AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

2005 TAX RETURN FILING SEASON AND THE IRS BUDGET FOR FISCAL YEAR 2006

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

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

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

APRIL 14, 2005

Serial No. 109–32

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

24–767 WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON WAYS AND MEANS

BILL THOMAS, California, *Chairman*

E. CLAY SHAW, JR., Florida
NANCY L. JOHNSON, Connecticut
WALLY HERGER, California
JIM MCCRERY, Louisiana
DAVE CAMP, Michigan
JIM RAMSTAD, Minnesota
JIM NUSSLE, Iowa
SAM JOHNSON, Texas
ROB PORTMAN, Ohio
PHIL ENGLISH, Pennsylvania
J.D. HAYWORTH, Arizona
JERRY WELLER, Illinois
KENNY C. HULSHOF, Missouri
RON LEWIS, Kentucky
MARK FOLEY, Florida
KEVIN BRADY, Texas
THOMAS M. REYNOLDS, New York
PAUL RYAN, Wisconsin
ERIC CANTOR, Virginia
JOHN LINDER, Georgia
BOB BEAUPREZ, Colorado
MELISSA A. HART, Pennsylvania
CHRIS CHOCOLA, Indiana

CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California
SANDER M. LEVIN, Michigan
BENJAMIN L. CARDIN, Maryland
JIM MCDERMOTT, Washington
JOHN LEWIS, Georgia
RICHARD E. NEAL, Massachusetts
MICHAEL R. MCNULTY, New York
WILLIAM J. JEFFERSON, Louisiana
JOHN S. TANNER, Tennessee
XAVIER BECERRA, California
LLOYD DOGGETT, Texas
EARL POMEROY, North Dakota
STEPHANIE TUBBS JONES, Ohio
MIKE THOMPSON, California
JOHN B. LARSON, Connecticut
RAHM EMANUEL, Illinois

ALLISON H. GILES, *Chief of Staff*
JANICE MAYS, *Minority Chief Counsel*

SUBCOMMITTEE ON OVERSIGHT

JIM RAMSTAD, Minnesota, *Chairman*

ERIC CANTOR, Virginia
BOB BEAUPREZ, Colorado
THOMAS M. REYNOLDS, New York
JOHN LINDER, Georgia
E. CLAY SHAW, JR., Florida
SAM JOHNSON, Texas
ROB PORTMAN, Ohio

JOHN LEWIS, Georgia
EARL POMEROY, North Dakota
MICHAEL R. MCNULTY, New York
JOHN S. TANNER, Tennessee
CHARLES B. RANGEL, New York

Pursuant to clause 2(e)(4) of Rule XI of the Rules of the House, public hearing records of the Committee on Ways and Means are also published in electronic form. **The printed hearing record remains the official version.** Because electronic submissions are used to prepare both printed and electronic versions of the hearing record, the process of converting between various electronic formats may introduce unintentional errors or omissions. Such occurrences are inherent in the current publication process and should diminish as the process is further refined.

CONTENTS

	Page
Advisories announcing the hearing	2

WITNESSES

Internal Revenue Service, Hon. Mark Everson, Commissioner	6
Internal Revenue Service Oversight Board, Raymond Wagner, Chair	58
U.S. Government Accountability Office, James R. White, Director, Tax Issues	30
American Bar Association, Kenneth Gideon	67
American Institute of Certified Public Accountants, Thomas J. Purcell, III	71
National Association of Enrolled Agents, Frank Degan	76
National Council for Taxpayer Advocacy, William Stevenson	80
Intuit Corporation, Brad Smith	84

SUBMISSIONS FOR THE RECORD

National Treasury Employees Union, Colleen M. Kelley, statement	101
Northern Illinois University, Katrina L. Mantzke, and University of Wisconsin-Milwaukee, Christin C. Bauman, joint statement	103
Scorse, Gerald E., New York, NY, statement	112

2005 TAX RETURN FILING SEASON AND THE IRS BUDGET FOR FISCAL YEAR 2006

THURSDAY, APRIL 14, 2005

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

The Subcommittee met, pursuant to notice, at 3:40 p.m., in room B–318, Rayburn House Office Building, Hon. Jim Ramstad (Chairman of the Subcommittee) presiding.

[The advisory and revised advisory announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
March 31, 2005
OV–1

CONTACT: (202) 225–7601

Ramstad Announces Hearing on 2005 Tax Return Filing Season and the IRS Budget for fiscal Year 2006

Congressman Jim Ramstad (R–MN), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the 2005 tax return filing season, current issues in tax administration, and the Internal Revenue Service (IRS) budget for fiscal year 2006. **The hearing will take place on Thursday, April 7, 2005, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:00 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. Government Accountability Office (GAO), the IRS Oversight Board, the Tax Section of the American Bar Association, the American Institute of Certified Public Accountants, National Council for Taxpayer Advocacy, and the National Association of Enrolled Agents.

BACKGROUND:

The 2005 tax return filing season refers to the period from January 1st to April 15th when U.S. taxpayers will file more than 100 million tax returns, including more than 50 million e-filed returns. During this period the IRS is expected to issue more than 80 million tax refunds, answer more than 20 million telephone calls from taxpayers asking for assistance, and its homepage will receive more than 100 million visits. The IRS website is among the busiest in the world during the filing season.

The Administration's budget requests $10.68 billion to fund the IRS for fiscal year 2006, an increase of 4.3 percent over the FY 2005 enacted amount. This level of funding will support approximately 97,010 employees who will collect nearly $2 trillion in revenue from all sources and pay over $200 billion in refunds. The fiscal year 2006 budget request addresses the Administration's key strategic goals for the IRS.

In announcing the hearing, Chairman Ramstad stated, "More than 130 million Americans will report their income and file a tax return this year. These taxpayers deserve efficiency and fair and courteous treatment from the government they are helping to support.

"I look forward to hearing from IRS Commissioner Mark Everson and a number of tax experts about this year's tax filing season. The Oversight Subcommittee will seek to ensure that the IRS is using its resources efficiently, that it is doing everything possible to promote voluntary compliance, and that it is dealing fairly and honestly with taxpayers."

FOCUS OF THE HEARING:

The hearing will focus on the 2005 tax return filing season, current issues in tax administration, and the IRS budget for fiscal year 2006.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, April 21, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item 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 submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies 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 submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission 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.

*** * * NOTICE—CHANGE IN DATE AND LOCATION * * ***

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
April 14, 2005
OV–1 Revised

CONTACT: (202) 225–7601

Change in Date and Location for Hearing on 2005 Tax Return Filing Season and the IRS Budget for fiscal Year 2006

Congressman Jim Ramstad (R–MN), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee hearing on the 2005 tax return filing season, current issues in tax administration, and the Internal Revenue Service budget for fiscal year 2006, previously scheduled for Thursday, April 7, 2005, at 2:00 p.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will now be held on Thursday, April 14, 2005, in B–318 Rayburn House Office Building, at 2:00 p.m., or at the conclusion of the full Committee hearing.**

The deadline to provide a submission for the record will now be close of business, Thursday, April 28, 2005. All other details for the hearing remain the same. (See Subcommittee Advisory No. OV–1, dated March 31, 2005).

Chairman RAMSTAD. The hearing will come to order. Please bear with me, because the last time I chaired a hearing or chaired anything, was as student council president.

[Laughter.]

Chairman RAMSTAD. I want to welcome all of you, on the eve of tax day, to this hearing on the 2005 tax return filing season and the 2006 Internal Revenue Service (IRS) budget. Now, I am going to apologize to all the witnesses and all of you here for the delay. House rules are House rules, and as long as the full Committee on Ways and Means was meeting, we could not convene this hearing for the Subcommittee on Oversight. Nonetheless, I apologize for the delay. I also want to say it is a privilege to serve on this Subcommittee with such a distinguished Ranking Member, my friend from Georgia, one of the most-respected Members in the entire Congress, Mr. Lewis. John, look forward to working with you, just as my predecessor, Chairman Amo Houghton, worked so closely with Mr. Pomeroy on this Subcommittee.

A hallmark of our tax system is the honesty of the American taxpayer. A recent study by IRS showed that over 80 percent of all income earned is faithfully reported by individuals and businessowners. Taxpayers will pay just over $2 trillion in taxes this year. These hard-working taxpayers want and deserve an IRS that is responsive to their needs. While there is still work to do, the IRS has made great strides in improving taxpayer service since

1998. One example of many is the IRS website which will receive well over 100 million visits during this tax filing season. More than 4 million taxpayers will file online for free, thanks to an innovative partnership with the private sector known as Free File. Retaining the goodwill of American taxpayers by providing professional service and detailed guidance on how to comply with the law is critical to sustaining voluntary compliance. I look forward to hearing Commissioner Everson's plans to maintain high levels of service in the face of expected budget constraints. Under Commissioner Everson's leadership, the IRS also has made outstanding progress in stemming the tide of corrosive tax shelters and overly aggressive tax planning. With President Bush's support, the Commissioner has increased the number of frontline enforcement personnel and has launched a series of enforcement initiatives aimed at stopping illegal tax fraud. Through these efforts, Commissioner Everson has helped restore peace of mind to compliant taxpayers who in recent years had begun to wonder if they were paying more than their fair share.

We are fortunate to have a number of distinguished witnesses before us today. The first panel will consist of IRS Commissioner Mark Everson. The second panel will consist of Director James White of the U.S. government Accountability Office (GAO) and Chairman Ray Wagner of the IRS Oversight Board. The third panel will feature testimony from representatives of practitioner groups. They will discuss the filing season from the perspective of experts who help the average taxpayer interact with the IRS. I am now pleased to recognize the distinguished Ranking Member, my friend, Mr. Lewis.

[The opening statement of Chairman Ramstad follows:]

Opening Statement of The Honorable Jim Ramstad, Chairman, Subcommittee on Oversight, and a Representative in Congress from the State of Minnesota

I want to welcome all of you to this hearing on the 2005 tax return filing season and the 2006 Internal Revenue Service (IRS) budget.

A hallmark of our tax system is the honesty of the American taxpayer. A recent study by the IRS showed that over eighty percent of all income earned is faithfully reported by individuals and business owners. Taxpayers will pay just over $2 trillion in 2005. These taxpayers deserve an Internal Revenue Service that is responsive to their needs.

While there is still work to do, the IRS has made great strides in improving taxpayer service since 1998. One example is the IRS website, which will receive well over 100 million visits during the tax filing season.

More than four million taxpayers will file online for free, thanks to an innovative partnership with the private sector, known as Free File. Retaining the good will of American taxpayers by providing professional service and detailed guidance on how to comply with the law is critical to sustaining voluntary compliance. I look forward to hearing Commissioner Everson's plans to maintain high levels of service in the face of expected budget constraints.

Under Commissioner Everson's leadership, the IRS also has made outstanding progress in stemming the tide of corrosive tax shelters and overly aggressive tax planning. With President Bush's support, the Commissioner has increased the number of frontline enforcement personnel, and has launched a series of enforcement initiatives aimed at stopping illegal tax dodges.

Through these efforts Commissioner Everson has helped to restore peace of mind to compliant taxpayers, who in recent years had begun to wonder if they were paying more than their fair share.

We are fortunate to have a number of distinguished witnesses before us today. The first panel will consist of IRS Commissioner Mark Everson.

On the second panel, we will hear from Director James White of the Government Accountability Office and Chairman Ray Wagner of the IRS Oversight Board. These witnesses will provide their assessment of the IRS's recent work, and its budget for next year.

The third panel will feature testimony from representatives of practitioner groups. They will discuss the filing season from the perspective of experts who help the average taxpayer interact with the IRS. We value their insights regarding a number of the challenges confronting the IRS, including the complexity of the tax code and electronic filing. I look forward to all of the witnesses' testimony.

Mr. LEWIS. Thank you very much, Mr. Chairman. I am pleased to serve as the Ranking Member of the Committee on Ways and Means, Subcommittee on Oversight for the 109th Congress. I look forward to working closer with you, Mr. Chairman, my friend, my colleague, my brother. It is wonderful to be working with you. Since serving on the Committee on Ways and Means, since serving on the Congress, we have been friends, and on this Committee we will continue to be friends. It is my hope and my prayer that we will work so close together, people will not know whether I am a Democrat or whether you are a Republican.

[Laughter.]

Mr. LEWIS. Mr. Chairman, I want to thank you for postponing the hearing today, so that I and the Subcommittee Members could be here to participate. As in the past, the Subcommittee is holding their first hearing of the year to examine how to current tax return filing season is progressing, and the adequacy of the Administration proposed budget for the IRS for the next fiscal year. I want to thank you, Mr. Chairman, for conducting this annual oversight review of the IRS. More than 130 million tax returns will be filed during the 2005 tax return filing season which ends tomorrow, April 15th. Reports indicate that the tax return filing season is progressing smoothly. IRS employees nationwide should be commended for their diligence and their very hard work. The Administration has proposed, for fiscal year 2006, an IRS budget of $10.68 billion. I note with great interest that the IRS Oversight Board recommend a 13-percent increase over the amount that Congress provided the IRS last year. I look forward to our discussion of the Board's concern and the testimony of our other distinguished witnesses. It is important that the IRS operate in a fair manner with a balanced approach to administer our tax laws. Mr. Chairman, again, it is a pleasure, an honor, to serve with you and I especially want to recognize and thank the Commissioner for being here, for all of his good work. Thank you very much, Mr. Chairman.

Chairman RAMSTAD. Thank you, Mr. Lewis.

It is now a pleasure to introduce our first witness, the Commissioner of the IRS, Commissioner Mark Everson.

STATEMENT OF MARK EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. EVERSON. Thank you, Mr. Chairman and Mr. Lewis. I appreciate the opportunity to be here with you today, and I congratulate you and thank you for your willingness to serve in your positions. We felt a little jilted by Mr. Pomeroy. I guess he decided that agriculture was more important to his State than maybe the taxes,

but we understand, and, Mr. Lewis, we are very pleased that you are devoting your energies to this position.

Mr. LEWIS. You won't miss him. He will be back. He will be right here, to my left.

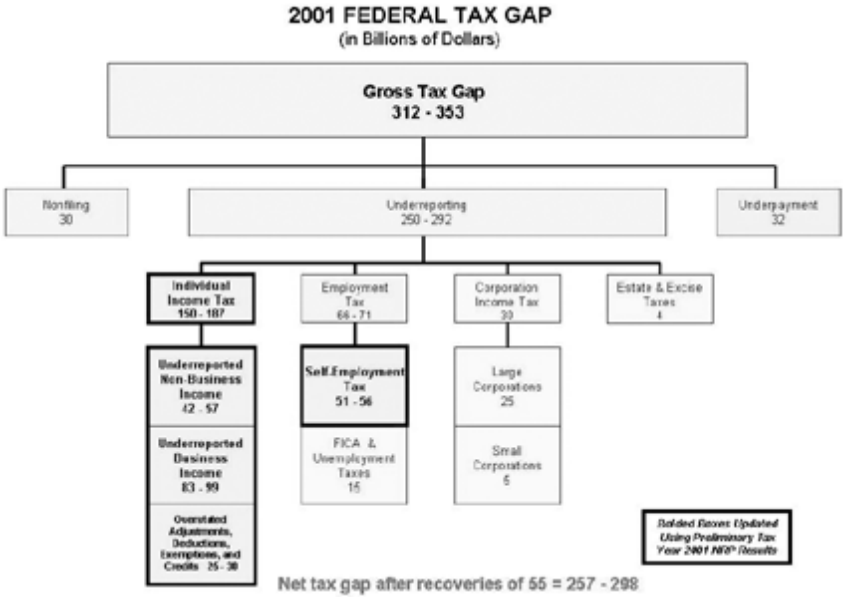
Chairman RAMSTAD. Still a Member of the Subcommittee.

Mr. EVERSON. Very good. As of April 8, 2005 we have received more than 88 million total individual returns. Of these, 55.8 million were electronically filed and 32.3 million were paper. Electronic filing continues to grow. Last year individuals filed almost 62 million electronic returns. This year we expect that over half of all individual returns will be e-filed. Paper filers are now in the minority. Electronic filing is fast, convenient and gets you your refund back in half the time of a paper return. As of April 2, use of our website, which you mentioned, Mr. Chairman, has already exceeded 110 million hits, about double the amount of last year. Taxpayer use of our popular "Where's my refund" feature on the web page has risen to 45 percent over last year. Our telephone service, that is answering questions from taxpayers, continues to improve. Through the end of March our customer accuracy was 91.6 percent, up from 89.3 percent, and our tax law accuracy has improved from 77.7 percent last year to 88 percent in 2005. While we improve services, we are boosting enforcement. The President's 2006 request for the IRS is crafted to continue to do the necessary rebuilding of our enforcement capabilities, and it maintains a stable commitment to our important IT modernization programs. Both enforcement and modernization were categorized earlier this year by the GAO as high-risk areas of government-wide importance.

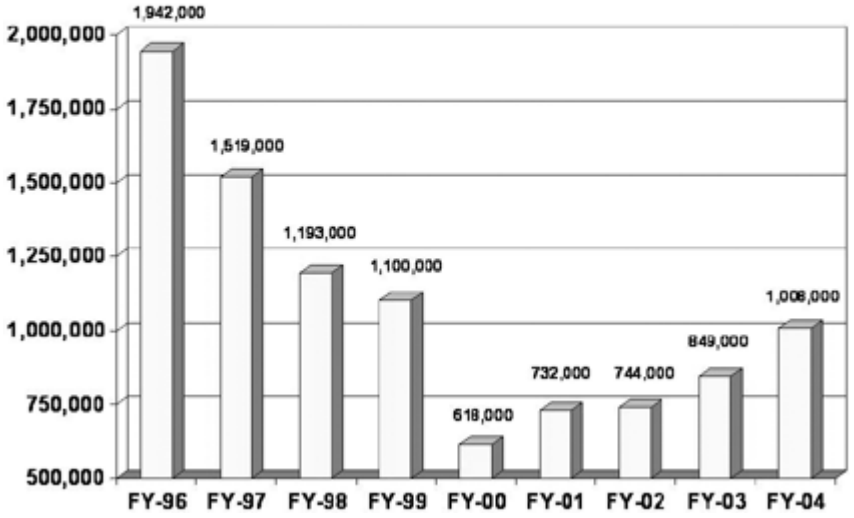
The 2006 budget request calls for a modest amount of belt tightening in taxpayer services. The percent cut to services is consistent with the request for domestic discretionary programs, other than those associated with homeland security. In a report issued last year—and there is a chart here—the GAO stated: "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' walk-in assistance sites is declining. The improvements in telephone service, increased website 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 President's request for the IRS adopts just this approach. I am comfortable with the request and support it wholeheartedly. I believe that if enacted at the requested level, without constraining language, the IRS will continue to provide good services to taxpayers. The budget will hold Business Systems Modernization (BSM) funding steady at substantially the same level as 2005. In terms of modernizing our big computer systems at the IRS after years of cost overruns and missed delivery dates, we are finally showing results. In the past 9 months, two important systems have come online. We have a new financial system to help better manage the Agency, and more importantly, this filing season we have already processed over a million 1040-EZ returns using the first new processing system in 40 years.

The 2006 budget continues investment in three critical areas: further work on return processing, collections and electronic filing. Several weeks ago we announced that the gross tax gap, that is, the difference between what taxpayers should pay and what they actually pay on a timely basis, exceeds $300 billion per year. Average Americans pay their taxes honestly and accurately, and have every right to be confident that when they do so, neighbors and competitors are doing the same. We have taken some important steps to bolster this confidence. We have ramped up our audits of individuals. That is, in that chart over there, 600,000 audits 4 years ago to over a million audits in fiscal year 2004. Particularly for high-income individuals, as you can see, we have basically doubled that number over the same period. Corporations have come up as well, and we are focusing more attention on abusive shelters and more criminal investigations. We recently announced collections of over $3.2 billion in a settlement initiative for Son of Boss, a particularly abusive shelter. The proposed 2006 budget calls for a nearly 8-percent increase for enforcement. This will enable us to expand our activities across each of our four strategic enforcement priorities; first, to discourage and deter noncompliance with emphasis on corrosive activity by corporations, high income individuals, and other contributors to the tax cap; second, to ensure that attorneys, accountants and other tax practitioners adhere to professional standards; third, to detect and deter domestic and offshore based tax and financial criminal activity; and, finally, to deter abuse within tax exempt and governmental entities and misuse of such entities by third parties.

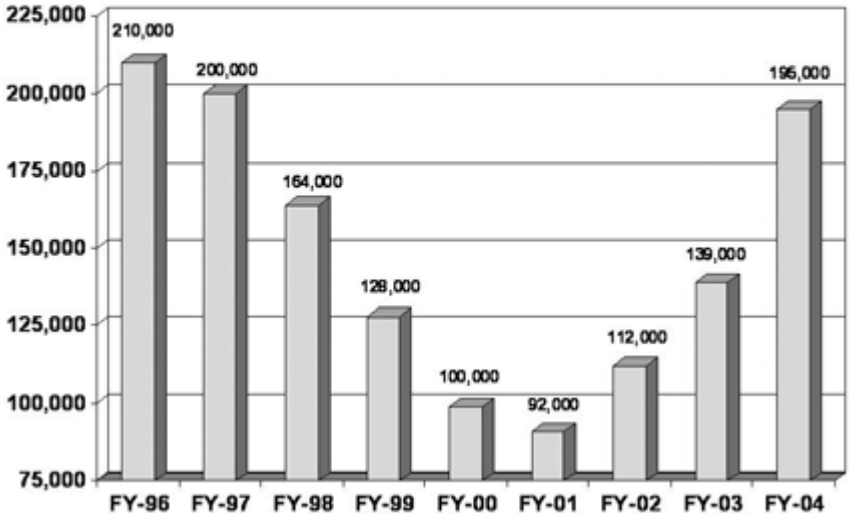
[The exhibits follow:]

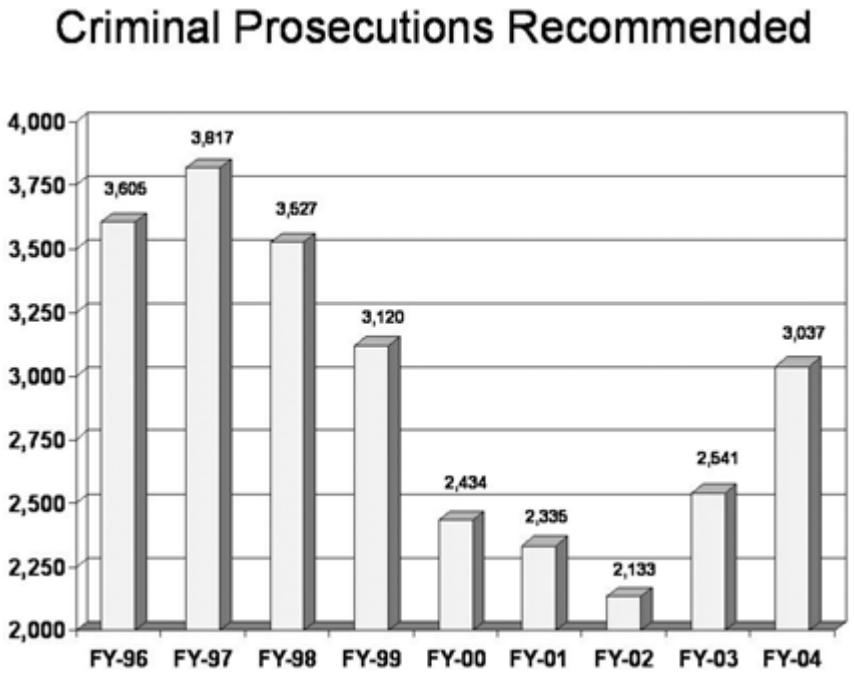


Individual Audits



High Income Audits





What I am going to do now is just make one final point, since I see your red light. I would point out that, in the Senate budget resolution there is a protection of this enforcement initiative. That is not present on the House side. I urge you to support what is the Senate's position so that we can get that money and continue to rebuild our compliance efforts, the success of which is in the final chart I have of the direct enforcement revenues, which have increased from $34 billion in fiscal year 2002 to $41 billion in fiscal year 2004.

[The prepared statement of Mr. Everson follows:]

Statement of The Honorable Mark Everson Commissioner, Internal Revenue Service

Chairman Ramstad, Ranking Member Lewis, and Members of the Subcommittee, thank you for the opportunity testify today on the 2005 tax filing season and our FY 2006 budget request. I congratulate you, Mr. Chairman and Ranking Member Lewis, for your selections as the leaders on this panel. I look forward to working with you as you exercise your oversight responsibilities and we ensure the fair and efficient administration of taxes.

I have been on the job for nearly two years. Last year, I testified about the IRS mission of service and enforcement, and about our need to modernize. I spoke about how the IRS was doing a good job improving service, had a mixed record on modernization, and had work to do to restore enforcement to proper levels.

Today, I wish to update the Subcommittee on what we have accomplished over the past year, addressing enforcement, the area where our challenges remain the greatest. Let me first update the Subcommittee about service. By service, I mean helping people understand their tax obligations and making it easier for them to participate in the tax system.

The IRS has greatly improved service to our nation's taxpayers over the last several years. We are delivering services to taxpayers and we have improved the efficiency and effectiveness for our tax administration system. The deficit in the quality of service that the IRS was providing prior to the 1990s is closing.

Customer Satisfaction

The American Customer Satisfaction Index (ACSI), which began in 1994, is a measure of customer satisfaction that covers seven economic sectors, 40 industries, more than 200 private sector companies, and many governmental agencies. Scores are reported on a 0 to 100 scale based on survey data from consumer households across the nation. The ACSI is produced by the NationalQualityResearchCenter at the University of Michigan Business School, the Claes Fornell International (CFI) Group, and the Federal Consulting Group (FCG). Claes Fornell, Chairman of the CFI Group, recently praised our progress. He said,

> The Internal Revenue Service (IRS) continues to improve its services. The IRS is obviously in a special category when it comes to the satisfaction of the people it deals with, and cannot be compared with the private sector or even with most public sector services. The collection of taxes is not an activity that taxpayers look forward to or expect a great deal of satisfaction from. But even in the face of this handicap, the IRS continues to improve on taxpayer satisfaction. Since 1999, IRS' overall ACSI score has surged by 26%. While the rate of the improvement has slowed recently, it is clear that a good deal of this increase is attributable to electronic filing. Filers find it convenient, accurate, and refunds are delivered quickly. The satisfaction score for electronic filing stands at a remarkable 78, compared with paper filing at 52. The more tax filers the IRS manages to move from paper to electronic filing, the more customer satisfaction can be expected to increase.

Return Receipts / Electronic Filing

Electronic filing continues to grow. Last year, individuals filed over 61 million electronic returns. This year, we expect that over half of all individual returns will be e-filed. Thus it appears that individuals who file paper tax returns will soon be in the minority. We take every opportunity we can to broadcast the benefits of electronic filing, including a reduction in processing errors and cost savings for taxpayers and the IRS. E-filing is fast, convenient, and gets your refund to you in half the time of paper returns.

As of April 8, 2005, we have received more than 88 million total individual returns. 55.8 million returns (63.4 percent) are electronically filed and 32.3 million (36.7 percent) are paper.

- The number of online returns is 13.6 million, a 14.6 percent increase from last year.
- Through March 30, 2005, 3.9 million Free File returns have been accepted, an increase of 44 percent from last year.
- We have issued 72.3 million refunds. Total dollars paid are 3.44 percent higher than last year, with an average refund of $2,189 paid.

IRS.gov

Use of our website, IRS.gov, has exceeded 105.4 million homepage visits, up 117 percent from 2004. Not surprisingly, during the filing season, it is one of the busiest websites in the world. We average more than one million visits a day. Many of those visits are to the "Free File" page, which allows taxpayers visiting the website to chose among several free, online filing options. As of April 9, over 16.1 million taxpayers used the "Where's my Refund" feature on the web page, an increase of 45 percent from the same time last filing season. These visits decrease the need to visit a Taxpayer Assistance Center (TAC), or to call our operators, which allows them to focus on more complex calls. During the past year, we have also rolled out important new online services to tax professionals to help them better serve their clients. Tax practitioners and other third parties, such as banks and brokerage firms that file 1099s, may now access the following functionalities online: electronic account resolution, transcript delivery, secure email, disclosure authorization, and bulk Taxpayer Identification Number (TIN) matching. In fact, as of April 12, 2005, tax practitioners submitted 2925 cases for Electronic Account Resolution, 52,824 requests for transcripts, 24.3 million Bulk TIN matching requests, and over 13,000 powers of attorney or disclosure authorizations.

Telephone Service

Our efforts to improve call routing, as well as staffing and training of phone assistors have allowed us to reach world-class service. In filing season 2005, we are maintaining the level of service that our customers have come to expect from us.

As recently as fiscal year 2002, the level of service for those taxpayers who want to speak to an assistor was 68 percent. Our improvement efforts raised the level to 80 percent in 2003 and to an all-time high of 87 percent in 2004.

Calls are routed from taxpayers to the proper subject matter expert and the system balances workforce planning against the historic workload patterns to reduce waiting time from 263 seconds in fiscal year 2002 to 205 seconds in fiscal year 2005. That's about a minute less time on hold for every call.

In FY 2004, the number of taxpayers receiving busy signals decreased to 220,000, a 66 percent reduction from the previous year. And, that is a reduction of 99.5 percent from the 2.6 million busy signals generated as recently as FY 2002.

Our telephone service—that is, answering questions from taxpayers—continues to improve. We measure telephone quality two ways, 1) customer account accuracy and 2) tax law accuracy. For the filing season, our customer account accuracy is 91.6 percent, up from 89.3 percent; our tax law accuracy has improvedfrom 77.7 percent in 2004 to 88 percent in 2005.

Continuing Service and Increasing Enforcement

We are quite aware of the need to operate efficiently, consolidate operations and drive down costs wherever we can. In today's fiscal environment, we recognize that resources are tight. Nevertheless, we are determined to do all we can to improve service and modernize the IRS. In the last several years, we have begun to arrest the decline in enforcement and stabilize IRS enforcement staffing; now 73 percent of taxpayers *completely agree* that it is every American's duty to pay their fair share of taxes, up from 68 percent in 2003. A 2004 IRS Oversight Board commissioned NOP World study revealed 79 percent of taxpayers believe it is very important for the IRS to enforce compliance from high-income individuals and 85 percent believe it is very important for the IRS to enforce compliance from corporations. But in order to continue to reverse the downward trend of compliance, we must continue to use our resources wisely.

We are working aggressively to improve productivity and achieve cost savings, which we will apply to other priority areas, such as enforcement. The FY 2006 budget reduction initiatives focus mainly on targeted reductions in assistance, outreach, and processing program areas. Reductions will also be achieved through improved efficiencies and re-engineering of business processes in key program areas in accounts management, submission processing, media and publications, field assistance, and outreach and education. Approximately 65 percent of these reductions will occur in assistance, 20 percent in outreach and 15 percent in processing. We will minimize the impact on taxpayers by providing alternative means to obtain service, wherever possible. Our budget estimates all these taxpayer service reengineering initiatives will yield $134 million in savings we can reinvest in other program areas. The reductions represent a balanced approach in program delivery and service to taxpayers to enable them to meet their tax obligations.

We estimate savings of $75 to 95 million from additional efficiencies in our field assistance, accounts management and toll-free telephone operations. We will achieve these savings, in part, because of our recent consolidation our Customer Accounts Service organizations and revamping our business processes. For example, due to the steady decline in taxpayers corresponding with us about their accounts, we will need fewer resources to manage these accounts. We are also adjusting the hours of our toll-free telephone operations from 15 to 12 hours daily, Monday through Friday in the local times zones, beginning in 2005. We expect minimal impact to our level of service for taxpayers who call us. Another portion of these savings will come from reducing the number of walk-in sites. In recent years, the number of taxpayers walking into a Taxpayer Assistance Center (TAC) site for assistance has decreased from a high of nearly 10 million contacts in FY 2000 to about 7.7 million contacts in FY 2004. This trend reflects the increased availability and quality of services that do not require travel or waiting in line. Examples include improved access to IRS telephone service, the increasing availability of volunteer assistance, and the many services now available through IRS.gov, such as "Free File" and "Where's My Refund." In addition, the ability to download forms online has also contributed to the decline in the number of customers walking into a TAC. We have also continued to improve our telephone service for taxpayers who call the IRS with questions. The use of other alternatives, such as volunteer return assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly (TCE) sites, has steadily increased while the number of TAC contacts decreased. In FY 1999, for example, VITA sites filed almost 584,000 returns, and TCE sites filed 446,000 returns. In the next five years, the numbers of returns filed through these sites increased 88 percent, reaching 976,000 VITA returns and 958,000 TCE returns in FY 2004.

Because of these other options, fewer taxpayers need to travel to an IRS office to get the services they need. There are currently about 400 TAC sites across the country which are serviced by approximately 2,300 TAC employees. We believe that adjusting the TAC sites to more closely align to this decreased walk-in volume will

yield staffing and building cost savings of $45 to 55 million of the $75 to 95 million in savings, and allow us the flexibility to improve efficiencies and concentrate more on front-line enforcement.

We have developed a criteria model that measures the impact on taxpayers across the country. The criteria include: location, employee cost, facilities cost, workload, and demographic measurements. In anticipation of the closing of approximately 70 TACs and their employees, we have requested authority to offer early-outs and buy-outs to all eligible IRS TAC personnel. We expect to have further announcements in the near future.

In addition to reducing the number of TAC sites, we will save $20 to $31 million in outreach programs though reductions in printing and postage and additional efficiencies in our outreach organizations. For example, we will save more money in printing and postage as taxpayers shift to e-filing, and as we eliminate redundant services and publications.

We will save another $17 to $23 million by retiring Telefile, implementing program enhancements in the processing of employment tax returns, and re-engineering processes in Submission Processing. We will redirect taxpayers who previously used Telefile to e-file alternatives, such as Free File, that are available through IRS.gov so we maintain an acceptable level of service.

Though we are re-engineering how we provide service, we will continually strive to improve service to taxpayers. Having stated this, I must address the fundamental issue of enforcement.

While the President's Budget Request to Congress would increase IRS enforcement activities by 7.8 percent, given the current budgetary constraints, we responsibly proposed to reduce spending in other areas throughout the Service. We are confronted with difficult choices.

Average Americans pay their taxes honestly and accurately, and have every right to be confident that when they do so, their neighbors and competitors are doing the same. Let me provide an overview of the steps we have taken over the past year to bolster this confidence, turning briefly to each of our four service-wide enforcement priorities.

Our first enforcement priority is to discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individuals, and other contributors to the tax gap.

- In 2004, audits of high-income taxpayers jumped 40 percent from the year before. We audited almost 200,000 high-income individuals last year—double the number from 2000.
- Overall, audits for individuals exceeded the one million mark last year, up from 618,000 four years earlier.
- In 2004, the number of audits of the largest businesses—those with assets of $10 million or more—finally increased after years of decline.

The centerpiece of our enforcement strategy is combating abusive tax shelters, both for corporations and high-income individuals. I will touch upon two important initiatives of the past twelve months.

We have continued our program of settlement offers for those who entered into abusive transactions in the past but would like to get their problems behind them. Last May, we made a settlement offer regarding the Son of Boss tax shelter, a particularly abusive transaction used by wealthy individuals to eliminate taxes on large gains, often in the tens of millions of dollars. In this program, for the first time, the IRS required a total concession by the taxpayer of artificial losses claimed. I am pleased with the response to the offer. So far, $3.2 billion in taxes, interest and penalties have been collected from the 1,165 taxpayers who are participating in the settlement initiative. The typical taxpayer payment was almost $1 million, with 18 taxpayers paying more than $20 million each and one paying over $100 million. Processing of individual settlements continues.

Based on disclosures we have received from promoter investigations and from investor lists from Justice Department litigation, we have determined that just over 1,800 people participated in Son of Boss. When the project concludes in the coming months, we expect the collected figure should top $3.5 billion.

In February 2005, we announced a second important settlement initiative—this one involving executive stock options. This abusive tax transaction involved the transfer of stock options or restricted stock to family-controlled entities. These deals were done for the personal benefit of executives, sometimes at the expense of public shareholders. This shelter was not just a matter of tax avoidance but, in some instances, raises basic questions about corporate governance. Again, the settlement offer is a tough one: full payment of the taxes plus a penalty.

A noteworthy point about the stock option settlement offer is that our actions in this matter were closely coordinated with the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

Our settlement initiatives and increased audits have sent a signal to taxpayers: the playing field is no longer as lopsided as it once was. Non-compliant taxpayers might have to pay the entire tax, interest, and a stiff penalty. A taxpayer might have to wrestle with questions like "how much am I going to have to pay the lawyers and expert witnesses to litigate this thing?" Moreover, going to court is a public matter. Damage to one's reputation is a potential factor. Many wealthy individuals, otherwise seen as community leaders, may not want to be identified as paying less than their fair share in taxes.

Another example of cooperation in the battle against abusive shelters is in the international arena. A year ago, I announced the formation of what has come to be known as the Joint International Tax Shelter Information Centre. Since last Labor Day, we have had an operational task force of personnel from Australia, Canada, the United Kingdom, and the U.S. working together on-site here in Washington. We are exchanging information about specific abusive transactions. Results to date are promising. Thus far, we have uncovered a number of transactions which, but for the Centre, we would have unraveled only over a number of years, if ever. It makes sense that we continue to work with other countries because, in this increasingly global world, we are up against what is, in essence, a reinforcing commercial network of largely stateless accounting firms, law firms, investment banks, and brokerage houses.

The government stepped up its use of civil injunctions in 2001 to prohibit promoters from selling illegal tax schemes on the Internet, at seminars or through other means. Currently the courts have issued injunctions against 99 abusive scheme promoters—81 permanent injunctions and 18 preliminary injunctions. They have issued injunctions against 17 abusive return preparers—all permanent injunctions. And an additional 49 suits have been filed by Justice seeking injunction action—28 against scheme promoters and 21 against return preparers. Injunctions issued have involved schemes such as:

- Using abusive trusts to shift assets out of a taxpayer's name while retaining control
- Misusing "corporation sole" laws to establish phony religious organizations
- Using frivolous "Section 861" arguments to evade employment taxes
- Claiming personal housing and living expenses as business expenses
- Filing tax returns reporting "zero income"
- Misusing the Disabled Access Credit

The IRS has another 1,000 investigations ongoing for possible referral to the Department of Justice; and individual examinations are being conducted on thousands of scheme participants. Most of the investigations and examinations are being conducted by the IRS Small Business/Self-Employed (SB/SE) Division.

Our second enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law.

Our system of tax administration depends upon the integrity of practitioners. Altogether, there are approximately 1.2 million tax practitioners. The vast majority of practitioners are conscientious and honest, but even honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures. The tax shelter industry had a corrupting influence on our legal and accounting professions.

We have done quite a bit since March 2004 to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. The IRS standards set forth rules governing what does and does not qualify as an independent opinion about a tax shelter.

Last year, the government won a series of court opinions on privilege. The cases established that promoters who develop and market generic tax shelters can no longer protect the identity of their clients by hiding behind a false wall of privilege.

Abusive tax shelters often flourished because penalties were too small. Some blue chip tax professionals actually weighed potential fees from promoting shelters, but not following the law, against the risk of IRS detection and the size of our penalties. Clearly, the penalties were too low. They were no more than a speed bump on a single-minded road to professional riches.

But these speed bumps have become speed traps. Last fall, Congress enacted the American Jobs Creation Act. The legislation both created new penalties and increased existing penalties for those who make false statements or fail to properly disclose information on tax shelters. Under the new law, the IRS can now impose

monetary penalties not just on tax professionals who violate standards, but also on their employers, firms, or other entities if those parties knew, or should have known, of the misconduct.

Our third enforcement objective is to detect and deter domestic and off-shore based criminal tax activity and related financial criminal activity.

Last year, the IRS referred more than 3,000 cases to the Justice Department for possible criminal prosecution, nearly a 20 percent jump over the previous year. We continue our active role in the President's Corporate Fraud Task Force. We are going after promoters of tax shelters—both civilly and, where warranted, criminally. This tactic is a departure from the past. Previously, during a criminal investigation, all civil activity came to a halt. The result was that our business units were reluctant to refer matters for criminal investigation lest they lose their traditional turf. But, we are now moving forward on parallel tracks with the Department of Justice. We have a number of important criminal investigations underway. The enforcement model is changing.

Our fourth enforcement priority is to discourage and deter noncompliance within tax-exempt and government entities, and misuse of such entities by third parties for tax avoidance purposes.

Consider, for example, certain credit counseling agencies. Increasingly, it appears that some credit counseling organizations have moved from their original purposes, that is, to counsel and educate troubled debtors, to inappropriately enrolling debtors in proprietary debt-management plans and credit-repair schemes for a fee. These activities may be disadvantageous to the debtors and are not consistent with the requirements for tax exemption. Further, a number of these organizations appear to be rewarding their insiders by negotiating service contracts with for-profit entities owned by related parties. Many newer organizations appear to have been created as a result of promoter activity.

Some shelter promoters join with tax-exempt organizations to create abusive shelters. The organization receives a large fee from the taxpayer who is taking advantage of its tax-free status. That is an unintended abuse of the tax exemption that our nation bestows upon charities.

It is heartening to see leading members of the nonprofit community taking steps to address abuses. I particularly want to salute the Independent Sector—which recently delivered a constructive report to the Senate Finance Committee. The report states that "government should ensure effective enforcement of the law" and calls for tougher rules for charities and foundations. The report calls for stronger action by the IRS to hold accountable charities that do not supply accurate and timely public information. I encourage the accounting, legal, and business communities to be as enthusiastic about confronting abuses and the erosion of professional ethics as the nonprofit community. An interesting point to note is that the report supports mandatory electronic filing of all tax returns for nonprofits.

The threat to the integrity of our nation's charities is real and growing. At the IRS, we take it very seriously. We are augmenting our resources in the nonprofit area. By the end of September, we will have increased the number of our personnel who audit tax-exempt organizations by over 30 percent from two years earlier. If we do not act expeditiously, there is a risk that Americans will lose faith in our nation's charitable organizations. If that happens, Americans will stop giving and those in need will suffer.

As we move forward with these priorities, we will leverage our success to achieve greater results within out FY 2006 budget request.

Budget Restructure

To facilitate full alignment and integration of the Service's goals and measures with its resources, we are proposing to restructure our budget beginning in FY 2006. These changes will facilitate a more accurate assessment of the overall value of IRS programs, simplify the full costing of programs, and allow the IRS to demonstrate incremental increases in an initiative's effectiveness based on the level of funding received.

In addition, this new budget structure will enable us to manage activities more effectively. The normal processing of tax returns generally proceeds from pre-filing activities to filing activities, and finally to compliance activities, should they prove necessary. Although these activities are interrelated, we currently distribute their resources among three appropriations, with unevenly distributed support costs. This system makes it difficult to manage, track, and report the full cost of a given Taxpayer Service or Enforcement program.

This new budget structure will enable us to prepare a true performance-based budget by providing the capability to integrate operational and support costs into one appropriation, thereby allowing us to cost budget activities and programs fully

for the first time. The new structure will also facilitate the full incorporation of performance measures into the budget, as the measures could be tied to funds in one appropriation rather than a series of program activities dispersed across multiple appropriations. The proposed new budget structure will allow stakeholders to assess more accurately the overall value of IRS programs, and make program reviews, such as the Office of Management and Budget's Program Assessment Rating Tool (PART), more effective, thus providing greater accountability and results-oriented management focus.

The proposed budget structure combines the three major appropriations accounts—Processing, Assistance and Management (PAM); Tax Law Enforcement (TLE); and Information Systems (ISY)—into one appropriation called Tax Administration and Operations (TAO).

The Taxpayer Service and Enforcement programs of the TAO appropriation are divided among eight critical program areas. These budget activities focus on Assistance, Outreach, Processing, Examination, Collection, Investigations, Regulatory Compliance, and Research. Full funding for each activity will be reflected in the budget, along with key performance measures. As we continue to move toward the development and implementation of this new structure, we will refine these program areas and the associated resource distributions to provide more accurate costing.

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

President's FY 2006 Budget Seeks Increase in Enforcement to Address Growing Tax Gap

The President's fiscal year 2006 budget requests $10.7 billion for the IRS, a 4.3 percent increase over the fiscal year 2005 enacted level. This request represents a 1 percent decrease in Taxpayer Service and a 2 percent decrease in Business Systems Modernization (BSM), but an 8 percent increase in enforcement.

This budget includes $265 million for initiatives aimed at enhancing the enforcement of tax laws. This request is above the increases to fund the pay raise and other cost adjustments ($182 million), for a total of $446 million for new enforcement investments and cost increases. It is important the Congress fully fund these cost increases and new enforcement investments. The President's budget proposal to fund them as contingent appropriations reflects the importance of this investment to the Administration.

To ensure full funding of the new enforcement investments, the budget proposes to employ a budget enforcement mechanism that allows for an adjustment by the Budget Committees to the section 302(a) allocation to the Appropriations Committees found in the concurrent resolution on the budget. In addition, the Administration will also seek to establish statutory spending limits, as defined by section 251 of the Balanced Budget and Emergency Deficit Control Act of 1985, and to adjust them for this purpose. To ensure full funding of the cost increases, either of these adjustments would only be permissible if the Congress funds the base level for IRS enforcement at $6.4 million and restricts the use of the funds to the specified purpose. The maximum allowable adjustment to the 302(a) allocation and/or the statutory spending limit would be $446 million for 2006, bringing the total enforcement level in the IRS to $6.9 million.

We will use the additional funds for enforcement in several key ways to combat the tax gap, the difference between what taxpayers are supposed to pay and what they actually do pay, due to non-filing, underreporting, and nonpayment. Combating tax non-compliance is a top priority for us. Americans deserve to feel confident that when they pay their taxes, their neighbors and competitors are doing the same. These investments will yield substantial results. Even though we have increased the focus on specific areas of noncompliance, the tax gap increased slightly to between $311 billion and $353 billion in tax year 2001. IRS enforcement activities, coupled with late payments, recover about $55 billion of the tax gap, leaving a *net* tax gap of between $257 billion and $298 billion.

Since 2001, the year covered by the National Research Program (NRP) three-year study in which we audited 46,000 individual income tax returns, we have taken a number of steps to bolster enforcement. We increased our enforcement revenues by nearly 28 percent from $33.8 billion in 2001 to $43.1 billion in 2004. Audits of high-income taxpayers—those earning $100,000 or more—topped 195,000 in fiscal year 2004, which is more than double those conducted in 2001.Total audits of all taxpayers topped 1 million last year—a 37 percent jump from 2001.

We are ramping up our audits on high-income taxpayers and corporations, focusing more attention on abusive shelters and launching more criminal investigations. We recently announced we collected $3.2 billion in the settlement initiative for Son of Boss, a particularly abusive tax shelter.

Our enforcement efforts are designed to increase compliance and reduce the tax gap.

The preliminary results of the NRP determined a range for the tax gap, which will be refined into final, more detailed estimates by year-end 2005. It is unlikely but possible that the final estimates of the total tax gap will fall outside the established range. We need to continue our efforts in these areas and increase the investment in these areas.

We need to enforce the law so that when Americans pay their taxes, they are confident that neighbors and business competitors are doing the same. At the same time, this research underscores the President's call for tax reform. Complexity obscures understanding. Complexity in the tax code compromises both the service and enforcement missions of the IRS. Those who try to follow the law but cannot understand their tax obligations may make inadvertent errors or ultimately throw up their hands and say "why bother." Meanwhile, individuals who seek to pay less than what they owe often hide behind the tax code's complexity in order to escape detection by the IRS and pay less than their fair share.

The IRS yields more than four dollars in direct revenue from its enforcement efforts for every dollar invested in its total budget. In FY 2004, we brought in a record $43.1 billion in enforcement revenue—an increase of $5.5 billion from the year before, or 15 percent. Beyond the direct revenues generated by increasing audits, collection, and criminal investigations, our enforcement efforts have a deterrent effect on those who might be tempted to skirt their tax obligations.

The nearly 8 percent increase for enforcement activities in the Administration's 2006 IRS budget request will increase audits of corporations and high-income individuals as well as expand collection and criminal investigation efforts.

Detailed Budget Summary

Our FY 2006 request of $10.7 billion includes a transfer from the Justice Department of $53.9 million and 329 FTEfor our portion of the Interagency Crime and Drug Enforcement (ICDE) appropriation, $277.6 million for a 2.3 percent pay raise and non-labor inflationary costs, and $264.6 million for initiatives aimed at enhancing our enforcement efforts. This request also includes a $22 million rent reduction to result from consolidation of space, and the $134.1 million reduction to taxpayer service activities that we will responsibly leverage through productivity improvements and program reengineering, as previously discussed. We will take a balanced approach to these targeted reductions.

In addition to the taxpayer service reengineering initiatives, we also expect to continue to realize savings, which we reinvest to other key areas, through the following other reengineering initiatives:

- *Savings from Increased Individual Master File (IMF) E-Filing (Reduction: −$7,700,000 and −190 FTE; Reinvestment: +$7,600,000 and +12 FTE):* This savings is based on processing efficiencies from the projected decrease in IMF paper returns and processing costs for electronically filed IMF returns in Submission Processing Centers. These savings will be reinvested to enable us to continue our consolidation of IMF returns processing into fewer Submissions Processing sites.
- *Consolidation of Case Processing Activities to Maximize Resources Devoted to Front-Line Operations (Reduction: −$66,654,000 and −649 FTE; Reinvestment: +$66,654,000 and +585 FTE):* Staffing for conducting case processing activities that support our examination, collection and lien-processing programs will be consolidated from nearly 100 sites and centralized among four campuses (Philadelphia, Cincinnati, Ogden and Memphis).
- *Consolidation of Insolvency Activities to Maximize Resources Devoted to Front-Line Operations (Reduction: −$14,928,000 and −134 FTE; Reinvestment: +$14,928,000 and +156 FTE):* Staff conducting insolvency operations to protect the government's interest in bankruptcy proceedings will be consolidated from numerous sites and centralized at the Philadelphia campus.
- *Detection and Deterrence of Corrosive Corporate Non-Compliance (Reduction: −$6,711,000 and −52 FTE; Reinvestment: +$6,711,000 and +52 FTE):* By using improved issue-management and risk-assessment strategies for examining corporations, the IRS expects to realize productivity improvements. These savings will be reinvested to fund front-line enforcement activities.

Finally, the FY 2006 request includes several program increases, totaling $264.6 million:

- *Attack Corrosive Non-Compliance Activity Driving the Tax Gap (+$149,700,000 and +920 FTE):* This initiative increases coverage of the growing number of high-risk compliance problems and addresses the largest portion of the tax

gap—underreporting of tax. It proposes a funding increase across all major domestic and international compliance programs to leverage new workload-selection systems and case-building approaches from continuing reengineering efforts.

- *Detect and Deter Corrosive Corporate Non-Compliance (+$51,800,000 and +236 FTE):* This initiative addresses complex, high-risk issues in abusive tax avoidance transactions, promoter activities, corporate fraud, and aggressive domestic and off-shore transactions, resulting in increased corporate and high-income return closures and audit coverage. This initiative also includes critical post-filing support provided by outside experts to expedite the resolution of issues at the field examination level, reducing taxpayer burden, and increasing the credibility of the Service's positions on the most complex and potentially highest compliance impact issues sent to court.
- *Increase Individual Taxpayer Compliance (+$37,900,000 and +417 FTE):* This initiative addresses the tax gap through: the identification and implementation of actions needed to address non-compliance with filing requirements; increased Automated Underreporter resources to address the reporting compliance tax gap; increased audit coverage; and expanded collection work in Taxpayer Assistance Centers.
- *Combat Abusive Transactions by Entities with Special Tax Status (+$14,460,000 and +77 FTE):* This initiative focuses on the most egregious cases of non-compliance and identifies compliance risks sooner, reducing burden on compliant customers and enabling the development of new interventions to curtail the growth of abusive transactions.
- *Curtailing Fraudulent Refund Crimes (+$10,772,000 and +22 FTE):* This initiative is aimed at attacking the increased questionable refunds and return preparer fraud identified through expanded operations of the Fraud Detection Centers located on IRS campuses. Fraudulent refund schemes are one of the most serious threats to voluntary compliance and an IRS investigative priority.

The FY 2006 request of $10.7 billion funds the IRS' three appropriations: Tax Administration and Operations (TAO) for operations, service and enforcement; Business Systems Modernization (BSM) for modernization; and, the Health Insurance Tax Credit (HITCA) for administering a refundable tax credit for qualified individuals. I will describe each in turn.

Tax Administration and Operations (TAO)

For FY 2006, we request funding of $10,460,051,000, an increase of 4.6 percent over the FY 2005 appropriation of $9,998,164,640 for programs previously funded from the PAM, TLE, and ISY appropriations.

The TAO appropriation provides resources for the IRS' service and enforcement programs. The IRS is responsible for ensuring that each taxpayer receives prompt and professional service. To that end, the IRS' assistance, outreach, and processing activities funded in the TAO appropriation are dedicated to providing assistance to taxpayers in all forms—electronic interaction, published guidance, paper correspondence, telephone contact, and face-to-face communication—so that taxpayers may fulfill their tax obligations timely and accurately. It also includes the resources the IRS requires to handle the processing and disposition of tax returns, refunds, and other filing materials.

We are also responsible for the fair enforcement of the nation's tax laws. Each year, a small percentage of taxpayers file erroneous returns or, for reasons both innocent and less benign, fail to file a return at all. The IRS conducts enforcement activities using a variety of methods, including correspondence audits, matching reporting documents (such as Forms W–2) to information on taxpayer returns, in-person audits, criminal investigations of those suspected of violating tax laws, and participation in joint governmental task forces. The IRS' examination, collection, investigations, regulatory compliance, and research activities funded in the TAO appropriation provide the resources required for equitable enforcement of the tax code and the investigation and prosecution of individuals and organizations that circumvent tax laws.

Business Systems Modernization (BSM)

The IRS tax administration system, which collects $2 trillion in revenues annually, is critically dependent on a collection of 40-year-old, obsolete computer systems. Recognizing the long-term commitment needed to solve the problem of modernizing these antiquated systems, Congress and the Administration created a special business systems modernization account. They designed the BSM program to bring the IRS' business systems to a level equivalent with best practices in the private and public sectors while managing the risks inherent in a program that is unquestion-

ably one of the largest, most visible, and most sensitive modernization programs ever undertaken.

In 2004, the modernization budget was $387 million. Based on the challenges the modernization program was facing, we realized the program needed to be smaller in 2005 so we requested a lesser budget of $285 million. In the end, Congress appropriated $203 million. One of the ways we are accommodating these changes is by substantially lowering the costs of the core infrastructure as well as the architecture, integration, and management parts of the BSM program in 2005. These two areas are the programmatic elements of the program, and cost $160 million in FY 2004. We certainly cannot justify that level of continued investment for a program that is roughly $200 million. Therefore, we are dramatically reducing those core services to $107 million in FY 2005 and we anticipate making additional reduction in FY 2006. For FY 2006, we request funding of $199 million for all BSM activities, substantially the same funding as the FY 2005 appropriated level.

Our most successful year ever for the modernization program was 2004; we measured our success by the number of projects we delivered, the schedule and cost targets we hit, and the substantial improvements we made in program management.

We delivered the first release of the Customer Account Data Engine (CADE) project in July 2004, allowing the IRS to process an initial set of the simplest tax returns on a new computer system for the first time in 40 years. We launched IRS' new Integrated Financial System (IFS), and declared it the IRS' financial accounting system of record. IFS will provide the capability for improved timeliness and accuracy of the financial reports and information available to IRS management and key stakeholders, facilitating continued clean financial audit opinions of the IRS. We deployed a full suite of e-Services products, providing tax professionals and businesses with new Web-based tools that dramatically improve their interface with the IRS. Additionally, we released Modernized e-File, whereby corporations and tax-exempt organizations can file their annual income tax and information returns electronically.

We have also made significant improvements in our cost estimating and scheduling. In the Fall and Winter of 2003, we re-baselined the cost estimates and delivery schedules for each of the BSM program projects. Since then, we have shown a marked improvement in significantly reducing our variances between cost estimates and actual delivery costs from 33 percent in 2002 to 4 percent in 2004.

In terms of improving program management, we identified four key areas that we had to address to enhance the performance of the modernization program:

- Resizing our modernization efforts to better align with our management and skill capacity;
- Engaging IRS business units to drive the modernization projects with a business focus;
- Improving contractor performance on cost, schedule, and functionality; and
- Hiring outside executives to achieve a better balance between large project management and tax administration experience.

We have made significant progress in addressing each of these major challenges.

First, the IRS will concentrate on a few key projects and will develop a track record of improved management and successful delivery of modernization projects.

Second, the IRS assigned a business unit leader to each project with responsibility for leading the related BSM Governance Committee, and sharing accountability for delivering the modernization project as stated in their annual performance commitments.

Third, we are making real progress in improving the accountability of the PRIME contractor. I meet monthly with the Chief Operating Officer of the Computer Sciences Corporation (CSC) to reinforce the accountability of the contractor to the IRS. Additionally, we have made major progress in restructuring BSM project contracts with the PRIME that shift an appropriate amount of financial risk to the contractor and tie costs to performance. These steps have resulted in improved contractor performance, as demonstrated in the deliverables in 2004 and the general adherence to costs and schedules.

Fourth, we have made great progress in hiring experienced executives and seasoned managers from outside the agency who have expertise in running large-scale information technology programs and projects. A little over a year ago the mix of leadership at the top of the BSM program consisted of one outside expert and six internal IRS executives. Today, that mix will soon be five outside experienced outside experts and three internal IRS executives. This mix is a much better balance of the project management and technology talent and tax administration experience needed to successfully run the BSM program.

While we were very successful in 2004, we have a lot of work ahead of us. It is critical that we continue this level of performance in 2005 and beyond.

Our focus for FY 2005 is on maintaining substantial modernization work for three key tax administration systems that will provide additional benefits to taxpayers and IRS employees, specifically:

- The Customer Account Data Engine (CADE) project;
- Modernized e-File; and Filing and
- Payment Compliance (F&PC).

CADE

CADE replaces the IRS' antiquated system called the Master File which is the Service's repository of taxpayer information. With CADE being the core fundamental component of the modernized systems, it is the IRS' highest priority technology project.

We cannot over-emphasize the importance of CADE. The current Master Files have served the IRS for more than 40 years. However, they were developed in a different era and rely on an obsolete programming language and a flat-file system that still requires batch updates. These systems are very expensive to maintain; development of new applications costs the IRS two to three times what it would cost if they were already retired. Yet the IRS must update the Master Files every year to take into account tax law changes. As importantly, the vast majority of the workforce who are familiar with these old systems will be retiring over the next few years and we cannot hire individuals with these obsolete skills. Until the Master Files are replaced, the IRS can not offer service approaching what a typical financial services firm offers today (such as full account views for employees and real-time account updates and settlement).

The returns we are processing in CADE are the most basic of 1040EZ forms and have a narrow range of taxpayer information, but it marks the first time since the 1960s that the IRS has processed individual tax returns in a new way. The success of CADE proves that we can deliver technology that will process tax returns on a 24-hour cycle, breaking the 40-year old standard of processing on a weekly cycle. As of April 11, 2005, CADE had processed 1.1 million returns and generated nearly $354 million in refunds to taxpayers. This achievement is significant. CADE will process over 1.3 million 1040EZ tax returns by the end of the 2005 filing season.

The CADE system is scheduled to be phased in over several years, processing increasingly more complex tax returns. When fully operational, CADE will be a modern database that will house tax information for more than 200 million individual and business tax returns. It will provide a variety of benefits to taxpayers, such as faster refunds (by over 50 percent) along with daily postings of transactions and updating accounts, which (with other technology elements) will significantly improve customer service and enforcement. With CADE, we will have the flexibility necessary to respond quickly to our complex tax law and tax reform changes.

One of the most significant changes that we introduced in 2004 was the segmentation of CADE releases into two annual deliveries—one in July and one in January. The July delivery will involve higher risk, more complex functionality, and the January delivery will include filing season changes combined with additional changes as capacity permits. For the July release, returns will be available from the previous six months which will enable us to test the higher risk, complex changes with high volumes, and then go live with reduced volumes, which will mitigate the operational risks.

Modernized e-File

Modernized e-File will provide a single point Federal/State filing option for Forms 1120, 1120S (corporations) and 990 (tax-exempt organizations) returns in many states via a Web Services interface. Our work on Modernized e-File will be comprised of Release 3.1, which includes additional Forms 1120, 7004 (Application for Automatic Extension of Time to file Corporation Income Tax Return) and 990, and tax law changes for filing season 2004. Release 3.1 deployed initial operating capabilities on schedule on January 10, 2005. Release 3.2 will provide an interface with state tax information retrieval systems and a redesign of the signature matching process for Form 8453 (U.S. Individual Tax Declaration for Electronic Filing).

Filing and Payment Compliance/Private Collection Agencies

In 2004, Congress passed the American Jobs Creation Act, allowing the IRS to use Private Collection Agencies (PCAs). The legislation authorized the IRS to augment our collection efforts by allowing us to use PCAs to pursue what has been deemed as uncollectible tax liabilities; these agencies will not have enforcement authority and will only contact delinquent taxpayers to arrange voluntary, full-pay-

ment installment agreements. We will use the Filing and Payment Compliance (F&PC) system to analyze tax collection cases and divide the complex cases requiring direct IRS involvement from the simple "balance due" cases that can be handled by PCAs. The use of PCAs is to supplement—not supplant—current IRS personnel. Quite frankly, this activity is geared for an inventory that the IRS currently can not chase with existing resources.

PCAs will benefit the IRS in three major ways:

1. PCAs will help reduce the significant and growing amount of tax liabilities deemed uncollectible.
2. PCAs will help maintain taxpayer confidence in our tax system.
3. PCAs will allow the IRS to focus on more difficult cases and issues.

We expect to issue a Request for Procurement (RFP) in the next several weeks. We plan to award contract in June 2005, to begin an initial limited release of the uncollected tax inventory in January 2006. We provided all interested parties notification via the IRS.gov/Business Opportunity webpage and electronic letters.

Safeguarding taxpayer rights is paramount. The same IRS standards for customer service and protection of taxpayer rights will be strictly enforced. PCAs will be prohibited from threatening or intimidating taxpayers or implying that enforcement action will be taken against them. Specific safeguards to protect the taxpayer include:

- Fair Debt Collection Practices Act protections;
- Protections against unauthorized disclosures;
- Assistance from the National Taxpayer Advocate; and,
- Protections with respect to third party contacts, installment agreements and communications.

The IRS expects to place cases with PCAs using the following criteria:

- The taxpayer does not dispute the liability;
- The liability is reportable on the Form1040 series of returns;
- The balance due is greater than $100; and,
- The case does not involve a restriction on collection or otherwise indicate that discretion or enforcement action may be required to resolve the liability.

The delivery of the CADE project was a major milestone, but we still have a long way to go and a lot of work ahead of us as we introduce technology changes and expand into processing more complex tax returns at greater volumes. To that end, we recognize that a project of this complexity must continually look at new technologies that can support the level of development and implementation productivity needed for a project of this scale.

We certainly hope, and expect, that we will build on the successes of 2004, and we will continue to mature the modernization program by gaining a solid reputation for on-time deliveries with high productivity.

Health Insurance Tax Credit Administration (HITCA)

In August 2002, the President signed Public Law 107–210, the Trade Act of 2002, which, among other things, provides a refundable tax credit for the cost of health insurance for certain individuals who receive a trade readjustment allowance or a benefit from the Pension Benefit Guaranty Corporation (PBGC). The Health Insurance Tax Credit Administration (HITCA) Appropriation funds the costs to administer a refundable tax credit for health insurance to qualified individuals. The tax credit is equal to 65 percent of the health insurance premium paid by eligible persons for themselves and qualifying family members. For FY 2006 we request funding of $20,210,000, a decrease of 41.5 percent below the FY 2005 appropriation of $34,562,272. Costs for the HITCA program have declined since implementation due to our active program oversight and management, as well as several cost-cutting initiatives we began to implement in March 2004. We developed a comprehensive action plan outlining cost-reduction initiatives and are following it to achieve these significant savings.

Program Performance

The IRS expects to achieve the following levels of performance after attaining full performance of the requested FY 2006 initiatives:

- Increase in field examinations for high-income individuals with complex returns; significant increase in collection processed; and closing of over 40 percent more delinquent balance-due accounts in FY 2008 than in FY 2004.
- Nearly double the audit coverage for individuals with income between $250,000 and $1 million, from 1.5 percent in FY 2004 to 2.8 percent in FY 2008.

- Auditing 15 percent more individuals earning above $1 million, from 3.4 percent projected for FY 2004 to 3.9 percent in FY 2008.
- Significantly more collection cases processed, closing 50 percent more delinquent accounts in FY 2008 than FY 2004.
- Double the audit coverage for mid-size corporations, from 7.6 percent in FY 2004 to 16 percent in FY 2008.
- Increased efforts to deter abusive tax shelters among corporations.

Legislative Proposals

The President's FY 2006 request includes several proposals that will assist me in managing the agency more efficiently and effectively. These proposals, if enacted, will allow us to focus more resources on high-income, high-risk areas, automate several routine transactions, use electronic data to reduce costly manual transactions, consolidate resources related to judicial and counsel review, and broaden administrative authorities and accesses to support further electronic administration and tax reform. We are seeking to:

- Make Section 1203 of the IRS Restructuring and Reform Act of 1998 more effective and fair;
- Curb the use of frivolous submissions and filings made to impede or delay tax administration;
- Allow for the termination of installment agreements for failure to file returns and for failure to make tax deposits;
- Consolidate judicial review of collection due process cases in the United States Tax Court;
- Eliminate the monetary threshold for counsel review of offers in compromise;
- Allow the Financial Management Service to retain transaction fees otherwise paid from IRS appropriations from levied amounts to recover delinquent taxes;
- Extend the due date for electronically filed returns to provide additional incentive for taxpayers to e-file and expand the authority to require electronic filing by businesses and exempt organizations; and,
- Allow IRS to access information in the National Directory of New Hires for tax administration purposes.

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 am happy to take your questions.

Chairman RAMSTAD. Thank you, Commissioner. Like the other witnesses, your complete statement will be entered into the record. I know you have another commitment at four o'clock, so I am going to be very brief, and then yield to my Ranking Member. I understand, given the budget constraints, you are going to be forced to close approximately 70 of the 400 Taxpayer Assistance Centers (TACs) around the country, including three in my own home State of Minnesota. Without these centers taxpayers in certain areas will be deprived of face-to-face interaction with the IRS, as you know. At the same time the Taxpayer Advocate has raised concern about the ability of taxpayers to interact with people in authority at the IRS by phone. In your judgment, Commissioner, what impact will the closure of these TACs have on taxpayers, and how does the IRS plan to improve service in other areas to compensate for the closing of the TACs?

Mr. EVERSON. As I indicated, Mr. Chairman, we have been asked to do a little bit of belt tightening in this area. We are working to continue to drive the demand into the phones where you get the best answer. If someone has a question on the Tax Code, which is so complicated, the best place to get an answer is from the phone lines where your question gets routed to someone who understands that area of the law very specifically. We are also directing people to the website. That change is comparable in many ways to what you see happening in other States such as, where I live, Virginia. You can't go to the library any more and get a Virginia tax return form. That just isn't provided any more. It has all migrated to telephones or print on demand off on the web.

We are trying to be as responsible as we can. Congressman Lewis, I have seen your letter. We are going to respond to you very quickly. We have gone through a modeling process here, which takes into account five different factors. Cost is certainly one of them, but so are geography, demographics and workload. The whole thing is depicted here. We have come up with two different proposals. One would close 67 sites. The other would close 105. The difference between the two is really the difference between weighting cost and weighting things like workload. If you weight workload, you tend to shutter more of the smaller centers out in the rural States. We need to work hard to continue to work on the phones. We also need to work on the volunteer sites. We have got 14,000 Volunteer Income Tax Assistance (VITA) sites, volunteer sites, around the country, where good community activists get out there and help people with their taxes as well.

[The exhibits follow:]

Selecting TAC's begins with agreeing to the criteria that make up the model—stakeholders helped to determine the components

Model Criteria and Components

Sub-Model	Criterion	Sub-Model Components
1	Geographic	▸ Traffic volumes (Filing and Non-Filing Season) ▸ Distance to next nearest TAC ▸ Distance to nearest VITA center ▸ Distance to nearest library, post office, or kiosk
2	Employee Cost	▸ Number of managers, secretaries, IARs, TRRs, CSRs, and others ▸ Number of employees at the TAC ▸ Number of full-time, seasonal, and part-time employees ▸ Total direct labor hours ▸ Total overhead hours ▸ Average salary ▸ Average benefits ▸ Retirement eligibility
3	Facilities Cost	▸ Space usage ▸ Furniture cost ▸ Square footage cost ▸ Total rent/leasing cost ▸ Length of rent/leasing contract ▸ MITS cost
4	Workload	▸ Tax Law, Forms and Pubs., Return Preparation, Accounts workloads ▸ Modernization efforts applied ▸ Abandoned TACs
5	Demographic	▸ Population size by zip code ▸ Income level by zip code ▸ Poverty level by zip code ▸ Percentage older than 65 by zip code ▸ Population of Household income <$30,000 ▸ Number of Returns filed by zip code ▸ Number of EITC Returns filed by zip code ▸ Percentage breakout by EEO demographic categories ▸ Percent of E-file by zip code ▸ Percent Unemployed by zip code ▸ Average Education Level by zip code ▸ Percent of Households with Computers

Approximately 13,000 data points in the model criteria

Application of Criteria for Closing TAC Sites

Option I	Option II
67 TACs closed in 26 states	105 TACS closed in 37 states
Greater weight on employee and facilities costs	Greater weight on workload, demographics and geography
Affects more large offices in urban areas	Affects more small, medium offices in rural areas

---

Chairman RAMSTAD. The other question I have, Commissioner, I know the IRS has an inventory of roughly $280 billion in unpaid tax assessments, not your Agency's fault, but a large percentage of this $280 billion is in a deferred status because I know you lack the resources at the IRS to pursue collection. Last year, as you know, we enacted legislation to allow you to use Private Collection Agencies (PCAs). My question is how soon will the IRS be in a position to get these PCAs, these contractors up and running, or as they say, up and collecting?

Mr. EVERSON. This is a very important question for us. This is an important new authority. It is one that is enjoyed by over 40 States that use PCAs. Of paramount importance to us is that we use it responsively, and accordingly, we are proceeding very deliberately. Probably later this year, about June, we will let the initial contracts to some of the providers, but we need to do some systems work before the collections begin. If a contractor contacts you because you owe us money, but you have already sent us a check in the last few days, we want to make sure that is recorded correctly. We need to do some systems work to achieve this level of timeliness. So, I would suggest sir, that the collections themselves will probably start very early January or so of next year.

Chairman RAMSTAD. Thank you, Commissioner. The Chair recognizes Mr. Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman. Thank you, Mr. Commissioner, for being here and for your testimony. I want to be very brief also, like the Chairman, and follow up on this whole idea of the shut down of some centers.

Mr. EVERSON. Sure.

Mr. LEWIS. Will they start very soon? I think I heard maybe as early as September.

Mr. EVERSON. They would start in the fall, sir, in order to realize the savings that we have embedded in the request. That is correct. Closures would start in this coming fall.

Mr. LEWIS. Are you planning—maybe this was in my letter—are you planning to shut down any operation in my State of Georgia, or in the city of Atlanta? Atlanta and the State of Georgia are growing so fast; there are a lot of people in Metropolitan Atlanta. The population is now moving toward 4 million in the metropolitan area.

Mr. EVERSON. I believe, sir, that Georgia is included on that list. I will make a very general comment, that if you look at nearly any model for closing these centers—and there are over 400 of these centers at present—the models tend to shutter more centers on the East Coast and in the Midwest. That is comparable to what has changed in the demographics of the country with people moving more toward California or into places like Texas. You do get a disproportionate impact on the eastern areas.

Mr. LEWIS. Is it true that a computer picked the sites to be shut down?

Mr. EVERSON. It is absolutely true. These sites were picked based on the model that was developed that had some three dozen factors. As I said, we used all those factors because we want to be scrupulously fair so that there is not some inference that we don't like you or we want to protect the appropriators which would actually, probably be a sensible thing to do.

[Laughter.]

Mr. EVERSON. So, what we have done is use the model and we are happy to take you through that model, sir. I will come up and do that myself if you wish, to make sure you think it is fair. Let me make one additional point on this subject. I talked about constraining language. I want you to know that if there is constraining language written in the Appropriations bill that says, "Don't shutter these centers," it just gets harder for us. We will have to cut back in other areas, which, we think, would be even more damaging.

Mr. LEWIS. This will be my final question, Mr. Chairman. How many times has the IRS revoked the tax exempt status of organizations in the past 10 years, or since you have been the Commissioner?

Mr. EVERSON. It is my understanding that we have not had a lot of revocations. It is a relatively small number, yes, sir.

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

Chairman RAMSTAD. The Chairman recognizes the distinguished gentleman from North Dakota, Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman, Ranking Member. I would note for the Subcommittee, this being our initial hearing, in particular that each of you have enormous shoes to fill, and of course, Amo Houghton we miss as our Chairman; I am told the last Ranking Member was something else too.

[Laughter.]

Mr. EVERSON. You missed my remarks. I said we feel jilted.

[Laughter.]

Mr. POMEROY. I am very pleased to be back on this Subcommittee, and we are very proud of Rob Portman, all of us are, that he has been chosen to ascend to the Ambassador rank as U.S. Trade Representative, and I would observe for the record that of Members of the—the Subcommittee on Oversight is the one that

really has to pay attention to the nitty-gritty details of revenue collection in this country, and we will work closely with the IRS as that moves forward. I don't think any Member of the Congress has been more diligent in this regard than Rob Portman.

Mr. EVERSON. Yes.

Mr. POMEROY. As he moves to the executive branch we will have to pick up the slack. We are going to miss him. I have like five areas of inquiry, all rather quick. First, I was very pleased to see that the issue of conservation reserve program income, for retired farmers, as part of a broader issue of the tax treatment of this kind of program payment to retired farmers not actively working their land, was part of your priority work list, and I am wondering how that is coming along.

Mr. EVERSON. It is on that list, the guidance list. As you know, there was a collision with the American Jobs Creation Act (P.L. 108–357) that caused the revision of that list to make sure we get out some very pressing guidance. It is still an active part of that list and receiving our attention.

Mr. POMEROY. Good. This will be the second tax year we have gone into this circumstance. I know that you are a man of your word and I simply hope that that doesn't in the end——

Mr. EVERSON. I will ask how it is going.

Mr. POMEROY. Thank you.

Mr. EVERSON. That always helps.

[Laughter.]

Mr. POMEROY. That is great. That is why I love being on this Subcommittee. An issue that I have been very interested in is the Savers Credit which is a savings incentive for modest income households, and the tax data from the last couple of years show that it has been very effective in '02 and '03 in terms of generating those applying for this credit. Now in order to qualify they had to make a contribution, a qualifying contribution to a savings account, and we show over the last couple of years about 5 million a year have done that. Now if that truly represents 5 million new retirement savings accounts the first couple years of this program, I think we are off to a good start. Unfortunately, it expires and if the administration allows it to expire, we will have to wrestle with this one in Congress. Do you have any observations in terms of whether the Savers Credit is functioning well?

Mr. EVERSON. Frankly, I have not had any conversations indicating one way or the other, from a tax administration impact, how this is functioning. It has not bubbled up as an issue, like the earned income tax credit (EITC), which is so controversial. That has not been the case, nor like the health coverage tax credit, which has had a very slow start, as you know.

Mr. POMEROY. One of the things that we are intrigued with is we couldn't reauthorize it and improve it by having the refund eligible for direct deposit into the savings account, as opposed to distribute it to the taxpayer. I understand that technically this is now possible. Do you have an evaluation?

Mr. EVERSON. We have looked. There is a comparable issue about split refunds that is coming up on the returns. Some of this work does take further investment in technology. As you know, despite your active efforts, we haven't always received as much

money from the Congress as the Administration has requested. This does have an impact, particularly in a systems area, so that is a constraint. On this particular matter I would have to check and see about it.

Mr. POMEROY. I would appreciate it if you would check and let us know what we need to do to make it work. I think that would be important. My final question involves—there was a news report that was quite interesting, and it was those using refund loans, which is a subprime lending activity that I think is generally scurrilous and overcharged, and varies significantly in different parts of the country. I know that in the past we have talked about this issue in the context of e-filing partners. The IRS, they would e-file without charge, but they would then be a vendor for their services, and I felt under that circumstance that the Service has a private partner, it ought to do some due diligence in terms of the quality of product sold. The fact that we are seeing substantially different take-up rates depending on which part of the country you are from tells me this is at least as much about marketing and information to the taxpayer as it is broad generic need for this kind of service. I am wondering if this is something the IRS is concerned about.

Mr. EVERSON. It could be about marketing. I don't have a defined position on that, but if you look across the country, e-filing varies dramatically by State. You get some States with relatively low rates of e-filing. Connecticut is relatively low, Iowa very high. So, there are geographic differences across all of these issues, and I don't know if there is a correlation along the lines that you are suggesting. We can certainly look at it. The Free File Alliance—I think you are hearing from them later—has been tremendously successful and is increasing the use of e-file. We are reaching the end of the initial period, and we will be reviewing the program with the 20-some companies that have worked on it as this filing season comes to an end.

Mr. POMEROY. Do you have a way of capturing, besides from the e-file part—I know my time—just a quick follow-up, Mr. Chairman. Thank you for indulgence. Do you have a way of capturing the refund loan information beyond your e-file partners?

Mr. EVERSON. We don't regulate those loans. That is not the job of the IRS. If it is in regulations, it is States or other Federal regulations with which I am not familiar. I don't like them. I am not suggesting that Refund Anticipation Loans (RALs) are a good thing. Our answer to that is electronic filing, and if somebody electronically files they get their refund back in half the time. It is even quicker if they use the direct deposit option, which takes a week off of it. So, I don't want you to misinterpret the fact that I am sticking up for refund loans. I am not. I would like to see that taken off the table at some point.

Mr. POMEROY. Would the Service send to the Committee or at least to my office the participants in your e-file partnership and——

Mr. EVERSON. Absolutely——

Mr. POMEROY. The services that they are then selling to Members? In addition to that, any inquiry, if any, by the IRS about the general suitability of those services, recognizing that some of this lending activity is duly regulated in other sectors?

Mr. EVERSON. Sure. We can certainly do that.

[The information follows:]

Logo	Company	Product	Offer	RALs	State Return
	#1 Discount Tax Return Service, LLC	Free Tax Return	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	Yes	$2.99/Form
1040Now	1040Now, Inc	1040Now.net	Free federal tax prep/e-file if live in AL, AR, AZ, CA, CT, CO, DE, GA, IA, ID, KS, LA, MO, MS, MT, NY, NC, OK, OH, PA, UT, VT, VA, WI, WV or if use 1040EZ or AGI of $100,000 or more	No	$14.95
	123 Easy Tax Filing, LLC	123Easytaxfiling	Free federal online tax preparation and e-filing if you have an Adjusted Gross Income (AGI) of $33,000 OR less.	No	$1.95/Form
TaxACT	2nd Story Software, Inc	TaxACT.com	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	No	$7.95
	Braman Tax Services	Braman Tax Services	Free federal online tax preparation and e-filing if you have a federal refund less than $500.	No	N/A
	C&S Technologies	eSmartTax	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	No	$9.95
CompleteTax	CCH, Inc	CompleteTax	Free federal online tax preparation and e-filing if you have an Adjusted Gross Income (AGI) of $28,500 OR less.	Yes	Free
EFile TAX RETURNS	Efile Tax Returns, Inc	efiletaxreturns.net	Free federal online tax preparation and e-filing if you have an Adjusted Gross Income (AGI) of $28,000 OR more.	Yes	$19.95
ezTaxReturn.com	ezTaxReturn.com	ezTaxReturn.com	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	Yes	$19.95
	FileYourTaxes.com	FileYourTaxes.com	Free federal tax prep & eFile if you live in AZ, CA, DE, GA, IL, MD, MI, NC, NJ, NY, OH, OR, VA, WI. Also qualify if age 18 AND less.	No	$29.75
	Free Tax Returns.com, Inc	Free Tax Returns	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	No	$2.88/Form
H&R BLOCK	H&R Block	H&R Block	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	Yes	$24.95 $34.95
TurboTax for the Web	Intuit	TurboTax for the Web	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	No	$29.95
	my1040ez.com, Inc.	FreeTaxUSA.com	Free federal online tax preparation & e-filing if you live in AZ, CA, CO, GA, IL, IN, LA, MI, NC, NJ, NY, OH, PA, UT, or VA	No	$9.95
	OnLine Taxes	OnlineTaxes.com	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	Yes	$5.95
	Tax Centers of America	TCOA.net	Free federal online tax preparation and e-filing if you have an Adjusted Gross Income (AGI) of $30,000 OR Less.	No	$5.95
taxengine.com	Tax-Engine.com	Liberty Tax Service & TaxEngine.com	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	Yes	$10.00
	TaxNet Inc.	TaxNet.com	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	No	$19.95
TAXSIMPLE	TaxSimple	TAX$IMPLE	Free federal online tax preparation and e-filing for all taxpayers. No restrictions. Everyone qualifies.	Yes	$7.95
	TaxSlayer	TaxSlayer	Free tax prep & e-file if you are age 25 OR younger OR 61 or older, OR active in the military, OR if you qualify for the EITC.	Yes	Free

(Rev. 05-02-05)

Mr. POMEROY. Thank you. Thank you, Mr. Chairman. Great to work with you again.

Mr. EVERSON. Nice to see you. I promised a visit to North Dakota, I know, but do I have to go to Georgia first now? I am not sure how that works.

[Laughter.]

Mr. POMEROY. The Commissioner did agree to come to North Dakota, but it was qualified. He said not in the winter.

Chairman RAMSTAD. We all know he is a very smart man. The Chairman now recognizes the distinguished gentleman from New York, Mr. Reynolds.

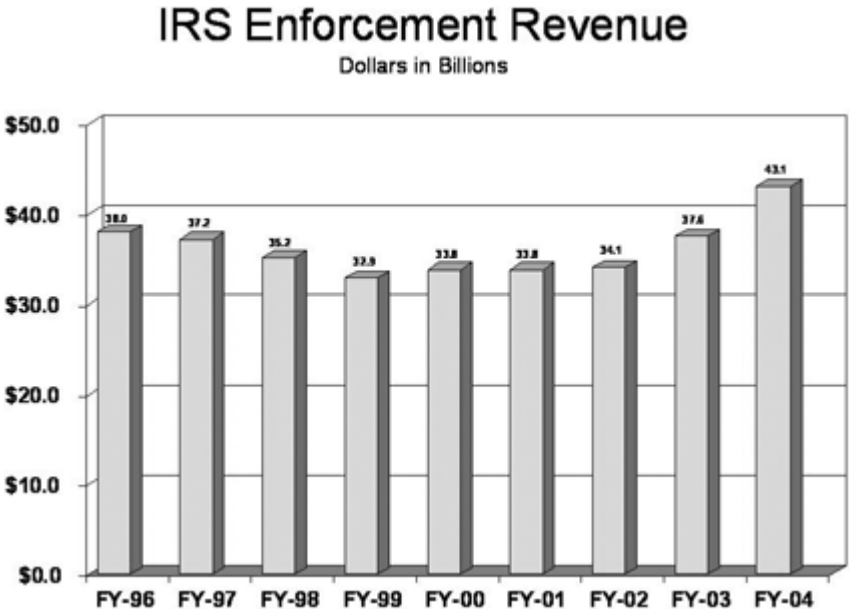
Mr. REYNOLDS. Commissioner Everson, thank you for being here today, and I look forward to working with you on a variety of issues in the 109th Congress. I am particularly interested in your testimony regarding the IRS plans to partner with PCAs. As you know, many of us in Congress worked hard last year to ensure that the Jobs Bill, which President Bush signed into law last October, include a limited and carefully crafted provision authorizing PCAs to assist the IRS in collecting delinquent tax debt. Although some critics of the partnership argued that taxpayer rights would be greatly threatened by permitting PCAs to play limited supplementary role to IRS collection efforts, isn't it true that the new law would include the important safeguards to ensure that taxpayer rights are protected, and could you elaborate on some of those key safeguards?

Mr. EVERSON. Yes, sir, you are absolutely right. We started to talk about this a moment ago. We are proceeding very deliberately on this. We recognize that we will get one shot at this. We can't blow this. We are going to respect taxpayer rights; the same standards of the Fair Debt Collections Act (P.L. 104–208) apply here. Also, the same standards that affect our own employees will apply. The Treasury Inspector General for Tax Administration (TIGTA) which is the independent inspector general, is going to be auditing this program as we build it up. I can only assure you that we will use this authority responsibly. It really gives us a terribly important benefit though. We are underfunded in this area, and as anybody who gets involved in debt can tell you, the longer you wait, the harder it is to get the money. This authority will help us speed up the process, and that is a good thing in terms of bringing in the revenues we need to bring in.

Mr. REYNOLDS. Just building further on the PCA issue, your testimony notes that the so-called tax gap, the difference between what U.S. taxpayers are supposed to pay and what they actually pay, grew between $311 billion and $353 billion in 2001, and the IRS enforcement efforts that year, coupled with late payments, did manage to bring the net tax gap back down to between $257 billion and $298 billion. I am sure that you will agree those figures are still totally unacceptable for what we are looking at. So, I guess the question is, do you believe, as I do, that the PCAs can play that useful role in closing the tax gap with the provisions of where we are set forth, and now you implementing the procedures that you just outlined?

Mr. EVERSON. Yes, sir. I believe that they will be an important component in increasing further the direct enforcement revenues that we already are building up through a variety of processes, increased examinations, the audits we are doing, increased collection efforts. This just shows you that these are the moneys that we get from audits, from collection efforts and from document matching. We brought that up from $33.8 billion three years ago to $43.1 billion. The collection agencies will help significantly.

[The chart follows:]



Mr. REYNOLDS. I thank the Commissioner. Mr. Chairman, thank you.

Chairman RAMSTAD. Thank you, Commissioner, and again, we are sorry for the delay. Thank you for your testimony.

Mr. EVERSON. For me it is just a question of point and shoot this time of the year. They tell me where to go, and, you know.

[Laughter.]

Chairman RAMSTAD. I will look forward to seeing you again.

Mr. LEWIS. Mr. Chairman, just before the Commissioner leaves, I would like to ask unanimous consent that additional questions be submitted for the hearing record. At this point I would like to submit questions from Representative Neal and Emanuel about the IRS plan to close the TACs.

Chairman RAMSTAD. Without objection, so ordered.

[The information was not received at the time of printing.]

Thank you, Commissioner. The second panel consists of IRS Oversight Board Chairman Ray Wagner and GAO Director of Tax Issues, James White. Gentlemen, welcome, and the same apologies are apropos in your cases. Thank you for your patience. Thank you for your service. You may proceed, and as I said, your complete statements will be entered into the record.

STATEMENT OF JAMES R. WHITE, DIRECTOR, STRATEGIC ISSUES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE; ACCOMPANIED BY DAVID A. POWNER, DIRECTOR, INFORMATION TECHNOLOGY MANAGEMENT ISSUES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. WHITE. Mr. Chairman and Members of the Subcommittee, I am pleased to participate in today's hearing. Since passage of the IRS Restructuring and Reform Act of 1998 (P.L. 105–206), IRS has

improved taxpayer service, achieved efficiency gains and implemented some modernized information systems. However, the progress has not been uniform. The IRS' enforcement programs declined after 1998. Despite a recent up-tick in enforcement staffing, it is not back to what it was. A number of systems modernization projects are over-budget and behind schedule. The IRS is shifting its priorities, and tending to better address these problems. First, IRS is asking for an 8-percent increase for enforcement for 2006, about $500 million. Second, IRS is proposing a 1 percent cut in spending on taxpayer service, although when cost increases are factored in, the real cut will be larger. To absorb the cut, IRS is proposing to reduce its teleph1 hours, has already reduced its telephone accessibility goal, and is proposing to reduce walk-in sites. These reductions might have been larger except for noticeable efficiency gains, especially in processing tax returns. Third, IRS is proposing a small cut in its BSM budget, intending to focus on its highest priority projects and shifting significant program management responsibilities from contractor staff to IRS staff. Although there are sound reasons for the shifts in priorities, they also involve risks. One risk, as IRS shifts its priorities toward enforcement, is that some of the recent gains in taxpayer service could be surrendered. Another risk with BSM is more cost overruns, scheduled delays and postponed improvements for taxpayers. Mr. Chairman, if IRS starts surrendering some of its improvements to taxpayers service, we could revert to a swinging pendulum, where enforcement gains are achieved at the expense of taxpayers service and vice versa.

Several steps could help avoid the swinging pendulum. One is to agree on long-term goals for IRS. The IRS is developing, but has not yet released such goals. Without long-term goals it is difficult to assess IRS' budget request or hold IRS management accountable. Long-term goals would make priorities clearer. For example, the budge request proposes some rollback in both telephone and walk-in service but does not provide details. What are IRS' taxpayer service goals? Are telephone and walk-in service equal priorities, or is one more important? Through mid March, IRS answered over 23 million telephone calls. About 9 percent as many taxpayers walked in. Another step to avoid a swinging pendulum is to review the menu of services that IRS provides to see if it is possible to maintain overall service to taxpayers, but at lower cost. The IRS has added one item to its service menu, Internet service, that now is used by tens of millions of taxpayers to get forms and information, access the Free File system, and learn the status of their refunds. Another menu item, telephone service, is noticeably improved. Despite reduced funding, telephone accuracy is improved and access is about the same. These new and improved services open up the possibility of maintaining overall service to taxpayers while cutting some items on the menu. The new or improved services might offset cuts in other areas. Targeting cuts requires criteria. Criteria might include duplication of services, cost per taxpayer served, and whether usage is declining. Options that fit some of these criteria include reducing walk-in sites and limiting certain types of calls. I call these options because these are not recommendations. There are tradeoffs.

A third step to help avoid a swinging pendulum is to succeed at BSM. Business Systems Modernization is critical to good taxpayer service and enforcement. It allows, for example, taxpayers to file and retrieve information electronically, and provides technology solutions to the backlog of collection cases. For several years we have stated concerns about IRS's schedule and cost estimating, citing weaknesses in management controls and capabilities. We have made recommendations to improve BSM management and IRS has implemented or has begun to implement them. Today, the BSM program is undergoing significant changes as it adjusts to budget reductions, reductions due to congressional concerns about cost overruns and schedule delays, and a desire to have IRS focus on its highest priority projects, particularly the Customer Account Data Engine (CADE). It is too early to tell what effect the reductions will have on BSM. According to the new associate Chief Financial Officer (CFO) for BSM, IRS is redefining and refocusing the BSM program. In summary, IRS will be challenged to maintain the quality of service while shifting resources to enforcement. Success will require smart management and success at BSM. Mr. Chairman, this concludes my statement. I would be happy to answer questions.

[The prepared statement of Mr. White follows:]

Statement of James R. White Director of Tax Issues, U.S. Government Accountability 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 2006 budget request and performance during the 2005 tax filing season.

IRS is in the midst of making significant adjustments to its modernization strategy to better serve taxpayers and ensure their compliance with the nation's tax laws. It is now seven years since the passage of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)[1] and IRS is shifting its priorities from improving taxpayer service to strengthening tax law enforcement efforts. IRS is also adjusting its strategy for managing its Business Systems Modernization (BSM) effort by shifting significant program management responsibilities from contractor to IRS staff. Although there are sound reasons for these adjustments, they also involve risk.

We have reported that IRS has made progress improving taxpayer service since the passage of RRA 98.[2] For example, IRS's telephone assistance is now more accessible and accurate. Further, IRS is more efficient at processing tax returns, in part, because of the growth of electronic filing, and has cut processing staff. IRS has also implemented some modernized information systems and increased its capacity to manage large systems acquisition and development programs.

However, progress has not been uniform. We have reported on large and pervasive declines in IRS's tax law enforcement programs after 1998. We have also reported that a number of systems modernization projects were over budget and behind schedule.[3]

As noted, IRS is shifting its priorities to better address these problems. The risk, as IRS shifts its priorities towards enforcement, is that some of the gains in the quality of taxpayer service could be surrendered. There are analogous risks associated with moving more of the management of BSM in-house.

With these risks in mind, our statement discusses both IRS's fiscal year 2006 budget request and 2005 filing season performance to date. To address your request, we assessed (1) how IRS proposes to balance its resources between taxpayer service

[1] Pub. L. No. 105–206 (1998).

[2] See for example, GAO–05–67, Tax Administration: IRS Improved Performance in the 2004 Filing Season, But Better Data on the Quality of Some Services Are Needed (Washington, D.C.: Nov. 15, 2004).

[3] GAO, Internal Revenue Service: Assessment of Fiscal Year 2005 Budget Request and 2004 Filing Season Performance, GAO–04–560T (Washington, D.C.: Mar. 30, 2004).

and enforcement programs and the potential impact on taxpayers, (2) the status of IRS's efforts to develop and implement the BSM program, and (3) the progress IRS has made in implementing best practices for developing its information technology (IT) operations and maintenance budget. With respect to the interim results of key 2005 filing season activities, we compared IRS's performance to past years' and goals it set for this year.

Our assessment of the budget request and BSM is based on a comparative analysis of IRS's fiscal year 2002 through 2006 budget requests, funding, expenditures, other documentation, and interviews with IRS officials. Our assessment of the interim results of the filing season is based on comparing IRS's performance this year to previous filing seasons, viewing operations at a processing center, call sites, and walk-in sites, monitoring various production meetings, interviewing IRS and Treasury Inspector General for Tax Administration (TIGTA) officials and paid tax practitioners and other external stakeholders, reviewing TIGTA and other external reports, and reviewing IRS's Web site. For both assessments, we used historical budget and performance data from reports and budget requests used by IRS, Department of Treasury, and Office of Management and Budget (OMB). In past work, we assessed IRS's budget and performance data.[4] Since the data sources and procedures for producing this year's budget and performance data have not significantly changed from prior years, we determined that the budget data and filing season performance data were sufficiently reliable for the purposes of this report. The budget and performance data for fiscal years 2005 and 2006 are subject to change. Regarding our analysis of IRS's BSM program, we primarily used the agency's BSM expenditure plans to determine the status of the program. To assess the reliability of the cost and schedule information contained in these plans, we interviewed applicable IRS officials to gain an understanding of the data and discuss our use of that data. In addition, we checked that information in the plans was consistent with information contained in IRS internal briefings. Accordingly, we determined that the data in the plans were sufficiently reliable for purposes of this statement. We performed our work in Washington, D.C. and Atlanta, Georgia from December 2004 through March 2005, in accordance with generally accepted government auditing standards.

In summary, our assessment shows that:

- IRS's 2006 fiscal year budget request reflects a continuing shift in priorities from improving taxpayer service to strengthening enforcement efforts, but the potential impact of these changes on taxpayers in both the short- and long-term is unclear. IRS is requesting $10.9 billion, an increase of 3.7 percent over fiscal year 2005 enacted levels. This includes an 8 percent increase for enforcement, and a 1 percent and 2 percent decrease for taxpayer service and BSM, respectively. IRS has not finalized the details on where reductions in taxpayer service would occur. In addition, IRS is developing, but currently lacks, long-term goals that can help IRS inform stakeholders, including the Congress, and aid them in assessing performance and making budget decisions. In light of the current budget environment and IRS's improvements in taxpayer service over the last several years, this is an opportune time to reconsider the menu of services it provides. It may be possible to maintain the overall level of assistance to taxpayers by changing the menu of services offered, offsetting reductions in some areas with new and improved service in other areas.
- IRS has taken important steps forward towards implementing the BSM program by delivering the initial phases of several modernized systems in 2004 and early 2005. Nevertheless, BSM continues to be high risk because, in part, its projects have incurred significant cost increases and schedule delays, and the program continues to face major challenges. As a result of funding reductions and other factors, IRS has made major adjustments to the BSM program, including reducing the management reserve and changing the mix and roles of contractor versus federal staff used to manage the program. It is too early to tell what effect these adjustments will ultimately have on the BSM program, but they are not without risk, could potentially impact future budget requests, and will delay the implementation of certain functionality that was intended to provide benefit to IRS operations and taxpayers. Finally, the BSM program is based on visions and strategies developed years ago, which, coupled with the already significant delays the program has experienced and the changes brought on by the budget reductions, indicates that it is time for IRS to revisit

[4] GAO, Tax Administration: IRS Needs to Further Refine Its Tax Filing Season Performance Measures, GAO–03–143 (Washington, D.C.: Nov. 22, 2002) and GAO, Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements, GAO–05–103 (Washington, D.C.: Nov. 10, 2004).

its long-term goals, strategy, and plans for BSM, including an assessment of when significant future BSM functionality would be delivered. According to the Associate Chief Information Officer (CIO) for BSM, IRS is redefining and refocusing this program.

- IRS has made progress toward implementing investment management best practices that would improve its budget development and support for its IT operations and maintenance funding requests. For example, the recent release of a new accounting system included an activity-based cost module, which IRS considered to be a necessary action to implement these best practices. However, Office of the Chief Financial Officer officials stated that IRS needs 3 years of actual costs to have the historical data necessary to provide a basis for future budget estimates. Accordingly, they expect that IRS will begin using the activity-based cost module in formulating the fiscal year 2008 budget and will have the requisite 3 years of historical data in time to develop the fiscal year 2010 budget.

Our assessment of the 2005 filing season to date shows that:

- IRS has generally maintained or improved its 2005 filing season performance compared to last year. Electronic filing continues to increase, allowing IRS to continue reducing resources devoted to processing. However, IRS may not meet this year's electronic filing goal and is likely to not to meet its goal of 80 percent of all individual tax returns filed electronically by 2007. Access to telephone assistors remains relatively comparable to last year, although there are other indications of slippage in telephone access such as more abandoned calls and longer wait times. The tax law accuracy rate for answers provided via telephone or IRS's Web site has improved. IRS's performance so far in 2005 is good news, considering IRS received $104 million less in fiscal year 2005 than 2004 for taxpayer services. IRS plans to absorb this reduction, in part, by consolidating paper—processing operations, shifting resources from service to enforcement, and reducing some services—for example, reducing access to telephone assistors—in 2005. However, the filing season is not over, and whether or not IRS will achieve efficiency increases and the impact on IRS operations and taxpayers is not yet known.

IRS's Budget Request Continues to Shift Priority from Taxpayer Service to Enforcement, but the Short—and Long-term Impacts on Taxpayers Are Unclear

IRS's fiscal year 2006 budget request reflects a continuing shift in priorities by proposing reductions in taxpayer service and increases in enforcement activities. The request does not provide details about how the reductions will impact taxpayers in the short-term. Nor does IRS have long-term goals; thus the contribution of the fiscal year 2006 budget request to achieving IRS's mission in the long-term is unclear. Because of budget constraints and the progress IRS has made improving the quality of taxpayer services, this is an opportune time to reconsider the menu of services IRS offers.

IRS Is Proposing Reductions in Taxpayer Service and BSM and Increases in Enforcement

IRS is requesting $10.9 billion, which includes just over a 1 percent decrease for taxpayer service, a 2 percent decrease for BSM, and nearly an 8 percent increase for enforcement, as shown in table 1.[5] As table 1 further shows, the changes proposed in the 2006 budget request continue a trend from 2004. In comparison to the fiscal year 2004 enacted budget, the 2006 budget request proposes almost 4 percent less for service, almost 49 percent less for BSM, and nearly 14 percent more for enforcement.[6]

---

[5] IRS is proposing a new budget structure beginning in fiscal year 2006. The proposal would integrate support costs and the IT appropriation into taxpayer assistance and operations appropriation with eight program areas involving both taxpayer service and enforcement. See appendix I for information on the new budget structure.

[6] The Administration proposes to fully fund enforcement efforts and costs as contingent appropriations. This would be achieved by using one of two budgetary mechanisms that would allow for an adjustment to total discretionary spending for fiscal year 2006 of not more than $446 million for IRS tax enforcement.

Table 1: IRS Budget Summary for Key Activities, Fiscal Years 2004–2006 (dollars in millions)

	Fiscal year 2004 (enacted)	Fiscal year 2005 (enacted)	Fiscal year 2006 (requested)	Percent change (2004–2005)	Percent change (2005–2006)	Percent change (2004–2006)
Taxpayer Service	$3,710	$3,606	$3,567	−2.8%	−1.1%	−3.8%
Enforcement	6,052	6,392	6,893	5.6	7.8	13.9
BSM	388	203	199	−47.6	−2.0	−48.7

Table 1:
Source: GAO analysis of IRS data.
Note: Numbers may not add due to rounding.

As table 1 also shows, taxpayer service sustained a reduction of $104 million or 2.8 percent between fiscal years 2004 and 2005. According to IRS officials, the majority of this reduction was the result of consolidating paper-processing operations, shifting resources from service to enforcement, and reducing some services. IRS officials said that this reduction is not expected to adversely impact the services they provide to taxpayers but added that the agency cannot continue to absorb reductions in taxpayer service without beginning to compromise some services.

For fiscal years 2005 and 2006, table 2 shows some details of changes in both dollars and full-time equivalents (FTE).[7] Both are shown because funding changes do not translate into proportional changes in FTEs due to cost increases for salaries, rent, and other items. For example, the $39 million or 1.1 percent reduction in taxpayer service translates into a reduction of 1,385 FTEs or 3.6 percent. Similarly, the over $500 million or 7.8 percent increase in enforcement spending translates into an increase of 1,961 FTEs or 3.4 percent.

Table 2: IRS Requested Changes in Funding for Taxpayer Service and Enforcement, Fiscal Years 2005 and 2006 (requested)

Program activities	Fiscal year 2005 (estimated)		Fiscal year 2006 (requested)		Change fiscal year 2005–fiscal year 2006	
	Dollars (in millions)	Full-time equivalents	Dollars (in millions)	Full-time equivalents	Dollars (in millions)	Full-time equivalents
Assistance	$1,829	20,798	$1,806	20,160	− $23	− 638
Outreach	500	2,473	466	1,905	− 34	− 568
Processing	1,276	15,695	1,295	15,516	19	− 179
Taxpayer service subtotal	3,606	38,966	3,567	37,581	− 39	− 1,385
Research	154	1,119	158	1,119	4	0
Examination	3,478	31,498	3,712	32,284	234	786
Collection	1,826	18,023	1,991	18,815	165	792
Investigation	682	4,899	767	5,250	85	351
Regulatory	253	1,912	265	1,944	12	32
Enforcement subtotal	6,392	57,451	6,893	59,412	500	1,961
Taxpayer service and enforcement total	*9,998*	*96,417*	*10,460*	*96,993*	*462*	*576*

Table 2:
Source: GAO analysis of IRS data.
Note: Numbers may not add due to rounding.

[7] According to IRS, an FTE is the equivalent of one person working full time for 1 year without overtime.

The difference between changes in dollars and FTEs could be even larger because of unbudgeted expenses. Unbudgeted expenses have consumed some of IRS's budget increases and internal savings increases over the last few years. Unbudgeted expenses include unfunded portions of annual salary increases, which can be substantial given IRS's large workforce, and other costs such as higher-than-budgeted rent increases. According to IRS officials, these unbudgeted expenses accounted for over $150 million in each of the last 4 years.

An IRS official also told us they anticipate having to cover unbudgeted expenses in 2006. As of March 2005, IRS officials were projecting unbudgeted salary increases of at least $40 million. This projection could change since potential federal salary increases for 2006 have not been determined.

IRS Is Proposing $39 Million Less for Taxpayer Service, but the Impact on Taxpayers Is Unclear

The budget request provides some detail on how IRS plans to absorb cost increases in the taxpayer service budget. IRS is proposing a gross reduction of over $134 million in taxpayer service from reexamining the budget's base and plans to use more than $95 million of it to cover annual increases such as salaries. This leaves a net reduction of nearly $39 million or 1.1 percent in the taxpayer service budget. The extent to which IRS is able to achieve the gross reductions will impact its ability to use the funds as anticipated.

Decisions on how the $134 million gross reduction would be absorbed were not finalized prior to releasing the budget. According to IRS officials, some of the reductions would result from efficiency gains such as reducing printing and postage costs; however, others would result from reductions in the services provided to taxpayers such as shortening the hours of toll-free telephone service operations. The officials also said most decisions have now been made about general areas for reduction and most changes will not be readily apparent to taxpayers.

Although IRS has made general decisions about the reductions, many of the details have yet to be determined. Therefore, the extent of the impact on taxpayers in the short term is unclear. For example, IRS plans to reduce dependence on field assistance, including walk-in sites, but has not reached a final decision on how to reduce services. Table 3 provides further detail on how IRS is proposing to reduce funding and resources for taxpayer service.

Table 3: IRS Requested Changes in Funding and Full-time Equivalents for Taxpayer Service, Fiscal Years 2005 and 2006

Program discipline	Fiscal year 2005 (actual)		Fiscal year 2006 (requested)		Change fiscal year 2005–2006	
	Dollars (in millions)	Full-time equivalents	Dollars (in millions)	Full-time equivalents	Dollars (in millions)	Full-time equivalents
Assistance						
Electronic	$1,536	17,745	$1,557	17,721	$21	−24
Field	274	2,796	230	2,181	−44	−615
EITC assistance	19	258	19	258	<1	0
Assistance total	*1,829*	*20,798*	*1,806*	*20,160*	*−23*	*−638*
Outreach						
Publication & Media	291	821	276	520	−15	−301
Taxpayer Education & Communication	203	1,592	184	1,326	−19	−266
EITC Outreach	7	60	7	60	<1	0
Outreach total	*500*	*2,473*	*466*	*1,905*	*−34*	*−568*
Processing	*1,276*	*15,695*	*1,295*	*15,516*	*19*	*−179*
Taxpayer service total	*3,606*	*38,966*	*3,568*	*37,581*	*−39*	*−1,385*

Table 3:
Source: GAO analysis of IRS data.
Note: Numbers may not add due to rounding.
IRS Continues to Request Significant Increases for Enforcement to Build on Recent Hiring Gains

IRS Continues to Request Significant Increases for Enforcement to Build on Recent Hiring Gains

IRS's fiscal year 2006 budget request is the sixth consecutive year the agency has requested additional staffing for enforcement. However, up until last year, IRS was unable to increase enforcement staffing; unbudgeted costs and other priorities consumed the budget increase.

IRS's proposal for fiscal year 2006, if implemented as planned, would return enforcement staffing in these occupations to their highest levels since 1999. Of the more than $500 million increase requested for 2006, about $265 million would fund enforcement initiatives, over $182 million would be used in part for salary increases, and over $55 million is a proposal to transfer funding authority from the Department of Justice's Interagency Crime and Drug Enforcement. The $500 million increase would be supplemented by internal enforcement savings of $88 million. As is the case with taxpayer service savings, the extent to which IRS achieves enforcement savings will affect its ability to fund the new enforcement initiatives.

The $265 million for new enforcement initiatives consist of:

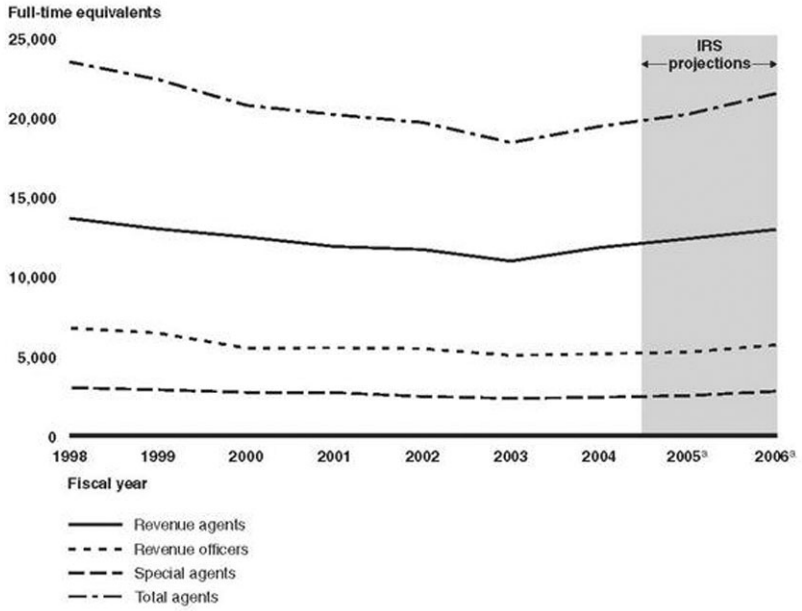
- $149.7 million and 920 FTEs to attack corrosive non-compliance activity driving the tax gap such as abusive trusts and shelters, including offshore credit cards and organized tax resistance;
- $51.8 million and 236 FTEs to detect and deter corrosive corporate non-compliance to attack complex abusive tax avoidance transactions on a global basis and challenge those who promote their use;
- $37.9 million and 417 FTEs to increase individual taxpayer compliance by identifying and implementing actions to address non-compliance with filing requirements; increasing Automated Underreporter resources to address the reporting compliance tax gap; increasing audit coverage; and expanding collection work in walk-in sites;
- $14.5 million and 77 FTEs to combat abusive transactions by entities with special tax status by initiating examinations more promptly, safeguarding compliant customers from unscrupulous promoters, and increasing vigilance to ensure that the assets of tax-exempt organizations are put to their intended tax-preferred purpose and not misdirected to fund terrorism or for private gain; and
- $10.8 million and 22 FTEs to curtail fraudulent refund crimes.

The $88 million in internal savings would be reinvested to perform the following activities:

- $66.7 million and 585 FTEs to devote resources to front-line enforcement activities;
- $14.9 million and 156 FTEs to, in part, address bankruptcy-related taxpayer questions; and
- $6.7 million and 52 FTEs to address complex, high-risk issues such as compliance among tax professionals.

In the past, IRS has had trouble achieving enforcement staffing increases because other priorities, including unbudgeted expenses, have absorbed additional funds. IRS achieved some gains in 2004 and expects modest gains in 2005. Figure 1 shows that the number of revenue agents (those who audit complex returns), revenue officers (those who do field collection work), and special agents (those who perform criminal investigations) decreased over 21 percent between 1998 and 2003, but increased almost 6 percent from 2003 to 2004.

Figure 1: Revenue Agents, Revenue Officers, and Special Agents, Fiscal Years 1998–2006

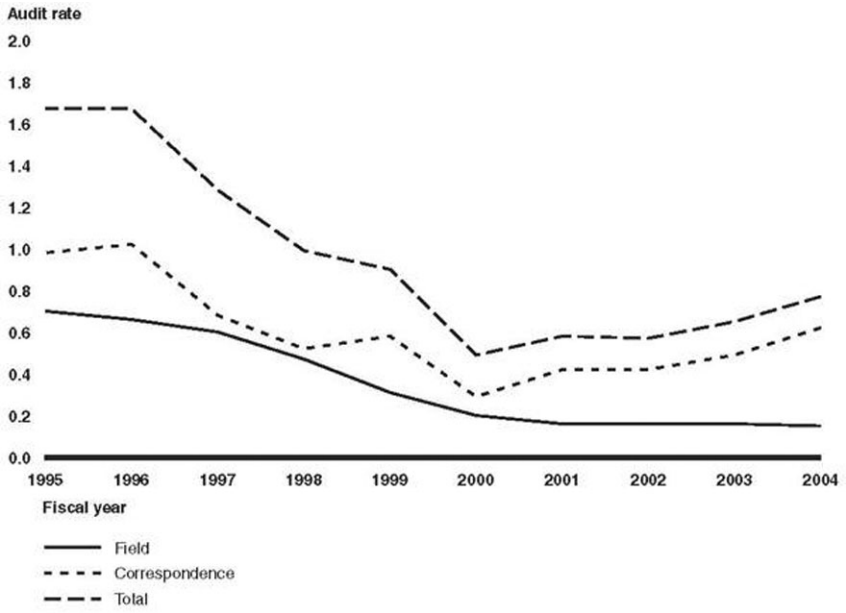


Source: GAO Analysis of IRS Data
[a] Fiscal years 2005 and 2006 are IRS projections.

IRS's recent gains in enforcement staffing are encouraging, as tax law enforcement continues to remain an area of high risk for the federal government because the resources IRS has dedicated to enforcing the tax laws have declined, while IRS's enforcement workload—measured by the number of taxpayer returns filed—has continually increased.[8] Figure 2 shows the trend in field, correspondence, and total audit rates since 1995. Field audits involve face-to-face audits and correspondence audits are typically less complex involving communication through notices. IRS experienced steep declines in audit rates from 1995 to 1999, but the audit rate—the proportion of tax returns that IRS audits each year—has slowly increased since 2000. The figure shows that the increase in total audit rates of individual filers has been driven mostly by correspondence audits, while more complex field audits, continue to decline.

[8] GAO, High Risk Series: An Update, GAO–05–207 (Washington, D.C.: January 2005).

Figure 2: Audit Rate of Individual Income Tax Returns, Fiscal Years 1995–2004



Source: GAO Analysis of IRS Data

The link between the decline in enforcement staff and the decline in enforcement actions, such as audits, is complicated, and the real impact on taxpayers' rate of voluntary compliance is not known. This leaves open the question of whether the declines in IRS's enforcement programs are eroding taxpayers' incentives to voluntarily comply. IRS's National Research Program (NRP) recently completed a study on compliance by individual tax filers based on tax data provided on 2001 tax returns. The study estimated that the tax gap—the difference between what taxpayers owe and what they pay—is at least $312 billion per year as of 2001 and could be as large as $353 billion. This study 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 should also help IRS better understand the impact of taxpayer service on compliance.

IRS Is Developing Long-term Goals That Can Be Used to Assess Performance and Make Budget Decisions

IRS is developing but currently lacks long-term goals that can be used to assess performance and make budget decisions.[9] Long-term goals and results measurement are a component of the statutory strategic planning and management framework that the Congress adopted in the Government Performance and Results Act of 1993.[10] As a part of this comprehensive framework, long-term goals that are linked

[9] IRS has one long-term goal set by the Congress in RRA 98 for IRS to have 80 percent of all individual income tax returns filed electronically.

[10] Pub. L. No. 103–62 (1993). The Government Performance and Results Act of 1993 seeks to improve the management of federal programs, as well as their effectiveness and efficiency, by requiring executive agencies to prepare multiyear strategic plans, annual performance plans, and annual performance reports. Under the Act, strategic plans are the starting point for setting goals and measuring progress towards them. The Act requires executive agencies to develop strategic plans that include an agency's mission statement, long-term general goals, and the strategies that the agency will use to achieve these goals. The plans should also explain the key external factors that could significantly affect achievement of these goals, and describe how long-term goals will be related to annual performance goals.

to annual performance measures can help guide agencies when considering organizational changes and making resource decisions.

A recent Program Assessment Rating Tool (PART) review conducted by OMB reported that IRS lacks long-term goals.[11] As a result, IRS has been working to identify and establish long-term goals for all aspects of its operations for over a year. IRS officials said these goals will be finalized and provided publicly as an update to the agency's strategic plan before May 2005.

For IRS and its stakeholders, such as the Congress, long-term goals can be used to assess performance and progress towards these goals, and determine whether budget decisions contribute to achieving those goals. Without long-term goals, the Congress and other stakeholders are hampered in evaluating whether IRS is making satisfactory long-term progress. Further, without such goals, the extent to which IRS's 2006 budget request would help IRS achieve its mission over the long-term is unclear.

This Is an Opportune Time to Review IRS's Menu of Taxpayer Services

For at least two reasons, this is an opportune time to review the menu of taxpayer services that IRS provides. First, IRS's budget for taxpayer services was reduced in 2005 and an additional reduction is proposed for 2006. As already discussed, these reductions have forced IRS to propose scaling back some services. Second, as we have reported, IRS has made significant progress in improving the quality of its taxpayer services. For example, IRS now provides many Internet services that did not exist a few years ago and has noticeably improved the quality of telephone services. This opens up the possibility of maintaining the overall level of taxpayer service but with a different menu of service choices. Cuts in selected services could be offset by the new and improved services.

Generally, as indicated in the budget, the menu of taxpayer services that IRS provides covers assistance, outreach, and processing. Assistance includes answering taxpayer questions via telephone, correspondence, and face-to-face at its walk-in sites. Outreach includes educational programs and the development of partnerships. Processing includes issuing millions of tax refunds.

When considering program reductions, we support a targeted approach rather than across-the-board cuts.[12] A targeted approach helps reduce the risk that effective programs are reduced or eliminated while ineffective or lower priority programs are maintained.

With the above reasons in mind for reconsidering IRS's menu of services, we have compiled a list of options for targeted reductions in taxpayer service. The options on this list are not recommendations but are intended to contribute to a dialogue about the tradeoffs faced when setting IRS's budget. The options presented meet at least one of the following criteria hat we generally use to evaluate programs or budget requests.[13] These criteria include that the activity

- duplicates other efforts that may be more effective and/or efficient;
- historically does not meet performance goals or provide intended results as reported by GAO, TIGTA, IRS, or others;
- experiences a continued decrease in demand;
- lacks adequate oversight, implementation and management plans, or structures and systems to be implemented effectively;
- has been the subject of actual or requested funding increases that cannot be adequately justified; or
- has the potential to make an agency more self-sustaining by charging user fees for services provided.

We recognize that the options listed below involve tradeoffs. In each case, some taxpayers would lose a service they use. However, the savings could be used to help maintain the quality of other services. We also want to give IRS credit for identifying savings, including some on this list. The options include

- closing walk-in sites. As the filing season section of this testimony discusses, taxpayer demand for walk-in services has continued to decrease and staff an-

[11] The PART was applied during the fiscal year 2004 budget cycle to "programs" selected by OMB. The PART includes general questions in each of four broad topics to which all programs are subjected: (1) program purpose and design, (2) strategic planning, (3) program management, and (4) program results (i.e., whether a program is meeting its long-term and annual goals). OMB also makes an overall assessment on program effectiveness.

[12] GAO, 21st Century Challenges: Reexamining the Base of the Federal Government, GAO–05–325SP (Washington, D.C.: February 2005).

[13] We selected these criteria from a variety of sources based on generally accepted government auditing standards.

swer a more limited number of tax law questions in person than staff answer via telephone.
- limiting the type of telephone questions answered by IRS assistors. IRS assistors still answer some refund status questions even though IRS provides automated answers via telephone and its Web site.
- mandating electronic filing for some filers such as paid preparers or businesses. As noted, efficiency gains from electronic filing have enabled IRS to consolidate paper processing operations.
- charging for services. For example, IRS provides paid preparers with information on federal debts owed by taxpayers seeking refund anticipation loans.

Progress in BSM Implementation, but the Program Remains High Risk and Budget Reductions Have Resulted in Significant Adjustments

Although IRS has implemented important elements of the BSM program, much work remains. In particular, the BSM program remains at high risk and has a long history of significant cost overruns and schedule delays. Furthermore, budget reductions have resulted in significant adjustments to the BSM program, although it is too early to determine their ultimate effect.

IRS Has Made Progress in Implementing BSM, but Much Work Remains

IRS has long relied on obsolete automated systems for key operational and financial management functions, and its attempts to modernize these aging computer systems span several decades. IRS's current modernization program, BSM, is a highly complex, multibillion-dollar program that is the agency's latest attempt to modernize its systems. BSM is critical to supporting IRS's taxpayer service and enforcement goals. For example, BSM includes projects to allow taxpayers to file and retrieve information electronically and to provide technology solutions to help reduce the backlog of collections cases. BSM is important for another reason. It allows IRS to provide the reliable and timely financial management information needed to account for the nation's largest revenue stream and better enable the agency to justify its resource allocation decisions and congressional budgetary requests.

Since our testimony before this subcommittee on last year's budget request, IRS has deployed initial phases of several modernized systems under its BSM program. The following provides examples of the systems and functionality that IRS implemented in 2004 and the beginning of 2005.

- Modernized e-File (MeF). This project is intended to provide electronic filing for large corporations, small businesses, and tax-exempt organizations. The initial releases of this project were implemented in June and December 2004, and allowed for the electronic filing of forms and schedules for the form 1120 (corporate tax return) and form 990 (tax-exempt organizations' tax return). IRS reported that, during the 2004 filing season, it accepted over 53,000 of these forms and schedules using MeF.
- e-Services. This project created a Web portal and provided other electronic services to promote the goal of conducting most IRS transactions with taxpayers and tax practitioners electronically. IRS implemented e-Services in May 2004. According to IRS, as of late March 2005, over 84,000 users have registered with this Web portal.
- Customer Account Data Engine (CADE). CADE is intended to replace IRS's antiquated system that contains the agency's repository of taxpayer information and, therefore, is the BSM program's linchpin and highest priority project. In July 2004 and January 2005, IRS implemented the initial releases of CADE, which have been used to process filing year 2004 and 2005 1040EZ returns, respectively, for single taxpayers with refund or even-balance returns. According to IRS, as of March 16, 2005, CADE had processed over 842,000 tax returns so far this filing season.
- Integrated Financial System (IFS). This system replaces aspects of IRS's core financial systems and is ultimately intended to operate as its new accounting system of record. The first release of this system became fully operational in January 2005.

Although IRS is to be applauded for delivering such important functionality, the BSM program is far from complete. Future deliveries of additional functionality of deployed systems and the implementation of other BSM projects are expected to have a significant impact on IRS's taxpayer services and enforcement capability. For example, IRS has projected that CADE will process about 2 million returns in the 2005 filing season. However, the returns being processed in CADE are the most basic and constitute less than 1 percent of the total tax returns expected to be processed during the current filing season. IRS expects the full implementation of CADE

to take several more years. Another BSM project—the Filing and Payment Compliance (F&PC) project—is expected to increase (1) IRS's capacity to treat and resolve the backlog of delinquent taxpayer cases, (2) the closure of collection cases by 10 million annually by 2014, and (3) voluntary taxpayer compliance. As part of this project, IRS plans to implement an initial limited private debt collection capability in January 2006, with full implementation of this aspect of the F&PC project to be delivered by January 2008 and additional functionality to follow in later years.

BSM Program Has History of Cost Increases and Schedule Delays and Is High Risk

The BSM program has a long history of significant cost increases and schedule delays, which, in part, has led us to report this program as high—risk since 1995.[14] Appendix II provides the history of the BSM life-cycle cost and schedule variances. In January 2005 letters to congressional appropriation committees, IRS stated that it had showed a marked improvement in significantly reducing its cost variances. In particular, IRS claimed that it reduced the variance between estimated and actual costs from 33 percent in fiscal year 2002 to 4 percent in fiscal year 2004. However, we do not agree with the methodology used in the analysis supporting this claim. Specifically, (1) the analysis did not reflect actual costs, instead it reflected changes in cost estimates (i.e., budget allocations) for various BSM projects; (2) IRS aggregated all of the changes in the estimates associated with the major activities for some projects, such as CADE, which masked that monies were shifted from future activities to cover increased costs of current activities; and (3) the calculations were based on a percentage of specific fiscal year appropriations, which does not reflect that these are multiyear projects.

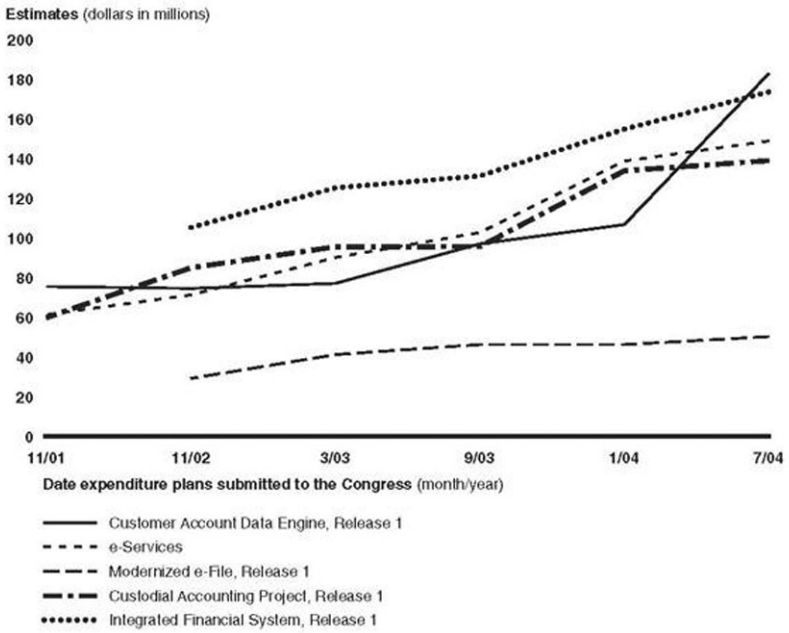
In February 2002 we expressed concern over IRS's cost and schedule estimating and made a recommendation for improvement.[15] IRS and its prime systems integration support (PRIME) contractor have taken action to improve their estimating practices, such as developing a cost and schedule estimation guidebook and developing a risk-adjustment model to include an analysis of uncertainty. These actions may ultimately result in more realistic cost and schedule estimates, but our analysis of IRS's expenditure plans[16] over the last few years shows continued increases in estimated project life-cycle costs (see fig. 3).

[14] For our latest high-risk report, please see GAO, High-Risk Series: An Update, GAO–05–207 (Washington, D.C., January 2005).

[15] GAO, Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload, GAO–02–356 (Washington, D.C.: Feb. 28, 2002).

[16] BSM funds are unavailable until the IRS submits to congressional appropriations committees for approval a modernization expenditure plan that (1) meets the OMB capital planning and investment control review requirements; (2) complies with IRS's enterprise architecture; (3) conforms with IRS's enterprise life-cycle methodology; (4) is approved by IRS, the Department of the Treasury, and OMB; (5) is reviewed by GAO; and (6) complies with acquisition rules, requirements, guidelines, and systems acquisition management practices.

Figure 3: Life-cycle Cost Estimates for Key BSM Projects



Source: GAO analysis of IRS data.

The Associate CIO for BSM stated that he believes that IRS's cost and schedule estimating has improved in the past year. In particular, he pointed out that IRS met its cost and schedule goals for the implementation of the latest release of CADE, which allowed the agency to use this system to process certain 1040EZ forms in the 2005 filing season. It is too early to tell whether this signals a fundamental improvement in IRS's ability to accurately forecast project costs and schedules.

The reasons for IRS's cost increases and schedule delays vary. However, we have previously reported that they are due, in part, to weaknesses in management controls and capabilities. We have previously made recommendations to improve BSM management controls, and IRS has implemented or begun to implement these recommendations. For example, in February 2002, we reported that IRS had not yet defined or implemented an IT human capital strategy, and recommended that IRS develop plans for
obtaining, developing, and retaining requisite human capital resources.[17] In September 2003, TIGTA reported that IRS had made significant progress in developing a human capital strategy but that it needed further development. In August 2004, the current Associate CIO for BSM identified the completion of a human capital strategy as a high priority. Among the activities that IRS is implementing are prioritizing its BSM staffing needs and developing a recruiting plan. IRS has also identified, and is addressing, other major management challenges in areas such as requirements, contract, and program management. For example, poorly defined requirements have been among the significant weaknesses that have been identified as contributing to project cost overruns and schedule delays. As part of addressing this problem, in March 2005, the IRS BSM office established a requirements management office, although a leader has not yet been hired.

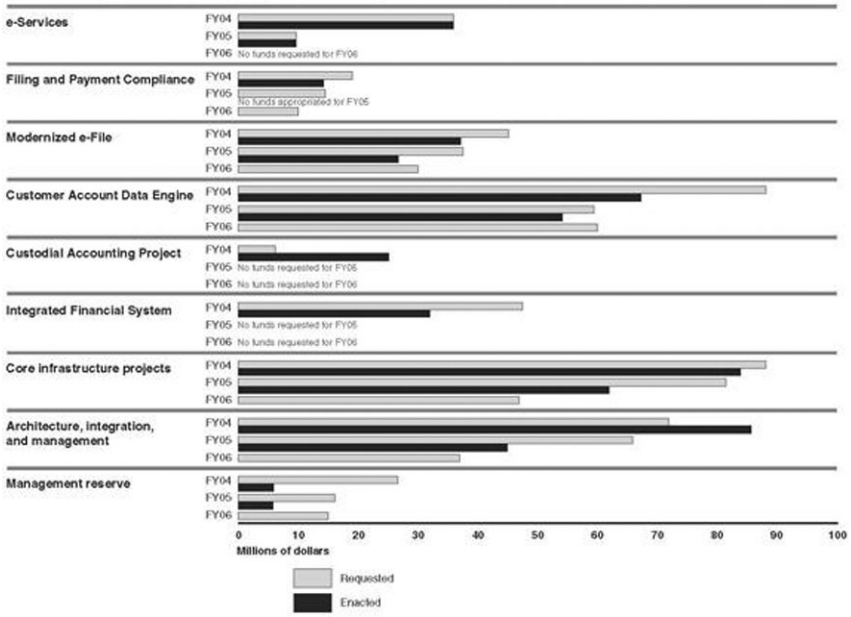
IRS Is Adjusting the BSM Program in Response to Budget Reductions

The BSM program is undergoing significant changes as it adjusts to reductions in its budget. Figure 4 illustrates the BSM program's requested and enacted budg-

[17] GAO–02–356.

ets for fiscal years 2004 through 2006.[18] For fiscal year 2005, IRS received about 29 percent less funding than it requested (from $285 million to $203.4 million). According to the Senate report for the fiscal year 2005 Transportation, Treasury, and General Government appropriations bill, in making its recommendation to reduce BSM funding, the Senate Appropriations Committee was concerned about the program's cost overruns and schedule delays. In addition, the committee emphasized that in providing fewer funds, it wanted IRS to focus on its highest priority projects, particularly CADE.[19] In addition, IRS's fiscal year 2006 budget request reflects an additional reduction of about 2 percent, or about $4.4 million, from the fiscal year 2005 appropriation.

Figure 4: Changes in the BSM budget (dollars in millions) [a]



Source: IRS.
[a] The BSM account authorizes funds to be obligated for 3 years.

It is too early to tell what effect the budget reductions will ultimately have on the BSM program. However, the significant adjustments that IRS is making to the program to address these reductions are not without risk, could potentially impact future budget requests, and will delay the implementation of certain functionality that was intended to provide benefit to IRS operations and the taxpayer. For example:

- Reductions in Management reserve/project risk adjustments. In response to the fiscal year 2005 budget reduction, IRS reduced the amount that it had allotted to program management reserve and project risk adjustments by about 62 percent (from about $49.1 million to about $18.6 million).[20] If BSM projects have future cost overruns that cannot be covered by the depleted reserve, this reduction could result in (1) increased budget requests in future years or (2) delays in planned future activities (e.g., delays in delivering promised functionality) to use those allocated funds to cover the overruns.

[18] IRS uses the appropriated funds to cover contractor costs related to the BSM program. IRS funds internal costs for managing BSM with another appropriation. These costs are not tracked separately for BSM-related activities.
[19] U.S. Senate, Senate Report 108–342.
[20] We did not include in our calculations, reductions to specific project risk adjustment amounts that were made for reasons other than the fiscal year 2005 budget reduction.

- Shifts of BSM management responsibility from the PRIME contractor to IRS. Due to budget reductions and IRS's assessment of the PRIME contractor's performance, IRS decided to shift significant BSM responsibilities for program management, systems engineering, and business integration from the PRIME contractor to IRS staff. For example, IRS staff are assuming responsibility for cost and schedule estimation and measurement, risk management, integration test and deployment, and transition management. There are risks associated with this decision. To successfully accomplish this transfer, IRS must have the management capability to perform this role. Although the BSM program office has been attempting to improve this capability through, for example, implementation of a new governance structure and hiring staff with specific technical and management expertise, IRS has had significant problems in the past managing this and other large development projects, and acknowledges that it has major challenges to overcome in this area.
- Suspension of the Custodial Accounting Project (CAP). Although the initial release of CAP went into production in September 2004, IRS has decided not to use this system and to stop work on planned improvements due to budget constraints. According to IRS, it made this decision after it evaluated the business benefits and costs to develop and maintain CAP versus the benefits expected to be provided by other projects, such as CADE. Among the functionality that the initial releases of CAP were expected to provide were (1) critical control and reporting capabilities mandated by federal financial management laws; (2) a traceable audit trail to support financial reporting; and (3) a subsidiary ledger to accurately and promptly identify, classify, track, and report custodial revenue transactions and unpaid assessments. With the suspension of CAP, it is now unclear how IRS plans to replace the functionality this system was expected to provide, which was intended to allow the agency to make meaningful progress toward addressing long-standing financial management weaknesses. IRS is currently evaluating alternative approaches to addressing these weaknesses.
- Reductions in planned functionality. According to IRS, the fiscal year 2006 funding reduction will result in delays in planned functionality for some of its BSM projects. For example, IRS no longer plans to include Form 1041 (the income tax return for estates and trusts) in the fourth release of Modernized e-File, which is expected to be implemented in fiscal year 2007.

The BSM program is based on visions and strategies developed in 2000 and 2001. The age of these plans, in conjunction with the significant delays already experienced by the program and the substantive changes brought on by budget reductions, indicate that it is time for IRS to revisit its long-term goals, strategy, and plans for BSM. Such an assessment would include an evaluation of when significant future BSM functionality would be delivered. IRS's Associate CIO for BSM has recognized that it is time to recast the agency's BSM strategy because of changes that have occurred subsequent to the development of the program's initial plans. According to this official, IRS is redefining and refocusing the BSM program, and he expects this effort to be completed by the end of this fiscal year.

Additional Actions Needed to Improve Budgeting for IT Operations and Maintenance

IRS has requested about $1.62 billion for IT operations and maintenance in fiscal year 2006, within its proposed new Tax Administration and Operations account. Under the prior years' budget structure, these funds were included in a separate account, for which IRS received an appropriation of about $1.59 billion in fiscal year 2005. The $1.62 billion requested in fiscal year 2006 is intended to fund the personnel costs for IT staff (including staff supporting the BSM program) and activities such as IT security, enterprise networks, and the operations and maintenance costs of its current systems. We have previously expressed concern that IRS does not employ best practices in the development of its IT operations and maintenance budget request.[21] Although IRS has made progress in addressing our concern, more work remains.

The Paperwork Reduction Act (PRA) 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 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

[21] GAO, Internal Revenue Service: Improving Adequacy of Information Systems Budget Justification, GAO–02–704 (Washington, D.C., June 28, 2002).

agencies are to select and manage IT projects. In addition, 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

- 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. 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 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.[22] To address our recommendation, IRS agreed to take a variety of actions, which it has made progress in implementing. For example, IRS stated that it planned to develop an activity-based cost model to plan, project, and report costs for business tasks/activities funded by the information systems budget. The recent release of IFS included an activity-based cost module, but IRS does not currently have historical cost data to populate this module. According to officials in the Office of the Chief Financial Officer, IRS is in the process of accumulating these data. These officials stated that IRS needs 3 years of actual costs to have the historical data that would provide a basis for future budget estimates. Accordingly, these officials expected that IRS would begin using the IFS activity-based cost module in formulating the fiscal year 2008 budget request and would have the requisite 3 years' of historical data in time to develop the fiscal year 2010 budget request. In addition, IRS planned to develop a capital planning guide to implement processes for capital planning and investment control, budget formulation and execution, business case development, and project prioritization. IRS has developed a draft guide, which is currently under review by IRS executives, and IRS expects it to become policy on October 1, 2005. Although progress has been made in implementing best practices in the development of the IT operations and maintenance budget, until these actions are completely implemented IRS will not be able to ensure that its request is adequately supported.

So Far This Filing Season IRS Has Generally Maintained or Improved Performance, Including Telephone Accuracy, with Less Funding

Results to date show IRS has generally maintained or improved its 2005 filing season performance in key areas compared to last year despite a decrease in the 2005 budget for taxpayer service. These key areas are paper and electronic processing, telephone assistance, IRS's Web site, and walk-in assistance. Table 4 shows performance to date in these four areas.

Table 4: IRS Performance in the First Weeks of the Filing Season, 2002–2005

Volume in thousands	2002	2003	2004	2005
Actual returns processed[a]				
Paper	24,491	22,117	20,232	17,607
Electronic	35,067	38,627	42,988	45,848
Telephone assistance				
Total calls[b]	34,489	27,905	29,058	23,340

[22] GAO–02–704.

Table 4: IRS Performance in the First Weeks of the Filing Season, 2002–2005—Continued

Volume in thousands	2002	2003	2004	2005
Answered by assistors	9,208	9,434	10,116	9,421
Answered by automation	25,281	18,471	18,942	13,919
Customer service representative level of service	62%	82%	84%	83%
Average speed of answer[c]	227 seconds	183 seconds	199 seconds	235 seconds
Accounts accuracy rate estimates[d]	88%+/−1%	88%+/−1%	89%+/−1%	92%+/−1%
Tax law accuracy rate estimates[d]	84%+/−1%	81%+/−1%	76%+/−1%	87%+/−1%
Internet assistance				
Forms and publications downloaded[e]	N/A	N/A	N/A	70,321
Refund status inquiries[f]	N/A	9,300	14,300	16,400
Walk-in assistance				
Total walk-in contacts[g]	N/A	2,740	2,433	2,163
Returns prepared at IRS walk-in sites[h]	436	291	186	145
Returns prepared at volunteer sites[i]	466	594	741	915

Source: IRS.
[a] From January 1 to March 22, 2002; March 21, 2003; March 19, 2004; and March 18, 2005.
[b] Total calls (i.e., calls answered by assistors and automation) and CSR level of service are based on actual counts from January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005. The 2002 totals include increased call demand as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107–16 (2001).
[c] From January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005.
[d] Based on a representative sample estimated at the 90 percent confidence level from January to February 2002, 2003, 2004, and 2005.
[e] As of February 28, 2005.
[f] From January 1 to March 20, 2003; 2004; and 2005.
[g] From January 1 to March 15, 2003; March 13, 2004; and March 12, 2005.
[h] From January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005.
[i] From January 1 to March 9, 2002; March 8, 2003; March 13, 2004; and March 12, 2005.

Overall IRS's filing season performance to date is good news because, as table 1 shows (page 6), IRS's budget for taxpayer service is $104 million less than the year before. According to IRS officials, it absorb this reduction by generating additional internal savings and program reductions. However, because the filing season is not over, the extent to which IRS will achieve efficiency gains and the full impact of reductions on taxpayers in this or future filing seasons is not yet known.

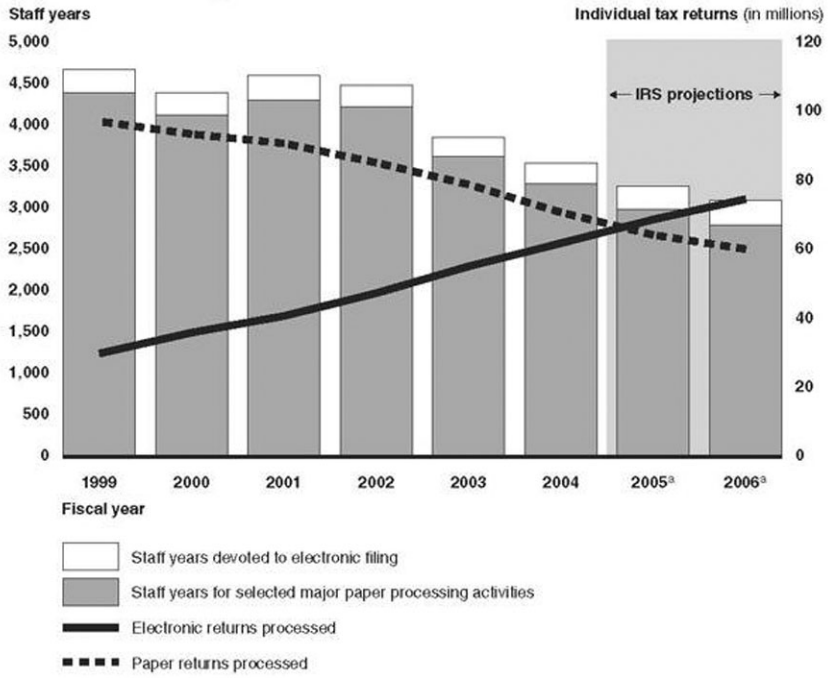
Processing Has Been Smooth, Staff Continues to Decline, and Electronic Filing Continues to Grow but not at a Rate to Meet Long-term Goal

As of March 18, IRS processed about 63 million individual income tax returns and 57 million refunds. According to IRS data and information from external stakeholders such as paid practitioners, processing has been uneventful and without significant disruptions. IRS officials attribute this year's smooth processing to adequate planning and few tax law changes. This year's processing activities are important, in part, because for the first time during the filing season, IRS is using CADE to process the simplest taxpayer accounts (1040EZ without problems or balance due). As we note in the BSM section, CADE is the foundation of IRS's modernization effort and will ultimately replace the Individual Master File that currently houses taxpayer data for individual filers. As of March 16, 2005, CADE has processed over 842,000 tax returns without significant problems.

Growth in electronic filing (e-filing) helps fund IRS's modernization. Electronic filing allows IRS to control costs by reducing labor-intensive processing of paper tax returns. E-filing also improves taxpayer service by eliminating transcription errors associated with processing paper returns. E-filing also has benefits for taxpayers, primarily by allowing them to get their refunds in half the time of paper filers.

As shown in figure 5, the number of e-filed returns has increased since 1999 and the number of paper returns has decreased. The figure also shows that these changes have allowed IRS to reduce the staff devoted to processing paper returns between 1999 and 2004 by just over 1,100 staff years. As the number of e-filed returns has increased, the number of staff years used to process those returns has not. The decline in paper processing staff allowed IRS to close its Brookhaven processing center in 2003. In addition, IRS is in the process of closing its paper processing operation in Memphis.

Figure 5: Number of Individual Returns and IRS Staff Years for Individual Paper and Electronic Processing, Fiscal Years 1999–2006



Source: GAO analysis of IRS data.
*Fiscal years 2005 and 2006 are IRS projections and, given the current lower e-file growth rates, the estimates may be optimistic.

Note: Staff years and FTEs are units of measurement that are often used interchangeably. According to IRS, an FTE is the equivalent of one person working full time for 1 year with no overtime. A staff year includes overtime. Therefore, the cost of 1 staff year is equal to the cost of one FTE plus overtime. As noted in the figure, staff years for paper filing are for selected major activities only.

Although the growth in e-filing is about 6.7 percent over the same period last year, it is growing at a slower rate than previous years. Based on the current trend and the fact that the percentage of returns e-filed traditionally declines as April 15 approaches, it appears that IRS will not achieve its goal of having 68.2 million individual tax returns e-filed this year (an 11 percent increase over last year).

Over recent years, IRS has undertaken numerous initiatives to increase e-filing. However, neither this year's current growth rate nor the projected annual growth rate will enable IRS to achieve its goal of 80 percent of all individual tax returns being e-filed in 2007. This goal has focused attention on increasing e-filing. As we reported last year, IRS officials believe that achieving the goal would require additional measures to convert the tens of millions of taxpayers and tax practitioners who prepare individual income tax returns on a computer, but filed on paper to e-filing. IRS officials also stated that the additional measures might need to include legislation that mandates e-filing for certain classes of returns, such as those pre-

pared by practitioners. Last year we reported five states, including California, that mandated the e-filing of state tax returns, also showed increases in the e-filing of federal returns.[23] This year, three additional states have introduced mandatory e-filing of state returns by tax practitioners.

Telephone Access Has Remained Relatively Stable and Accuracy Has Improved

Between January 1 and March 12, IRS received approximately 23 million calls. As shown in table 4, IRS's automated service handled nearly 14 million calls and customer service representatives (CSRs) handled just over 9 million. The percentage of taxpayers who attempted to reach CSRs and actually got through and received service—referred to as the CSR level of service—remained relatively stable at 83 percent compared to 84 percent at the same time last year.

IRS reduced its 2005 goal for CSR level of service from 85 percent in 2004 to 82 percent because of the budget reduction for taxpayer service. However, IRS has been able to achieve a relatively stable CSR level of service of 83 percent since last year. According to IRS officials, this level of performance is due to

- staff plans being made before the level of service goal was reduced;
- the agency receiving fewer calls due to fewer tax law changes than in 2004;
- the agency improving methods for handling calls; and
- an increased use of IRS's Web site.

Although CSR level of service is about the same as last year, down one percentage point, there are other indications of slippage in telephone access. Specifically, taxpayers are waiting longer to speak to a CSR. Wait times have increased by about 35 seconds or 15 percent compared to the same period last year. Additionally, the rate at which taxpayers abandon their calls to IRS increased from 10 percent to 11.5 percent, which translates into about 99,000 calls. The responsible IRS official considers the increase in wait time and increase in abandon rate to be acceptable, in part because IRS data are showing that the agency is using 9 percent fewer FTEs than last year and answering 195 more calls per FTE.

IRS officials said they lowered the CSR level of service goal in response to the reduction in the taxpayer service budget, and will adjust staffing plans after the filing season to address the taxpayer service budget reduction. IRS officials believe the adjustments will likely result in a lower level of service than is currently being achieved.

IRS estimates that the accuracy of CSRs' answers to taxpayers' tax law questions improved compared to last year. Specifically, tax law accuracy increased to an estimated 87 percent as compared to 76 percent at the same time last year. This represents a significant change from last year, when we drew attention to the declining tax law accuracy rate.[24] According to IRS officials and staff, the improvement is primarily due to formatting changes made in 2004 to the guide that CSRs use to help them answer taxpayers' tax law questions that have enhanced the usability of the guide. IRS officials stated that the revised guide is better and more user-friendly, partly because many of the suggested improvements were from CSRs who use the guide daily. In addition, IRS officials stated that the improved tax law accuracy rate reveals that the previous version of the guide was indeed the reason for last year's decline in tax law accuracy, and attributed fluctuations in the tax law accuracy rate to changes in the guide in past years.

IRS estimates that accounts accuracy (the accuracy of answers to questions from taxpayers about the status of their accounts) has improved compared to last year and since 2002. Taxpayers who called about their accounts received correct information an estimated 92 percent of the time, which is an improvement compared to last year's 89 percent rate and the 88 percent rate seen in 2002 and 2003. The responsible IRS official told us that accounts accuracy rates have improved because IRS has improved its ability to monitor and manage staff, expanded training, and improved its ability to search for account information.

Web Site Performing Well and Used Extensively

Various data indicate that IRS's Web site is performing well. We found it to be user-friendly because it was readily accessible and easy to navigate. Problem areas that we reported in the past, such as the search function, were much improved this filing season, thus eliminating our previous concerns about the search function. Furthermore, an independent weekly study done during the filing season has reported that IRS's Web site has ranked in the top 4 out of 40 government Web sites and

[23] GAO–05–67.
[24] GAO–04–560T.

that users were able to access the IRS Web site in.65 seconds or less. The same independent weekly assessment reported that IRS ranked first or second in response time of downloading data. Finally, the electronic tax law assistance program on IRS's Web site has shown marked improvement this year over last. For example, the average response time is down from 3.8 days to 1.6 days and the accuracy rate has improved from 56.9 percent to 87.5 percent.[25] According to IRS officials, this significant improvement is due to a decrease in the number of tax law questions being submitted—down from about 56,000 to 8,700 for the same time period.

IRS's Web site is experiencing extensive usage this filing season based on the number of visits, pages viewed, and forms and publications downloaded. As of February 28, 2005, the Web site was visited about 83 million times by users who viewed about 628 million pages. This is the first time that IRS has publicly reported the number of visits to and number of pages viewed on its Web site. Further, about 70.3 million forms and publications had been downloaded this fiscal year through February, with about 45 million of those downloads occurring in January and February.

IRS's Web site continues to provide two very important tax service features: (1) "Where's My Refund," which enables taxpayers to check on the status of their refund and (2) Free File, which provides taxpayers the ability to file their tax return electronically for free via IRS's Web site. As of March 20, 2005, about 16 million taxpayers accessed the "Where's My Refund" feature to check the status of their tax refund—about a 15 percent increase over the same time period last year. Also, IRS provided new functionality for "Where's My Refund" whereby a taxpayer whose refund could not be delivered by the Postal Service (i.e., returned as undeliverable mail), can change their address on the Web site. In addition, as of March 16, 2005, 3.6 million tax returns had been filed via Free File, which represents a 44 percent increase over the same time period last year. In the 2005 filing season, all individual taxpayers are eligible to file free via IRS's Web site.

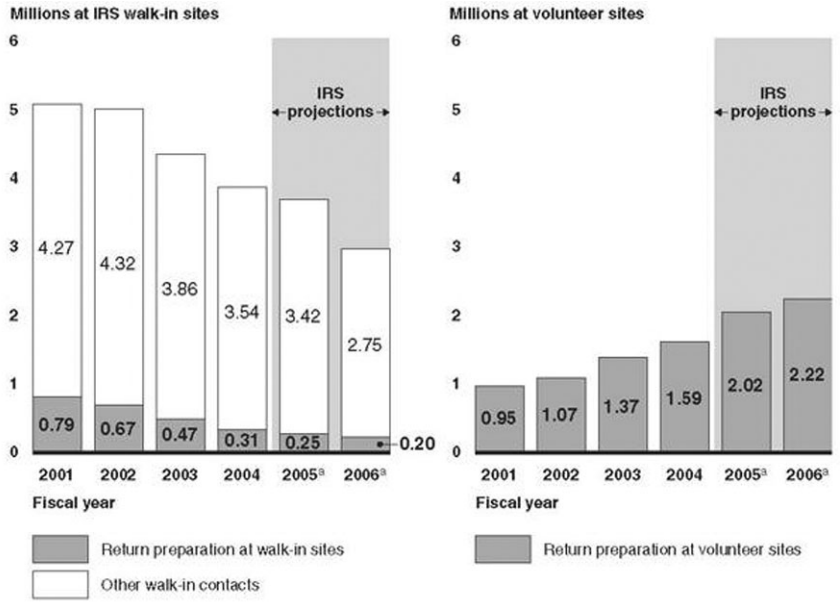
Use of IRS's Walk-in Assistance Continues to Decline, While Use of Volunteer Assistance Increases

As of March 12, assistance provided at IRS's approximately 400 walk-in sites declined by 11 percent compared to the same time last year, with the number receiving tax preparation assistance declining by about 22 percent. Staff at those sites provides taxpayers with information about their tax accounts and answer a limited scope of tax law questions.[26] If staff cannot answer taxpayers' questions, they are required to refer taxpayers to IRS's telephone operations or have taxpayers correspond via IRS's Web site. In combination with decreased demand, IRS reduced the staff used at walk-in sites for return preparation assistance and continues to encourage taxpayers to use volunteer sites for return preparation. These declines are consistent with IRS's goal to further limit return preparation and tax law assistance at walk-in sites by 2007 and with its 2006 budget request.

[25] These estimates are based on IRS's random samples of electronic tax law assistance questions submitted via IRS's Web site. These estimates have a +/−4.6 percentage points range and +/−2.8 percentage points range in 2004 and 2005 respectively, with a 90 percent confidence level.

[26] Walk-in site employees are trained and authorized to only answer tax law questions on specific tax topics such as those related to income, filing status, exemptions, deductions, and related credits.

Figure 6: Assistance Provided by IRS Walk-in and Volunteer Sites, 2001–2006 Filing Seasons (in millions)



Source: GAO analysis of IRS data.
[a] Fiscal years 2005 and 2006 are IRS projections.
Note: "Other walk-in contacts" includes assistance for account notices, tax law inquiries, forms, and compliance work, but not return preparation. For the walk-in sites, the time periods covered are December 31, 2000, through April 28, 2001; December 30, 2001, through April 27, 2002; December 29, 2002, through April 26, 2003; and December 28, 2003, through April 24, 2004. For volunteer sites, the time period covered for 2001 is January 1, 2001, through April 21, 2001; all other periods are the same as those for IRS walk-in sites.

As reflected in table 4 and figure 6, in contrast to IRS walk-in sites, the number of taxpayers seeking return preparation assistance at volunteer sites has increased this year and every year since 2001. These sites, staffed by volunteers certified by IRS, do not offer the range of services IRS provides, but instead focus on preparing tax returns primarily for low-income and elderly taxpayers and operate chiefly during the filing season. IRS officials estimated that the number of taxpayers receiving assistance at approximately 14,000 volunteer sites has increased over 23 percent compared to the same time last year.

The shift of taxpayers from walk-in to volunteer sites is important, because it has transferred time-consuming services, particularly return preparation, from IRS to volunteer sites and allowed IRS to concentrate on services that only it can provide such as account assistance or compliance work. As a result, IRS has devoted fewer resources to return preparation. While this shift is important to IRS, others have been more cautious. For example, in her January 2005 report,[27] the Taxpayer Advocate has expressed concern about the reduction of face-to-face services, such as those offered at walk-in sites. She stated that IRS's plan does not adequately provide for the segment of the population that continues to rely on the interaction provided by walk-in sites. At the same time, last year, we[28] and TIGTA[29] called attention to

[27] National Taxpayer Advocate, 2004 Annual Report to Congress (Washington, D.C.: Dec. 31, 2004).
[28] GAO, Tax Administration: IRS Improved Performance in the 2004 Filing Season, but Better Data on the Quality of Some Services Are Needed, GAO–05–67 (Washington, D.C.: Nov. 4, 2004).
[29] Treasury Inspector General for Tax Administration, Improvements Are Needed to Ensure Tax Returns Are Correctly Prepared at Taxpayer Assistance Centers, Reference No. 2004–40–

Continued

issues related to the quality of service at both IRS walk-in and volunteer sites. IRS has separate quality initiatives under way at both IRS walk-in sites and volunteer sites, although data remain limited and cannot be compared to prior years.

Conclusions

As IRS shifts its priorities to enforcement and faces tight budgets for service, the agency will be challenged to maintain the gains it has made in taxpayer service. In order to avoid a "swinging pendulum," where enforcement gains are achieved at the cost of taxpayer service and vice versa, IRS and the Congress would benefit from a set of agreed-upon long-term goals. Long-term goals would provide a framework for assessing budgetary tradeoffs between taxpayer service and enforcement and whether IRS is making satisfactory progress towards achieving those goals. Similarly, long-term goals could help identify priorities within the taxpayer service and enforcement functions. For example, if the budget for taxpayer service were to be cut and efficiency gains did not offset the cut, long-term goals could help guide decisions about whether to make service cuts across the board or target selected services. To its credit, IRS has been developing a set of long-term goals, so we are not making a recommendation on goals. However, we want to underscore the importance of making the goals public in a timely fashion, as IRS has planned. The Congress would then have an opportunity to review the goals and start using them as a tool for holding IRS accountable for performance.

In addition, the Congress would benefit from more information about the short-term impacts of the 2006 budget request on taxpayers. The 2006 budget request cites a need for reducing the hours of telephone service and scaling back walk-in assistance but provides little additional detail. Without more detail about how taxpayers will be affected, it is difficult to assess whether the 2006 proposed budget would allow IRS to achieve its stated intent of both maintaining a high level of taxpayer service and increasing enforcement.

BSM and related initiatives such as electronic filing hold the promise of delivering further efficiency gains that could offset the need for larger budget increases to fund taxpayer service and enforcement. Today, taxpayers have seen payoffs from BSM; however, the program is still high risk and budget reductions have caused substantive program changes. IRS has recognized it is time to revisit its long-term BSM strategy and is currently refocusing the program. As we did with long-term goals above, we want to underscore the importance of timely completion of the revision of the BSM strategy.

Recommendation

We recommend that the Commissioner of Internal Revenue supplement the 2006 budget request with more detailed information on how proposed service reductions would impact taxpayers.

Appendix I

Description of IRS's Proposed Budget Structure

IRS's proposed new budget structure as depicted in figure 7 combines the three major appropriations that the agency has had in the past—Processing, Assistance, and Management; Tax Law Enforcement; and Information Systems into one appropriation called Tax Administration and Operations. The Business Systems Modernization and Health Insurance Tax Credit Administration appropriations accounts remain unchanged. The Tax Administration and Operations appropriation is divided among eight critical program areas. These budget activities focus on Assistance, Outreach, Processing, Examination, Collection, Investigations, Regulatory Compliance, and Research. According to IRS, as it continues to move forward with developing and implementing this new structure, these program areas and the associated resource distributions will be refined to provide more accurate costing.

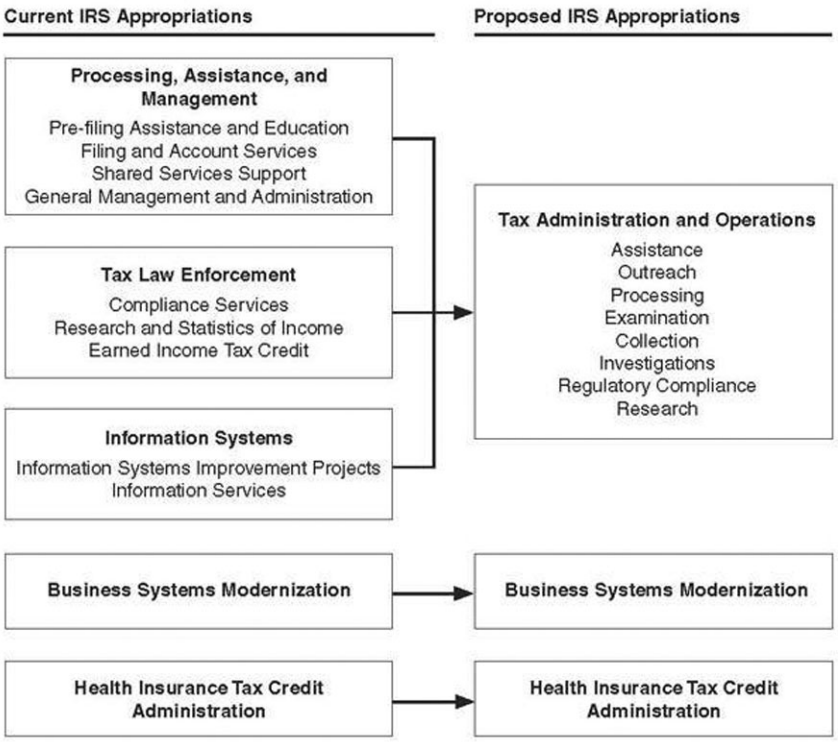
IRS reported that the new budget structure has a more direct relationship to its major program areas and strategic plan. We did not evaluate IRS's proposed budget structure as part of this engagement because it was not within the scope of our review. However, we have recently completed a study on the administration's broader budget restructuring effort. In that study we say that, going forward, infusing a performance perspective into budget decisions may only be achieved when the underlying information becomes more credible and used by all major decision makers. Thus, the Congress must be considered a partner. In due course, once the goals and

---

025 (Washington, D.C.: 2003) and Treasury Inspector General for Tax Administration, Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites, Reference No. 2004–40–154 (Washington, D.C.: 2004).

underlying data become more compelling and used by the Congress, budget restructuring may become a better tool to advance budget and performance integration.[30]

Figure 7: IRS's Proposed Budget Structure



Source: GAO representation of IRS information.

Appendix II

BSM Project Life Cycle Cost/Schedule Variance and Benefits Summary

The table below shows the life-cycle variance in cost and schedule estimates for completed and ongoing Business Systems Modernization (BSM) projects, based on data contained in IRS's expenditure plans. These variances are based on a comparison of IRS's initial and revised (as of July 2004) cost and schedule estimates to complete initial operation[31] or full deployment[32] of the projects.

[30] For a more detailed discussion, see GAO, Performance Budgeting: Efforts to Restructure Budgets to Better Align Resources with Performance,GAO–05–117SP (Washington, D.C.: February 2005).

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

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

Table 5: BSM Project Life Cycle Cost/Schedule Variance and Benefits Summary

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.					
Security and Technology Infrastructure Release 1	+$8,450	$45,401	+5	1/31/02 (initial operation) [a]	Provides infrastructure for secure telephony and electronic interaction among IRS employees, tax practitioners, and taxpayers
Customer Communications 2001	+14,562	60,762	+9	2/26/02 (full deployment)	Improves telecommunications infrastructure, including telephone call management, call routing, and customer self-service applications
Customer Relationship Management Exam	−721	9,245	+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 Connect Release 1	+200	10,200	0	12/31/02 (initial operation) [a]	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
Modernized e-File Release 1	+21,057	50,303	+6.5	5/31/04 (initial operation) [a]	Provides initial electronic filing capability for large corporations, small business, and tax-exempt organizations
Ongoing projects					

Table 5: BSM Project Life Cycle Cost/Schedule Variance and Benefits Summary—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
Modernized e-File Release 2	0	26,325	0	9/30/04 (initial operation)	Provides additional functionality to support corporate electronic filing and other capabilities, including required public access to filed returns for tax-exempt organizations
Modernized e-File Release 3	+5,300	27,175	0	3/31/05 (initial operation)	Provides additional functionality to support electronic filing for tax-exempt organizations and other capabilities, including the interface with state retrieval systems
e-Services	+102,271	148,820	+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	+118,129	182,774	+30	6/30/05 (full deployment)	Provides the modernized database foundation to 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	+73,710	173,580	+15	6/30/05 (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

Table 5: BSM Project Life Cycle Cost/Schedule Variance and Benefits Summary—Continued

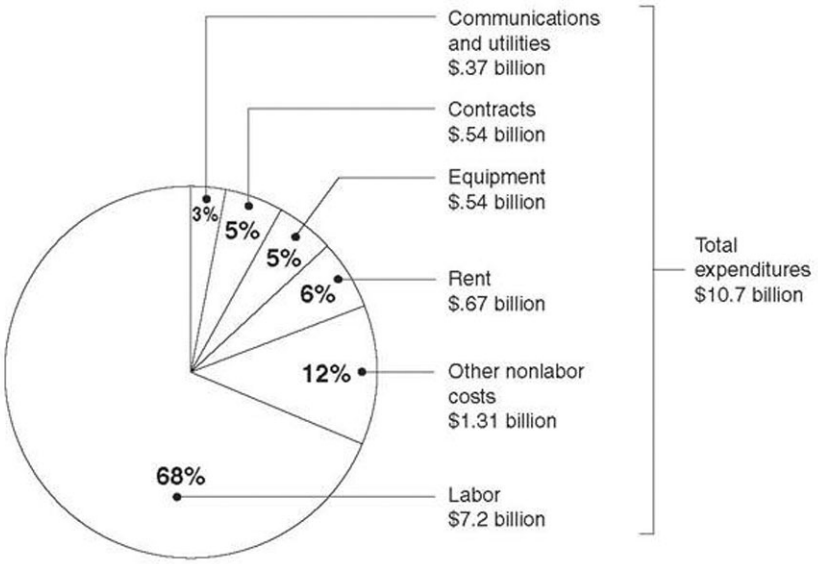
Project	Cost variance (in thousands)	Reported/ revised estimated cost (in thousands)	Schedule variance (in months)	Reported/ revised estimated completion date	Reported IRS/ taxpayer benefits
Custodial Accounting Project Release 1	+91,789	138,950	+33	11/01/05 (full deployment)	Provides integrated tax operations and internal management information to support evolving decision analytics, performance measurement, and management information needs

Source: GAO analysis of IRS data.
a Information on the costs and schedule for the full-deployment stage of these projects was not available in the BSM expenditure plans.

How IRS Allocated Expenditures and Full-Time Equivalents in Fiscal Year 2004

Figures 8 and 9 illustrate how the Internal Revenue Service (IRS) allocated expenditures and full-time equivalents (FTE) in fiscal year 2004. Figure 8 shows total expenditures. The percentage of expenditures devoted to contracts decreased from 9 percent in 2002 to 5 percent in 2004, because of fewer private contracts. The percentage of expenditures devoted to other nonlabor costs increased from 8 percent in 2002 to 12 percent in 2004, due to increases in miscellaneous costs.

Figure 8: IRS Expenditures in Fiscal Year 2004

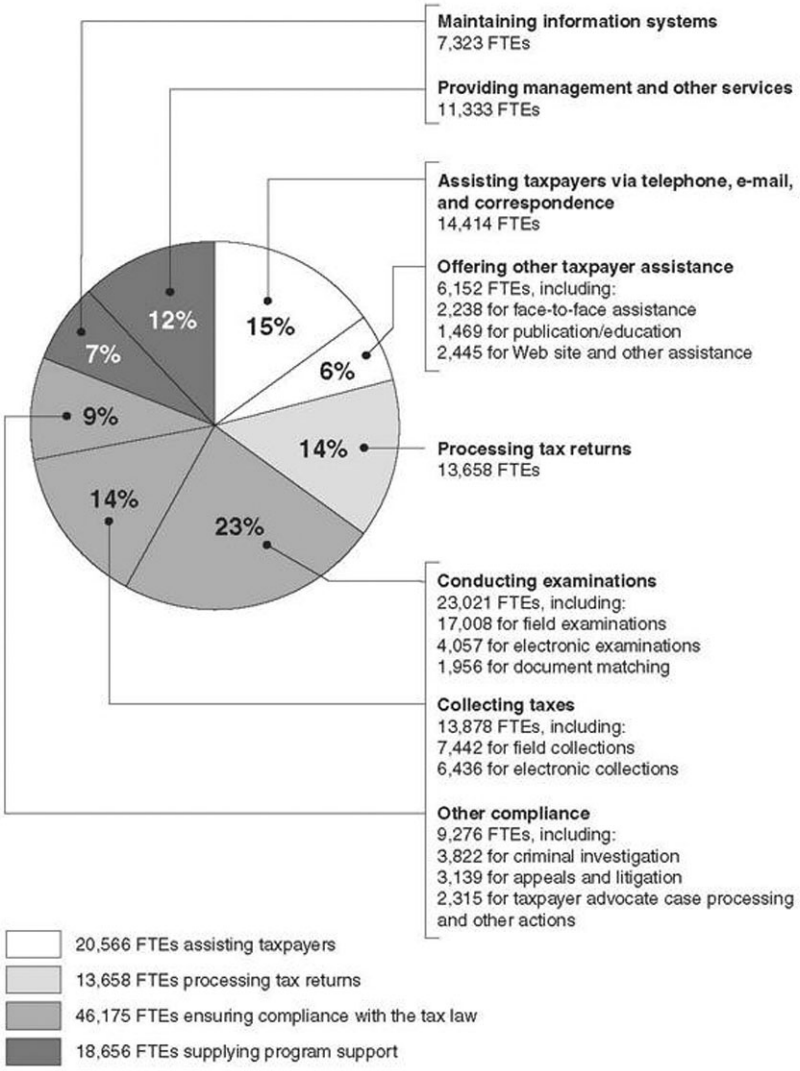


Source: GAO analysis of IRS data.
Note: Numbers do not add to the total and percentages do not add to 100 percent due to rounding.

Figure 9 shows IRS's total FTEs. FTEs have decreased slightly from 99,180 in 2002 to 99,055 in 2004. We previously reported that processing FTEs declined 1 percentage point between 2002 and 2003. Between 2003 and 2004, IRS's allocation of

FTEs remained similar with a 1 percentage point increase in conducting examinations, and in management and other services.

Figure 9: How IRS Spent 99,055 FTEs in Fiscal Year 2004



Source: GAO analysis of IRS data.

Chairman RAMSTAD. Thank you, Mr. White. Mr. Wagner.

STATEMENT OF RAYMOND T. WAGNER, JR., CHAIRMAN, INTERNAL REVENUE SERVICE OVERSIGHT BOARD

Mr. WAGNER. Thank you, Mr. Chairman, for this opportunity to testify before the Subcommittee and to present the IRS Oversight Board's views on the President's proposed fiscal year 2006 budget for the IRS. Also, I would extend my congratulations to you, sir, and to you, Mr. Lewis, on your new positions of leadership on the Subcommittee. I believe I also speak for the entire Board when I say how much we too will miss Representative Portman and his leadership in the area of tax administration. Mr. Chairman, the IRS Oversight Board recently released its fiscal year 2006 budget report. I would like to ask that the report be entered into the record at this time.

[The information is being retained in the Committee files.]

The Oversight Board's report describes improved performance which the IRS has achieved in fiscal year 2004 in three important areas: customer service, BSM and enforcement. Yet, while progress has been made we still face an enormous challenge, the amount of known taxes that are not paid. We all heard recently that as of 2001, the tax gaps stood at between $312 billion and $353 billion. To put this into perspective, if all taxpayers paid what they owe each year, our government would have enough money to cover more than 80 percent of the cost of running all non-Defense and non-Homeland Security agencies. With that in mind, I think we can all agree that the job is far from done.

Before describing the Board's budget recommendations for the 2006 budget, I want to summarize the factors that influenced the Board's recommendations. First, we recognize the need for all discretionary funding to be thoroughly justified, and we must give priority to the tax administration as a whole. Second, the Board believes that with an effective tax administration system, taxpayers would find compliance easy to achieve and difficult to avoid. This simple paradigm illustrates the balance between service and enforcement that must be achieved. Third, taxpayers should feel that the service they receive is valuable to them in fulfilling their tax paying duties. Mr. Chairman, there is much to like in President Bush's 2006 budget request for the IRS. When most budgets are being tightened, the President is asking for greater budget increases for the IRS than any other non-Defense or non-Homeland Security agency.

With that in mind, the Board's recommendation builds upon the President's budget request. It calls for $11.6 billion in funding for fiscal year 2006, a 9-percent increase over the Administration's recommendation. The Board believes that the IRS must begin to close the tax gap through greater enforcement. For that reason we recommend an additional $435 million for IRS enforcement efforts that could easily generate more than a billion and a half dollars in additional revenues. That is a solid business case we believe. The Board also recommends additional funding toward maintaining and improving customer service and supporting the BSM program. We are concerned and fear that the proposed reductions in customer service and modernization resources in the budget will have a negative impact on the IRS' ability to deliver quality service to taxpayers which ultimately will have a negative effect on taxpayer

compliance. The Board is pleased to see the Administration's recommendation to adjust the 302(a) allocations to increase enforcement funding for the IRS. To deal with various problems, the Board's budget report recommends a full range of alternatives that recognize the value of investing in IRS enforcement. We urge the Committee to give our recommendations active consideration, especially the ones falling under this Committee's jurisdiction.

The BSM program is critical to the future of the IRS, as you have heard. It must be successfully completed to provide a reliable and efficient means to serve the American taxpayers. Unfortunately, this program has a checkered history. Poor management by the IRS, and lack of delivery by the prime contractor have resulted in missed schedules and cost overruns. In response to this performance, the level of activity of the program was appropriately and significantly reduced in the past. Under Commissioner Everson's efforts, significant improvements have been made. The Board is now recommending an increased funding level for fiscal year 2006 for BSM. The Board, in short, believes that the BSM program should move forward at an accelerated pace. We have heard the Commissioner say many times that service plus enforcement equals compliance. A tax gap of $312 billion annually amounts to an unacceptable $2,000 per taxpayer every year. We must improve compliance, which means more enforcement and more service, and improved technology if we want to close this unacceptable gap.

Mr. Chairman, in conclusion, the Board strongly believes that our Nation can ill afford to return to the days when the IRS fluctuated between customer service and enforcement, and in an effective tax administration system, the taxpayers would find compliance easy to achieve and difficult to avoid. The IRS is now on the right track and is making progress toward this goal, but we must give it the resources to do its job. Thank you and I would be happy to answer any questions.

[The prepared statement of Mr. Wagner follows:]

Statement of Raymond Wagner, Chair, Internal Revenue Service Oversight Board

Thank you, Mr. Chairman for this opportunity to testify before the subcommittee and to present the IRS Oversight Board's views on the President's proposed FY2006 budget for the Internal Revenue Service.

I also want to thank and commend you and the members of the subcommittee for your continued oversight of tax administration issues. It is greatly appreciated. And I believe that I speak not only for the Board, but the entire tax administration community when I say how much we will miss Representative Portman. He has been an outstanding advocate for America's taxpayers.

Mr. Chairman, the IRS Oversight Board recently released its FY2006 IRS Budget Report. I would like to ask that this report be entered into the record.

Three Influencing Factors

Before describing the Board's budget recommendations for the FY2006 IRS budget, I want to present three factors that influenced the Board's recommendations

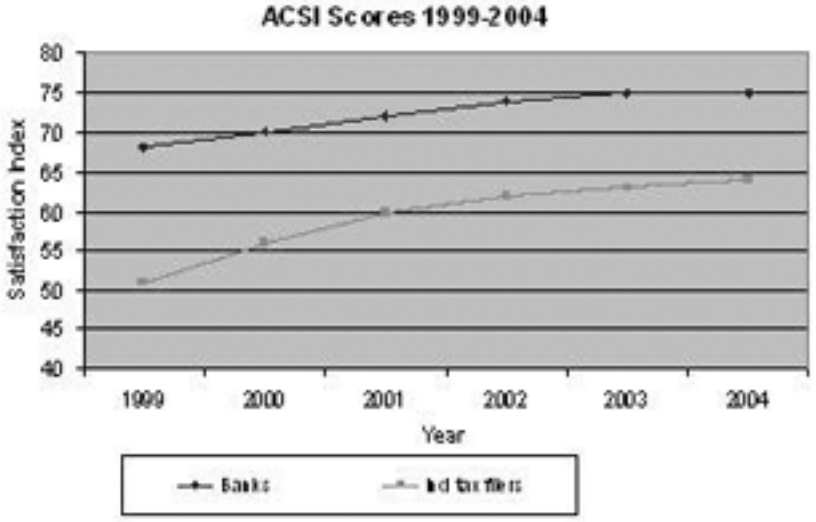
First, the Oversight Board must weigh competing factors when considering the budget it recommends. The Board is cognizant that the world situation and projected deficits for the next several years increase the need to ensure that all federal spending be thoroughly justified, deliver value to the taxpayers, and meet priority needs. However, in our roles as members of the Oversight Board, we must always be mindful of how well the tax administration system is serving taxpayers.

Second, the Board believes that with an effective tax administration system, taxpayers would find compliance easy to achieve and difficult to avoid. This simple paradigm illustrates the balance between service and enforcement that must be

achieved. Those who need service to be compliant should receive it; those who flout the law should be identified and pursued.

Third, taxpayers should feel that the service they receive is valuable to them and to society. While the tax collector will never win a popularity contest, the Oversight Board's most recent taxpayer attitude survey found wide support for additional funding for the IRS—62 percent of respondents favor more funding for enforcement and 64 percent favor more taxpayer assistance. The Board believes that this finding underscores a fundamental belief that our tax administration should operate in a way that is balanced between *both* service and enforcement.

In fact, the willingness of a majority of taxpayers to support additional funding for the IRS reflects the increasing levels of satisfaction that taxpayers show in the IRS. Taxpayer satisfaction surveys such as the American Customer Satisfaction Index (ASCI) have shown a steady increase since 1999, as shown in the figure below.



FY2004: Across-the-Board Progress

The Oversight Board has advocated balance since its inception and it applauds the IRS for staying focused and raising both service and enforcement performance levels in FY2004 while also seeking greater efficiencies through its modernization program. The Board's recent budget report describes improved performance the IRS has achieved in FY2004 in three important areas: (1) customer service, (2) business systems modernization and (3) enforcement.

Telephone service has greatly improved, helping taxpayers navigate an extremely complex tax code. In 2005, the IRS estimates that more than half of individual taxpayers will file their returns electronically and millions are using the IRS web site to download forms, get information on their tax law questions and track the status of their refunds. The IRS' computer modernization program met its cost and schedule milestones in 2004 and the first taxpayers have been moved off the old tape-based system to a modern reliable database. And although the agency's enforcement effort has been suffering from a declining resource base, in FY2004 the IRS was able to increase its enforcement resources and showed an impressive gain in enforcement revenue.

While progress has been made, we still face an enormous challenge: our nation's tax gap—the amount of known taxes that are not paid. We all heard last week that as of 2001, the gap stood at between $312 and $353 billion; a slight increase from 1988, which was the last time the IRS measured the amount of known unpaid taxes.

To put this into perspective, if all taxpayers paid what they owe each year, our government would have enough money to cover more than 85 percent of the cost of operating[1] all non-defense and non-homeland security agencies.

With that in mind, I think we can all agree that the job is far from done. A lot more hard work is still required if the IRS is to become the tax administration agency envisioned by the authors of the IRS Restructuring and Reform Act of 1998.

FY2006 Budget Recommendation

Mr. Chairman, let me now turn to President Bush's FY2006 budget request for the IRS. There is much to like in this request. First, the Oversight Board recognizes and appreciates that at a time when most budgets are being tightened, the President is asking for a greater budget increase for the IRS than other non-defense and non-homeland security agencies.

The Board is heartened by the request for additional enforcement funding and is pleased that the Administration acknowledges that investments in IRS enforcement result in increased tax revenue.

In addition, the President's focus on tax reform is most welcome by not only the Board, but all honest taxpayers. In the long term, simplification of the code will reduce the burden on America's taxpayers and in turn, on IRS customer service and even enforcement. In the short term, however, changes to the tax code will almost certainly increase the demand for IRS customer service.

With that in mind, the Board's recommendation builds on the President's budget request. It proposes a budget that it believes will allow the IRS to fully achieve its strategic goals and objectives. It calls for $11.6 billion in funding for FY2006, a nine percent increase over the Administration's recommendation.

Comparison of Administration's Request, IRS Oversight Board's Recommendation, and Enacted Appropriations

(in $ millions)

FY2005			FY2006	
Admin.	Oversight Board	Enacted	Admin.	Oversight Board
10,674	11,206	10,233	10,679	11,629

The Board believes that the IRS must begin to close the tax gap through greater enforcement. For that reason, we recommend an additional $435 million for IRS enforcement efforts that could easily generate more than a billion and a half dollars in additional tax revenue using the Administrations return on investment of four-to-one. From its private sector perspective, the Board believes it makes perfect sense to make the additional investments in enforcement that will pay for themselves many times over.

The Board also recommends additional funding towards maintaining and improving customer service and supporting the BSM program. We are concerned that proposed reductions in customer service and modernization resources in the proposed FY2006 budget will have a negative impact on the IRS' ability to delivery quality service to taxpayers, which ultimately will also have a negative effect on taxpayer compliance.

The IRS has already announced that it will end its TeleFile service, used by almost four million taxpayers. Another example of reduction in service is the requirement that tax return and tax account transcripts provided by Taxpayer Assistance Centers (TACs) must now be requested by phone or mail, which requires a two-week waiting period. These transcripts are often needed urgently by those applying for mortgages or other loans. This change in procedure burdens taxpayers and is counter to the IRS commitment to provide excellent customer service.

Other possible customer service cuts may include:

- Closing some Taxpayer Assistance Centers, which in total serve 7.5 million taxpayers each year, many of them elderly and lower-income taxpayers and those with limited or no English proficiency;
- Reducing hours on the IRS' toll-free lines; and
- Providing fewer paper versions of forms and publications, further burdening lower-income taxpayers who do not have ready access to the Internet.

[1] According the Office of Management and Budget, in FY2004, discretionary budget authority for non-defense and non-homeland security totaled $386 billion. The mid-point of the tax gap range, $333 billion, is 86 percent of this amount.

Business systems modernization is also key to improving customer service and enforcement. The program should be accelerated, not only to reduce costs and speed up delivery time, but to avoid a catastrophic collapse of the IRS' archaic legacy computer systems.

However, for the past few years, the IRS has slowed down modernization even though it has demonstrated that past problems can be overcome and tangible benefits can be delivered to taxpayers.

Mr. Chairman, the IRS needs a realistic budget that recognizes and provides for the anticipated expenses it will likely incur, such as congressionally-mandated pay raises, inflation and rent increases. By not fully funding these costs—as has been the case in the past—the IRS may yet again be forced to make program cuts to pay for them.

Unfortunately, while we may completely agree that the Board's budget recommendations deliver value to taxpayers, the existing budget evaluation methodology makes it difficult to act on these recommendations because it considers enforcement initiatives simply as an expense, and does not recognize the amount of revenue that will be raised.

Changing the Way Congress Assesses the IRS Budget

For that reason, the Board is pleased to see the Administration's recommendation to adjust 302(a) allocations to increase enforcement funding for the IRS.

However, it is unclear how this recommendation could play out should Congress accept it. The Board is concerned that there could be unintended consequences. The recommendation could result in additional reductions in taxpayer services or modernization should budgets be cut or unanticipated costs arise.

To deal with these potential problems, the Board recommends that Congress reviews a full range of alternatives that recognize the value of investing in IRS enforcement. These options could include revisiting the Office of Management and Budget's own budget methodology regarding enforcement revenue, authorizing enforcement increases under non-discretionary funding, or allowing the IRS to retain a small percentage of enforcement revenue. The Board recognizes that several of these options fall under the jurisdiction of this Committee, and the Board urges the Committee to give this recommendation active consideration.

Conclusion

Mr. Chairman, in conclusion, the Board strongly believes that our nation can ill afford to return to the days when the IRS fluctuated between customer service and enforcement. We cannot shift resources to pursue those who knowingly avoid taxes while neglecting the needs of honest taxpayers attempting to comply with a complex tax code. As I mentioned in the beginning of my testimony, in an effective tax administration system taxpayers would find compliance easy to achieve, but difficult to avoid.

The IRS is now solidly on the right track and is making progress toward that goal but we must give it the resources to do its job. Thank you and I would be happy to answer your questions.

Chairman RAMSTAD. I want to thank both Members of this panel for your excellent testimony and for adhering to the 5-minute rule as well. I have two questions. The first is for Chairman Wagner concerning the Free File Alliance and the Free File program. I know that when the Free File program was formed, the intent was to cover at least 60 percent of individual filers. However, it wasn't agreed that service would be limited to 60 percent, or that it would be stuck at 60 percent. This year all individual filers, I believe, have access to Free File. There is some dispute about whether this program should be made available to all taxpayers or restricted to low income taxpayers. What is your opinion? Do you think it should be available to as many taxpayers as possible or are limits needed?

Mr. WAGNER. Mr. Chairman, thank you for that question. I would say preliminarily that the Board does wholeheartedly support the Free Filing Alliance. We were supportive of the original

purpose, to provide free filing opportunities for oftentimes low income individuals. It is only in the past year, as I understand it, that the program has been expanded to include 100 percent of all individual taxpayers. The Board has not taken a position on this issue, but we are aware of some of the concerns that surround it. We are aware of the concerns between Members of that alliance and I believe you will be hearing more about that this afternoon. The National Taxpayer Advocate has expressed concerns about the ancillary products which are being marketed at the same time. That all said, my own personal opinion is that, to the extent that we can facilitate for all individual taxpayers, whether they be low, middle or high income individuals, the use of electronic systems, then I would support as many people as possible being encouraged to file electronically and for free.

Chairman RAMSTAD. Should the priority be to low income individuals?

Mr. WAGNER. The priority to the low income individuals, yes, sir. The second question concerns an issue you both broached in your testimony and that is BSM. I know that the IRS is taking on more of the management, as you mentioned—I believe Mr. White—in your testimony, of the BSM programs. Prior to the start of BSM, Congress ended a lengthy effort by the IRS to modernize computers. Both you gentlemen, I am sure, remember that. It came with great expense to taxpayers, and I believe the program failed because the IRS lacked the capacity to manage the modernization of the scale and scope that was proposed. It was a huge undertaking and I just don't think they had the resources nor the capability. My question to either or both of you, does the IRS have the capacity to manage BSM today? Mr. White?

Mr. WHITE. Mr. Chairman, my statement was jointly authored by Dave Powner, who is Director of Information Technology at GAO. He is here and he would be an excellent person to answer that question.

Chairman RAMSTAD. Thank you. Welcome to the Subcommittee.

Mr. POWNER. Thank you, Mr. Chairman. Clearly the IRS is in a transition mode as we transition responsibility from the contractor to the IRS. There have been steps in the right direction to have the appropriate resources on board, but they acknowledge that they still have many challenges in this human capital area to fill important positions in order to manage this effectively. In addition to that, managing the contractor will still be a challenge for the IRS as they move responsibilities in-house. That is something that is acknowledged by the current CIO. Then third, bolstering their program management remains a challenge for them. So, I think there is movement in the right direction. They acknowledge those risks, but clearly there is a lot of work ahead, and this next year will be a true test of whether they can successfully pull this off.

Chairman RAMSTAD. So, it is a fair summation that the jury is still out?

Mr. POWNER. Correct.

Chairman RAMSTAD. I appreciate your responses, from all three of you, and your testimony. The Chairman will now yield to the distinguished Ranking Member.

Mr. LEWIS. Thank you very much, Mr. Chairman. Thank you, Director White and Chairman Wagner for your testimony. Director White, what is the appropriate level of spending for the IRS, the level proposed by the President or the higher level proposed by the IRS Oversight Board?

Mr. WHITE. That is an excellent question, and I think the answer depends on IRS' long-term goals. As I indicated, IRS right now does not have long-term goals for either service or enforcement, which makes it very difficult to evaluate the budget proposal for 2006. With long-term goals, Congress and others would be much better positioned to be able to tell how much the budget proposal—how close the budget proposal would move the IRS to those long-term goals; being able to achieve its long-term goals. So, we think it is very important that IRS finish developing these goals and make them public so that there can be some assessment of the goals in terms of whether they are appropriate or not.

Mr. LEWIS. Thank you. Let me just ask you, what concern does GAO have about cuts to IRS taxpayer service as proposed by the Administration? Are you concerned about it?

Mr. WHITE. We are. As I indicated, our major concern is the swinging pendulum sort of situation. We don't want to end up with a swinging pendulum where taxpayer service suffers in order to shift resources to enforcement, and then in turn enforcement gets cut back when the focus returns to providing service. IRS has made noticeable improvements to service since 1998. We hope that those service gains would not be surrendered. In order to do that, we think that one thing that IRS needs to do in thinking about services is to think about what their priorities are right now. They have added some new services that didn't exist 10 years ago such as the Internet. Telephone service is greatly improved compared to 10 years ago. I look back at one of our statements from 10 years ago, and 92 percent of phone calls to IRS got busy signals then. That situation has been dramatically turned around. So, with the new service and the improved service, we think there may be options to change the menu of services that IRS offers; to provide good overall service to taxpayers but at lower cost. So, in our statement we laid out some material about areas to cut if cuts are needed without sacrificing the overall level of service. That would be focusing on things like duplication, for example.

Mr. LEWIS. Thank you very much, Director White. Chairman Wagner, do you know which Taxpayer Service sites are on the Administration's chopping block? Do you have any idea?

Mr. WAGNER. Mr. Lewis, we have just recently begun to explore that. We intend to meet with the Commissioner and learn of the 60 to 105 sites that he discussed. We are very concerned about the issue of closing the sites. We have raised the issue before for the same reasons that Mr. White articulated, that these are important services. Our surveys have indicated that many taxpayers prefer walk-in sites over the Internet, over the telephone. That said, I appreciate what Commissioner Everson said about trying to drive taxpayers to perhaps more cost effective vehicles for services, but

this is something that we at the Board have expressed our concerns about, and we have agreed to monitor it.

Mr. LEWIS. Let me ask you, what could IRS do with an addition of $1 billion for resources? Could they use another $1 billion? Would it be helpful for them to get an additional billion dollars? Most of the agencies would like to have more moneys to do a lot of things.

Mr. WAGNER. Yes, sir, Mr. Lewis. I believe if you take a look at our report, we have outlined and listed a number of initiatives that would effectively total up to $1 billion of additional resources. We are mindful that a recent study has indicated that for every dollar that goes into the IRS, $4 of revenue are produced with that. So, there comes a point at which perhaps a billion dollars or some amount of money wouldn't be efficiently absorbed into the organization. With proposed improvements in services, which we have outlined, enforcement, pursuing to a greater extent at this time BSM, the Board has taken the position that the IRS could use additional resources.

Mr. LEWIS. Thank you very much, Chairman Wagner. Thank you, Mr. Chairman.

Chairman RAMSTAD. The Chairman recognizes the gentleman from North Dakota.

Mr. POMEROY. Thank you, Mr. Chairman. I want to commend you, Mr. Wagner, for the Board's work, because I think it is extremely helpful to have a highly-qualified group of individuals provide basically a fresh look at whether the country is getting from the Service what it needs and whether the Service is getting fair treatment by Congress.

Mr. WAGNER. Thank you, sir.

Mr. POMEROY. I note with great interest your recommendation that additional resources, especially additional resources to the Service, means better service to taxpayers, to keep centers open that you are otherwise going to have to close, and accelerated collection. Indeed your testimony talks about a 4 to 1 return on additional investment in collection. Could you elaborate on that just briefly?

Mr. WAGNER. Let me make a couple of points with respect to that question. Additional resources will buy additional services and additional enforcement activities, but I need to be careful to say, the IRS can also improve performance out of the current resources. I don't want to suggest that only additional monies are going to make the lone difference in improving collections and reducing that tax gap. I think the Commissioner's points are very well taken with respect to the improvements within the IRS that they are making both with technology, and the Internet, and with the particular initiatives they have under way with respect to enforcement. Again, that said, our statutory charge provided to us in the IRS Restructuring and Reform Act 1998, with which you are familiar, is to focus on the IRS and to come up with a budget, and to submit a budget that would ensure that the IRS obtains its strategic long-term goals, and its annual plans.

Mr. POMEROY. I am sorry to interrupt. You have been very patient in waiting to testify, but my time is going to run too short, sir.

Mr. WAGNER. Sure.

Mr. POMEROY. I am just looking at page 3 of your testimony, "For that reason we recommend an additional $435 million for IRS enforcement efforts that could easily generate more than a billion and a half additional tax revenue using the Administration's return on investment, 4 to 1."

Mr. WAGNER. Yes, sir.

Mr. POMEROY. You also have a table that shows, although you asked for more than the Administration sought, Congress didn't even fund the Administration's request; is that correct?

Mr. WAGNER. That is correct, sir, and——

Mr. POMEROY. That has resulted in lost revenue to the treasury as a consequence and a deeper deficit to this country; is that correct?

Mr. WAGNER. One could argue that, and I would urge this Congress to fund the President's budget at a minimum.

Mr. POMEROY. You would like even more than that?

Mr. WAGNER. We believe that the IRS could utilize the additional resources above that recommendation.

Mr. POMEROY. We have an expression at home, "You don't eat your seed corn," and if you cut revenue to the IRS, and you can't collect the revenue that you are owed, you are essentially eating your seed corn.

Mr. WAGNER. Right.

Mr. POMEROY. There is another thing that I would like to direct you to, and I would like to direct the GAO to as well. I think it is important, and that is this private participation we have with Free File. If we are putting the auspices of partnership with the IRS before the public, we, I believe, infer approval of the private partner, and the private partner's ongoing relationships with the public. So, someone entering, basically a relationship with one of our private partners because they are a partner of the IRS, this just creates something that we need to be attentive to. Are you aware of whether the IRS has been able to collect information on what has been sold by these private partners?

Mr. WAGNER. I am not aware if they have been able to collect the information, or if they have that available. I know that it is an issue that has been raised.

Mr. POMEROY. I don't think they do. I have got my hand on a letter that just makes me mad. I don't know why I didn't see it before, but I had written and asked for, "What are you selling?" I get a letter back saying, "Our Member companies cannot lawfully examine and combine a report of the taxpayer information you are seeking without the lawful consent of subject taxpayers." I think that is a crock because we are talking about aggregated data of sales information. This isn't individual tax—I am not asking whether Harry Hanson bought a certain policy. I am asking, "What did Intel sell as a private partner?" Do you think that we ought to be able to have this information?

Mr. WAGNER. I think the information probably could be obtained by simply going to the sites and seeing what products are offered with respect to other financial services and other investment opportunities, the RALs and so on. The short answer is, I

think that information in the aggregate most definitely should be available.

Mr. POMEROY. I think it should be available. I also think it is something that the Board might want to exercise some Service oversight, because if among vendors we have vastly different take-up rates on, for example, refund lending, it certainly might raise an inquiry in terms of, say, what is our private partner doing here to generate such a differential return. To the GAO, I would also think that this would be a matter of interest. Is it something that you think might be an appropriate inquiry of the GAO?

Mr. WHITE. It very well could be. One general management proposition that we support is programs and initiatives ought to periodically be reviewed, ought to be assessed, their performance ought to be judged based on empirical data. We now have several years worth of experience with the Free File program, so this might be a good time for such a review.

Mr. POMEROY. Right. The Free File program; we were interested of course in the numbers that used it, but I always had an interest in what are they selling.

Mr. WHITE. Right.

Mr. POMEROY. It doesn't seem to me that that inquiry has even begun. I am going to work with you on getting it done, but I hope that within the——

Mr. WAGNER. Your point is well taken, Congressman, and we will communicate with each other and begin to look into that.

Mr. POMEROY. I appreciate it and look forward to the ongoing input the Board will give this Subcommittee on Oversight as we try to work these things through. Thank you very much. Thank you. I yield back.

Chairman RAMSTAD. I want to thank the Members of this second panel for your important testimony and your important service. You are now excused. Thank you very much. It is now a pleasure to call the third panel. As I said earlier, this panel will feature testimony from representatives of practitioner groups. Mr. Kenneth Gideon, Chair of the Tax section of the American Bar Association; Mr. Thomas J. Purcell, Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants; Mr. Frank Degen, President-elect of the National Association of Enrolled Agents; Mr. William Stevenson, Enrolled Agent, Spokesperson for the National Council of Taxpayer Advocacy; and finally, Mr. Brad Smith, Senior Vice President, Consumer Tax Group of Intuit Corporation. Welcome, gentlemen to the Subcommittee and thank you for your patience this afternoon. Please deliver your testimony. I don't know if you have any order.

Mr. GIDEON. I am on the list first and I am happy to begin, Mr. Chairman. My name is Kenneth Gideon.

Chairman RAMSTAD. Let us go right down the list, Mr. Gideon, Mr. Purcell, Mr. Degen, Mr. Stevenson, Mr. Smith. Please, Mr. Gideon.

STATEMENT OF KENNETH W. GIDEON, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. GIDEON. I am the Chair, as you said, of the ABA Tax Section. The ABA appreciates this opportunity to appear before the

Subcommittee on Oversight to talk about the critical need for simplification of our Federal tax laws and to support full funding of the IRS budget request. Making the tax system fairer, simpler and easier to administer has been a legislative priority of the ABA for nearly 30 years. We have been on the record urging simplification, a broad tax base and lower rates. In recent years we worked with our colleagues at the American Institute of Certified Public Accountants and the Tax Executives Institute to identify simplification priorities and realistic simplification initiatives on which Congress can act. It is important that Congress act in every tax bill and that it also join in the effort and actually simplify the tax law.

A substantial effort at identifying complex provisions that can be simplified has already been undertaken by the staff of the Joint Committee on Taxation (JCT) in their comprehensive 2001 study on simplification. The effects of complexity, we believe, contributes substantially to taxpayer perceptions that our tax laws are not fair. While JCT's 2001 study provides a substantial number of simplification alternatives, we believe that some like the Alternative Minimum Tax (AMT) require urgent attention. The dual system created by the AMT is one of the most serious complexity problems of the current Code. Each year more and more middle class Americans have to compute their taxes under two systems to determine which they must pay. The individual AMT is complex. It leads to frequent errors, and whatever policy justification it may have had long ago has long since disappeared. We believe that the individual and corporate AMT should be repealed. We recognize that replacement sources of revenue will likely have to be identified to accomplish this, but the time has come to eliminate the complexity and burden imposed by the AMT. Even if big ticket simplification such as AMT repeal cannot be accomplished immediately, there are a range of important but smaller simplification proposals, such as simplifying phase-out provisions that can be accomplished with appropriate legislative focus. Other useful simplification proposals, such as the elimination of provisions that have little current utility or current revenue impact, called "deadwood," should be considered.

If, in every session, Congress would set itself the task of enacting legislation to address some of these problems, Members could create momentum that, over time, could make a real difference in improving the Code, easing taxpayer burdens and making tax laws far more administrable. In addition, we have consistently urged that the IRS be provided with adequate resources to carry out its missions of taxpayer service and fair administration and enforcement of the Federal tax statutes. We continue to believe that adequate funding is vital and, therefore, urge you and your colleagues to work with the appropriators to fully fund the President's budget request for the IRS and to consider the further requests made by the IRS Oversight Board.

In closing, we understand that simplification is not easy. It frequently requires that either revenue be foregone or choices be made that some taxpayers benefit and some taxpayers suffer as a result of enacting simplification proposals, but simplification is worth the cost. It pays dividends in terms of easing the burden of compliance for all taxpayers, simplifying the task of taxpayer edu-

cation and law enforcement for the IRS, and improving taxpayer morale by making it easier to appreciate that the law operates fairly for all taxpayers. The tax section Members stand ready to work with you and your staff Members to achieve simplification. We commend you for what you have done, and it is vital that you continue and that you succeed. Thank you.

[The prepared statement of Mr. Gideon follows:]

Statement of Kenneth Gideon Chair, Tax Section, American Bar Association

Thank you, Mr. Chairman. My name is Kenneth Gideon. 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—and to motivate Congress to enact important simplification legislation.

ABA Section of Taxation

The ABA is comprised of more than 400,000 members and its Section of Taxation has more than 18,000 tax lawyers who work in law firms, corporations and other business entities, government, nonprofit organizations, academia, accounting firms and other multidisciplinary organizations.

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

Making the tax system fairer, simpler and easier to administer is a legislative priority of the ABA. For nearly thirty years, the ABA and the Section of Taxation have been on record urging tax law simplification, a broad tax base and lower tax rates.

In recent years, the Section of Taxation has worked with our colleagues at the AICPA Tax Division and the Tax Executives Institute to identify simplification priorities and realistic simplification initiatives on which Congress can act. The Tax Section and our colleagues in our cooperating organizations will continue this important work. But it is important that Congress—in every tax bill—also join in the effort and actually enact viable simplification proposals. In this regard, we want to acknowledge that the Congress did just that last year in enacting important simplification in the definition of a "child" in the Internal Revenue Code. This definition affects many provisions of the Code. Your efforts last year made life a little easier for millions of taxpayers, and we thank you for it. But much more needs to be done.

We believe that complexity is at the root of many significant obstacles to efficient and effective administration of the tax laws. Indeed, the National Taxpayer Advocate and others have repeatedly demonstrated that complex tax law provisions make life harder for everyone. They cost taxpayers time in simply trying to understand what is required of them, and they make errors by taxpayers and the IRS a virtual certainty. Eliminating complexity where we can identify it and fix it must be a continuing priority of the Congress.

We understand that simplification is not easy. It frequently requires that either revenue be foregone or choices made such that some taxpayers benefit and some taxpayers suffer as a result of enacting simplification proposals. But simplification is worth the cost. It pays dividends in terms of easing the burden of compliance for all taxpayers, simplifying the task of taxpayer education and law enforcement for the IRS, and improving taxpayer morale by making it easier to appreciate that the law operates fairly for all taxpayers.

A substantial effort at identifying complex provisions that can be simplified has already been undertaken by the staff of the Joint Committee on Taxation in their comprehensive 2001 study on tax simplification. As the Joint Committee noted, complexity reduces 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, the effects of complexity, we believe, contribute substantially to taxpayer perceptions that our tax laws are not fair.

While the Joint Committee's 2001 study provides a substantial number of simplification alternatives, we would like to emphasize a few requiring urgent attention. The dual tax system created by the Alternative Minimum Tax is one of the most serious complexity problems in the current Code. Each year, more and more middle-class Americans have to compute their taxes under two systems to determine which they must pay. The individual AMT is complex, leading to frequent errors. It results in indefensible policy outcomes such as a taxpayer prevailing in a lawsuit only to find that she owes the IRS more than she collected. In short, whatever policy justification may have existed for the individual AMT when it was enacted has long since disappeared.

The American Bar Association believes that the individual AMT should be repealed. We recognize that replacement sources of revenue will likely have to be identified to accomplish this—but the time has come to eliminate the complexity and burden of having a growing number of middle-class Americans each year compute individual taxes under two different systems.

The Tax Section also notes that the corporate alternative minimum tax creates complexity for corporate taxpayers that is in many ways akin to the problem for individuals. The Tax Section has written to Congressional leaders urging that the corporate AMT also be repealed. Again, we recognize that this may well require replacement revenues to be identified and substituted—but, as a matter of tax policy, making corporate taxpayers compute their taxes under two different systems creates major and wholly unnecessary complexity in our tax system. Our position on the corporate AMT represents the views of the Section of Taxation. This position has not been approved by the ABA House of Delegates or its Board of Governors and should, therefore, not be construed as representing the position of the American Bar Association.

Even if big ticket simplification such as AMT repeal cannot be accomplished immediately, there are a range of important, but smaller scale, simplification proposals that can be adopted if appropriate legislative focus is applied. We called your attention last year to the need to address the complexity arising from the numerous provisions such as educational benefits, the earned income tax credit, and retirement savings provisions that are phased out as a taxpayer's income increases. Because these provisions have typically not been coordinated, the phase out thresholds and ranges in such provisions vary widely—and often overlap.

The result is not merely mind-numbing complexity but often disappointed taxpayer expectations as the complicated calculations make it difficult for taxpayers to plan whether they will be able to utilize tax benefits subject to phase-outs. For example, a teacher contributes to an individual retirement account only to discover that she earned $1500 too much last year to claim the deduction. Perhaps even more important are the disincentives created by combining phase-outs that occur when a taxpayer attempts to avail himself of benefits under several provisions. Such combination phase-outs can create marginal tax rates well in excess of what the section 1 tax table says that taxpayer's marginal rate should be. Again, we applaud the Congress for the limited but important action it has taken to address the phase-out problem in the context of personal exemptions and the overall limitation on itemized deductions. But much more can and should be done—and the time has come to do it.

Other useful simplification proposals such as elimination of provisions that have little current utility or current revenue impact, *i.e.*, "deadwood," should be considered. There has been progress: corporate taxpayers will be spared having to consider what might make a corporation "collapsible" because Congress repealed the provision. Congress could also review whether the accumulated earnings tax provisions are needed and whether one set of anti-deferral rules could replace the multiple sets of rules we have now.

We strongly recommend, as we have in the past, that Congress seriously consider the many excellent simplification recommendations made by the Joint Committee in 2001. If, in every session, Congress would set itself the task of enacting legislation to address some of these problems, members could create momentum that, over time, could make a real difference, by improving the Code, easing taxpayer burdens, and making the tax laws far more administrable. We urge you to call on us and our colleagues in the AICPA and TEI. There is a consensus for simplification, and we are ready to roll up our sleeves and to help you make tax simplification a reality.

We and others recently testified before the IRS Oversight Board in support of Treasury and IRS efforts to achieve simplification through the regulatory process. Fundamental to this effort is the publication of prompt and clear administrative guidance dealing with new legislation as well as new developments in the way busi-

ness is transacted. The Treasury and IRS deserve commendation for their efforts to publish guidance on the 2004 Act that was timely and answered important questions. But the guidance process is continuous, and its work is never done. Timely, clear guidance advances the goal of simplification by reducing ambiguity and uncertainty. We believe that a strong published guidance program constitutes one of the most important contributions the Treasury and IRS can make to simplification.

We also want to record our continuing support for IRS efforts to improve the examination process by improving its targeting and currency. Important practical simplification can also be achieved administratively by the creation of clear, accessible procedures for the resolution of recurring taxpayer errors. There are several such programs now, but more could be implemented. It is worth noting, however, that consistently recurring errors over a period of years are probably a strong signal to the Congress that the Code provision giving rise to such errors could probably be improved.

As always, Tax Section members stand ready to work with you and your staff members to achieve simplification. We commend you for what you have done, but it is vital that your efforts continue and that they succeed.

Chairman RAMSTAD. Thank you, Mr. Gideon. Mr. Purcell, please.

STATEMENT OF THOMAS J. PURCELL, III, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. PURCELL. Mr. Chairman and Members of the Subcommittee, it is my pleasure today to represent the American Institute of Certified Public Accountants before you, and thank you for the opportunity to testify. You have my written comments. I have four brief points that I want to make in my oral testimony: first, I want to address the filing season; second, I want to address the budget request; third, the simplification issues; and fourth, tax practitioner responsibility.

With respect to the filing season, it has been our experience so far this year not to have any significant issues, and in terms of practitioners, we have not heard of issues coming up through the ranks to us. So, partly we think that is because of the fact that there have not been any significant new changes in the law, and so they have had a chance to implement over the past year. We do recognize, though, that there have been some isolated events with regard to the 1099 dividend form that we noted last year. We are still monitoring that, and we will be pleased to provide you with information as we get more information. Again, with the filing, we think it is very important to continue the effort toward e-filing. We support the IRS' moves in that regard. However, we did express some concern. They just recently proposed mandatory e-filing for certain corporations and nonprofit organizations to take place for next filing season, and we have been on record as asking for a suspension of that for 1 year. It does not appear that they are going to offer that suspension, and our concern with that is, not so much that taxpayers will have problems being able to implement, although that will be a major imposition on taxpayers, but also that the IRS will be able to absorb that number of e-filed returns when it comes to the time of the filing crunch that will take place in September, when things get extended to the September filing deadline. So, that is a major concern that we have.

Second, on the budget, we do support the budget appropriation for the IRS. We think it is important to give the IRS the money it needs to do its job. Currently, for every dollar that you appropriate, they generate revenue of $180. That is a pretty good return on the investment. If, at the margin, the 4:1 number that has been suggested today is accurate, even that is a very good return on investment. My colleague and friend from Omaha, Warren Buffett, would probably jump at the chance to get that kind of return. So, I would encourage that if that is, in fact, the rate of return that is there. However, we do share the concern about the TACs that the IRS proposes to close, because they touch a major segment of the population that does not otherwise have a chance to interact with the IRS, or provide information that people need to do their tax return. Coupled with a decrease and suspension of the TeleFile Program, some people do not have Internet access, do not have access to volunteer taxpayer sites, and so they will be left without very many resources to provide information they need to do their tax return. So, we are concerned with that, as well as the Oversight Board's concern mentioned earlier today.

Third, with regard to simplification, it has been our pleasure to partner with the ABA and the TEI in the past, and we continue to support the sentiments that Mr. Gideon has mentioned today. Again, my experience of over 35 years of being involved in tax practice is that there is no quick fix to this. It did not get complex overnight. You are not going to fix the complexity overnight, so I really support Mr. Gideon's proposal that you incrementally fix this. If you take it upon yourselves as a regular basis to try and implement simplification in the process and we are there to help you do that, to identify areas where we can make it a more simpler Code, then this will pay off in the long run in terms of helping taxpayers become more compliant. There has been some recent empirical evidence which indicates that once you get an equilibrium point of compliance and you start to cut back on the enforcement efforts, you stay at an equilibrium level of compliance for a while, but when those efforts become lower, the equilibrium shifts downward, and to shift it back up takes even more effort and a longer period of sustained enforcement activities. So, we would encourage the funding for enforcement, that it continue, and the simplification, which would help compliance.

Finally, the last point—and I am almost out of time, but would be happy to answer questions in the later period—would be that we support taxpayer responsibility. As a profession, we are constantly challenging ourselves to have high ethical standards, and we are constantly looking to our Members and requiring that they comply with our high ethical standards. So, we support the efforts of the IRS in trying to implement that. However, we work in partnership with them rather than in opposition. So, we are trying to help make that work for all practitioners. Thank you for your time today, and I will answer questions at the end.

[The prepared statement of Mr. Purcell follows:]

Statement of Thomas J. Purcell, III, Chair, Tax Executive Committee, American Institute 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 Tom Purcell, Chair of the AICPA Tax Executive Committee; and Associate Professor of Accounting and Professor of Law at Creighton University, Omaha, Nebraska. The AICPA is the national, professional organization of certified public accountants comprised of more than 340,000 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 2005 tax filing season.

The AICPA is happy to report that the 2005 filing season is progressing largely without any significant problems and American taxpayers and practitioners are generally pleased with the Service's performance. However, we would like to bring an issue to your attention. Last year, brokerage firms and mutual funds had major difficulties determining which dividends constituted "qualified dividends" for purposes of the new 15 percent rate, a situation that resulted in large numbers of erroneous Forms 1099–DIV being sent to taxpayers.

While the complaints from practitioners and taxpayers are substantially less than what occurred in 2004, we have received a number of reports from CPAs that some taxpayers still have not received their Forms 1099–DIV or that they are receiving a number of corrected Forms 1099–DIV. We will keep the Subcommittee on Oversight apprised should any significant developments occur with respect to Form 1099–DIV.

Our comments focus on a number of programs of critical importance to the Service, specifically: (1) the IRS budget for fiscal year 2006; (2) Business Systems Modernization; (3) achieving e-filing goals; (4) tax practitioners and professional responsibility; and (5) tax simplification.

1. THE IRS BUDGET

The AICPA urges Congress to support full funding of the Internal Revenue Service's fiscal year 2006 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 process tax returns and enforce the tax laws is vital to maintaining our voluntary compliance tax system. 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.

The Administration's 2006 budget requests a $500 million increase in IRS funding, bringing the allocation to $10.7 billion. The AICPA supports the budget proposal's objectives of principally focusing on increasing staffing and resources in the enforcement area. In light of Commissioner Mark Everson's February 7, 2005 statement that increased enforcement funding would be coupled with "a modest amount of belt tightening in the area of taxpayer services," we encourage Congress and the Administration to maintain an appropriate balance between enforcement and taxpayer service. The AICPA stands ready to work with the Service to ensure that the needs of American taxpayers are adequately addressed.

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 taxpayers as customers. We have also witnessed the improvements initiated by Commissioner Everson, particularly with respect to enforcement. Any lack of attention to the Service's funding needs will likely only serve to undercut the tax administration improvements Congress expects and the nation's taxpayers deserve.

2. BUSINESS SYSTEMS MODERNIZATION

The fiscal year 2006 budget submission generally recommends funding the Service's Business Systems Modernization (BSM) program at approximately the same level Congress approved for 2005. In acknowledging this relatively flat funding level in his February 7, 2005 statement, Commissioner Everson highlighted the successes that the IRS's modernization program had over last year, including "the first update to the main IRS database in 40 years, the roll-out of new Internet services for taxpayers and practitioners and improved administration systems."

Although we appreciate and commend the IRS's successes, the Service continues to experience difficulties with BSM. We strongly encourage Congress to stay the course in terms of supporting appropriate funding for the modernization effort. This is an issue that must remain a central feature of the Service's strategic plan.

The BSM goals are critical to future IRS success. BSM is designed to change the entire way the Service conducts business with taxpayers and stakeholders, by (1) implementing systems to improve IRS 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 in particular, and we applaud the success of e-filing for the 2004 and 2005 filing seasons. As of March 25, 2005, taxpayers have submitted 49 million e-filed returns, or a 7 percent increase over the same period last year. Approximately 60 million Americans utilized e-file options in 2004.

We concur with Commissioner Everson'sJanuary 11, 2005, comments that "electronic filing can improve both [the IRS's] service and enforcement missions." Moreover, we appreciate the administrative benefits e-filing offers, including faster tax processing, reduced cycle time, quicker identification of emerging audit trends, and the potential for more current resolution of taxpayer uncertainties.

The IRS has done a commendable job of introducing programs—such as the Free File and the Volunteer Income Tax Assistance (VITA) programs—to help low income taxpayers who often don't own computers to file their own income tax returns. We are pleased to report that many CPAs routinely volunteer at VITA sites to help these taxpayers with their returns. Another critical component of helping low income taxpayers is to consider funding for low-income tax return preparation clinics, in a similar fashion to the funding low income (controversy) clinics receive under Internal Revenue Code section 7526. We believe this latter recommendation would encourage e-filing and improve compliance by low income taxpayers generally.

The IRS has developed an excellent website for use by taxpayers through IRS.gov. We have received a number of suggestions for further improvements for the website, including a suggestion for the Service to upgrade the website's search capacity. We have received a few reports that persons searching for a particular tax form have found it difficult to find the form because the current search engine at the IRS.gov home page searches the full IRS website—unless the person alternatively scrolls down and clicks on the Forms and Publications category. The Service should consider having two separate search engines at the agency's home page—one for the website at large and one specifically for forms and publications.

We support the IRS's suite of web-based products for tax professionals and taxpayers called "e-services." Through e-services, practitioners and taxpayers have access to a suite of online products, including the Preparer Tax Identification Number (PTIN) Application; the Online e-file Application; Electronic Account Resolution (EAR); submission of Form 2848, Power of Attorney and Declaration of Representative; and the Service's Transcript Delivery System (TDS).

When the program was launched in 2004, e-services was made available to tax professionals who e-filed 100 or more individual returns. The IRS announced last month that the e-Services suite will now be available to tax professionals who e-file 5 or more individual and business income tax returns. We believe this expansion of e-services to more practitioners should have the added benefit of making the IRS's interaction with tax professionals more efficient, thereby generating significant cost savings to the Service as well.

E-File for Large Corporations and Exempt Organizations

On January 11, 2005, the IRS issued temporary and proposed regulations (REG–130671–04) regarding mandatory requirements for electronically filing (1) income tax returns for large corporations; and (2) annual information returns for certain exempt organizations. Based on the Service's difficult experience several years ago with the mandatory large partnership e-file program, the IRS should expect to encounter significant issues when implementing this new mandatory e-filing program for large corporations and exempt organizations.

During the last several years, the IRS has generally done an outstanding job in terms of seeking input from key stakeholders on the details and development of tax administration programs, prior to formal announcement of the program's start-up. Unfortunately, the IRS did not actively reach out and seek prior input from all key stakeholders in advance of the launch of the corporate component of the e-file project. When the Service announces a new initiative without vetting the proposed program with stakeholders in advance, the new program has often encountered significant problems, forcing the IRS to suspend the program in mid-course.

Our members have concerns about the steps, if any, the IRS has taken to mitigate chances of a significant security breach. Corporate and exempt organization officers are likely to be very concerned about the risks associated with the implementation of a weak security system otherwise subject to attack by computer viruses or hack-

ers attempting to steal sensitive financial data or tax return information. Before engaging in electronic filing, practitioners and taxpayers should be made comfortable with the security features of the e-file program.

We appreciate that the IRS intends to issue guidance as to how a taxpayer may request a hardship waiver. Nevertheless, because the corporate and exempt organization e-file program is so new, the IRS should maintain a posture of flexibility on the issue of filing waivers and not attempt to establish a stated policy of only granting waivers in exceptional cases.

The regulations' preamble states that: "A return filed electronically is deemed to be filed on the date of the electronic postmark." While we strongly support the concept and use of an electronic postmark with the new e-file program, we are concerned that the electronic postmark feature could become unworkable or meaningless should the IRS experience "capacity" problems with the mandatory e-file system or should the system "crash."

At the IRS's March 16, 2005 hearing on REG–130671–04, we stressed the need for further planning and collaboration between the Service and stakeholders; and accordingly, we recommended during the hearing that the IRS delay implementation of the regulations by at least one year to allow these issues to be resolved satisfactorily. During this transition period from a voluntary to mandatory e-file program, we look forward to working with the Service to develop, test, and ultimately implement an effective program for taxpayers.

4. TAX PRACTITIONERS AND PROFESSIONAL RESPONSIBILITY

Professional Ethics

The AICPA applauds Commissioner Everson's commitment to high standards for tax professionals, as exemplified by the final regulations revising Circular 230 (as released on December 8, 2004), and his efforts to upgrade the Office of Professional Responsibility. We view this commitment as one of the best opportunities for the Service to take advantage of working with external stakeholders.

We have a longstanding track record of establishing high professional standards for our CPA members, including the AICPA Code of Professional Conduct and enforceable Statements on Standards for Tax Services. These standards provide meaningful guidance to CPA members in performing their professional responsibilities.

The AICPA is actively communicating with our membership and state CPA societies regarding the new Circular 230 provisions governing "best practices" for tax advisors and tax shelter ("covered") opinion standards. In this context, we are interested in the IRS providing further guidance to help clarify some of the inevitable questions that are arising as a result of these new provisions. We agree with the preamble of the final regulations, that:

Tax advisors play a critical role in the Federal tax system, which is founded on the principles of compliance and voluntary self-assessment. The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice.

The AICPA has a clear position on abusive tax transactions—we unequivocally support their eradication. We have consistently supported protecting the public interest by prohibitions against the misuse of our tax system. We continue to be actively engaged in proposing and evaluating various legislative and regulatory measures 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.

We also support initiatives focused on ethics training for Service employees. We believe that IRS examination and collections employees must be able to "step into the shoes" of tax professionals and vice versa. Government workers and professional tax practitioners must be able to understand each other in order to ensure greater strides in tax compliance.

Registration of Federal Income Tax Return Preparers and Refund Anticipation Loans

The AICPA strongly supports the implementation of high professional standards for tax practitioners, as discussed above. For this reason, we support the *concept* of the Senate Finance Committee's proposal requiring the registration of all income tax preparers. This measure was included in the *Tax Administration and Good Government Act* (H.R. 1528); legislation that passed the full Senate in 2004 but which was not enacted into law.

It is apparent that the legislation was introduced as a partial response to (1) the high error rate associated with Earned Income Tax Credit (EITC) claims and (2) consumer protection concerns with refund anticipation loans. The AICPA believes that direct approaches might better resolve these enforcement and consumer protec-

tion issues and result in more tangible increases in compliance levels than a preparer registration process alone might yield.

We recommend enacting legislation that directly attacks the fraud, negligence, and abuses committed by some preparers with respect to EITC claims. We also strongly urge Congress to enact legislation that further restricts or outright prohibits the use and availability of refund anticipation loans.

Tax Return Outsourcing

On the issue of tax return outsourcing,the AICPA has adopted two new and one revised ethics rulings that address a member's responsibilities when outsourcing services to third-party service providers. In general, we define a third-party service provider as any entity that an AICPA member individually or collectively with his firm, does not control and any individual who is not employed by the CPA member or his firm. Accordingly, the new standards would apply to all independent contractors used by the firm.

The new ethics ruling under Rule 102, *Integrity and Objectivity* of the AICPA Code of Professional Conduct requires that, prior to sharing confidential client information (such as a tax return) with a service provider, the AICPA member must inform the client, preferably in writing, that he or she may be using a third-party service provider when providing professional services to the client. The rule also emphasizes that members are not required to inform clients of third-party service providers used only to provide administrative support services such as record storage, software application hosting and authorized e-file tax transmittal services. In addition, the new ethics ruling under Rule 201, *General Standards* and Rule 202, *Compliance With Standards*, states the AICPA's longstanding belief that members—who use third-party service providers in providing professional services to clients—remain responsible for the work performed by the service provider.

Finally, Rule 301, *Confidential Client Information,* of the AICPA Code of Professional Conduct was updated to require an AICPA member to (1) enter into a contractual agreement with the third-party service provider to maintain the confidentiality of the client's information and (2) be reasonably assured that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of such information.

5. TAX SIMPLIFICATION

Enacting tax simplification measures is integral to the success of future filing seasons. As Commissioner Everson stated in his March 3, 2005 testimony before the Tax Reform Commission:

Complexity in the tax code compromises both the [IRS's] service and enforcement missions. That is because complexity obscures understanding. Those who seek to comply but cannot understand their tax obligations may make inadvertent errors or ultimately throw up their hands and say why bother. In the enforcement context, complexity in the code facilitates behaviors at variance with those intended by Congress.

Simplification of the tax laws is a high priority of the AICPA. We have worked closely with the American Bar Association and the Tax Executives Institute to jointly identify specific proposals for simplification. Similarly, we have recently released a study entitled, "Understanding Social Security Reform: The Issues and Alternatives," and we anticipate releasing a study on fundamental tax reform in the next few months.

The IRS released a study in the last few weeks stating the tax gap is in excess of $312 billion. We believe tax simplification can play a significant role in helping to reduce the overall tax gap, as simplification would (1) result in fewer errors on tax returns and (2) reduce taxpayer susceptibility to the marketing of abusive tax shelters.

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

Chairman RAMSTAD. Thank you, Mr. Purcell. Mr. Degen, please.

STATEMENT OF FRANCIS X. DEGEN, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. DEGEN. Thank you, Mr. Chairman, Mr. Lewis, Mr. Pomeroy. I will speak today as NAEA, which represents 40,000 enrolled

agents throughout the United States. We appreciate our time here today. Enrolled agents are the only practitioners for whom the IRS directly attests competency and ethical behavior. As it has been noted, it has been a relatively smooth season, though I would like to concentrate my remarks on three areas to ensure equally successful seasons in the future.

The first area is that Congress must provide adequate budgetary resources to the IRS, which includes both enforcement and service to the taxpayer, as well as to the practitioner community. Please do not let the pendulum swing wildly back and forth between funding customer service on one side and funding compliance programs on the other. The truth of the matter is that both of these strategic objectives, service and enforcement, must be adequately funded for the system to work correctly. The IRS interacts with more citizens than any other government agency. The Service's budget allocation should reflect the agency's essential position within the government.

The second area, the recent push for tax reform provides a wonderful opportunity to create a simpler system. While the Presidential Commission's search for the best theoretical tax system is interesting, I suggest that efforts to insert plain language into instructions, regulations, and the Code would go a long way toward creating a better, more understandable, and simpler system. The esteemed jurist, Learned Hand, once wrote, "The Tax Code is a fantastic labyrinth whose words merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception." Gentlemen, the Tax Code is undecipherable to the average taxpayer, and I submit if we can send a man to the moon, we should be able to write a Tax Code in plain language that a high school graduate can read and understand.

The third area, we urge the Subcommittee to move expeditiously to regulate all people doing tax returns in order to ensure the integrity of the tax administration system. If I get my hair cut, I go to a licensed barber. If my wife goes to get her nails done, she goes to a licensed manicurist. If a taxpayer goes to someone for tax preparation, shouldn't that individual also be licensed? NAEA believes the answer should be yes, and we encourage Congress to enact legislation.

The good news is that there is an existing structure already in place. The IRS has established an Office of Professional Responsibility. This office regulates what I will call Circular 230 practitioners: enrolled agents, CPAs, and attorneys. Legislative changes should focus on expanding and promoting this current regulatory regime rather than creating an overlapping and possibly confusing new system. The legislation should direct the U.S. Department of Treasury to enroll individuals under a modified Circular 230.

Additionally, the legislation must ensure adequate funding for the Office of Professional Responsibility by dedicating all fees and penalties for practitioners for its operations. Simply mandating the regulation of potentially hundreds of thousands of new enrollees without beefed-up enforcement would merely push the problem preparers underground. The professionalism of the practitioner completing the return is among the most important and the lowest cost of the factors in increasing compliance. An ounce of prevention is

worth a pound of cure. An incorrect return dramatically shifts its cost over to the IRS.

Finally, the IRS needs to be given the resources to promote all Circular 230 practitioners with the public in this new system. Most taxpayers would be astounded to find out, while their barber or their manicurist is licensed, that their tax preparer may not be and usually is not. Comparing the downside of a bad haircut to an incorrect tax return, I would hazard to say that the public would support legislation requiring all preparers to demonstrate ethical behavior and basic competency. As Members of Congress, you have dedicated your professional lives to public service. We ask you to carry this mission out and ensure that the taxpayers of this country are protected. In summary, Mr. Chairman, I thank you once again for allowing NAEA to speak today. We ask Congress to provide the correct funding for the IRS, to simplify the tax system and starting working on the plain language, and to expand and enhance the current system of regulating preparers. Thank you, sir.

[The prepared statement of Mr. Degen follows:]

Statement of Frank Degen President-Elect, National Association of Enrolled Agents

Thank you, Mr. Chairman, Ranking Member Pomeroy, and members of the Oversight Subcommittee for asking the National Association of Enrolled Agents (NAEA) to testify before you today. As you know, NAEA is the premier organization representing the interests of the 40,000 enrolled agents (EAs) across the country. EAs are the only practitioners for whom the IRS directly attests competency and ethical behavior. Over the years, NAEA has worked tirelessly to increase the professionalism of its members and the integrity of the tax administration system as a whole.

The 2005 filing season has progressed relatively smoothly this year. EAs have reported precious few problems. Those reported are fairly insignificant and range from the inability to e-file some complex returns (i.e., cases in which more than 50% of pension or wages are withheld for taxes) to a printing problem with thousands of Forms 1120H (Income Tax Return for Homeowners Associations), which, as printed, would have credited tax to another homeowners association. On the flip side, EAs are by and large pleased with the quick e-file cycle time and the new Schedules K–1 (notwithstanding any difficulties with businesses that prepare them incorrectly).

Using the success of the 2005 filing season as a springboard, we would like to take this opportunity to emphasize three areas for the subcommittee to focus its attention on in the coming months and years to ensure future filing seasons are equally successful.

First, we urge the subcommittee to dedicate its substantial prestige to advocating your fellow Members of Congress for adequate resources at the IRS, which includes **both** enforcement and service—and service includes service to the taxpayer as well as to the practitioner community. Second, please continue to act as the conscience of the tax-writing committee when it comes to the creation of tax laws that are both administrable by the agency and understandable to the public. Finally, we urge the subcommittee to move expeditiously to pass legislation to require all people doing tax returns to demonstrate competency and ethical standards under the existing regulatory framework.

We cannot urge too strongly that the subcommittee—in its capacity as the overseer of the IRS and its budget—continues to advocate that the IRS budget is adequate for the agency to meet its strategic goals. An adequate budget includes funding to meet reasonable goals for both compliance and service, as well as funding for the technology investments the agency needs to support its strategic objectives in those two areas. NAEA urges you to act as a bulwark against the tendency of policymakers to pendulum wildly back and forth between funding taxpayer/practitioner service on one side and funding compliance programs on the other. As to service, we need to stress that IRS is uniquely positioned to provide assistance and education to taxpayers as well as to practitioners. The truth of the matter is that **both** of these strategic objectives—service and enforcement—must be adequately funded for the system to work correctly. Particularly in light of IRS' recent tax gap estimate, which pegs the gap between $312 and $353 billion annually, we hope that

members of the committee can work with the appropriators to ensure sufficient funding. Let's not forget that the IRS collects nearly all the government's revenues and interacts with more citizens than any other government agency. As a result, we believe the Service's budget allocation should reflect the agency's essential position within the government.

At a micro level, Congress should continue to support (and urge the agency to support) a number of programs that at first blush appear to be strictly taxpayer service oriented, but upon closer inspection have real returns for compliance. The public liaison program is one such function. Immediately after the passage of the IRS Restructuring and Reform Act, the IRS instituted a significant field-base public liaison effort with practitioners around the country. These forums made a real contribution to improving efficiency in helping taxpayers comply with the tax laws. Recently, our members have seen these meetings curtailed drastically or eliminated completely. We have every reason to believe this shortsighted movement will serve only to increase downstream costs for the agency as it attempts to respond—after the fact—to problems that could have been resolved with better communications upfront at a lower cost.

The e-services program is another example of front-loaded investment that will produce untold millions of dollars of return. By allowing practitioners to go online to resolve a large number of taxpayer problems, it has freed up thousands of staff hours at the agency and saved taxpayers millions of dollars worth of practitioner costs. We applaud the recent IRS announcement expanding the program to preparers e-filing five or more returns. At the same time, we sincerely hope Congress and the IRS will continue to expand this program with new technology investments and by making it accessible to all Circular 230 practitioners, without respect to the number of returns e-filed. We note that some Circular 230 practitioners provide representation services exclusively and comprise, in our opinion, one of the populations that could benefit most from Electronic Account Resolution. While expanding electronic filing continues to be an important priority, it should not happen in spite of good tax administration. Our members have noticed a marked increase in advertising that seems to suggest that being an ERO indicates some level of competency in the preparation of returns. This is a serious problem for the system.

Tying e-services back to the budget, we are seriously concerned to hear that due to cuts for business systems modernization, the IRS has cancelled all scheduled improvements and additional rollouts of the e-services program. While we acknowledge the current budget constraints, we believe canceling the technology expansions of the program is a quintessential example of being penny wise and pound foolish.

In the area of simplification, the President's Advisory Panel on Tax Reform, the Department of Treasury, IRS, and Congress are well advised to heed Commissioner Everson's trenchant comments when he unveiled the new tax gap estimates. He said, "Complexity obscures understanding." Everson went on to say, "Those who try to follow the law but cannot understand their tax obligations may make inadvertent errors or in the end simply throw up their hands. . . ."

The recent push for tax reform provides a wonderful opportunity to create a simpler system. We hope policymakers remember that for low and middle income people—who comprise the vast majority of all taxpayers—the measure of simplification is straightforward: How long does it take or how expensive is it to do my return every year? We hope that in the search for a new system, practical simplification proposals are not lost in the search for more academic or theoretical solutions. Additionally, and I cannot stress this enough, do not add to the IRS' woes by creating a whole new tax system for it to administer without repealing an old tax regime. For instance, if policymakers are going to institute a VAT or new consumption tax, they need to eliminate one of the existing systems such as the corporate tax or payroll tax. At the risk of sounding like Chicken Little, such a move could be the last straw for the tax administrator.

During the last Congress, key members of the tax-writing committees considered whether to regulate all return preparers. NAEA has worked closely with Senators Grassley and Baucus as well as Congressman Portman and former Congressman Houghton to ensure they do not reinvent the wheel. We believe strongly that if Congress is going to expand oversight of all preparers, its legislative changes should focus on expanding and promoting the current regulatory regime rather than creating an overlapping and possibly confusing new system. We feel strongly that to avoid confusion and possible opposition from state accountancy boards, the legislation should direct the Department of Treasury to enroll individuals under a modified Circular 230. Additionally, the legislation must ensure adequate funding to IRS' Office of Professional Responsibility by dedicating all fees and penalties for practitioners to its operation. Simply passing the regulation of potentially hundreds of

thousands of new enrollees without beefed up enforcement will merely push the problem preparers underground.

Additionally, the IRS needs encouragement from policymakers at Treasury and Congress to do everything within its means to promote Circular 230 practitioners to taxpayers and to support and enhance this credential. The IRS is making a major shift toward bolstering compliance. What we can learn from the current system is that the professionalism of the practitioner doing the return in the end is one of the most important factors in increasing compliance. The old adage, "An ounce of prevention is worth a pound of cure," is certainly apt here. If the information on the return is purposely incorrect, then the cost of compliance shifts dramatically over to the agency. Let's face it, the IRS has gone through the time and money to create a regime of certifying competency and integrity; it needs strenuously to support those practitioners that equally have gone through the effort and cost to enroll and stay current under this program.

In closing, Mr. Chairman and members of the subcommittee, the National Association of Enrolled Agents and its members stand prepared to work with you and the IRS in ensuring a strong tax administration system and improving voluntary compliance. It is up to Congress, however, to do its part to provide the agency with the proper level of funding; simplify the tax system; and to encourage the use of Circular 230 practitioners, expanding and enhancing the current system of regulating practitioners to include all people paid to complete a tax return.

Thank you and I stand ready to answer any questions you may have.

The **National Association of Enrolled Agents (NAEA)** is the professional society representing enrolled agents (EAs), which number some 40,000 nationwide. Its 11,000 members are licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the IRS, including examination, collection, and appeals functions.

While the enrolled agent license was created in 1884 and has a long and storied past, today's EAs are the only tax professionals tested by IRS on their knowledge of tax law and regulations. EAs provide tax preparation, representation, tax planning, and other financial services to millions of individual and business taxpayers. EAs adhere to a code of ethics and professional conduct and are required by IRS to take Continuing Professional Education. Like attorneys and certified public accountants, enrolled agents are governed by Treasury Circular 230 in their practice before the IRS.

Since its founding in 1972, NAEA has been the enrolled agents' primary advocate before Congress and the IRS. NAEA has affiliates and chapters in 42 states. For additional information about NAEA, please go to our website at www.naea.org.

Chairman RAMSTAD. Thank you, Mr. Degen. Mr. Stevenson, please.

STATEMENT OF WILLIAM STEVENSON, ENROLLED AGENT, AND SPOKESPERSON, NATIONAL COUNCIL FOR TAXPAYER ADVOCACY

Mr. STEVENSON. My name is Bill Stevenson. I, too, am an enrolled agent. An interesting thing about enrolled agents is that we are creatures of Congress. We were created by Congress as a group authorized to represent taxpayers before the IRS. Today marks my 10th anniversary of providing testimony for this Committee, and I kind of miss Congressman Portman down at the other end, who was there at the time. Ten years ago, 2 1/2 years prior to the famous Senate hearings, I pleaded with this organization that I am looking at now to provide more oversight to the IRS, and here I am 10 years later asking the same thing, and this is why. When we were working with the Commission to Restructure the IRS, the major issue that we faced in the beginning is: What is the mission of the IRS? Is it an enforcement mission? We are talking primary

mission, because an organization can only have one primary mission. Is it enforcement? Is it service?

The Commissioners and the staff of the restructuring commission came to the conclusion that what this Nation needed was an agency with a service mission. That was one of the most important decisions that was made because if you make that decision, then everything that follows, every decision you make after that, you ask your question: Is this following our primary mission? If the Commission had said we should have an enforcement agency, the restructuring would have been entirely different. The most important moment of my life, because I am the one who recommended this, is when Congress adopted that mission and made it statutory. I thought my work was done in trying to help provide feedback and insight into how to improve the IRS, because a primary mission of service layered on top of people of good will would give us what we wanted as far as raising the quality of life of Americans everywhere and not having an abusive type of agency in our lives.

Let me give you examples, though, that really trouble me, and these examples show that the adoption of the primary mission may not be service. An organization that emphasized service would emphasize liaison with the people in the community. Practitioners don't—we don't just do 1040 tax returns. We are the ones who stand in between most of the taxpayers and the IRS. We are on the frontlines. The money that comes into the IRS is not collected. It is received. It is a process that is in place where, through W-2 withholding, most of the money goes in automatically. Who prepares these taxes? It is the practitioner community; and when there is a problem, who has to resolve these problems? It is the Members of the practitioner community.

Tax processing has really become great. The IRS has done a fabulous job. It is the problems that have to get resolved afterward where things start falling apart, because the agency is not seeing itself as a service agency. Another example is, you gave us a Taxpayer Advocate service to help us—not only the taxpayers but the practitioner community—resolve problems because these people were more sensitive and knew the shortcuts. The IRS has taken them away from us. They are cutting their budget. Another example is the IRS Oversight Board. Now, I am talking from an outside practitioner. I am not on the inside. I don't owe anything to anybody. I know a little bit about administration. I have a doctorate in that field, and I am here to tell you, from my perspective and those of many of my colleagues, the IRS is making it very difficult for the Oversight Board to provide oversight. Another example, education and training was viewed as a major component of restructuring the IRS. You even had it in your Committee report and insisted that the IRS deploy assets to fund education and training of its employees. It is not an acceptable program. They don't deploy enough assets to it. Its employees are not trained. When we try to deal with them to resolve problems, they cannot resolve them because they do not know how, and they are not even empowered to do it, even if some of them did know how. Another example is the offer in compromise program. You told the IRS to liberalize it, and yet most of us have taken it off the table. We cannot use it because the IRS has made it more restrictive. We have well-meaning people

in the IRS trying to do a job. We respect them, but they have not followed congressional intent and the law in administering the service through the eyes of a service mission.

[The prepared statement of Mr. Stevenson follows:]

Statement of William Stevenson Enrolled Agent and Spokesperson, National Council for Taxpayer Advocacy, New York, New York

Considering any balance between the concepts of service and enforcement presumes that both concepts have equal weight. It is axiomatic to professionals of administrative theory that an organization can have only one primary mission. The United States Supreme Court realized in the 1950's that the concept of 'separate but equal' was flawed. The United States Congress in the IRS Restructuring and Reform Act of 1998 (RRA '98) also agreed with the notion that there could only be one primary mission and ordered the IRS to revise its mission statement to place the emphasis on serving the public and meeting taxpayers' needs.

Congress' recognition of the need to have a service-oriented IRS was significant. All of the recommendations made by the Commission to Restructure the IRS that became the blueprint for RRA' 98 describes an IRS that is to be built on a foundation of service. Legislating adoption of a primary mission of enforcement would have yielded entirely different results in both the Commission's report and the legislation that followed.

Service should be the foundation of our voluntary tax system. In a democracy we will not achieve broad based tax compliance without having service as the primary mission of the tax administration agency. The belief that the Internal Revenue Service is a tax collection agency is a myth. The Internal Revenue Service is a tax receiving agency. The major portion of the tax revenues of our nation is collected by employers who are required by law to withhold taxes from the wages of their employees. Tax practitioners of all kinds: Enrolled Agents, Certified Public Accountants, Attorneys, commercial tax preparers, payroll tax services and others facilitate the process. Practitioners prepare over 60% of all individual tax returns, most employment tax returns and a wide variety of business related returns. In doing so, these professionals determine the additional taxes that are paid by taxpayers through their calculations of estimated tax payments and balance due tax returns.

The practitioner community and taxpayers need and deserve a service oriented Internal Revenue Service to nourish and foster our voluntary tax system. Most taxpayers, with the help of practitioners early or timely file tax returns indicating overpaid taxes. These citizens deserve the service of rapid processing and prompt refund of their money. Also deserving service are the several million employers who, with the help of practitioners, have actually collected the tax from their employees. These non paid 'tax collectors' deserve service in the form of easy deposit systems; accurate accounting for receipts; trouble-free information return procedures and straight forward, post-filing resolution of problems. Practitioners, who are the real compliance experts, play a major role in the process of administering our tax laws. They deserve the opportunity for liaison with IRS management so that they may understand the difficulties IRS employees face when they attempt to service the needs of practitioners' clients. Liaison activities are more beneficial to the IRS than they are to the practitioner community. Yet, opportunities for liaison between the IRS and practitioners are declining. Longstanding and regular forums, panels and mutual education opportunities have been reduced by IRS management officials at national and local levels. For example, in 2004 the IRS Nationwide Tax Forums attracted an audience of over 17,000 practitioners who serve almost ten million taxpayers. The Forums provided a conduit of information helpful to practitioners who prepare tax returns and helpful to those who are eligible to represent their clients before the IRS. In addition, the IRS Forums provided feedback to the IRS useful in improving the effectiveness of its programs and procedures. Additionally, the IRS Forums provided 'case resolution' services where with help from the Taxpayer Advocate Service, practitioners were given the opportunity to bring difficult, yet to be resolved taxpayer problem cases for resolution assistance. The Taxpayer Advocate Service employees were able to resolve 90% of these cases on site. The Forums are scheduled for this year. However, due to budget cuts in service, practitioners understand that the Forums are not being supported by IRS management to the same degree. It is even rumored that the Service has determined that case resolution is too expensive to devote the resources of the IRS Taxpayer Advocate Service even though its employees remain dedicated to the program. Practitioners have been advised that many of the supporting divisions such as Criminal Investigation and Appeals may not be sending staff to interact with practitioners. Accordingly, compliance and enforce-

ment initiatives will not be shared by IRS management with practitioners and the opportunity to receive feedback information which might reveal potential problems in IRS strategy will be lost. An organization with a primary mission of Service would be making different decisions about how it interacts with the professional community.

Another example of a different decision that should have been made is the IRS decision to deny access to the electronic account resolution (EAR) services to the only practitioners that it tests and licenses—the Enrolled Agent. The Services refuses access to these account resolution services unless applicants file five electronic returns a year. Many Enrolled Agents do not process tax returns, but specialize on representing taxpayers before various divisions of the IRS. These are the professionals who need the EAR system more than any other. The IRS has lost an opportunity to provide rapid access for account resolution to the most capable account resolvers.

Everyone understands that noncompliant taxpayers must face enforcement. The IRS, however, doesn't seem to distinguish among those who are temporarily unable to comply from those who intentionally fail to comply. Those who are trying to comply should be treated sympathetically and realistically in light of their current inabilities. Those who won't comply should get the service of prompt enforcement measures.

In RRA '98 Congress called for a new mission statement that emphasized service as the primary mission for the Internal Revenue Service. Yet, the IRS' 2005–2009 Strategic Plan identifies service and enforcement as equal priorities. Their strategic plan is in conflict with the principles of administration and possibly violates the law and intent of Congress. In fact, it is our understanding that the Service is making significant cuts in the budgetary areas that they don't consider enforcement.

Congress saw the need to provide taxpayers with a powerful tool to cut through the red tape inertia that is endemic to bureaucracies. They gave taxpayers a service-minded IRS including a Taxpayer Advocate Service sympathetic to hardships and taxpayer rights. From a practitioner's perspective, it appears that IRS has management eliminated service as first priority and marginalized the vital functions of the Taxpayer Advocate Service by slashing their budget and leaving their personnel unempowered and demoralized. Most taxpayers will never know what a friend they may have had in the Taxpayer Advocate Service, a would be friend that is being returned from whence it came. At this crucial time, the National Taxpayer Advocate's voice inside the IRS must be heeded. Practitioners have high hopes that Congress will respond positively and constructively to the recommendations within her annual report and restore the Taxpayer Advocate Service to the original intent of Congress.

As part of its attempt to rebuild public confidence in the tax system, Congress created the IRS Oversight Board. The practitioner community considers the Board to be acting as its voice in the process of improvement of tax administration. The Board is generally responsible for overseeing the IRS in its administration and management of the internal revenue laws. Our country needs an effective Oversight Board. It appears, however, that the IRS has made oversight difficult for the Oversight Board. The Service, contrary to Congressional intent, does not seem to want the Board to make a real difference any more than it wants the Taxpayer Advocate Service to be effective.

Congress in RRA '98 directed the IRS to implement an employee training program to ensure adequate service training because the need was apparent to change the internal structure of the IRS from one that is enforcement driven to one that is more responsive to taxpayer service needs. While the IRS believes it has followed the letter of the law by providing Congress with such a plan, everyday observations reveal that the culture of the agency remains enforcement minded. The IRS' in-service educational programs in most areas are relatively ineffective, inconsequential and unacceptable by even the minimum of standards. Evidence of this is manifest by IRS employees involved in telephone and face to face conferences who are unaware of the law and regulations they are paid to administer.

An organization dedicated to a mission of service would have a robust training and education program at every level. Problem solving by under trained staff is preventing both compliant and out-of-compliance taxpayers from efficiently resolving their issues efficiently. A service mission requires that IRS staff at all levels be involved in a continuous training program to bolster their abilities to perform their functions with a perspective of the real world built on a foundation of technical knowledge. The Committee Report from RRA '98 stated: "The bill requires the IRS to place a high priority on employee training and to adequately fund employee training programs. . . ." Also, TIGTA reported on September 29, 2003, that ". . . the training data provided to the IRS Oversight Board by the IRS were not adequate

for the Board to perform an assessment or to develop a baseline of training in the IRS." The apparent lack of commitment to education and training is revealed by the lack of resources deployed to fund and support a major effort. Even when the IRS adopts service as its primary mission, it will fall short in the delivery due to the lack of appropriate funding for its education and training programs.

Congress legislated an Offer in Compromise (OIC) program years ago and recently directed the IRS to make it available to more taxpayers by liberalizing it. In response, the IRS created an obtuse and unrealistic program. It is so flawed that many practitioners have removed OIC's from the box of tools they use to try obtain relief for taxpayer's problems. The OIC program is more restrictive now than it was prior to RRA '98. With a new bankruptcy law on the horizon, practitioners will have lost their last outpost of financial mercy on the route to repairing taxpayers' financial lives.

In conclusion, There can be no balance between service and enforcement. Service is the foundation of enforcement in a voluntary tax system and it must have the greatest weight. If service is not the IRS' primary mission, perhaps the name Internal Revenue Service should be replaced with Internal Revenue Enforcement Agency.

William Stevenson is president of National Tax Consultants, Inc. (a tax preparation and taxpayer representation firm for individuals and businesses). Bill is an Enrolled Agent, a Certified Financial Planner, and earned a Doctorate in Education from Temple University in administration. In addition, he is admitted to practice before the United States Tax Court as a non-attorney. He serves on both IRS "Area" and New York State Taxation and Finance liaison committees. He is the only Enrolled Agent to serve on the New York State Tax Tribunal's Advisory Committee on Practices and Procedures. Bill is a member of the National Council for Taxpayer Advocacy, the National Society of Accountants, the National Association of Enrolled Agents, and is a Fellow of the National Tax Practice Institute. He has served a two-year term on the Commissioner's Advisory Group, worked closely with the Commission to Restructure the IRS, and meets periodically with IRS and Congressional officials in Washington to recommend changes in procedure as well as to provide the staff with feed-back from the practitioner community. Dr. Stevenson has testified on numerous occasions before both Houses of Congress, the IRS Oversight Board, the Government Accountability Office and the Treasury Inspector General for Tax Administration. In 2002, Bill was named "Accountant of the Year" by the National Society of Accountants. He is also the spokesperson for the National Council for Taxpayer Advocacy.

Chairman RAMSTAD. Well, thank you, Mr. Stevenson. Finally, Mr. Smith, please.

STATEMENT OF BRAD SMITH, SENIOR VICE PRESIDENT, CONSUMER TAX GROUP, INTUIT CORPORATION

Mr. SMITH. Thank you, Mr. Chairman, Mr. Lewis, Mr. Pomeroy. I am appreciative of the opportunity to present Intuit's views on this year's tax filing season, as well as other issues that we feel face our tax system as a whole. Our mission at Intuit is to simplify complex financial functions and activities for consumers, for small businesses, and for their most trusted advisor, the tax practitioner. Our ultimate goal is to actually allow them to take control of their financial lives. We are a 21-year-old company. We have industry-leading products that you may recognize: Quicken, personal finance software; QuickBooks for small businesses; ProSeries and Lacerte for the tax practitioner; and also the Nation's industry-leading consumer tax product, TurboTax.

First, I would like to begin with a few comments on e-filing. As was mentioned earlier, this year the United States will cross that important threshold of having over half of all of our individual Federal income tax returns filed electronically. That is a major mile-

stone. We want to congratulate the Commissioner; the new IRS Director of the Electronic Tax Administration, Bert DuMars; as well as recognize the former Director of Electronic Tax Administration, Terry Lutes, for having laid the foundation for this tremendous success. It is important to note that other countries' tax systems have not achieved nearly as much in such a short period of time. For example, Great Britain chose to build and deploy a government-provided tax software system rather than unleashing the private sector in the competitive consumer marketplace. As a result, today only 3 percent of British taxpayers are willing to use that government system. Now, this is a sharp contrast between our American citizen-centric solution and the Great Britain government-centric solution.

Now, despite our success to date, our focus must be on affirmative efforts to continue to identify and remove the remaining barriers to electronic filing. These barriers range from having to remember your adjusted gross income—for many consumers, that term in and of itself is Greek. In addition to that, the fact that you have to remember last year's adjusted gross income to file this year's return is definitely a challenge. In addition to that, you have to do other things, like pick a one-time personal identification code, or wait 48 hours to actually know whether or not it was electronically received by the IRS. These are just some of the examples that represent that we still have opportunities in front of us. The good news is, the software in the e-filing industry has all the capabilities needed to make e-filing work and go beyond the 50-percent threshold we have reached today and continue to push forward. Once again, the key enabler must be a renewed government commitment to both modernization as well as the speedy removal of these barriers.

I would like to briefly comment on the Free File Alliance that has come up several times in the afternoon. The former IRS Commissioner Charles Rossotti testified before Congress in 2000 and said, and I quote, "I don't think there is any gray area about what the IRS role is in terms of providing services, because I don't believe we should provide tax preparation services nor tax software." We clearly agree. Intuit is proud to have originated a national program of voluntary deductions of online tax preparation and e-filing services. We called this program the Intuit Tax Freedom Project, and we launched this program in 1998, becoming the model for what is now today the Nation's Free File Alliance Initiative. This initiative was created in 1998 and, once again, formed with private and public partnership in 2002 to provide electronic tax preparation and e-filing to lower-income, working poor, disadvantaged, and underserved populations. I am proud to say in the 3 years since its inception, the program has supplied these services to literally millions of people across the Nation at no cost to the user nor the public treasury.

Unfortunately, something has happened along the way. The Free File program has drifted far from its original purpose. Rather than focusing on assisting the underserved with no obligation to purchase any additional products or service, it has now become a universal free service program operating off a national marketing and sales platform hosted by the IRS and heavily dependent on ancil-

lary sales of additional products. Now, after a couple of years of this trend developing unfettered, others, including Intuit, have joined the fray, but we want to be clear. We have concerns—concerns about consumer protection in this environment, concerns about the government serving as either a market maker for commercial business in this country or permitting public assets and endorsement to be used for commercial marketing and sales. The good news is the Free File Alliance is up for renewal and renegotiation, and this is an opportunity for us to get the program refocused on servicing the lower-income and the underserved taxpayers.

So, let me conclude by saying it has always been said that voting and paying your fair share of taxes are two of the most basic obligations of citizenship. Whatever tax policies are eventually developed over the years in this country, it will be important to retain the citizen-centric character of voluntary compliance that is uniquely American, preserving the personal participation of our people in these most basic processes and obligations of individual citizenship. It helps keep government on its toes, and it helps keep our citizens in charge. Thank you.

[The prepared statement of Mr. Smith follows:]

Statement of Brad Smith Senior Vice President, Consumer Tax Group, Intuit Corporation

Chairman Ramstad and Members of the Subcommittee, I am Brad Smith, Senior Vice President of Intuit, responsible for our Consumer Tax Group. Thank you for the opportunity to present Intuit's views on this year's tax filing season, the IRS budget, and other issues facing our tax system.

Our mission at Intuit is to make complex financial functions and activities easy for consumers, small businesses, and accountants helping them to simplify and take control of their financial lives and better manage the financial lives of their clients. A 21-year-old company, Intuit's market-leading products include Quicken, QuickBooks, the ProSeries and Lacerte suites of tax and accounting software for accountants, and, of course, the leading consumer tax software, TurboTax.

The private sector invention of tax software has reduced much of the pain and complexity of tax compliance for average Americans, while bringing accurate preparation and speedy filing of returns within the economic reach of all. In addition, Intuit is proud to have originated a national program of voluntary donation of free online tax preparation and e-filing services for lower income, disadvantaged and underserved taxpayers across the country, as well as for our active duty military. The Intuit Tax Freedom Project, begun in 1998, became the model for today's industry-wide Free File Alliance initiative, a national public-private partnership between the private sector and the IRS that was created in 2002 and has donated millions of tax returns to the needy. And likewise, a Free File Alliance has now been created in almost 20 States, once again providing free services for those who need them most, at no cost to either the government or the individual.

Let me begin my testimony today by addressing the current income tax filing season.

Filing Season 2005 Success

The 2005 filing season has gone very smoothly with few exceptions. The working relationship between the IRS and the tax software industry continues to improve each year. As the IRS now describes it, there is an *eco-system* of support for the American taxpayer that involves the cooperative and complementary roles of the IRS and the private sector, working together to serve our citizens.

The IRS has reported that electronic filing is up over 7% year-to-date, with a total of over 50 million returns accepted so far. At this rate, it is likely that over 50% of individual American taxpayers will fulfill their obligation this year via electronic filing. This represents a tremendous milestone for the IRS and industry along the road to achieving the 80% goal set by Congress in 1998.

Just this year, e-file growth at Intuit has been dramatic. Intuit has produced over one quarter of the e-filed returns received by the IRS, having electronically filed

over 28 million returns through the end of March—a growth rate in excess of 21% over last year.

We congratulate the new Director of the Electronic Tax Administration, Bert DuMars, for his leadership in ensuring the success of the electronic filing season. We would also like to recognize the former Director of ETA, Terry Lutes, for his many years of exceptional leadership, which continue in his new role as Associate Chief Information Officer at the IRS.

As we cross the 50% e-filing threshold in theUnited States, the significance of this progress cannot be understated, and it can be directly attributed to the productivity of the partnership between government and industry to drive toward this national objective for our American citizen-centric tax system.

In comparison, tax systems elsewhere around the world have not fared as well nor achieved as much in this same period of time. One often-cited example is the United Kingdom, where the government set a 50% e-filing objective at the same time we set ours at 80%. However, the UK chose to build and deploy a government-provided tax software system rather than unleashing the private sector in the competitive consumer marketplace. As a result, today only about 3% of British taxpayers are willing to use that government's online tax system, and as a result, just last summer the British tax agency, Inland Revenue, quietly lowered their national long-term e-filing objective down to only 25%. The sharp contrast between the failure of that *government-centric* solution, and the success of the American *citizen-centric* solution, is dramatic, and we're very proud to be part of the remarkable success story here in the United States.

Ways to Improve and Accomplish More

Although much has been accomplished in the drive toward electronic filing as the preferred method of tax compliance in the United States, we still have further to go.

Today, it is still easier to mail a tax return than to electronically file one. But this is not a matter of cost. The filing of paper returns still requires the cost of either postage, special delivery, registered mail or express services. In contrast, there are free electronic tax preparation and e-filing alternatives widely and readily available. And so our focus must be on continued affirmative efforts to identify and remove the remaining barriers to electronic filing, and we should do so as expeditiously as possible.

If cost is not the issue, then what are the real impediments to electronic filing? One of the obstacles is time and effort. As modern software tools have reduced the time it takes to self-prepare a simple return down to a half hour, the process of electronic filing commonly takes another 50% of that time, or an additional fifteen minutes, just to transmit the return. Here are some of the reasons why electronic filing is still unnecessarily difficult:

- Taxpayers need to enter up to 20 additional figures from their W–2, just to electronically file;
- Taxpayers need to electronically sign their return using their previous year's Adjusted Gross Income number, when a great many taxpayers can neither understand the concept of what AGI is, nor remember what last year's AGI number was; many taxpayers approximate what they think their income was in the previous year, effectively making up a number;
- The number one reason e-filed returns are rejected by the IRS is a mismatch of what the taxpayer enters as their previous year's AGI vs. the number the IRS has in their database;
- Taxpayers must make up and use a Personal Identification Number (PIN), a number that they'll never use again;
- Once the taxpayer transmits their return, they then need to wait 24–48 hours before they know whether their return has been accepted or rejected; this is in sharp contrast to commercial transactions in electronic commerce which are generally instantaneous;
- If the taxpayer's electronic return is rejected (which happens to between 14 and 19% of e-filed returns for various reasons), they need to repeat the entire process over again; many simply give up and print and mail their returns;
- Many taxpayers are not able to e-file due to late law changes that result in a late release of IRS forms; for example, filers who donated over $500 dollars in non-cash contributions to a charity were not able to electronically file until late in February due to the late release of form 8283 by the government, driven by the late enactment of the changes to the law;
- Approximately 20% of tax filers owe a balance due, and many of these taxpayers believe that they will have to pay instantly if they electronically file, and

therefore choose to file by paper to slow down payment and improve family cash flow.

In addition to these obstacles that can be removed to facilitate greater taxpayer reliance on e-filing, there are important barriers which must also be removed to encourage greater e-filing by the professional tax preparer and accountant community. Major expansion of e-filing by professional tax practitioners must take place in order to substantially improve today's e-filing numbers; in order to do this, the government must:

- Eliminate the awkward and archaic requirements that stand in the way of expanding registration of tax professionals as authorized e-filers; most professional tax practitioners (73%) are one-person operations for whom the current process of e-file registration is burdensome and unattractive;
- The current reporting agent enrollment process for e-filing takes up to 30 days and is paper based and subject to error and rework; the process does not use electronic signatures, and requires manual entry of information both at the IRS and at the small businesses; this must be modernized;
- E-filing processes must be improved to take into consideration the workflow needs of practitioners, eliminate the need for rework, and recognize that they are in a business that must work efficiently if they are to earn a living. E-filing must be at least as easy for a practitioner as paper filing.

All of these obstacles must be addressed and removed, effectively and expeditiously, if we are to accelerate the national transition to electronic filing as the predominant method of Voluntary Compliance in the American tax system.

Beyond barrier removal, there are also affirmative steps that can be taken which could contribute in significant ways to the growth and acceptance of e-filing. Primary examples would include:

- Expand educational and public information efforts to promote the benefits of e-filing and help taxpayers overcome misconceptions; for example, the top reasons that our customers e-file are to get a faster refund and an acknowledgement from the IRS confirming receipt of their return, while the top reason that people don't e-file relates to worries about security and also fear of being targeted for audit
  - Public awareness efforts must be redoubled in reassuring public confidence in the security of electronic filing, and that e-filing in no way increases the chances of audit, and indeed may reduce such chances due to a reduction in errors in returns.
- Add meaningful benefits for the 20% of tax filers who do not have the attraction of getting a refund; such ideas include:
  - Extended time to pay—consider offering all e-filers additional time to pay their taxes due;
  - It has been proposed by several Administrations that a small tax credit be offered for those who electronically file; it is time to take that step;
  - Work with the banking industry to encourage balance due payment by major credit card with no convenience fee;
    - Current solutions such as Opay and Link2Gov charge users a 2.49% convenience fee;
    - In contrast, our learnings from this filing season indicate that there is pent up demand for a no-convenience-fee option; this year in partnership with the Discover Card we waived the convenience fee for the balance due payment option and saw 5-fold growth in consumer adoption.

In addition, expanded public-private partnership between government and industry will be an essential element of taking e-filing to the next level. Congress and the IRS should look to existing vehicles such as a well-focused "free file" program and the Electronic Tax Administration Advisory Committee (ETAAC) to drive a collaboration strategy:

- Work jointly with industry to simplify the e-file use experience;
- Work jointly with industry to eliminate and reduce e-file rejects (for example, having the ability to ping the IRS' database to proactively detect issues that might result in a rejected return could save time, resources and wasted effort, which could benefit everyone);
- Remove barriers to facilitate small business e-filing, e-payment and other transactions;
- Enhance coordination between the IRS, states and industry:
  - The Joint Tactical Advisory Group between the IRS and the state Federation of Tax Administration is a good concept to focus energy at a working level

on Fed/State issues, but Industry has no seat at the table; that void needs to be rectified, as all three parties together can accomplish much more than any two alone;

- The current national Free File Alliance program today is a federal-only Agreement; as a result, some 20 states have had to create their own look-alike free file program for free state returns to assist lower income, disadvantaged and underserved citizens in their jurisdictions; many states have found that building, deploying, and operating their own tax software systems wasn't the optimal use of scarce budget dollars and drew little public acceptance or participation; as a result, many states have turned to the Free File Alliance solution instead; however, the absence of the states from the federal program has created a complex and awkward substitute strategy, and reduced company participation in the state programs; to correct this deficiency, the renegotiation of the federal Free File Agreement this year should include dialogue with states aimed at finding ways to facilitate state participation in coordinated free file programs, and likewise encourage industry participation in the state programs.

If an updated national e-filing strategy is approached with a new sense of commitment and innovation, substantial additional growth in e-filing is still possible and could be achieved in a foreseeable timeframe, just as the first 50% milestone was reached in a relatively short period of time. The only question is how serious we are about driving e-filing even further as the preferred method of Voluntary Compliance in this country. Substantially greater growth is achievable if there is a genuine commitment to making it happen.

Tax Services to Assist those in Need

The Free File Alliance program began as an innovative solution to the public interest objective of providing ready access to electronic tax preparation and e-filing for lower income individuals and families, the working poor, disadvantaged, underprivileged, and underserved taxpayer populations at no cost to either the taxpayer or the public treasury. A voluntary public-private partnership between the IRS and the software industry, the current Free File Alliance program had the objective of making free electronic tax preparation and filing available to 60% of American taxpayers. The ability to assist the needy and underserved would be made possible by commercial sales of online tax preparation and e-filing to the rest of the taxpaying public. And at typical costs of $20 per tax return, web-based tax software and e-filing had already driven the costs of tax compliance down to very low levels, within the reach of almost everyone.

The commitment of the private sector to donate electronic returns and filing to those in need enabled government to completely avoid the potential cost of trying to build and provide its own tax software products, which countries like the United Kingdom have discovered to be a failed and expensive strategy. After spending hundreds of millions of Pounds Sterling building, deploying, operating and advertising the Inland Revenue's *Self-Assessment OnLine* tax software service, UK taxpayer adoption has not exceeded 3%, and the Chancellor of the Exchequer has reported to the House of Commons that the cost of the system still exceeded $ 50 per return after several years of operation. This government-centric solution stands in sharp contrast to the U.S. estimated cost of.75 cents a return for our government receiving and processing a privately prepared and electronically filed return in this country, employing our citizen-centric system to get the job done efficiently and inexpensively.

The adoption of the private-sector-provided Free File solution in the United States allowed the IRS to instead focus its investment on critical infrastructure modernization, enabling those unique and specialized operations and services that only government can provide. As then-IRS Commissioner Charles Rossotti said in Congressional testimony:

> *"I don't think there is any gray area about what the IRS role is in terms of providing services, because I don't believe we should provide tax preparation services or tax software."*

Agreement was reached between industry and government in July 2002, through the auspices of the Electronic Tax Federal Advisory Committee (ETAAC): the industry would provide free access to consumer electronic tax services to segments of the population underserved and under-represented among electronic tax filers, and those with the greatest financial need. As a part of the agreement, the government would not seek to duplicate private sector investments or services. The agreement was published in the Federal Register in August 2002, and received more than 700 public comments, which ran 6-to-1 in favor of the innovative proposal.

In the three years since the Free File Alliance project was launched, millions of taxpayers have received free electronic tax returns and free electronic filing. The IRS has reported that the Free File Alliance program has significantly contributed to the growth in e-filing over that time period. Unfortunately, something else has happened. The current Free File Alliance program has drifted very far from its original public service purpose and objective.

Rather than being dedicated to assisting the working poor, disadvantaged, and underserved, the Free File Alliance has now become a "universal-free" program, operating off a national marketing and sales platform hosted by the IRS, where participating companies depend on the sales of other products and services to the free return recipients in order to make it possible to provide the federal returns for free, such as sales of a basic staple like state tax returns. This kind of economic interdependency was never supposed to be the business model for *free file*. The original idea, of great merit, was for industry to have the ability to donate services to those in need as a result of their ongoing competitive commercial sales to the vast bulk of customers in the regular marketplace, where companies would normally be selling their services in substantial quantities to the general public. That original *free file* business model, enabling public service donation to the truly needy through a philanthropic model, was in the public interest and must be restored.

After several years of this new universal-free trend developing unfettered within Free File Alliance program, others, including Intuit, have individually found it necessary to join the fray in competitive response. However, we and others have expressed a range of concerns about the interests of low income consumers in this kind of free-for-all environment, and concerns as well about the government serving as either the market-maker for commercial business in this country, or permitting public assets and endorsement to be used for commercial marketing and sales purposes. Finally, the absence of the states from a place at the table for discussion with the Federal Government and industry in the Free File Alliance program limits the potential public benefits from the program since state tax filers, including low income participants, are being charged for tax preparation under the current model.

The original public service concept of a free file initiative had great merit. It was an unprecedented public service initiative to help those least able to enjoy the benefits of modern electronic commerce in this country. We believe a private-sector-provided *free file* program can still have great merit, but any public-private partnership must focus on helping the underserved and underprivileged, with appropriate and sensible rules, governance and accountability, in which the IRS must play a key, active, and engaged program management role in cooperation with the private sector.

Indeed, recent budgetary decisions by government underscore the need for an improved and refocused *free file* program to be successful and stable for years to come. The inordinate costs of government providing TeleFile have long been a practical concern, and more recent decisions to cut back significantly on traditional bricks-and-mortar IRS Walk-In assistance centers, underscores the crucial role a well-focused *free file* program can play in providing assistance to the working poor, to those in need, to the disadvantaged, to the elderly on fixed incomes, and to various other underserved taxpayer populations. This dedicated purpose of voluntary public service to assist those in need must be restored as *the* purpose and mission of *free file*, and should be accomplished well before the beginning of the next tax season.

The current Free File program agreement between IRS and industry is up for renegotiation this year, and that milestone represents the opportunity to establish an improved program for the purpose of providing a philanthropic tax preparation and e-filing service program for those in our society who need it most, harnessing the investments, innovations and capabilities of the private sector to achieve important public service objectives. A midcourse correction in this program is urgently needed, indeed overdue, to restore this founding and defining purpose. We pledge ourselves to actively support that important objective, and strongly urge Congress and the IRS to do the same, restoring this valuable initiative to its original purpose and promise, so it can serve the public interest for years to come.

Looking Ahead

The Congressional policy decision to move the United States toward an electronic-filing tax culture was not only the right direction, but as we look ahead should be thought of in much broader terms about the whole process of taxation in the American economy:

- As states increasingly adopt Simplified Sales Tax legislation, the path forward is clearly to enable electronic filing of sales tax reports by small businesses across the country to the respective jurisdictions, eventually enabling all forms of sales to be compliant, whether businesses are of the traditional "bricks and

mortar" variety or are conducted over the Internet. Software will even further simplify the complexity of different sales tax rates across jurisdictions, making compliance practical and easy. Such basic technologies can likewise make it possible for thousands of web-based small businesses to track and report income from their internet transactions.

If part of future federal taxation were to eventually include either some form of a Value-Added or Sales Tax, the process of compliance could be greatly simplified through software and electronic filing that would be available through the competitive commercial marketplace. Indeed, all of these tools are well-within industry's capability to provide to American taxpayers. Whatever the future tax compliance needs of consumers and small businesses may be, the software industry can make them simple, fast, and inexpensive.

At the same time, the ability of industry to invent and bring to market easy software tools for tax compliance should never be an excuse for building excessive complexity into the U.S. tax code. Tax simplification benefits everyone and is the right policy direction.

- There is also a huge opportunity to expand small business e-filing beyond income tax and into the employment and sales tax areas. Our data show that while some small businesses are e-paying federal taxes (about 40%) significantly fewer are e-filing federal forms, only 15%. More importantly, these small businesses would also strongly prefer to integrate their e-filing with their accounting software. This e-filing integration with accounting software has benefits both to small business and the government. The small business will benefit from accuracy, ease of use, and time-savings. The government will benefit from increased e-filing participation, lower costs, and increased accuracy.

There are a couple of key barriers to small businesses adopting e-filing.

- First, there is no integrated methodology to e-file from within accounting software.
- Second, the government agency enrollment mechanisms are complex, lengthy, and paper-based. For companies such as Intuit, that are working to offer payroll e-filing, the barriers are similar—no automated enrollment mechanisms, no industry standards, complexity of dealing with 50 different states and the federal government, and the lack of a joint Federal/State gateway for employment taxes. Manual processes are too costly and lead to higher prices for small business and, therefore, less usage.

We recommend several steps to increase small business employment tax e-filing and payment, including the development of the following:

1. A joint Federal/State gateway for employment taxes and forms.
2. Completely automated enrollment for federal and state employment taxes e-filing.
3. Completely automated filings. (For example, the SSA requires W–2s to be manually uploaded to a web site by payroll operators, and there is no automated server-to-server (computer-to-computer) connection.)

E-Filing can be a **win-win** for small business and government, helping everybody save time and money. Industry can enable efficient and accurate e-filing for almost a million small businesses. Taking steps such as the joint Federal/State gateway, and completely automating enrollment and filings, will help us all realize this vision faster.

Summary Thoughts

The fact is that the technology industry that invented income tax software can also greatly simplify and facilitate whatever tax system needs we may have in the future, for both consumers and small business, where the vast bulk of compliance burdens would otherwise lie. Having said this, it is also clear from our experience with millions of taxpayer customers that there is extensive complexity in the tax system that would plainly benefit from simplification and clarification in the best interest of the nation, our citizens, and the government itself.

Some of the most common difficulty today comes from the use of what may seem to be basic concepts in the current tax code, but which actually represent great confusion for taxpayers, such as "Adjusted Gross Income," a term which many find inexplicable. Similarly, the multiplicity of current retirement and other specialized savings vehicles are likely underutilized today due to practical confusion and uncertainty as to the tax status, treatment, rules and differences of the various alternatives. Likewise, the multiplicity of current tax credits leaves many taxpayers mystified, uncertain which may really apply to them or what the rules may be, which may result in under-claiming of credits for which the taxpayer may be eligible. We

in the tax software and electronic financial services industry significantly help taxpayers sift through the complexity of the current tax code, and minimize their tax liability to only that which they truly owe, but confusion and uncertainty remains.

Other examples include the Earned Income Tax Credit, and non-cash charitable deductions, which are each becoming more difficult for eligible citizens to claim as these shift to more paper intensive processes. These are areas of the code that would benefit a great deal from fresh thinking that would bring them into fuller conformity with the nation's statutory policy preference for electronic tax administration—that is, to fully apply electronic filing to the process of claiming these credits and deductions, rather continuing a growing presumption that they must be claimed via paper, which can substantially raise costs and difficulty for citizens. The bottom line is that real movement toward statutory and regulatory reduction of complexity is in everyone's interest, but broader eligibility for all elements of the code to be available for electronic filing can be an important part of that practical simplification for everyone.

Notwithstanding these opportunities for improvement, easy-to-use software and e-filing has already enabled millions of individuals, families, and small businesses to deal with taxes with a much greater degree of simplicity, at much lower cost, as a central part of taking personal control of their finances. And looking ahead, the next generation of highly computer-literate young men and women entering the workforce will be the first generation in history to *never* file a paper tax return. In fact, the tech-savvy generation is already using the fast and inexpensive electronic tools of web-based tax preparation and e-filing to meet their obligation, viewing this as an integrated part of how they manage and control their personal finances. They are the future of tax compliance in this country, and the leading edge of a generational change that will help the nation not only meet but exceed the original 80% e-filing objective.

It has always been said that voting and paying your fair share of taxes are two of the most basic obligations of citizenship. These really are two of the essential ways we directly participate in our democracy, the ways by which we touch our government and hold it accountable—even to understand the costs of our government.

Just this week, in remarks delivered before a tax policy conference at Urban Institute, the IRS Taxpayer Advocate Nina Olson said how important it is to retain the role of an active, engaged citizenry in the process of annual tax compliance in the culture of the United States. Some others have tried to suggest that the ultimate answer for the United States tax structure is to put the government in charge, from cradle to grave, not only collecting taxes, enforcing compliance, auditing returns, and writing and administering tax regulations, but also acting as the citizen's tax preparer at the outset of the process, effectively removing the taxpayer from the equation altogether through a Return-Free Tax System.

Some have estimated a revenue boon, as is being experimented by the California Franchise Tax Board in that state right now, pursuing a strategy that assumes putting government in charge of both ends of the tax process—automatic return preparation at the front end, and revenue collection and enforcement at the back end—will produce significantly higher revenue receipts from taxpayers overall. Some have suggested that the tax collector might have little motivation to point out all the deductions, exemptions and credits a citizen might be entitled to, resulting in an unfair individual tax burden. But the removal of the citizen from the process would have other downsides beyond the obvious risk of paying higher taxes. As Nina Olson observed:

> *"I don't think the IRS and the government really give credence to that ritual act. For many, many individuals it's the only time they sit down and look at what happened to them financially over the last year, and I wouldn't want to lose that in a Return-Free System, because for the broader financial health of the country, that's an important ritual."*

At this same tax policy conference this week, Eric Toder of the Urban Institute echoed the Taxpayer Advocate's advice and conclusions:

> *"There's something healthy about that. I don't think it should be complicated, but I think there's something positive about the citizenship (seeing what they pay annually)."*

We agree. Managing your taxes is an integral element of managing your personal finances, part of both financial literacy and achieving financial self-reliance. Indeed, in whatever tax policies are adopted over the years in this country, it will be vitally important to retain the *citizen-centric* character of American Voluntary Compliance that is so unique to our national history and culture, preserving the personal participation of our people in these most basic processes and obligations of individual

citizenship. It helps keep our government accountable and on its toes, and our citizens in charge.

Chairman RAMSTAD. Thank you, Mr. Smith. I am going to adhere to the 5-minute rule myself, so I would like to ask each of you experts—truly we have five of the best and brightest tax experts in this town—in a minute or less, because I only have 5 minutes, if you could identify the single most important reform Congress should enact to simplify the Tax Code. I will start with you, Mr. Gideon.

Mr. GIDEON. I think it is easy and short. Get rid of the AMT.

Chairman RAMSTAD. Mr. Purcell?

Mr. PURCELL. Well, I would certainly echo that, but also there is a significant series of overlapping definitional terms. Last year, Congress addressed the one definition of a child, which makes life easier, will make life easier. We have identified those types of things over the years. So, that would certainly help implement simplification across the board.

Chairman RAMSTAD. Thank you, Mr. Purcell. Mr. Degen?

Mr. DEGEN. I will go back to what I said about the plain language. If I was writing the Tax Code—I will give you an example because researchers recently, based on a post on a tax web board—these are catch-up provisions, so people that are 50 or older, if they want to contribute an extra $3,000. If I was writing the Code, I would have said, "If you are 50 or older and you participate in a 401(k) or 403(b), a SARSEP or a simple IRA, or a 457 plan, you can put an extra $3,000 in your plan." Does the Code say that? No. You start in section 414(d) where catch-ups are defined. That sends you to 414(u). section 414(u) now sends you to 402(d)(3). section 402(d)(3) sends you—you have to look at 402(h), and then that sends you back somewhere in 408. I may have some of those numbers wrong, but you gather the drift of my conversation. So, I think we could really serve the public and get rid of some of that deadwood which was mentioned before.

Chairman RAMSTAD. Your point, Mr. Degen, is very well taken and very well illustrated by you. Mr. Stevenson?

Mr. STEVENSON. You expect me to follow that?

[Laughter.]

Chairman RAMSTAD. I think he has lectured on that before.

Mr. STEVENSON. Standard deductions for Schedule C, 1120 S's, partnership returns, keep standard deductions at a level that is acceptable, and if the taxpayer wants to go above it, then they have got to take the chance of being audited. By the way, I have ten revenue-raiser concepts that I have copyrighted that I have provided to your staff in case you are interested, but we have to do a deal to release the copyright.

Chairman RAMSTAD. Thank you.

Mr. STEVENSON. Only kidding.

Chairman RAMSTAD. Thank you. Mr. Smith, please.

Mr. SMITH. Mr. Chairman, we would focus the energy and the efforts on simplifying tax credits and retirement and education savings vehicles.

Chairman RAMSTAD. I want to take the remaining time. Mr. Degen, I believe, talked about the need—I don't think that is an overstatement—for the registration, limited registration of paid preparers. In my home State of Minnesota, I have heard some real horror stories of unscrupulous preparers preying on recent immigrants, particularly from Somalia. We have the second-largest Somalian population now in the country, and some of these people have been treated just outright fraudulently. Do you believe, like your barber and like your wife's manicurist, that simple registration with a number of continuing education courses—what do you foresee there?

Mr. DEGEN. I think, Mr. Chairman, the thing we want to do is keep it as simple as possible without creating a new system. As I mentioned in my testimony, there is a system in place now. It may have to be modified to some degree, but absolutely we would anticipate and hope that when this program began—we call it enrollment of tax preparers—that we would definitely want to have continuing education requirements. It is absolutely essential. Also, what is very, very important is there has to be an enforcement action. Currently right now in Circular 230, the Office of Professional Responsibility can censure, sanction, suspend, or disbar—that is the wrong word. I should not use that word, but get rid of either an attorney, a CPA, or an enrolled agent if they perform unethical practices. You could go home right now and start doing tax returns, and if you screw them up, the IRS could not do anything about—unless you were fraudulent, but that is what we want to stop.

Chairman RAMSTAD. I think it is alarming. According to our figures, there are approximately 1.2 million tax preparers that have no formal training and are not required to adhere to any professional standards. Thank you again, gentlemen. I appreciate your testimony. I now recognize the distinguished Ranking Member.

Mr. LEWIS. Thank you very much, Mr. Chairman. Thank you, gentlemen, for being here today. Mr. Gideon, do you think the IRS is funded and staffed so they can appropriately deal with tax shelter abuse, tax evasion by large corporations, and welfare taxpayers? Do you think there is more lost revenue in this area or by those claiming EITC?

Mr. GIDEON. I wouldn't be capable of speculating on where more lost revenue would occur between those two. I would simply say that from prior experience at the IRS, it is important that there be a balanced program. In other words, the IRS, in order to do its job, has to have the resources to perform adequate enforcement tasks across all areas. If it is missing—in other words, if it is not enforcing the law in any sector of the economy, we are going to have a problem because people will figure that out pretty quickly. So, I think the important problem for appropriators is achieving balance, and it is important to stay balanced across all areas.

Mr. LEWIS. Thank you. Mr. Purcell, I think in your testimony you answered this question, but I would like for you to just state it again maybe for the record. Does your organization think the IRS should cut taxpayer service in the coming year as proposed by the President's budget?

Mr. PURCELL. When we prepared our comments, we had not seen the suggestion that the TACs be abolished or be cut back, and

so we did not address that specifically. We are concerned that the taxpayer service must also be provided as well as enforcement efforts. So, I think we would be in favor of maintaining service as much as possible, given the payback that you have from service, and recognizing that low-income people generally are the ones who would benefit most from that personal touch of service. They need that type of service, so, yes, I think we would be in favor of that.

Mr. LEWIS. Thank you, Mr. Purcell. Mr. Smith, why does your company refuse to offer an RAL to low-income customers?

Mr. SMITH. Mr. Lewis, we are very familiar with RALs, but we don't offer them because our customers aren't interested in them. In fact, several years ago, we moved away from RALs. We do feel, however, that there is a challenge in the United States, particularly for low-income families, and it is unbanked, and we think there are creative alternatives to help individuals who don't have banking relationships today get access to tools. In fact, in the last week there has been a lot of press around a program that we are actually working with several people in the industry to try to provide a reverse Automated Teller Machine (ATM) card that basically allowed a lower-income family to be able to take their refund, put it directly on this ATM card, and pay their bills, do their grocery shopping, or other things. We think there are many other avenues beyond RALs today that we are interested in pursuing.

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

Chairman RAMSTAD. The gentleman from North Dakota.

Mr. POMEROY. I thank the Chairman. Very interesting panel, and each of you did a superb job, and I appreciate it. Mr. Gideon, you are a tax lawyer?

Mr. GIDEON. Yes, sir.

Mr. POMEROY. Are you familiar with this Free File relationship?

Mr. GIDEON. Actually, I have not been as familiar with it as others clearly are here, but I learned about it when I testified before the Oversight Board, and I filed my daughter's tax return with it about 2 days ago.

[Laughter.]

Mr. POMEROY. That is sufficient background. What I want to ask is if in your view the Committee's inquiry into aggregate data on products sold by a Free File participant would be violative of taxpayer confidentiality information.

Mr. GIDEON. Well, I think that the Committee ought to be able to get aggregate data. I think there is always a concern about data that would be identifying that would invade anyone's privacy needs.

Mr. POMEROY. Absolutely.

Mr. GIDEON. On the other hand, the Committee gets aggregate data from the IRS. It gets aggregate data from many other sources. While care would have to be exercised, it seems to me, it certainly would be reasonable for you to get aggregate data from those who participate in this program.

Mr. POMEROY. Is Michael Cavanaugh in the room? I have a letter that I want to introduce for the record of the Committee's inquiry to Mr. Cavanaugh, the manager for the Free File Alliance,

and his response, wherein they totally stiff the Committee in getting information, hiding behind taxpayer confidentiality.

[The information follows:]

Committee on Ways and Means
Subcommittee on Oversight
Washington, DC 20515
March 4, 2003

Mr. Michael F. Cavanagh
Free File Alliance
600 Cameron Street,
Suite 309
Alexandria, VA 22314

Dear Mr. Cavanagh:

Thank you for testifying at the recent Ways and Means Oversight Subcommittee hearing on the Free File Program. I commend you and your Alliance Members for providing taxpayers, nationwide, with a great public service. As I stated at the hearing, it is exciting to see this kind of public-private partnership in action for the 2003 tax return filing season.

I am writing to follow-up on our discussion at the hearing. Thank you for agreeing to survey your association Members on use of the Free File Program and add-on products/services purchased by taxpayers seeking free tax return filing through www.irs.gov. Based on testimony at the hearing, I believe that the following information would be useful:

- the number of filers (out of 78 million eligible);
- the number of filers by various income levels
- the number of filers claiming the EITC;
- the total number and amount of product sales/services sold (including specific information on (1) the number/amount of tax refund anticipation loans sold, amounts charged for such loans and related services, and the number of "direct deposit indicators" provided by the IRS, (2) the number and amount of state returns sold, and (3) the number and amount of other product sales/services sold by type; and,
- the number of taxpayers entering the website for free filing services that did not qualify for free services (and the percentage that purchased Federal return services).

I would like this information to cover the current tax return filing season (January-April 15th) and I request an informal report from you by the end of May 2003. (I have made a similar request of IRS Acting Commissioner Wenzel and suggested that the IRS' work incorporate some of your survey results.)

I appreciate your commitment to the success of the Free File Program. Your survey will be most helpful to me in understanding taxpayers' experiences in using the new Free File Program this year and how it might be expanded and/or improved for the future.

Thank you again for your assistance. If you have any questions, please contact Beth Vance of the Committee staff at (202) 225–4021 or A.J. Wojciak of my Washington Office staff at (202) 225–2611.

Sincerely,

Earl Pomeroy
Ranking Member

Free File Alliance
Alexandria, Virginia 22314
June 5, 2003

Hon. Earl Pomeroy
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Pomeroy:

On March 4, 2003, you requested certain information regarding the Free File Program. This letter is a preliminary response, based on the conclusion of the first season of the Free File Program.

In response to your final question, approximately 2.7 million taxpayers utilized the free tax preparation and e-filing services from the 17 Member companies. We are very proud that the number of returns provided substantially exceeded the IRS' well considered pre-season estimates. It is a base for continued success. We believe the value of the service to taxpayers saved them tens of millions of dollars, and that the IRS avoided costs of hundreds of millions of dollars.

As to your remaining questions, we have spent a significant amount of time considering how to meet your request, and have met several times with the IRS to review the issue, because IRS privacy restrictions are such a significant barrier to reporting the information you seek. Modem data base technology can normally enable the collection of certain types of customer data, provided it is done in a manner consistent with law, regulation, a company's own published privacy policies, and the data collection capabilities of individual company systems. However, that is not true of companies that provide tax preparation or e-file services. The legal and policy restrictions protecting the privacy of taxpayers impose strict limitations on service providers which substantially exceed those imposed even for similar types of financial services data under appropriately restrictive laws such as Title V of Gramm-Leach-Bliley. Much of the taxpayer information you have sought [1] in your request is protected from collection or disclosure by longstanding law and associated IRS regulations. Therefore, our Member companies cannot lawfully examine, compile or report the taxpayer information you are seeking without the lawful consent of the subject taxpayers. Under IRS Regulation 7216, taxpayer "consent" must be obtained before returns or collecting taxpayer private data.

In addition, the 7216-compliant privacy policies published by Alliance Member companies constitute a condition of the terms of service under which the individual customer transactions were conducted. Our FFA companies did not, and as a practical matter could not, seek each of the 2.7 million separate consents that would be necessary to permit the companies to review, collect and report the taxpayer information you seek. Even if the establishment of such individual consents to disclosure of taxpayer information were feasible, it is unclear how many of the 2.7 million individuals would respond to the disclosure request, or grant permission. Given the practical limitations to such an undertaking, our Members have no previous experience which would be predictive of the likely taxpayer response. It would, of course, be additionally unlawful for the Alliance management staff to have collected such taxpayer information from each of the companies, since the Alliance staff is not in privity with the customer taxpayers to seek their lawful consent.

IRS may be able to provide you some aspects of the taxpayer information you wish to review, from its unique legal position as the revenue agency of the United States and the holder of much individual taxpayer information, but even here we are not sure that legal privacy requirements may not also restrict the disclosure of taxpayer information by the IRS itself.. The legal interpretation of applicable Federal rules, policies and procedures as they pertain to disclosure of private taxpayer information is a subject best pursued directly with the IRS General Counsel.

We look forward to working with your office and Committee to make the Free File Alliance a continued success. Your support of the Free File option is important to us. We remain available to be of ongoing assistance as you conduct your Oversight of this important public service initiative.

Sincerely,

Michael F. Cavanaugh

Mr. POMEROY. I will send another letter to Mr. Cavanaugh, or the Free File Alliance, in the event Mr. Cavanaugh is no longer with this association, asking once again for aggregate data so that we might observe the marketing practices of these Free File partners.

---

[1] The number of filers by various income levels; the number of file's claiming the EITC; the total number and amount of product sales/services sold (including specific information on (1) the number/amount of tax refund anticipation loans sold, amounts charged for such loans and related services. and the number of "direct deposit indicators" provided by the IRS, (2) the number and amount of state returns sold, and (3) the number and amount of other product sales/services sold by type; and the number of taxpayers entering the website for free filing services whose personally identifiable taxpayer profile did not qualify for free services (and the percentage that purchased Federal return services).

Mr. Smith, I commend Intuit for your testimony, which I think is very candid and direct. It is not often to have a self-critique moved forward by a private sector participant in a program, and I frankly take some of your testimony to be a self-critique, not of Intuit, but of the industry, in terms of the drift of the original incentive of providing these services to taxpayers, to now much more of a profit motive, "sell them stuff" type of circumstance. Would you describe basically what you mean in this portion of your testimony that is found—you do not have page numbers, but that portion of your testimony that alludes to that?

Mr. SMITH. Yes, Mr. Pomeroy, I would be happy to. When this program was originally launched—actually, prior to the program, when we launched the Intuit Tax Freedom Project, we had very specific qualifications to have the program focused on underprivileged, underserved, lower-income, active military, and other select citizens in the country. Unfortunately, what has happened, as a result of the last 3 years in this public-private partnership, is that you have new companies coming into the Free File Alliance and actually seeing it as an IRS-hosted platform to enter into the business and then be able to get product into the hands of a consumer with a free lead offer and then sell additional products. This is completely contrary to the spirit of the program. It is contrary to the program we have had in existence since 1998. We resisted this and have worked with the alliance and the IRS in the off seasons for the last 3 years. Unfortunately, this year we found ourselves in a situation, competitively, where we had no alternative but to enter into the game.

Mr. POMEROY. Do you believe the IRS has actively exercised oversight for the entrepreneurial practices of its partners relative to U.S. taxpayers?

Mr. SMITH. Mr. Pomeroy, I believe that the IRS has an opportunity to take it further. There is only so much private industry can do before it begins to step toward the lines of the Sherman Act and any areas in antitrust. The good news is the IRS, by not only the laws of the country but also by the alliance voting unanimously, has given the IRS the ability to govern this program more tightly. Unfortunately, up to this point, they haven't been willing to do that, and we are confident as we go into this year's renegotiation that that will be addressed.

Mr. POMEROY. Tell me about the renegotiation. Who is that between?

Mr. SMITH. At this point in time, the IRS is meeting with each of the individual alliance Members to better understand their needs. It has historically been between the executive director of the Free File Alliance, who was Mike Cavanaugh, who has resigned at this point, and the IRS. So, at this point each individual company is meeting with the IRS, and we are looking forward to a defined process to get it back on the table.

Mr. POMEROY. Mr. Chairman, I would ask that you consider having a hearing, an oversight hearing, to bring in the IRS and bringing in Free File partners at this critical time of renegotiation. I think we need to get a handle on what is taking place relative to industry practices, and what is in the Service's mind as they sit down with private sector partners. I want them to be looking—I

want them to be seeking information in terms of what are the private sector activities that these companies are doing with taxpayers. Basically they are entering into the relationship on an IRS platform, and I believe there is at least the impression conveyed that there is almost an endorsement of these services. I very much want to hear from the IRS in terms of the safeguards that they exercise relative to consumer protections. We heard the Commissioner say, well, they don't regulate these products. They may not, but they have got—they don't regulate the products as a bank lender. On the other hand, these products come into contact with the taxpayer by virtue of the IRS, so they surely have some oversight responsibilities. I trust that they are doing something, but I want to hear more about what they are doing.

In addition, I want to acquire a better understanding about what is being sold, about whether or not product mix is roughly consistent across the private sector participants. For example, if we have a private sector participant that has got a ton of refund loans relative to its overall business, I would be highly suspicious of the marketing practices of that private sector partner. It alarms me deeply that it does not seem like the IRS has not even inquired as to this aggregate data, because I think some—it would seem to me that that would be basic information the IRS would want, and to be rebuffed by the alliance, as we were in 2003, is, quite frankly, very irritating. I appreciate the forthright testimony Intuit has brought us today, and I really do think, Mr. Chairman and Ranking Member, that this should be a matter of further inquiry.

Mr. LEWIS. On this point that Mr. Pomeroy is raising, maybe Mr. Smith could give us some of the worst, outlandish examples.

Mr. SMITH. I am sorry, Mr. Lewis. Examples of the up-selling that may be occurring?

Mr. LEWIS. Yes.

Mr. SMITH. This year, for example, the growth in the alliance participation has gone from roughly a dozen Members last year to literally over 20. If you go back in time and you look at how long these businesses have been in existence, I think you are going to find them ranging from companies like ourselves, who have been in business for decades, to companies that literally have started in the last year. Unfortunately, when you start——

Mr. LEWIS. Are these sort of fly-by-night?

Mr. SMITH. Well, Mr. Lewis, I would say that——

Mr. LEWIS. You do not want say anything about——

[Laughter.]

Mr. SMITH. Thank you for——

Mr. LEWIS. I understand. I understand.

Mr. SMITH. Right. So, the ultimate concern that we have is that you have companies out there who do not make a living at doing this or have not done this for years and have not learned the proper ways to actually do tax preparation software and e-filing. The other concern we have is that they make their money today—you very seldom find them in the paid market. You only find them in the Free File Alliance where they have a pseudo-endorsement from the IRS, where they are using the IRS' basic platform as a sales and marketing platform, and they are bringing consumers in for

free, and then they are selling additional products. That was not the intent. So, outlandish examples go from RALs——

Mr. POMEROY. Like what? What products?

Mr. SMITH. Like RALs, access to IRAs, access to buying additional products and services that they may sell, refund transfers.

Mr. LEWIS. Are you saying this is a rip-off of taxpayers? You are not saying that?

Mr. SMITH. No, sir, not at all. In fact, I will tell you that the Free File Alliance, its philosophy is right on target. There have been millions and millions of consumers who have been able to leverage this Free File Alliance to get access to consumer tax software. Unfortunately, because of the way the program is today and it is not being governed, it is getting out of control, and it is putting a lot of people at risk, particularly the consumer.

Mr. POMEROY. Mr. Chairman, you have been most indulgent, but I would just make a final observation. If it is incorrect, you can correct me. So, the IRS—is there a due diligence requirement in terms of participating on this platform?

Mr. SMITH. There is. Yes, Mr. Pomeroy, there is.

Mr. POMEROY. There is no due diligence relative to side products offered?

Mr. SMITH. There are operating philosophies in the operating agreement that the adherence of—actually governing those philosophies has been less than diligent.

Mr. POMEROY. Is there an inspection by the IRS of the products prior to their marketing?

Mr. SMITH. There is an inspection of each of the offerings that come into the Free File Alliance. Yes, there is.

Mr. POMEROY. Is that by the alliance or the IRS?

Mr. SMITH. Excuse me 1 second. Thank you, sir. It is with the IRS. There are third parties that will look at some of the products as well, but it is basically just around the offer itself. It is not necessarily around the product and the functionality of the product.

Chairman RAMSTAD. Well, thank you again——

Mr. POMEROY. Finally, there is not a review of the product, and then there is not a review of the aggregate sales numbers?

Mr. SMITH. That is correct, sir.

Mr. POMEROY. Mr. Chairman, what do you think about further inquiry on that?

Chairman RAMSTAD. Hearing what I have just heard, the Chairman will certainly take your suggestion under advisement. I want to thank the five distinguished Members of this panel for your counsel, your testimony, and your patience as well. Is there any other business to come before the Subcommittee?

[No response.]

Chairman RAMSTAD. No further business. The hearing is adjourned.

[Whereupon, at 5:25 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Colleen M. Kelley, National Treasury Employees Union

"2005 Tax Return Filing Season and the IRS Budget for Fiscal Year 2006"

NTEU represents l50,000 federal employees in 30 federal agencies and departments, including the men and women who work at the Internal Revenue Service. I appreciate the opportunity to provide the Subcommittee with comments on the IRS budget for fiscal year 2006.

There are several items in the Administration's IRS budget that NTEU believes would be detrimental to the IRS' mission. The two most egregious items include the Administration's plans to contract out tax collection to private collection agencies starting this summer, and an inadequate budget request that will prevent the IRS from continuing to improve its customer service record while bolstering enforcement efforts.

Budget

The President's FY 2006 IRS budget proposal is woefully inadequate to provide the resources necessary to meet its enforcement goals to reduce the outstanding U.S. tax gap. I commend the Administration for acknowledging in its Budget in Brief that the "IRS yields more than four dollars in direct revenue from its enforcement efforts for every dollar invested in its total budget." But I must criticize the Administration for failing to request a budget that would enable the IRS to meet the enforcement challenges it faces with its $350 billion annual tax gap.

The IRS brought in $5.5 billion more in FY '04 than it did in FY '03 through enforcement efforts. This represents a 15% increase. It makes good business sense to fund the Agency at an amount where it can continue to see a similar return on investment. Unfortunately, the President's budget does not make good business sense.

The IRS needs an appropriation that anticipates required expenses such as congressionally imposed pay raises and rent increases. Part of the President's IRS budget request for enforcement will be used to cover inflationary costs. Of the $446 million proposed for new enforcement investments, $182 million will be needed just to keep enforcement at its current levels.

Furthermore, the way in which the Administration proposes to enhance the enforcement budget will mean cuts to other parts of the IRS budget—such as taxpayer assistance. The President's budget calls for a cut of 1,385 service personnel—87 percent of whom directly assist taxpayers and tax professionals. The IRS has taken great strides to improve taxpayer service over the past few years and has been quite successful in making significant progress. The Service must not let the pendulum swing in the other direction and neglect service so that it can focus on enforcement. Service and enforcement must go hand in hand toward increasing taxpayer compliance and shrinking the tax gap.

NTEU strongly supports the IRS Oversight Board's proposed budget recommendation of $11.6 billion for FY '06—a nine percent increase over the President's budget recommendation and a thirteen percent increase over the FY '05 appropriation. I urge the Subcommittee to also support the Board's recommendation.

Private Tax Collection

NTEU strongly opposes the Administration's plan to privatize IRS debt collection, as authorized by Congress last year in H.R. 4520, American Jobs Creation Act of 2004. Under the statute, the IRS would be permitted to hire private sector debt collectors and pay them a bounty of up to 25 percent of the money they collect. Let me be clear: NTEU opposes this short-sighted proposal, anticipates its complete failure as witnessed in a similar 1996 pilot program and will work towards its repeal.

This proposal would risk the loss of confidentiality of millions of taxpayers' private information, would subject taxpayers to the abusive tactics of private debt collectors, and would cost U.S. citizens much more money than if IRS employees did the job.

One of the most often heard arguments in favor of the use of private collection agencies is that if they are paid out of the proceeds of what they collect, it increases the IRS' enforcement capabilities without having to increase appropriations. Numerous Congressional supporters said they would prefer to have tax collection done by federal employees, but would go along with the use of private collection agencies solely because it avoids the difficult issue of getting Congress to approve additional appropriations for the IRS.

The statute that gives the IRS the authority to use private collection agencies (PCAs) allows 25 percent of collected revenue to be returned to the collection companies as payment and 25 percent to be retained by the IRS for enforcement efforts, thereby circumventing the appropriations process altogether.

There is nothing magical about revenues collected by private collection companies. If those revenues could be dedicated directly to contract payments and IRS enforcement efforts, there is no reason some small portion of other revenues collected couldn't be dedicated to IRS enforcement efforts. This would allow for increased enforcement by IRS employees, which most people indicate is the preferable route and eliminate large payments (up to 25% of collections) to private collection companies, significantly increasing net revenue to the General Treasury. While legislation would be required to allow for this kind of dedication of revenue, I believe the precedent has now been set with the private collection agency funding provisions. Congress should consider supporting this approach as a common sense way to make real progress in closing the tax gap, lowering our deficits and making more funding available for our Nation's critical needs.

According to GAO's May 2003 testimony before the House Treasury Appropriations Subcommittee (GAO–03–732T), one major concern the IRS must address prior to implementing tax collection outsourcing is the ability to identify "delinquent debts with the highest probability of resolution through PCA contacts. Earlier pilot efforts to study the use of PCAs in 1996 and 1997 were hindered, in part, because the IRS was unable to do this—While IRS proposes using the "case selection analytics" to identify appropriate cases, the analytical model has not been developed."

It appears as though the IRS has not yet addressed case selection. According to the IRS' February 15, 2005 "Filing and Payment Compliance Modernization Briefing: The Use of Private Collection Agencies," there are five major issue areas that still need to be addressed before handing work over to the PCAs. One of the issue areas is selecting the workload for PCAs (called Filing and Payment Compliance), which will be part of the Business Systems Modernization Program. Since case selection was a major obstacle for the IRS in its 1996 pilot program, the IRS should ensure that the technology is in place prior to handing over any work to the PCAs.

Furthermore, the IRS does not have the technology in place to ensure that taxpayer information is kept secure and confidential when it is handed over to the PCAs. The IRS expects to hand over taxpayer information, including Social Security number, to the private collection companies.

Recent security breaches at three data brokerage firms here in the U.S. should alarm every Member of Congress and put into question the IRS' plans for moving forward with this privatization plan. ChoicePoint compromised the personal information of 145,000 Americans. At LexisNexis, thieves were able to access 32,000 records including Social Security numbers and drivers licenses. And Bank of America recently reported it has lost personal data—including Social Security numbers and account information—on 1.2 million federal employees, including some members of the Senate. These are companies that are in the business of trading—and securing—personal information. If they aren't able to secure confidential consumer information, I have little faith that a private debt collection company will be able to guarantee U.S. taxpayers that their information will remain secure.

I would urge the Subcommittee to work with your colleagues to repeal this ill-fated proposal. Additionally, I would urge the Subcommittee to require the IRS to perform cost comparisons and closely track the contractors' costs. This is the only way that taxpayers can be certain their tax dollars are being spent wisely.

Customer Service Cuts

The President's budget proposes to cut $134,103,000 and 1,205 positions from customer service, with Taxpayer Assistance Centers (TACs) targeted for drastic reductions. IRS Taxpayer Assistance Centers are taxpayers' source for personal, face-to-face tax help. Taxpayers who have complex issues, need to resolve a tax problem, or are more comfortable talking with someone in person can visit a local Taxpayer Assistance Center. IRS representatives in these offices can help with inquiries or adjustments to tax accounts, payment plans for those who owe tax and cannot pay the full amount, questions about IRS letters and notices, and levies on wages or bank accounts.

These cuts will mean that minorities and low-income taxpayers, who rely on the Centers to help with language barriers, the earned-income tax credit and general tax preparation, will see the tax services they rely on cut. As Janet Spragens, law professor and director of American University College of Law's Federal Tax Clinic, notes in her testimony before the IRS Oversight Board (February 1, 2005):

". . . these taxpayers, many of whom have limited or no proficiency in English, are generally not part of the information age. They are not Internet connected. . . . They tend to be helped better through local walk-in offices and opportunities for face-to-face meetings than with an organizational structure based on specialization of function, remote offices, mailed documents, telephone trees with automated selections and electronic transfers."

Even the IRS Oversight Board raises concerns of the IRS' plan to eliminate additional customer service personnel. In its FY2006 IRS Budget Special Report (March 2005), the Board states its concerns:

"Increasing enforcement resources at the expense of service resources is a trend that can lead to a system that fails to meet the needs of all honest taxpayers."

The IRS claims that taxpayers will continue to have access to tax forms and information through on-line access, telephone assistance and volunteer tax preparation. Unfortunately, many taxpayers who use the walk-in centers have little or no proficiency in English and are not part of the electronic information age. Tax forms on the Internet and phone trees do them little to no good. They rely on face-to-face contact with their local Taxpayer Assistance Centers to help them comply with various complexities of the tax code.

While the agency has not yet provided specific information either to NTEU or to affected employees, it is my understanding that the agency is reviewing options that include closing either 105 TACs, affecting 528 employees, or 67 TACs, affecting 516 employees. Either way, the plan is a significant step backward in the ability of the IRS to do its job effectively.

The IRS has suggested that private tax assistance programs using volunteers can fill the void that will be created by the cutbacks. While volunteer taxpayer assistance organizations play an extremely helpful role in assisting taxpayers to meet their tax obligations, it is foolhardy for the agency to rely on volunteers to do work that should be performed by trained and accountable federal employees. Volunteers claim there's already a shortage of computers and other resources to help every taxpayer who seeks assistance, and that situation will only worsen if the IRS follows through with its proposed cuts to customer service.

Furthermore, as the IRS is cutting back walk-in customer service operations, it is also planning to close six of its call sites in Boston, Houston, Chicago Des Moines, Wichita, and Omaha. Especially hard hit will be the Boston, Houston and Chicago facilities where nearly 200 employees could be affected. These are facilities where the employees receive taxpayers' inquiries and respond to their tax questions.

Congress must commit to funding the IRS at adequate levels so the IRS is not made to choose between bolstering enforcement and providing the superior service our taxpayers expect and deserve. I urge the Subcommittee to again take the budget recommendation of the IRS Oversight Board, prohibit the IRS' proposed cuts in customer service and require the Service to maintain all current Taxpayer Assistance Centers.

Conclusion

On behalf of the dedicated federal employees NTEU represents, I am proud to submit these views for the hearing record. I encourage the Oversight Subcommittee to make a strong investment in the federal workforce by supporting a strong budget for the IRS; repealing the IRS' authority to privatize tax collection; and prohibiting the IRS from closing up to one-quarter of its Taxpayer Assistance Centers.

Without a doubt, the frontline employees are committed to working with management and Congress to increase efficiency and customer satisfaction. NTEU is committed to striking a balance between taxpayer satisfaction, business results and employee satisfaction. I encourage Congress to join us in this commitment.

Statement of Christine C. Bauman, University of Wisconsin-Milwaukee, and Katrina L. Mantzke, Northern Illinois University

AN EDUCATION AND ENFORCEMENT APPROACH TO DEALING WITH UNSCRUPULOUS TAX PREPARERS

ABSTRACT

In both her 2002 and 2003 Annual Reports to Congress, the National Taxpayer Advocate (NTA) proposed national registration, examination, certification, and enforcement requirements for all Federal Tax Return Preparers (FTRP). An FTRP is defined as someone, other than an attorney, CPA, or enrolled agent, who prepares more than five federal tax returns in a calendar year. This proposal was primarily motivated by the NTA's experience in dealing with taxpayers who were exploited by unscrupulous tax preparers, especially with respect to the earned income credit (EIC). Although the IRS believes that all taxpayers should have access to quality tax return preparation, it contends that it is premature to consider a legislative

remedy to tax preparer problems since the full extent of the problem is unknown and the related financial impact on limited IRS resources has not been quantified.

The purpose of this paper is to examine the proposed regulation of FTRPs by reviewing the development of similar regulatory proposals over the past several decades, outlining current and proposed federal regulation of tax preparers, discussing state regulation of tax preparers, describing concerns with increased regulation, and offering alternative recommendations to regulation, specifically education and enforcement.

AN EDUCATION AND ENFORCEMENT APPROACH TO DEALING WITH UNSCRUPULOUS TAX PREPARERS

In its 90 years of existence, the U.S. income tax has evolved into a complex taxation scheme. As a result, taxpayers bear not only the burden of their taxes but also the burden of complying with a complex and often confusing taxation system. Not surprisingly, IRS Statistics of Income Data[1] show over 60% of all individual 2001 income tax returns were prepared by federal tax return preparers (FTRP). A tax preparer is defined under Internal Revenue Code (IRC) Section 7701(a)(36) as any person who prepares any U.S. income tax return or any claim for refund of U.S. income tax for compensation. This definition also includes any person who employs one or more persons to prepare such tax returns.

A recent U.S. Government Accounting Office (GAO) survey found that 77% of taxpayers that used paid preparers were generally confident that they did not pay more than their share of taxes. However, anecdotal evidence indicates that some taxpayers are poorly served by their FTRPs.[2] Unfortunately, little data exists on the overall quality of the services provided by FTRPs to the population of taxpayers using their services. Nevertheless, the quality of these services can be inferred. The GAO estimates that over 2 million taxpayers overpaid their 1998 taxes by $945 million because they used the standard deduction instead of itemizing. Since half of all tax returns are prepared by FTRPs, the GAO concluded that these data raise questions regarding the quality of service provided by FTRPs.[3] Similar arguments can be made with respect to tax credits available to taxpayers. The Treasury Inspector General for Tax Administration (TIGTA) estimated that 230,000 taxpayers who used FTRPs for their 2001 tax returns appeared to be eligible to claim the additional child tax credit but did not.[4] Similarly, the IRS estimated that a subset of 1999 tax returns claimed $11 billion more in EIC than was permissible, while another subset of 1999 tax returns claimed $710 million less EIC than was permissible.[5] Since more than 65 percent of tax returns claiming EIC for 1999 were filed by FTRPs, it is likely that some of these EIC errors relate to services provided by FTRPs.

While most tax preparers are reputable, there is a concern that some FTRPs prey on taxpayers. According to a May 2002 Brookings Institute and Progressive Policy Institute Report[6], the vast majority of paid tax preparation services for individuals are provided by a disparate array of unaffiliated professionals including certified public accountants, attorneys, and enrolled agents, as well as fly-by-night amateurs. Since there are no national educational or professional standards for tax preparers, the tax preparation industry is fragmented, unregulated, and primarily seasonal. This observation is corroborated by Treasury Regulation Section 301.7701–15(a)(3) which states that "a person may be an income tax return preparer without regard to educational qualifications and professional status requirements." Similarly, many preparers are ill-equipped to deal with the ever-increasing complexity of tax laws.

---

[1] Internal Revenue Service. *Statistics of Income Data*, 2002.

[2] U.S. Government Accounting Office. *Paid tax preparers: most taxpayers believe they benefit, but some are poorly served*. GAO–03–610T, April 1, 2003. The GAO is quick to note that its survey only measures taxpayer perceptions. Since many taxpayers use paid preparers because they do not understand the tax laws, they are ill-equipped to truly evaluate their paid preparers' work. As such, the results of the GAO survey may overstate the actual quality of the services being provided.

[3] U.S. Government Accounting Office. *Tax deductions: further estimates of taxpayers who may have overpaid federal taxes by not itemizing*, GAO–02–509, March 29, 2002.

[4] Treasury Inspector General for Tax Administration. *Analysis of statistical information for returns with potentially unclaimed additional child tax credit*. Washington, D.C., January 2003, Ref. Number: 2003–40–046.

[5] Internal Revenue Service, Department of the Treasury. 2002. *Compliance estimates for earned income tax credit claimed on 1999 returns.* Washington, D.C.: February 28, 2002.

[6] Berube, A., A. Kim, B. Forman, and M. Burns. May 2002. *The price of paying taxes: How tax preparation and refund loan fees erode the benefits of the EITC*. Center for Urban & Metropolitan Policy, The Brookings Institute and the Progressive Policy Institute.

As a result, the issue of improved regulation of tax preparers has been hotly debated over the past three decades.

In both her 2002 and 2003 Annual Reports to Congress, the NTA recommends that Congress enact a registration, examination, certification, and enforcement program for FTRPs. An FTRP is defined in the proposal as someone, other than an attorney, CPA, or enrolled agent, who prepares more than five federal tax returns in a calendar year and satisfies registration, examination, and certification requirements. The NTA has convened a cross-functional team to explore the feasibility of requiring annual certification and professional education for all commercial preparers *not* currently covered by Treasury Department Circular 230 (31 C.F.R. Part 10).[7]

The proposed regulation of FTRPs is not a novel suggestion. Such regulation has been considered numerous times during the last 30 years without subsequent changes to the status quo. The purpose of this paper is to examine the currently proposed FTRP regulation by reviewing the history of former proposals, outlining current and proposed federal regulation of tax preparers, discussing state regulation of tax preparers, describing concerns with increased regulation, and offering alternative recommendations.

HISTORY OF PROPOSED TAX PREPARER REGULATION

As early as 1972, the National Society of Accountants (NSA)[8] called for increased regulation of tax preparers.[9] The NSA presented the IRS with an eight-point plan focused primarily on the mandatory registration of every individual providing tax preparation services for a fee. The NSA argued that incompetent and irresponsible tax preparers would be easier to identify once they were registered. Once identified, the NSA argued that these preparers would then be held accountable for their work, thereby protecting American taxpayers. The NSA plan did not require any competence qualifications for initial registration. However, registration renewal would require preparers to participate in IRS prescribed continuing education, reported in three-year intervals. The plan called for penalties for those preparers who did not comply. Preparing tax returns without a registration or with an invalid registration would be a misdemeanor subject to fine and/or imprisonment upon conviction. Similarly, the IRS would have the power to revoke or suspend registrations for appropriate cause.

There is no evidence that the IRS did anything with the NSA plan proposed in the 1970s. Yet, the issue of regulating tax preparers did not die. In 1989, the Commissioner's Advisory Group (CAG) within the IRS studied the issue.[10] The CAG's report outlined the concerns many had about tax preparers and summarized the penalties to which these individuals were subject. The report weighed the pros and cons of a regulatory/registration program and concluded that such a program should be established. Shortly after this recommendation was made, Congress busied itself with changes to the IRC's tax preparer and accuracy related penalties, and the Treasury Department made changes to the regulations governing practice before the IRS. Accordingly, the CAG's recommendations were shelved.

In 1994–1995, the issue resurfaced. Following up on its concept-oriented report from the 1980s, the CAG now made specific recommendations for a formal regulation/registration program.[11] The program called for the registration of all tax preparers as defined by IRC Section 7701(a)(36) that were not already covered by the regulations outlined in Circular 230. While initial registration would not require proof of continuing professional education (CPE), subsequent registration renewal would require proof of CPE. The report was presented to the IRS Commissioner for consideration but did not result in any changes to the tax preparation industry.

Most recently, Senator Bingaman (Democrat, New Mexico) sponsored the "Low Income Taxpayer Protection Act of 2003." Among other things, this bill would have required the registration of tax preparers and refund anticipation loan (RAL) providers, and the prohibition of the payment of refunds to tax preparers and RAL providers that fail to provide their registration numbers. On March 31, 2003, this bill was referred to the Senate Finance Committee. To date, there is no evidence that this bill progressed any further in the legislative process.

---

[7] Circular 230 provisions apply to attorneys, certified public accountants, and enrolled agents.

[8] Prior to 1995, the National Society of Accountants was called the National Society of Public Accountants.

[9] Anonymous. 1972. NSPA's eight-point program for regulating tax return preparers. *The National Public Accountant*, Vol.17, No.5, May, pp. 16–18.

[10] Shapiro, L. 1995. Commercial tax return preparers. *The National Public Accountant*, Vol. 40, Sept., p. 7.

[11] See supra note 10.

EXISTING FEDERAL REGULATION OF TAX PREPARERS

The IRS is empowered to deal with incompetent and irresponsible tax preparers via existing laws. Various code sections assess penalties based on the content of tax returns compiled by paid preparers. IRC Section 6694 imposes penalties on tax preparers for understatements of tax due to unrealistic positions. IRC Section 6701 imposes penalties on tax preparers for aiding and abetting taxpayers in the understatement of tax. Finally, IRC Section 6702 imposes penalties on tax preparers who file frivolous income tax returns on behalf of their clients.

Other code sections assess penalties on tax preparers for their actions in compiling tax returns. IRC Section 6695 assesses a litany of penalties on tax preparers, including penalties for failure to provide the taxpayer with a copy of his/her tax return, failure to sign the tax return, failure to furnish the preparer's identification number, and failure to be diligent in determining eligibility for EIC. IRC Section 6713 imposes penalties on tax preparers for disclosing taxpayer information or using such information for purposes other than tax return preparation. Gutierrez[12] presents a thorough discussion of each of the foregoing provisions and their legislative history.

The Internal Revenue Code also provides for civil and criminal sanctions with respect to the preparation of tax returns. From a civil perspective, IRC Section 7407 permits the Secretary of the Treasury to bring a civil action against a preparer to enjoin him/her from preparing tax returns if he/she has engaged in any conduct subject to the penalties discussed above or the following criminal penalties. IRC Section 7201 assesses criminal penalties on taxpayers and their return preparers who willfully attempt to evade taxes. IRC Sections 7206 and 7207 assess criminal penalties on the making of fraudulent or false statements, the willful aiding, assisting, counseling or advising in the preparation or presentation of fraudulent or false statement, and the delivery or disclosure of a fraudulent or false statement. Finally, IRC Section 7216 assesses criminal penalties on tax preparers who disclose or use taxpayer information for purposes other than the preparation of the tax return.

It is interesting to note that the only substantive change made to the IRC penalties for tax preparers since the CAG's last report in 1995 was the addition of Section 6695(g), due diligence requirements with respect to EIC. This change suggests that problems exist with the administration of the EIC. In addition, there is significant evidence that the extensive penalty provisions for tax preparers are not being enforced.

Failure to Enforce Tax Preparer Penalties

On October 18, 2002, the IRS Advisory Council (IRSAC) presented a "General Report" at a public forum expressing concern with the underutilization of tax preparer penalties given tax preparation error rates.[13] IRSAC members of the IRS Wage and Investment Subgroup were concerned about the relative scarcity of preparer penalties in recent years. For example, in 2001, only 248 paid preparers were assessed the $100 penalty for violating due diligence requirements regarding EIC. Further, a mere 3,000 preparers were assessed a $50 penalty under IRC Section 6695(a)-(f). About 4,000 preparers were assessed the $250 penalty for negligent return preparation. A $1,000 penalty for deliberate or willful return errors was imposed on about 3,000 preparers. The Subgroup expressed similar concern with the low number of criminal sanctions compared to reported error rates on EIC returns.

IRSAC concluded that the low rate of tax preparer sanctions imposed for preparer malfeasance creates the perception in the non-enrolled (not subject to Circular 230) tax community that negligent or willful errors on returns carry a limited risk of penalty sanctions. The IRSAC panel urged the IRS Wage and Investment group to review its current allocation of resources and its strategies for imposing sanctions against non-enrolled, paid preparers.[14]

The IRS's disciplinary authority is the *de facto* source of tax practice standards that all tax practitioners have in common, whether they be CPAs, attorneys, enrolled agents, or unenrolled preparers.[15] Thus, the failure to enforce current regulation of tax preparers raises the concern about how additional regulation will succeed.

---

[12] Gutierrez, T. 2001. Return preparer penalties: A comprehensive review. *The CPA Journal*, Vol. 71, Issue 6, June, pp. 34–43.

[13] Neuder, L. 2002. IRSAC praises Commissioner Rossotti's recent programs. *CCH*, 2002TaxDay, October 23.

[14] See supra note 13.

[15] Raby, B. and W. L. Raby. 2002. Tax practitioner standards and professional self-discipline. *Tax Notes Today*, October 25.

PROPOSED FEDERAL REGULATION OF TAX PREPARERS

The NTA's 2002 Annual Report recommended that Congress enact a registration, examination, certification, and enforcement program for FTRPs. The FTRP program would include the following components:

(1) A requirement that all persons who prepare more than five federal tax returns for a fee must register with the IRS. The IRS would be authorized to impose a per return penalty for failure to register, absent reasonable cause for the failure.

(2) A requirement that the IRS develop a series of examinations designed to test the technical knowledge and competency of unenrolled return preparers to prepare federal tax returns.

(3) A requirement that all persons who prepare more than five federal tax returns for a fee must pass, in their first year of preparing such returns, an initial examination testing their technical knowledge and competency to prepare individual and/or business tax returns.

(4) A requirement that the IRS annually certify as FTRP those unenrolled paid preparers who have successfully passed the required examinations and are authorized to prepare federal tax returns for a fee.

(5) Authorization for the IRS to conduct a public information and consumer education campaign, utilizing paid advertising, to inform the public of the requirements that paid preparers must (1) sign the return prepared for a fee; and (2) display their FTRP registration card, which demonstrates current skill and competency in federal tax return preparation.

(6) Authorization for the IRS to maintain a public list of FTRP who are registered and certified, registered but not certified, and whose registration has been revoked.

(7) Authorization for the IRS to notify any taxpayer about the fact that his or her return was prepared by an unenrolled return preparer who is not registered or by a FTRP who is registered but not certified.

In her 2003 Annual Report to Congress, the NTA makes 15 recommendations with respect to FTRPs. Topping this list is the call for a registration, examination, certification, and enforcement program for FTRPs. This recommendation echoes the primary recommendation made in the NTA's 2002 report. The next 10 recommendations call for new or increased penalties for preparer wrong-doing. Recommendation #12 calls for a study of the accuracy of tax returns prepared in conjunction with the cross-marketing of other consumer products and services. Recommendation #13 requires the appointment of consumer protection advocates to the IRS' Electronic Tax Administration Advisory Committee. Recommendation #14 calls for the FTRP to identify his/her return preparer category (e.g., attorney, CPA, enrolled agent, or unenrolled preparer), and recommendation #15 encompasses taxpayer education regarding their rights and responsibilities in dealing with FTRPs.

STATE REGULATION OF TAX PREPARERS

While the issue of improved regulation of tax preparers has been kicked around at the federal level for years with no real resolution, the states have been similarly reluctant to address the issue. In recent years, licensing laws were proposed but were not enacted in Florida, Illinois and Texas.[16] However, the exceptions to this general rule are California and Oregon.

California

Since July 1997, the California Tax Education Council (CTEC) has regulated tax preparers in the state. Compliance with the California Tax Preparers Act (California Business and Professions Code, Chapter 14, Sections 22250–22259) requires completing a qualifying education tax course, obtaining a surety bond, and obtaining a certificate of completion from the CTEC. Failure to comply with these rules is a misdemeanor, punishable by fine and/or imprisonment.

While California law governs tax preparers practicing in California, a private institution handles the enforcement of this law. The CTEC is an industry association that establishes the standards against which professional tax education is measured and approves educators that meet these standards. The CTEC's other responsibilities include verifying and registering paid preparers who meet California's education and/or experience requirements. To date, the CTEC has not published statistics regarding its enforcement efforts.

Oregon

While California has established education and registration requirements for its tax preparers, Oregon has gone much further with its regulation of tax preparers.

[16] Sager, W. 1995. Why regulation and registration of commercial tax return preparers is a bad idea. *The National Public Accountant*, Vol. 40, December, pp. 34–35.

For the past thirty years, the Oregon State Board of Tax Practitioners (the Board) has required instate tax preparers to be licensed (http://www.open.org/ortaxbrd/). This licensing program requires preparers to demonstrate their competence via examination. Once licensed, tax preparers must comply with continuing education requirements on an annual basis.

Oregon's licensing program was established with the primary goal of protecting taxpayers from incompetent and unethical tax return preparers. While this is still one of the Board's primary goals, issues surrounding identity theft have accounted for many of the Board's investigations in recent years. The Board is continually working to improve the efficiency and effectiveness of the program, including the education of Oregon taxpayers. The Board utilizes a variety of outlets to spread the word about this program, including public service announcements, press releases, and print and television ads. The Board also benefits from industry associations communicating information about the program to their members.

Oregon's Board differs from the California Tax Education Council in that it is a governmental agency, with all board members being appointed by the Governor and approved by the Senate. The Board's other responsibilities include investigating taxpayer complaints and when appropriate, assessing civil penalties, suspending or revoking licenses, and requiring the payment of restitution to harmed consumers. The Board also works with other governmental authorities to bring criminal charges when warranted. To date, the Board has not published statistics regarding its enforcement efforts.

CONCERNS WITH A REGULATORY APPROACH

By all indications, it appears that U.S. tax system is at least somewhat impaired by problems caused by FTRPs. However, evaluating proposals for increased regulation is hampered by the lack of systematic evidence of the extent of the problem and the effectiveness of existing regulation.[17] As such, it is not clear that increased regulation is the answer.

Identification and Quantification of the Problem

It is very difficult, if not impossible, to solve a problem before determining what the problem truly is. In recommending increased regulation for tax preparers, the NTA does not specifically identify the problem with tax preparers nor does she quantify the cost of this problem.[18] The only statistics that are presented relate to returns claiming the EIC. In identifying EIC return preparation as a problem area, the NTA quotes various statistics regarding errors encountered on EIC returns[19], but acknowledges that there is no consistent data regarding the number and types of errors on returns, tracked by type of tax preparer. Consequently, it appears that the broad-reaching proposals to regulate tax preparers are based on anecdotal evidence of emotionally charged taxpayers and tax advisors rather than statistical evidence of error rates and noncompliance. Without knowing the source of the problem and its size, it does not follow that increased regulation is necessarily the correct fix.

Unfortunately, it appears that quantifying the problems associated with unscrupulous tax preparers might be an insurmountable task. The GAO notes repeatedly in its recent studies that "examples of problematic preparer behavior are easy to find but reliable estimates of the number of taxpayers affected by the problems do not exist and would be difficult, perhaps impossible, to develop".[20] Interestingly, the GAO noted that nothing suggested that the percentage of taxpayers affected by unscrupulous tax preparers is large. The GAO also noted that the IRS has several offices responsible for taking action against problem paid preparers including the newly formed Office of Professional Responsibility.[21] Therefore, it would be illogical to create a new regulatory system when a newly formed IRS office has already been charged with this responsibility.

In concluding its report, the GAO did not make any recommendations but stated that expanded regulation of tax preparers is a judgment call that Congress and IRS management must make together, after considering 1) the benefits and costs to taxpayers, 2) that the IRS is not in the consumer protection business, and 3) the related implications for IRS resources.[22]

---

[17] U.S. Government Accounting Office. *Tax administration: most taxpayers believe they benefit from paid tax preparers, but oversight for IRS is a challenge*. GAO–04–70, October, 2003.

[18] National Taxpayer Advocate Report to Congress. 2002. pp. 216–217.

[19] See supra note 18. pp. 69–72.

[20] See supra note 17. p. 25.

[21] In January 2003, the new Office of Professional Responsibility for Tax Practitioners (OPR) replaced the old Director of Practice. OPR has a core staff of approximately 35.

[22] See supra note 17. p. 22.

The Cost of Increased Regulation

Although the cost of increased regulation has not been estimated, there is little doubt that it will be a costly venture. Not surprisingly, the IRS indicated it had insufficient resources to administer a FTRP program as outlined in the proposed legislation and could not support a legislative remedy to the problem. The NTA estimates that there may be up to 600,000 FTRPs that would be covered by the legislative proposal. While specific costs have not yet been projected, the IRS looked at existing procedures that govern practice before the IRS as well as other areas that require high volume processing of information. If the proposed regulation of FTRPs has at least the same if not more processing and monitoring requirements, the IRS hypothesized that increased regulation would require the creation of a new mini submission processing operation with operating systems to process applications, certification, test results, etc.

According to the IRS, significant additional resources would be required.

IRS Concerns with Proposed Regulation

The IRS in its formal response[23] to the NTA on the FTRP proposal outlines concerns similar to those listed previously. The IRS specifically cites five concerns namely that licensing of professionals has been a states' rights issue; public perception, opportunity cost, enforcement, and added taxpayer cost.

ALTERNATIVE RECOMMENDATIONS

Instead of regulation, we posit that increased enforcement of existing preparer sanctions and increased taxpayer education will help to mitigate the problems caused by FTRPs. Then, in the event that increased regulation is seriously considered, steps must be taken to identify and quantify the problem. The state regulatory programs should then be evaluated to determine if those programs are effective and if so, how a similar system could be effectively implemented at the federal level.

Increased Enforcement

Paid returns preparers are currently subject to criminal and civil penalties for a wide range of inappropriate behavior. However, there is a dearth in the enforcement of existing regulations. The lack of tax preparer penalty enforcement cannot be ignored as a contributing factor to problems with tax preparers.

If additional resources were to become available, IRS prefers to increase enforcement of the current return preparer penalty provisions, thus encouraging higher professional standards of practitioners and unenrolled return preparers.[24]

The IRS's Small Business/Self-Employment (SB/SE) division is responsible for assessing and collecting monetary penalties against any paid tax preparer who does not comply with tax laws in return filing. For calendar years 2001 and 2002, SB/SE assessed about $2.4 million in penalties and collected 12 percent of them, including all or some portion of penalties from 44 percent of penalized preparers.[25] While a reprioritization on enforcement and collection may help to curb abuse, SB/SE stated that its priorities are focused on abusive tax schemes and it cannot afford to make relatively low dollar paid preparer cases a priority.

The GAO also noted that the monetary amounts of preparer penalties, although small in comparison to IRS's other compliance efforts, may not reflect the overall importance that penalties play as a deterrent to unscrupulous tax preparers. According to the Internal Revenue Manual, penalty assertion is the key enforcement vehicle for noncompliant preparers. However, the GAO duly noted that the IRS may actually be sending preparers a mixed message about whether poor performance by preparers will be tolerated when penalties are assessed but not collected.

Alternative enforcement methods should also be employed. According to Richard Speier Jr., former acting deputy chief of IRS Criminal Investigation Unit, low-income individuals are swindled by tax preparers who guarantee them greater returns. Speier states that "the best way to address [abusive preparers] is with undercovers." CI has instituted a "return-preparer shopping" task force whereby undercover agents are assigned to get word-of-mouth referrals to these tax preparers during tax filing season.[26]

Over the past two decades, numerous studies have researched the effectiveness of preparer penalties from different perspectives. Jackson and

---

[23] Internal Revenue Service Position Paper. 2003. *Regulation of federal tax return preparers*.
[24] See supra note 23.
[25] See supra note 17. p. 16.
[26] Gary, K. A. 2003. CI division increases productivity, IRS official says. *Tax Notes Today*, October 30.

Jones[27] provide evidence that the magnitude of the penalty may be more important than the risk of detection in developing an effective penalty system. A decade later, Carnes and Englebrecht[28] modeled the penalty sanctions included in the Internal Revenue Code. They found that even low levels of penalty sanctions influence compliance behavior, suggesting that penalties can successfully deter noncompliance. Research has also considered the effect that penalties have on the aggressiveness of tax advice. Cuccia[29] found that increasing sanctions on preparers caused CPAs to invest more effort in finding tax savings for their clients and had little effect on the aggressiveness of their interpretations of ambiguous tax issues. In contrast, Anderson and Cuccia[30] studied experimental markets that incorporated competition and moral hazard and found that increased penalties resulted in a reduction of aggressive advice. While the extant literature has studied different aspects of preparer penalties, a synthesis of the literature suggests that penalty sanctions do have a positive influence on tax preparer behavior. Thus, academic research supports our contention that increased enforcement of existing penalties would better address the problems associated with paid preparers than would increased regulation of that group.

Taxpayer Education is Paramount

While the foregoing discussion focuses on the supply side of the equation (i.e., regulation of FTRPs supplying these services), the demand side (i.e., taxpayers demand for these services) should also be addressed. Educating taxpayers about their rights may prove to be equally effective in deterring unscrupulous FTRPs. Similarly, taxpayer education may prove to be the most fruitful use of resources since taxpayers cannot be ruled out as contributing to the problems seen with tax compliance (e.g., by providing incorrect/incomplete information; by active complicity in avoiding taxes, etc.). Finally, the taxpayer is ultimately responsible for his/her tax return and what it reports, regardless of any tax preparer involvement. Therefore, it would seem logical that any efforts to deal with the problems surrounding tax preparation start with the taxpayers themselves.

Currently, taxpayers must be proactive in determining their rights and responsibilities with respect to the tax returns they file.[31] In April 2001, the NTA recommended that the IRS do more to build public awareness regarding taxpayer rights and responsibilities. She suggested that the IRS include a consumer alert in appropriate brochures and publications. This alert should state in plain language that taxpayers that pay for return preparation should receive a copy of their return signed by the preparer. The message should also clearly state, "If they don't sign, don't pay." Public service announcements could then be used to reinforce that message and toll-free phone numbers could be established for reporting tax preparers who refused to sign returns.

The NTA has suggested that regulation is necessary because return preparer penalties are not sufficient to combat the problem. In light of the enormous profits to be made, the NTA's goal is to get the "bottom feeders" out of the industry. Those who lack proficiency and knowledge in return preparation harm taxpayers in a number of ways, in the form of significant adjustments to taxpayers' accounts, errors made in filing status, exemptions and credits, and preparation based on outdated tax provisions. However, the IRS used education and enforcement, not preparer regulation, in a successful education campaign to address inappropriate slavery reparation claims and to reduce unscrupulous tax preparers operating in this area. The IRS indicated that more than 80,000 tax returns were filed in 2001 seeking fictitious slavery tax credits totaling $2.7 billion.[32] IRS estimated that $30 million was mistakenly paid out in slave reparations in 2000 and part of 2001. How-

---

[27] Jackson, B. and S. Jones. 1985. Salience of tax evasion penalties versus detection risk. *Journal of the American Taxation Association* 6 (Spring): 7–17.

[28] Carnes, G. and T. Englebrecht. 1995. An investigation of the effect of detection risk perceptions, penalty sanctions, and income visibility on tax compliance. *Journal of the American Taxation Association* 17 (Spring): 26–41.

[29] Cuccia, A. 1994. Tax preparers: Integrating economic and psychological factors. *Journal of the American Taxation Association* 16 (Spring): 41–66.

[30] Anderson, S. and A. Cuccia. 2000. A closer examination of the economic incentives created by tax return preparer penalties. *Journal of the American Taxation Association* 22 (Spring): 56–77.

[31] Taxpayers must access the IRS website or other IRS resources such as Tax Topic 254, "How to Choose a Paid Tax Preparer," to learn about their rights and responsibilities.

[32] Bergman, J. 2003. Dad, daughter get prison for slavery claim. *Milwaukee Journal Sentinel*, October 25.

ever, the Service reports a significant drop in reparation claims attributable to stepped up scrutiny of tax returns and an aggressive media campaign targeting scam artists promising to secure these phony tax credits for taxpayers.

The IRS recognizes that it faces a particularly difficult challenge in getting information to and identifying the needs of unenrolled tax return preparers. A current IRS effort to test the effect of education materials on those preparers who prepare EIC returns may provide a model of how to meet this challenge. This effort centers on a pilot program that sends a brochure to three groups of EIC preparers and then compares their subsequent rates of errors over three years to groups with similar characteristics who did not get the brochure. The brochure, with a desired outcome of reducing errors and improving EIC compliance, includes material on tax law changes, due diligence and information on where to get further EIC information.[33]

In addition to these efforts, the IRS has several education and outreach projects that educate taxpayers about unscrupulous tax preparers. IRS Fact Sheet 2004–10[34] urges taxpayers to be very careful when choosing a tax preparer by stating that taxpayers should "be as careful as you would in choosing a doctor or a lawyer. It is important to know that even if someone else prepares your return, you are ultimately responsible for all the information on the tax return." The fact sheet offers "Helpful hints when choosing a return preparer," including "Use a reputable tax professional that signs your return and provides you with a copy for your records." Taxpayers hearing claims from preparers offering larger refunds than other preparers are encouraged to check it out with a trusted tax professional or the IRS before getting involved. The fact sheet also lists examples of four tax return preparers sentenced to prison.

IRS Fact Sheet 2004–08[35] is directed at taxpayers claiming the EIC. It reminds these taxpayers that "the vast majority of EIC claimants allow a third-party to prepare their taxes. If you allow someone to prepare your taxes, make sure you seek out reputable tax professionals. Regardless of who completes your tax form, you are responsible for its accuracy."

IRS New Release 2004–12[36] is also directed at taxpayers that are eligible for EIC. This release states that "EIC is an important program, and you should check to see if you qualify. EIC rules can be complicated so you should carefully review the qualifications. Know, don't guess, if you are qualified. If in doubt, contact the IRS or its volunteer partners for help. If someone prepares your taxes, seek out a reputable professional who understands EIC rules and who will avoid common mistakes."

Identity and Quantify the Problem

If Congress and the IRS do embrace increased tax preparer regulation, the existing problems must first be identified and quantified. The IRS National Research Program (NRP) provides a timely opportunity to take the necessary first step.

The NRP is a comprehensive effort by the IRS to measure payment, filing and reporting compliance for different types of taxes and different sets of taxpayers.[37] The NRP began collecting data on individual taxpayers in September 2002. In addition to the information that will be collected to serve the NRP, this program could also collect information regarding tax preparers for subsequent analysis regarding preparer performance. By focusing on tax preparers rather than individual taxpayers, the IRS may make more effective use of its limited resources. In addition to the NRP data, it seems the IRS could perform more statistical sampling of signed and unsigned tax returns identifying high error rates. For the "invisible tax preparer," the IRS may consider using geographic error rates to highlight unscrupulous preparers.

In the event that increased regulation is imposed, such regulation will need to include penalties for failure to register. The IRS notes that without such penalties, it is likely that many of these preparers will simply ignore regulatory provisions and continue their business as usual. Alternatively, many unscrupulous tax preparers could go underground (making their detection extremely difficult) offering their services at a lower cost, not signing tax forms, and evading any subsequent enforcement activities. This would make IRS enforcement that much more difficult and resource intensive.

---

[33] See supra note 23.

[34] Internal Revenue Service. Fact Sheet, FS–2004–10. 2004. Return preparer fraud.

[35] Internal Revenue Service. Fact Sheet, FS–2004–08. 2004. IRS outlines EITC eligibility for 2003 tax year.

[36] Internal Revenue Service. News Release, IR–2004–12. 2004. IRS urges taxpayers to review EITC eligibility.

[37] Internal Revenue Service. 2002. IRS Release No. FS–2002–07. National research program—fact sheet.

Learn from State Regulation

In addition to studying this issue at the Federal level, a rigorous investigation of Oregon's and California's programs could provide useful insights for the proposed Federal regulation. The GAO noted in its study that neither state has systematically evaluated the effectiveness of its regulation efforts, so little is known for certain about the successes and challenges of these programs.[38]

Based on the foregoing, it is surprising that the NTA believes Oregon's program has significantly improved the accuracy of tax returns. For the 1999 tax year, the NTA looked at the number of tax returns containing errors to the total number of returns filed. The NTA found that the error rate of tax preparers in Oregon was 30 to 60% lower than those of the other states when Oregon is compared to states similar in size. In her 2002 report to Congress,[39] the NTA concluded that this statistic is "compelling support for registering tax preparers." However, neither the IRS nor the GAO concurs with this position. A simple comparison of error rates between states lacks the rigor necessary to draw inferences regarding the overall effectiveness of the Oregon program.

The IRS Position Paper[40] duly notes that neither California nor Oregon has data on the effectiveness of their programs and California specifically noted the difficulty in identifying unregistered preparers. It remains an empirical question whether or not California and Oregon's efforts at tax preparer regulation are effective. The IRS indicated intent to continue dialogue with these states as their experience could provide important information to guide future Federal action in this area.

SUMMARY REMARKS

For several years, the NTA has proposed national registration, examination, certification, and enforcement requirements for all FTRPs, including unenrolled tax preparers. However, given the lack of quantification of the problem, cost/benefit justification, and the documented failure to enforce paid tax preparer penalty provisions already in place, the proposed legislation does not appear justified at this time.

As a supplement to regulation, the NTA has also advocated an extensive campaign to educate taxpayers about using certified return preparers. She cites some low-cost solutions to help reduce low-income taxpayers' reliance on unenrolled preparers. One is to get Congress to including funding for return preparation services in grants to low-income taxpayer clinics. Another is to underwrite programs on computer and financial literacy for low-income taxpayers. "There are 20,000 answers that government could come up with—. If it cared to, to address this problem," Olson said.[41]

An initial approach to addressing the unscrupulous tax preparer problem is focusing on education and enforcement. The IRS has been extremely successful through education and outreach in drastically reducing slavery reparation claims over a short period of time. In addition, both the IRS and the GAO note that the Service needs to establish an effective enforcement program to show taxpayers and tax return preparers that they must comply with the law. The education campaign used in Oregon could serve as a starting point for a national campaign. In his response dated October 28, 2003 to the GAO report[42] on paid tax preparers, IRS Commissioner Everson indicates that the IRS has formed a multi-functional work group to improve communications between functions and develop a national return preparer strategy. These education and enforcement strategies should be given a reasonable time to be implemented and evaluated before revisiting national regulation of unenrolled tax preparers.

Statement of Gerald E. Scorse, New York, New York

This is my third submission for the record urging the closing of a particular loophole in the personal income tax law. No loophole is desirable, but some are small and relatively innocuous; by contrast, this one is large and especially offensive.

---

[38] See supra note 17.
[39] See supra note 18. p. 226.
[40] See supra note 23.
[41] Miller, K. 2003. ABA Tax Section Meeting: Taxpayer Advocate plugs enrolled agent registration. Tax Notes Today, September 16.
[42] See supra note 17.

Wages are reported by a third party to the IRS. The same goes for interest and dividends, and various types of miscellaneous income. But capital gains income is exempt from this standard reporting requirement, and instead is self-reported.

This is inequitable and costly. Why should wages be reported to the IRS, and not capital gains? At a time of soaring budget deficits, why should double-digit billions be lost every year because of this loophole?

There is no good reason; what's more, the loophole could be easily closed.

I invite the Subcommittee, the full Committee and the House at large to read "Searching for Tax Fairness," below, which explores the issue and suggests an obvious and simple solution.

Thank you (for the third time) for the opportunity to make a submission.

Searching for Tax Fairness

If you haven't read James Surowiecki's *The Wisdom of Crowds*, get ready for a surprise.

In a book that's part math, part psychology and part common sense, Surowiecki upends the popular belief that individuals are smarter than groups. Not so, he says. When it comes to solving problems, look to the group for dead-on answers.

Paying taxes, Surowiecki states, "is a classic example of a cooperation problem". Everyone benefits from the services that taxes provide, but this is true whether or not they pay any taxes. Therefore, why pay?

In Surowiecki's view, taxpayers ante up in large part because they believe that others are doing likewise. Americans, according to historian Margaret Levi, are "contingent consenters". Few of us are thrilled to pay taxes, but we don't mind paying our share as long as we're sure that the folks next door are paying theirs.

But hold on. What makes us believe that our fellow citizens are giving the taxman his due? Are we being chumps, or does something in the system give us the assurance we need?

The answer arrives like clockwork every tax season. It's the blizzard of W–2s and 1099s sent out by employers, banks, brokerage houses and mutual funds, telling us how much we made the year before in wages, interest, dividends and other forms of income. Each bears the reminder, "This information is being furnished to the Internal Revenue Service."

It's this third-party reporting that forms the linchpin of our "voluntary" tax system. It is the lodestar that keeps us on the straight and narrow, and tells us that we're all in the same boat.

But hold on one more time. There's a gold mine of unearned income that has its own set of rules, that isn't "furnished to the Internal Revenue Service." This rich vein is capital gains income from the sale of stocks, bonds and mutual funds. None of this income is reported by a third party to the IRS, though you could easily think it is.

To explain: The IRS does get reports of proceeds from stock, bond and mutual fund sales. But the agency isn't told what these holdings cost to begin with, or when they were bought. In tax-speak, income from these transactions is "self-reported"; the figures don't come from a third party, they come from the taxpayer.

This is unfair on its face, and porous tax policy besides.

A major IRS study found that misreporting rises sharply with self-reporting, climbing to more than 12 times the rate for income reported by third parties. Other government and scholarly studies have produced similar results. Kim Bloomquist, a senior economist with the IRS, makes the point the other way around: "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."

There's no question that the self-reporting of capital gains costs the U.S. Treasury; the only question is how much. Unless we're a nation of angels, the figure likely hits the double-digit billions every year. On top of that there's the multiplier effect: states and cities which simply plug federal totals into their tax returns get short-changed as well.

The solution is only half a step away, staring us in the face and daring us to put it in place.

Brokerage houses and mutual funds routinely track their customers' basis prices, purchase dates and realized capital gains, and report the information to them. With little more than the click of a mouse, the same data could be reported to the IRS at tax time.

Circle back to Surowiecki: "Getting people to pay taxes is a collective problem. We know what the goal is: everyone should pay their fair share—." Just last month, IRS Commissioner Mark W. Everson sounded a similar note when he told the Na-

tional Press Club, "Average Americans pay their taxes honestly and accurately, and have every right to be confident that when they do, their neighbors—are doing the same."

It's time to put more reality into Everson's rhetoric; it's time to treat capital gains income the same as wage income, and have it reported by third parties.

Just ask any crowd.

SOURCES

Bloomquist, Kim M. "Trends as Changes in Variance: The Case of Tax Noncompliance," presented at the IRS Research Conference, June 2003. Bloomquist is Senior Economist, Office of Research, IRS. His paper cites the agency's major study, and several others, on the relationship between tax compliance, third-party reporting ("matchable income") and self-reporting ("non-matchable income"). The article is accessible online: go to Google, search for "Kim M. Bloomquist," and click on the third link, which is the title of the paper. See pp. 2–3.

Everson, Mark W. Speech at the National Press Club, Washington, D.C., March 15, 2005.

Surowiecki, James M. The Wisdom of Crowds: Why the Many Are Smarter Than the Few and How Collective Wisdom Shapes Business, Economies, Societies and Nations. Doubleday, 2004. The quote in paragraph 3 is from p. 137; in paragraph 4, from p. 138; in the next-to-last paragraph, from p. 141.

Note: Capital gains distributions by mutual funds are a technical exception to the rule; they are the only capital gains reported by a third party.

Supplemental Sheet

I make this submission on my own behalf as a taxpayer and a citizen of the United States of America. I represent no-one other than myself.