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INTERNAL REVENUE SERVICE OPERATIONS AND THE TAX GAP

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

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

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INTERNAL REVENUE SERVICE OPERATIONS AND THE TAX GAP

TUESDAY, MARCH 20, 2007

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

The Subcommittee met, pursuant to notice, at 10:10 a.m., in room 1100, Longworth House Office Building, Hon. John Lewis (Chairman of the Subcommittee), presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
March 12, 2007
OV–3

CONTACT: (202) 225–5522

Lewis Announces a Hearing on Internal Revenue Service Operations and the Tax Gap

House Ways and Means Oversight Subcommittee Chairman John Lewis (D–GA), today announced that the Subcommittee on Oversight will hold a hearing on Internal Revenue Service (IRS) operations, the 2007 tax return filing season, and the "tax gap." **The hearing will take place on Tuesday, March 20, 2007, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

The Commissioner of IRS, the Honorable Mark W. Everson, will be the only witness at the hearing. Any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

FOCUS OF THE HEARING:

The IRS is responsible for administering federal tax laws. In 2006, IRS collected $2.4 trillion in taxes and processed 140 million individual and corporate income tax returns. The Subcommittee will review overall IRS operations, the status of the current tax return filing season, and the "tax gap," which is a term used to describe the amount of unpaid taxes owed to the federal government.

The Subcommittee will review IRS operations and tax administration priorities in the areas of taxpayer services, examinations, collections, and modernization. As part of this review, the Subcommittee will examine the Administration's budget and staffing levels for IRS as proposed in the President's Fiscal Year 2008 Budget for the IRS.

The Subcommittee will discuss the status of the current tax return filing season, including the large number of unclaimed telephone tax refunds, and consider areas where IRS can better assist taxpayers in their efforts to comply with their tax obligations. Also, the Subcommittee will discuss tax fraud schemes and tax scams that IRS has identified this year.

The Subcommittee will examine the estimated annual $345 billion tax gap, identify components of the tax gap, and discuss ways IRS can improve individual and corporate tax compliance. Specifically, the Subcommittee will review the Administration's proposals for addressing the tax gap as recommended in the President's Fiscal Year 2008 Budget for IRS.

In announcing the hearing, Chairman Lewis said, **"Our tax system is based on honesty and integrity. It is the Subcommittee's responsibility to ensure that our voluntary tax system operates properly and Americans pay their fair share."**

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 "*110th Congress*" from the menu entitled, "*Committee Hearings*" (*http://waysandmeans.house.gov/Hearings.asp?congress=18*). 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 **Tuesday, April 3, 2007**. **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.

Chairman LEWIS. Good morning. The hearing is now called to order, the hearing of the Subcommittee on Oversight. Today, we will examine the administration of our tax laws. Today, the Subcommittee on Oversight is holding its annual hearing on Internal Revenue Service (IRS) operations. We will examine the current tax return filing season, the tax gap and the IRS budget.

We are very pleased to have the Internal Revenue Service Commissioner Everson before the Subcommittee for the first time this year. I look forward to hearing his views on the estimated tax gap of $345 billion.

I am also interested in learning whether the IRS proposed budget of $11 billion is enough to protect the honesty and integrity of our tax system.

As Members of Congress and Members of this Committee, we have a responsibility, along with the commissioner, to administer

our tax laws properly and efficiently in a manner that is fair to all Americans.

Now I am pleased to recognize the distinguished ranking Member, my dear friend, Mr. Ramstad of Minnesota, for his opening statement.

Mr. RAMSTAD. Thank you, Mr. Chairman. You are a dear friend. I thank you for convening this important hearing on Internal Revenue Service operations.

Commissioner, it is good to see you again. As I said before, I believe you are doing a tough job very well. Being in charge of such a vast bureaucracy, responsible for collecting two and a half trillion dollars in revenues is no easy assignment. I certainly appreciate your commitment to this important job and your leadership.

I noted that your agency is only answering 58 million phone calls this year and you are only getting 200 million hits on your website. I think that underscores what I just said about the large responsibility that you have as the commissioner.

One of my main concerns, Commissioner, I know we will get into it here today after your testimony, but certainly one of my major concerns and I think it is a major concern of everyone on the Subcommittee, and that is the tax gap. I know the Administration's budget includes several proposals to help close the tax gap and I look forward to the discussion on that important issue.

I know additional enforcement tools are probably necessary to close the tax gap or to reduce it, but I think we must remember bottom line the most effective way to close the tax gap would be to simplify the Tax Code. I hope we can work together to simplify the tax code with the new Congress. I know this is a goal of members on both sides of the aisle and I know the American taxpayer would welcome a simplified tax system.

Again, Commissioner, thank you for being here today. Mr. Chairman, thank you for calling this hearing. I yield back.

Chairman LEWIS. All right, thank you very much, Mr. Ramstad.

Now we will hear from our witness. I ask that you, Mr. Commissioner, limit your testimony to 5 minutes. Without objection, your entire statement will be included in the record.

It is now my great pleasure to introduce the Commissioner of the Internal Revenue Service, Mark Everson. Mr. Commissioner.

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

Mr. EVERSON. Thank you, sir. Chairman Lewis, Ranking Member Ramstad, and Members of the Subcommittee, thank you for the opportunity to testify today on IRS operations and on the Administration's budget proposal for fiscal year 2008. It is always a pleasure to be before the Subcommittee.

Chairman Lewis, I look forward to working with you as you direct the operations of the Subcommittee, and expect to enjoy the same constructive relationship that the IRS had with Congressman Ramstad when he was the chair and you were the ranking Member.

First, let me say a few things about the filing season currently under way. At the IRS we recognized some time ago that this would be a challenging filing season. Two of the reasons were

Congress's late action on the extender legislation and the fact that we did not have an operating budget until well into February. The one time refund of the telephone excise tax and the initiation of the split refund were also of concern.

Taken together, we anticipated the most difficult filing season in a number of years. Sitting before you today with about a month to go, I would say so far so good. We are keeping up with the work and the system is functioning well. The extenders were successfully implemented, our software updates were taken care of by early February. Electronic return filing continues to grow and our service indicators are healthy.

On the other hand, we have seen a lower than expected claim rate for the telephone excise tax refund. Thus far, I would characterize as minimal interest in the split refund program.

Along with the increase in the e-file rate, we are seeing healthy gains in our volunteer prepared returns, a cornerstone in our outreach programs. As you know, this helps eligible participants claim the earned income tax credit.

Probably our most significant disappointment is the fact that, while we have successfully made our planned upgrade to Customer Account Data Engine (CADE), the new individual system faster file, we completed our work a number of weeks late. Our volumes, while still expected to be more than double compared to last year, will fall short of what we had hoped to do for the season.

Let me now turn to enforcement. As you know, we enjoyed significant increase in our enforcement results in fiscal year 2006. I am pleased to report we are making continued strides in fiscal year 2007. One of the things that I am proudest of is that the IRS has restored the credibility of its enforcement programs without generating a significant amount of noise or increased allegations of infringement of taxpayer rights.

The President's 2008 budget builds on these results. I am pleased that the President's request provides additional moneys for IRS systems infrastructure and modernization as well as for enforcement, notably, for increased research. There is also a modest increase for taxpayer services. This is the best budget that I have seen in my four years on the job.

I ask the Members of the Subcommittee to support the President's budget and to enact an appropriation before fiscal year 2008 actually starts. These requested moneys will help us generate continued progress in attacking the tax gap. However, they are not the only things we need to do. The Administration has made 16 legislative proposals. I would direct your attention to four that I think are particularly important.

First, reporting of credit card gross receipts. Second, making willful failure to file a tax return a felony rather than a misdemeanor. Third, requiring basis reporting for sales of securities. Fourth, lowering the threshold for mandatory electronic filing for large corporations and partnerships.

I think these proposals are an important step and I hope the Congress will enact them swiftly.

Thank you, sir.

[The prepared statement of Mr. Everson follows:]

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

Introduction

Chairman Lewis, Ranking Member Ramstad, and members of the Subcommittee, thank you for the opportunity to testify today on the 2007 Income Tax Filing Season. I would also like to update you on the progress we have made in the areas of taxpayer service and enforcement, our FY 2008 budget request, and our latest efforts to improve voluntary compliance and reduce the tax gap.

2007 Filing Season

This filing season presented the potential to be one of the most challenging in recent memory. The Tax Relief and Health Care Act of 2006 (TRHCA), which passed late last year, included the extension of several significant tax benefits. Since forms and publications for Tax Year 2006 were printed and distributed prior to enactment, we were required to notify taxpayers on IRS.gov as to how to modify those forms to claim the allowable benefits. We are also faced with implementing the Telephone Excise Tax Refund Program (TETR). This was the first filing season that we allowed taxpayer refunds to be split and deposited into separate accounts. And, because the normal April 15th filing date falls on a Sunday and the following Monday is a legal holiday in the District of Columbia, we had to adjust our programs to provide taxpayers an extra two days to file and pay this year.

Despite these challenges, I am proud to report that thus far the filing season has gone very well. By early February, we were able to begin processing tax returns claiming the tax benefits authorized by the enactment of TRHCA in December. We have also taken a number of steps to make sure that taxpayers understand how to claim the benefits. For example, we provided instructions on IRS.gov and conducted extensive outreach and media events to publicize these provisions. In addition, we sent a special mailing of Publication 600, which included the state and local sales tax tables and instructions for claiming the sales tax deduction on Schedule A (Form 1040), to 6 million taxpayers who had previously claimed the state and local sales tax deduction.

I will discuss the TETR Program later in my testimony, but let me first give an update on some of the numbers we are looking at approximately one month from the return due date.

Numbers Thus Far

We expect to process almost 136 million individual tax returns in 2007, and we anticipate a continued growth in the number of those that are e-filed. In the 2006 filing season, 54 percent of all income tax returns were e-filed. We fully expect to exceed that number this year. As of March 10, we have received almost 45.5 million tax returns electronically, an increase of 4.87 percent compared to the same period last year.

This increase in e-filing is being driven by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by over 8 percent compared to this time a year ago. Over 13.3 million returns have been e-filed by people from their personal computers, up from over 12.3 million for the same period a year ago.

Overall, 75 percent of the 60.9 million returns filed thru March 10th have been e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in two weeks or less. That is about half the time it takes us to process a paper return. For the IRS the error reject rate for e-filed returns is significantly lower than that for paper returns.

More people are choosing to have their tax refunds directly deposited into their bank account than ever before. So far this year, we have directly deposited over 39 million refunds, or 77 percent of all refunds issued this tax filing season. This is up from 73 percent for the same period in 2006.

People are also visiting our web site, IRS.gov, in record numbers. We have recorded almost 83.4 million visits to our site this year, up over 9 percent from 76.4 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the web site. We have made it easier for taxpayers to get answers to many of their tax questions online. The web site:

- Assists the taxpayer in determining whether he or she qualifies for the Earned Income Tax Credit (EITC);
- Assists the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);

- Allows more than 70 percent of taxpayers the option to file their tax returns at no cost through the Free File program;
- Allows taxpayers who are expecting refunds to track the status via the "Where's My Refund?" feature; and
- Allows a taxpayer to calculate the amount of their Sales Tax Deduction.

As of March 10, we have received almost 60.9 million returns, a very slight increase over the same period as last year. We have issued 50.5 million refunds so far this year, for a total of $128.7 billion. The average refund thus far is $2,548, approximately $125 more than last year. In addition, over 16.8 million taxpayers have tracked their refund on IRS.gov, up 15.19 percent over last year.

As of March 10th, our Taxpayer Assistance Centers (TACs) are reporting a very slight 0.6 percent decline in face-to-face contacts this filing season as compared to last year. We have also seen a decline in the number of calls answered (−2.54 percent) as well as automated calls (−5.13 percent). We believe that the decline in visits to our TACs is largely attributable to taxpayers increasing their use of IRS.gov, volunteer services, and other more convenient means of obtaining tax forms, filing their returns or getting their questions answered. The decline in the number of calls answered can be attributed to a few weather-related temporary call site closures earlier this winter and a slight decrease in overall caller demand.

Free File

Almost 2.5 million people have utilized Free File as of March 9th, down 5.5 percent from last year. This year anyone with adjusted gross income of $52,000 or less is eligible for Free File. This would include 95 million taxpayers. The number of Free File returns compared to the prior year has been steadily increasing and we expect to meet or exceed 2006 totals by the end of the filing season.

A key difference in this year's Free File program is that Alliance members are no longer offering ancillary products, such as refund anticipation loans (RALs) through the Free File program. IRS data from the last filing season shows that only 0.5 percent of Free File users chose to utilize a RAL. The Free File Alliance may still offer customers the option of having their state tax return prepared for a fee though some Alliance members are offering to do the state return at no cost as well as the Federal.

In the 2006 filing season an indicator was included for the first time on Free File returns, which allowed the IRS to identify those taxpayers using Free File. As a result, the Service was able to obtain important information such as customer satisfaction and demographic data that had never before been available.

This information allowed us to verify that there was a high level of customer satisfaction with Free File. According to a survey conducted for the IRS, 94 percent said they intend to use Free File again next year; the same number said they found Free File very easy or somewhat easy to use; and 97 percent said they would recommend Free File to others. Convenience, not the free cost, was the most appealing factor of Free File.

VITA/TCE Sites and Other Community Partnerships

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased while the numbers of TAC contacts have decreased. In FY 2006, over 2.2 million returns were prepared by volunteers. As of March 10th, volunteer return preparation is up 7.6 percent above last year's level. Volunteer e-filing is also up slightly, by 0.6 percent over the same period in the last tax filing season. This is reflective of continuing growth in existing community coalitions and partnerships.

We have also made a concerted attempt to improve outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored EITC Awareness Day on February 1, in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge them to claim the credit.

Telephone Excise Tax Refunds

In the middle of 2006, the IRS announced plans to refund at least $13 billion in telephone excise taxes to more than 160 million taxpayers. To do this, the IRS modified every individual and business tax return form, retooled our systems to handle the forecast demand, and launched an extensive communications campaign to increase awareness and encourage people without a filing requirement to request a refund anyway.

One difficulty in administering this refund was that taxpayers could have experienced significant burden if they had been required to find 41 months of old phone

bills in order to obtain the information they needed to compute their refunds. For this reason, the IRS created a set of standard amounts that individuals can claim in lieu of actual amounts. For businesses and non-profits—faced with potentially more paperwork than individuals—the IRS developed an estimation method that could require significantly less paperwork than requesting an actual amount.

A review of returns filed so far this year turned up a surprising fact: nearly 30 percent of returns we have received did not include a telephone excise tax refund request. Though one of our communications goals was to encourage taxpayers not to overlook the telephone tax refund, it appears many taxpayers are missing out. In response, to these early numbers, we consulted with tax professionals, citizens groups and tax software companies to determine potential causes for the low take up rate. The only logical reason we were given was that despite our best efforts, some taxpayers were still not aware of the credit and how to claim it. We then conducted additional media outreach to increase awareness of the refund and were able to generate broad national media coverage, including CNN, the Associated Press, and USA Today.

As we monitored the initial returns, we also noticed some problems. Even though 99.5% of all taxpayers who are requesting the refund are claiming the appropriate standard amount, some tax-return preparers are requesting thousands of dollars of refunds for their clients in instances where clients are entitled to only a tiny fraction of that amount. This may indicate criminal intent on the part of the return preparer. In some cases, taxpayers requested a refund in the thousands of dollars, suggesting that the taxpayer paid more for telephone service than they received in income. While some of the large claims may be the result of misunderstandings—a number of refund requests appear to be for the entire amount of the taxpayer's phone bill, rather than just the three-percent long-distance tax—others may be deliberate attempts to scam the system.

To address this problem, in late February, IRS special agents executed search warrants seeking evidence from a small number of tax-preparation businesses suspected of preparing returns on behalf of clients requesting large, improper amounts in telephone excise tax refunds. Special agents temporarily closed these businesses, seizing computers and documents to use in their investigations. In addition, IRS revenue agents (auditors) and special agents also visited other tax preparers who were suspected of preparing questionable telephone tax refund requests.

On a positive note, the number of returns with seemingly high telephone excise tax refunds dropped significantly this month. This suggests our enforcement actions, along with increased communications, may be having the desired effect.

Tax Scams

Each year, we alert taxpayers about the "Dirty Dozen", 12 of the most blatant tax scams affecting American taxpayers. This is in part an effort to alert taxpayers so that they may be wary if approached and encouraged to participate in any of the listed schemes. It also alerts promoters that we are aware of the scam and will be taking steps to prevent them from getting away with it.

This year the "Dirty Dozen" highlights five new scams that IRS auditors and criminal investigators have uncovered. Topping the list this filing season are fraudulent refunds being claimed in connection with TETR, which I have already discussed. Other scams making the list include:

- **Abusive Roth IRAs:** Taxpayers should be wary of advisers who encourage them to shift under-valued property to Roth Individual Retirement Arrangements (IRAs). In one variation, a promoter has the taxpayer move under-valued common stock into a Roth IRA, circumventing the annual maximum contribution limit and allowing otherwise taxable income to go untaxed.
- **Phishing:** This is a technique used by identity thieves to acquire personal financial data in order to gain access to the financial accounts of unsuspecting consumers, run up charges on their credit cards or apply for loans in their names. These Internet-based criminals pose as representatives of a financial institution—or sometimes the IRS itself—and send out fictitious e-mail correspondence in an attempt to trick consumers into disclosing private information. A typical e-mail notifies a taxpayer of an outstanding refund and urges the taxpayer to click on a hyperlink and visit an official-looking Web site. The Web site then solicits a social security and credit card number. It is important to note the IRS does not use e-mail to initiate contact with taxpayers about issues related to their accounts. If a taxpayer has any doubt whether a contact from the IRS is authentic, the taxpayer should call 1–800–829–1040 to confirm it.
- **Disguised Corporate Ownership:** Domestic shell corporations and other entities are being formed and operated in certain states for the purpose of dis-

guising the ownership of the business or financial activity. Once formed, these anonymous entities can be, and are being, used to facilitate underreporting of income, non-filing of tax returns, listed transactions, money laundering, financial crimes and possibly terrorist financing. The IRS is working with state authorities to identify these entities and to bring their owners into compliance.

- **Zero Wages:** In this scam, which first appeared in the Dirty Dozen in 2006, a Form 4852 (Substitute Form W–2) or a "corrected" Form 1099 showing zero or little income is submitted with a federal tax return. The taxpayer may include a statement rebutting wages and taxes reported by the payer to the IRS. An explanation on the Form 4852 may cite statutory language behind Internal Revenue Code sections 3401 and 3121 or may include some reference to the paying company refusing to issue a corrected Form W–2 for fear of IRS retaliation.
- **Return Preparer Fraud:** Dishonest return preparers can cause many headaches for taxpayers who fall victim to their schemes. Such preparers make their money by skimming a portion of their clients' refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Some preparers promote filing fraudulent claims for refunds on items such as fuel tax credits to recover taxes paid in prior years. Taxpayers should choose carefully when hiring a tax preparer. As the old saying goes, "If it sounds too good to be true, it probably is." Remember that no matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. In recent years, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others. During fiscal year 2006, 109 tax return preparers were convicted of tax crimes and sentenced to an average of 18 months in prison.
- **American Indian Employment Credit:** Taxpayers submit returns and claims reducing taxable income by substantial amounts citing an American Indian employment or treaty credit. Although there is an Indian Employment Credit available for businesses that employ Native Americans or their spouses, there is no provision for its use by employees. In a somewhat similar scam, unscrupulous promoters have informed Native Americans that they are not subject to federal income taxation. The promoters solicit individual Indians to file Form W–8 BEN seeking relief from all withholding of federal taxation. A recent "phishing" variation has promoters using false IRS letterheads to solicit personal financial information that they claim the IRS needs in order to process their "non-tax" status.
- **Trust Misuse:** For years unscrupulous promoters have urged taxpayers to transfer assets into trusts. They promise reduction of income subject to tax, deductions for personal expenses and reduced estate or gift taxes. However, these trusts do not deliver the promised tax benefits. There are currently more than 150 active abusive trust investigations underway and 49 injunctions have been obtained against promoters since 2001. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering into a trust.
- **Structured Entity Credits:** Promoters of this newly identified scheme are setting up partnerships to own and sell state conservation easement credits, federal rehabilitation credits and other credits. The purported credits are the only assets owned by the partnership and once the credits are fully used, an investor receives a K–1 indicating the initial investment is a total loss, which is then deducted on the investor's individual tax return.
- **Abuse of Charitable Organizations and Deductions:** The IRS continues to observe the use of tax-exempt organizations to improperly shield income or assets from taxation. This can occur when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund but maintains control over the assets or income. Contributions of non-cash assets continue to be an area of abuse, especially with regard to overvaluation of contributed property. In addition, the IRS is noticing the return of private tuition payments being disguised as charitable contributions to religious organizations.
- **Form 843 Tax Abatement:** This scam rests on faulty interpretation of the Internal Revenue Code. It involves the filer requesting abatement of previously assessed tax using Form 843. Many using this scam have not previously filed tax returns and the tax they are trying to have abated has been assessed by the IRS through the Substitute for Return Program. The filer uses the Form 843 to list reasons for the request. Often, one of the reasons is: "Failed to properly compute and/or calculate IRC Sec 83–Property Transferred in Connection with Performance of Service."
- **Frivolous Arguments:** Promoters have been known to make the following outlandish claims: the Sixteenth Amendment concerning congressional power to lay

and collect income taxes was never ratified; wages are not income; filing a return and paying taxes are merely voluntary; and being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy. Taxpayers should not believe these or other similar claims. These arguments are false and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law or else they may subject themselves to increased penalties. As part of the Tax Relief and Health Care Act of 2006 [Public Law No. 109–432], Congress amended the Code to increase the amount of the penalty for frivolous tax returns from $500 to $5,000 and to impose a penalty of $5,000 on any person who submits a "specified frivolous position." Last week, we released guidance identifying these and other frivolous claims that, when asserted by a taxpayer on a tax return filed with the Service or submitted in a collection due process request, offer-in-compromise, application for an installment agreement, or application for a Taxpayer Assistance Order, expose the taxpayer to the $5,000 penalty.

A Commitment to Service *and* Enforcement

In FY 2006, we continued making improvements in both our service and enforcement programs. This is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards "transforming itself into a modern institution that provides efficient and effective tax administration services to America's taxpayers."

Improving Taxpayer Service

According to a survey commissioned by the Board in 2006, taxpayers increasingly recognize that the IRS provides quality service through a variety of channels, such as its web site, toll-free telephone lines and Taxpayer Assistance Centers (TACs). This is supported by the metrics that we use to determine the effectiveness of our taxpayer service efforts. In category after category, we continue to see improvement in the numbers in our telephone services, electronic filing, and IRS.gov access. This is demonstrated by the following FY 2006 business results:

- Electronic filing by individuals continued to increase. It rose three percentage points from FY 2005, to 54 percent of all individual returns.
- The level of service for toll-free assistance was 82 percent, about the same level of FY 2005 and up substantially from FY 2001. The level of customer satisfaction with the toll-free line remains 94 percent.
- The tax-law accuracy of toll-free responses improved to 91 percent and account accuracy increased to over 93 percent.
- Visits to the IRS web site jumped nearly 10 percent in FY 2006 to more than 197 million visits.
- More taxpayers used the online refund status tool "Where's My Refund." In FY 2006, there were 24.7 million status checks, up nearly 12 percent from FY 2005.

At the IRS, we continue to work to improve services. Clearly, we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July, 2005 in response to a Congressional mandate to develop a five year plan that outlines the steps we should take to improve taxpayer services. We sent Phase 1 of the Blueprint to Congress in April, 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer, partner, and government value:

- Improve and expand education and awareness activities: This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.
- Optimize the use of partner services: This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.
- Enhance self-service options to meet taxpayer expectations: This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.
- Improve and expand training and support tools to enhance assisted services: This theme highlights the need for ensuring accurate information across all

channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.

- Develop short-term performance and long-term outcome goals and metrics: This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

Phase 2 of the Blueprint will be sent to Congress soon. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year Strategic Plan for taxpayer service.

The Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The Strategic Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder, partner, and employee engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance. More details on TAB Phase 2 will be available when the report is delivered to Congress.

While the TAB remains a work in progress, the FY 2008 budget request includes the funding necessary to implement some of the telephone service and web site enhancements recommended by the Blueprint. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help.

The Blueprint also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding non-compliance, the FY 2008 budget includes funding for research to understand better the effect of service on compliance.

Expanding Enforcement Efforts

Another reason for the Oversight Board's positive assessment of our work in FY 2006 is that IRS enforcement efforts have increased in virtually every area. According to the Board, "As demonstrated by a variety of measures, the IRS' performance on enforcement has improved considerably, and real progress has been achieved over the past six years."

One of the most obvious measures is the increase in enforcement revenue, which has risen from $34 billion in FY 2002 to almost $49 billion in FY 2006, an increase of 43 percent. Since 2003, Federal government receipts have also increased by $600 billion. In FY 2006, the Federal government collected over $2.4 trillion in total receipts. This is an historic level, with annual receipts up 12 percent over FY 2005 alone. From FY 2005 to FY 2006, the U.S. has seen the highest year-to-year revenue growth in 25 years. This growth is primarily the result of a strong economy supported by sound economic and tax policy. But, corporate and high-income individual taxpayers are also both areas where we have substantially increased our enforcement presence in recent years.

In FY 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This is almost 75 percent more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.58 percent in FY 2001 to more than 0.97 percent in FY 2006.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over $1 million. The number of examinations in the category rose by almost 78% compared to FY 2004, the first year the IRS began tracking audits of individuals with income over $1 million. The coverage rate has risen from 5 percent in FY 2004 to 6.3 percent in FY 2006.

Growth in audit totals and coverage rates extend to other taxpayer categories. Preliminary estimates show that the IRS examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over $10 million, examinations rose from 8,718 in FY 2001 to 10,578 in FY 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over $250 million, examinations have increased by over 29 percent growing from 3,305 in FY 2001 to 4,276 in FY 2006.

Finally, examinations of tax exempt organizations have also risen. In FY 2001 5,342 tax exempt examinations were closed. This number rose to 7,079 in FY 2006.

President's FY 2008 Budget Maintains the Balance between Taxpayer Service and Enforcement

The IRS and its employees represent the face of the Federal Government to more American citizens than any other government agency. The IRS administers America's tax laws and collects 95 percent of the revenues that fund most government operations and public services.

The IRS' taxpayer service programs provide assistance to millions of taxpayers to help them understand and meet their tax obligations. The IRS' enforcement programs are aimed at deterring taxpayers inclined to evade their responsibilities while vigorously pursuing those who violate tax laws. Delivering these programs demands a secure and modernized infrastructure able to fairly, effectively, and efficiently collect taxes while minimizing taxpayer burden.

The IRS FY 2008 President's Budget request supports its five-year strategic plan and Treasury's compliance improvement strategy. These documents underscore the IRS' commitment to provide quality service to taxpayers while enforcing America's tax laws in a balanced manner. The IRS' strategic plan goals are:

- *Improve Taxpayer Service.* Help people understand their tax obligations, making it easier for them to participate in the tax system;
- *Enhance Enforcement of the Tax Law.* Ensure taxpayers meet their tax obligations, so that when Americans pay their taxes, they can be confident their neighbors and competitors are also doing the same; and
- *Modernize the IRS through its People, Processes and Technology.* Strategically manage resources, associated business processes and technology systems to effectively and efficiently meet service and enforcement strategic goals.

Budget Request

Our total budget request for FY 2008 is for $11.1 billion in appropriated resources and represents a 4.7 percent increase over the recently enacted FY 2007 Joint Resolution (JR) level of $10.6 billion.

The IRS' taxpayer service and enforcement activities are funded from three appropriations: Taxpayer Services (TS); Enforcement (ENF); and Operations Support (OS). The total FY 2008 Budget request for these three operating accounts is $10.8 billion supplemented by the $180 million from user fee revenue, for a total operating level of $10.9 billion, or 5.5 percent increase over the FY 2007 JR level. As in FY 2006 and FY 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment, and I am pleased that the Senate Budget Committee mark for the 2008 resolution includes the full cap adjustment for this activity, recognizing the return on investment from these enforcement investments.

The Budget also includes $282.1 million for Business Systems Modernization (BSM) and $14.2 million to administer the Health Insurance Tax Credit program, a 32.6 percent and 2.6 percent increase, respectively, over FY 2007 JR level.

Our FY 2008 Budget request provides $409.5 million for new initiatives and $340.0 million for the pay raise and other cost adjustments needed to sustain base operations. The IRS' initiatives focus on the most significant needs for FY 2008:

- *$20.0 million to enhance taxpayer service* through expanded volunteer tax assistance, increased funding for research to determine the most effective means to help taxpayers, and implementing new technology to improve taxpayer service;
- *$246.4 million to expand enforcement* activities targeted at improving compliance; and
- $143.1 million to improve the IRS' information technology (IT) infrastructure, including $62.1 million for the BSM program and $81.0 million for security and infrastructure enhancements.

This request also includes several program savings and efficiencies that reflect the IRS' aggressive efforts to identify and deploy work process and technology improvements that will benefit both taxpayer service and enforcement programs. Collectively, these cost savings total $120.0 million:

- *Taxpayer Service Efficiencies −$23.4 million/−527 FTE:* These savings will result from operational efficiencies achieved through on-going efforts to automate and enhance IRS taxpayer service programs' workload distribution such as the implementation of automated issuance of Employer Identification Numbers and Correspondence Imaging System. Additional efficiencies and savings are ex-

pected to be achieved through the implementation of optimal service channels identified from the Taxpayer Assistance Blueprint.

- *Enforcement Program Efficiencies −$60.2 million/−620 FTE:* These savings will result from productivity and efficiency improvements realized through the implementation of enhanced technology and business processes such as improved case selection tools and techniques. In addition, the completion of initial training and transition of the FY 2006 new hires back to their front-line enforcement activities will result in additional efficiencies for the examination and collection programs.
- Shared Service Support Efficiencies −$36.4 million/*−37 FTE:* These savings will result from several efforts including the optimization and consolidation of space projects, implementation of cost-efficient government-wide contract support, and postage savings achieved through the consolidation, automation, and renegotiation of contract services for correspondence delivery.

A Strategic Plan to Improve Voluntary Compliance

Enhancing Taxpayer Service

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the IRS.gov web site, TACs, VITA, and TCE sites.

Assisting taxpayers with their tax questions before they file their returns reduces burdensome post-filing notices and other correspondence from the IRS, and proactively addresses inadvertent noncompliance.

The FY 2008 Budget contains three significant taxpayer-service initiatives. First, we are requesting $5 million to expand volunteer income tax assistance, a significant component of our effort to support taxpayers eligible to claim the Earned Income Tax Credit. This taxpayer service initiative will help expand our volunteer return preparation, outreach and education, and asset building services to low-income, elderly, Limited English Proficient (LEP), and disabled taxpayers.

The budget also requests $5 million for additional resources to enhance our understanding of the role of the taxpayer service on compliance. This research will focus on understanding taxpayer burden, opportunities for enhanced service to help reduce errors made on returns, and the impact of service on overall levels of voluntary compliance.

Finally, the budget requests $10 million for four of the initiatives recommended by the Taxpayer Assistance Blueprint (TAB). As part of the TAB effort, we conducted a comprehensive review of our current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the Blueprint, the funding for this initiative will implement the following telephone service and web site interaction enhancements:

- *Contact Analytics* provides an analytical tool for evaluating contact center recordings for the purpose of improving business processes and lowering business costs, as well as improving customer service.
- *Estimated Wait Time* provides a real-time message that informs taxpayers about their expected wait time in queue, allowing them to make more informed decisions based on the status of their call and thus reducing taxpayer burden and increasing customer satisfaction.
- *Expanded Portfolio of Tax Law Decision Support Tools* enables taxpayers to conduct key word and natural language queries to get answers to tax law questions through the Frequently Asked Questions database accessed on IRS.gov, thereby steadily increasing customer satisfaction and operational savings.
- *Spanish "Where's My Refund?"* adds the ability to check refund status to the Spanish web page on IRS.gov, enabling the Spanish-speaking community to receive the same level of customer service on the web as available to the English web page.

Continued technological advancements offer significant opportunities for the IRS to improve the efficiency and effectiveness of call center services. Web site enhancements are designed to maximize the value of IRS.gov, making the site taxpayers' first choice for obtaining the information and services required to comply with their tax obligations.

Improving Compliance Activities

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. We will continue to reengineer our examination and collection procedures to reduce cycle

time, increase yield, and expand coverage. As part of our regular examination program, we are expanding the use of cost-efficient audit techniques first pioneered in the National Research Program (NRP).

We are also expanding our efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as nonfilers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

There are six specific initiatives proposed in the FY 2008 Budget aimed at improving compliance. These initiatives provide:

- $73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance. This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating persons who have evaded taxes for possible criminal referral. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year, once new hires reach full potential in FY 2010.
- $26.2 million for increasing compliance for large, multinational businesses. This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multinational transactions where the potential for noncompliance is significant in the reporting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 to 8.2 percent in FY 2008, and produce over $74 million in additional annual enforcement revenue, once the new hires reach full potential in FY 2010.
- $28 million for expanded document matching in existing sites. This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. We believe the additional resources will result in an increase in AUR closures from 2.05 million in FY 2007 to 2.64 million in FY 2010. We expect $208 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010. In addition, the budget requests $23.5 million to establish a new document matching program at our Kansas City campus. This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this new AUR site should result in over $183 million in additional enforcement revenue per year once the new hires reach full potential in FY 2010.
- $6.5 million to increase individual filing compliance. This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in FY 2008 and produce $82 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010.
- $15 million to increase tax-exempt entity compliance. This enforcement initiative will deter abuse by entities under the purview of the Tax-Exempt and Governmental Entities Division (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE compliance contacts by 1,700 (six percent) and employee plan/exempt organization determinations closures by over 9,000 (eight percent) by FY 2010.
- $10 million for increased criminal tax investigations. This will help us to aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which include an emphasis on the fraud referral program. Our robust pursuit of tax violators and the resulting publicity is aimed to foster deterrence and enhance voluntary compliance.
- $41 million for conducting research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance. The data collected from these studies will enable the IRS to develop strategies to combat specific areas of non-compliance.

In addition to these initiatives, I would stress the importance of allowing us to continue with the private debt collection program. The use of private collection agents (PCAs) was authorized by the American Jobs Creation Act of 2004. As we continue to debate the efficacy of this program, I want to take this opportunity to make a couple of points for purposes of our ongoing discussions.

One issue that has been debated is the relative efficiency of using PCAs versus IRS employees to collect the taxes owed. The most important question is not whether IRS employees or PCAs can do the job more efficiently, but rather whether PCAs collect money that would otherwise go uncollected. The IRS lacks the resources to pursue the relatively simple, geographically dispersed cases that are now being assigned to PCAs. It is not realistic to expect that the Congress is going to give the IRS an unlimited budget for enforcement, and if Congress provided the IRS additional enforcement resources, I believe those resources would be applied best by allocating them to more complex, higher priority cases that are not appropriate for PCAs.

The IRS continues to work with PCAs to ensure that the program is fair to taxpayers and respects taxpayer rights. We currently estimate that between now and FY 2017, our partnership with PCAs will result in approximately 2.9 million delinquent cases receiving treatment that would otherwise have gone unworked. This partnership will help reduce the backlog in outstanding tax liabilities, which has grown by 118 percent over the last 12 years. From September 7, 2006, when cases were first assigned to PCAs, through February 15, 2007 PCAs collected $14.47 million in gross revenue. We estimate that cases worked by PCAs will generate estimated gross revenue of between $1.4 billion through FY 2017.

Another reason to continue to use this tool is to evaluate whether we in the public sector can learn anything from these PCAs that will enable us to do our jobs better. Particularly over the last 20 years, government agencies at all levels have adopted many practices and ways of doing business that have been pioneered in the private sector. One need look no further than the vastly expanded use by the government of the Internet in providing services to the public as an example of a practice that was pioneered in the private sector, but adopted quickly and effectively by the government. We should not remove PCAs as a tool for addressing the problem before we have an opportunity to evaluate the potential of this initiative to help improve compliance and perhaps even to show the government how to be more effective in its own efforts.

Reducing Opportunities for Evasion

The IRS is already aggressively pursuing enforcement initiatives designed to improve compliance and reduce opportunities for evasion. As I pointed out earlier, these efforts have produced a steady climb in enforcement revenues since 2001, as well as an increase in both the number of examinations and the coverage rate in virtually every major category.

In the budget request, the Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties in the following ways:

Expand information reporting—Specific information reporting proposals would:

(1) Require information reporting on payments to corporations;
(2) Require basis reporting on sales of securities;
(3) Expand broker information reporting;
(4) Require information reporting on merchant payment card reimbursements;
(5) Require a certified taxpayer identification number (TIN) from non-employee service providers;
(6) Require increased information reporting for certain government payments for property and services; and
(7) Increase information return penalties.

Improve compliance by businesses—Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:

(1) Require electronic filing by certain large businesses;
(2) Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes; and
(3) Amend collection due process procedures applicable to employment tax liabilities.

Strengthen tax administration—The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:

(1) Expand IRS access to information in the National Directory of New Hires database;
(2) Permit the IRS to disclose to prison officials return information about tax violations; and
(3) Make repeated failure to file a tax return a felony.

Expand penalties—Penalties play an important role in discouraging intentional noncompliance. Specific proposals to expand penalties would:

(1) Expand preparer penalties;
(2) Impose a penalty on failure to comply with electronic filing requirements; and
(3) Create an erroneous refund claim penalty.

The Administration also has four proposals relating to IRS administrative reforms.

The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.

The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.

The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding $50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.

The fourth proposal modifies the way that Financial Management Services (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to add the fee to the liability being recovered, thereby shifting the cost of collection to the delinquent taxpayer. The offset amount would be included as part of the 15-percent limit on continuous levies against income.

Collectively, these proposals should generate $29.5 billion in revenue over 10 years. The proposed budget provides $23 million to implement these initiatives. This will fund the purchase of software and the modifications to IRS information technology systems necessary to implement these legislative proposals.

Enhancing Research

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line-by-line audits of random samples of returns. This provided us with information on compliance trends and allowed us to update audit selection formulas. However, this method of data gathering was extremely burdensome on the taxpayers who were forced to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without the benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done for Tax Year (TY) 1988.

We have conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, until the recent NRP data, all of our subsequent estimates of the tax gap were rough projections that basically assumed no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program, which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 individual returns for TY 2001. This was less than previous compliance studies, even though the population of individual tax returns had grown over time. Like the compliance studies of the past, the NRP was designed to allow us to estimate the overall extent of reporting compliance among individual income tax filers, and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The NRP provided updated estimates for determining the sources of noncompliance. The IRS also uses the NRP findings to better target examinations and other compliance activities, thus increasing the dollar-per-case yield and reducing "no change" audits of compliant taxpayers. Innovations in audit techniques to reduce

taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among those major tax gap components since the most recent compliance estimates were compiled (i.e., for TY 1988 or earlier).

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target resources, effectively provide the best service possible, and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts.

The FY 2008 Budget requests funds for two significant research initiatives. First, the budget requests $41 million to improve compliance estimates, measures, and detection of noncompliance. This will fund research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance. Unlike in the past, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This will provide fresh compliance estimates each year, and by combining samples over several years, will provide a regular update to the larger sample size needed to keep our targeting systems and compliance estimates up to date.

The second research program funded by the request is to research the effect of service on taxpayer compliance. The budget requests $5 million for this project, which will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:

- Meeting taxpayer needs by providing the right channel of communication;
- Better understanding taxpayer burden;
- Understanding taxpayer needs through the errors they make; and
- Researching the impact of service on overall levels of voluntary compliance.

Continuing Improvements in Information Technology

Tax administration in the 21st century requires improved IRS information technology (IT). We are committed to continuing to make improvements in technology and the FY 2008 Budget reflects that commitment. The FY 2008 Budget requests $81 million to improve the IRS' information technology infrastructure. Sixty million dollars of this amount is requested to upgrade critical IT infrastructure. This infrastructure initiative will provide funding to upgrade the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in FY 2008 include procuring and replacing desktop computers; automated call distributor hardware; mission critical servers; and Wide Area Network/Local Area Network routers and switches.

The other $21 million will be used to enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Finally, the FY 2008 Budget requests a total of $282.1 million to continue the development and deployment of the IRS Business Systems Modernization (BSM) program in line with the recommendations identified in the IRS Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

The development of the CADE (Customer Account Data Engine) and AMS (Account Management Services) systems is the heart of the IT modernization of the IRS. The combination of these two systems working together will enable the IRS to process tax returns and deal with taxpayer issues in a near real-time manner. In fact, our objective is that the IRS operate similarly to what one expects from one's bank; account transactions occurring during the business day will be posted and available by the next business day. In addition, AMS will enable the IRS rep-

resentatives who work with taxpayers to have access to all the information regarding that taxpayer, including electronic access to tax return data, and electronic copies of correspondence. Equipped with such comprehensive and up-to-date information, our representatives will be in a much better position to help taxpayers resolve their issues.

MeF is the future of electronic filing. It provides a standard data format for all electronic tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns, resulting in a quicker acknowledgement of the filing to the taxpayer or their representative. In FY 2007, the IRS will start development and implementation of the 1040 on the MeF platform.

CSP will provide funding for new portals, which are technology platforms that meet many IRS business needs through web-based front-ends, and provide secure access to data, applications, and services. The portals are mission-critical components of the enterprise infrastructure required to support key business processes and compliance initiatives.

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, the business community, and government, but also contribute to operational improvements and efficiencies within the IRS.

Summary

The FY 2008 Budget request includes significant increases for IRS enforcement efforts. Fully funding that request will help us make progress in greatly improving voluntary compliance. Based on our analysis covering the most recent 11 years of collection experience, we estimate that every dollar we have spent on enforcement has generated a direct return of an average of four dollars in increased revenue to the Federal Treasury. This return can be expected to occur when the full productive benefit of the investment is realized.

Our role is not unlike that of a highway patrolman. He will never be able to ticket every speeder, but he attempts to position himself in areas where he knows that his time is more likely to be spent productively. He also knows that every time he pulls a speeder over, other motorists see that and slow down as well.

We also believe that dollars spent on taxpayer service have a positive impact on voluntary compliance. The complexity of complying with the nation's current tax system is a significant contributor to the tax gap, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of improving voluntary compliance. To this end, the IRS remains committed to a balanced program assisting taxpayers in both understanding the tax law and remitting the proper amount of tax.

In addition, the President's FY 2008 Budget contains a number of legislative proposals that provide additional tools for the IRS to enforce the existing tax law. Perhaps the most critical of these tools is greater third party reporting.

An analysis of the data from the National Research Program of TY 2001individual income tax returns leads to one very obvious conclusion. Compliance is much higher in those areas where there is third party reporting. For example, only 1.2 percent of wages reported on Forms W–2 are underreported. This compares to a 53.9 percent underreporting rate for income subject to little or no third party reporting.

The FY 2008 Budget request asks Congress to expand information reporting to include additional sources of income and make other statutory changes to improve compliance. These legislative proposals are intended to improve tax compliance with minimum taxpayer burden. When implemented, it is estimated that these proposals will generate $29.5 billion over ten years.

I anticipate that some of this year's Budget proposals will be criticized, perhaps because of concerns about their potential impact on small businesses. While the information reporting proposals will inevitably impose some burden on compliant taxpayers, they are designed to minimize that burden and to help the IRS better target its audit resources, thereby reducing the number of burdensome audits that result in little or no change to compliant taxpayers' reported liability. The challenges that a small business faces are difficult enough without having to compete directly with noncompliant competitors. We have an obligation to support those compliant small businesses by ensuring that their competitors are also paying their fair share. This is not only a matter of fairness, but also a way of supporting compliant small businesses in their efforts to remain compliant.

Finally, full funding of the budget request will enable the IRS to improve our research with respect to compliance. Despite all of our progress, there is still much we do not know about the tax gap. Although the updated estimates provided by the NRP study are more accurate than our previous estimates, and more accurate than

the estimates made at various times by others using more indirect methods, they have many limitations. These estimates are useful for understanding the general areas and levels of noncompliance and the scope of the problem, but they are far from exact measurements. With the exception of the individual income tax gap, the estimates do not adjust for noncompliance that goes undetected during examination, and estimates are not even available for certain (minor) components of the tax gap. Beginning in October 2007, the IRS will begin ongoing annual research activities that will ensure we have the most up to date compliance data possible to measure portions of the tax gap, focus our resources, and improve our audit selection criteria.

I appreciate the opportunity to testify this morning, and I will be happy to respond to any questions that Members of the Committee may have.

Chairman LEWIS. Thank you very much, Mr. Commissioner, for your statement.

At this time, we will open the hearing for questions. I ask that each Member follow the 5-minute rule. If the commissioner will follow with short and concise answers, all Members should have the opportunity to ask questions, if possible, there may be a second round.

Mr. Commissioner, during the current tax filing season the IRS has warned taxpayers about a scam called "phishing." This involves fake e-mails from con artists claiming to be the IRS. They try to get taxpayers' Social Security numbers and bank account numbers.

Can you please tell the Members of the Committee about this?

Mr. EVERSON. Certainly, sir. This is an important issue. We emphasize to everyone that we do not take contact with individuals via e-mail. We have had over 200 confirmed instances of this. They come and go very quickly. They are largely operated offshore, sir, where something is set up and it looks like they refer you back to what looks like an IRS website.

As soon as we get word of it, we refer it to Treasury Inspector General for Tax Administration (TIGTA) that has the statutory authority in this area. Unfortunately, all too often, the damage is done. Somebody is sucked in. They say, we have got some money for you, purporting to be the IRS, and then some people do fall for this. It is very unfortunate.

Again, they will set up and then work for a little while then close down the shop.

Chairman LEWIS. Could you tell the Members of the Committee how many taxpayers have been abused by this scam?

Mr. EVERSON. We have had over something like 16,000 variants of this. I would not know how many people actually would be swept into it. That is 16,000 individuals, I guess, that we know of in these 200 plus schemes. However, there could be many more that have not actually come to our attention.

Chairman LEWIS. What has the IRS done about it?

Mr. EVERSON. Each time we hear about it, we immediately refer it over to TIGTA and try and get them involved on it. However, again, many times, most often these things are being established overseas. The responsibility—another question has been raised on setting up websites that look like the IRS, IRS.com or others. This is something that falls outside of our jurisdiction, sir. If there are abuses there, it is the Federal Trade Commission and the Department of Justice. I am comfortable with that.

Some have said maybe the authority to monitor that ought to be given to the IRS. I would not think that is the right answer.

Chairman LEWIS. However, at times, do you refer cases, incidents, to the Department of Justice?

Mr. EVERSON. I think TIGTA on the phishing schemes would act if they saw a basis to prosecute and confine the people who were actually the culprits.

Chairman LEWIS. The IRS provides some free tax assistance in IRS offices. How many returns have been prepared for free by the Internal Revenue Service this year alone?

Mr. EVERSON. I don't have the exact number for this year. However, that number has been declining over recent years. I think it was about 30,000 or 33,000 last year, down from up above. What has happened is we have given greater emphasis to our community partnerships where we have some 12,000 sites around the country help for the elderly, they are picking up that work, sir, at the same income—they have the same income threshold that we would use.

Chairman LEWIS. Do you have any idea how many taxpayers pay to have their returns prepared? What percentage?

Mr. EVERSON. If you look at the overall statistics, about 80 percent of all taxpayers are either using a paid preparer or some software. At this point, I think the paid preparer, I will give you the exact number for the record, but I think it approaches 60 percent of all taxpayers are using a paid preparer.

Chairman LEWIS. Thank you very much, Mr. Commissioner. Now I must recognize the ranking Member, Mr. Ramstad, for questions.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Commissioner, as you know, the bulk of the tax gap derives from underreporting. However, I am sure you will agree, there is no silver bullet solution. It seems an underpayment of taxes is an equal opportunity problem committed by individuals, estates, corporations large and small, as well as the self-employed.

As you know 2 years ago or three years ago, I believe it was in 2004, Congress authorized the use of private debt collection agencies to help close the tax gap. Also, it seems from what I have read and heard, that that effort is now bearing fruit with collections of unpaid taxes rising rather quickly.

My question is this. I know the IRS does a customer satisfaction and a quality rating for programs like the private collection agency program. How do those satisfaction and quality ratings compare to the ratings that IRS employees receive when they attempt to collect unpaid taxes?

Mr. EVERSON. We are running this program. It is a new program, as you indicate. We started this in September. I would say thus far, it is proceeding well.

There are, generally the customer satisfaction is very high. There are some complaints, several dozen complaints. A lot of those were received, about half of them, in the first month or two of the program. So, I would say that the quality indicators in that regard are good and comparable to what we do.

Collections is a tough business and it does generate complaints, whether it is being done by the IRS or by someone on the outside.

Mr. RAMSTAD. So, vis-a-vis the in house collection efforts, you would say the ratings are comparable?

Mr. EVERSON. I guess, broadly. I would say broadly speaking in the complaints we have been getting have been very limited in number, and we are following up on each one of them and trying to make sure, to meet my commitment I made to this Committee and others in the Congress, that we would hold this to a particularly high level. I meet with the team on this every month, sir, to make sure that they are satisfied with how this program is going.

Mr. RAMSTAD. I think every Member on this dais would be happy if his or her office only received several dozen complaints in the same time period. So, I think that speaks——

Mr. EVERSON. I didn't say those were the only complaints I got.

Mr. RAMSTAD. No, no. I am talking about the Private Collection Agency (PCA) program.

I want to also ask you as a follow-up, Commissioner, to a hearing that we held in the last Congress on the truly unbelievable tax fraud occurring in our prison system across the country. In addition, I was glad to see the President's tax gap proposals included legislation that Chairman Lewis and I introduced in the last Congress that would allow the IRS to disclose inmate tax violations to prison officials.

I mean, that was an absurdity that we learned at the hearing that such criminal behavior could not be reported to prison officials by the IRS.

Can you update us on the IRS efforts to crack down on tax return fraud by inmates?

Mr. EVERSON. The good news here, sir, as you will recall, we did have difficulties. Probably the most serious problem we had last year was the failure of us to get this Electronic Fraud Detection System (EFDS) system which was screening out the potential fraudulent refunds. We did not get that running for the filing season last year.

We have done that. This year, it is functioning. So, it is working on just those kinds of schemes. We are taking a deeper look now as to how we want to redevelop that system for the future to make it even better. However, that will be a process that will roll out over a period of years.

Mr. RAMSTAD. Again, Commissioner, I thank you. Thank you for your responsiveness to your questions. I look forward to your further interchange.

Thank you. I yield back.

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

Now I turn to Mr. Neal of Massachusetts for questions.

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

First, Commissioner, I want to thank you and the staff. We had a serious problem in my hometown of Springfield, Massachusetts, with retirees who had been exposed to what would have been a series of unfair penalties and interest charges. Also, the local office, working with my staff here in Washington, really did a fine job of coming to relief of the individuals that were involved. Also, 2,200 individuals will now not face the wrath of the IRS, largely because it was a mistake that the city of Springfield made. So, I do want to acknowledge the role that your office played in that instance.

Mr. EVERSON. Thank you. I wasn't familiar with that. However, I am glad to hear it, sir.

Mr. NEAL. Just a quick follow-up to Mr. Ramstad's question. Haven't there been some abuses with the whole notion of collections, though, that have been acknowledged?

Mr. EVERSON. You are talking about the private collection program?

Mr. NEAL. Yes.

Mr. EVERSON. We have had complaints. As I indicated, it is about five dozen out of 30,000 cases that have been placed. They run across a range of problems. Also, some have been things that we consider serious and we have worked with the contractors to address those.

We did take an action. The first tranche of this program ran through early March. We had three contractors working on that first element of the program. We had a go, no-go decision solely at the discretion of the and as to whether, looking at each contractor, we would extend them into a second period, a year.

We elected to extend two of the contractors. We did not elect a third. It was not that we felt they had not done their job, but we felt we had a very high confidence level. Also, the other two, we wanted to make sure that we did everything we possibly could to address any and all, and we felt better about the responsiveness of the two that we retained.

Mr. NEAL. Thank you. Let me go specifically to questions that I have more than a little interest in. Let me ask you about the Administration's proposals on closing the tax gap. As you know, I am currently working on legislation to provide long-term and significant relief from the Alternative Minimum Tax (AMT). However, as we all know, it doesn't come without cost. Also, closing that $345 billion annual tax gap is one major way we could provide relief to these 23 million families who expect to be hit this year by AMT.

I notice that the Administration's proposals, they will only raise 29 billion over 10 years. That is less than $3 billion a year for the $345 billion annual problem. I thought and had hoped that we would have had more energy from the Administration in efforts to close that tax gap, and nobody is better suited than you, Commissioner, to make recommendations on closing the gap. Moreover, we could certainly, I think, use more than what we are currently witnessing.

Mr. EVERSON. I appreciate your sentiment. The Secretary and I have had a lot of conversations on this along with Assistant Secretary Eric Solomon. I believe that what we have here is a balanced program. The funding component for the IRS, particularly to help us on the infrastructure side, because getting better infrastructure helps on services and enforcement.

Some have characterized even more directly than you the 16 initiatives as too modest. I think that they are an important start. I can tell you, I get a lot of heat from interested parties in here that they do not want us to do more third party reporting, the credit cards and everything.

We had five proposals, sir, last year. Only one of them got through. I would like to see us get these 16 done and then we will come back obviously and look at more. However, the problem is,

the more you do, the more you get into an incremental burden. In addition the more controversy you get to, as you know.

Mr. NEAL. Just quickly, who would be the individual that might be high profile in these instances that you might hope to target?

Mr. EVERSON. The proposal that I advocate most strongly is that first one that I mentioned, gross receipts for credit cards for businesses. If you go to the tax gap visibility chart, this shows you, sir, that out at the left is the amount of the tax gap that comes from wages or where you have third party reporting and withholding. There is only a 1 percent noncompliance rate in that instance. We know how much you make as a congressman. You are not going to fudge on that, nobody does. It is 1 percent.

If you go out all the way to the right, you get to a 50 percent or so noncompliance rate where there is no reporting or withholding. Also, this is largely underreported income in the small business community where there is a real significant understatement of revenues. We believe that the third party reporting, once a year, of gross receipts of a business, gross credit card receipts, will start to get at that problem.

Mr. NEAL. Thank you, Commissioner. Thank you, Mr. Chairman.

Chairman LEWIS. Thank you very much.

I now turn to Mr. Pascrell of New Jersey for questioning.

Mr. PASCRELL. Thank you, Mr. Chairman.

Thank you, Commissioner, for being here today. When I look at the returns of those of the IRS and how much money it has spent to collect back taxes, it is $1 spent for every $32 collected. When I look at private concerns and businesses that have been brought into the mix, it is $1 spent and we are collecting $4, so I want to talk about these private collectors.

The recent IRS data shows that the service spent 42 cents to collect each $100 of tax revenue in fiscal year 2006, the third lowest figure in the last 25 years and down from 46 cents the year before. In addition, among collection cases handled solely through phone calls, the same type of work that is being contracted out to private collection companies, the IRS has estimated a return on investment of about 13 to one.

So, why would the IRS agree to pay private collectors almost 25 cents for every dollar collected on the easiest cases, phone calls, easiest cases, in which the taxpayer themselves have not disputed the liability? Also, which IRS employees could collect much more effectively?

Also, then I want to ask you, how are these firms hired, a minicapsule of——

Mr. EVERSON. Sure.

Mr. PASCRELL. Would you answer the first question first?

Mr. EVERSON. Okay. I have consistently stated, sir, that the IRS could do this work cheaper. Although I would point out, at this point, having made the significant investments that we have made, if you look at the incremental money coming in, it will have already paid for itself and be totally in the black, if you will, by next April.

The blunt reality though is that, because of attrition in our work force, including at the phone centers, hiring to replace that attri-

tion, and then even if you have an enforcement increment billed as we do in the 2008 budget, it would take a number of years hiring and training at maximum capacity before we would get to the work that you are talking about. So, there is no short term capability for us to get to all of the potential collection work we have.

Also, why are we doing this? This is the law of the land, and Congress asked us to do that. It is true, the Administration supported it because of this issue. However, it is the law now.

Mr. PASCRELL. However, it doesn't mean, Mr. Commissioner, and you have a great responsibility and you do it well, but it doesn't mean that you capitulate if you think that the process that is being suggested is not working. In fact, that you had to reduce, to get rid of one of the collection firms is an indicator to me, and I am sure that you know more about this than I do, it is an indicator to you.

Mr. EVERSON. Yes.

Mr. PASCRELL. Also, there is a fetish here in this town of moving into the private sector. Furthermore, we want the private sector to succeed. However, if the numbers don't work out, Mr. Commissioner, you educate me as to what I am missing, please.

Mr. EVERSON. Let me go back to that second question you asked. There was a competitive procurement in which a number of entities applied, went through the normal government procurement process. In actual fact, the first time around, there was a bid protest, we had to redo this and we did it and we went with three.

I draw a different inference from the fact that we did not continue one contractor. I believe what we have done here is we have executed, made good our promise to hold to the absolute highest standard here because of the sensitivity. I recognize the sensitivity of it. I don't want this to in any way damage the agency's reputation or undermine respect for compliance with the tax law. So, I think what we did was we wanted to assure ourselves beyond any reasonable doubt. That is why we took the action, sir.

Mr. PASCRELL. However, it would seem to me in looking at the bottom line that there is only one inference I can draw. Also, that is that the public employees who have been charged with the responsibility of going after cheats and trying to reduce the gap that exists are doing a far batter job, are more efficient and more effective than the private collectors, God bless them all, that are not doing it. The numbers don't show that, do they, Commissioner?

Mr. EVERSON. I have said repeatedly that the and could do this work and that it would be cheaper. What I do draw to your attention is what I just said a minute ago, that our capability to do that over the period of the next several years, we would be unable to do that.

Mr. PASCRELL. Let the record show that, Mr. Chairman. Thank you.

Chairman LEWIS. Thank you.

Now I turn to Mr. Linder, my colleague from Georgia, for questions.

Mr. LINDER. Thank you, Mr. Chairman.

Commissioner, welcome.

Mr. EVERSON. Nice to see you, sir.

Mr. LINDER. Nice to see you.

The last year for which numbers were available, was that 2005, for the tax gap of 345 billion?

Mr. EVERSON. What that goes back to, sir, is it was research about tax year 2001. The returns came in in 2002. Also, during 2003 and 2004, they did the audits. It took a long time to get all the 46,000 audits done with all the procedural obligations and other things. So, it is 2001, unfortunately.

Mr. LINDER. What did you actually collect in 2001?

Mr. EVERSON. In terms of revenues?

Mr. LINDER. Yes.

Mr. EVERSON. I would have to go back and give you that figure. However, if you go back and you look at the 2.4 trillion that we collected last year in 2006, it was up over 600 billion from 2003.

Mr. LINDER. So, it wasn't 2 trillion?

Mr. EVERSON. Yes, because it was—what happened was 2001 was higher. The revenues, as you recall, they went down and they reached the low level. I think it was right about, I have it here, right about 2 trillion probably in total. Then it declined a little bit through 2003 and then it came back smartly, as I indicated.

Mr. LINDER. So, you collect about 80 percent of the money you think is owed?

Mr. EVERSON. That research indicated it is actually higher than that. It is close to 84 percent, sir.

Mr. LINDER. That does not take into consideration the underground economy?

Mr. EVERSON. That is correct, or illegal activity. It takes it into account to a certain degree, but it doesn't take into account illegal activity.

Mr. LINDER. Do you have any idea how large the underground economy is?

Mr. EVERSON. Well, cash, some cash transactions are taken into there. If somebody is doing a cash business, we do our best to estimate that within that piece. I probably misspoke.

Mr. LINDER. What do you think the size of the underground economy is today?

Mr. EVERSON. I don't have a precise figure on that.

Mr. LINDER. Would you be shocked if I said it was over 2 trillion?

Mr. EVERSON. That sounds quite significant to me, but I am not the economist.

Mr. LINDER. Do you take into consideration tracking money offshore?

Mr. EVERSON. We do our best to do this. This is a very tough area. The intentional disguising of flows of funds offshore, particularly by individuals, is very hard to track, especially if it goes through tax havens or countries that have secrecy laws or, in some instances, don't have treaty obligations for exchange of information with us.

Mr. LINDER. Three different groups, McKinsey was one, Boston Group was another and a third one I forget, but in 2005 they estimated the size of the offshore economy in excess of 10 trillion, growing by 800 billion a year. Does that sound real?

Mr. EVERSON. I have seen large numbers like that, yes.

Mr. LINDER. Why is that money offshore?

Mr. EVERSON. I am not going to get drawn, sir, into a policy debate that gets over my head. There are a variety of factors in this. One is, there is no doubt, there are competing tax systems in the world, across the world. That is fine. You write a law that sets up a tax system in this country and if other countries do something different, there is a certain degree of competition for capital, if you will.

The other thing that is in there, though, is a compliance issue where some might seek to get out from under the scrutiny of their host nations, if you will.

Mr. LINDER. Do you get access to credit card information?

Mr. EVERSON. The offshore credit cards, we do not routinely get that. We went through one initiative to look at that. I would not characterize it has having been particularly successful in terms of what we did learn through our offshore initiative.

Mr. LINDER. If a high net worth individual had significant money offshore and had a debit card at that bank and just paid for everything they bought with that debit card, would you ever know that?

Mr. EVERSON. We probably wouldn't unless we stumbled across it on an audit for some other reason that we were looking at, sir.

Mr. LINDER. Thank you, Mr. Commissioner. Thank you, Mr. Chairman.

Chairman LEWIS. Thank you very much.

Now I turn to Mr. Pomeroy of South Dakota for questioning.

Mr. POMEROY. Mr. Chairman——

Chairman LEWIS. North Dakota.

Mr. POMEROY. Thank you. One time, I was introduced as being from North Korea.

It is a great pleasure, Mr. Chairman, to be with you on this panel.

Chairman LEWIS. Thank you, Mr. Pomeroy, for being here.

Mr. POMEROY. I appreciate it very much. I think the work of this Oversight Committee is so extremely important.

Commissioner, it is great to see you again.

I have been interested for some time in this whole business of e-filing and the unique joint venture with these private partners to try and expand e-filings. Now, our e-filing numbers, as good as they are, are not what we hoped they would be. Do you recall what the targets were for by this time?

Mr. EVERSON. I believe when Congress led on this it was back in Revenue Service Restructuring and Reform At of 1988 (RRA 98) (P.L. 105–206). The target that was established was to get to 80 percent by 2007. Also, it has been recognized, as I think you are inferring, for some time that this is not going to happen. The program has continued to grow, as you know, and it is growing again this year by several percentage points.

Mr. POMEROY. It is absolutely fascinating. It is maybe the best way to watch the technological transformation of the United States of America. However, you have got this huge database of tax filers and preparation and submission of a tax return is fairly——

Mr. EVERSON. It is a tremendous success, of which the Congress for setting that goal, I would suggest to you, and you were here, I wasn't, it was a guess. It was not an informed——

Mr. POMEROY. There are a couple disappointments that I have relative to whether this free file alliance thing is something we need to continue as people do continue to progress in their own maturity in terms of accessing the IRS webpage and using information you make available, as you talk about.

Mr. EVERSON. Yes.

Mr. POMEROY. First of all, I know we used to, as part of the deal we struck with our private partners, we used to let them sell all kinds of stuff. I use the refund anticipation loan, which is the tax equivalent, in my view, of a payday loan, a bad value for the consumer in every instance, we used to allow the marketing of that right as part of the deal.

Now that has been reduced somewhat. Can you tell me what——

Mr. EVERSON. Yes. Happy to do that. The free file program never had a high takeup rate on the Refund Anticipation Loans (RALs). Let me be clear for the Committee, I think the RALs re predatory. I think they are extremely distasteful. However, the free file program had a low percentage of RALs. I think it was actually less than 1 percent.

Nevertheless, we have expressed concern and they have dropped those this year altogether as well as any tie in to products. So, I believe most people would agree, it is a much cleaner program now, this filing season, sir, than it had been.

Mr. POMEROY. I appreciate those changes. I think they are responsive to questions you have had in the Oversight Committee in the past. I appreciate it.

There is a new one that I have discovered, not that I have discovered, I note the taxpayer advocates' comments on, and that is this business of providing e-file providers debt indicators on taxpayers for purposes of whether or not they might underwrite this refund anticipation loan.

Mr. EVERSON. Yes.

Mr. POMEROY. Now, if I understand it correctly, Commissioner, we are allowing confidential taxpayer information to be shared with e-file providers so that they can essentially write a zero risk loan that they price at predatory rates, as you and I acknowledge these things are predatory. Why in the world would we provide sensitive taxpayer information such as debt indicators to private businesses inquiring about taxpayers?

Mr. EVERSON. Sure. This has been studied and we took a good look at it as to whether we ought to reverse ourselves on this. The group of people that looked at it decided that this actually is of more benefit to the taxpayers than not for two reasons. One, if you didn't have that information there, what it is basically doing is saying, if that loan, instead of the refund coming back to the taxpayer and being able to pay off that loan, if the taxpayer is unaware that there is going to be an offset, because when they file that return the and is going to take that $3,000 because they owe it to the, then that person is going to owe the $3,000 to the and still and also owe the money on the loan, so——

Mr. POMEROY. Commissioner, Commissioner, Commissioner, you and I know how the financial markets work. It is just possible, if this is a noncreditworthy applicant for a loan, the ultimate per-

son that is not going to get paid is the private entity, the e-file provider, the one that is charging the exorbitant, usurious interest.

Mr. EVERSON. We were satisfied——

Mr. POMEROY. You want to take them completely out of the risk. So, you basically allow the providing to e-file providers of sensitive, confidential taxpayer information so they can write a zero-risk loan for which they charge high interest.

I don't know what group consulted you. Also, I will tell you what, I am mightily offended that confidential taxpayer information is provided to banks that are then charging high loans to taxpayers. This thing calls out for greater scrutiny. I think you have made a terrible call here.

Mr. EVERSON. We were convinced, sir, also that the banks would just charge higher fees to absorb that bad loan cost, and that they would do that. So, that is the other reason.

Mr. POMEROY. Well, I will tell you, I think that is really a shocking piece of news. I am really disturbed by it. I will look forward to working with you on it, Commissioner.

I yield back.

Chairman LEWIS. Thank you, Mr. Commissioner. Thank you, Mr. Pomeroy.

Now I turn to Mr. Crowley of New York for questions.

Mr. CROWLEY. Thank you, Mr. Chairman.

Shift focus in the issue for just a moment. My question deals with the earned income tax credit.

Mr. EVERSON. Yes, sir.

Mr. CROWLEY. It is my understanding the IRS automatically scans every return and through that process, they pull out those that they think ought to qualify for the earned income tax credit and then notify the taxpayer with the appropriate forms that they would need to complete in order to get a return from the IRS and from the Federal Government. We appreciate that. I understand that process.

From what I understand, and correct me if I am wrong, Commissioner, the taxpayer fills out the return and then returns them to the IRS. Many do not do that. Many do not go through that process who otherwise would qualify for them. However, those that do return them, do get a check back from the IRS, correct?

Mr. EVERSON. Yes. I am not sure that the procedure you mention at the start is correct. New York is trying to do that. You may be thinking about a program they had in New York. Also, at a Federal level, I do not believe——

Mr. CROWLEY. No, no, no. I am speaking about in terms of you write the letter to the taxpayer saying that you are qualified for the earned income tax credit?

Mr. EVERSON. We have outreach programs. We have 12,000 partnership locations around the country where they are doing active outreach.

Mr. CROWLEY. I guess my question is, does the IRS ever notify the taxpayer that he or she is qualified for the earned income tax credit, possibly?

Mr. EVERSON. I don't believe that we reach out directly in that regard. I will have to answer that for you for the record, sir.

Yes, it is confirmed to me that is incorrect. We do not do that.

Mr. CROWLEY. So, the Federal Government does not notify an individual——

Mr. EVERSON. No. Also, there are many factors, sir, as to why you might or might not be eligible. You frankly wouldn't know whether you have a qualifying child or whatever else. You wouldn't want to mislead somebody on those series of issues. We don't do that on anything in the Code.

Mr. CROWLEY. So, it is not true that you send—you do not send a letter to 500,000 to 700,000 people per year letting them know that they may be eligible for the earned income tax credit?

Mr. EVERSON. Oh, well, previous filers, I gather. However, that is different from all the—I thought you were sort of referring to the larger population of individuals that may qualify but have never taken part in the program.

Mr. CROWLEY. Okay. So, of those individuals, the half a million to three quarters of a million people that you send a letter to telling them that they are eligible for the earned income tax credit, many of them do not then follow through and request—fill out the form and then, through the form, receive their check, correct?

Mr. EVERSON. Okay. It is a highly transient—there is a lot of turnover in that population for a whole host of reasons. One of them is the success of the program and people no longer qualifying.

That is right, we are concerned because, while it is a very successful program with about an 80 percent participation rate, still 20 percent of the eligible people aren't claiming the credit.

Mr. CROWLEY. Well, let me ask you this. Could the IRS in the first letter that you send out to those individuals ask about the past 3 years as well as that present year? In other words, if the individual knows that he or she may be eligible 3 years and not just 1 year of a rebate or a check, why is it you don't do that?

Mr. EVERSON. I don't know why. We will take a look at that, sir. I know again, the community partnerships, when they get somebody to apply and take the credit, they often go back and then try to determine was there eligibility for the 3 years, because then that $4,500 credit can become over $10,000. So, they try to do that.

Mr. CROWLEY. The reason why I ask that is because, as you and I had a private discussion before, many of these people, all these people are working poor. They don't have the resources nor the time, necessarily. They are raising families, they are doing everything they can to put food on the plate. No one wants to walk away from money.

There also is maybe an innate fear of the IRS and the Federal Government and all those other issues. Why is it that we can't work in a way—this is a great program, you and I have talked about it before. It is working for so many Americans in terms of an antipoverty program. However, still there are many. Look at my district alone, $55 million is left on the table.

If I were to bring $55 million back to my district, I would be unbeatable. Yet, and what that could do to the economy of my district. I have a hardworking district, but $55 million that ought to be in the economy is not in the economy because people are not able to access the complexity of the form, the format, in terms of my constituents.

Even the present Secretary of the Treasury said that the forms for filling out the application for the EITC is so complicated he couldn't even do it.

Mr. EVERSON. I don't think he qualifies.

Mr. CROWLEY. No, he doesn't. He doesn't qualify. However, he is the former head of Goldman Sachs, and he had difficulty filling it out.

Mr. EVERSON. No, I agree.

Mr. CROWLEY. So, there is something wrong here when there are eight definitions for a child. We are asking people who have a very incredibly difficult life to begin with to have to go through that process.

Mr. EVERSON. Sir, this goes back to Ranking Member Ramstad's comments. Complexity beguiles success in this area, as in so many other areas of the Code. Simplification would be important here.

Mr. CROWLEY. We would like to work with you, and the Chairman——

Mr. EVERSON. We are devoted to doing better on this. It gets a lot of my personal time. The Secretary has got an interest. I will look forward to working with you directly on it.

Mr. CROWLEY. Suggestions that we may make to help make this possible.

Mr. EVERSON. Absolutely, sir.

Mr. CROWLEY. Thank you.

Chairman LEWIS. Thank you very much, Mr. Crowley, for your line of questions. With the Commissioner, it is something that we all can work on.

Now, I recognize the gentleman from California, my classmate, Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman. I appreciate, even though I don't serve on this Subcommittee, you allowing me to sit in. This is certainly a very important issue. No one wants to pay more taxes than they have to. Yet it does concern all of us if there are some out there who are cheating who aren't paying theirs that we get that in. The concern is there is this balance we have, that we aren't over-inflicting pain on our taxpayers, but it is the medium we should have.

Mr. Commissioner, last year, the Congress passed some legislation in a provision in section 511 that would require the, State and local and to withhold 3 percent of every payment made for goods or services. This would most likely apply to payments to government contractors as well as Medicare, farm disaster payments. Are you familiar with this?

Mr. EVERSON. Yes, sir. We had a proposal, one of the five proposals we made touched on this area. The Congress went further with the withholding you are referring to than what the Administration had suggested.

Mr. HERGER. Right. My concern is with how much further we went. Particularly with how it affects small businesses. Some small businesses, their profit margin isn't even maybe 3 percent that is going to be withheld.

My question to you, from the Governement's standpoint, the Federal Government, is the cost that would be involved and your abil-

ity to be able to implement this. This hasn't gone into effect yet. Hopefully we can make a change so it doesn't go into effect. Also, each payment that is withheld would generate an additional filing with the IRS. That is a great deal of paperwork.

Does the IRS have the capability to match and credit all this additional data with the taxpayer identification numbers?

Mr. EVERSON. We will have to improve our infrastructure to do that. With any change in the law, sir, it has a cost impact on the IRS, just to make sure that we update our systems. When you get to third party reporting or withholding of new provisions, we do have to work on that. So, there would be a cost, as there is with most provisions.

Mr. HERGER. Can you tell us how large an investment? and Just an estimate, in the IRS infrastructure, like new computer systems or additional personnel would be required to fully implement this provision?

Mr. EVERSON. I would have to get you an answer for the record. We do have some additional moneys that are provided in our budget for the accompanying legislative proposals this year in the tens of millions. It is not a huge amount of money. I don't have a specific figure for that statute. I will be happy to get it for you, sir.

Mr. HERGER. Given the changes that would be required for the IRS, how difficult do you suppose it would be for State and local s to comply with these new requirements as well?

Mr. EVERSON. I have not had any conversations with my counterparts at the State level. I have heard opposition to this, as you indicate, from small businesses. I have not heard that, any commentary from State officials.

Mr. HERGER. Maybe some again, we have a couple years yet before this would be implemented. Some of them probably aren't aware yet.

However, do you believe that this will result in more correct tax filing for companies that are unaware, uneducated about the laws, not attempting to cheat, but who just don't know better?

Mr. EVERSON. As I indicated before, where there is third party reporting and withholding, you get much better compliance. That does happen. However, there is, as you are indicating, incremental burden.

Mr. HERGER. Very good. Thank you very much.

Thank you, Mr. Chairman.

Chairman LEWIS. Thank you very much.

Now I turn to Mr. Doggett for questions, Mr. Doggett of Texas.

Mr. DOGGETT. Thank you, Mr. Chairman. Thank you, Commissioner, for your testimony this morning and for your courteous reply to my letter expressing concern about the way auditing is being handled of businesses.

Mr. EVERSON. Yes, sir.

Mr. DOGGETT. I would like to ask the Chairman to make my letter to you and your response of February 28 a part of the record. I think your comments there are important, I would like to just review some of that with you.

I don't know if you have a copy, but I am going to quote directly from your letter.

Chairman LEWIS. Without objection. It will be included in the record.

[The information follows:]

LLOYD DOGGETT
25TH DISTRICT, TEXAS

COMMITTEE ON
WAYS AND MEANS

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HEALTH
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January 23, 2007

Mr. Mark W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue NW
Washington, D.C. 20224-0002

Dear Commissioner Everson:

I am writing to express my concerns about the Internal Revenue Service's reported practice of prematurely closing corporate audits without fully investigating their efforts to avoid legal taxes.

As detailed in the *New York Times* on January 12, 2007, large- and mid-sized business auditors for the I.R.S. in multiple states reported being ordered to ignore tax avoidance issues that would prevent the audit from closing by a predetermined date. These disturbing accounts of agents being refused access to I.R.S. experts, to necessary resources, and the time needed to fully complete audits permits corporate respondents to pay only a fraction of the taxes they potentially owe. This "catch and release" policy must end.

The I.R.S. has stated that its practices have increased the amount of corporate taxes paid. However, the employee reports indicate any increase in collections can be explained by an increase in tax avoidance schemes, not the troubling I.R.S. policy of limiting the time and scope of audits. Corporate tax creativity should not be rewarded by donning blinders or looking the other way and closing cases where the facts suggest a broader investigation is required.

The use of performance incentives that reward closing cases in place of enforcing the law and collecting billions in tax avoidance each year is unacceptable and runs counter to the letter and intent of the law.

I request a full report on these disturbing practices and a cessation of short cycle time and limited-scope audit policies that cost the government billions of dollars a year.

Sincerely,

Lloyd Doggett

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

February 28, 2007

The Honorable Lloyd Doggett
U. S. House of Representatives
Washington, DC 20515

Dear Mr. Doggett:

I am responding to your January 23, 2007, letter about assertions made in a *New York Times* article on the IRS's large corporate audit program. I appreciate your support of our mission to collect the taxes that are due the government from both ordinary citizens and large corporations alike. We have made large corporations and high-income individuals the focus of significant compliance efforts over the past several years.

We took great care in our decision to shorten corporate audit time and increase the number of corporate audits. Our decision arose from a recognition that the corporate enforcement function of the IRS had declined in the years since the IRS Restructuring and Reform Act of 1998. For example, corporate audit coverage had declined by 2003 to less than half its 1997 levels, managers and field staff were sometimes reticent to use enforcement tools, and we were not addressing abusive tax shelters with sufficient vigor.

We have successfully rebalanced the corporate audit program to address these and other concerns. Specifically, we increased the total number of corporate audits by 21 percent from 2001 to 2006, and the number of audits of the nation's largest corporations, those with assets of $250 million or more, by 29 percent. Significantly, corporate tax receipts increased 169 percent from 2003 to 2006. I am enclosing a chart on corporate tax receipts and audit data. We achieved these increases while the size of our workforce that audits these entities has remained flat. This suggests that we have done more than simply ride the wave of economic growth of recent years.

Moreover, we have good reason to conclude that well-designed and well-executed audits of shorter duration can be more effective than traditional, protracted, large-business audits. This is true because we can redeploy savings in examination time earned in one case to other cases, including some cases that might not have otherwise been examined. Targeting key issues, holding employees accountable for disciplined application of their work time, and evaluating the likely outcome of the expenditure of additional time and resources constitute sound practices. Slow-paced audits that can drag on for years do not serve the interest of the government or taxpayers, particularly when they involve compliant taxpayers.

The *Times* article cites accusations by employees that managers directed them to conclude examinations prematurely, at significant cost to the government in lost revenue. In promoting more efficient and swifter resolution of corporate audits, we rely on field managers and auditors to make appropriate choices, including the hard choices that often present themselves when they must decide to bring an audit to conclusion. This certainly includes, where appropriate, bringing an examination to closure more swiftly than might have been the case in the past. It also includes extending examinations in appropriate circumstances beyond the originally anticipated closure date.

We monitor the success of these new audit procedures, in part, by continuously scrutinizing metrics for signs of possible compromises in corporate examination quality. For example, a significant increase in the number of examinations closed that is accompanied by a corresponding decrease in proposed adjustments per return or per hour of examination time, or an increase in the no-change rate (the proportion of cases where we initiated and concluded an exam without any adjustment) will normally result in scrutiny by management and field executives. We also rely on other processes and measures that can point to possible compromises in examination quality, such as quality control scores, employee satisfaction scores, review by a unit independent of the field to ensure that audit quality standards are met, and feedback obtained in business forums, town halls, and one-on-one meetings between managers and direct reports. They share a common purpose in communicating our recognition that examiner judgments, such as extending an examination in appropriate instances until we can more fully work the issues, occupy an important place in the corporate examination process.

I also assure you that we do not agree in advance to limit the scope of corporate audits in a way that "handcuffs" examiners from exploring issues that we may identify during an audit. Our practice is to develop and follow an audit plan to conduct these large-scope examinations. These plans allow us to convey to the taxpayer the expected path and timetable of the audit and our needs in terms of documentation and discussions with their staff. We also identify the issues we anticipate concentrating on. In no event do we fashion the plan in a way that prevents us from pursuing additional issues we may identify as we conduct the audit.

To deter the rewarding of performance incentives for closing cases, the IRS Restructuring and Reform Act of 1998 (RRA 98) prohibits us from using records of tax enforcement results to evaluate employees or to impose or suggest production quotas or goals. It also requires us to evaluate employees using the fair and equitable treatment of taxpayers as a performance standard. We require quarterly certifications from managers that attest to whether we have used Records of Tax Enforcement Results (ROTRs) or production quotas or goals in a prohibited manner. Annually, the Treasury Inspector General for Tax Administration (TIGTA) determines whether we are complying with restrictions on the use of enforcement statistics.

When employees believe internal processes are inadequate to address their concerns, we tell them that they may seek redress from external overseers, such as TIGTA, the General Accountability Office, or other bodies.

I hope this information will bolster your confidence that we are meeting the Congress's expectations, contrary to the tenor of the article. I would be happy to meet with you to discuss this further. Please contact me or call Floyd Williams, Director of Legislative Affairs, at (202) 622-4725 if you would like to schedule a meeting.

Sincerely,

Mark W. Everson

Enclosure

Congressman - I am sorry this response did not come to your corner, and am glad you raised the subject at the recent Budget Committee hearing. I would be happy to meet with you directly on any follow up questions you may have.

Mark

Enclosure

Corporate Tax Receipts / IRS Audit Data

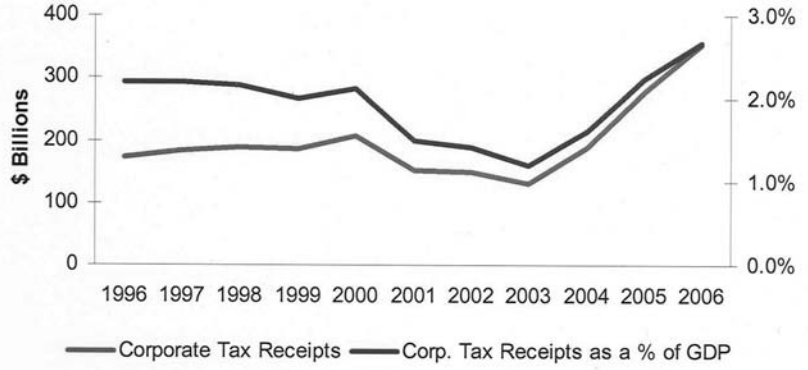
Corporate Audits (Assets $10 Million - $250 Million)	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	% Change FY03-FY06
Returns Audited	5,413	4,694	3,795	5,137	5,970	6,302	66%
Dollars Recommended ($B)	$0.54	$0.63	$0.80	$0.76	$1.42	$1.31	64%
Dollars Rec. per Return ($K)	$99.3	$140.4	$211.8	$147.5	$238.5	$208.6	-2%
Audit Cycle Time (months)	17.0	17.1	18.3	13.6	12.0	10.0	-45%
Audit Staff Years (direct time)	368	353	291	323	375	432	48%

Corporate Audits (Assets over $250 Million)	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	% Change FY03-FY06
Returns Audited	3,305	3,749	3,330	4,386	4,859	4,276	28%
Dollars Recommended ($B)	$12.77	$13.67	$12.29	$15.23	$30.14	$25.53	108%
Dollars Rec. per Return ($M)	$3.86	$3.65	$3.69	$3.47	$6.20	$5.97	62%
Audit Cycle Time (months)	31.9	33.2	32.8	29.4	31.2	29.0	-12%
Audit Staff Years (direct time)	1,230	1,260	1,187	1,279	1,237	1,151	-3%

Total Corporate Audits (Assets over $10 Million)	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	% Change FY03-FY06
Total Returns Audited	8,718	8,443	7,125	9,523	10,829	10,578	48%
Total Dollars Recommended ($B)	$13.31	$14.30	$13.10	$15.99	$31.56	$26.84	105%
Dollars Rec. per Return ($M)	$1.53	$1.69	$1.84	$1.68	$2.91	$2.54	38%
Audit Cycle Time (months)	23.0	24.4	25.4	21.1	20.9	17.8	-30%
Audit Staff Years (direct time)	1,598	1,613	1,478	1,602	1,612	1,583	7%

Government Receipts ($ Billions)	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	% Change FY03-FY06
Corporation Income Tax	$151	$148	$132	$189	$278	$354	169%

From 2003 to 2006, Corporate Tax Receipts Increased 169% and More than Doubled as a Percentage of Gross Domestic Product



Mr. EVERSON. I am familiar with this issue, as you know.

Mr. DOGGETT. Yes, sir. We have talked about it previously on the Budget Committee.

You indicate in your reply that one effect of the IRS restructuring and reform act 1998 is that "corporate audit coverage declined by 2003 to less than half its 1997 levels." Or, in other words, at the time you got to the Service, the level of corporate audits had dropped by more than 50 percent since the passage of this act; is that correct?

Mr. EVERSON. That is correct, sir. That was not unique to corporate audits. There was a broad-based decline in our enforcement activities.

Mr. DOGGETT. You also stated in the letter that the managers and field staff at the Service "were not addressing abusive tax shelters with sufficient vigor" at the time you arrived there at the Service?

Mr. EVERSON. I believe that, sir. I believe that the long time it has taken to issue regulations and then do audits and then go through the appeals process in the courts, this helped contribute to the confidence and the creation of these abusive shelters.

Mr. DOGGETT. Of course, you certainly agree that if we, as you determined had occurred there, if we failed to vigorously address abusive corporate tax shelters, that simply adds to our soaring national debt and it means that much of the tax burden is shifted to the hardworking taxpayers, individual and business, that are playing by the rules and paying their fair share.

Mr. EVERSON. Going after the corporations and the high-income folks was job one for me over the last four years.

Mr. DOGGETT. It also remains a high priority at the Service to address abusive tax shelters, does it not?

Mr. EVERSON. I agree with you, sir.

Mr. DOGGETT. Determining where to focus the limited resources that you have, I know, is important. Corporations, and you refer to the class of corporations with assets over $250 million in your letter to me, because they control about 90 percent of all corporate assets and contribute about 87 percent of all corporate income, it is important to ensure that those large corporations are paying their fair share of taxes and I believe, are they not, that they are more or less responsible for roughly three-fourths of the taxes that the auditors find in their audits are owed to the government?

Mr. EVERSON. You mean the corporate——

Mr. DOGGETT. The corporations——

Mr. EVERSON. There is a very disproportionate piece. That is where the action is, yes, sir.

Mr. DOGGETT. These corporations, of course, have the ability to hire the brightest and most creative people in their tax departments. I will tell you they also have demonstrated the ability to hire the best and brightest lobbyists and they have the most flush political action Committee in terms of influencing what we do here.

You also note in your letter that the size of your work force for audits of these entities has remained flat. So, you are having to audit using audits of a shorter duration to try to stretch your work force to address these large corporations, are you not?

Mr. EVERSON. I would say it is partially to get more coverage. Also, as I indicated, I do believe this is a case, and as Gladstone

said, justice delayed is justice denied. I think it is in everybody's interest to get these things resolved.

Mr. DOGGETT. Absolutely. If you have an audit that goes on forever, that is unfair to the taxpayer.

Mr. EVERSON. Yes.

Mr. DOGGETT. On the other hand, if you have a cut and run audit, where you leave prematurely and you don't do the audit thoroughly, it is unfair——

Mr. EVERSON. I agree 100 percent with that.

Mr. DOGGETT. It is also noteworthy that once you close one of these audits, if they are closed prematurely, they won't be reopened. They are done and closed while you are commissioner and for any future commissioner?

Mr. EVERSON. That is correct.

Mr. DOGGETT. In order to encourage performance from your managers and auditors that would return the maximum amount of money owed, is there any reason why the performance incentives cannot be based on the identification of new tax shelter scams or previously unidentified issues?

Mr. EVERSON. It is probably illegal.

Mr. DOGGETT. To focus on the issues, even though you are not evaluating based on revenue raised?

Mr. EVERSON. There is a section of the law, section 1204, that says you cannot evaluate individuals based on enforcement results. It would take careful analysis as to where that would get you. However, you would be in a competition for Joe got shelter X which was worth a billion and Susie only got shelter Y, which was worth 80 million.

Mr. DOGGETT. Are you familiar with the use of sweeps where agents with cases that have been in process for certain periods of time are told that those cases must be closed by a certain date, regardless of whether they have found all that's owed in a particular case?

Mr. EVERSON. Not really. I have, again, given the directive that we work to reduce the cycle time and I believe we have made some—this hasn't been a dramatic change, a period of several months. Where we are really going to get faster, sir, is with the electronic filing now is really going to change things. However, management looks and if someone says, I have more to do, they have that discussion and then they make a decision.

Mr. DOGGETT. So, sweeps do not happen and would be contrary to policy at IRS?

Mr. EVERSON. I am not sure what a sweep is, and I would ask you to define that and I will get back to you for the record.

Mr. DOGGETT. Is that a term that you have heard of before?

Mr. EVERSON. No, it is not a term that I have heard of.

Mr. DOGGETT. Has IRS used quotas or goals for revenue agents with regard to the number of cases that they are expected to close in a certain period of time.

Mr. EVERSON. Not to my knowledge.

Mr. DOGGETT. That also would be contrary to IRS policy?

Mr. EVERSON. I would not want quotas to be used there. I do want serious conversations about how long we are working on this. One of the issues we have here is we have some employees who are

upset now because we are enforcing standards where they need to rotate off an audit after an extended period of time, like 7 years. Some people don't want to do that.

Mr. DOGGETT. I understand that there have been enough complaints about rotating them off before some of the auditors think it is appropriate to be rotated off, that a Deborah Nolan, who heads the division of businesses of 10 million and above, has set up a website for those auditors to forward their complaints?

Mr. EVERSON. Yes, she and I are both very concerned about this. Also, I think that the employee engagement, the satisfaction with the programs generally in that area is high. There is clearly a small group of people that is dissatisfied with the very issues you are getting after.

Mr. DOGGETT. Are those types of complaints that are coming in to that website with appropriate redaction something that you can forward to this Subcommittee if an appropriate request is made?

Mr. EVERSON. I would be happy to keep you personally informed on this, sir.

Mr. DOGGETT. The use of the limited issue focus examination, is that something that is being done currently in this area?

Mr. EVERSON. It is. We have a variety of programs, sir. We have something called the Capital Access Programs (CAP) program, which is to work with large corporations to try and get—if we can identify issues and get the returns accepted as filed.

Mr. DOGGETT. Specifically on what is called the Life program, it requires a risk assessment before it is implemented, doesn't it?

Mr. EVERSON. It does. My understanding is the employees and the managers, the team that is working on this, they get together, they make the decision. It is not driven down from the top, look only at A, B and C. It is the team members, the auditors themselves, that make the choices.

Mr. DOGGETT. Thank you, Mr. Chairman. I will have a few more questions in the next round.

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

Thank you very much, Mr. Commissioner.

I now recognize Mr. Tiberi from Ohio for questioning. You may have some extra time also.

Mr. TIBERI. Thank you, Mr. Chairman.

Mr. Commissioner, the last time you came to Congress, you were testifying before the budget Committee. You were nice enough to bring your daughter. I hope her experience wasn't too bad that you didn't bring her back this time.

Mr. EVERSON. We had an argument last night, and I don't think she would have come if I had asked her today.

Mr. TIBERI. Thank you for being here today. We really appreciate it.

I was talking a couple weeks ago to a person I know back in central Ohio who has been doing taxes for 30 years for individuals and small businessowners. She has a Certified Public Accountant (CPA), she has a tax background in law, so she is a tax lawyer as well. She was lamenting to me about how, over the last 30 years, we in Congress have made it so much more complicated for regular individuals to do their own taxes. It is gotten to the point where she, as a tax lawyer and CPA, has to constantly reeducate herself

for her client base. So, while we have maybe helped her and her profession, in terms of being more in need of them, she doesn't believe we have helped make it any simpler for Americans to file their taxes.

In relation to that, she was telling me how—I don't know if you have heard this before—how we have also made it more difficult for people like her in doing taxes, in terms of the responsibility that goes along with a CPA and a tax lawyer, in certifying a client's taxes. At the same time, agencies that have cropped up on the outside who are doing people's taxes may not be a CPA, may not be a tax lawyer, and don't have the same sort of responsibility to have the tax return of their clients done in an ethical manner.

Is there something that we can do here in Congress to make sure that playingfield is level while we talk about this tax gap?

Mr. EVERSON. Sure. This has been the subject of a fair amount of discussion, just last year in fact, should there be regulation more broadly of preparers. I have been reluctant to embrace that at this stage because of our capability to administer it, should it happen. I do believe that where people are unscrupulous, instead of if someone is making an error because they don't understand it, they are providing a lower level of service, that is one thing. Perhaps through education and testing you would do better. However, I would worry where people are unscrupulous, they would say, I have this prepared, now you just sign it and they won't show up as a preparer at all. So, the idea that this would get after fraud, I don't think it would.

Mr. TIBERI. Thank you. Do you think that there, obviously not today but over the next several years, that we as policymakers, from what you have seen, can get back to where we were 30 years ago, in terms of my dad with a sixth grade education, who was a laborer and is retired today, could do his taxes like he did 30 years ago, because it was a lot simpler? Our Tax Code was a lot simpler. Instead of him having to go hire an accountant to do his taxes? That that would help solve this tax gap as well? Plus the cost to Americans to find a preparer to do their taxes? If we simplified our Tax Code, would that help?

Mr. EVERSON. I am a strong advocate of simplification of the Code. What I say, sir, is that complexity obscures understanding. The taxpayer who seeks to comply can be confused and finally raise their hands and say, why bother. Or the taxpayer who seeks to avoid or evade taxes can use complexity as well. So, I think simplification would be a good thing.

The other point I would make to you, sir, is this is a hard issue. We have a representative democracy and your constituents, they asked you to do your best to get them a slightly separate deal from Mr. Lewis's constituents in Georgia, and that is the nub of this. That is the competition between good policy, simplification, and a representative democracy.

Mr. TIBERI. So, when we talk about the tax gap, this friend of mine who has been doing taxes for a long time, she believes that much of that—comment on this—much of that comes from small businesses, entrepreneurs, individuals who don't realize maybe that they are not paying as much as they should be paying. Can you comment on your thoughts of where that gap might be?

Mr. EVERSON. The biggest piece of the tax gap—there are three components. There is the area out at the left, less than 10 percent, that is nonfiling. The area out at the right is underpayment. Over 80 percent of the tax gap is in underreporting of income, mostly by individuals.

When you get down within that, there is a lot that is associated with small businesses. There is no doubt confusion. I would suggest to you, sir, that the biggest component of that is understatement of revenues. I have got to tell you, this comes down to the fact that there is no third party reporting on the revenues. What is so hard to understand if you have 100,000 in revenues that you have to report 100,000 in revenues? That is not necessarily a confusion issue.

There are a lot of things in the code that are a confusion issue, though.

Mr. TIBERI. Talking again about the tax gap, the tax collection program by private tax collectors, are there other agencies in the Federal Government that use private tax collectors to your knowledge?

Mr. EVERSON. There are a number of other agencies. The Financial Management Service (FMS), part of Treasury, also education loans, they use private debt collectors. Over 40 States use private collectors for elements of their tax collection program.

Mr. TIBERI. Do you believe that without these private collectors that you would have taken in less money last year?

Mr. EVERSON. Yes, sir. We are now successfully implementing that program. We brought in I think about $12 million so far. It will increase over time.

As I have indicated in questioning before, this is work we could not get to, even if you wanted to throw money at us in the next few years, we just couldn't have the capacity to hire and train all the people to do the work.

Mr. TIBERI. Last question, Mr. Chairman. Thanks for your indulgence.

Do you believe since you have been at the IRS that private collectors have helped close that tax gap?

Mr. EVERSON. This is a new program. It has not yet generated significant returns. It is—Senator Grassley has called it a pilot. I think it is very much in the wait and see mode.

Mr. TIBERI. Thank you. Thank you, Mr. Chairman.

Chairman LEWIS. Thank you very much.

Now I turn to Ms. Tubbs Jones for questions, Ms. Tubbs Jones of Ohio. You may have some extra time for being so patient.

Ms. TUBBS JONES. Thank you, Mr. Chairman, Mr. Ranking Member.

Before I get started, I would like to have the students from Cuyahoga Community College Metro Eastern and Western Campus to stand up. Stand up, ladies and gentlemen. Meet the Chairman of the Subcommittee on Oversight, Ways and Means, Congressman John Lewis from Georgia, the Ranking Member, Mr. Ramstad, and meet the IRS commissioner, Mr. Everson.

Thank you, ladies and gentlemen.

Chairman LEWIS. Welcome. We are delighted, very happy and very pleased to have you here, seeing how the and works.

Ms. TUBBS JONES. I'm sorry, Mr. Doggett, as well as my friend, Mr. Pomeroy, all my colleagues. Mr. Tiberi from Ohio.

Mr. EVERSON. Just give me your name and Social Security number when you're leaving.

Ms. TUBBS JONES. Actually, my students wanted to ask you to make sure that you did additional tax collection so that you can assure them that there will be greater dollars available from the and dollars for Pell grants. Is that what you asked me to do, students?

Thanks very much. You can be seated.

I am very happy to have them here and participating in the process. My first question for you, first of all is to say good morning. Secondly, to ask you are any of the tax collection agencies or private firms that you hire African American, Hispanic or any minority?

Mr. EVERSON. Well, are you saying are they minority owned businesses under——

Ms. TUBBS JONES. Yes, yes.

Mr. EVERSON. I don't believe they are. I don't have a definitive answer to that question. They were selected in a competitive procurement process that recognizes all the various factors and we ended up with who we ended up with.

Ms. TUBBS JONES. I am not sure what those factors are. I would hope that in the process of granting these contracts, that there would be access and opportunity for minority business firms.

Mr. EVERSON. I am sure there was.

Ms. TUBBS JONES. Check for me, please, and get back with me——

Mr. EVERSON. What I am saying, in this area we follow the law scrupulously and apply it and those are written into procurement standards.

Ms. TUBBS JONES. I hear you, Mr. Commissioner. I used to be an Equal Employment Opportunity Commission (EEOC) trial lawyer. As a trial lawyer, sometimes the law on its face appears to be neutral but in its implementation, it is discriminatory. So, all I am asking you to do is take a look at it and make sure that minorities have access to that opportunity.

Mr. EVERSON. Certainly.

Ms. TUBBS JONES. In addition to which, it may be that minority contractors could help you do a better job at collection of these resources, depending on who they are dealing with. That has come to fruition in a lot of other areas.

Mr. EVERSON. Absolutely, ma'am. In fact, I would note if you are unaware of this, Senator Nelson has spoken about trying to get the disabled veterans to help do some of this work too.

Ms. TUBBS JONES. Okay. Next subject. The new piece on the horizon this year is in fact the telephone excise tax refund that many people are eligible for but a number of them have not applied for. I do have a press release from the IRS where you have suggested that people make sure they apply or include this in their tax return. Can you tell me what the result of that has been? What else you've done other than a press release to make the American people aware that they are entitled to a telephone excise tax refund?

Mr. EVERSON. Yes, ma'am. This has been a surprise to us. The claim rate, if you will, has been fairly consistent over the course of the filing season, about 30 percent or right around 30 percent are not claiming that. Some people would not be eligible but he's a dependent of mine, so I got my 60 dollars, including Leonard's, the impact of Leonard. So, some of that was to be expected. We think it is running higher.

From the start, we worked with the software providers and everybody else to make sure that they tried to recognize this opportunity. We're surprised that even going through on some of the different routines that they've got that people will skip over the question because last year it wasn't there, it is only going to be there this year, as you know, as a one-time item, and they just seem to be ignoring it. Let alone the folks who do a paper return and they've done it the way year after year. We've worked with all those people and we've tried to publicize it as much as we can, ma'am.

Ms. TUBBS JONES. I would encourage you to make sure you—by you, not just you personally but the IRS take a look at opportunities for savings for low-income Americans like the earned income tax credit and like this one-time telephone credit. For people who are in low-income areas, $60 is like $60 million at the upper echelon. The earned income tax credit is a significant opportunity for those people to have the chance to gain some of those dollars back.

So, I would encourage you specifically to come up with ways in which we can jointly, the Congress and the IRS, get out to the people access to that.

Mr. EVERSON. I agree with you. We work very closely with partnerships. We have 12,000 volunteer sites around the country to try and do that. We want to keep growing that program for all the reasons you suggest.

Ms. TUBBS JONES. Lastly, on the telephone excise tax, are you also finding people who are trying to abuse the refund by claim their whole phone bill in the process?

Mr. EVERSON. Yes, ma'am. In fact, we were very aggressive about this in the initial weeks. We saw a pattern of returns. We had criminal investigators going to seven different practitioners around the country with search warrants and get after it right away, because we wanted to make sure that people understood. We had some individuals claiming in excess of $10,000. You have to have a pretty big phone bill to get that amount of credit.

Ms. TUBBS JONES. I would like to thank you for your testimony, Mr. Commissioner. My colleagues, if any of you have time, we are going to be in the Ways and Means library. Stop back and say hi to some of the finest students in this and from Cuyahoga Community College. Thank you very much.

Mr. EVERSON. Thank you. Nice to see you again.

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

Mr. Commissioner, how would the proposed budget for the new year for the IRS, it is $11 billion, how would the IRS use an additional one million dollars?

Mr. EVERSON. An extra one million dollars?

Chairman LEWIS. If you had another one million dollars, how would you use it? It's not much money when you look at $11 billion.

Mr. EVERSON. Not much money. I think that would be swallowed up, sir, by the many contingencies that occur over the course of a year. We—a couple years ago, we got a very modest increase. We had a lot of different proposals we had made. In that instance, I elected to use it all in our tax exempt and governmental entities unit. You try to make balanced decisions. That was in an area that was, I felt, suffering from under funding. However, I would—I would make the decision at the time, depending on how we had done overall in the budget.

Chairman LEWIS. Thank you, Commissioner.

I now turn to the ranking Member, Mr. Ramstad, for questions.

Mr. RAMSTAD. Thank you, Mr. Chairman. Commissioner, thanks for being so generous with your time. I will be brief.

I just wanted to follow up on Mr. Pascrell's question and concern that "only 75 cents on the dollar in the private debt collection program is returned to the Treasury."

Since the IRS would not be able to work these cases, as you testified, for a number of years, and at dramatically increased staffing levels, isn't it better to collect 75 cents on the dollar rather than zero cents on the dollar?

Mr. EVERSON. Well, I spent most of my career, sir, in the private sector. A program that pays out and gets back to break even after just 2 years and then generates that kind of return is an easy investment decision, yes.

Mr. RAMSTAD. Isn't it true that much of this tax debt literally becomes uncollectible because of the statute of limitations?

Mr. EVERSON. Well, the statute goes out a long time. However, the truth is, with debt, the longer you wait, the harder it is to get it.

Mr. RAMSTAD. Just another question. Mr. Pomeroy raised the issue of the free file program, albeit in another context. I want to ask you whether the new $50,000 income cap is contributing to the decline in the free file program?

Mr. EVERSON. That program has been at that level for the last couple of years. We are seeing—the program started out much lower this year. It was down 15 percent in the initial weeks. It is now running ahead of last year. Filing season to date, it is about 5 percent down year over year. I am a little bit surprised by this. I expect at this point, it will end up at about the same level as next year. May even surpass it, but just modestly.

Mr. RAMSTAD. So, no causal relationship with the $50,000 cap?

Mr. EVERSON. I don't think so. I think that that has been in effect for 2 years now, it is my understanding. I think that there was a lot of support for this and hype of it in the first year or two. There is a little less attention to it now.

Mr. RAMSTAD. Thank you again, Commissioner. Mr. Chairman, I yield back.

Chairman LEWIS. Thank you, Mr. Ranking Member.

I now turn to Mr. Pomeroy of North Dakota for questioning.

Mr. POMEROY. Thank you. Mr. Commissioner, I want to come back to this whole free file business, e-file business and the pro-

viders we work with. First of all, I am still a little hacked off about slapping the $52,000 cap on there, referencing the preceding question. It seemed to me we have a program going along and then suddenly you have these private partners saying, wait a minute, wait a minute, these are—we can charge for part of this group and with the Service's full complicity, you slap a $50,000 cap on there and a lot of people that might have otherwise used it are now not able to use it for free. On the other hand, the free file alliance gets to concentrate on the group that might be most susceptible to the refund anticipation loan business.

This whole thing, Commissioner, I think you have the highest standards of integrity, professionalism, wonderful background, a great organization leader. However, there are things about these relationships with these free file folks and the refund anticipation loans that look badly for the Service.

Mr. EVERSON. Sir, let me be perfectly clear here. Free file does not include RALs this year. That is knocked out.

Mr. POMEROY. I think that that is virtuous. I am glad about that.

Also, there are other things still swirling about here that just don't look good. First of all, I think substantively this business of providing confidential taxpayer information to private sector entities, that is just bad. It is just inappropriate for the Service. It is a unique departure from anything else the Service does relative to confidentiality and I am surprised you went down that road.

Also, beyond that, that was the last series of questions. What would you think about a group that basically used as a domain name like IRS.com to try and interact with the public? Do you think that IRS.com is an appropriate domain name to be privately available?

Mr. EVERSON. I am not going to comment on what an enterprise—it is not my area of oversight. I think it is unfortunate, I would say. Obviously, anything that causes confusion.

Let me start over again, the tax code, complying with your civic obligation to pay your taxes is complicated enough and there are enough folks out there who are misleading and trying to take advantage of folks. We don't need additional confusion or susceptibility to wrong things from things like that.

Mr. POMEROY. Right. Now, even though we have a taxpayer advocate within the Service, I trust and I hope that you in the commissioner's spot think that taxpayer advocacy in terms of simplicity of complying and this kind of thing, is a big part of what your job is.

So, IRS.com, and you were reluctant to express an opinion on it. I'm not reluctant. I think that that is a deliberate attempt to confuse the public, to basically use, again, market opportunity on a domain name that reflects a very important government agency. Also, as commissioner, you didn't have an opinion on it, I'm surprised. I have a strong opinion on it.

Mr. EVERSON. I don't know exactly what they do. Furthermore, I don't like anything that causes confusion. Basically I am taking a pass, because it is not my area of oversight.

Mr. POMEROY. Well, what they do is they make tax loans available. They are a RAL provider, they are lender, at these exorbitant,

usurious rates. In fact, they got a breakout of their rates, as probably required by law. Estimated Annual Percentage Rate (APR), the interest rate, 93 percent. Unless you have a loan above $3,000 and then it drops down to 82 percent interest rate. They are using the name IRS.com.

Now, as unfortunate as that is, this IRS.com links to a group called Tax Act and they advertise themselves as a free and online tax preparation service. So, IRS.com is basically just a domain name they use to get people in that think they are writing to you while they are writing to this private entity that files them then to Tax Act. Bad business. That would really bother me.

In addition, beyond that, commissioner, on your own webpage, IRS.gov, you have these free file alliance companies and you have Tax Act listed right on your own webpage. So, you have IRS.com and IRS.gov referring to the same Tax Act.

Mr. EVERSON. Is Tax Act, are they part of the Free File Alliance? Is that it?

Mr. POMEROY. Yes, sir.

Mr. EVERSON. I see.

Mr. POMEROY. If I had a private partner conducting themselves like that, that private partner and I would be parting ways. I am going to be very interested in watching what the Service does relative to this kind of activity by one of your Free File Alliance partners.

Mr. EVERSON. I will make sure we take a look at it, sir.

Mr. POMEROY. Thank you.

Chairman LEWIS. Thank you very much, Mr. Pomeroy, for your line of questioning.

I now recognize the gentleman from Texas, Mr. Doggett.

Mr. DOGGETT. Thank you. Commissioner, when IRS reviews are short cycled, at the conclusion of the audit, do you have an exit procedure where the auditor can note how much money he or she thinks has been left on the table or at least what questionable issues or practices were left unattended to?

Mr. EVERSON. I am unfamiliar with our procedures at that level of operations, sir. I will get an answer for you for the record.

Mr. DOGGETT. Do you think that would be a good idea to know what your auditors believe they are leaving behind?

Mr. EVERSON. I would want to reflect carefully before answering that question.

Mr. DOGGETT. That is fair enough.

Mr. EVERSON. Since you can get people to overstate or understate. There could be an inference that an individual has done something when we haven't felt that it is serious enough to proceed. It could be problematic.

Mr. DOGGETT. Is there information currently posted on the internal IRS website calling for cycle times to be cut in half during the next year?

Mr. EVERSON. I do not know the answer to that question. I would be surprised. Cycle times cut in half over a 1-year period would be quite significant.

Mr. DOGGETT. You would be surprised if that is an objective?

Mr. EVERSON. I would be surprised. I could be wrong. I would say to you, again, I have emphasized we need to reduce cycle times.

I have also said, sir, they will change, things will change dramatically with the introduction which we have made of electronic filing which will change the whole audit process. That, too, is going to generate controversy for some employees who are resistant to change, as you can imagine.

Mr. DOGGETT. Well, are managers and their performance evaluated? Is one of the factors how many cases have been closed?

Mr. EVERSON. I do not know whether numbers like that are actually considered. Obviously one case, when you are talking about big corporations, can be very different from another case. So, I would be surprised if that was the instance, was the fact. I am not sure, again, that you could look at that in the context of section 1204 and make that stick legally.

Mr. DOGGETT. I am encouraged by your answers to my previous set of questions about what IRS policy is. I contrast that with the reports that at least one e-mail message from Audit Quality Assurance to some of the auditors said, "We must have 10 cases a piece closed by 3/7/2007. You must keep me informed and make me aware immediately if you will have any problems meeting this goal. The goal translates into two cases per week."

That is contrary to the policy that you said was the IRS policy?

Mr. EVERSON. I am not sure it is, sir. Because my understanding is that that was an e-mail exchange between people who were doing a quality review, not the audit itself. That is a very different thing to say, we need to keep making sure we get our job done assessing the quality and getting at the very issues that you are getting at. So, I don't think those were, as it was reported to me this morning, that was not about an auditor per se.

Mr. DOGGETT. So, that e-mail and your analysis of what it was or wasn't is something you can again respond to us and follow up.

Mr. EVERSON. Yes. Certainly.

Mr. DOGGETT. The same with regard to the report that one of your directors for audits of telecommunications technology companies chastised subordinates for not closing the audits quickly enough?

Mr. EVERSON. I will certainly get back to you, sir on that, and take a look at it.

Mr. DOGGETT. Thank you. I think overall we will be interested in looking at the training materials and the evaluation criteria to ensure that IRS does not have a catch and release program, that not only releases people, releases corporations on these other issues, but doesn't even measure the size of the fish. That is my concern. As I look at the overall data and the impact that that policy can have, you referred to the fact that you have more coverage this year than you did, more coverage in 2006 than you did when you arrived there in 2003.

Mr. EVERSON. Yes, sir.

Mr. DOGGETT. You actually have a decline in coverage for large corporations from fiscal year 2005 to 2006. If you compare it going back to 1997, you have a rather significant decline in coverage on large corporation audits over a 10-year period, don't you?

Mr. EVERSON. You are probably right in that statistic because, as I indicated before, you had a very broad-based decline in en-

forcement activities. Over 25 percent of our revenue agents were drawn down over a period of years. Now we are bringing that back.

Mr. DOGGETT. So, we have not gotten back to the 1997 level?

Mr. EVERSON. Not in the corporate area. If you look at certain areas like the levies, we have gotten back. In the corporate area, we have brought it back over the last few years, as I have indicated, though.

Mr. DOGGETT. My concern, sir, is that again overall, looking at this tax gap question, and this is my final query, Mr. Chairman, there have been estimates that the tax gap is as much as $300 billion a year. You testified to the Senate Budget Committee last year that we could get between $50 billion and $100 billion "without changing the dynamic between the IRS and the people."—yet the 16 proposals to which you refer are estimated by, I guess, OMB to raise only 29 billion over 10 years.

So, it is a very small portion of the tax gap, a very small portion of what you estimated could be raised to close the tax gap that is being addressed in these legislative proposals.

Mr. EVERSON. Let me make two points, sir. First, I appreciate your keen interest in this area of corporate compliance. It is a top priority of mine. I look forward to a continuing dialog on it. We are doing our level best to improve the compliance here. I think there are some indications, as we said in the Budget Committee, that there are improvements.

On overall progress in the tax gap, I would, as I indicated before Chairman Spratt's Committee, we have made some progress with ramping up the enforcement and the indirect effect there. I believe that the Administration's proposals, both on the funding side for the IRS and in these 16 proposals are significant. A relatively modest amount of money, you are correct. I think that they have generated a fair amount of heat already. I would like to see us as a group, the Congress and the Administration, get these done and then we will take a look beyond them. However, each time you do more, you get into this burden question that was addressed a few minutes ago.

Mr. DOGGETT. Thank you, Mr. Chairman. Thank you, Commissioner. My concern is that, while we are waiting, billions of dollars are being lost to the Treasury which have to be made up some other way. To assure that what is happening in practice, with these frontline auditors, is consistent with what you have told us is IRS policy. Thank you very much.

Mr. EVERSON. Thank you for your interest, sir.

Chairman LEWIS. Thank you very much.

I now turn to Mr. Tiberi of Ohio for questioning.

Mr. TIBERI. Thank you, Mr. Chairman.

One last question, Commissioner, and you may not be able to answer it and you may have to get back to me, which is fine. In the Administration's fiscal year 2008 budget request before Congress, they propose granting authority to the Department of the Treasury to promulgate rules requiring organizations that process credit cards for merchants who accept credit card payments to report to the IRS gross reimbursement payments made to those merchants.

My question is, how did we go in the Administration's fiscal year 2007 budget from a figure of 225 million collected from that pro-

gram to nearly 11 billion, with a B, which is a pretty big jump even by Washington standards, in the 2008 budget?

Mr. EVERSON. I will have to get back to you for the record on that. As was indicated before, my team doesn't make estimates of what are the revenue impacts on any of the legislative proposals. That is done, and I think appropriately so, independently by the Treasury Department. Generally and it goes back to Congressman Doggett's question. I think that those estimates, from my point of view, are somewhat conservative.

However, I don't want to comment on any discrepancy between figures 1 year and the next.

Mr. TIBERI. I appreciate that. It is just that the numbers really stood out in terms of 225 million to nearly 11 billion.

Mr. EVERSON. One may be over a period of time. I am not sure.

Mr. TIBERI. Both are over 10 years.

Mr. EVERSON. They are?

Mr. TIBERI. Both are over 10 years. So, there is a significant difference.

Mr. EVERSON. Well, I think we will do well if we get that proposal done. So, I think there is real money there. I would like to see us get it done.

Mr. TIBERI. Thank you.

Chairman LEWIS. Well, let me take this moment to thank the ranking Member and all Members of the Committee for being present and for participating in this hearing.

Mr. Commissioner, I want to thank you for your time, you gave us a lot of time, and for your testimony. We look forward to continuing to work with you. We wish you well during this tax filing season.

There being no other business coming before the Committee, the Committee is now adjourned.

[Whereupon, at 11:42 a.m., the hearing was adjourned.]

[Questions submitted by the Members to the witness follow:]

Question Submitted by Mr. Tanner to Mr. Everson

Question: Our nation's fiscal house is a mess, and the entitlement nightmare is fast approaching. But before we even consider asking the American taxpayer to reach further into their pocket to help restore our fiscal discipline, we have got to find out how this government is spending the money it already receives and figure out how to best retrieve the money it is owed. The annual tax gap is estimated to be about $350 billion. The President has put forward some ideas on how to reduce the gap, and we are certain to see both the Senate and the House present their own plans on how to close this gap. But I would like to know what the IRS is doing today to reduce this obscene number. Under the current approach, what will the tax gap look like in 5 years?

Answer: The IRS' long-term goal is to increase the Voluntary Compliance Rate (VCR) to 86% by tax year 2009 and Senate Finance Committee Chairman Max Baucus has asked for a 90 percent voluntary compliance goal by 2017. However, even with a constant VCR, the tax gap grows over time to the extent tax liabilities grow over time.

On August 2, 2007, the IRS released the report "*Reducing the Federal Tax Gap:* A Report on Improving Voluntary Compliance," outlining steps that the IRS will take to increase voluntary compliance and reduce the tax gap. One of the primary challenges that the IRS faces in improving compliance is to get a better understanding of the current sources of noncompliance by improving research in this area. The IRS has taken significant steps in this direction, most importantly through the

National Research Program (NRP), which is the source of updated estimates of compliance among individual taxpayers for Tax Year 2001.

The IRS does not have annual estimates of overall compliance. However, based on the limited information available, compliance rates appear to have remained relatively stable at around 85 percent for decades. To make a meaningful improvement in this number without a fundamental change in the relationship between taxpayers and the government will require a long-term, focused effort. Implementation of the steps outlined in this document and in the Administration's Fiscal Year (FY) 2008 Budget request for the IRS will be subject to the uncertainties associated with the annual budget process. Moreover, it must be recognized that the causes of noncompliance are numerous and that only a portion of the tax gap results from intentional avoidance or evasion of the law. An equally or perhaps more important part of the problem lies in the growing complexity of the tax laws, which will continue to frustrate efforts to improve compliance. The Administration is committed to working with Congress and other stakeholders to reduce the tax gap. The Administration's FY 2008 Budget request includes $11.1 billion for the IRS, a 4.7-percent increase over the budget enacted for FY 2007. A total of $410 million is for new enforcement initiatives as part of a strategy to improve compliance by:

- Increasing frontline enforcement resources;
- Increasing voluntary compliance through improved taxpayer service options and enhanced research;
- Investing in technology to reverse infrastructure deterioration, accelerate modernization, and improve the productivity of existing resources; and
- Implementing legislative and regulatory changes.

[Submissions for the Record follow:]

Statement of Colleen M. Kelley, National Treasury Employees Union

Chairman Lewis, Ranking Member Ramstad, and distinguished members of the Subcommittee, I would like to thank you for allowing me to provide comments on IRS operations and the tax gap. As President of the National Treasury Employees Union (NTEU), I have the honor of representing over 150,000 federal workers in 30 agencies men and women at the IRS.

Mr. Chairman, the National Treasury Employees Union has serious concerns about a number of IRS policies that we believe are undermining the agency's ability to fulfill its tax enforcement mission as well as hampering efforts to close the tax gap. These include ongoing staff cuts of some of the IRS's most productive employees, reliance on outside contractors to handle inherently governmental activities such as the collection of taxes, and a shift in philosophy which focuses enforcement efforts too much on wage earners and not enough on high-income individuals and large businesses and corporations.

Tax Gap

In April 2006, the IRS released updated estimates showing that the tax gap was approximately $345 billion in Tax Year 2001. As Nina Olson, the National Taxpayer Advocate noted, this amounts to a per-taxpayer "surtax" of some $2,000 per year to subsidize noncompliance. And while the agency has made small inroads and the overall compliance rate through the voluntary compliance system remains high, much more can and should be done. NTEU believes that in order to close the tax gap, the IRS needs additional employees on the frontlines of tax compliance and customer service. In addition, we believe Congress should establish a dedicated funding stream to provide adequate resources for those employees.

History has shown that the IRS has the expertise to improve taxpayer compliance but lacks the necessary personnel and resources. The President's own fiscal 2008 budget proposal trumpets the increased tax collections produced by IRS's own employees and cites the increased collections of delinquent tax debt from $34 billion in 2002 to $49 billion in 2006, an increase of 44 percent. Unfortunately, instead of providing additional resources to hire more enforcement staff, IRS personnel resources have been slashed in recent years resulting in a 36% decline in combined collection and examination function enforcement staff between 1996 and 2003. In addition, these staffing cuts have come at a time when the IRS workload has dramatically increased.

According to IRS's own annual reports and data, taxpayers filed 114.6 million returns in 1995. After a steady annual climb, eleven years later, the Service saw more than 132 million returns filed. In addition, between 1997 and 2005, the number of

individual tax returns with $100,000 in reported income, which are generally more complex returns, increased by more than 52 percent. Yet, between 1995 and 2003, total numbers of employees shrunk from 114,000 to 94,000. Even more alarming is that during that period, revenue officers and revenue agents—two groups critical to reducing the tax gap—shrunk by 40 and 30 percent respectively. Revenue officers who collect large delinquent accounts went from 8,139 to 5,004 and revenue agents who do audits fell from 16,078 to 11,513. Unfortunately, instead of reversing this trend, the IRS has continued efforts to reduce its workforce and has moved forward with downsizing in several different areas which have targeted some of the service's most productive employees.

These include last year's re-organization of the Estate and Gift Tax Program which sought the elimination of 157 of the agency's 345 estate and gift tax attorneys—almost half of the agency's estate tax lawyers—who audit some of the wealthiest Americans. The Service pursued this drastic course of action despite internal data showing that estate and gift attorneys are among the most productive enforcement personnel at the IRS, collecting $2,200 in taxes for each hour of work.

The IRS decision to drastically reduce the number of attorneys in the estate and gift tax area flies in the face of several reports made to Congress by Treasury and IRS officials over the past few years, indicating that tax evasion and cheating among the highest-income Americans is a serious and growing problem. In fact, an IRS study found that in 1999, more than 80 percent of the 1,651 tax returns reporting gifts of $1 million or more that were audited that year understated the value of the gift. The study found that the average understatement was about $303,000, on which about $167,000 in additional gift taxes was due. This alone cost the government about $275 million. Consequently, it is difficult to understand why the IRS sought the elimination of key workforce positions in an area that could produce significant revenue to the general treasury.

In addition, the Service continues to move forward with its plan to close five of its ten paper tax return submission facilities by 2011. The IRS originally sought the closings of the five paper return submission centers due to the rise in the use of electronic filing (e-filing) and in order to comply with the IRS Restructuring and Reform Act of 1998 (RRA 98) which established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. But in their recent report to Congress on e-filing, the IRS Oversight Board noted that the IRS will fall well short of the 80 percent goal and urged Congress to extend the deadline to 2012. The report noted that in 2006 just 54 percent of individuals e-filed their returns, well short of the 80 percent goal. Furthermore, the report cited a decline in 2006 in the number of e-file returns received from individual taxpayers who self-prepared their taxes. And finally a recent GAO report on the 2006 filing season noted the year over year percentage growth in individual e-filing slowed to a level lower than any of the previous three years

While overall use of e-filing may be on the rise, the number of taxpayers opting to use this type of return is not increasing as rapidly as the IRS had originally projected. Combined with the fact that almost a third of American taxpayers do not even have internet access and changes to the IRS Free File Program that are expected to increase the number of paper filing returns, it is clear that paper submission processing facilities are still necessary and that serious thought and consideration must be given before any additional closings are undertaken.

Mr. Chairman, it is clear that drastic reductions in some of the agency's most productive tax law enforcement employees has undermined agency efforts to close the tax gap and directly contradicts the Service's stated enforcement priority to discourage and deter non-compliance, particularly among high-income individuals.

NTEU Staffing Proposal

In order to address the staffing shortage at the IRS and combat the tax gap, NTEU supports a two percent annual net increase in staffing (roughly 1,885 positions per year) over a five-year period to gradually rebuild the depleted IRS workforce to pre-1998 levels. A similar idea was proposed by former IRS Commissioner Charles Rossotti in a 2002 report to the IRS Oversight Board. In the report, Rossotti quantified the workload gap in non-compliance, that is, the number of cases that should have been, but could not be acted upon because of resource limitations. Rossotti pointed out that in the area of known tax debts, assigning additional employees to collection work could bring in roughly $30 for every $1 spent. The Rossotti report recognized the importance of increased IRS staffing noting that due to the continued growth in IRS' workload (averaging about 1.5 to 2.0 percent per year) and the large accumulated increase in work that should be done but could not be, even aggressive productivity growth could not possibly close the compliance gap. Rossotti also recognized that for this approach to work, the budget must provide for

a net increase in staffing on a sustained yearly basis and not take a "one time approach."

Although this would require a substantial financial commitment, the potential for increasing revenues, enhancing compliance and shrinking the tax gap makes it very sound budget policy. One option for funding a new staffing initiative would be to allow the IRS to hire personnel off-budget, or outside of the ordinary budget process. This is not unprecedented. In fact, Congress took exactly the same approach to funding in 1994 when Congress provided funding for the Administration's IRS Tax Compliance Initiative which sought the addition of 5,000 compliance positions for the IRS. The initiative was expected to generate in excess of $9 billion in new revenue over five years while spending only about $2 billion during the same period. Because of the initiative's potential to dramatically increase federal revenue, spending for the positions was not considered in calculating appropriations that must come within annual caps.

A second option for providing funding to hire additional IRS personnel outside the ordinary budget process could be to allow IRS to retain a small portion of the revenue it collects. The statute that gives the IRS the authority to use private collection companies to collect taxes allows 25 percent of collected revenue to be returned to the companies as payment, thereby circumventing the appropriations process altogether. Clearly, there is nothing magical about revenues collected by private collection companies. If those revenues can be dedicated directly to contract payments, there is no reason some small portion of other revenues collected by the IRS could not be dedicated to funding additional staff positions to strengthen enforcement.

While NTEU agrees with IRS' stated goal of enhancing tax compliance and enforcement, we don't agree with the approach of sacrificing taxpayer service in order to pay for additional compliance efforts. NTEU believes providing quality services to taxpayers is an important part of any overall strategy to improve compliance and that reducing the number of employees dedicated to assisting taxpayers meet their obligations would only serve to exacerbate, not shrink, the tax gap. The Administration's own budget proposal for 2008 notes that in FY 2006, IRS' customer assistance centers answered almost 33 million assistor telephone calls and met the 82 percent level of service goal, with an accuracy rate of 91 percent for tax law questions. In addition, a recent study commissioned by the Oversight Board found that more than 80 percent of taxpayers contacted said that IRS service was better than or equal to service from other government agencies. And while these numbers show that IRS taxpayer services are being effective, more can and should be done.

Mr. Chairman, in order to continue to make improvements in taxpayer services while simultaneously processing a growing number of tax returns and stabilizing collections and examinations of cases, it is imperative to reverse the severe cuts in IRS staffing levels and begin providing adequate resources to meet these challenges. With the future workload expected to continue to rise, the IRS will be under a great deal of pressure to improve customer service standards while simultaneously enforcing the nation's tax laws. NTEU strongly believes that providing additional staffing resources would permit IRS to meet the rising workload level, stabilize and strengthen tax compliance and customer service programs and allow the Service to address the tax gap in a serious and meaningful way.

Private Tax Collection

Mr. Chairman, as stated previously, if provided the necessary resources, IRS employees have the expertise and knowledge to ensure taxpayers are complying with their tax obligations. That is why NTEU continues to strongly oppose the Administration's private tax collection program, which began in September of last year. Under the program, the IRS is permitted to hire private sector tax collectors to collect delinquent tax debt from taxpayers and pay them a bounty of up to 25 percent of the money they collect. NTEU believes this misguided proposal is a waste of taxpayer's dollars, invites overly aggressive collection techniques, jeopardizes the financial privacy of American taxpayers and may ultimately serve to undermine efforts to close the tax gap.

NTEU strongly believes the collection of taxes is an inherently governmental function that should be restricted to properly trained and proficient IRS personnel. When supported with the tools and resources they need to do their jobs, there is no one who is more reliable and who can do the work of the IRS better than IRS employees.

As you may know, under current contracts, private collection firms are eligible to retain 21% to 24% of what they collect, depending on the size of the case. In testimony before Congress, the IRS Commissioner, Mark Everson, has twice acknowledged that using private collection companies to collect federal taxes will be more expensive than having the IRS do the work itself. The Commissioner's admission

directly contradicts one the Administration's central justifications for using private collection agencies—that the use of private collectors is cost efficient and effective.

In addition to being fiscally unsound, the idea of allowing private collection agencies to collect tax debt on a commission basis also flies in the face of the tenets of the IRS Restructuring and Reform Act of 1998. Section 1204 of the law specifically prevents employees or supervisors at the IRS from being evaluated on the amount of collections they bring in. But now, the IRS has agreed to pay private collection agencies out of their tax collection proceeds, which will clearly encourage overly aggressive tax collection techniques, the exact dynamic the 1998 law sought to avoid. Furthermore, the IRS is turning over tax collection responsibilities to an industry that has a long record of abuse. For example, in 2005 (the latest year statistics are available), the Federal Trade Commission received 66,627 consumer complaints about debt collection agencies—giving debt collectors the impressive title of the FTC's most complained-about industry.

NTEU believes that a better option would be to provide the IRS with the resources and staffing it needs. There is no doubt that IRS employees are—by far—the most reliable, cost-effective means for collecting federal income taxes. As noted previously, the IRS Commissioner himself has admitted that using IRS employees to collect unpaid tax debts is more efficient than using private collectors. In addition, the 2002 budget report submitted to the IRS Oversight Board, former Commissioner Charles Rossotti made clear that with more resources to increase IRS staffing, the IRS would be able to close the compliance gap.

This is not the first time the IRS has tried this flawed program. Two pilot projects were authorized by Congress to test private collection of tax debt for 1996 and 1997. The 1996 pilot was so unsuccessful it was cancelled after 12 months, despite the fact it was authorized and scheduled to operate for two years. A subsequent review by the IRS Office of Inspector General found that contractors participating in the pilot programs regularly violated the Fair Debt Collection Practices Act, did not adequately protect the security of personal taxpayer information, and even failed to bring in a net increase in revenue. In fact, a 1997 GAO report found that private companies did not bring in anywhere near the dollars projected, and the pilot caused a $17 million net loss.

Despite IRS assurances that it has learned from its past mistakes, two recent reports indicate otherwise. A March 2004 report by the Treasury Inspector General for Tax Administration raised a number of questions about IRS' contract administration and oversight of contractors. The report found that "a contractor's employees committed numerous security violations that placed IRS equipment and taxpayer data at risk" and in some cases, "contractors blatantly circumvented IRS policies and procedures even when security personnel identified inappropriate practices." (TIGTA Audit #200320010). The proliferation of security breaches at a number of government agencies that put personal information at risk further argue against this proposal. These security breaches illustrate not only the risks associated with collecting and disseminating large amounts of electronic personal information, but the risk of harm or injury to consumers from identity theft crimes.

In addition, a September 2006 examination of the IRS private collection program by the Government Accountability Office (GAO) reveals that like the 1996 pilot, the program may actually lose money by the scheduled conclusion of the program's initial phase in December 2007. The report cited preliminary IRS data showing that the agency expects to collect as little as $56 million through the end of 2007, while initial program costs are expected to surpass $61 million. What's more, the projected costs do not even include the 21–24 percent commission fees paid to the collection agencies directly from the taxes they collect.

In addition to the direct costs of the program, I am greatly concerned about the potential negative effect that the private tax collection program will have on our tax administration system. In her recent report to Congress, the National Taxpayer Advocate voiced similar concern about the unintended consequences of privatizing tax collection. Olson cited a number of "hidden costs" that private tax collection has on the tax system including reduced transparency of IRS tax collection operations, inconsistent treatment for similarly situated taxpayers, and reduced tax compliance. Clearly the negative effects of contracting out tax collection to private collectors hampers the agency's ability to improve taxpayer compliance and will only serve to undermine future efforts to close the tax gap.

NTEU is not alone in its opposition to the IRS' plan. Similar proposals allowing private collection agencies to collect taxes on a commission basis have been around for a long time and have consistently been opposed by both parties. In fact, the Reagan Administration strongly opposed the concept of privatizing tax collections warning of a considerable adverse public reaction to such a plan, and emphasizing the importance of not compromising the integrity of the tax system. (Treasury Dept.

Statement to House Judiciary Comm. 8/8/86). More recently, opposition to the private tax collection program has been voiced by a growing number of members of Congress, major public interest groups, tax experts, as well as the Taxpayer Advocacy Panel, a volunteer federal advisory group—whose members are appointed by the IRS and the Treasury Department. In addition, the National Taxpayer Advocate, an independent official within the IRS recently identified the IRS private tax collection initiative as one of the most serious problems facing taxpayers and called on Congress to immediately repeal the IRS' authority to outsource tax collection work to private debt collectors (National Taxpayer Advocate 2006 Report to Congress).

Instead of rushing to privatize tax collection functions which jeopardizes taxpayer information, reduces potential revenue for the federal government and undermine efforts to close the tax gap, the IRS should increase compliance staffing levels at the IRS to ensure that the collection of taxes is restricted to properly trained and proficient IRS personnel.

Mr. Chairman, NTEU believes that frontline IRS employees are the best defense against an increasing U.S. tax gap. Unfortunately, the Administration has not requested the funding necessary to close the tax gap. Congress must, therefore, act to provide IRS with the necessary staffing and a dedicated funding stream to support those additional workers.

IRS Audits of High-Income Individuals and Large Businesses and Corporations

Mr. Chairman, I would also like to briefly discuss IRS enforcement efforts with regard to high-income individuals and large businesses and corporations. I previously noted the drastic staff reductions in the estate and gift tax division that occurred last year and will obviously hamper the Service's ability to achieve greater compliance from the wealthiest Americans. In addition, recent IRS data shows that IRS audits of high-income individuals have dropped dramatically over the past decade. The audit rate for face-to-face audits fell from 2.9 percent of high-income tax filers in FY 1992 to 0.38 percent in FY 2001 and then drifted down to 0.35 percent in FY 2004. While the audit rate has rebounded somewhat in the last two years, it is still far below the level of the mid-1990's. These facts seem to directly contradict claims by the IRS that the Service's first enforcement priority is to discourage and deter non-compliance, with an emphasis on high-income individuals.

We are seeing similar troubling trends with respect to large corporations. While this issue has just started receiving public attention in recent weeks, it has long been of concern to IRS employees that believe recent IRS currency and cycle time initiatives are resulting in the premature closing of audits of large companies, possibly leaving hundreds of millions of dollars of taxes owed on the table. IRS data shows the thoroughness of IRS enforcement efforts for the nation's largest corporations—measured by the number of hours devoted to each audit—has substantially declined since FY 2002. IRS data also show that the annual audit rates for these corporations, all with assets of $250 million or more, while increasing in FY 2004 and 2005, receded in 2006 to about the level it was in 2002 and is much lower than levels that prevailed a decade or more ago.

Although the number of the largest corporations is small, they are a very significant presence in the American economy. In FY 2002, the largest corporations were responsible for almost 75 percent of all additional taxes the IRS auditors said were owed the government. By comparison, low and middle income taxpayers in the same year were responsible for less than 10 percent of the total.

Agency data shows that audit attention given those corporations with $250 million or more in assets has substantially declined in the last five years. In 2002, an average of 1,210 hours were devoted to each of the audits of the corporations in this category. The time devoted to each audit dropped sharply in 2004 and by 2006 the number of hours per audit remained 20% below what it was in 2002.

But what may be most disturbing is that according to IRS' own data, while the coverage rate of large corporation returns(identified as those with assets of $10 million and higher) increased in FY 2004 and 2005, the number of audits for these corporations actually decreased in 2006. Clearly, the rationale the IRS is using to justify a reduction in time and scope of large corporation audits, that is, to allow for expanding the total number of companies audited is not working.

IRS officials have continued to point to a rise in additional tax recommended for each hour of audit as a sign that the policy is working, but most auditors know that this rise can be primarily attributed to the proliferation of illegal tax shelters which makes it easier to find additional taxes due.

Warnings about the potential negative consequences of such policy decisions were made by a number of IRS employees in a recent New York Times article and are

not new. In fact, when the IRS first began limiting the time and scope of business audits through implementation of the Limited Issue Focused Examination (LIFE) process in 2002, the former chief counsel of the IRS said that the IRS' proposed reductions in cycle time of corporate audits would "virtually guarantee that IRS auditors would miss tax dodges, fail to explore suspicious transactions, or even walk away from audits that are on the verge of finding wrongdoing."

In addition, IRS employees have raised concerns about this shift in approach to the auditing of business tax returns since its implementation several years ago. Their concerns are multi-fold. Primarily, employees' feel that their experience and professional judgment is being ignored when the scope of audits is limited and cycle times are reduced. Revenue agents need flexibility to determine the scope of an audit and need the ability to expand the examination time when necessary. The men and women of the IRS that perform these audits are highly experienced employees who know which issues to examine and when more time is necessary on a case. But under current IRS policies, this is just not the case.

Mr. Chairman, we have heard directly from a number of our members about the detrimental effect this policy has had not just on efforts to ensure corporations are in full compliance, but also how this misguided policy is damaging employee morale. In one instance, an IRS agent with 29 years of experience, including 19 as an international specialist examining tax returns of large, multinational corporations was given an unreasonably short period of time to examine three tax years of a very large company. The agent reported being constantly harassed for refusing to further limit the scope of the examination beyond that which was set at the beginning of the audit, even though he had successfully completed two prior examinations of the same taxpayer in a timely manner. The employee knew the issues and how to examine them but also knew they would need more than the allotted time to complete his part of the examination. But, despite past successes, management refused to provide the employee with additional time to complete his portion of the audit and labeled the employee as uncooperative and not a "team player." Although the employee refused to compromise, he believed that other members of the examination team had been pressured into dropping issues which likely would have resulted in additional tax.

Mr. Chairman, in the face of a rising tax gap and exploding federal deficits, it is imperative that the agency is provided with the necessary resources to allow IRS professionals to pursue each and every dollar of the taxes owed by large businesses and corporations. Allowing these corporations to pay just a fraction of what they owe in taxes greatly hinders efforts to close the tax gap and is fundamentally unfair to the millions of ordinary taxpayers that dutifully pay their taxes. Only by increasing the overall number of IRS employees that do this work can the Service ensure that businesses and large corporations are complying with their tax obligations and that the tax gap is being closed.

IRS Budget

Mr. Chairman, the final issue that I would like to discuss is the Administration's FY '08 budget request for the IRS. As you know, the IRS budget forms the foundation for what the IRS can provide to taxpayers in terms of customer service and how the agency can address the ever-increasing tax gap through enforcement. Without an adequate budget, the IRS cannot expect continued improvement in customer service performance ratings and will be hampered in its effort to shrink the tax gap. I would like to applaud the Administration for acknowledging in its FY–08 Budget in Brief (page 65) that "assisting the public to understand their tax reporting and payment obligations is the cornerstone of taxpayer compliance and is vital for maintaining public confidence in the tax system." However, I was disappointed in the Administration for failing to request a budget for FY '08 that meets the needs of the Agency to fulfill its customer service and enforcement challenges as well as to address closing the tax gap in a meaningful way.

Although it's widely recognized that additional funding for enforcement provides a great return on the investment, the Administration seems reluctant to request an adequate budget for the IRS. In addition, despite citing a lack of resources as the primary rationale for contracting out a number of inherently governmental activities, such as the collection of taxes, the Commissioner of the IRS has told Congress that the IRS does not need any additional funding above the President' budget request.

NTEU believes that Congress must provide the IRS with a budget that will allow the Service to replenish the depleted workforce, particularly with respect to enforcement personnel. And while it is imperative that Congress provide the IRS with sufficient staffing resources, we also believe that the IRS can look at the management to bargaining unit employee ratio to find additional resources for increased frontline

tax compliance efforts. As noted previously, while the number of employees at the IRS has decreased by almost 20,000 since 1995, the number of managers who supervise these employees has *increased* over this same period. If the IRS decreased the number of managers and management officials at the same rate as it has decreased its rank and file employees, the Agency could put the savings toward bolstering enforcement staff which would clearly aid efforts to close the tax gap. While the IRS has previously cited concerns about the number of employees that would have to be taken offline to train additional frontline employees, we believe this training could be done with minimal disruption to current operations. One possibility would be to use the increasing number of managers and management officials to do the training. This would ensure that these employees are afforded the best possible training while allowing current operations to continue to run efficiently.

Electronic Transactions Association
April 3, 2007

Honorable John Lewis
Committee on Ways and Means, Subcommittee on Oversight
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Lewis:

The Electronic Transaction Association[1] ("ETA") is pleased to submit our comments to the Subcommittee on Oversight regarding the Hearing on Internal Revenue Service Operations and the Tax Gap. Specifically, ETA would like to address a proposal in President Bush's FY2008 Federal Budget for the U.S. Department of Treasury that would require merchant acquiring banks to report aggregate credit/debit card reimbursements made to merchants.

ETA Position

ETA strongly recommends that the Subcommittee consider the effects this new reporting requirement would have on merchant acquiring banks, small businesses, and individual consumers. While ETA supports efforts to ensure greater tax compliance, the merchant acquirer reporting proposal as stated is vague and could lead to misleading information being provided to the IRS. Moreover, the estimates provided by Treasury (approx. $10 billion over 10 years) are unsubstantiated and likely significantly overstated. In order for this proposal to provide actionable information to the IRS for compliance purposes, ETA believes it would require an exhaustive amount of information that would be a significant burden on the merchant acquiring payment industry. The increased costs of complying with these burdensome reporting requirements would be born by consumers.

The Proposal/Background

In the FY2008 Federal Budget, the President has proposed requiring merchant acquiring banks to report to the IRS annually on aggregate credit and debit card reimbursement payments made to businesses. A similar proposal existed in the FY2007 Federal Budget; however no action was taken in the last Congress. The purpose of requiring this reporting is based on the belief that small businesses are underreporting their income for a variety of reasons, including tax avoidance and lack of understanding related to the tax law. It has been proposed that by requiring merchant acquiring banks to provide reports on payments to merchants, the IRS could compare actual reported credit and debit card sales with reported tax filings, thereby allowing the IRS to extrapolate what a business' cash transaction income should be. If the reported income on tax returns is not as it should be, the IRS would conceivably be able to target audit resources at those businesses that appear to have underreported.

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[1] ETA, founded in 1990, is the nation's oldest and largest organization of businesses representing the merchant acquiring industry that enables merchants to offer electronic payment services to consumers. With over 500 member companies, ETA's diverse membership, including state/federal chartered financial institutions, merchant service providers (also know as independent sales organizations), and credit card companies, is part of the backbone of the American economy that facilitates electronic payments.

Reporting Requirements Unfair to Small Businesses and Merchant Acquiring Banks

The rapid growth of credit, debit, and stored value card use as a percentage of sales will constantly and materially change as the shift in consumer payment preferences evolve. This evolution—along with consumer payment preferences that vary significantly by business type, region and other factors—reduce the reliability of card transactions alone as a measure of business total sales. ETA believes that the burden that this reporting requirement would place on merchant acquiring banks, as well as small businesses, will vastly outweigh any benefits gained from such reports. Furthermore, as this would be a system of guessing, it is ripe for abuse. With thousands of businesses currently operating in the U.S., it is not practical to expect that the IRS could become an expert on the spending habits of individuals and businesses.

While ETA supports increased compliance by small businesses when filing their tax returns, it is not a simple process for merchant acquiring banks to send the credit and debit reimbursement information to the IRS that would be meaningful. For example, there are cash back options on purchases; returns/chargebacks; tips/merchandise on a single transaction; redemption of gift cards purchased in one tax season and redeemed in another; retained merchant fees (e.g., terminal rental, custom services, etc); and many more such examples that illustrate why a single aggregate number may provide misleading information. Implementing a reporting system that would provide useful information to the IRS would cost merchant acquiring banks millions of dollars and countless hours to gather information for an effort that is fundamentally flawed.

In addition, most merchant banks would likely be required to rely on third parties, such as payment processors and other third party service providers to provide information that the IRS wants. This proposal will have far reaching efforts and unintended consequences.

Source of Budget Estimates Unclear

The uncertainty over the benefits of this reporting requirement is most evident in the Federal budget proposals from FY2007 and FY2008. In the FY2007 report, the Treasury estimated that the reporting requirement would help generate $9 million in 2007, $92 million during the years 2007–2011, and $225 million during the years 2007–2016. In contrast, the FY2008 report stated that the reporting requirement would help generate $113 million in 2008, $3.3 billion during the years 2008–2012, and $10.8 billion during the years 2008–2017. Both the FY2007 and FY2008 report are based on data gathered from the 2001 tax year, and there is no explanation for how the proposed revenue estimate jumped astronomically from 2007 to 2008.

Disincentive for Small Merchants to Accept Credit and Debit Cards

ETA believes that the proposed merchant acquirer reporting requirement may have the unintended consequence of driving away traditional cash-based merchants from accepting payment cards. The proposal would punish the vast majority of small businesses that are in compliance with reporting because of the indiscretions of those few that underreport. Those few dishonest small businesses that knowingly underreport may choose not to accept payment cards in the future when it is known that credit and debit card expenditures are reported to the IRS and any misrepresentation could be revealed upon review. Therefore, this approach would only increase the costs associated with credit and debit card usage without identifying any additional taxable income that would not have already been reported.

Finally, the increased costs of compliance for merchant acquiring banks will be passed on to the merchants and eventually borne by consumers in the form of higher prices for goods and services.

Conclusion

ETA requests that the Subcommittee undertake a critical evaluation of the proposed merchant acquiring bank reporting requirement. ETA believes that as proposed, the reporting requirement would: (1) provide potentially misleading information to the IRS; (2) create a costly new reporting requirement that would increase consumer prices; and (3) drive small businesses away from accepting payment cards.

The ETA stands ready to assist the Subcommittee as it considers this proposal. Should you have any questions or need additional information, please contact Rob Drozdowski of my staff at (202) 828–2635 or Rob.Drozdowski@electran.org.

Sincerely,

Carla Balakgi
Executive Director

Statement of Gerald E. Scorse, New York, New York

Taxes on long-term capital gains are at their lowest level in over 70 years. Should we be celebrating? Not to my mind, and I hope to win you over to my point of view. First a brief preface: President Bush has dubbed himself The Decider, and he most definitely is. Far away, about as far from deciding as a person could possibly get, I've dubbed myself a fact-finder.

Nobody can find all the facts so I had to pick a category and I chose taxes. Within the category I opted to focus on tax fairness for ordinary Americans.

This is the fifth year in which I've filed written testimony on a tax fairness issue, and I greatly appreciate these opportunities. It's a wonderful country where a plain fact-finder gets to present his arguments directly to the lawmakers.

With that I invite you to read "The Spurious, Curious Case for Low Taxes on Capital Gains" plus an addendum. The addendum includes important, related points which would have slowed down the article itself.

Once you have read all the material, I further invite you to draw your own conclusions based on (what else) the facts.

The Spurious, Curious Case for Low Capital Gains Taxes

These are heady times for backers of low taxes on capital gains. Presidents Clinton and Bush both cut the capital gains rate, bringing the current levy on long-term gains down to 15%. That's the lowest in more than 70 years, "gloriously low" in the words of economist Ben Stein, and it means that profits on stock market transactions are now taxed at a lower rate than the wages of average Americans.

There's no good reason for this preferential treatment, and powerful reasons to end it. Leading the list is the simple fact that stock market "investors" are almost never real investors in the first place.

The argument for a low rate on capital gains is invariable (and in recent years, invariably effective): it holds that investments in the stock market grow jobs, grow businesses, and provide vital fuel for the United States economy. Partly as inducement and partly in gratitude, the argument goes, it behooves government to reward investors with low capital gains taxes.

A potent blend of myth, propaganda and misimpressions. Let's look instead at some truths.

It's routine on Wall Street these days for trading volume to run in the billions of shares. On any given day, only a tiny fraction of those billions has any valid claim to growing jobs or businesses or the economy. On many days not a single share qualifies as a bona fide investment.

Almost all the time, all that's happening is money changing hands as shares move from sellers to buyers. Not a cent goes to the companies whose shares are traded. No jobs are created (except in the financial community, which is not the point here). No businesses are expanded. Investments are really being made not in the economy but in personal portfolios.

The only genuine stock market investments are those in initial public offerings (IPOs) and secondary offerings. In those cases alone does the money move on to do the work it's purported to do. All the rest is aftermarket noise as the players place their bets at the tables down on Wall Street.

Securities markets clearly play an energizing role in the American economy. All the same it's nonsense to claim that buyers of stocks deserve a tax break when they sell their shares at a profit. A tax break? For making money in the market?Now for more reasons why this is poor policy.

There's a fairness issue that flows from taxing one kind of income differently from another. Income is income and should be taxed at the same rates no matter where it comes from; what's good for the goose is good for the gander.

There's the issue of income inequality, which has soared in America lately. According to the David Cay Johnston book *Perfectly Legal*, the top one percent of taxpayers controls about half the nation's financial assets. Two-thirds of the income of the 400 highest-income Americans comes from long-term capital gains. Undeniably, the benefits of tax breaks for capital gains flow overwhelmingly to the already-wealthy; undeniably, preferential rates on capital gains exacerbate income inequality.

Finally there's a tax equity issue which our forebears even considered a moral issue. In 1924 Congress first differentiated between earned income (wages and salaries) and unearned income (e.g., capital gains and dividends), and taxed the unearned income at higher rates. It was deemed the right thing to do; old-timers would have shuddered at the notion of taxing wages at higher rates than capital gains.

Those were the days. Now it's 2007.

Under the trumped-up cover of spurring economic growth, average American workers have to pay higher taxes on their wages than if they made the same

amount of money in the stock market. They're getting stiffed by carrying a heavier relative tax burden, getting fewer services or some of both.

The latest capital gains tax cut is set to expire in 2010, and the new Democratic Congress has indicated that it has no plans to visit the issue until after the 2008 elections. This gives them plenty of time to look beyond the propaganda, and to consider taxing capital gains at least as much as earned income. A political pipedream? It was the rule not long ago: from 1988 to 1992, long-term realized gains were essentially taxed at the same rate as other income.

Then the K Street apostles went forth and preached, and the spurious case became gospel.

SOURCES

Johnston, David Cay. Perfectly Legal (New York: The Penguin Group, 2003), pp. 16–17, p. 310

Stein, Ben. "It's a Great Country, Especially if You're Rich," Sunday Business, The New York Times, February 11, 2007

Weisman, Steven. The Great Tax Wars (New York: Simon and Schuster, 2002), p. 351

ADDENDUM

(1) *A Way to Pay for Repeal of the Alternative Minimum Tax*

The Congress could look at restoring equal taxes on ordinary income and capital gains as a way to fund repeal of the AMT.

It will immediately be objected (by Republicans and likely some Democrats), no doubt at high decibel levels, that this is a tax increase, and that the increase will have a chilling effect on investments. Let's go straight to these arguments, starting with the "tax increase":

Millions of Americans for whom the AMT was never intended are already paying a tax increase because of the AMT. In 2006 about 20 million taxpayers qualified for the AMT and about 3.5 million actually paid it (the difference between those numbers being those who were spared by the latest of Congress's AMT patches).

But the patches have become increasingly expensive as millions more cross into AMT territory. Estimates are that 30 million taxpayers will qualify by 2010 and 60 million within a decade. According to a news article in The New York Times on March 14, a two-year freeze currently being considered by Congress would cost $200 billion.

There's an idiom for Congress's handling of the AMT: "kicking the can down the road." The kicking has to stop sometime.

This is a choice you have: continue a tax increase that was never intended, or let expire a tax decrease that should never have been enacted.

(Regarding the Iraq War, Senator Hagel admonished his fellow senators that they were in politics to make the hard choices. Do the Senator's words also apply to the choice between continuing the AMT or annulling the capital gains tax cuts? Only you can decide.)

Now to the supposed ill effects on investments of the increase in capital gains taxes:

If it wishes, Congress could in fact continue the favorable taxation of capital gains on shares purchased in initial public offerings (IPOs) or secondary offerings. Current technology would make it a simple matter to identify and track these shares for tax purposes.

It might also be argued that investors need no extra tax incentive: the profit motive is alive and well, and can be counted on to operate even when the tax on capital gains is the same as the tax on earned income.

(2) *Average Americans' Capital Gains Are Taxed as Ordinary Income*

One defense of low taxes on capital gains is the notion that stockholding has become commonplace in America: everybody owns stocks, so everybody benefits.

The argument contains an ounce of truth and a pound of deceit.

Stock ownership by average Americans has surely risen in recent years, most particularly since the government's creation of tax-deferred retirement accounts in 1974. The number and type of such accounts has increased continually as Congress has approved (and the financial community has created) new ways for workers to save for retirement.

But workers and their families have run into strong headwinds. U.S. employment has undergone a structural shift away from higher-paying, higher-benefit jobs in manufacturing and toward lower-paying, lower-benefit jobs in the service sector. Defined-benefit pension plans, once the norm, have steadily given way to defined-con-

tribution plans. The new plans carry no guarantees and essentially amount to cuts in retirement benefits.

Moreover, despite incentives such as tax deductions, tax deferral, and matching contributions by employers, the percentage of workers enrolling in retirement plans has not lived up to expectations. Congress took note of this as recently as last summer when it included, in the Pension Protection Act of 2006, a provision for automatic enrollment of workers in companies offering 401(k), 403(b) and 457 plans.

Dollar amounts put away for retirement have also fallen short. The 2006 Fidelity Retirement Index showed that the typical working American household had saved only $20,000 toward retirement, and 15% of families had not even started to save.

So one part of the deceit is the idea that "everybody" owns stocks, and "everybody" benefits, from low capital gains tax rates. The Cato Institute unwittingly underlined the second, most telling part in its Policy Analysis No. 586 (January 8, 2007).

On page 6 of the analysis Cato's Alan Reynolds correctly notes that "—in recent years, an increasingly large share of middle-income investment returns have been sheltered inside tax-favored accounts." On page 7 Reynolds notes, also correctly, that when these investments are withdrawn they will show up as ordinary income.

This means, of course, that the realized capital gains of average Americans are taxed as ordinary income. They are not covered by the capital gains tax cuts passed under Presidents Clinton and Bush (nor should they be, but that is irrelevant here).

To sum up: stockholding is not genuinely widespread in America, and most middle-income Americans who do own stock do not benefit from low capital gains tax rates because their capital gains are taxed at ordinary income rates.

An ounce of truth, a pound of deceit.

(3) *Repeal The $3,000 Annual Capital Loss Tax Write-off*

All the arguments against preferential taxation of stock market capital gains apply with equal force to the tax write-off of the first $3,000 of net capital losses (and more: amounts greater than $3,000 can be carried forward indefinitely until they too are amortized).

Investors in original and secondary offerings fully deserve these write-offs, and for them the amounts should be increased; $3,000 is little more than chump-change these days.

But the write-offs for all other "investors" should end. The government has no business subsidizing stock market losses. It serves no public policy purpose; as for fiscal policy, the only possible result is to cost the Treasury billions upon billions, year after year.

Congress can end these losses, and strike a small blow for tax fairness, by repealing this provision of the Internal Revenue Code.

(4) *Bond Interest Taxed As Ordinary Income*

The arguments for low taxes on capital gains are totally undercut by the taxation of bond interest at ordinary income rates.

Initial and secondary-issue corporate bonds are vital debt instruments. They *do* create jobs, *do* grow businesses and *do* stimulate the economy.

Please note that there is no lack of demand for these offerings. This is true even though the major reason for their purchase, the interest they pay, is taxed at ordinary income rates.

James R. White
April 3, 2007

The Honorable Jim Ramstad
Ranking Minority Member
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Ramstad:

Effective tax administration requires a balance of taxpayer service and tax law enforcement. To provide enforcement and taxpayer service in fiscal year (FY) 2008,

the Internal Revenue Service (IRS) has requested an $11.6 billion[1] operating level budget with about 63 percent going for enforcement activities and 31 percent for taxpayer service (including operational support). The remaining request includes funding to develop and implement modernized information systems.

IRS provides much of its services to taxpayers during the annual tax return filing season, making filing season performance a key indicator of how well IRS is serving taxpayers. In past reports and testimonies, we said that IRS has made significant progress improving taxpayer service since passage of the IRS Restructuring and Reform Act of 1998 (RRA 98).[2] Improvements include increased electronic filing, better access to IRS's telephone assistors, and more accurate answers to taxpayers' questions. However, we have also described taxpayer service challenges such as the quality of assistance at walk-in and volunteer sites where taxpayers get face-to-face assistance. Moreover, the Commissioner of Internal Revenue stated that this year's filing season is high risk for several reasons, including challenges in implementing the new telephone excise tax refund (TETR), split refund option (refunds can now be directly deposited to up to three separate accounts), and several tax law extensions that passed late in 2006.

Although IRS has increased revenue collected through its enforcement programs in recent years, enforcement continues to be included on our list of high-risk federal programs.[3] This is due, in part, to the persistence of a large tax gap.[4] IRS estimated the gross tax gap to be $345 billion for tax year 2001. After late payments by taxpayers and revenue brought in by IRS's enforcement efforts, the resulting net tax gap is estimated to be $290 billion.

Another high-risk challenge is IRS's ongoing Business Systems Modernization (BSM) program, a multibillion-dollar, highly complex effort that involves the development and delivery of a number of modernized information systems that are intended to replace the agency's aging business and tax processing systems. The program is critical to supporting IRS's taxpayer service and enforcement goals and reducing the tax gap. We recently reported that despite progress made in implementing BSM projects and improving modernization management controls and capabilities, significant challenges and serious risks remain, and further program improvements are needed, which IRS is working to address.[5]

In light of the challenges IRS faces, you asked us to assess IRS's 2007 tax filing season performance, FY 2008 budget request, and the status of the BSM program. Our objectives were to (1) describe IRS's 2007 tax filing season performance for returns processing and taxpayer assistance including the impact of tax system changes, such as the TETR, split refund option, and several tax law extensions that passed late in 2006, (2) assess IRS's proposed FY 2008 budget and compare it with prior years' spending and staffing and determine what information it provides on the impact of proposals on the tax gap, how new spending initiatives are justified, and whether there are opportunities to reduce or reallocate resources, and (3) evaluate the status of IRS's efforts to develop and implement BSM.

On March 15, 2007, we briefed your staff and staff of the Subcommittee Chair on the preliminary observations of our review. This report transmits the updated materials we used at the briefing, which are reprinted as appendix I in the complete version of this report.

In summary, we made the following major points:

- Despite initial concerns and IRS's characterization of this year's filing season as high risk, early data show that tax systems changes have not had a significant effect on filing season operations or performance. In particular, TETR-related requests and telephone calls have been far less than IRS planned. As of March 16, 2007, IRS has processed 63.5 million individual income tax returns, with 69 percent including TETR requests. The number of returns filed electronically is 5 percent greater than this time last year. Also, IRS is achieving its goals for telephone service. However, there are areas of concern. In early March,

[1] The $11.6 billion includes $11.1 billion in new appropriated funds and $0.5 billion in other funds.

[2] See, for example, GAO, Tax Administration: IRS Improved Some Filing Season Services, but Long-term Goals Would Help Manage Strategic Trade-offs, GAO–06–51 (Washington, D.C.: Nov. 14, 2005), Internal Revenue Service: Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request, GAO–06–615T (Washington, D.C.: Apr. 6, 2006), and Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings, GAO–07–27 (Washington, D.C.: Nov. 15, 2006).

[3] GAO, High-Risk Series: An Update, GAO–07–310 (Washington, D.C.: January 2007).

[4] The tax gap is an estimate of the difference between what taxpayers pay in taxes voluntarily and on time and what they should pay under the law.

[5] GAO, Business Systems Modernization: Internal Revenue Service's Fiscal Year 2007 Expenditure Plan, GAO–07–247 (Washington, D.C.: Feb. 15, 2007).

the latest release of the Customer Account Data Engine (CADE), one of IRS's key tax return processing systems, became operational—2 months behind schedule. As a result of the delay, IRS has had slower processing times and delayed refunds for up to several days for millions of taxpayers. This delay may have a more serious impact on IRS's ability to deliver future releases of CADE, because it caused contention for key resources, but it is too early to know. Taxpayers' use of the Free File program (an alliance of companies that offer free return preparation and electronic filing on their Web sites to eligible taxpayers) is 5.5 percent below last year at this time.

- IRS's 2008 budget request would increase spending, particularly for enforcement. The $11.6 billion requested total operating budget is an increase of $608.8 million (5.6 percent) over the FY 2007 continuing resolution level. IRS proposes spending $7.2 billion for enforcement (including operational support), an increase of 6.5 percent, continuing a trend since 2004 of shifting a greater proportion of overall spending toward enforcement as compared to taxpayer service. IRS's budget request includes initiatives and legislative proposals to address the tax gap. There is limited data in IRS's request on the expected impact of the proposals on the gap. The expected direct enforcement revenue to be gained is small compared to the size of the tax gap. For example, IRS expects to yield about $699 million in FY 2010, or about 1/4 of 1 percent of the tax year 2001 net tax gap from additional enforcement staffing. However, the indirect effect on voluntary compliance is unknown. Several research studies by economists, while subject to data limitations, suggest that indirect revenue might exceed direct revenues gained. We asked for supplementary documents on six initiatives to better understand their expected benefits and costs. The documented justifications for those initiatives varied in the depth of useful information they provided. We continue to assess the justifications for the initiatives and whether IRS could cost effectively provide additional information that could be useful for the Congress and others as they assess IRS's budget request. IRS identified savings in the 2008 budget request, but other savings opportunities may exist. For example, IRS may be able to change the mix of services provided—such as giving taxpayers more options for help by e-mail or its Web site in place of more costly telephone or walk-in operations—but its study to identify cost-effective service delivery methods is several months behind schedule.
- IRS continues to make progress in implementing BSM projects and meeting cost and schedule commitments, but two key projects—CADE (discussed above) and Modernized e-File (a new electronic filing system)—experienced significant cost overruns during 2006. Future BSM project releases face serious risks, which IRS is working to mitigate. For example, delays in deploying the latest release of CADE have resulted in contention for key resources and will likely impact the design and development of the next two important releases, which are scheduled to be deployed later this year. IRS has made significant progress in implementing our prior recommendations and improving its modernization management controls and capabilities. However, critical controls and capabilities related to requirements development and management and post implementation reviews of deployed BSM projects have not yet been fully implemented. In addition, more work remains to be done by the agency to fully develop a long-term vision and strategy for completing the BSM program, including establishing time frames for consolidating and retiring legacy systems.

Scope and Methodology

To assess IRS's filing season performance for processing, telephones, face-to-face assistance and its Internet Web site, we obtained and analyzed IRS's performance and production data and compared it to annual goals and prior years' performance. Our work also included direct observations of key filing season operations, and interviews with IRS officials and other external stakeholders.

To assess IRS's 2008 budget request, we reviewed IRS's congressional budget justifications and supplementary documents to (1) identify trends in spending and staffing from FYs 2004 through 2008, (2) assess information on the tax gap and selected spending initiatives to assess the information provided to justify the request, and (3) identify areas of potential opportunities for savings and efficiencies. Our assessment is based on a comparative analysis funding, expenditures, and other documentation and interviews with IRS officials.

Our filing season and budget audit work was done primarily at IRS's National Office and its operating divisions including the Large and Mid-Size Business operating division in Washington, D.C; Small Business/Self-Employed operating division in New Carrollton, Md; and Wage and Investment Division operating division headquarters and Joint Operations Center and call site in Atlanta, Ga. We also inter-

viewed officials at the IRS Oversight Board in Washington, D.C. Additionally, we reviewed relevant external documentation and our reports and reports of the Treasury Inspector General for Tax Administration.

Our analysis of the BSM program was based primarily upon the results of our detailed review of the FY 2007 BSM expenditure plan that we issued in a recent report.[6]

In past work, we assessed IRS's budget and filing season performance data. We considered filing season performance measures and data that cover the quality, accessibility, and timeliness of IRS's services to be objective and reliable based on our prior work. Since the data sources and procedures for producing this year's budget and filing season data have not significantly changed from prior years, we determined that the data were sufficiently reliable for the purposes of this report. To the extent possible, we corroborated information from interviews with documentation and data and where not possible, we report the information as attributed to IRS officials. We have determined that the estimates for cost savings and Web site performance come from competent sources and are reasonable. Data limitations are discussed where appropriate. We performed our work from December 2006 through March 2007 in accordance with generally accepted government auditing standards.

Agency Comments

In commenting on a draft of this report, IRS officials emphasized that the budget's initiatives and legislative proposals will result in additional direct and indirect revenue and, ultimately, increase compliance. It also reported that it will soon release its strategic plan for taxpayer service delivery, which will serve as the foundation for future decisions for service improvements and efficiencies.

We are sending copies of this report to the Chairmen and Ranking Minority Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for the IRS. We are also sending copies to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Chairman of the IRS Oversight Board, and the Director of the Office of Management and Budget. Copies are also available at no charge on the GAO Web site at http://www.gao.gov.

If you or you staff have any questions or wish to discuss the material in this briefing further, please call me. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in Appendix II in the complete version of this report.

Sincerely yours,

James R. White
Director

Colfax, California
March 22, 2007

The Honorable Richard E. Neil
2208 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Neal,

My name is Janine Valdivieso, 49, I grew up in Southern California, and now work as a Child-Support Specialist in North-Eastern California. My husband Joe and I have three daughters, and live Colfax, ca. Joe and I began saving for college tuition for our two youngest daughters, and setting aside money for our retirement fund

I have spent the majority of my work life in public service. I served in the United States Army and worked for 2 state governments and 2 county governments. It wasn't until August 1999, when I was offered a job at Symyx, that I made the decision to enter the private sector. As a part of my overall compensation, I was granted incentive stock options (ISOs). Like many others, I hoped that it would some day offer our family a little better financial future. I accepted a lower salary then I needed, because the company offered ISOs, which I hoped would someday make up for the lower salary.

Joe also received incentive stock options from Sandisk). We were told by our employers that we would not be impacted by alternative minimum tax (AMT), as long

[6] GAO–07–247.

as we held on to the stock, and did not sell during the same year (it made common sense since Congress also encourages people to hold stock for the long term). Unfortunately, this was information that would prove to be both incorrect and financially devastating.

Joe and I followed that advice, and purchased the shares as they vested throughout the year. One transaction in particular was especially damaging. The option, or strike price, was around $3, but the company stock closed that day at $94.

The alternative minimum tax is assessed based on the difference between the price paid for the options and the fair market value, or closing price, on that same day. By the end of the year, even though it was a paper profit only, we did not actually sell any of those shares, we owed tax in the amount of $100,000 in addition to the almost $25,000 in regular tax that we paid throughout the year, an amount greater then our combined annual income. Please remember, there were no capital gains because we had not sold the stock.

To pay the AMT, we had to sell most of our stock at a much lower price than what we were taxed on. We also had to sell all of the stock in our retirement funds and cash-in our girls' college tuition savings. Meanwhile the AMT overpayment sits as an interest-free loan with U.S. Treasury while we are out $100,000 in retirement savings and college funds! This makes NO logical sense and we feel that we are be penalized for being good tax paying citizens.

"It hurts every day to feel that we have been unfairly taxed by our government when I have spent a good part of my life working for that same government. I have been trying for six years to figure out how the IRS is using our money while we struggle each and every day."

Actually we were some of the lucky people who were able to sell the stock and pay the tax. I have met hundreds of people who have been financially devastated and are now in fear of losing their houses and cannot hope to pay the tax in a lifetime.

Please help to fix this insidious tax.

Janine Valdivieso

Statement of Nancy L. Shoemake, Burnsville, Minnesota

I would like to share with you a first-hand encounter into the culture and abuse of the IRS.

I have been preparing tax returns for the past 20 years. I predominately serve airline employees and handle specific issues pertaining to the travel industry. In July, 2005 many of my clients began receiving audits out of the Fresno, California IRS Service Center. After 300+ clients received these letters requiring substantiation of all Schedule A deductions, it became apparent that this was no ordinary procedure. A "Freedom of Information Request" was filed and the report identified an "informant" had precipitated this action. Upon further investigation it was evident that my "former husband and his new wife" had launched a smear attack to discredit and destroy my business to coerce me to cease pending child support litigation.

Most of these audit clients sought the assistance of my office. The IRS requested an initial response within 30 days of receipt of the audit letter. Consequently, my small staff was inundated with over 300 "correspondence audits" initiated by a Service Center halfway across the country. Over 30,000 documents were copied and faxed to Fresno from my Minnesota-based office. Fresno basically ignored this documentation and issued "deficiency" letters to approximately 80% of these taxpayers. The letters required that if the Tax Court Petition was not filed within 90 days, then the tax recomputed by the Service Center (computed basically with the disallowance of all employee expenses and itemized deductions) would be assessed and collected. In essence, these taxpayers were given two choices: take their case to Tax Court or accept the disallowance of their deductions and pay the balance due.

Under these circumstances, the majority of the taxpayers elected to go to Tax Court. Unfortunately, this infuriated a number of people at the IRS St. Paul offices since what should originally have been conducted as 300 "office audits" at the initial audit level had now been transferred to being 300 "office audits" conducted at the "Appeals" or "IRS Counsel" level. Each department has been more than ready to voice their hostility to this procedure since it is clearly not a customary practice to handle an audit in this manner. The taxpayers had sought to compromise and limit the cost and inconvenience of the representation and required appearances before the IRS by the taxpayers and their representatives versus paying the actual pro-

posed deficiency. Some of my clients (as anticipated by the IRS Service Center) had concluded that the cost of paying the deficiency is less than the cost and inconvenience of the actual trial. However, with the guidance of the Taxpayer Advocate Office in St Paul, it was decided that to encourage this course of action was a disservice to the taxpayer.

What caused this problem? According to the IRS Commissioner's most recent numbers, there are now approximately 12,500 IRS audit personnel (as opposed to 15,000 FBI agents). Since the IRS audit and enforcement personnel and budget has been slashed by such drastic and substantial amounts, in order to maintain the appearance of anything like "adequate" audit coverage (in the ?70's and ?80's approximately 3% of the tax returns were audited whereas today less than 1 in 2000 is audited), the definition of an "audit" has been changed from the previous procedure of an actual office auditor or IRS agent making face to face contact and actually examining items of substantiation related to a return in their possession to a "new definition" of an "audit". Today the IRS defines an "audit" as any piece of paper generated by the Service Center and directed to the taxpayer in relation to their tax return. In essence, if you receive a letter from the Service Center that your return was "accepted as filed", you have been "audited" and this entitles the Commissioner to appear before congress and allege that this administration has conducted substantially more audits with much less in the way of resources. Of course, this is bogus, but the majority of the public and congress is totally in the dark that what has changed is not the efficiency of the IRS but rather the definition of an "audit".

In summary, it appears that the administration, in their quest to generate a large number of "audits" without the expenditure of any manpower or resources, chose to spray 300 Statutory Notices of Deficiencies without ever having conducted an actual "audit". When this process blew up in their face, they just walked away from it and left the taxpayers and my office to deal with the problem of conducting real audits at the Tax Court level.

When these several hundred cases docketed for trial reached St. Paul, an effort was made to resolve them all without the necessity of trial. However, District Counsel stated that it was their intent to "try them all". Once it had become apparent that the IRS had no interest in settling these cases on a basis that was fair and equitable to both the taxpayers and the government and the government's position was basically "bring' em on", the taxpayers proceeded to trail. In April 2006, (8) taxpayer cases were tried in Tax Court with a cumulative deficiency (after amending a few of the tax returns due to subsequent corrected interest amortization and other adjustments) of $735.50 per client. The Tax Court decisions were more favorable to the taxpayers than what the taxpayers had offered to settle for in order to avoid the time, trouble, cost and inconvenience of an actual Tax Court trial.

Not at all chastened by this outcome, the IRS proceeded to trial again with more of these cases in October of 2006, but this time with a more favorably disposed Judge. A handful of clients are still awaiting the determination of the October, 2006 Tax Court.

It should be noted that the Judge brought in to handle these October, 2006 "S" cases was a local lady who started the proceedings by stating to the taxpayers (and made the same comment for the record numerous times) they had been "duped" by their tax preparer and the deductions they had claimed were bogus and not allowable. The Judge was making these pronouncements prior to having received or heard any evidence whatsoever. Furthermore, this Judge had previously stated during telephone conferences held with the taxpayers who had pending cases prior to trial that she knew the District Counsel attorney and that the taxpayers should ignore what their CPA was telling them and rely instead upon what the IRS attorney advised them was an allowable deduction because she knew the attorney to be "trustworthy and reliable". Keep in mind that this Judge is giving this advice to pending litigants when the results of the identical cases tried the previous April resulted in the allowance of the expenses claimed far in excess of what the IRS alleged was "allowable".

Since this Judge had absolutely no prior dealings with me in the past and had no first hand knowledge of me, it would appear that there were exparte discussions being held between the Judge and the Office of District Counsel which this Judge had accepted as "gospel". She made the decision to shed the robes of a judge and had assumed instead the mantel of the advocate prior to ever setting foot in the courtroom. Hence, several of the taxpayers have written the Chief Judge of the Tax Court expressing their dismay at the conduct of the Court. The taxpayers were looking for a Judge who was impartial and not so blatantly biased.

The Judge in the October "S" Court Trial Calendar having made the above remarks prior to the start of the trials moved the other taxpayers who had pending "S" cases to request that their cases be removed from the S calendar and tried as

a regular Tax Court case since the Court had basically rendered her decision prior to the cases having even started and in essence told the taxpayers they were "going to lose".

This past year and a half has opened my eyes as well as many taxpayers to a system and process that drastically needs accountability and change. The mission statement of the IRS is "To provide America's taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." The responsible parties are now telling us "mission accomplished"? However, everyone who has witnessed and experienced this process would take issue with that mission statement.

To hold taxpayers accountable for providing proof of their deductions is a necessary and reasonable expectation. In order to maintain voluntary compliance a certain level of audit verification is essential. However, this administration, in order to distort the level of audit compliance actually in effect has changed the definition of an "audit" to allow the Service Centers to contact and spray Statutory Notices of Deficiencies to allow the Commissioner to claim that he has maximized the efficiency of the IRS to conduct a massive increase in audits with much lower manpower and resources. In order to attempt to maintain this bogus claim it is necessary to use intimidation tactics and then to create such a cumbersome, exhausting and expensive process for the purpose of exchanging information at the Service Center level that taxpayers become exhausted both financial and emotionally. This is not reasonable.

While it appears that IRS reform began in the late 1990's to create an environment that was conducive for communication, it appears as though this "reformation" did not reach the Appeals and General Counsel Level. Many of my clients desire an opportunity to share their experiences concerning "abuse of power" and "techniques of manipulation" by both employees in the St. Paul Appeals and Counsel divisions. Unfortunately, the accountability that is needed to promote change has not reached the upper levels of the IRS. This is apparent in the communication and actions of these departments.

As stated above, I have been in the business of tax preparation for over 20 years and have filed close to 30,000 tax returns. This entire debacle has been one of harassment since the IRS could not find wrong doing with the 300+ returns that were audited. The IRS acted on behalf of a dubious informant with malicious intent and has invested numerous dollars into my demise.

As Mr. Paul Ferber, IRS Officer, EIN 41–03970, stated during an October 17, 2006 meeting at my office the "typical investigative protocol" is 15–20 audits to see if there were truly any patterns of tax preparer misconduct. This was not followed.

Unfortunately, this whole investigation was skewed with the intention of finding some form of misconduct attributed to me instead of choosing to look at the reasons the IRS resorted to the "mass mail audit method" initiating over 300 audits based on a spiteful ex-spouse. This has been an exhausting ordeal to the taxpayers and I can only estimate the cost to the American public is in excess of seven digits.

Thank you for the opportunity to communicate this pernicious and prejudicial experience. In addition to my statement there are many of these 300+ taxpayers that would welcome the opportunity to share the injustice perpetrated by the IRS.

Statement of William David Kebshull

The purpose of this statement is to bring to the attention of the Subcommittee on Oversight Internal Revenue Service misconduct concerning instructions that produce illegal "**Double or Nothing Taxation**" of the income and recovery related to an itemized deduction. Because IRS instruction are not consistent with section 111(a) of the Internal Revenue Code, some taxpayers are defrauded by numerous IRS instructions, at least one of which, the instruction for the calculation of taxable Social security benefits, goes back to 1984. On the other hand, the bollixed IRS instruction for Line 7 on Form 6251, Alternative Minimum Tax—Individuals, has caused the loss of billions of dollars to the United States Treasury since 1988.

IRS's Bollixed Interpretation of Section 56(b)(1)(D): A Multi-billion Fraud on the United States Treasury

In 1999, two letters from me to IRS and two letters from IRS to me were released by IRS as Tax Correspondence and published in *Tax Analyst*.[i] The letter from a respondent in the IRS Office of Chief Counsel presented a detailed response to my concerns about the tax treatment of itemized deduction recoveries. Unfortunately, the respondent seemed to subscribed to the philosophy of John Sears, an advisor to Ronald Regan, "reality is an illusion that can be overcome." Here is how the respondent tried to justify the IRS instruction (currently line 7 on Form 6251) that has produced a multi-billion dollar fraud on the United States Treasury.

As stated in prior correspondence we disagree with your assertion that recoveries of taxes described in paragraphs (1), (2), or (3) of section 164(a) should only be excluded from gross income in computing AMTI to the extent deduction of the taxes did not reduce the taxpayer's income tax liability. Under your interpretation section 56(b)(1)(D) would be unnecessary; it would only apply to exclude items from gross income when such items are already excluded from gross income under section 111.

Comment:

When the respondent's letter was published in 1999 his assertion that a tax deduction taken in a year that the Alternative Minimum Tax(AMT) was paid could not have reduced a taxpayer's income tax liability and therefore the refund should not be included in gross income on Form 1040 was no longer true. In fact, beginning in 1997, a tax deduction claimed on Schedule A (Form 1040) could have reduced a taxpayer's tax liability when the AMT was paid as a result of what I have described below as the limited long-term capital gains rate-based tax benefit which results from the two tier capital gains rate structure. See page 2 of Form 6251. The benefit of a tax overpayment is revealed by application of IRS instructions in Publication 525.

The IRS respondent then stated:

Section 56(b)(1)(D) provides that no recovery of any tax to which section 56(b)(1)(A)(ii) applied shall be included in gross income for purposes of computing AMTI. By its terms section 56(b)(1)(A)(ii) denies any deduction in computing AMTI for taxes described in section 164(a)(1)-(3). It does not limit its application to taxable years in which the taxpayer is liable for AMT. Because these taxes are never deductible in computing AMTI, recoveries of such taxes are always excluded from gross income, under section 56(b)(1)(D), for purposes of computing AMTI.

Comment:

What the IRS respondent is saying is that section 56(b)(1)(D) provides that refunds of taxes that were allowed as itemized deductions under section 164(a) and as such produced a tax benefit when the regular tax was paid are excluded from AMTI in addition to the taxes that were not allowed as a deduction under section 56(b)(1)(A)(ii) and therefore produced no tax benefit because the AMT was paid.

When the respondent stated, *It does not limit its application to taxable years in which the taxpayer is liable for AMT,* he was simply wrong. Section 56(b)(1)(D) means exactly what it says: *no recovery of any tax to which subparagraph (A)(ii)* ***applied*** *shall be included in gross income for purposes of determining alternative minimum taxable income.* For subparagraph (A)(ii) to have applied to the tax being refunded, payment of the AMT would have been required. Section 56(b)(1)(D) is necessary to appropriately preclude the inclusion in AMTI of a refund of a tax overpayment that produced a limited long-term capital gains rate-based tax benefit in a year the AMT was paid. When the tax benefit is the result of paying tax on less taxable income rather than the result of paying tax at a lower rate on a portion of capital gains, the tax refund must be included in AMTI based on a rational interpretation of the tax benefit rule.

If it were the intent of Congress not to include the refunds of all taxes claimed as itemized deductions on Schedule A (1040), section 56(b)(1)(D) would state the following:

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[i] Tax Analyst,Tax Notes Today,March 18, 1999 Thursday, Department: Official Announcements, Notices, and News Releases; IRS Tax Correspondence, Cite: 1999 TNT 52–53. HEADLINE: 1999 TNT 52–53 Taxpayer Irate About IRS's Position on AMT and Tax Benefit Rule (Section 111—Tax Benefit Recovery Items;) (Release Date: DECEMBER 08, 1998) (Doc 1999–10275 (28 original pages))

Treatment of certain recoveries

No recovery of any tax claimed as a itemized deduction under subparagraphs (1), (2), or (3) of section 164(a) shall not be included in gross income for purposes of determining alternative minimum taxable income.

But that is not what 56(b)(1)(D) states.

This is a question for the Internal Revenue Service and the Treasury Department to answer:

If a tax overpayment is allowed as a deduction and produces a tax benefit in a year that the regular tax is paid and the refund of that overpayment is to be excluded from alternative minimum taxable income in a year the AMT is paid as indicated by the IRS respondent, just when is the income/refund taxed directly?

IRS's Defective Interpretations of the Tax Benefit Rule, Section 111(a) of the Internal Revenue Code, Produces Double Taxation of Itemized Deductions Recoveries.

Section 111(a) of the Internal Revenue Code provides: Deductions.

Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter.

Here are two fundamental facts related to the impact of itemized deductions on the taxes paid on an individual's federal income tax return.

- An itemized deduction included on Schedule A (Form 1040) does not reduce the amount of gross income reported on Form 1040.
- The reduction in taxable income attributable to an itemized deduction cannot reduce taxable income by more than the amount of the itemized deduction.

Here are some of the results of instructions related to the Internal Revenue Service's erroneous interpretation of section 111(a) of the Internal Revenue Code:

- Inclusion of an itemized deduction recovery in the calculation of taxable Social Security benefits can result in the gross income attributable to a recovery being up to 1.85 times the amount of the recovery. (Remember, the income used for the payment of the deductible expense could have produced a similar result the a prior year.)
- Inclusion of itemized deduction recoveries in the calculation of taxable Social Security benefits and in adjusted gross income (AGI) or one of the numerous versions of modified adjusted gross income, when calculating deductions, credits, exemptions, exclusions, or eligibilities, can result in the taxable income attributable to a recovery being more than twice the amount of the recovery.
- In the case of some credits, the reduction in the allowable tax credit attributable to a itemized deduction recovery may be many times the amount of the recovery. Take the retirement savings contribution credit for example where a tax refund of only a few dollars can eliminate a $400 credit.

The National Taxpayer Advocate 2006 Annual Report to Congress lists 23 provisions, in addition to those cited above with income-based phase-outs.[ii] In addition, there is now the refundable AMT credit provision that was included in late 2006 legislation that is subject to a MAGI phase-out. The effect of including an itemized deduction recovery in the calculation of these items are adverse to the interest of the individual taxpayer in every case.

Here is how the Internal Revenue Service defined the "tax benefit rule", section 111 of the Internal Revenue Code in IRS Publication 525:

Tax benefit rule. You must include a recovery in your income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year.

The Internal Revenue Service omitted a very important word in defining the tax benefit rule. The rule should read to be consistent with the language in section 111(a). You must include a recovery in your **taxable** income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. —

Parsing the language in section 111(a) of the Internal Revenue Code yields the inescapable conclusion that it must be applied to every provision in the Internal Revenue Code that affects the determination of taxes. When this is done, taxable income will be increased by a recovery by the amount that IRS instructions indicate that is to be entered on either line 10 or line 21 of Form 1040. The Subcommittee

[ii] National Taxpayer Advocate 2006 Report to Congress, Table 2.4.1, pp. 473–476.

should find the 1994 law review article by Professor Matthew J. Barrett of interest with respect to the application of the tax benefit rule. [iii]

If the Oversight Subcommittee of the House Ways and Means has any concern about IRS conduct here is a question that the subcommittee must demand that IRS and Treasury officials answer.

Precisely, what is about the language in section 111(a) of the Internal Revenue Code that permits the Internal Revenue Service to issue instructions can result in the gross income attributable to an itemized deduction recovery exceeding the amount of the recovery? (Remember the inclusion of itemized deduction recoveries in the calculation of taxable Social Security benefits!)

IRS's Interpretation of Section 56(b)(1)(D) Yields a Multi-billion Fraud on the Treasury

While the Internal Revenue Service abuses taxpayers with instructions that result in taxes in excess of those permitted under the Internal Revenue Code as described above, other taxpayers are the beneficiaries of a bollixed IRS interpretation of a code section that defrauds the Treasury of the United States.

Here are the applicable sections of the Internal Revenue Code that are relevant to the tax treatment of deductible taxes and tax refunds when payment of the AMT is involved..

Section 56(b)(1)(a)(ii) and 56(b)(1)(D)

(b) Adjustments applicable to individuals In determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), the following treatment shall apply (in lieu of the treatment applicable for purposes of computing the regular tax):

(1) Limitation on deductions

(A) In general No deduction shall be allowed

(ii) for any taxes described in paragraph (1), (2), or (3) of section 164(a). Clause (ii) shall not apply to any amount allowable in computing adjusted gross income.

(D) Treatment of certain recoveries No recovery of any tax to which subparagraph (A)(ii) applied shall be included in gross income for purposes of determining alternative minimum taxable income.

Section 164(a)

(a) General rule Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes.

(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes

Here two fundamental facts related to tax deductions reported on Schedule A when the alternative minimum tax is paid:

- Deductions claimed for taxes reported on Schedule A (Form 1040) are not allowed as deductions in determining alternative minimum taxable income (AMTI).
- Deductions claimed for taxes reported on Schedule A (Form 1040) may provide a limited long-term capital gain rate-based tax benefit in a year the AMT is paid if the tax deduction increases the portion of capital gains being tax at 5 percent and reduces the portion being taxed at 15 percent. This tax benefit is reveal by application of instructions in IRS Publication 525.

Here are the result of IRS instructions when the AMT is paid in the year of a tax overpayment and the year that the refund of the overpayment is received.

- Provided there is no long-term capital gains rate-based tax benefit, a tax overpayment would have not have produced a tax benefit and the refund in a subsequent year is not included in gross income based on section 111(a) of the Internal Revenue Code.
- However, if there was a limited long-term capital gains rate-based tax benefit, when the AMT is paid, the portion of the refund that produced the benefit would be included in gross income and then appropriately excluded from AMTI by the instruction on line 7 of Form 6251. The refund amount included in gross income would flow to regular taxable income and thus increase the portion of long-term capital gains taxed at 15 percent and reduce the portion taxed at 5 percent thus offsetting the tax benefit from the tax overpayment in the prior year.

[iii] Matthew J. Barrett, "Determining an Individual's Federal Income Tax Liability When the Tax Benefit Rule Applies: A Fifty-Year Checkup Brings a New Prescription for Calculating Gross, Adjusted Gross, and Taxable Incomes" Tax Analyst, Tax Notes Today Cite: 94 TNT 87–34, May 5, 1994

- When there is a long-term capital gains rate-based tax benefit from a tax overpayment in a year that the AMT is paid, IRS instructions erroneously include the refund of the overpayment in AGI when calculating a medical expense deduction thus reducing the deduction.

Now consider the result of IRS instructions when there is a tax overpayment and refund and the regular tax is paid in one of the years and the AMT is paid in the other.

- When an itemized deduction is claimed for a tax overpayment in a year that only the regular tax is paid and the refund of the overpayment is received in a year that the alternative minimum tax (AMT) is paid, neither the income used for the overpayment nor the refund of the overpayment is taxed directly because of IRS's bollixed interpretation of section 56(b)(1)(D) of the Internal Revenue Code. The instruction that results from this bollixed interpretation is currently on line 7 of Form 6251. The consequence of this instruction has been the loss to the United States Treasury of billions of dollars since 1988. My estimate of the loss for tax year 2006 is about $500,000,000.
- Even though neither the income nor the refund related to a tax overpayment are tax directly under the circumstances described above, both the income used for the overpayment and the refund can reduce medical expense deductions. Inclusion of the refund in AGI when calculating medical expense deductions violates section 111(a) of the Internal Revenue Code.
- When an itemized deduction is claimed on Schedule A (Form 1040) for a tax overpayment in a year that the AMT is paid and there is a limited long-term capital gains rate-based tax benefit (under the circumstances described above) and the regular tax is paid in the year that the tax refund is received, the refund will be included in gross income per IRS instructions. Thus the income used for the tax overpayment will be taxed at the AMT rate and the refund will be taxed at the regular tax rate. Based on section 111(a) the refund of a tax overpayment that produced a limited long-term capital gains rate-based benefit should only be include in gross income for the purpose of determining the capital gains portion of a person's income tax in the refund year.

To summarize, based on IRS instructions when the regular tax is paid in one year and the AMT is paid in the other, and there is a tax benefit as a result of a tax overpayment included on Schedule A, the sequence in which the regular tax and the AMT is paid determines whether the income/refund related to the tax overpayment is taxed **"Double or Nothing".** I believe that it was Nina Olsen, the National Taxpayer Advocate, who described the tax treatment of income under the AMT as being "counterintuitive". I believe that because of IRS instructions a better term would be **fraudulent**.

The IRS Mission: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all".

Based on its mission, IRS would have us to believe that under the law all taxpayers are created equal. The reality is based on IRS's conduct, to paraphrase George Orwell, all taxpayers are created equal, but some taxpayers are more equal than others in the eyes of the Internal Revenue Service. If this assessment of IRS attitude were not true, there would be no "**Double or Nothing Taxation** " of the income/recovery related to an itemized deduction.

Anecdotal Experience—Eliminating Double Taxation With an Amended Return

On March 8, 2004, I amended the 2000 and 2001 Federal Income Tax returns for my father, who had died in early 2002, to reduce the taxable income attributable to state income tax refunds on those returns from being more than twice the amount of the refunds to being equal to the refunds. Tax professional were responsible for determining estimated taxes and preparing his tax returns.

Before receiving the second of the two refunds, I received Letter 3175 SC (Rev. 1999).

I believe this letter was in response to information that I provided the IRS Office of Chief Counsel and which was reviewed by the Office of Treasury Inspector General for Tax Administration. The letter closed with "Federal courts have consistently ruled against the arguments you have made. Therefore, we will not respond to future correspondence concerning these issues." If the courts have consistently ruled against my arguments, why did I subsequently receive a refund based on my arguments? Examination of the Title 26, United States Code, Annotated section 111 suggests that the courts have ruled in favor of my arguments.

Two days after I filed the two amended returns, March 10, 2004, Newsday reported that Commissioner Mark Everson had announced that he had paid the AMT for the first time. Taxpayers, especially Social Security recipients who have been double taxed on their tax refunds, can only wonder if Commissioner Everson was the beneficiary of the fraudulent instruction on line 7 of Form 6251.

Any continuing failure of the Subcommittee on Oversight to reign-in IRS's misconduct related to "**Double or Nothing Taxation"** under sections 111(a) and 56(b)(1)(D) will bring into question the commitment of the Subcommittee to effective oversight of the Internal Revenue Service.

Here is Letter 3175 (SC) (Rev. 2–1999) with notations of errors in the heading. Department of the Treasury

Internal Revenue Service
1973 North Rulon White Blvd.
Ogden, UT 84404

Date: Ddecember 14, 2004 (yes, Ddecember)

William D Kiebschull (Correct spelling is Kebschull)
Churchville, Maryland 21028

Dear Taxpayer(s):

This is in reply to you recent correspondence. Federal tax laws are passed by Congress and signed by the President. The Internal Revenue Service is responsible for administering Federal tax laws fairly and ensuring that taxpayers comply with the laws. We do not have authority to change the laws.

The Internal Revenue Service strives to collect the proper amount of revenue at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency, and fairness. In accomplishing this, we continually strive to help taxpayers resolve legitimate account problems as effectively as possible. While tax collection is not a popular function of government, it clearly is a necessary one. Without it all other function would cease.

There are people who encourage others to deliberately violate our nation's tax laws. It would be unfortunate if you were to rely on their opinions. These persons take legal statements out of context and claim that they are not subject to tax laws. Many offer advice that is false and misleading, hoping to encourage others to join them. Generally, their advice isn't free. Taxpayers who purchase this kind of information often wind up paying more in taxes, interest, and penalties than they would have paid simply by filing correct tax returns. Some may subject themselves to criminal penalties, including fines and possible imprisonment.

Federal courts have consistently ruled against the arguments you have made. Therefore, we will not respond to future correspondence concerning these issues.

Sincerely yours,

Facsimile signature for Dennis Parizek
Operations Manager
Exam SC Support

Enclosure
Publication 2105

Letter 3175 (SC) (Rev. 2–1999)
Cat. No. 26859J

April 3, 2007

My submittal to the Oversight Subcommittee of the House Ways and Means Committee concerning the Hearing on Internal Revenue Service Operations and the Tax Gap represents my opinions and only my opinions.

William David Kebschull

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