws. We know this is an issue the Subcommittee takes seriously, and we appreciate the efforts the Chairman and other Members of the Subcommittee have taken over the past few years to focus attention on the need for simplification.

ABA Section of Taxation

The ABA is comprised of more than 400,000 members and its Section of Taxation has approximately 20,000 tax lawyers who work in law firms, corporations and other business entities, government, nonprofit organizations, academia, accounting firms and other multidisciplinary organizations. Accordingly, to make the tax system fairer, simpler and easier to administer is one of the Association's legislative priorities.

Our members provide advice on every substantive and procedural area of the tax laws, and interact regularly with the Internal Revenue Service (the "Service"), the Treasury Department, and other government agencies and offices responsible for administering and enforcing the tax laws. Many of our members have served in staff and executive-level positions at the Service, the Treasury Department, the Tax Division of the Department of Justice, and Congressional tax-writing committees.

The Need for Simplification

The ABA and its Section of Taxation have long been strong advocates for simplification of the Internal Revenue Code. For nearly thirty years, the ABA has been on record urging tax law simplicity, a broad tax base and lower tax rates.

We have reiterated this position in testimony before Congressional tax-writing committees on numerous occasions. For a number of years, the Section of Taxation has worked with our colleagues at the AICPA Tax Division and the Tax Executives Institute on this important issue. The Tax Section will continue these efforts and we remain optimistic that real steps can be taken by Congress to simplify the tax laws.

We believe that complexity is at the root of many significant obstacles to efficient and effective administration of the tax laws.

First, as the National Taxpayer Advocate and others have well documented, the scope and complexity of the tax laws make it virtually certain that taxpayers will face procedural, technical and bureaucratic obstacles in meeting their tax obligations. This not only creates problems on the front end, when taxpayers attempt to prepare and file returns, but also at the back end, when errors rooted in complexity result in audits and controversy with the Service.

Second, as the staff of the Joint Committee on Taxation documented in their comprehensive 2001 study on tax simplification, complexity has materially reduced taxpayers' perceptions of fairness of the federal tax system by creating disparate treatment of similarly situated taxpayers. Although perceptions—and their impact—are difficult to measure, it is hard to imagine how taxpayers or Congress can see the Service as an efficient, modern and responsive agency if they do not perceive the tax law itself to be fair.

Third, as we have seen in recent years, tax law complexity creates opportunities for technical manipulation of the tax laws—often in ways never contemplated by Congress. Aggressive exploitation of ambiguities in the laws not only further aggravates the perception problem, but also forces the Service to divert resources from working with compliant taxpayers in resolving legitimate issues of interpretation to pursuing the aggressively noncompliant instead.

Legislative Simplification

Of course, we recognize that simplifying the tax law requires Congress to make difficult choices. This is particularly true when, as now, the political realities of the fiscal balance limit the ability to simplify in a manner that reduces revenue. Simplification necessitates a willingness to embrace objective proposals that are often dull and without passionate political constituencies. Simplification also requires that politically popular proposals be avoided if they would add significant new complexity. Simplification—and preventing greater complexity—may not garner political capital or headlines, but it is crucial to a tax system that is fair and can be efficiently administered.

The Code is replete with tax provisions where the burden of complexity is much greater than the perceived abuse to which the provision was aimed, or the benefit that was deemed gained by its addition.

Frequently, taxpayers, or more likely their tax representatives, must engage in a torturous struggle through a maze of cross-references and inconsistent definitions to ascertain that a set of complex provisions are not relevant to a transaction or tax obligation.

The Code contains many provisions that at the time of enactment may have been desirable, but with the passage of time, or the enactment of other changes, have truly become "deadwood." Despite the absence of any practical utility in such provisions (whether in a relative or absolute sense), analysis of the effect of such provisions will generally be required, either in the preparation of the tax return or in the consummation of a proposed transaction. The elimination of such provisions would greatly simplify the law.

In the past, working with our colleagues in the AICPA and TEI, examples of provisions have been offered that, when analyzed, do not justify their continuation in the law. We are grateful that the Congress has acted to address some of these prob-

lems. We encourage you to continue these efforts, as every step taken to simplify the tax laws is an important part of providing tax relief to the American taxpayers.

Today I want to draw your attention to a few areas in particular: the complexity wrought by the numerous provisions of the tax code that phase-out tax benefits based on income levels, and the complexity caused by the multiple definitions of a "child" under the tax code.

As you know, the tax code is often used to distribute benefits under a variety of social policy programs among selected groups of taxpayers. To accomplish these diverse goals, many code sections phase-out available deductions and credits over various income ranges based on differing measures of taxpayer income. Currently, these phase-out ranges are not consistent either in defining income, the applicable levels of income, the range of income over which the phase-out applies, or the method of applying the phase-outs. The phase-out ranges even differ depending on the filing status of the taxpayer, and these differences are also internally inconsistent. As a result, phase-outs cause inordinate complexity—particularly for taxpayers attempting to prepare their own returns without the assistance of tax preparation software.

The staff of the Joint Committee on Taxation recommended three years ago that most phase-outs be eliminated and in 2002, the ABA adopted a formal policy to support that position. Congress has already taken an initial step in this effort by providing that, beginning in 2006, two of these troubling phase-out provisions, dealing with personal exemptions and the overall limitation on itemized deductions, will begin to be eliminated. We applaud this legislative action, and encourage the Subcommittee to seek out ways of building on that experience to address further the problem of unduly complex phase-outs.

As the Subcommittee is undoubtedly aware, the use of different definitions to determine who is a qualifying child for purposes of:

(1) the dependency exemption;
(2) the earned income tax credit ("EITC");
(3) the child credit;
(4) the dependent care credit;
(5) and head of household filing status,

has led to widespread confusion and inadvertent errors. Taxpayers mistakenly believe that if they have a "child" who qualifies for one of the benefits, they are entitled to all of them. These errors inevitably lead to controversies with the Service that are very difficult for taxpayers and particularly, lower-income families to handle.

To the extent that the Service is required to devote its limited resources to sorting through the controversies caused by five (5) different definitions of "child," the end result is that the Service is not able to focus attention on other taxpayers in need of assistance or in pursuing enforcement against tax evasion.

The problems wrought by these confusing definitions of a child are well-documented, and similar approaches to simplifying this part of the tax laws have been endorsed by both the Treasury Department and the staff of the Joint Committee on Taxation, as well as several Members of this Subcommittee. We encourage the Subcommittee to take whatever steps it can to further these efforts this year. We note that the 2005 budget proposals contain nine (9) specific tax simplification items. We strongly recommend consideration of the many recommendations made in the 2001 Joint Committee on Taxation Staff Report.

Regulatory Simplification

We also want to touch on the need to encourage regulatory simplification within the Treasury Department and the Service.

We appreciate that the Treasury Department and the Service have stepped up their efforts in recent years to work towards simplification through the regulatory process. The ABA and the Section of Taxation are committed to work with Treasury and the Service to continue such efforts. We also commend the Service for steps taken since 1998 to streamline the administrative system and improve the way the Service interfaces with taxpayers. We applaud efforts underway to redesign the examination and appeals processes to make them work more efficiently for both taxpayers and the Service. However, more can be done in the regulatory and administrative areas. As we recently advised the IRS Oversight Board, a cornerstone of the IRS strategic plan for the next five years must be a meaningful effort to simplify the tax law itself and the Service's procedures for interacting with taxpayers.

The Service's efforts to refine its modernization program should consistently consider the necessity for quality and efficiency in dealing with taxpayers. The lack of

efficiency is evidenced by the inability of the system to satisfy adequately the statutory and regulatory objectives of the Offers-in-Compromise program. Taxpayers should not be stranded in compliance limbo while offers take more than three years to be processed through Appeals.

Prompt issuance of guidance advances the goal of simplification by reducing ambiguity and uncertainty. This can take the form of formal Revenue Rulings and Revenue Procedures that provide clarity and simplify the administration of complex and ambiguous laws and regulations. Prompt public releases are essential to provide guidance on new tax legislation. There have been at least twenty (20) new tax acts within the past five years affecting more than 300 sections of the Code. In addition, a strong program to modernize forms and instructions that make them more readily understandable and manageable to the average taxpayer can advance procedural simplification.

There are success stories. Much litigation was eliminated when the Treasury adopted a "check-the-box" system for unincorporated associations to elect to be treated as either corporations or partnerships. Likewise, the Service adopted practical procedural guidelines for remedying defecting Selections without requiring taxpayers to file expensive requests for revenue ruling approval.

Additional training is essential so that auditors and appeals officers are better able to explain and apply complex tax laws in a fair, consistent and just manner. Taxpayers and the system are not served well by Service Center communicators who are correct on complex tax laws only about 70% of the time.

We have encouraged the Service to actively work with this Subcommittee and the other tax-writing committees to ensure that you are fully educated on how much complexity adversely impacts the ability of the Service to achieve its mission.

In summary, our primary message today is the need for Congress to devote its energy and resources to promote changes in the tax laws that will lead to greater simplification. It is difficult to expect taxpayers to have any confidence that taxes imposed under current laws are collected accurately, when even experienced tax return preparers consistently get different tax results on similar data because of the complexity of the tax laws. The integrity, fairness and equity of the tax system require a concerted effort to obtain simplification.

* * * *

The ABA Section of Taxation hopes that the foregoing observations and suggestions are helpful to the Subcommittee. The Tax Section would be pleased to meet with you to further discuss these views or any other matters. Thank you.

Chairman HOUGHTON. All right. Thank you very much, Mr. Shaw. I don't think anybody disagrees. We will get into this a little later. Could I ask the rest of you if you could stay within the 5 minutes? I sure would appreciate that. Mr. Zarzar.

STATEMENT OF ROBERT A. ZARZAR, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. ZARZAR. Thank you, Chairman Houghton and Ranking Member Pomeroy, for this opportunity to appear here today. The American Institute of Certified Public Accountants (AICPA) is the national, professional organization of certified public accountants comprised of more than 330,000 members. We believe that the 2004 filing season is progressing largely without any significant problems, and American taxpayers and practitioners generally are pleased with the IRS' performance. I would first like to commend Chairman Houghton for his sponsorship and active support of H.R. 22, the Individual and Small Business Tax Simplification Act of 2003. As Mr. Shaw has said, we firmly believe that the enactment of tax simplification measures is integral to the success of future filing seasons, and we encourage Congress to continue to make tax simplification a major legislative priority. As for the IRS budget

and the Business Systems Modernization program, we urge Congress to support full funding of the IRS' fiscal year 2005 budget.

We note and appreciate the Administration's fiscal year 2005 request to increase the IRS' funding. We have long advocated funding levels that would allow the IRS to efficiently and effectively administer the tax laws and collect taxes. Giving the IRS the resources necessary to properly enforce the tax laws is vital to maintaining our voluntary compliance tax system. Last month, before this Subcommittee, Commissioner Everson reported on the difficulties the IRS has faced with implementation of its Business Systems Modernization program—testimony that was generally consistent with the conclusions found in the Oversight Board's December report. Despite these problems, we strongly urge Congress to stay the course in terms of support for appropriate funding for this modernization effort. This is an issue that must remain a central feature of the IRS' strategic plan for the next 5 years.

As for the IRS' e-filing goals, we support their long-range goals for electronic tax administration. We applaud the IRS' current success with e-filing for the 2004 season, following on its successes of last year. We also commend the IRS' efforts to phase in the electronic filing of business returns and its rollout of the "Electronic IRSs" section on the IRS website. During the last year, the IRS has taken positive steps to listen to the practitioner community about the myriad problems tax professionals still face when contemplating conversion of their firms to practices offer e-file services to their clients. We appreciate this effort on the IRS' part, and to this end, we look forward to serving as a positive e-file partner with the IRS.

Now, I do regret to inform you that there have been some information return problems this year along the whole line of complication rather than simplification. The 2003 Tax Act (P.L. 108–27) cut the rate to 15 percent for qualified dividends received by individuals. Unfortunately, compliance with the new 15-percent dividend tax rate has proved to be the biggest challenge for taxpayers and practitioners during the current filing season. Brokerage firms and mutual funds are having major difficulties determining when dividends are qualified dividends, which has resulted in large numbers of erroneous Forms 1099–DIV being mailed to taxpayers. This situation has caused havoc for many taxpayers and practitioners.

Many taxpayers filed their Forms 1040, only to receive an amended Form 1099–DIV after the fact from a financial institution. The taxpayer and preparer thus are faced with a dilemma as to whether an amended return should then be filed, including State amended returns, or whether an earlier filed return remains the realistic snapshot of the taxpayer's position for 2003 and wait for the IRS' matching program to satisfy the ultimate obligation of tax. The AICPA stands ready to work with Congress and the IRS to develop procedures to minimize the processing burdens placed on taxpayers and practitioners from such changes.

Finally, with respect to tax practitioners and their professional responsibility, the AICPA commends the IRS and Treasury for its efforts to address the professional responsibility standards of tax professionals generally, and particularly with respect to the eradication of abusive tax transactions. These are actions that we sup-

port. We have a longstanding track record of establishing professional standards for our CPA members. The AICPA has adopted and has in place a Code of Professional Conduct, as well as enforceable "Statements on Standards for Tax IRSs."

On the issue of return outsourcing, the AICPA's Professional Ethics Executive Committee appointed a task force in January 2004 to consider what changes, if any, should be made to our Code of Professional Conduct in connection with third-party-provider information. We are currently awaiting the task force's recommendations on this matter. Regardless of what decision a tax professional may make in this area, nevertheless, the public should understand that the practitioner remains fully responsible for the accuracy of a return and for ensuring confidentiality of client information. Mr. Chairman, I have completed my remarks and would be pleased to answer any questions you may have.

[The prepared statement of Mr. Zarzar follows:]

Statement of Robert Zarzar, Chair, Tax Executive Committee, American Institue of Certified Public Accountants

Mr. Chairman and members of the House Ways and Means Subcommittee on Oversight, the American Institute of Certified Public Accountants thanks you for the opportunity to appear before you today. I am Robert A. Zarzar, Chair of the AICPA's Tax Executive Committee. The AICPA is the national, professional organization of certified public accountants comprised of more than 330,000 members. Our members advise clients on federal, state, and international matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses. It is from this broad base of experience that we offer our comments today on the IRS budget and the 2004 tax filing season.

The AICPA is happy to report that the 2004 filing season is progressing largely without any significant problems and American taxpayers and practitioners generally are pleased with the Service's performance. We note that enactment of tax simplification measures is integral to the success of future filing seasons. Mr. Chairman, the AICPA is particularly encouraged by your sponsorship and active support of H.R. 22, the Individual and Small Business Tax Simplification Act of 2003.

Our comments herein focus on the IRS budget for fiscal year 2005 and a number of programs of critical importance to the Service. Specifically, we are pleased to address: (1) the IRS budget, (2) Business Systems Modernization, (3) achieving E-filing goals, (4) information return problems, (5) tax practitioners and professional responsibility, and (6) tax simplification.

1. The IRS Budget

The AICPA urges Congress to support full funding of the Internal Revenue Service's fiscal year 2005 budget. The AICPA has long advocated funding levels which would allow the IRS to efficiently and effectively administer the tax laws and collect taxes. Giving the Service the resources necessary to properly enforce the tax laws is vital to maintaining our voluntary compliance tax system. Obviously, we expect the Service to identify responsible ways to allocate any additional resources it receives over prior year funding and Congress will through its oversight responsibilities ensure that those resources are properly utilized.

We note and appreciate the Administration's fiscal year 2005 budget request to increase the Service's funding to $10.674 billion, representing an approximate increase of $490 million in funding and 2,200 staff positions over fiscal year 2004. The AICPA supports the objectives of the Administration's budget proposal, which principally focuses on increasing staffing and resources in the enforcement area. Commissioner Mark Everson recognizes that any increase in enforcement funding must be balanced with positive responses to the taxpaying public as customers. We encourage this type of balanced approach and stand ready to work with the Service to ensure that the needs of American taxpayers are fulfilled.

Many AICPA members are tax practitioners. As such, we have seen first-hand the problems caused by an IRS that is not responsive to the taxpaying public as customers. We have also witnessed the improvements initiated by former Commissioner Charles Rossotti and Commissioner Everson, initiatives involving the reorga-

nization mandated by Congress in the *IRS Restructuring and Reform Act of 1998*. Any lack of attention to the IRS's funding needs will likely only serve to undercut the tax administration improvements Congress expects and we believe the nation's taxpayers will suffer as a direct result.

2. Business Systems Modernization

In testimony before the House Ways and Means Subcommittee on Oversight on February 12, 2004, Commissioner Everson reported on the difficulties the IRS has faced with implementation of the agency's Business Systems Modernization (BSM) program; testimony that was generally consistent with the conclusions on BSM found in the December 2003 report by the IRS Oversight Board. While touching on a number of BSM projects, Everson testified about the Service's continuing problems with implementation of the customer account data engine (CADE), the system designed to replace the agency's master file of taxpayer records.

Despite the problems the IRS has experienced with Business Systems Modernization, we strongly urge Congress to stay the course in terms of their support for appropriate funding for the modernization effort. This is an issue that must remain a central feature of the Service's strategic plan for the next five years.

The BSM goals are critical to the future successes of the Service. The program is designed to change the entire way the IRS conducts business with taxpayers and stakeholders, by (1) implementing systems to improve the IRS's effectiveness in receiving, routing, and responding to millions of taxpayer telephone calls; (2) supplying Revenue Agents with software capable of accurately assessing a taxpayer's liability when faced with a complex tax matter or calculation; (3) establishing a modern, reliable data base; and (4) implementing a nationwide e-mail and voice-mail messaging system for Service employees.

3. Achieving E-Filing Goals

The AICPA supports the IRS's long-range goals for electronic tax administration in general, and electronic filing (ELF) in particular. We applaud the Service's current successes with e-filing for the 2004 filing season, as well as the successes of last year. As of March 17, 2004, taxpayers have submitted 43 million e-filed returns, or an 11.4 percent increase over the same period last year. Approximately 53 million Americans utilized e-file options in 2003.

We also applaud the Service's efforts to phase-in the electronic filing of business returns; and its rollout of the "Electronic Services" section on the IRS website, which includes a suite of web-based products for practitioners to do business with the IRS electronically. With respect to the Form 1040 e-file program, the IRS has implemented a number of improvements to the program in recent years that should prove positive for practitioners who file returns electronically. We especially appreciate that (1) nearly all Form 1040 forms and schedules have been made available to electronic filers; (2) electronic filers are no longer required to use a paper signature document; and (3) the electronic payment options have been expanded.

One drawback with electronic filing is that it is not an option for many low income taxpayers who don't own a computer. These taxpayers routinely find that they must rely on commercial preparers who often charge disproportionately large fees. Also, blinded by the appeal of immediate cash, these taxpayers have high-interest refund anticipation loans (RALs) foisted on them by some commercial preparers. As an alternative to the regrettable RAL situation, taxpayers can go to a low-income taxpayer clinic or get assistance through programs like the Volunteer Income Tax Assistance (VITA) Program.

Unfortunately, funding for low-income taxpayer clinics was curtailed last year due to an IRS Chief Counsel interpretation that IRS "matching" funds should only be available to controversy clinics that don't prepare returns. National Taxpayer Advocate Nina Olson has recommended that the IRS support separate funding for low-income return preparation clinics, a recommendation that should encourage e-filing and improve compliance by low-income taxpayers generally. Senator Jeff Bingaman has introduced legislation that includes a provision supporting funding for low-income return preparation clinics. We support these recommendations and initiatives.

The IRS has taken some positive steps during the last year to listen to the practitioner community about the myriad problems tax professionals still face when contemplating offering e-file services to their clients. For a long time the AICPA had been frustrated by the Service's response to our attempts both to partner with the IRS in promoting ELF to our membership and in explaining the effects of the current e-file programs' limitations on our constituency. As the IRS shifts its electronic filing focus from individual returns to business returns, the importance of involving, listening to, and responding to the various stakeholder groups will become all the more critical.

We recognize the many hurdles on the road to achieving the goals established for the electronic filing program by Congress, but look forward to a positive partnership in traveling the ELF road.

4. Information Return Problems

The Jobs and Growth Tax Relief Reconciliation Act of 2003 cut the tax rate to 15 percent for "qualified dividends" received by individuals for tax years 2003 through 2008, the same rate that applies to a net capital gain. The 15 percent rate is not available for individuals who (1) do not meet certain securities holding period requirements and (2) are obligated to make related payments on positions in substantially similar or related property.

Compliance with the new 15 percent dividends tax rate has proved to be the biggest challenge for taxpayers and practitioners during the current filing season. Brokerage firms and mutual funds are having major difficulties determining which dividends that a taxpayer receives qualify as a "qualified dividend" and the new 15 percent tax rate, resulting in large numbers of erroneous Forms 1099–DIV being mailed by financial institutions to taxpayers. This situation is causing havoc for many taxpayers and practitioners.

Many taxpayers filed their Form 1040, only to receive an amended Form 1099–DIV from a financial institution after the fact from a financial institution. The taxpayer and preparer are faced with the dilemma as to whether an amended return should be filed; or whether the earlier filed return remains a realistic and reasonable "snapshot" of the taxpayer's tax position for 2003 and therefore, obviating the need to file an amended return. Unfortunately, there is nothing to say that the same taxpayer will not receive a third generation of corrected Forms 1099–DIV.

We have also received reports that "eligible education institutions" also are having difficulty providing "correct" Forms 1098–T (Tuition Statement) to students. This form reports the amount of qualified tuition and related expenses that a student is required to pay when enrolled at an eligible education institution. A number of AICPA members have informed us that education institutions are making a number of mistakes on the Form 1098–T, including (1) incorrectly including income on the information return and (2) reporting inaccurate education tax credit information. Practitioners suggest that the instructions and tax regulations for the Form 1098–T are not fully developed, and that the eligible education institutions are not generally experienced in tax compliance.

The AICPA stands ready to work with Congress and the IRS to develop procedures to minimize processing burdens placed on taxpayers and practitioners to ensure proper compliance with the new dividend law, as well as the filing and processing of Form 1098–T.

5. Tax Practitioners and Professional Responsibility

The AICPA commends the IRS and Treasury for its efforts to address the professional responsibility standards of tax professionals in general, and particularly with respect to the eradication of abusive tax transactions. We are encouraged by Commissioner Everson's commitment to upgrade the Office of Professional Responsibility; and we are pleased to have had the opportunity to testify at the February 19, 2004 IRS hearing on the proposed amendments to Circular 230 involving tax opinion standards.

We have a longstanding track record of establishing professional standards for our CPA members. The AICPA has adopted and has in place a Code of Professional Conduct, as well as enforceable *Statements on Standards for Tax Services* (SSTSs). Both the Code of Professional Conduct and the SSTSs provide meaningful guidance to CPA members in the performance of their professional responsibilities. We believe compliance with professional standards also confirms the public awareness of the professionalism that is associated with CPAs as well as the AICPA.

The AICPA has a clear position on abusive tax transactions—they should be eradicated. We have consistently supported the protection of the public interest and prohibitions on the misuse of our tax system. Our enforceable SSTSs are a clear example of this. We continue to be actively engaged in proposing and evaluating various legislative and regulatory measures that are designed to identify and prevent taxpayers from undertaking, and tax advisers from rendering advice on, transactions having no purpose other than the reduction of federal income taxes in an abusive manner.

Through our Tax Executive Committee, over the last several years, we have shared with Congress and relevant regulatory bodies our recommendations to help them deal with misuse of the tax code through inappropriate tax avoidance transactions. The conceptual framework of our solution is built on our belief that the

most effective way to combat abusive tax shelters, without interfering with a taxpayer's right to legally minimize taxes, is through disclosure.

We support the objectives of the (final) tax shelter/reportable transaction regulations issued by the Treasury Department on February 28, 2003, regulations that have existed in various forms (Proposed, Temporary) for several years. In specific, these regulations strive to (1) identify and shut down abusive tax avoidance transactions and (2) provide greater clarity; which, if met, will trigger enhanced taxpayer and promoter responsibilities and obligations—accomplished principally through disclosure.

In addition to any governmental sanctions under the February 2003 reportable transaction regulations, our own disciplinary process will be (and has been) invoked where our rules of professional conduct, including the enforceable *Statements on Standards for Tax Services*, are violated. Tax practice by AICPA members has always been subject to the Institute's Code of Professional Conduct. Most recently, the AICPA adopted an Interpretation to SSTS No. 1, which discusses a member's ethical obligations and responsibilities in connection with *tax planning*. The Interpretation clarifies how the standards would apply across the tax practice spectrum, including situations involving tax shelters (regardless of how that term is defined).

On the issue of tax return outsourcing, the AICPA's Professional Ethics Executive Committee appointed a task force in January 2004 to consider what changes, if any, should be made to our Code of Professional Conduct in connection with the use of third party providers; and we are currently awaiting the task force's recommendations on the matter. Also, in the March 2004 *Journal of Accountancy*, we have published an article entitled, "Legal and Ethical Considerations Regarding Outsourcing," authored by Alan W. Anderson, AICPA Senior Vice President—Member and Public Interests, and Richard I. Miller, AICPA General Counsel and Secretary.[1]

The Journal of Accountancy article provides our CPA members with guidance regarding the *current* state of the ethical and legal climate surrounding the outsourcing issue. Concerned CPAs have inquired about their professional responsibilities regarding the use of third party providers in the performance of professional services. This AICPA article responds to their questions.

The AICPA first addressed the use of third-party service providers in 1973, in response to the then-new practice of computerizing tax return preparation. (See Ethics Ruling No. 1, AICPA Code of Professional Conduct Rule 301.) Then, as now, to satisfy their professional responsibilities, our members should investigate and be satisfied with a third-party provider's competence, quality controls, security controls, and confidentiality controls. But, regardless of who the CPA teams with to provide the service, the CPA always remains fully responsible for the accuracy and completeness of the services, the confidentiality of client information, and to assure the services are performed with due professional care. The article also reviews the privacy notification regulations under the Gramm-Leach-Bliley Act, and the Internal Revenue Code prohibition on inappropriate disclosures of tax-related information (section 7216) and client confidentiality requirements (section 7525).

6. Tax Simplification

The AICPA believes that one of the best ways of ensuring a positive tax filing season for taxpayers, practitioners, and the IRS is through the passage of major simplification of the tax laws. We encourage the Administration and the Congress to continue to make tax simplification a major legislative priority.

Mr. Chairman, the AICPA supports your tax simplification bill (H.R. 22), the *Individual and Small Business Tax Simplification Act of 2003.* While the AICPA supports outright repeal of the alternative minimum tax, we believe the AMT simplification provisions of your legislation should provide taxpayers with meaningful burden reduction and relief from tax law complexity. Also, we support the provisions of H.R. 22 that (1) accelerate the repeal of the phase-outs for personal exemptions and the limitation on itemized deductions and (2) simplify and harmonize the definition of "child."

We have worked closely with the American Bar Association and the Tax Executives Institute to jointly identify specific proposals for simplification. Tax simplification should result in fewer errors on tax returns. Also, we believe tax simplification should mitigate many taxpayers' reliance on vague, contorted interpretations of the law that have resulted in the marketing of abusive transactions.

The AICPA is similarly encouraged by the Administration's inclusion of simplification proposals in its fiscal year 2005 revenue proposals. The Administration's pro-

[1] *Journal of Accountancy*, Vol. 197, No. 3 (March 2004); http://www.aicpa.org/pubs/jofa/mar2004/miller.htm.

posals should result in meaningful simplification of the tax laws for families by (1) providing for a uniform definition of a child, (2) eliminating the income related phase-outs for the adoption credit and exclusion, and (3) abolishing the household maintenance test for "head-of-household" filing status.

Thank you for the opportunity to share these views with you.

Chairman HOUGHTON. Thank you very much, Mr. Zarzar. Mr. Leimbach.

STATEMENT OF JAMES D. LEIMBACH, ENROLLED AGENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS, PANAMA CITY, FLORIDA

Mr. LEIMBACH. Mr. Chairman, I am deeply honored today to present this statement on behalf of the 10,000 members of the National Association of Enrolled Agents (NAEA), the professional society of Enrolled Agents. I am James Leimbach, and I became an Enrolled Agent in 1997 while on active duty in the United States Air Force. My wife, Kelly, and I jointly operate a private practice in Panama City, Florida, where we work with both individual and small business taxpayers in the preparation and electronic filing of their returns. I also represent taxpayers before the IRS.

With regards to filing season readiness, overall, filing season has run very smoothly. At the beginning of the season, however, we did experience processing problems in e-filing. Practitioners received a number of erroneous reject notices from overwhelmed e-filing centers. During this period, the IRS' Quick Alert e-mail system provided practitioners immediate notification of these problems, and it was invaluable. This information allowed us to plan around the problems as we were notified of them. Many practitioners also rely on an IRS CD–ROM or Volume 2 of Package X to get their updated forms and publications. It is particularly important for practitioners who live in areas where they do not have access to high-speed Internet service. Unfortunately, the products didn't arrive until as late as February 20th.

NAEA has long supported full funding of the IRS. We believe that a properly resources IRS can efficiently process tax returns, collect taxes, and resolve taxpayer problems. For far too long, IRS has been hamstrung by its legacy computer system. NAEA realizes that billions of dollars have been poured into the modernization effort. I am here today to tell you that it has not been in vain, as I am one of 14 NAEA members testing the new suite of e-services products allowing us to represent taxpayers electronically. In January of this year, the IRS reached a major milestone in the development of new electronic capabilities that will revolutionize the way we as tax practitioners will conduct future business with the IRS.

This new electronic capability, which I prefer to call "e-representation," will enable tax practitioners to quickly resolve their clients' IRS individual or business account problems via the Internet in a secure environment. It has taken the IRS 7 years to reach the point we are at today, and based on my experience in computer technology, I do not find that unusual in the least. The difficulty in integrating a sixties-era mainframe with the Internet and doing so in an environment using highly complex encryption is enormous, costly, and worth every effort and every dime spent. This new e-

services capability is truly going to revolutionize the way we conduct business with the IRS in resolving taxpayer problems.

Under the new suite of e-services products called Disclosure Authorization, Transcript Delivery System, and Electronic Account Resolution, I have the ability 24 hours a day, 7 days a week, to submit processing requests to the IRS' computer system. This access provides me instant processing of my power of attorney submittals and instant processing of my requests for crucial transcripts. It also allows me to submit proposals for problem resolution at any time I choose. When you combine the capabilities of Disclosure Authorization, Transcript Delivery System, and the Electronic Account Resolution, the end result is phenomenal e-representation capability. This will truly revolutionize the way we do business with the IRS.

Even though these products are undergoing testing and are not yet ready for nationwide deployment, NAEA has concerns about the future of this new capability. Our concerns are regarding Enrolled Agents that will be denied access due to the 100 e-file requirement established by the IRS; limitation on the types of issues that can be addressed electronically; granting full access of e-services to unenrolled tax preparers; potential results from premature nationwide deployment. Aside from these concerns, NAEA understands, respects, and supporting the need for more e-filing of tax returns. We also believe in leading by example. Therefore, we respectfully would like to make the following suggestion: The IRS needs to lead by example when promoting e-filing to the tax practitioner community. They can do so easily by requiring all IRS employees to e-file their personal and individual returns.

With regards to regulation of commercial preparers, I have included NAEA's recent statement before the IRS Oversight Board on the proposed regulation of commercial tax preparers. This is not my area of expertise, but NAEA would be pleased to provide a written response to any questions in this area. Mr. Chairman, it truly is a pleasure and an honor to be able to have shared with you our members' views, and if I may be able to answer any of your questions, I would be very delighted. Thank you.

[The prepared statement of Mr. Leimbach follows:]

Statement of James D. Leimbach, Enrolled Agent, National Association of Enrolled Agents, Panama City, Florida

Mr. Chairman and members of the Oversight Subcommittee, I am deeply honored today to present this statement on behalf of the National Association of Enrolled Agents (NAEA), the professional society of Enrolled Agents.

I am James Leimbach, and I became an Enrolled Agent in 1997 while on active duty in the United States Air Force. My wife, Kelly, and I jointly operate our private practice in Panama City, FL where we work with both individual and small business taxpayers in the preparation and electronic filing of their returns. I also represent taxpayers before the IRS for problem resolution. I believe you already have a copy of my biography in your notebook.

Today, I am representing NAEA whose 10,000 members are tax professionals licensed by the U.S. Department of Treasury to represent taxpayers before all administrative levels of the Internal Revenue Service (IRS).

Enrolled Agents were created in 1884 to ensure ethical and professional representation of claims brought to the Treasury Department. Members of NAEA ascribe to a Code of Ethics and Rules of Professional Conduct and adhere to annual Continuing Professional Education standards that exceed IRS requirements.

Like attorneys and CPAs, we are governed by Treasury Circular 230 in our practice before the IRS. We are the only tax professionals who are tested by the IRS on our knowledge of tax law.

Each year, we collectively work with millions of individual and small business taxpayers by providing tax preparation, tax planning, representation, and other financial services. Consequently, Enrolled Agents are uniquely positioned to observe and comment on the average American taxpayer's experience within our system of tax administration.

Filing Season Readiness

Overall, filing season has run very smoothly. NAEA members did experience some processing problems in e-filing during the opening of filing season. Practitioners received a number of erroneous reject notices from overwhelmed filing centers. Most software companies were able to quickly recover. I would have to praise IRS for its Quick Alert system by which practitioners can receive e-mailed notices of problems. Information is the key. If we have it, we can plan around it.

A greater problem occurred with late delivery of the IRS 2003 CD–ROM. Many practitioners rely on this to get their updated forms and publications. It's particularly important for practitioners who live in areas where they don't have access to high speed Internet service. Unfortunately, some practitioners reported that they didn't receive their CDs until as late as February 20, long after the start of filing season.

Another problem involved distribution of Volume 2 of Package X, a paper bound volume which contains essential tax forms and instructions. Some NAEA members reported that their copy did not arrive until mid February which is far later than normal.

In both cases, these glitches are unfortunate because these are tools practitioners have come to rely upon to get their tax returns prepared accurately. We hope that this lateness will not be repeated.

IRS Budget and Modernization: E-Services: Electronic IRS Representation

NAEA has long supported full funding of the IRS. We believe that a properly resourced IRS can efficiently process tax returns, collect taxes, and resolve taxpayer problems. For far too long, IRS has been hamstrung by its legacy computer system. NAEA realizes that billions of dollars have been poured into the modernization effort. I am here today to tell you that it has not been in vain as I am one of 14 NAEA members who is testing the new Electronic Account Resolution Service (EAR). I have attached two *EA Journal* articles which explain the EAR program.

In January of this year, the IRS reached a major milestone in the development of new electronic capabilities that will revolutionize the way we, as tax practitioners, will conduct future business with the IRS. This major milestone involved using real taxpayers in the final testing of the suite of new capabilities that will be available through the IRS' e-services secure Web site this year. I was very pleased and honored to have been chosen by the IRS to be the first tax professional to use this new e-services capability. The new suite of e-services products, which will allow tax practitioners to represent their clients electronically and in a highly secure environment, has left me utterly speechless. I can assure you that I do not make that statement lightly.

This new electronic capability which I prefer to call "E–Representation," will enable tax practitioners to quickly resolve their client's IRS individual or business account problems via the Internet in a secure environment. The goal of the IRS is to provide a response to the tax practitioner within three business days versus the weeks and months we currently experience.

It is important to note that the effort to provide this capability has been ongoing since November 26, 1997, when the Electronic Tax Administration (ETA) released a Request for Agreement to which NAEA responded. NAEA submitted a proposal that members be provided the capability to resolve exam and collection issues with the IRS via secure email.

In response, the IRS established a working group in July 1998 that determined it would be expedient to provide the capability to address electronically the types of account and notice issues normally resolved by the IRS' Customer Service sites.

From that 1997 NAEA initiative, the IRS in February of 2000 launched a prototype secure Web site that would be used to develop and test the concept of electronic representation and was the forerunner of the final secure Web site that will be implemented nationwide this year. The prototype was called the Practitioner Secure Messaging System (PSMS) and it provided NAEA members with the ability to securely resolve account and IRS notice related issues.

After two years of extensive testing by approximately 450 NAEA members, Terence Lutes, Director of ETA, deemed the PSMS prototype a success. Mr. Lutes stated in his email to the PSMS participants that, "For the *first time* in the history of the Service, we demonstrated the capability to interact securely with our practitioners over the Internet to resolve account-related inquiries."

The PSMS prototype was unfortunately discontinued in May of 2002 due to budgetary constraints, but that did not hamper the IRS' effort with the development of the final secure Web site. Usability Testing of the IRS' final secure Web site was conducted on April 22—23, 2003, by a small group of tax practitioners, myself included.

In January 2004, the IRS reached a major milestone when live taxpayers were represented electronically through the IRS' e-services secure Web site. It has taken the IRS seven years to reach the point we are at today and I do not find that unusual in the least. The difficulty in integrating a 1960s era mainframe with the Internet and doing so in an environment using highly complex encryption is enormous, costly, and worth every effort and every dime spent. This new capability is truly going to revolutionize the way we conduct future business with the IRS. The ultimate beneficiary is your constituent, the American taxpayer. I am truly amazed and thrilled beyond description at this new way of doing business with the IRS and I would like for you to understand why I feel as I do.

Representing taxpayers before the IRS is very challenging due to the complexity of our tax code. It is also very frustrating due to the difficulty we encounter in trying to obtain the necessary information we need in order to resolve the taxpayer's problem and receiving a timely response from the IRS. There are three crucial steps. The first is to establish with the IRS the taxpayer's authority to represent them, which is done via a Power of Attorney. The next step is to obtain the information the IRS has on the taxpayer for the year or years in question. The final step is in receiving the response from the IRS on our proposed resolution for the taxpayer.

In our current way of doing business with the IRS, the first step of establishing the authority to represent the taxpayer is done by either faxing or mailing in the IRS' Form 2848, Power of Attorney and Declaration of Representative or acceptable substitute. An IRS employee then manually enters the POA into the IRS' computer system. The normal turnaround for this to occur is two to three days via fax, and slightly over a week for those that are mailed in to the IRS.

Today, I have the ability, 24 hours a day, seven days a week, to submit directly into the IRS' computer system the POA for instant processing. This electronic version of the POA is called the ***Disclosure Authorization***.

Through Disclosure Authorization, I can also view and modify those POAs that were previously faxed or mailed into the IRS. This is an enormous step forward and one that is certainly going to result in a cost savings to the IRS by reducing the manpower needed to manually input those POAs into the IRS' computer system.

The next step is to request transcripts, which are printouts of the taxpayer's account reflecting pertinent actions that have been recorded by the IRS. For example, these actions would include the date a tax return was received by the IRS and tax assessed, the detailed information on the return, penalties and interest assessed, other crucial dates and the like.

When I first began representing clients before the IRS, the quickest I could ever obtain that information from the IRS was to drive 20 minutes to the local IRS office, stand in line for another 20 minutes, obtain the necessary transcripts, and then drive 20 minutes back to my office. I was fortunate in that the IRS office was only 20 minutes away. Others are not as fortunate as I am and they end up having to use either mail or fax services which can take days to weeks, sometimes months, to receive those crucial transcripts.

With very rare exceptions, I simply cannot represent a client before the IRS without transcripts.

Today, I have the ability, 24 hours a day, seven days a week, to submit directly into the IRS' computer system a request for that crucial transcript. This capability within the IRS' e-services Web site is known as the ***Transcript Delivery System***.

The process of preparing the Transcript Delivery System submittal takes about one minute. Once I submit the request, the transcript is delivered immediately. I now find it takes me longer to print the transcript than it does to receive it from the IRS. This remarkable capability leaves me speechless.

The cost savings to the IRS because of TDS will be significant. The tax practitioner is going to be thrilled beyond words, and the taxpayer will be the ultimate beneficiary in that his or her representative can begin addressing their IRS issues more quickly than ever before.

The final step in resolving the taxpayer's IRS problem is receiving a timely response from the IRS to our proposed solution. This is the most frustrating aspect

for the taxpayer when he or she is told to expect an IRS reply in several weeks if we are lucky; but more than likely it will take months before we have an IRS reply.

These taxpayers are very anxious for their problem to be resolved and I am unable to adequately describe the anguish I have witnessed that some of these people go through waiting for their IRS problem to finally come to an end.

Today, I have the ability at any time of the day or week to submit directly to the IRS's Customer Service Representative our proposed resolution. This capability within the IRS' e-services Web site is known as ***Electronic Account Resolution***.

The IRS' goal is to provide a response to our Electronic Account Resolution submittal within three business days. That has been achieved.

When you combine the capabilities of Disclosure Authorization, Transcript Delivery System, and Electronic Account Resolution, the end result is phenomenal e-representation capability. This is going to revolutionize the way we do business with the IRS; it will result in cost savings in the days to come; and it will have a significant positive impact on taxpayers dealing with perhaps the most stressful and agonizing experience of their lives, running afoul of the IRS.

All of this testimony is not to imply that the system is working flawlessly, it is not. The system is undergoing the final stages of testing for security, disclosure, and privacy issues. Users are encountering some processing problems and this is the normal result for such a complex project as Disclosure Authorization, Transcript Delivery System, and Electronic Account Resolution. Those processing problems are being identified and resolved which is the whole intent of this final testing stage. I witnessed the same while in the U.S. Air Force with the new technology they brought into operation.

Much like a child who is learning to take his first few steps, this new capability will encounter some stumbling and an occasional bruising of the knees. So long as the tax professional community is allowed and encouraged to help nurture and guide the maturing of this new capability, I foresee e-representation becoming the standard way of practice when resolving taxpayer problems.

Like any parent with a newborn child, concerns for the future will arise and the tax professional community has already recognized concerns about the future of this new capability.

Concerns of NAEA Members:

The ability to electronically represent taxpayers through the e-services Web site is limited by the IRS to only those tax practitioners who e-file more than 100 individual returns in a season. The intent of the IRS is to offer this extraordinary capability as an incentive to tax practitioners who continue to prepare returns and file them in paper format to start incorporating e-filing into their practices. It is working. I have seen tax practitioners who were adamantly opposed to e-filing incorporate e-filing into their practice solely upon hearing about this new capability.

Enrolled Agents Denied Access:

The unfortunate aspect of the IRS' decision to restrict this capability to only those tax practitioners who meet the e-file requirement is that many of our most experienced and knowledgeable tax professionals will be denied this access because they do not prepare returns. Their sole focus is on IRS representation. Another type of tax professional is one who prepares far fewer than 100 individual returns and will never meet the e-file requirement.

This will be a huge travesty that will adversely affect thousands of tax professionals and millions of taxpayers if left unresolved.

Limitation of Problem Resolution Issues:

Another concern we have is the level of issues that can be addressed electronically through the Electronic Account Resolution element of e-services. Issues that are currently being handled by the collections and under reporter entities within IRS cannot be addressed through Electronic Account Resolution. This represents a large segment of our workload that will continue to be handled in a less efficient manner and it does not need to happen. A possible remedy would be either expanding the level of authority and responsibility of the Customer Service Representative responding to the Electronic Account Resolution submittals or integrating both collections and under reporter entities within e-services. Either of which need to be done soon since not being able to address collection and under reporter issues will undermine to some degree the intent of this new way of doing business; namely, the timely resolution of taxpayer problems and encouragement of tax practitioners to e-file.

Access Granted to Unenrolled Tax Preparers:

Allowing unenrolled tax preparers who have no training, experience, or knowledge in IRS representation full access to the e-services capabilities while at the same

time denying access to highly-trained, experienced, and knowledgeable tax professionals is nothing more than a disaster just waiting to happen. Aside from the huge uproar you can expect to hear from the tax professional community about this inequity, unenrolled tax preparers pose a significant problem. In all states except California and Oregon, all it takes to declare yourself a tax preparer is to hang out a shingle. There are no CPE requirements, no code of ethics, no disciplinary action by IRS, except loss of ERO status if the individual is an e-filer. The end result is they can potentially bog the Electronic Account Resolution capability with frivolous and wasteful submissions thereby denying the tax professional the attention of the Customer Service Representative in a problem resolution submission that is based on sound knowledge of tax law and regulations.

NAEA would strongly urge you and the IRS to at the very least limit the Electronic Account Resolution portion of e-services to just Circular 230 tax practitioners—Enrolled Agents, CPAs, and attorneys.

Lead by Example:

The IRS needs to lead by example when promoting e-filing to the tax practitioner community. They can do so easily by requiring all IRS employees to e-file their personal individual returns. If this suggestion were to be adopted, then it would need to be promulgated to the tax practitioner community and NAEA believes it would have a positive impact on the tax practitioners' perception of the importance of e-filing.

Premature Nationwide Deployment:

NAEA is concerned that disastrous results may occur due to a premature deployment of this new capability. It is imperative that the actual deployment of this new capability only occur after all involved in its development have had an opportunity to voice—in an environment free from coercion—any and all problem areas they feel could undermine the success of this long and expensive effort. Much like Mission Control at the Kennedy Space Center prior to a launch, everyone has an opportunity to give a "go" or "no go" from their respective areas. Without such input from all involved in the development, we could be setting ourselves up for disastrous consequences.

Regulation of Commercial Preparers

At this point, I would like to include NAEA's recent statement before the IRS Oversight board in my testimony. NAEA is aware of S. 882, the Tax Good Government Act which includes a proposal by National Taxpayer Advocate Nina Olson on registration and regulation of commercial preparers. The NAEA statement follows:

"The members of NAEA are dedicated to the integrity of the tax system and the roles professional responsibility and ethics play in preserving that integrity. It therefore is disturbing to us that there is an increase of taxpayer belief that tax returns will be accepted regardless of the facts reported on them. This growth principally emanates from the declining rate of audits conducted on returns in recent years. It seems that a great number of taxpayers have been lulled into concluding that gaming the system and playing the audit lottery are acceptable behavior. A recent Gallup survey of taxpayers found that there is a marked increase in taxpayers feeling it is all right to cheat on their tax returns. An obvious centerpiece concern in this respect is that promoters and some tax professionals are selling a wide range of tax schemes and devices designed to improperly reduce taxes based on the simple premise that they can get away with it. It is clear that addressing this concern is needed. However, its resolution undoubtedly will not be limited to such schemes and devices.

"The IRS has undergone major changes in the last several years. Former Commissioner Rossotti's reorganization of the IRS and the emphasis he placed on customer service may in part have been a catalyst in modifying taxpayer attitude. Most agree that his initiatives were good, were consistent with the 1998 IRS Restructuring and Reform Act, and have produced a better IRS. However, their implementation resulted in resources being shifted away from enforcement activities. Other contributing factors include discontinuance of the Taxpayer Compliance Measurement Program (TCMP), ineffective technology, and tax law complexity.

"Commissioner Everson has begun efforts to turn that around. While he acknowledges that customer service plus enforcement equal compliance, he has announced that effective enforcement of the tax laws rather than further improving customer service will be the main focus of his administration. In this connection, he implicated the tax practitioner community in the diminishment of compliance and challenged all practitioners to raise their ethical standards in order to avoid actions being taken against them by the government. While much of this was done in regard to abusive tax schemes, it seems clear to NAEA (and we believe him) that his

efforts will not stop there. For example, at a November [2003] meeting of the IRS Advisory Council (IRSAC), he was asked what IRSAC could do to help his enforcement endeavor. The IRSAC members were told in essence to stress the important role practitioners play in making our tax system work as it should. He did not limit his response to abusive tax schemes. Recent amendments to the regulations governing practice before the IRS (Circular 230) bear this out. The increased staffing in the Office of Professional Responsibility, the office that enforces those regulations, emphasizes his intent. Very recent proposed amendments to Circular 230, designed primarily to deal with abusive tax schemes, contain a "best practices" section that appears to address all aspects of tax advice and return preparation, which is further evidence of the role ethics play in our tax system. In addition, Mark Matthews has joined the IRS as deputy commissioner for services and enforcement. Mr. Matthews has a strong enforcement background, including having served as director of the IRS Criminal Investigation Division. Cono Namorato recently was appointed Director, Office of Professional Responsibility, replacing the incumbent who was in office for just one year. We surmise that it is Mr. Namorato's enforcement experience that resulted in his entry into the Office of Professional Responsibility and further evidence of the Commissioner's resolve.

"Other initiatives, such as the replacement of TCMP by the National Research Program, enforcement programs being implemented in all four divisions of the IRS, and the recent announcement by the Commissioner of reallocation of human resources in order, in part, to complement his enforcement mandate, help round out the conclusion that cannot be escaped. He means business.

"All who provide tax services must be cognizant of the strong enforcement component of tax compliance. It has the possibility of touching every aspect of tax advice and return preparation. Consequently, the topic of this panel at today's meeting is both important and timely.

"NAEA finds that commercial return preparers are an enigma in today's tax practice world. We all seem to know there are problems in connection with services performed by paid preparers, but in many respects those problems are unknown and the product of anecdotal information and conjecture.

"The first order of business is to define commercial return preparers. We define them as those (1) who prepare federal tax returns for a fee and (2) who are not required to possess any knowledge of tax law and procedure. At the state level, only California and Oregon regulate commercial tax return preparers and it is unlikely that there will be a significant increase in states engaged in that type of program in the future.

"The number of commercial preparers is not known with any accuracy, but estimates of upwards of 1 million individuals have been bandied about. With 55% of returns having been prepared by someone other than the taxpayers in 2001 and perhaps even more in 2002 and 2003, it seems safe to conclude that the number of returns prepared by commercial preparers is considerable and growing. A great number of these commercial preparers probably work in a structured environment, such as being with a return preparation chain, or those who are entrepreneurs in the tax business. Others undoubtedly are seasonal tax return preparers who set up shop in January and close them down in April—sometimes referred to as "card table jockeys." Still others may be somewhere in the middle. Even if we had the numbers, we do not know the extent of training, if any, many of the commercial preparers have had and the manner in which they keep abreast of the changes in tax laws and procedures. Perhaps of greatest concern is the belief the public is not aware of the fact that many commercial preparers have no credentials. This may in part be the reason taxpayers "shop" for preparers who will prepare tax returns the way taxpayers wish them to be prepared (often unsigned by those preparers), to the detriment of responsible return preparers and the integrity of the tax system.

"NAEA understands that tax return preparer penalties asserted in recent years have been minimal in number as related to the apparent potential for such penalties. Those that have been imposed in large measure have not been collected. We also know that attempts to implement recognition procedures in the electronic filing area, i.e. electronic filer originators (EROs), have been the subject of criticism due to systemic problems in background checks and the like as documented in the Treasury Inspector General for Tax Administration (TIGTA) report of June 2002. Further, many of the problems in the Earned Income Tax Credit (EITC) program are attributable to paid preparer involvement. Again, there does not seem to be a great deal of empirical data to support a conclusion as to the number of commercial preparers involved in the program and whether or not they do a consistently worse job than other preparers, even though there have been some informative and well-written white papers on the subject.

"Last year the National Taxpayer Advocate recommended in her report to Congress that there be a program to register commercial return preparers. It was an extremely ambitious program and one that would be expensive to establish and run. The IRS disagreed with the recommendation citing, among other factors, the expense of the program and that the issue is one for states to address rather than the federal government. NAEA believes there are problems both with the recommendation and the IRS response. We understand that Ms. Olson plans to propose more rigorous penalties and liability for commercial EITC preparers. While it may be unfair to opine on this year's proposal since we have not seen it, a threshold concern is the basis for believing that the IRS will be more successful than it has been in the past in collecting the penalties, buying into the program, and/or putting the troublesome violators out of business.

"So what is the solution? There does not seem to be an easy one. We don't have hard facts. The available data is said to be inconsistent. Attempts to address the issues have not been successful. The IRS in fact may not be interested in the subject at this moment in time. Attempts by former advisory groups to come to grips with commercial preparer issues have met resistance. While there was support for a commercial preparer program by the National Commission on IRS Restructuring, it was removed from its final report. In addition, legislation sponsored by Senator Bingaman of New Mexico appears not to have gone anywhere. A recommendation by last year's IRSAC did not endorse a course of action for recommendation to the Commissioner, even though a subgroup supported a preparer certification program that would enhance the competency of individuals or firms that prepare tax returns for a fee.

"In spite of all the above, NAEA supports Ms. Olson's quest, if not her vehicles for achieving it. If left unchecked, the perceived problems will continue to grow. In this connection, we believe the IRSAC Wage & Investment and Small Business/Self Employed subgroup reports warrant favorable consideration. In particular, the SB/SE subgroup's belief that the IRS should begin working with outside stakeholders to develop a program after examining a number of the "unknowns" would be beneficial.

"NAEA subscribes to the belief that ethics are the fabric that holds a profession together. In the tax arena, Congress has identified those who qualify as federally-authorized tax practitioners (FATPs), i.e., Enrolled Agents, Attorneys, and CPAs. All are licensed individuals whose professional practice is circumscribed by codes of professional conduct and continuing education requirements. NAEA, of course, believes that the most meaningful step in overcoming the commercial preparer issues is to have all preparers attain Enrolled Agent status. Perhaps our Attorney and CPA colleagues have similar aspirations.

"With the above said, FATPs have dual loyalties. One, of course, is to their clients. The other is to the tax system itself. NAEA thinks it safe to conclude that all FATPs share the goal of safeguarding the integrity of our tax system and would be willing to work to make that happen. A possible beginning to assist the IRS in this respect is to form a task force comprised of representatives from the Enrolled Agent, attorney, and CPA organizations to work with the Service and others to help make this happen. NAEA would be pleased to head a practitioner organization steering committee to do this. Other organizations, individuals, academicians, and the like with similar goals could be invited to participate to the extent that the numbers would be manageable.

"We are eager to move off dead center in our support of overcoming the frustrations we all share with respect to the unknown factors relative to the issue and doing our part in establishing a program evidencing ethics as a vital part of our tax system's integrity."

Conclusion:

Mr. Chairman and members of the subcommittee, I am pleased and honored to have been able to share with you our members' views. If I may answer your questions or provide you with any additional information, it would be an honor and my pleasure to do so.

Thank you.

Lend Me Your Ear

By James Leimbach, EA

For Enrolled Agents, the word "ear" will be taking on a whole new meaning next spring when the IRS unveils, nationwide, to tax professionals the "Electronic Account Resolution" program (EAR).

EAR will, quite simply, enable tax professionals to quickly resolve their clients' IRS individual or business account problem(s) via the Internet in a secure environment. EAR will be one of several electronic services available through the IRS' e-services Web site. The technology has been available for quite some time now; implementing it, though, was easier said than done.

Thanks mainly to the more than 250 Enrolled Agents that participated in the IRS' prototype named Practioner Secure Messaging System (PSMS), that capability is now becoming a reality.

The PSMS—launched in February of 2000—was the test project designed to precede the nationwide implementation of the EAR program. PSMS participation was limited to only EAs who met, among other criteria, a high level of involvement in the e-file arena. The prototype testing involved test-case scenarios as well as live cases submitted by EAs. As can be expected with the implementation of any new security intensive Internet technology, problems did arise. The intent of PSMS was to identify and develop the procedural and software corrections for the problems encountered.

"For the first time in the history of the service, we demonstrated the capability to interact securely with our practitioners over the Internet to resolve account-related inquiries" wrote Terence H. Lutes, Director of Electronic Tax Administration (ETA) in his email to the PSMS participants. Unfortunately, due to budgetary constraints, the IRS was forced to discontinue the PSMS prototype on May 1, 2002. Initially, the EAR program was scheduled for nationwide implementation this fall; however, due to the demands of project management and testing, the IRS found that a more realistic date will be after the 2003 filing season.

Operating the prototype was invaluable not only for the IRS, but also for EAs. The EA profession was the only one selected to participate in the prototype testing of what will have a profound impact on all tax professionals in future representation before the IRS.

Unlike PSMS, EAR will be much easier to use. The PSMS system required users to download and install a Digital ID on their computer. The IRS' PSMS web site then used the Digital ID to ensure that the user connecting to the site was in fact authorized access. Without the Digital ID, nothing could be accessed on the PSMS Web site, not even the home page.

In addition to the Digital IDs required, all users had to install Rivest-Shamir-Adleman (RSA) Security Keys on their computers. The RSA Security Keys were required in order to decrypt the encrypted email the IRS sent in reply to the user's PSMS submission.

Instead of Digital IDs and RSA Security Keys, the EAR system will utilize a transparent version of the Secure Sockets Layer (SSL) software—an IRS issued PIN number and password. Users will go to the IRS' e-service site and simply log on. The elimination of Digital IDs and RSA Security Keys was a major improvement in streamlining access for users, particularly for AOL users.

A significant problem encountered with the PSMS system for AOL users was the encrypted email they received. The AOL software was unable to handle decrypting the IRS' email due to it being in a Secure/Multipurpose Internet Mail Extensions, (smime).p7m format. This major roadblock required AOL users to set up a separate email account with another email service such as Microsoft's Hotmail and use other software such as Microsoft Outlook Express in order to access and read the encrypted email.

All of those previous PSMS security problems will be eliminated with the use of SSL, IRS issued PINs, and passwords. To be sure, security is a paramount issue for the IRS in implementing the EAR program. By utilizing SSL encryption, the IRS' security concerns have been resolved. Users will log on to the EAR system via a transparent security system and retrieve their IRS email response(s) from a secure mailbox.

As with the PSMS system, EAR will require the user to have a Form 2848, Power of Attorney (POA) or equivalent on file with the Centralized Authorization File (CAF) system prior to being granted access to a client's account.

To handle the POA requirement, the PSMS system had a dedicated fax machine for its users. After transmitting the POA, users would usually have to wait 1—3 days for the POA to be manually input into the CAF system before being able to address a client's account electronically.

With the EAR system, users will access the IRS' Web site, prepare a Disclosure Authorization (DA) application which is an electronic alternative for submitting a POA. Once the form has been filled out completely, the user hits "Submit" on the screen, and the DA is immediately processed into the CAF system. Practitioners will then be able to immediately access their clients' accounts electronically with no waiting.

Another constraint for PSMS users was the inability to electronically obtain IRS transcripts such as an IRP, IRMF, etc. The Transcript Delivery System (TDS), which is a separate IRS e-service from EAR, will resolve that problem by enabling practitioners to obtain transcripts from the IRS' secure Internet site.

The TDS system is planned for implementation at roughly the same time that the IRS unveils the EAR Program in 2003. TDS will not be a direct part of the EAR system, but instead a separate electronic option.

The ability of a tax professional to resolve a client's IRS account problem in a matter of hours via the Internet as opposed to weeks or months using the postal system is worthy of every EA's attention.

With the nationwide implementation of the EAR, DA, and TDS systems, tax professionals will be able to have POAs processed immediately into the CAF system, obtain transcripts in a matter of minutes, and resolve client account problems in a matter of hours.

As a client with an IRS account problem, which of the following would you rather engage:

1. A tax professional who estimates 4—8 weeks (or more) for resolution of your IRS problem?

   OR

2. An EA who estimates a few hours to resolve your problem?

This is a major change for our profession and it is one that we can all participate in and help nurture to become what our clients, the IRS, and we need.

The bottom line is that ⅔ of the EAR name already has our EA credential in it. We, as EAs, need to take advantage of this golden opportunity.

About the Author:

James D. Leimbach, EA (USAF Ret.) is a retired U.S. Air Force Senior Master Sergeant who obtained his EA credential while on active duty. While in the USAF, he held positions as Superintendent of Operations, Chief of Computer Operations, Chief of Systems Control, Database Manager and various other computer operations and programming positions. His practice provides tax preparation, e-filing, IRS representation, with a special focus on military clients. He was the 36th person selected to participate in PSMS.

EA Journal

Electronic Account Resolution (EAR) Update Are You Listening?

By Jim Leimbach, EA

A new client came in today. We'll just call him Mr. Joe Smith. He's single with no dependents. He came in with a letter from the IRS, Letter Number 2566 (SC/CG) a "Proposed Individual Income Tax Assessment." Mr. Smith had lost the tax calculation summary that had been sent with the letter, so I did not know what the basis was for the proposed tax assessment.

While Mr. Smith was in my office, I informed him that in order for me to address his problem with the IRS, I would need his permission to represent him. He concurred that was what he wanted and I then accessed the IRS' e-services, secure Web site. From there, I selected the Disclosure Authorization (DA) product and I then asked him to sign the electronic version of the Form 2848, Power of Attorney and Declaration of Representative (POA) called a DA.

He first entered in his AGI, AGI year, and date of birth to authenticate who he was, and then entered his electronic signature which was done by entering in a self-selected PIN he made up. I also electronically signed the DA by entering in my Centralized Authorization File (CAF) Number, my password for accessing the IRS' e-services Web site, and then my self-selected PIN. After hitting the "Send" button, it took about five seconds for me to obtain confirmation that the DA had been successfully processed into the CAF system.

I then informed my client that I needed to obtain a transcript showing all the income he had received during the year in question in order to ascertain the correctness of the proposed tax assessment. While he was in my office, I submitted a "Wage and Income Documents" transcript request from the Transcript Delivery System (TDS) portion of the e-services Web site for the year in question.

There were two choices in how I could receive the transcript: the first choice was to have it displayed on my screen and the other choice was to retrieve an IRS email response from my secure (encrypted) mailbox on the e-services Web site. I chose to

have it displayed on my screen since I would still be able to print it when displayed. After hitting the "Send" button, it took approximately one minute to receive the transcript.

I printed all six pages and after reviewing the information, concluded the proposed tax assessment was correct. My client owed $7,890 but he was not in any position to pay the full amount. I discussed the options available and we both agreed that an Installment Agreement (IA) was the only alternative available to him.

I went back to the e-services Web site, and selected the EAR product which then allowed me to access the IA feature. I completed our proposed IA and I explained to my client that it could take up to three business days for a response on the IA submittal but that I expected to receive a response later in the afternoon. At the end of the day, six hours after having submitted the IA, I received the IRS approval for our proposed IA via an email I retrieved from my e-services secure (encrypted) mailbox.

Just before going to lunch, a prior client, we'll just call him Mr. Huffy, came in with a CP2000 Notice containing proposed changes to his 2001 tax return. Again, using the e-services Web site, I submitted the DA; obtained transcripts; and after reviewing the transcripts, determined that the CP2000 Notice was in error. The proposed change involved income that had, in fact, been reported on the client's 2001 return.

I logged onto the EAR portion of the e-services Web site and this time I accessed the "Notice" feature which would allow me to address the CP2000 Notice and submit our disagreement with the proposed change. The Notice form provided me plenty of room to describe how the income had in fact been reported in my client's return. After transmitting our "Notice" submittal, I received my onscreen confirmation number which I printed for future reference.

After returning from lunch, I went back to the e-services Web site and retrieved the IRS' response from my e-services secure mailbox concurring that an error had been made and that they were updating my client's account to reflect no change.

All this sounds pretty far fetched doesn't it?

While it did not actually occur, the capability to electronically represent our clients via a secure session on the Internet will be unveiled nationwide late this year, and you can be sure it will have a tremendous impact on the services we provide to our clients.

The IRS' effort to provide Electronic Account Resolution has been on going for several years. It all started back on November 26, 1997 when the Electronic Tax Administration (ETA) released a Request for Agreement (RFA) that NAEA responded to, by submitting a proposal that members be provided the capability to resolve exam and collection issues with the IRS via secure email.

From that NAEA initiative, the IRS, in February 2000, launched a prototype secure Web site that would be used to develop and test the concept of electronic representation and would be the forerunner of the final secure Web site that would be implemented nationwide in 2003. The prototype was called the Practitioner Secure Messaging System (PSMS) and it provided NAEA members the ability to securely resolve account related issues.

After two years of testing by approximately 450 NAEA members, Terence H. Lutes, Director of ETA, deemed PSMS a success. Lutes stated in his email to the PSMS participants that, "For the *first time* in the history of the Service, we demonstrated the capability to interact securely with our practitioners over the Internet to resolve account-related inquiries."

The PSMS prototype was discontinued in May 2002 due to budgetary constraints, but that did not hamper the IRS' effort with the development of the final secure Web site. Usability Testing of the IRS' final secure Web site was conducted on April 22–23 of this year by a group of six practitioners. The following capabilities are those you can expect when the IRS unveils nationwide the Electronic Account Resolution (EAR) Web site and are based on my firsthand experience from participating in the Usability Testing.

Practitioner Qualifications: Circular 230 practitioners (in good standing) must have e-filed 100 or more returns in the latest filing season. **Exception:** The IRS waived the 100 e-file requirement for the PSMS participants.

Practitioner EAR Registration: Practitioners will register over the Internet (via secure session) and submit specific personal tax information. IRS will validate the information, and the practitioner will then obtain a username, password, and PIN. The IRS will send the practitioner a confirmation number by mail and the practitioner must confirm the registration within 28 days.

EAR Services

1. **Disclosure Authorization (DA):** The DA is essentially an electronic version of the Form 2848, POA that is processed directly into the CAF system via the IRS' secure (encrypted) Web site. The data elements needed for the Web site DA pages are the same as those required for the Form 2848 and follow the same flow. The biggest difference is how a client and practitioner sign the form.

For the client to sign, the practitioner will need to ensure the client has the following:

- AGI (from any return filed in the last three years)
- AGI Year
- Date of Birth
- PIN (self selected PIN like the e-file)

For practitioners to be able to sign, they will need:

- CAF number
- Password used for e-services Web site access
- PIN (self-selected)

DA Pros:

- Immediate processing into the CAF system
- Immediate access to client's account

DA Cons:

- Additional representatives must be able to access the Web site in order to digitally sign the DA. Not all practitioners will be granted access due to the IRS' 100 e-file requirement.
- DA is not available for business clients other than Sch C. Form 2848 must be mailed or faxed for manual input into the CAF prior to e-service access.

2. **Tax Information Authorization (Form 8821):** An additional option to the DA, this form can also be submitted to obtain information pertaining to a client. The digital signature requirement is the same.

3. Transcript Delivery System (TDS):
The TDS was hands down, the most impressive portion of the Usability Testing. The TDS is actually a separate portal of the e-services Web site, yet a key component of EAR. After accessing TDS, the user is provided a pop-down menu from which to select the type of transcript desired. Transcript menu selections are all in plain English such as "Wage and Income Documents" versus the computer transaction ID such as RTVUE or IRPOL, making it very easy for users to determine what type of transcript to select.
Transcripts can only be selected for one year at a time, but multiple requests can be submitted together in one session. So if a user needed transcripts for the last three years, they would fill out the form once and the tax period separate for each of the three years. Each tax period/type of return appears in a box at the bottom of the request screen. Once all information on the client is entered, you submit the transcript request containing all three years. There are five types of transcripts to be made available, they are:

TDS	Similar To:
1. Account Transcript	MFTRA–X
2. Return Transcript	RTFTP
3. Record of Account	MFTRA–X + RTFTP
4. Verification of Non-filing	IRS Letter
5. Wage & Income Documents	IRPTR

The user can choose from two delivery methods as to how they wish to receive the transcripts. The first choice is to receive the transcript online (directly on the user's screen) and the second is to have it sent to the Secure Online Repository (SOR) which is a secure (encrypted) mailbox repository that the user will have to register for and receive during the e-services registration process. The secure mailbox can only be accessed by the authorized userafter logging on to the e-services Web site. The user's SOR mailbox will contain all IRS responses from EAR and TDS submittals sent by the user. Either selection will allow a user to print the transcript.

The transcripts received will show the typical Transaction Code (TC) and also a short literal definition of the TC. This will be especially helpful for those practi-

tioners who are not familiar with the multitude of TCs or who are not in possession of documentation to decipher the codes.

TDS Pros:

- Ease of navigation. Web pages are kept simple and concise.
- Transcripts received in just a few minutes (at most).
- Two selections of transcript delivery: onscreen or SOR (either of which can be printed).

TDS Cons:

- No help is available in determining exactly what data is provided in a particular transcript.
- TC literal description is much shorter than the full description which is not available to the user.
- SOR does not provide any identification in the email header that clearly identifies the taxpayer it pertains to, which makes it difficult to locate the desired email if several taxpayers are being addressed at similar times.

Electronic Account Resolution:

The EAR portal of the e-services Web site is where practitioners will correspond directly with the IRS to resolve a client's tax issue. The products to be offered for individuals and businesses are:

- Account Problem
- Notice
- Complex Refunds
- Payment Tracer
- Installment Agreement

All selections provide a free text or memo area in which to elaborate on the details for a client's issue as you normally would in a letter. If additional information is requested by the IRS, the practitioner will submit a "Follow-up Inquiry" that will be linked to the previous submission.

Account Problem: Provides the practitioner the capability to address specific account posting issues such as those related to exam, collection, record of payments, and resolution of tax form(s) filed for a taxpayer, to name just a few. For instance, you would use Account Problem if you needed to find out the current balance owed or how 1040ES payments were posted.

Individual Notice: Provides the capability to address any IRS-generated notice that has been sent to the taxpayer. For instance, a practitioner would be able to resolve a CP2000 Notice (Notice of Proposed Changes) by submitting an agreement or disagreement for the CP2000.

Comples Refunds: Provides the capability to address refunds that can involve multiple years and a range of issues involving a taxpayer who has not received a refund due to 1040ES posting errors, 1040 refunds applied to other years, FMS Offsets, undeliverable or destroyed refund(s), and erroneous refund(s).

Payment Tracer: Provides the tracing of payments made by a taxpayer to the IRS that have not been posted by the IRS.

Installment Agreement: Provides the capability to submit an IA on behalf of a taxpayer. IAs are limited to just guaranteed and streamlined.

The Usability Testing of EAR and TDS did uncover shortfalls with both, which is to be expected in any development project this complex. Most notably was the excessive amount of Web pages required to complete for a particular submittal. There were numerous tutorials some of which were a bit excessive and others contained hard to read graphics imbedded in the tutorial. All-in-all though, the IRS has made a huge step forward in providing the tax practitioner community the capability to electronically represent clients and resolve their problems in a more efficient, timely, and secure manner.

The lessons learned from the two-year testing of PSMS were invaluable to the progress made so far. One significant improvement made as a result of PSMS was replacing the use of Digital IDs and RSA Security Keys with 128-bit encryption call Secure Socket Layer (SSL). The use of SSL provides the highest degree of security available for the IRS' e-services Web site while at the same time making it much easier for the user to access the Web site.

EAR and TDS will continue to undergo additional levels of testing before being implemented nationwide later this year. Earlier projected implementation dates had envisioned late August or early September for implementation. However, it appears

that it will more than likely occur in November. The possibility of additional delays in the final implementation is certainly there but the IRS recently solicited the PSMS participants for verification of their name and EFIN, which is an encouraging step forward.

I believe that EAR and TDS will grow much like e-file has, in which each year; new and improved capabilities are added. Once the general public is aware of tax practitioners having the capability to represent them electronically before the IRS, you can be sure that those utilizing EAR and TDS will be the *preference of choice* by taxpayers when it comes to meeting their representation needs.

About the Author:

James D. Leimbach, EA (USA Ret.) is a retired U.S. Air Force, Senior Master Sergeant who obtained his EA credential while on active duty. While in the USAF, he held positions as Superintendent of Operations, Chief of Computer Operations, and Chief of Systems Control, Database Manager, and various other computer operations and programming positions. His practice involves individual and business tax preparation, e-filing, and IRS representation, with a special focus on military clients.

EA Journal

Chairman HOUGHTON. Well, thanks very much, Mr. Leimbach. Mr. McCormally?

STATEMENT OF TIMOTHY J. MCCORMALLY, EXECUTIVE DIRECTOR, TAX EXECUTIVES INSTITUTE, INC.

Mr. MCCORMALLY. Good afternoon, Mr. Chairman. I am Timothy McCormally, Executive Director of Tax Executives Institute (TEI), whose 5,400 members work for 2,800 of the largest companies in North America and Europe. Almost without exception, the companies employing TEI's members have been assigned to the IRS' Large and Mid-Size Business Division (LMSB). The largest 1,600 taxpayers within LMSB are subject to heightened scrutiny and ongoing audits as part of LMSB's Coordinated Industry Cases program. Our members cannot play the audit lottery because, for the most part, they are audited every year. From this perspective, TEI has long supported adequate funding for the IRS, particularly in respect of training and technology, and collaborative efforts between taxpayers and the IRS to enhance tax administration, and the proper balance between taxpayer service and compliance activities.

At the outset, I wish to echo the testimony of Mr. Shaw and the written statement of Mr. Zarzar, as well as the comments of the Commissioner and Mrs. Killefer, about how the complexity of the tax law strains the limited resources of taxpayers and the IRS and impairs the ability of the government to administer a fair and efficient tax system. While we are pleased that the Bush Administration has included several simplification provisions in its 2005 budget, we believe that much broader efforts must be undertaken. These include the repeal of both the individual and the corporate alternative minimum tax and the reform of the international provisions of the Tax Code. These changes are necessary to enhance taxpayers' ability to comply and the IRS' ability to perform efficient and effective audits.

Effective management of human resources is not a new challenge, but it takes on added importance as the government's work

force ages. Within LMSB, for example, 40 percent of all revenue agents will be eligible to retire in fiscal year 2006, and that number will rise to more than half just 2 years later. This development underscores one of the IRS' greatest challenges: the recruitment, retention, and training of qualified personnel. Nowhere is that need greater than within the LMSB Division, which is responsible for ensuring compliance by the country's largest and most complicated enterprises. The success of the agency—and LMSB in particular—depends on having an effective, efficient, well-trained, and motivated staff. Adequate funding is a prerequisite to achieving that goal.

Adequate funding is also required if the IRS is to maintain effective compliance strategies. LMSB has developed several important programs to streamline the compliance process and empower revenue agents and others to resolve issues and settle cases more quickly and efficiently. One recent effort deserves mention: a project to develop a focused audit planning process, which was rolled out to taxpayers and LMSB personnel last fall. TEI was pleased to participate not only in the design of the program but also in LMSB's training strategy with respect to it. A fuller explanation of the program is in our written statement.

Several other innovative procedures—such as the Advance Pricing Agreement program, Limited Issue Focused Examinations, and Pre-Filing Agreements—have also been used to improve the examination process and to promote currency and compliance. These initiatives should be encouraged, first, by providing ample training resources in connection with them, and then by ensuring that the IRS' renewed focus on enforcement does not mute their ongoing value. These procedures enable personnel to make decisions at a lower level, to resolve disputes fairly and more quickly, and thereby to preserve resources. Mr. Chairman, TEI commends the Subcommittee for holding this hearing, and we look forward to working with you, the staff, and the IRS to improve tax administration. I, like the other witnesses, would be pleased to respond to your questions.

[The prepared statement of Mr. McCormally follows:]

Statement of Timothy J. McCormally, Executive Director, Tax Executives Institute, Inc.

Good afternoon. I am Executive Director of Tax Executives Institute, the preeminent association of business tax professionals. The Institute is pleased to participate in today's hearing on the tax filing season and the Internal Revenue Service's budget.

Background

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today, the Institute has 53 chapters in the United States, Canada, and Europe. Our 5,400 members are accountants, attorneys, and other business professionals who work for 2,800 of the leading companies in North America and Europe; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. Hence, TEI represents the business community as a whole, and our members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily basis. TEI is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike.

The companies that employ TEI's members have almost without exception been assigned to the IRS's Large and Mid-Size Business (LMSB) Division. The largest 1,600 taxpayers within LMSB are part of the Coordinated Industry Cases (CIC) program; this means that they are subject to heightened scrutiny and, indeed, continual audit by the IRS. As non-participants in the so-called audit lottery, TEI members and the companies they represent have a keen interest in ensuring the efficient operation of the IRS and the proper balance of the agency's taxpayer service, enforcement, and other activities. Specifically, TEI has long supported adequate funding for the IRS, particularly in respect of training and technology, and collaborative efforts between taxpayers and the IRS. We are pleased to offer our views on the IRS's budget for fiscal year 2005.

Increased Demand, Decreased Resources

The Bush Administration has proposed a budget for the IRS for fiscal year 2005 of $10.674 billion, a 4.8 percent increase from 2004. The proposal would increase funding for the agency's enforcement program by $366 million while decreasing funds for business systems modernization by $105 million. According to the Administration, the reduction in funding for the modernization program flows from independent studies concluding that the program should be resized. The IRS Oversight Board has also recently recommended that the IRS reduce the number of modernization projects to permit better management of the program.

Given current budgetary constraints, TEI agrees that the IRS must reexamine its goals and objectives. If the agency is to respond to taxpayer needs and to administer the tax code in a fair and efficient manner, it must have the resources necessary to fulfill its mission. TEI has consistently supported both adequate funding for the Internal Revenue Service—including its training and modernization programs—complemented by oversight by the IRS Oversight Board, the Treasury, and Congress. We know the Subcommittee shares our concern and urge you to continue to support adequate funding of the IRS to fulfill its responsibilities for taxpayer service and enforcement.

Our testimony today focuses primarily on two areas where adequate funding is particularly crucial: (i) the need to attract, train, and retain top-notch tax professionals, and (ii) the need to obtain currency on audits. But before addressing these issues, we believe that it is appropriate to note how the complexity of the tax code strains the limited resources of both the IRS and taxpayers and impairs the fair and efficient operation of the tax system.

Achieving Simplification

Complexity and changes in the tax system have important ramifications for tax administration and compliance. During the five-year period ending in 2002, there were 19 enacted tax bills that changed 292 tax code sections and required 515 changes to forms and instructions. More changes—including the introduction of a new Schedule M–3 (which is intended to advance the goal of currency by providing the IRS with much more detailed and timely information on the differences between financial and tax accounting)—are inevitably on the horizon. And each change, no matter how laudable in isolation, will require revision of forms and instructions, as well as new training efforts that cannot help but detract from the IRS's goals of achieving currency on audits.

More than five years ago, TEI joined with the American Institute of Certified Public Accountants and the American Bar Association Section of Taxation to recommend changes to simplify the law not only for taxpayers—both large and small—but the government as well. We believe that even small changes—such as harmonizing the various definitions of "child" as the Administration has proposed—can have a positive effect on job performance. Larger changes—such as the repeal of both the individual and corporate alternative minimum tax—can have significant effect on taxpayers' ability to comply with the law and the IRS's ability to perform efficient and effective audits. Enactment of simplifying measures can ease pressures and make workers more productive. In this regard, we are pleased that the Bush Administration has included several simplification provisions in its 2005 budget request.

Incremental simplification is commendable, but steps must also be taken to address systemic and structural complexity in the tax law. For example, the international tax provisions are among the tax code's most complicated and need significant reform and simplification. Several pending bills—such as H.R. 2896, the American Jobs Creation Act of 2003, and S. 1637, the JOBS Act of 2003—contain provisions to address this complexity. We urge Congress to move forcefully to make the law less complex and therefore more competitive and efficient.

Achieving a Well-Trained Workforce: Management of Human Resources

Effective management of human resources is not a new challenge, but it is one that demands more attention as the government's workforce ages. The IRS Oversight Board's 2003 report to Congress observed an increased demand for IRS services and a decreased level of resources. Specifically, the Board documented a 16-percent increase in the IRS's workload between 1992 and 2002 and, during the same period, a 16-percent *decrease* in the number of full time equivalent employees (from 115,205 to 96,714). The Board explained that the result of these trends is a huge gap between what taxpayers need and what the IRS can deliver. Closing the gap is one of the IRS's greatest challenges, the Board concluded.

During the past few years, the LMSB workforce declined by 600 employees, 40 percent of LMSB's revenue agents will be eligible to retire in FY2006, and that number will rise to more than 50 percent in FY2008. Among the division's managers, approximately 40 percent are currently eligible to retire.

These statistics underscore what may be the greatest challenge for the IRS over the next five years—its personnel. LMSB is responsible for ensuring compliance by approximately 180,000 entities each of whom has more than $10 million in assets. These taxpayers are the largest enterprises, and correspondingly have the most complex issues and the most complex organizational structures. They themselves employ qualified tax attorneys and accountants and, in return, they require experienced, well-trained agents to understand the complexities and to audit those returns. The success of the agency—and the LMSB Division and CIC program in particular—depends on an effective, efficient, well-trained, and motivated staff. Adequate funding for new hiring is an obvious prerequisite to achieve this goal.

We urge the Subcommittee to ensure that the IRS receives the funding it needs to maintain a qualified workforce.

Achieving Currency: Tools for Enforcement

Adequate funding is required if the IRS is to maintain effective enforcement strategies. LMSB has initiated several important initiatives to enhance collaboration between taxpayers and IRS personnel; to focus on significant (as opposed to immaterial) issues; and, more generally, to empower its agents to resolve issues and settle cases more quickly and efficiently. Over the years, TEI is pleased to have cooperated in numerous efforts to bring greater efficiency to the examination process.

One recent effort deserves mention—a project to develop a focused audit planning process, which was rolled out to taxpayers and LMSB personnel in October. The goals of the LMSB–TEI Joint Audit Planning Process are two-fold: (i) to establish accountability in executing a jointly developed audit plan, and (ii) to develop an issue-focused plan to, if you will, separate the "wheat from the chaff" and thereby increase audit efficiency. The resulting report emphasizes that the keys to a successful audit are communication, trust, and openness.

1. *Joint Audit Planning—The Benefits of Collaboration.* This project produced a planning and monitoring tool that lists the steps a taxpayer and audit team can take to enhance the quality and timeliness of tax examinations. A key to this initiative is the delineation of both the individual and the joint responsibilities of all participants—the taxpayer, team manager, audit team, specialists, and Counsel—thereby focusing time and resources on the most important areas.

The Joint Audit Planning Process brings home the message that, even though taxpayers and the IRS sit on opposite sides of the table, they share an interest in ensuring that the resources expended in examining corporate tax returns are used efficiently and wisely. The initiative also underscores the continuing merit of collaborative efforts.

Several other innovative procedures—such as Limited Issue Focused Examination (LIFE), Pre-Filing Agreements, Fast Track Mediation and Settlement, Accelerated Issue Resolution, and Early Referral to Appeals—have also been introduced in the past few years to improve the examination process and promote currency. The Advance Pricing Agreement (APA) program—begun more than a decade ago—is also a worthwhile process that should be continued and encouraged; the program permits the tax system to work more efficiently and effectively without costly litigation by resolving fact-intensive pricing issues before tax returns are filed. In TEI's view, the APA program is a model alternative dispute resolution process that benefits the government and taxpayers alike.

An informal survey of TEI members recently confirmed that LMSB's LIFE initiative—which focuses on materiality of issues and risk analysis of issues to be audited—is streamlining the examination process. We understand that LMSB's interim review of LIFE validates this conclusion, and accordingly strongly recommend that future initiatives be designed to complement and supplement these programs, not replace or supplant them. In addition, we believe that these audit techniques

could be adapted for other divisions and may resolve some of the frustrations felt by personnel concerning their ability to make decisions.

2. *Overriding Importance of Training*. Training is a critical element to the success of these initiatives. Procedures such as LIFE and other initiatives empower personnel to make quality decisions at the lowest level, to resolve disputes fairly and more quickly, and to husband and preserve resources. Training also enhances employee job satisfaction and encourages employees to continue pursuing public service careers. Many agents are still receiving the training needed to implement the initiatives discussed in this testimony. In addition, it is our understanding that more significant changes are under consideration that will require even *more* training. While LMSB and the IRS generally should remain open to new ideas and programs, the costs and consequences of change cannot be ignored. Each new program creates new training needs, and a "flavor-of-the-month" approach to examination techniques has the potential for causing confusion and malaise in the field. Steps must be taken to ensure that agents receive consistent and timely training.

TEI recommends that funding be provided to permit continued training of revenue agents in alternative dispute resolution techniques.

Tax Executives Institute commends the Oversight Subcommittee for holding this public hearing. TEI looks forward to working with the Subcommittee and the IRS itself to improve tax administration.

Chairman HOUGHTON. Well, I thank you very much. Mr. Pomeroy has a question. I have questions, but what I would like to do, because of the time here and because we have votes, is to submit them in writing to you gentlemen? Would that be all right? We just do have a crunch, and I am terribly sorry, but there was not anything we could do about it. It is out of our hands. Mr. Pomeroy, you probably want to ask a question. I will leave. I will leave the whole thing in your hands. Can I trust you?

Mr. POMEROY. You can.

[Laughter.]

Chairman HOUGHTON. Well, thank you very much. Gentlemen, I really appreciate your participation here today. Thanks very much.

Mr. POMEROY. [Presiding.] Mr. Chairman, let me just advise the panel what an odd thing it is, an unusual thing it is for a Member of the majority to leave the hearing still in process with the minority now to chair it. I assure you I will confine my comments only to the CRP issue, and after Mr. Orwick has traveled so far, I thank you so much for letting me get some information from him into the record. My apologies to the rest of the panel. I would like to explore some of these issues with you as well, but I believe under the circumstances I should best focus on CRP and Mr. Orwick's expertise in that area. If you would make one request of the IRS today relative to the existing confusion about the taxable status of CRP income for retired farmers, what would it be?

Mr. ORWICK. I think it would be the first of Dr. Harl's recommendations, which would be the withdrawal of CCA Letter Ruling 200325002 of May 29, 2003, or the reissuance with a narrowing of the ruling to harmonize it with Letter Ruling 8822064, March 7, 1998, that this would remove much of the current confusion.

Mr. POMEROY. There was a 1988 ruling that very clearly addressed the question of retired farmers and determined that CRP income was not subject to self-employment tax. Is that correct?

Mr. ORWICK. For retired individuals, yes.

Mr. POMEROY. For retired individuals. So, harmonizing the two letter rulings would simply be some clarification to indicate, as

they orally indicated to us when we met with IRS representatives in North Dakota Friday, that this was not—that the subsequent letter ruling in 2003 was not written in contemplation of the retired farmer and should not have application for this tax reporting period to the retired farmer. Is that essentially what you would——

Mr. ORWICK. Yes, that is correct. My understanding of the meeting was the IRS' position was that each of these rulings were geared specifically to the people in question in each of those rulings and not to be used as a precedent, but as Dr. Harl indicated, without any other rulings to go by, by default we did need to use those to guide us in our decisionmaking process.

Mr. POMEROY. The Commissioner indicated this afternoon—and you heard him—that there could be a lot at issue here in light of types of income that may or may not involve SE tax, and it gets quite involved. I believe that that is a little over thinking on this particular question. The fact is, from 1988 on, the IRS has essentially had one position. People have relied upon that position. It was inadvertently placed in question by a letter ruling that the IRS now indicates they wrote without any contemplation of the retired farmer. So, some simple clarification of that letter ruling harmonizing with the earlier letter ruling would at least get us through this tax season, and we would welcome further clarification from the IRS in the area. Is that essentially the state of play?

Mr. ORWICK. Yes, that is very true. I think that it really puts the tax practitioners and taxpayers in an awful position the way that it is right now, because we have no idea what is our real guidance. Each client is having to step up to the plate and make the decision based on their own circumstances, and they are not tax professionals and not attorneys well versed in this area. We as practitioners can guide them as best we can with the facts and circumstances, but they really shouldn't be placed in a position to have to make that decision and lay awake at night wondering if the IRS is going to be knocking on their door with an audit or that there would be extra money to pay; or, as most of my clients are choosing to do, pay the extra tax because of their conservative nature and the fact that they want to be law-abiding citizens.

Mr. POMEROY. You indicated at the hearing or the meeting that we had in North Dakota, you are a conservative practitioner, and you have a very conscientious group of clients; and if they think they may owe it, they pay it. That is why this situation is really particularly unfair to them. It will have broad—I believe by far most retired farmers may not be aware of this letter ruling, will not be paying the self-employment tax. In light of the discussion in this area in our community, they will be aware of it. Maybe they will pay the tax. The thing to do is lift the uncertainty relative to this filing season and then deal with it in a more comprehensive and involved way with the kind of fact gathering that the IRS would appropriately do prior to issuing such further rules in this area. Is that right?

Mr. ORWICK. Yes, that would be a very prudent process.

Mr. POMEROY. Well, I want to thank all of the panel, and especially, again, in absentia, express my appreciation for the Chairman. There is only 5 minutes left in the vote, and I believe it is his indication that the hearing will end at this point in time, so I

will do something I have never done before and gavel adjournment. Thank you.

[Whereupon, at 5:35 p.m., the hearing was adjourned.]

[Questions submitted by Chairman Houghton and Representative Ryan to Commissioner Everson, Mr. Orwick, Mr. Zarzar, and Mr. Leimbach, and their responses follow:]

Questions from Chairman Houghton to Mr. Leimbach

Question: As more and more Americans turn to tax preparers to prepare their returns, the role of practitioners in the tax system has become more important. According to the National Taxpayer Advocate, as many as half of the 1.2 million tax preparers have no formal training and are not required to adhere to any professional standards. As you may know, the Advocate and others have discussed limited registration of paid preparers. What is your view of the proposal?

Answer: The members of the National Association of Enrolled Agents are dedicated to the integrity of the tax system and the roles professional responsibility and ethics play in preserving that integrity. It therefore is disturbing to us that there is an increase in taxpayer belief that tax returns will be accepted regardless of the facts reported on them.

The IRS has undergone major changes in the last several years. Former Commissioner Rossotti's reorganization of the IRS and the emphasis he placed on customer service may in part have been a catalyst in modifying taxpayer attitude. Most agree that his initiatives were good, were consistent with the 1998 IRS Restructuring and Reform Act, and have produced a better IRS. However, their implementation resulted in resources being shifted away from enforcement activities. Other contributing factors include discontinuance of the Taxpayer Compliance Measurement Program (TCMP), ineffective technology, and tax law complexity.

Commissioner Everson has begun efforts to turn that around. While he acknowledges that customer service plus enforcement equal compliance, he has announced that effective enforcement of the tax laws rather than further improving customer service will be the main focus of his administration. In this connection, he implicated the tax practitioner community in the diminishment of compliance and challenged all practitioners to raise their ethical standards in order to avoid actions being taken against them by the government. While much of this was done in regard to abusive tax schemes, it seems clear to NAEA and we believe to him that his efforts will not stop there.

All who provide tax services must be cognizant of the strong enforcement component of tax compliance. It has the possibility of touching every aspect of tax advice and return preparation.

NAEA finds that commercial return preparers are an enigma in today's tax practice world. We all seem to know there are problems in connection with services performed by paid preparers, but in many respects those problems are unknown and the product of anecdotal information and conjecture. We define commercial preparers as those 1) who prepare Federal tax returns for a fee, 2) who are not required to possess any knowledge of tax law and procedure, and 3) who are subject to very limited oversight. At the state level, only California and Oregon regulate commercial tax return preparers.

The number of commercial preparers is not known with any accuracy but, as your question suggests, estimates of upward of 1 million individuals have been bandied about. With 55% of returns having been prepared by someone other than the taxpayers in 2001 and perhaps even more in 2002 and 2003, it seems safe to conclude that the number of returns prepared by commercial preparers is considerable and growing. Even if we had the numbers, we do not know the extent of training, if any, many of the commercial preparers have had and the manner in which they keep abreast of the changes in tax laws and procedures. Perhaps of greatest concern is the belief the public is not aware of the fact that many commercial preparers have no credentials. This may in part be the reason taxpayers "shop" for preparers who will prepare tax returns the way taxpayers wish them to be prepared (often unsigned by those preparers), to the detriment of responsible return preparers and the integrity of the tax system.

NAEA understands that tax return preparer penalties asserted in recent years have been minimal in number as related to the apparent potential for such penalties. Those that have been imposed in large measure have not been collected. We also know that attempts to implement recognition procedures in the electronic filing area, i.e. electronic filer originators (EROs), have been the subject of criticism due

to systemic problems in background checks and the like as documented in the Treasury Inspector General for Tax Administration (TIGTA) report of June 2002. Further, many of the problems in the earned income tax credit (EITC) program are attributable to paid preparer involvement. Again, there does not seem to be a great deal of empirical data to support a conclusion as to the number of commercial preparers involved in the program and whether or not they do a consistently worse job than other preparers, even though there have been some informative and well-written white papers on the subject.

As you are aware, the National Taxpayer Advocate's report to Congress for the year 2002 recommended that there be a program to register commercial return preparers. It would be an extremely ambitious program and one that would be expensive to establish and run. The IRS disagreed with the recommendation citing, among other factors, the expense of the program and that the issue is one for states to address rather than the federal government. NAEA believes there are problems both with the recommendation and the IRS response. Consequently, we were pleased that her request for the year 2003 compromised the previous recommendation by recommending that there be a legislatively mandated task force established to study the situation and the many unknowns.

In spite of the above, NAEA supports Ms. Olson's quest, if not her vehicles for achieving it. If left unchecked, the perceived problems will continue to grow. In this connection, we believe the IRS Advisory Council's Wage & Investment and Small Business/Self Employed subgroup reports warrant favorable consideration. In particular, the SB/SE subgroup's belief that the IRS should begin working with outside stakeholders to develop a program after examining a number of the "unknowns" would be beneficial.

NAEA subscribes to the belief that ethics are the fabric that holds a profession together. In the tax arena, Congress has identified those who qualify as Federally authorized tax practitioners (FATPs), i.e. Enrolled Agents, Attorneys, and Certified Public Accountants. All are licensed individuals whose professional practice is circumscribed by codes of professional conduct and continuing education requirements.

With the above said, FATPs have dual loyalties. One, of course, is to their clients. The other is to the tax system itself. NAEA thinks it safe to conclude that all FATPs share the goal of safeguarding the integrity of our tax system and would be willing to work to make that happen. A possible beginning to assist the IRS in this respect is to form an independent private sector task force comprised of representatives from the Enrolled Agent, attorney, and CPA organizations to consider the issue and make recommendations addressing them. NAEA would be pleased to head a practitioner organization steering Committee to implement this. Other organizations, individuals, academicians, and the like with similar goals would be invited to the extent that the numbers would be manageable.

We are eager to move off dead center in our support of overcoming the frustrations we all share with respect to the unknown factors relative to the issue and doing our part in establishing a program evidencing ethics as a vital part of our tax system's integrity. However, our eagerness would be meaningful only if there is an intent by Congress to pursue the matter through legislation or another vehicle.

Question: In your written statements, all of you have emphasized the need to simplify the Tax Code. How did the tax code become so complex, and what should Congress do to simplify our tax Code?

Answer: Our current tax system tries to address every aspect of our economy and, to a large degree, social issues as well. The complexity resulting therefrom warrants simplification of the tax laws and their administration. The National Association of Enrolled Agents believes that incremental changes are the most effective means by which to accomplish tax simplification. For example, in the recent years, NAEA has requested simplification of the Alternative Minimum Tax (AMT), the definition of a child, particularly in the context of the earned income tax credit, and rationalization of phase-ins and phase-outs.

Question: Occasionally, we have heard opposition from practitioners to a tax simplification proposal that might alter or upset the practitioner's chosen specialty of tax. Are your members willing to give up a lucrative practice that depends on a wrinkle in the Tax Code? How important is tax simplification to your membership and to the tax system as a whole?

Answer: The practice of the members of the National Association of Enrolled Agents would not be adversely affected by an incremental approach to simplifying the tax system.

Question: I understand that the IRS is in the process of launching a new program that will allow tax preparers to access certain information on behalf of the clients and will improve communication with the IRS. What is

your impression of the new service so far? Are there any improvements the IRS should make?

Answer: The capabilities being referred to are Disclosure Authorization, Transcript Delivery System, and Electronic Account Resolution within the IRS' e-services, secure Web site. NAEA believes that these three (secure) capabilities are, without question, going to revolutionize the way tax practitioners conduct business with the IRS.

The Disclosure Authorization (DA) capability allows tax practitioners the ability to submit an electronic Power of Attorney (POA) directly into the IRS' Centralized Authorization File (CAF) computer system. The process of preparing a DA for a taxpayer takes approximately 3–5 minutes. Once the DA is prepared, the submittal and processing of the DA into CAF is *instantaneous*.

The DA capability will replace the current process of faxing (or mailing) a POA into the IRS' IRS Centers for *manual* input into CAF. The normal wait time for the manual input into CAF is usually 2–3 days. The cost savings to the IRS will be truly significant when this capability becomes available this year once the final testing has been completed. The instantaneous processing of the DA into CAF allows tax practitioners immediate access to account information on the taxpayer(s) being represented via the Transcript Delivery System.

The Transcript Delivery System (TDS) is the true powerhouse of the three capabilities. With TDS, tax practitioners can access the specific account related information that is crucial to problem resolution for the taxpayer(s). The account information is delivered to tax practitioners instantly. It now takes a practitioner longer to print the account information transcripts than it does to actually fill out the request and receive them. The type of information that can be obtained is:

1. *Account Transcript* (Reflects a summary of the return and all subsequent information posted to the account.)
2. *Return Transcript* (Contains most of the lines from an original return, including the various forms and schedules submitted with the return. The transcript contains both the "per return" and "per computer" entries from IRS databases.)
3. *Record of Account* (Merger of both Account Transcript and Return Transcript)
4. *Verification of Non-Filing* (This transcript is used in circumstances where a taxpayer may need a letter from the IRS indicating that he or she did NOT file a tax return. A good example would be where a taxpayer has applied for a state-backed mortgage subsidy bond.)
5. *Wage and Income Transcript* (W–2, 1099–DIV, 1099–MISC, and so forth. Practitioners can also select "All Documents" to retrieve every wage and income document reported to the IRS)

Prior to TDS the practitioner either had to drive to the local IRS office and obtain transcripts which took a total of 1 hour, or contact the IRS' Practitioner Priority IRS and request transcripts to be faxed to me. The general turnaround time for receipt of the faxed transcripts was anywhere from 1 hour to 1 day.

TDS is an utterly amazing capability for tax practitioners and will have a major impact on the practitioner's ability to better serve their clients.

Once the DA and TDS capabilities have provided the necessary service to the tax practitioner, the final step is in the electronic (secure) correspondence with the IRS for problem resolution. The secure Internet interaction with the IRS is achieved via the Electronic Account Resolution (EAR) capability.

EAR provides practitioners the following:

1. *Account Problems Inquiry:* This type of inquiry will allow users to address account related issues (not in ACS or Under Reporter) for resolution. A good example would be abatement of penalties due to reasonable cause.
2. *Notice Inquiry:* This inquiry will allow users to respond to IRS Notices with the exception of those that are outside the scope of EAR such as a CP2000, Notice of Underreported Income.
3. *Complex Refund Inquiry:* The Complex Refund inquiry will allow users to address refunds that were issued via direct deposit or by paper check and have either been destroyed, lost, not received, or stolen. It is also possible to inquire about refunds that have been offset by the Financial Management System (FMS) or have been applied to other tax debt owed to the IRS.
4. *Payment Inquiry:* The Payment Tracer will allow you to inquire on behalf of an individual or business, payments made to the IRS but not yet posted or to verify the posting of a payment on the account. A good example would be 1040–ES payments.
5. *Installment Agreement Inquiry:* The Installment Agreement provided in EAR is limited to Guaranteed Installment Agreements (under $10,000) and Stream-

lined Installment Agreements (under $25,000). Installment Agreements for amounts over $25,000 cannot be processed through EAR at the present time. In addition, the only payment method available is through Direct Debit. In addition to submitting a new Installment Agreement, you can revise an existing one or reinstate a previous Installment Agreement, which are two features that will be very useful.

6. *Follow Up Inquiry:* The Follow Up Inquiry will allow users to address previously submitted EAR inquiries that require additional information for the original submittal (i.e. not enough room in comments area), or in responding to a CSR's request for additional information.
7. *Multiple Inquiry:* The Multiple Inquiries function allows tax practitioners to address simultaneously the first five types of inquiries above on behalf of an individual or business.

The current turnaround for an IRS response to a proposed problem resolution is generally 1 month, many times much longer. With EAR, the IRS' response will be within three business days.

The combination of DA, TDS, and EAR is just plain phenomenal capability in IRS representation. The products will be the first of its kind and certainly, enhancements will be needed since many of the desired representation aspects will not be included in the initial release. Two excellent examples for future inclusion in EAR would be the ability to address collection related issues and those handled by the under reporter IRS entities.

The IRS has already solicited the Enrolled Agents and CPAs that have been testing the products for their input for future enhancements. NAEA's biggest concern for future enhancements is whether or not adequate funding will be available. It is crucial that Congress ensure that adequate funding for this new capability and the future enhancements will be there when needed.

Question: One of the things that make the tax system complex is that the IRS does not always provide a clear answer to the tax treatment of a common transaction. Is the IRS doing enough to publish clear and concise guidance to taxpayers? Would increasing the resources available to the IRS in this area help to make the tax system more transparent?

Answer: The IRS has made progress in its effort to publish clear and concise guidance to taxpayers. Part of such progress is making information available on the Internet and CDs. The problem in trying to publish clear and concise guidance is that the tax issue itself is complex and can only be simplified to a point. For example, taxpayers with children are faced with numerous different definitions of a child for 1) Dependent, 2) Child Tax Credit, 3) Earned Income Credit, 4) Credit for Child and Dependent Care Expenses, 5) Adoption Credit. Having one definition versus numerous definitions for a child is a longstanding problem that has been addressed repeatedly without success.

Increasing the number of IRS personnel working the Customer IRS telephone lines and answering questions from the public, especially during the tax season would be a sound objective. Bright line guidance for IRS employees and the public is agoal worth pursuing. All of this would require appropriate training.

Question: We have discussed the IRS budget with the government panelists. What is your view of the budget, as practitioners? Where do you believe the IRS should allocate its resources?

Answer: The National Association of Enrolled Agents always has supported full funding for the IRS. In addition to the training discussed above, we believe the IRS should focus its resources on modernizing antiquated computer systems, expanding the new electronic capabilities such as DA, TDS, and EAR, and increasing enforcement, especially with respect to non-filers.

Question: I imagine you have heard about the delays in Business Systems Modernization program. Can you explain why it is important to you, as practitioners, to complete this important program? What benefits do you see, and what services should the IRS provide in the future?

Answer: The Business Systems Modernization effort is crucial for the future administration of our tax system. The effective administration of our tax system depends, to an enormous degree on having computer systems that can process the workload. A 19sixties-era mainframe cannot be expected to handle the demands placed upon it fifty years later. The volume of taxpayers now and in the future is just beyond the computer processing power built in the sixties.

Question: The IRS has hired a new director of the Office of Professional Responsibility, and it is beginning to coordinate the efforts of the various working divisions to interact with practitioners. What is your initial im-

pression of the IRS's efforts in this area, and what should be done in the future?

Answer: NAEA is very pleased that IRS is finally able to address the resource and modernization needs of the Office of Professional Responsibility (OPR). As practitioners, we look forward to seeing progress in having OPR address longstanding issues involving tax professionals. In doing so, we hope that the OPR will be sensitive to the independence of this office in fulfilling its quasi-judicial role. We believe it is too early to assess the success of its initiatives.

Question: What is your assessment of the state of the tax system today, compared to 6 years ago, when Congress enacted the IRS Restructuring and Reform Act?

Answer: The IRS Restructuring and Reform Act resulted in a tremendous cultural shift at IRS. During the process (which is ongoing), practitioners found that IRS employees were placed in new positions without adequate training. On the front lines, they did not know where to send taxpayers for proper resolution or assistance and the negative impact it had on the morale of the IRS employees is still evident today. The IRS failed in the proper planning and execution of the reorganization and it still plagues the IRS today. This is not to imply the RRA was wrong. NAEA believes that the same shift in culture affecting IRS employees also has affected taxpayers and practitioners.

Questions from Chairman Houghton to Mr. Orwick

Question: As more and more Americans turn to tax prepares to prepare their returns, the role of practitioners in the tax system has become more important. According to the National Taxpayer Advocate, as many as half of the 1.2 million tax prepares have no formal training and are not required to adhere to any professional standards. As you may know, the Advocate and others have discussed limited registration of paid prepares. What is your view of the proposal?

Answer: I do not oppose limited registration of paid prepares if those whom do questionable work are "weeded" out of the business of preparing tax returns. This registration should have some sort of grandfather clause included for qualified prepares.

Question: In your written statements, all of you have emphasized the need to simplify the Tax Code. How did the Tax Code become so complex, and what should Congress do to simplify the tax Code?

Answer: I started preparing tax returns in 1980. Since that time every new tax law has added some degree of complication. IRS rulings such as Rev. Rul. 2000–4 regarding depreciation and those of which I spoke on the taxation of CRP income for retired taxpayers, adds to the confusion and frustration of taxpayers and practitioners. The alternative minimum tax has also become a burden for many average taxpayers; this was not the original intent when it became part the tax Code many years ago. When Congress passes tax legislation, it is very important that their intent be clear, so the IRS knows how to interpret and enforce the law. This alone would "simplify" the current tax system.

Question: Occasionally, we have heard opposition from practitioners to a tax simplification proposal that might alter or upset the practitioner's chosen specialty of tax. Are your members willing to give up a lucrative practice that depends on a wrinkle in the Tax Code? How important is tax simplification to your membership and to the tax system as a whole?

Answer: Since I do not represent any particular organization I can only speak for myself. I believe that simplification is the cornerstone to the success of our current tax system. If we as practitioners or the taxpayers themselves cannot comply with the law because it is to complicated the system no longer works. As to altering or upsetting my particular practice with simplification, I feel that we have a broad base of clients whom even in a more "simple" tax system would continue to require the professional services we offer. However, simplification would allow my staff and myself to work a normal workweek rather than eighteen hours a day, 7 days a week for the tax season.

Question: I understand that the IRS is in the process of launching a new program that will allow tax prepares to access certain information on behalf of clients and will improve communication with the IRS. What is your impression of the new service so far? Are there any improvements the IRS should make?

Answer: I have had limited exposure to the current system and do not feel that this exposure has yet given me an opportunity to make an educated comment on

it's effectiveness. However, I was part of a pilot program a few years ago dealing with the same issues and found the system a fantastic tool in resolving my clients' account problems with the IRS.

Question: One of the things that makes the tax system complex is that the IRS does not always provide a clear answer to the tax treatment of a common transaction. Is the IRS doing enough to publish clear and concise guidance to taxpayers? Would increasing the resources available to the IRS in this area help to make the tax system more transparent?

Answer: Yes, I believe it would. Also the passage of clear and concise tax legislation would aid the IRS in reaching their goals.

Question: We have discussed the IRS budget with the government panelists. What is your view of the budget, as practitioners? Where do you believe the IRS should allocate its resources?

Answer: As with anything, the more funds that are available the easier it is to do a better job. I feel the IRS is currently doing a good job, additional programs designed to build a team effort between the IRS, taxpayers and practitioners would be a positive place to apply additional funding.

Question: I imagine you have heard about the delays in the Business Systems Modernization program. Can you explain why it is important to you, as practitioners, to complete this important program? What benefits do you see, and what services should the IRS provide in the future.

Answer: I do not feel that I have enough facts to comment on this issue.

Question: The IRS has hired a new director of the Office of Professional Accountability, and it is beginning to coordinate the efforts of the various working divisions to interact with practitioners. What is your initial impression of the IRS's efforts in this area, and what should be done in the future?

Answer: I believe that all advances in this area are very positive steps and I commend them for their efforts. I have not personally been exposed to this program, so I do not at this time have an initial impression of the IRS's efforts in this area.

Question: What is your assessments of the state of the tax system today, compared to 6 years ago, when Congress enacted the IRS Restructuring and Reform Act?

Answer: I believe that the IRS has become more customer service orientated. This along with movement toward electronic filing and other advancements of technology have been very positive steps. On the downside, I believe the tax legislation passed during this period along with the interpretation of it and previous laws by the IRS has made working with the current tax system more complicated and cumbersome.

Questions from Chairman Houghton to Mr. Zarzar

Question: As you may know, the Advocate and others have discussed limited registration of paid preparers. What is your view of the proposal?

Answer: National Taxpayer Advocate Nina Olson, as part of the Advocate's 2003 Annual Report to Congress, calls for the establishment of a "registration, examination, certification, and enforcement program for Federal tax return preparers."

The legislative intent of the tax return preparer registration proposal is to raise the professional standards for unenrolled preparers. Providing meaningful guidance to practitioners in the performance of their professional responsibilities is an objective we strongly support, as reflected by the AICPA's Code of Professional Conduct and our Statements on Standards for Tax IRSs. However, we are concerned that this registration initiative has not undergone sufficient review regarding the level of financial resources required for proper administration of the program. No budgetary commitment to this program is reflected in the Administration's proposed IRS budget for fiscal year 2005.

In conjunction with any review of the proposal, we also recommend that the IRS and Congress study how the current Electronic Return Originator (ERO) application process might overlap or duplicate even a "limited" registration process for tax return preparers. Under the current ERO application process, IRS conducts a background check of all principals and responsible officials affiliated with a tax return preparer's firm. This background check includes: (1) an FBI criminal background review; (2) a credit history check; and (3) an IRS records check with respect to the preparer and the firm's adherence to tax return and tax payment compliance requirements, including a review of any prior non-compliance under the IRS e-file program.

Question: In your written statement, all of you have emphasized the need to simplify the Tax Code. How did the Tax Code become so complex, and what should Congress do to simplify the Tax Code?

Answer: In our testimony, the AICPA reaffirmed its support of efforts to reduce complexity in existing tax law and to curtail incremental complexity in the future. While we acknowledge that an absolutely simple tax system is not feasible in today's complex business and economic environment, we believe it is possible to design a simpler tax system.

We believe that the problem of undue complexity has arisen in part because of the dominance of other legislative goals (such as revenue enhancement, rate reduction, economic incentives and social policy) over the goal of simplification. As a starting point, lawmakers need to balance the goal of tax simplification with these competing objectives. Incremental additional complexity can be curtailed by following basic guiding principles for tax law simplification.[1] For example, as legislation and administrative guidance is drafted, legislators and regulators should: (1) seek the simplest approaches; (2) minimize both compliance and administrative burdens; (3) avoid inconsistent concepts and definitions; and (4) avoid enacting provisions that apply to only a few or for only a short period of time.

Congress must then undertake meaningful tax simplification to existing law. Considerable consensus has developed in recent years identifying desirable proposals that would simplify the law for a large number of taxpayers. For example, the AICPA provided lengthy comments on the 2001 Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System.[2] In addition, in February 2000, the AICPA sent to Congress a package of tax simplification recommendations the Institute hammered out in a historic joint initiative with the Tax Executives Institute and the American Bar Association Section of Taxation.[3] Among the recommendations were: (1) repeal of the alternative minimum tax; (2) harmonization of family status definitions; (3) streamlining education tax incentives; and (4) eliminating or making uniform the numerous phase-outs contained in the Code.

These changes alone would make the Code more consistent, rational, fair, and transparent—particularly for low—and middle-income taxpayers. While there are revenue costs associated with simplification reforms, it is also important to recognize that there are significant compliance burdens that will be eliminated by such reforms.

We note with pleasure Chairman Houghton's introduction of nine separate tax simplification bills on April 2, 2004, many of which address our top complexity concerns.

Question: Occasionally, we have heard opposition from practitioners to a tax simplification proposal that might alter or upset the practitioner's chosen specialty in tax. Are your members willing to give up a lucrative practice that depends on a wrinkle in the Tax Code? How important is tax simplification to your membership and to the tax system as a whole?

Answer: The AICPA has surveyed its membership on the topic of tax law simplification. This has resulted in our firm belief that it is essential to simplify the Tax Code in order to preserve our voluntary compliance tax system and, as a consequence, preserve a viable tax practice for our membership. As a consequence, the AICPA has actively supported many Congressional tax simplification efforts and has offered Congress many specific recommendations over the years.

Tax advisers spend considerable time assisting clients with compliance problems; time that they believe would be better spent on activities such as personal financial or strategic business planning.

Question: I understand that the IRS is in the process of launching a new program that will allow tax preparers to access certain information on behalf of clients and will improve communication with the IRS. What is your impression of the new service so far? Are there any improvements the IRS should make?

Answer: The IRS has taken a number of positive steps during the last year to listen to the practitioner community about the myriad of problems tax professionals still face when contemplating offering e-file services to their clients. This includes the IRS's efforts to phase-in the electronic filing of business returns and its rollout of the "Electronic IRSs" section on the IRS Website, including a suite of Web-based products for practitioners to do business with the IRS electronically. Electronic IRSs

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[1] See AICPA comments on 2001 Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System, February 2002.

[2] See AICPA, American Bar Association section of Taxation and Tax Executives Institute Tax Simplification Recommendations, February 25, 2000.

[3] Id.

would enable practitioners who e-file more than 100 "accepted" individual tax returns in a season to (1) submit many commonly used IRS contact forms electronically and receive an acknowledgement of acceptance from the IRS; (2) make electronic inquiries about individual and business tax account problems and issues; and (3) request tax return transcripts and account transcripts. We support the new e-services, but we encourage the IRS to eliminate the 100 return threshold, allowing all practitioners to benefit and contribute to the growth of e-filing and account resolution.

Question: Is the IRS doing enough to publish clear and concise guidance to taxpayers? Would increasing the resources available to the IRS in this area make the tax system more transparent?

Answer: All IRS guidance must be effective, clear, timely, and designed to promote a uniform understanding and consistent application of the tax laws. In this context, we support any initiative designed to improve the quality of published IRS guidance. The IRS has made great strides in recent years, and we look forward to increased efficiency and timeliness in the future. Allocating appropriate resources to increase the volume of guidance published will make the tax system more transparent.

Question: What is your view of the IRS budget, as practitioners? Where do you believe the IRS should allocate its resources?

Answer: We applaud Congressional efforts to provide full funding for the IRS's fiscal year 2005 budget. The AICPA has long advocated funding levels which would allow the IRS to efficiently and effectively administer the tax laws and collect taxes. We support the objective of the Administration's budget proposal which focuses on increasing staffing and providing more resources for enforcement. In addition, we believe the budget should strive to provide a positive balance among: (1) improving taxpayer service; (2) enhancing enforcement of the tax law; and (3) modernizing the IRS through its people, processes, and technology.

Question: Can you explain why it is important to you, as practitioners, to complete the Business Systems Modernization program? What benefits do you see, and what services should the IRS provide in the future?

Answer: The IRS Oversight Board's December 2003 Business Systems Modernization and the IRS have detailed continuing delays in implementing the customer account data engine designed to replace the IRS Master File of taxpayer records.

Despite these problems, we urge Congress to stay the course in supporting appropriate funding for the modernization effort that must remain a central feature of the IRS's strategic plan for the next 5 years. The Business System Modernization goals are critical to the future of the IRS, taxpayers, and the effectiveness of our tax system.

Question: The IRS has hired a new director of the Office of Professional Responsibility and it is beginning to coordinate the efforts of various working divisions to interact with practitioners. What is your initial impression of the IRS's efforts in this area, and what should be done in the future?

Answer: The AICPA is encouraged by Commissioner Everson's commitment to upgrade the Office of Professional Responsibility, and his appointment of Cono Namorato as the office's new Director. These efforts should greatly enhance the IRS's ability to address professional responsibility standards for all tax professionals and help eradicate abusive transactions.

We also commend Treasury and the IRS for their commitment to issue final regulations under Circular 230 over the next several months to address: (1) "best practices" for tax advisors (which we believe should be aspirational in nature); and (2) tax shelter opinions. These regulations should help to "raise the bar" of professionalism for tax advisors, as well as the quality of written tax opinions. The final regulations should clearly address the need for restoring integrity and confidence in the tax system, and we are proud to join with the Treasury and the IRS to ensure that tax practitioners have a role in that restoration.

Question: What is your assessment of the state of the tax system today, compared to 6 years ago, when Congress enacted the IRS Restructuring and Reform Act?

Answer: The IRS Restructuring and Reform Act has resulted in: (1) improved taxpayer service; (2) greater equity in the administration of the tax law; and (3) higher productivity of the IRS's workforce. Nevertheless, we recognize that further improvements can and should be made—improvements that can result in an even higher level of service for America's taxpayers. We support Commissioner Everson's push to increase staffing in the compliance area and to ensure a proper balance between service and enforcement within the context of the IRS budget initiatives for fiscal year 2005 and the IRS's strategic plan for the next 5 years.

Questions from Chairman Houghton to Mr. McCormally

Question: As more and more Americans turn to tax preparers to prepare their returns, the role of practitioners in the tax system has become more important. According to the National Taxpayer Advocate, as many as half of the 1.2 million tax preparers have no formal training and are not required to adhere to any professional standards. As you may know, the Advocate and others have discussed limited registration of paid preparers. What is your view of the proposal?

In your written statements, all of you have emphasized the need to simplify the Tax Code. How did the Tax Code become so complex, and what should Congress do to simplify the tax Code?

Occasionally, we have heard opposition from practitioners to a tax simplification proposal that might alter or upset the practitioner's chosen specialty of tax. Are your members willing to give up a lucrative practice that depends on a wrinkle in the Tax Code? How important is tax simplification to your membership and to the tax system as a whole?

I understand that the IRS is in the process of launching a new program that will allow tax preparers to access certain information on behalf of clients and will improve communication with the IRS. What is your impression of the new service so far? Are there any improvements the IRS should make?

One of the things that makes the tax system complex is that the IRS does not always provide a clear answer to the tax treatment of a common transaction. Is the IRS doing enough to publish clear and concise guidance to taxpayers? Would increasing the resources available to the IRS in this area help to make the tax system more transparent?

We have discussed the IRS budget with the government panelists. What is your view of the budget, as practitioners? Where do you believe the IRS should allocate its resources?

I imagine you have heard about the delays in the Business Systems Modernization program. Can you explain why it is important to you, as practitioners, to complete this important program? What benefits do you see, and what services should the IRS provide in the future?

The IRS has hired a new director of the Office of Professional Accountability, and it is beginning to coordinate the efforts of the various working divisions to interact with practitioners. What is your initial impression of the IRS's efforts in this area, and what should be done in the future?

What is your assessment of the state of the tax system today, compared to six years ago, when Congress enacted the IRS Restructuring and Reform Act?

Answer: On behalf of Tax Executives Institute, I am pleased to respond to your follow-up questions to the Oversight Subcommittee's hearing on the 2004 IRS filing season and IRS budget for FY 2005. TEI appreciates the opportunity to express our views.

In your April 5, 2004, letter, you asked about the effect of the complexity of the Internal Revenue Code on tax administration. The IRS National Taxpayer Advocate (NTA) has consistently identified the complexity of the tax laws as the number one problem facing taxpayers. In her 2003 annual report, Nina Olson ranked the alternative minimum tax (AMT) for individuals as the number one problem, noting that according to IRS estimates, taxpayers spent more than 29 million hours in 2000 completing and filing AMT tax forms, or roughly 63 hours per taxpayer who actually pays the AMT. "The AMT is extremely and unnecessarily complex," the report concludes, "and results in inconsistent and unintended impact on taxpayers." Your recent proposal (H.R. 4131) to gradually raise the AMT exemption amount and repeal the individual AMT after 2013 is a good first step in reducing complexity.

The corporate AMT, however, suffers from the same policy and administrative deficiencies as the individual AMT: It creates enormous compliance burdens. TEI strongly believes that taxpayers should not be required to compute their taxes twice or to keep two sets of books. In addition, the AMT taxes corporations when they can least afford it—when they are struggling to survive in a down economy. The AMT represented poor public policy when it was enacted, and ensnares taxpayers who do no more than engage in activities that Congress independently determined should be encouraged. The AMT should be repealed for *all* taxpayers, individuals and corporations.

Everyone—Congress, the U.S. Department of Treasury, the IRS, tax professionals, and taxpayers—bears responsibility for the current complex state of the law. More than five years ago, TEI joined with the AICPA and ABA Tax section to draw atten-

tion to the problem and to seek solutions. Mr. Chairman, you have been a strong supporter of these efforts, and, indeed, during your 17 years in Congress, you have been a strong champion for making the tax law simpler. TEI commends you and this Subcommittee for highlighting this issue.

TEI wishes you well on your retirement at the end of this year and pledges to continue seeking changes that will make the tax law simpler for all of us.

If you have any questions, please do not hesitate to contact me or Fred F. Murray, TEI's General Counsel and Director of Tax Affairs, at 202.638.5601.

Questions from Representative Paul Ryan to Commissioner Everson

Question: My question is in regards to child tax credit overpayments as a result of the child tax credit advance payments that were sent out last year.

A constituent shared with me that they approached the IRS with the following scenario: In the case of divorced parents, the individual ex-spouses may alternate tax years in which they claim the personal exemptions and the child tax credit. One parent, for example, may have claimed the child tax credit in 2002 and received the child tax credit advance payment in 2003. This parent, however, will not claim the child tax credit for tax year 2003 because it is the turn of the other parent to claim the child tax credit. The constituent asked the IRS if the parent who received the child tax credit advanced payment in 2003 would have to repay the advance in some way to the IRS? The constituent also asked if the parent who will claim the child tax credit for 2003 would have to reduce the $1,000 per child credit by the amount of the advance payment received by the other parent?

The IRS indicated to the constituent that if the advance payment exceeds the total of the child tax credit and the additional child tax credit, the taxpayer does not have to repay the difference. This is true even if the taxpayer isn't eligible for the credit in 2003. In addition, the IRS told the constituent that a taxpayer takes into account only his or her advance payment, not the amount received by someone else, even if that person had claimed the qualifying children the previous year. Therefore, in the constituent's situation, no repayment would need to be made and the other parent would claim the full credit allowable without subtracting the advance payment amount.

My question is, first, is this true? Second, if this is in fact true, what does IRS estimate these child tax credit overpayments will amount to for tax year 2003?

Answer: In the scenario described, your constituent was given the correct answer. The divorced parent claiming the child for 2003 may claim the full credit without regard to the advance child tax credit payment received by the other divorced parent. The parent that is not claiming the child for 2003 but received the advanced child tax credit payment is not required to repay the credit to the IRS.

IRS does not have a way to calculate the amount of overpaid ACTC to parents that have alternating support agreements.

Question: The Federal tax refund offset program, which is referred to as the Treasury Offset Program (TOP), allows government agencies to submit to the IRS claims for delinquent debts up to 10 years old. The State of Wisconsin is currently participating in this program for the purpose of recovering state-owed debts. Local municipalities, however, are not permitted to participate in TOP to include debts owed to local and municipal agencies.

Do you believe that the current system could accommodate local municipalities to participate in TOP? If so, what is needed to allow local municipalities to participate in TOP? If you do not believe the current system could accommodate local municipalities, why?

Answer: Although the IRS participates in the TOP, the Treasury bureau responsible for the operation of TOP is the Financial Management IRS (FMS). Therefore, we referred your question to FMS for a response. FMS's response is below.

State debt currently collected through TOP is limited to delinquent child support obligations and delinquent state income taxes, which may include delinquent local income taxes administered by the chief tax administration agency of the state. Legislation would be required to expand the program to include debts owed to local and municipal agencies.

FMS receives information about state debt from the U.S. Department of Health and Human IRSs for delinquent child support obligations and from a single point within each state for state/local income tax debt. TOP could not accommodate debt

owed to local and municipal agencies because to do so would require telecommunications connections with hundreds of end-points and extensive systems modifications to accommodate hundreds of connections per state. Additionally, we do not currently have the resources required to manage and troubleshoot a program to collect large volumes of debt owed to local and municipal agencies nor to handle debtor inquiries, transfer funds to hundreds of end-points, and train thousands of new users.

To accommodate debt owed to local and municipal agencies, the Financial Management IRS would need to forego other priority projects and increase development, operational and program staff. Such a project would require a significant development effort and modification to debt systems with no substantial benefit to the Federal Government. Even if these challenges could be met, Treasury might be reluctant to support expansion of the program to collect debts that do not have a Federal component or a Federal/State partnership interest.

[Submission for the record follows:]

Statement of Gerald E. Scorse, New York, New York

I first want to thank the Committee for the opportunity to make a Submission for the Record. Thousands of voices clamor to be heard as you go about the nation's business. What claim do I have to be listened to? Only this: that the Ways and Means Committee, as the originator of all tax legislation, is the proper place to make this petition; that the issue I raise is just, as this document will demonstrate; and that the issue has a clear and ready solution, if the Committee chooses to seek a solution.

I grew up believing that all income is reported to the Internal Revenue Service. Starting with my teen years I received a W–2, which reported my wages. In later years I received the 1099 forms on which bank interest is reported (and dividends as well, though it would be a while before I saw any of those).

In the 1980s and 1990s, when I began to put money into the stock market, I gradually became aware that capital gains income is *not* reported; when it comes to stock transactions, the only information reported by a third party to the IRS is the amount of the proceeds and the date of the sale. The IRS receives no information on the initial purchase of the stock. It does not know the price that was paid; it does not know the date of the purchase. I was offended when I found this out. It seemed to me then, and seems to me now, profoundly unfair.

Wages are earned income. People get up early and work late for wages. Capital gains are unearned income. (Mine included. I don't work for them. I don't sweat for them. They come to me like manna from heaven.) Fairness is crucial to our income tax system. When it comes to capital gains, the system is unfair. I resolved to find out why, and to try to change it. On March 5, 2001, I took my cause to Washington. I wrote to Charles Rangel, my Congressman and the ranking Democrat on the Ways and Means Committee.

Why Third-Party Reporting is Not Currently Required

Third party reporting is the foundation of income tax collection in the United States. Third parties report income from wages, dividends, and interest to the Internal Revenue Service. They report all manner of miscellaneous income, e.g., non-employer compensation and gambling winnings. Safe to say, our income tax system would collapse without third-party reporting.

Yet this standard reporting requirement does not apply to capital gains income. Why so? The answer arrived in a letter dated May 23, 2002, from Pamela F. Olson, Acting Assistant Secretary (Tax Policy), Department of the Treasury, to Representative Rangel, with a carbon to myself. Rep. Rangel had relayed my concerns to Treasury Secretary O'Neill, who had asked Secretary Olson to reply.

Secretary Olson restated my position and offered the Treasury's opinion: ". . . Mr. Scorse believes that tax compliance would be improved if information reporting for capital gains included the amount of capital gains income that a taxpayer is required to show on his or her return. We couldn't agree more! Information reporting is the most efficient, least intrusive way of helping taxpayers comply with their tax obligations to the federal government."

So why, when it comes to capital gains from stock transactions, do we not help taxpayers comply? In two words, "specific identification". A brief explanation will suffice. An investor buys 100 shares of IBM on one date, and 100 additional shares on another date. Later, the investor sells 100 shares. As Secretary Olson stated, the broker does not know which 100 shares the taxpayer will treat as sold. In addition, the purchases might have been handled by different brokers.

Therefore, the Secretary concluded, "unless taxpayers are denied the flexibility of specific identification," capital gains income cannot be reported by third parties to

the IRS. In this view, third-party brokerage houses and mutual funds simply do not have the information. My reply pointed out that there are millions, indeed billions of occasions when "specific identification" has no application. These include 1. When there is a single purchase and a single sale of a stock or a mutual fund; 2. When there are many purchases of a stock or mutual fund, but a single sale of the entire holding. In both instances, third-party holders have exact information on taxpayers' capital gains; in neither instance would "specific identification" stand in the way of third-party reporting.

I also addressed the issue of shares that move from one financial institution to another: "It should be required . . . that basis prices and acquisition dates travel with shares; complete information should be part and parcel of any equities transfer." (An analogy: do medical records vanish when people change doctors?) But ahead of these points, I stressed to Secretary Olson and would stress to the Committee, there is the larger issue. That issue is the fairness and integrity of the tax system.

The current tax treatment of capital gains income is inherently inequitable. It separates taxpayers into first-class and coach. Those in first class are allowed to self-report their income, while those in coach are required to have their income reported by a third party. It hardly needs saying that first-class taxpayers are concentrated among the well-to-do and ultra-rich, while those in coach are overwhelmingly in the lower income brackets. All so that IRS might provide "the flexibility of specific identification" to a privileged group of taxpayers, myself included.

The Case for Instituting Third-Party Reporting

The late Senator Everett M. Dirksen is most remembered for a statement he likely never made: "A billion here, a billion there, and pretty soon you're talking real money." Apropos revenues lost because of unreported capital gains income, a paraphrase might well read: "Ten billion here, ten billion there, and pretty soon you're talking real money." (*The website for the Dirksen Congressional Center says there is no record that the fiscally conservative senator ever spoke those famous words. The Center is quick to add, however, that he undoubtedly would have agreed with the sentiment.)

Now let's look at several ways by which an interested party, such as the Committee, might arrive at that $10 billion figure. It comes as no surprise that revenue from capital gains taxes varies sharply from year to year, and that it rose by leaps and bounds in recent years. A generation ago, in 1980, capital gains taxes netted the Treasury $12.5 billion. The figure climbed close to 50% by 1983, when it reached $18.5 billion. In 1992 it was almost double that amount, or $32 billion. That number, too, was almost doubled in 1996 when the revenue inflow hit $62 billion.

And of course there were the stock market's peak years. Capital gains taxes ratcheted up to $84 billion in 1999 and to a record $110 billion in 1999. All of this, of course, from *reported* capital gains income. What about the revenue shortfall from income that went *unreported* because of the third-party loophole?

And so we arrive at one of the ways by which the yearly tax shortfall, resulting from unreported capital gains income, can be estimated at $10 billion or more. That figure could easily be reached by an underreporting rate in the neighborhood of 10% to 15%. Is this a harsh assessment of the nation's taxpayers? On the contrary, such an estimate assumes a remarkable degree of personal honesty; it assumes that 85–90 out of 100 people will be completely honest even when presented with a golden opportunity to be dishonest, to profit from their dishonesty, and to get away clean.

Here are some less sanguine viewpoints: In a December 2002 op-ed piece in The New York Times, Manhattan district attorney Robert M. Morgenthau decried what he saw as an escalating disregard for tax laws. He cited a survey which found that one in four Americans believe it's alright to cheat on their taxes, double the percentage who answered the same in a 1999 survey.

Or consider the valedictory of Charles O. Rossotti, who retired after five years as IRS commissioner with the admission that "the agency is steadily losing the war with tax cheats, especially the wealthiest and most sophisticated among them." Messrs. Rossotti and Morgenthau did not single out capital gains tax evasion, but Pulitzer journalists Donald L. Barlett and James B. Steele spoke directly to it in their book, *The Great American Tax Dodge: How Spiraling Fraud and Avoidance Are Killing Fairness, Destroying the Income Tax, and Costing You.* Here is a key sentence: "Of all the areas where fraud is easy to commit and most difficult to identify, capital gains income ranks near the top."

But all of this is only words. The most compelling rationale for third-party reporting of capital gains comes from hard data assembled by the IRS itself. We turn now to that information, and to its clear implications. Less than a year ago, Kim M. Bloomquist of the IRS presented a paper entitled *"Trends as Changes in Variance:*

The Case of Tax Noncompliance " at the 2003 IRS Research Conference. Early on, the paper addressed and reaffirmed the common-sense assumption that tax compliance (and non-compliance) correlate directly with third-party reporting: "One of the few generally accepted facts in the literature on tax compliance economics is the existence of a positive relationship between transaction visibility and reporting compliance. Over the years, various Government and academic studies have affirmed this relationship (Klepper and Nagin, 1989; Long and Swingden, 1990; Andreoni, Erard, and Feinstein, 1998). Random taxpayer audits conducted by the Internal Revenue Service (IRS) have consistently shown higher compliance rates among income items subject to third-party information reporting and withholding (i.e., matchable) versus nonmatchable sources of income (Christian, 1994). In the 1988 Taxpayer Compliance Measurement Program (TCMP) study, the average weighted net misreporting percentage of reported income was 1.8 percent for matchable income and 22.6 percent for nonmatchable income (Internal Revenue Service, 1996). Therefore, ceteris paribus, we would predict a positive correlation between the evasion rate and share of nonmatchable income."

Unfortunately for the Treasury, and for the nation's honest taxpayers, nonmatchable income has been increasing. Not surprisingly, one of the major causes has been capital gains income: "Table 1 shows the trend in matchable and nonmatchable sources of income between 1980 and 2000. In 1980, 91.3 percent of total reported taxpayer income was matchable. By 2000, this percentage had fallen nearly 10 percentage points to 81.6 percent. The principal factor responsible for this trend was the faster than average growth in the nonmatchable income components of taxable net capital gains and partnership and small business corporation (SBC) net income." (*Table not included in this submission.)

Leading, of course, to the predictable tax evasion consequences: "Holding constant the 1988 TCMP misreporting rates for matchable and nonmatchable income, it is estimated that, between 1980 and 2000, overall income underreporting rose from 3.6 percent to 5.6 percent of reported income due solely to the increase in the percentage of nonmatchable income. This trend of rising noncompliance is not driven by a change in taxpayer behavior but is simply the result of improved success from existing behavior. Therefore, if tax noncompliance is increasing, it is possible that this trend is unrelated to taxpayers' higher tax burdens or tax law complexity. Instead, taxpayers simply may be enjoying greater success at evasion due to reduced transactions visibility."

Summing up, the paper reiterated the role played by capital gains in driving up the share of unreported income: "What has caused the share of nonmatchable income to increase during the last two decades? Clearly, the stock market bubble of the late 1990's contributed significantly to the explosive growth in the value of financial assets. Between 1995 and 2000, the share of taxpayer reported adjusted gross income (AGI) from net capital gains jumped from 4 percent to 9‡ percent."

Let me repeat for the Committee, from the IRS paper, the tax compliance consequences that flow from reported and unreported income: *". . . the average weighted net misreporting percentage of reported income was 1.8 percent for matchable income and 22.6 percent for nonmatchable income."*

And then there is the fairness issue. Let me suggest, first of all, that there really is no issue. It is inequitable on its face that capital gains income should be exempt from the third-party reporting requirements that apply to wages and other forms of income.

I am hardly alone in noting this inequity. On March 26, 2001, IRS Commissioner Charles O. Rossotti wrote to Senator Charles Grassley, chairman of the Senate Finance Committee. Senator Grassley had seen an article in The New York Times quoting from an interview with Mr. Rossotti, and had written to him for elaboration. Here is some of what Mr. Rossotti said in reply: "One of my real concerns about the decline in audits is fairness to the majority of taxpayers whose income is reported and can be readily verified. It is relatively easy for the IRS to verify the returns and reported income of taxpayers whose income results from wages, interest and dividends and who take the standard deduction, who comprise the majority of taxpayers. It is harder, and often requires audits, to verify the income of taxpayers with other forms of income and deductions or more complex returns, who are often higher income taxpayers. The proportion of income that cannot be verified through document matching is 10% for taxpayers with income under $100,000, as compared with 35% for taxpayers over $100,000. Also, 91% of returns reporting income over $100,000 itemize deductions, compared to 26% of those below $100,000, and most itemized deductions cannot be verified through document matching. To the extent that the IRS uses more and more document matching and less and less auditing, the effect may be perceived as, and will in fact be unfair because higher income tax-

payers will not have their returns verified to the same degree as middle income taxpayers."

So that the original inequity, the non-reporting of capital gains, helps spawn a downstream inequity, the disproportionate surveillance by the IRS of the tax returns of the middle class. These inequities should not and need not stand. Neither should the Treasury have to lose upwards of $10 billion a year, year after year, to a tax loophole that could easily be closed. (As an aside, realize the difficulty of trying to estimate Treasury losses from unreported income. Exactly how is anyone to know? The IRS, for instance, has promised the Ways and Means Committee an answer by June 1 of this year to the question of whether annual tax losses on partnership/K–1 income are in the range of $9 billion to $64 billion. This is a huge range, and for much the same reason; such income is self-reported, and not subject to verification.)

Shortly before his retirement from the IRS, Rossotti spoke movingly of "the crown jewel, which is the fairness and faith the honest taxpayer has in the system." The crown jewel needs burnishing. Capital gains, like wages and other forms of income, should be subject to third-party reporting. There are a number of ways by which this can be accomplished. They are both simple and feasible, and I commend them to the Committee's attention.

Proposed Methods for Instituting the Reform

While the methods discussed below are different, and would yield different capital gains income figures, they share important characteristics. Each has particular qualities, but no special ones. None requires any exotic software, any development time, any trial-and-error experimentation. All are standard, everyday tools, employed by mutual funds and brokerage houses to calculate their customers' capital gains, and to communicate this information to them. Customers with internet access can view the information 24 hours a day, 7 days a week; other customers receive written statements monthly or quarterly, or, if they desire, can obtain the same information by telephone any business day.

Putting it another way, it would impose no burden on financial institutions to require third-party reporting of capital gains income. The institutions routinely compile the information, routinely update it on a daily basis, and routinely report it to their customers. Come tax time, they should be required to report the same information to the IRS.

Any of the methods presented here could be the sole method by which third-party reporting is implemented. Alternatively, the methods could be offered as a choice to investors. And of course there are methods other than these. A small reminder before proceeding. This submission is not about which method to use. The only issue at hand is third-party reporting of capital gains income, by whatever method the Congress elects. Here are three ways that third-party reporting might be achieved.

Average Cost Basis

Average cost basis is probably the most commonly used method, particularly by mutual funds, of calculating investors' basis costs. It simply totals the number of shares and the prices paid, and determines the basis by dividing the total price by the number of shares held. It does not consider when any particular shares were purchased, or how much was paid for any particular group of shares. It is simple and straightforward, and would be a perfectly equitable method of third-party reporting. However, thanks to computer technology, two other methods offer investors superior tax-efficiency.

Highest-In, First-Out (HIFO)

Current tax rules require that mutual funds distribute essentially all of their dividends and realized capital gains each year as taxable income. These rules have led to a relatively new breed of so-called tax-managed funds. The objective of these funds is to keep the taxable gain to shareholders as low as possible; the funds do this by first selling their highest-cost shares, which can be a much more tax-efficient method than FIFO (first-in, first-out). HIFO not only minimizes capital gains, it also maximizes capital losses. Losses of course can be written off dollar-for-dollar against gains, and an additional $3,000 can be used to offset ordinary income; losses greater than $3,000 can be carried forward and used to offset future gains. All things considered, HIFO would probably be the most attractive method for investors of determining basis costs for third-party reporting of capital gains. And the higher the tax bracket, the more investors would stand to gain from HIFO accounting.

Specific Identification

"Specific Share Trading for Mutual Fund Shares Now Available."

That was the announcement from Fidelity Investments on October 18, 2002 to its customers, including myself. The announcement went on: "Looking to use the specific share method when selling your mutual fund positions online? Look no further. Fidelity now offers customers who hold eligible mutual fund positions in non-retirement accounts to track and specify shares when selling those positions."

Among other things, subject to "certain exceptions and limitations," the company said that customers could 1) "Request Fidelity to sort and pre-select the tax lots that best match your tax objectives . . .", 2) "Sort and review up to 150 open tax lots by holding period (short—or long-term) and/or by cost basis per share," 3) "Get a confirmation of your specific share instructions on either your regular trade confirmation or via special correspondence. The gain or loss is then reported both online and on your regular Investment Report."

As Fidelity put it, "Fidelity customers have always been able to use the specific share method for their mutual fund holdings. However, they needed to maintain their own cost basis tracking—a complicated recordkeeping requirement that deterred many from taking advantage of the accounting feature. Now, Fidelity is taking all that recordkeeping off of your hands." It deserves to be noted that investors have no inherent right to specific identification as a means of calculating basis costs. While current tax law grants such a privilege, it is outweighed by both tax equity and fiscal policy considerations. That said, specific identification is in fact another possible means of achieving third-party reporting of capital gains income. We have this information from an excellent source. We have it from Fidelity Investments, which announced the availability of specific identification more than a year and a half ago.

Summary

We have examined and explored the lack of third-party reporting of capital gains income. To what conclusions does the evidence lead? There is no tax equity defense (nor has the author ever seen one put forth) for allowing self-reporting of capital gains income while requiring third-party reporting of wages, dividends, interest, and all manner of miscellaneous income. Similarly, it makes no fiscal sense for the Congress to tolerate the untold billions of dollars lost to the Treasury, year after year, due to the lack of third-party capital gains reporting. The IRS's own statistics show that tax evasion is 12‡ times more frequent when income is self-reported than when it is reported by third parties; this alone should be inducement enough for the Congress to require third-party reporting of capital gains.

In a sense, the Committee is blessed to face this problem. There is no complexity here; there is no opaqueness. The problem is simple and straightforward, and the solution as well. The problem is the absence of third-party reporting of capital gains; the solution is to require such reporting, and the systems are essentially already in place to perform it. If the Committee will allow, let me repeat the quote from Assistant Treasury Secretary Olson's letter of May 23, 2002: ". . . Mr. Scorse believes that tax compliance would be improved if information reporting for capital gains included the amount of capital gains income that a taxpayer is required to show on his or her return. We couldn't agree more! Information reporting is the most efficient, least intrusive way of helping taxpayers comply with their tax obligations to the federal government." I ask the Committee to review the facts, and to do the right thing.

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