REPORT OF THE JOINT COMMITTEE ON TAXATION RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY SECTION 8022 OF THE INTERNAL REVENUE CODE

Prepared for the

HOUSE COMMITTEES ON WAYS AND MEANS,
APPROPRIATIONS, AND GOVERNMENT REFORM
AND THE SENATE COMMITTEES ON
FINANCE, APPROPRIATIONS, AND
HOMELAND SECURITY & GOVERNMENTAL AFFAIRS

For a Joint Review
Scheduled on May 19, 2005

By the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Internal Revenue Service Restructuring and Reform Act of 1998[1] (the "IRS Reform Act" or the "Act") made comprehensive changes relating to the operations of the Internal Revenue Service ("IRS"). Goals of the IRS Reform Act included increasing public confidence in the IRS and making the IRS an efficient, responsive, and respected agency that acts appropriately in carrying out its functions.[2]

The Act provided for changes in the organization and management of the IRS, Congressional oversight, electronic filing, and taxpayer protections and rights.[3] The Act also directed the IRS to review and restate its mission to increase its emphasis on serving the public and meeting taxpayer needs.[4]

Under provisions relating to Congressional oversight, the IRS Reform Act added Internal Revenue Code ("Code") section 8021(f),[5] which requires a joint review of IRS activities by members of the Senate and House Committees with IRS oversight responsibility. Specifically, the joint review is to be conducted by three members from each of the House Committees on Ways and Means, Appropriations, and Government Reform, and Senate Committees on Finance, Appropriations, and Homeland Security & Governmental Affairs. The joint review is to be held at the call of the Chairman of the Joint Committee on Taxation ("Joint Committee") and is to take place before June 1 of each calendar year 1999 through 2004.[6]

The requirement for a joint review by the Committees with oversight authority over the IRS builds on the findings of the National Commission on Restructuring the IRS. The Commission observed "a lack of coordinated focus on high level and strategic matters" among the Congressional Committees responsible for IRS oversight and found that "this nonintegrated approach ... blurs the ability to set strategic direction and focus on priorities."

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[1] Pub. L. No. 105-206 (July 22, 1998).

[2] H.R. Rep. No. 105-364, Pt. 1, at 34-35 (1997) and S. Rep. No. 105-174, at 11-12 (1998).

[3] For a summary of the IRS Reform Act's taxpayer rights and protections, see *Summary of Revenue Provisions Contained in Legislation Enacted During the 105th Congress* (JCX-75-98), November 19, 1998, at 61-77. *See* also, Internal Revenue Service, *Highlights of 1998 Tax Changes,* Publication 553 (December 1998) at 20-25.

[4] IRS Reform Act sec. 1002.

[5] Unless otherwise indicated, all section references are to the Code.

[6] The first five joint reviews were held on May 25, 1999, May 3, 2000, May 8, 2001, May 14, 2002, and May 20, 2003, respectively. No joint review was held in 2004. Pursuant to the Working Families Tax Relief Act of 2004, Pub. L. No. 108-311 (Oct. 4, 2004), the 2004 joint review will be considered timely if held before June 1, 2005.

The joint review is to address the strategic plans and budget of the IRS and such other matters as determined by the Chairman of the Joint Committee. The current joint review will include consideration of the possibility of developing agency performance goals (such as the goal of 80 percent electronic filing), IRS training and recruitment, and the use of fees and charges to finance IRS operations.

The IRS Reform Act also amended section 8022 to require the Joint Committee to report annually to the House Committees on Ways and Means, Appropriations, and Government Reform and Senate Committees on Finance, Appropriations, and Homeland Security & Governmental Affairs regarding certain matters relating to the IRS.[7] This document,[8] prepared by the staff of the Joint Committee, contains the report of the Joint Committee relating to the IRS required by section 8022.

A joint review of the strategic plans and budget of the IRS has been scheduled for May 19, 2005.

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[7] Sec. 8022(3)(c).

[8] This document may be cited as follows: Joint Committee on Taxation, *Report of the Joint Committee on Taxation Relating to the Internal Revenue Service as Required by Section 8022 of the Internal Revenue Code* (JCX-35-05), May 17, 2005.

EXECUTIVE SUMMARY

A. IRS Strategic Plan

1. In general

To assist the IRS in achieving its mission, the IRS has developed three strategic goals. These goals are: (1) to improve taxpayer service; (2) to enhance enforcement of the tax law; and (3) to modernize the IRS through its people, processes, and technology.

2. First strategic goal: improve taxpayer service

The IRS's first strategic goal, improving taxpayer service, is designed to ensure that taxpayers understand their tax obligations and to make it easier for taxpayers to comply with those obligations. Survey results show that a majority of taxpayers are satisfied with the level of service provided by the IRS. Measures of telephone service show a slight decline in service provided in 2005 from 2004 levels, which has been attributed to reductions in the IRS's service budget. Rates of electronic interactions with the IRS, including visits to the IRS's webpage, e-filing, and electronic payments, have continued to increase steadily. However, the IRS remains well short of the 80 percent e-filing goal established by the IRS Reform Act. Taxpayer visits to IRS walk-in sites, or Taxpayer Assistance Centers ("TACs"), have declined as a result of the increased availability of alternative sources of information, such as the IRS website. The IRS plans to close a substantial number of TACs in part due to budgetary constraints.

3. Second strategic goal: enhance enforcement of the tax law

The IRS's second strategic goal is to enhance enforcement of the tax law. With new estimates showing a slight expansion in the tax gap (i.e., the difference between the amount taxpayers owe and the amount they voluntarily pay on a timely basis), the IRS has stepped up enforcement activities in an effort to increase collections and deter noncompliance. Combating abusive tax shelters is the centerpiece of the IRS's enforcement strategy. The IRS has made significant progress in this regard by, among other things, pursuing settlement initiatives, forming a Joint International Tax Shelter Centre, and cooperating with the Department of Justice to obtain injunctions against tax shelter promoters and return preparers.

The government has also sought to enhance compliance by tax practitioners. Recent efforts have included: the issuance of final Circular 230 regulations that tighten the rules relating to tax shelter opinions; the pursuit of court cases regarding privilege; and the enactment of the American Jobs Creation Act of 2004, which increased existing penalties and added new penalties for failure to disclose tax shelter information or making false statements with regard to tax shelters.

Detecting and deterring criminal activity is another of the IRS's enforcement goals. To this end, the Department of Justice has prosecuted numerous cases involving illegal off-shore-based and other activities, and the IRS's Criminal Investigation Division has pursued and stopped billions of dollars in false refund claims. The IRS's enforcement priorities also include pursuing abuses by charitable and other tax-exempt organizations and preventing the misuse of such organizations by third parties.

After a several-year decline in audit activity, the IRS has seen a modest increase in the number of audits of individual returns since 2000. Much of this increase, however, is attributable to correspondence audits; the number of field audits has continued to decline. Although the audit rate for corporate returns declined steeply between 1997 and 2003, the number of audits of businesses with assets of $10 million or more increased in 2004. The IRS also continues to realize significant benefits from matching Forms W-2 and 1099.

To address the growing inventory of unpaid taxes, the American Jobs Creation Act of 2004 authorizes the IRS to use private collection agencies ("PCAs") to contact delinquent taxpayers and to arrange voluntary installment payment agreements. The IRS anticipates awarding contracts to an initial group of PCAs in the summer of 2005 and beginning initial collection activities under the new program in early 2006.

4. Third strategic goal: modernize the IRS through its people, processes, and technology

The IRS's third strategic goal is to modernize the IRS through its people, processes, and technology.

The IRS faces a growing number of external threats to its people, facilities, and information systems. The Treasury Inspector General for Tax Administration continues to monitor and pursue threats and assaults against IRS employees and facilities, as well as other attempts to corrupt tax administration. In addition, the IRS will partner with the General Services Administration and local law enforcement to ensure the safety of IRS workers. Furthermore, the IRS has committed to ensuring the safety and security of the massive amounts of data it stores and processes on its computer systems, although the Treasury Inspector General for Tax Administration has highlighted weaknesses in the IRS's security infrastructure and applications.

The IRS collects approximately $2 trillion in revenue annually but still depends on antiquated, decades-old computer systems. Over the years, the IRS's business systems modernization ("BSM") project has been plagued by cost increases and schedule delays. However, the IRS had a number of significant BSM achievements in 2004, including the initial release of the Customer Account Data Engine ("CADE"), which is intended ultimately to replace the IRS's Master File system. The IRS expects to process approximately 2 million Forms 1040-EZ using CADE during the 2005 filing season. The IRS also released Modernized e-File, which will allow corporations and tax-exempt organizations to file annual tax and information returns electronically. The IRS is resizing its BSM program to focus on fewer, but higher-priority projects, an approach the IRS views as being better aligned with the skill and capacity of IRS management. This streamlined approach is reflected in budget reductions for BSM for fiscal years 2005 and 2006.

5. Use of performance measures

As stated above, in the IRS Reform Act, Congress established a goal of 80 percent e-filing by fiscal year 2007. Although the IRS has made progress toward this goal, with approximately 53.91 percent of individual returns having been filed electronically during the 2005 filing season as of May 6, 2005, the IRS may fall short of the 80 percent e-filing goal absent implementation of new e-filing incentives. Agency performance goals, such as the 80 percent e-filing requirement, are important, because they allow for measurement of an agency's progress and for a more precise allocation of resources among an agency's functions. Without clear benchmarks, it is more difficult for an agency, or for parties exercising oversight responsibility, including Congress, to assess the agency's performance. Notwithstanding the need for clear benchmarks to measure the IRS's performance, there are few statutorily-mandated performance measures that relate to the IRS. As a result, some have suggested a need for legislation that would formalize IRS performance measures by establishing clear statutory benchmarks.

6. Employee training, recruiting, and retention

The IRS Reform Act placed an emphasis on training and required the Commissioner to implement a training program within 180 days of the date of enactment of the IRS Reform Act. The Commissioner was also required to submit a training plan to the Senate Committee on Finance and the House Committee on Ways and Means. The mandated plan was submitted to Congress on March 9, 1999, and by the end of that year, 50,000 IRS employees had received new customer service training relating to the IRS Reform Act.

With an increasing number of key IRS employees nearing retirement age, recruiting, retaining, and training employees is growing in importance. The IRS has committed to an aggressive management recruitment effort and intends to use technology to improve the retention and transfer of information to limit losses of institutional memory. The IRS is also improving its training of employees by, for example, increasing its use of e-learning opportunities.

B. IRS Budget for Fiscal Year 2006

For fiscal year 2006, the President's IRS budget request totals $10.679 billion and 97,010 full-time equivalent employee positions. The budget request reflects an increase of $443 million (4.3 percent) over the fiscal year 2005 appropriated level of $10.236 billion. It also represents an increase of 576 full-time equivalent employees (0.6 percent) from the fiscal year 2005 estimated operating level of 96,434 full-time equivalent employees.

The IRS fiscal year 2006 budget request is divided into three broad categories: (1) tax administration and operations; (2) health insurance tax credit administration; and (3) business systems modernization. With respect to the IRS's strategic goals, the 2006 budget request reflects a shift in resource allocation from taxpayer service and modernization to enforcement.

The IRS estimates that it will collect $100 million in user fees during fiscal year 2006. It will collect additional amounts in IRS-related excise taxes. The funds raised from these user fees and excise taxes are not automatically appropriated to the IRS. Some have suggested that such fees and excise taxes should be automatically appropriated to the IRS to offset costs of the programs to which they relate.

The IRS Oversight Board recommended a budget that provides $950 million (8.9 percent) more than the Administration's requested IRS budget. This amount represents a 13.6 percent increase over the amount appropriated by Congress for 2005. The IRS Oversight Board's recommendation calls for additional funding to enhance tax law enforcement and customer service, as well as additional funds for business systems modernization.

The Government Accountability Office released an assessment of the President's IRS fiscal year 2006 budget request. That report noted that the effect of the projected shift in resources from service to enforcement is unclear but that it may be possible to maintain the overall level of service to taxpayers by offsetting reductions in some areas with new and improved service in other areas, such as on the IRS website. The report also noted that while the IRS has taken important steps forward in its modernization program, the program remains at risk because of cost increases and schedule delays. Finally, the report noted that the IRS has made progress toward implementing investment management best practices that would improve its budget development and support for its information technology operations and maintenance funding requests.

The Government Accountability Office's 2003-2004 audit of the IRS concluded that the IRS's financial statements fairly presented the IRS's assets and liabilities and conformed with generally accepted accounting principles. However, the report also observed that the IRS had continuing material weaknesses in its internal controls.

I. IRS STRATEGIC PLAN

A. In General

In the IRS Reform Act, the Congress directed the IRS to review and restate its mission to increase its emphasis on serving the public and meeting taxpayer needs.[9] Prior to its revision, the IRS mission statement focused on collecting the proper amount of tax. The current mission statement emphasizes interaction with taxpayers. It states:

> 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.[10]

To assist in achieving its mission, the IRS has developed three strategic goals. The first goal is to improve taxpayer service. The second goal is to enhance enforcement of the tax law. The third goal is to modernize the IRS through its people, processes, and technology.[11] As is discussed below, current budget priorities signal a greater emphasis on enforcement.

The IRS has outlined a number of external and internal factors that may affect the achievement of the IRS's strategic vision, either negatively or positively: (1) frequent legislative changes; (2) the preeminence of the Internet for communication; (3) the prevalence and complexity of abusive tax avoidance transactions; (4) the increasingly diverse population, including the growing number of taxpayers with limited English language proficiency; (5) globalization of the business world; (6) terrorism; (7) the growing retirement eligibility of the Federal workforce; and (8) other changes in the workforce.[12]

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[9] IRS Reform Act sec. 1002.

[10] The most recent strategic goals, objectives, and strategies of the IRS are contained in Internal Revenue Service, *IRS Strategic Plan (2005-2009)*, Publication 3744 (June 2004) (hereinafter referred to as "IRS Strategic Plan") at 5.

[11] *Id*. In its 2000-2005 strategic plan, the IRS had stated its goals as follows: (1) to provide top quality service to *each* taxpayer; (2) to provide top quality service to *all* taxpayers; and (3) to increase productivity within the IRS by providing IRS employees with a quality work environment. The IRS described the process of change necessary to meet its strategic goals and fulfill its mission as "modernization." See Internal Revenue Service, *IRS Strategic Plan (Fiscal Years 2000-2005)*, Publication 3744 (February 2001). The current IRS Strategic Plan embodies many of the same goals and objectives outlined in the 2000-2005 strategic plan, although the goals and objectives are now stated somewhat differently.

[12] IRS Strategic Plan at 8-10.

B. First Strategic Goal: Improve Taxpayer Service

1. In general

The IRS's first strategic goal, improving taxpayer service, is designed to ensure that people understand their tax obligations and to make it easier for taxpayers to participate in the tax system. To achieve this goal, the IRS has outlined the following objectives: (1) to improve service options for the tax paying public; (2) to facilitate participation in the tax system by all sectors of the public; and (3) to simplify the tax process.[13]

The IRS plans to use the following types of information to measure its success in improving taxpayer service: (1) customer satisfaction data; (2) rates of accuracy; (3) the degree of burden reduction; (4) the level of service provided; (5) rates of electronic interactions (e.g., e-filing levels); and (5) timeliness of responding to customer inquiries.[14]

2. Customer satisfaction

In its 2004 report to Congress, the IRS Oversight Board concluded:

> While enforcement is still problematic, the IRS has made considerable strides in improving customer service. Taxpayers are better able to get through on the agency's toll-free lines. IRS web site usage continues to surge and new features such as "Where's My Refund?" and "Where's My Advance Child Tax Credit" have been added. The number of electronically-filed tax returns grew by 15 percent during the past filing season. The Board believes that these hard-earned gains directly result from the investments that have been made in business systems modernization and training.[15]

In a survey conducted in July 2004, the IRS Oversight Board found that the percentage of taxpayers stating that they were "very satisfied" with the IRS declined slightly from 2003 to 2004.[16] Respondents were asked to rate their satisfaction level using the following categories:

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[13] *Id*. at 12-16.

[14] *Id*. at 17.

[15] IRS Oversight Board, *Annual Report* (2004) at 16.

[16] IRS Oversight Board, *2004 Taxpayer Attitude Survey* (April 2005) ("Taxpayer Attitude Survey"), Question 10.

very satisfied; somewhat satisfied; not very satisfied; or not at all satisfied. The specific results were as follows:

Table 1.–Taxpayer Attitude Survey: Level of Taxpayer Satisfaction with Personal Interactions with the IRS

	04/%	03/%
Very satisfied	38	41
Somewhat satisfied	41	41
Not very satisfied	6	5
Not at all satisfied	5	6
DK/NA/NR	10	8

SOURCE: Reproduced from Taxpayer Attitude Survey, Question 10.

The American Customer Satisfaction Index survey for 2004 shows a satisfaction rate for all individual filers of 64 out of 100 points, below the satisfaction rate of 72.1 points for all Federal government agencies and departments.[17] The satisfaction rate for electronic filers was 78 out of 100 points, in contrast with 52 out of 100 points for paper filers.[18] The satisfaction rates for 2003 were comparable: 63 points for all individual filers, 77 points for electronic filers, and 53 points for paper filers.[19] Commissioner Everson recently stated that customer satisfaction is expected to increase as more tax filers move from paper to electronic filing.[20]

Respondents participating in the IRS Oversight Board's Taxpayer Attitude Survey were asked to rate the value of various sources of information, including IRS sources and non-IRS sources, in obtaining tax advice or information. The responses for 2003 and 2004 are summarized in the following table:

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[17] American Customer Satisfaction Index, *ACSI Overall Federal Government Scores with Historic Scores of Agencies Measured 1999-2004*, available at *http://www/theacsi.org/government/govt-all-04.html*.

[18] *Id*.

[19] *Id*.

[20] Statement of The Honorable Mark Everson, Commissioner, Internal Revenue Service, before the Subcommittee on Oversight of the House Committee on Ways and Means (April 13, 2005) (hereinafter "Everson Oversight Testimony") at 1 (citing Claes Fornell, Chairman of the CFI Group).

Table 2.–Taxpayer Attitude Survey: Views on Value of IRS and Non-IRS Sources of Information

	Very valuable/%		Somewhat valuable/%		Not very valuable/%		Not at all valuable/%		DK/NA/Ref/%	
	04	03	04	03	04	03	04	03	04	03
IRS representatives	49	51	33	32	7	6	8	10	3	2
IRS printed publications, for example, brochures, instructions	52	50	30	32	8	8	7	8	3	2
IRS web site	50	51	27	26	7	7	12	14	5	2
Paid tax professional	50	52	31	31	8	7	7	9	4	2
Family or friends	30	30	33	31	18	17	16	20	3	2
Reference materials from sources other than the IRS (for example, books, software, private sector web sites)	28	26	40	41	17	14	11	17	3	2

SOURCE: Reproduced from Taxpayer Attitude Survey, Question 9.

The results generally show that IRS sources of information compare favorably or comparably to non-IRS sources of information.

3. Taxpayer service during the 2005 filing season

Overview

As indicated above, the IRS uses several benchmarks, beyond overall customer satisfaction, to measure its success in improving taxpayer service, including: rates of accuracy in responding to taxpayer requests; the level of service provided; rates of electronic interactions, including e-filing and electronic payment; and timeliness of responses to customer inquiries.[21] In a preliminary report regarding the 2005 filing season, the Government Accountability Office analyzed data relevant to certain of these benchmarks and concluded that the IRS has maintained or improved performance over the prior year, despite a decrease in the 2005 budget for taxpayer service.[22] The Government Accountability Office similarly found improvement in 2004 as

[21] IRS Strategic Plan at 17.

[22] Government Accountability Office, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season* (GAO-05-416T), April 14, 2005, at 25.

compared to 2003.[23] IRS statistics regarding individual returns filed during the 2005 filing season, as of May 6, 2005, are summarized in Table 3 and discussed in the following subsections.

Table 3.–2005 Filing Season Data (through May 6, 2005)

	2004	2005	Percent Change
Total Return Receipts (*thousands*)	121,952	122,956	0.82
Paper Returns Filed (*thousands*)	62,086	56,666	-8.73
Electronic Returns Filed:			
Total (thousands)	59,866	66,290	10.73
Practitioner	41,812	46,249	10.61
Telephone	3,759	3,284	-12.64
Home Computer	14,294	16,756	17.22
Free File	3,429	5,027	46.60
Refunds:			
Total (number in thousands)	93,113	92,310	-0.86
Total (dollars in millions)	$191,418	$195,061	1.90
Average dollars	$2,056	$2,113	2.77
Direct Deposit (number in thousands)	47,702	51,030	6.98
IRS Home Page Visits	80,924,569	134,554,454	66.27
"Where's My Refund?"	12,421,391	18,888,452	52.06
Telephone:			
Total Assistor Calls Answered	17,619,300	16,353,982	-7.18
Assistor Level of Service	85.09%	81.87%	-3.78
Total Automated Calls Completed	27,277,676	20,439,077	-25.07
Telephone Quality Rates:			
Tax Law Customer Accuracy Rate	77.72%	88.08%	13.33
Accounts Customer Accuracy Rate	89.28%	91.58%	2.58
Taxpayer Assistance Sites:			
Field Assistance Contacts	4,017,700	3,630,269	-9.64
Volunteer Return Preparation	1,587,614	1,751,592	10.33
Outreach	52,929,570	69,188,516	30.72

SOURCE: Compiled from data obtained from Internal Revenue Service. Certain figures may not reflect full results through May 6, 2005.

[23] See generally Government Accountability Office, *Tax Administration: IRS Improved Performance in the 2004 Filing Season, But Better Data on the Quality of Some Services Are Needed* (GAO-05-67), November 2004.

Telephone service

The Government Accountability Office notes that the IRS reduced its goal for level of service – i.e., the percentage of callers who attempt to reach a representative and actually get through and receive service – from 85 percent for 2004 to 82 percent for 2005 because of the budget reduction for taxpayer service.[24] Indeed, data in Table 3 show a slight decline in the level of service to approximately 81.87 percent for 2005. At the same time, however, 2005 has seen improvements over prior year accuracy rates for telephone responses to tax law inquiries and to questions about the status of customers' accounts.

Commissioner Everson recently testified that, from 2002 to 2005, the amount of time callers spent on hold waiting for an IRS representative decreased by nearly one minute, from 263 seconds to 205 seconds.[25] He attributes this reduction in wait time to the fact that calls are now routed to the proper subject matter expert, and the system balances workforce planning against historical workload patterns.[26] However, the Government Accountability Office recently reported that, as of mid-March 2005, wait times had increased by about 35 seconds, or 15 percent, over 2004 wait times, and that the rate at which taxpayers abandon their calls to the IRS had also increased.[27] The IRS again attributes these results to the reduction in the service budget.[28]

Electronic interactions

The IRS Reform Act set a goal of 80 percent electronic filing by the year 2007.[29] The data in Table 3 show an overall increase in the number of individual returns filed electronically of 10.73 percent from 2004 to 2005 and a nearly corresponding decline in the number of paper returns filed of 8.73 percent. Of the total number of individual returns filed as of May 6, 2005, approximately 53.91 percent were filed electronically. The most significant increase, 46.60 percent, was in the number of taxpayers taking advantage of the Free File initiative, which allows taxpayers to file their tax returns electronically at no charge via the IRS website. The

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[24] Government Accountability Office, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season* (GAO-05-416T), April 14, 2005, at 29.

[25] Everson Oversight Testimony at 2.

[26] *Id*.

[27] Government Accountability Office, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season* (GAO-05-416T), April 14, 2005, at 30.

[28] See *id*.

[29] IRS Reform Act sec. 2001.

IRS's progress toward meeting the 80 percent e-filing requirement is discussed in greater detail in section I.E below.

Use of the IRS's website also continues to grow. The data in Table 3 show an increase of 66.27 percent in the number of visits to the site, *www.irs.gov*, during the 2005 filing season as compared to the prior year. Visits to the "Where's My Refund?" page, which enables taxpayers to check on the status of their refunds, have increased by 52.06 percent over the prior year. Commissioner Everson recently testified that, during the 2005 filing season, the IRS has averaged more than one million visits to its webpage every day.[30] He also testified that visits to the IRS website reduce the need to visit a Taxpayer Assistance Center or to call the IRS operators, which allows IRS operators to focus on more complex calls.[31] He highlighted the following functionalities now available online that are intended to allow tax practitioners to serve their clients more efficiently: electronic account resolution; transcript delivery; secure email; disclosure authorization; and bulk Taxpayer Identification Number matching.[32] The Government Accountability Office recently confirmed that the IRS website is "performing well," noting that the site has ranked in the top four of 40 government websites.[33]

<u>Taxpayer Assistance Centers ("TACs")</u>

Staff at IRS walk-in sites, or Taxpayer Assistance Centers ("TACs"), provide taxpayers with information about their tax accounts and answer a limited range of tax law questions. In a study of TAC performance during the 2004 filing season, the Treasury Inspector General for Tax Administration found that IRS TAC employees provided correct answers to "in scope"[34] questions about 67 percent of the time.[35] According to the data in Table 3, visits to the IRS's approximately 400 TACs declined by about 9.64 percent from 2004 to 2005. Several factors may explain the decrease in demand for TACs, including the availability of quality IRS services that do not require travel or waiting in line (e.g., the IRS telephone service and website) and the ability to download forms online.[36] The Government Accountability Office noted that these

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[30] Everson Oversight Testimony at 2.

[31] *Id*.

[32] *Id*.

[33] Government Accountability Office, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season* (GAO-05-416T), April 14, 2005, at 31.

[34] TAC employees respond only to questions on certain topics and typically refer taxpayers with "out of scope" questions to the IRS's telephone operations or suggest that such taxpayers correspond with the IRS via the IRS's website.

[35] Treasury Inspector General for Tax Administration, *Taxpayer Experience at the Taxpayer Assistance Centers Could Be Improved* (2004-40-152), September 2004, at 4.

[36] Everson Oversight Testimony at 3.

results are consistent with the IRS's goal of limiting return preparation and tax law assistance at walk-in sites by 2007.[37] The IRS's fiscal year 2006 budget proposes closing a substantial number of TACs.[38]

In contrast to the decrease in emphasis on TACs, the IRS continues to encourage the use of volunteer return preparation assistance.[39] Free tax preparation and e-file services are available in many communities through the Volunteer Income Tax Assistance ("VITA") and Tax Counseling for the Elderly ("TCE") programs. Table 3 shows that visits to such volunteer sites have increased by approximately 10.33 percent over the prior year. In its 2004 report to Congress, the National Taxpayer Advocate expressed concern about ambiguities regarding, among other things, which party bears ultimate responsibility for the VITA program and the IRS's relationship with the volunteer organizations that operate the VITA sites.[40] In its September 30, 2004, semiannual report to Congress, the Treasury Inspector General for Tax Administration noted that its auditors visited 44 VITA sites nationwide seeking to have 35 different tax returns prepared, "none of which was prepared correctly."[41]

The Government Accountability Office notes that the shift away from TACs and toward volunteer tax preparation assistance allows the IRS to reallocate resources previously spent on time-consuming services, primarily tax preparation, to account assistance and compliance work, which can only be done by in-house IRS personnel.[42] However, the TIGTA Semiannual Report suggests that this shift may also reduce compliance given the number of return preparation errors at VITA sites.

Burden reduction

The IRS Oversight Board recently called attention to the increasing complexity of the Code, noting that, as of 2004, it took an estimated 28 hours and 30 minutes to complete an average tax return, as compared to 17 hours and seven minutes in 1988.[43] In its 2004 report to

[37] *Id*. at 32.

[38] See Internal Revenue Service, *The Budget in Brief FY 2006*, (February 2005) at 7 (describing reduction in dependence on walk-in centers).

[39] See Everson Oversight Testimony at 3.

[40] National Taxpayer Advocate, *2004 Annual Report to Congress*, at 110-131.

[41] Treasury Inspector General for Tax Administration, *Semiannual Report to Congress*, April 1, 2004 through September 30, 2004, (hereinafter "TIGTA Semiannual Report") at 11.

[42] Government Accountability Office, *Internal Revenue Service: Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season* (GAO-05-416T), April 14, 2005, at 34.

[43] IRS Oversight Board, *Annual Report* (2004) at 17.

Congress, the National Taxpayer Advocate identified the complexity of the Code as the most serious problem facing taxpayers and the IRS.[44] The Taxpayer Advocate's report notes that the Code includes well over a million words and contains confusing provisions such as the alternative minimum tax and the earned income tax credit.[45] The Taxpayer Advocate also expressed concern that the increased emphasis on compliance is resulting in inadequate planning for taxpayer education and outreach.[46]

<u>Taxpayer Advocate Service</u>

The Taxpayer Advocate Service assists taxpayers in resolving problems that have not been adequately addressed through other IRS channels. In its September 30, 2004, report to Congress, the Treasury Inspector General for Tax Administration noted a significant increase over the past five years in the time it takes the Taxpayer Advocate Service to resolve a problem, from 37 days in 1998 to 76 days in 2003.[47] However, staffing at the Taxpayer Advocate Service has remained fairly constant, and new case receipts and closures have actually decreased.[48] The Treasury Inspector General for Tax Administration attributed much of the increase in time required to resolve cases to case management inefficiency.[49]

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[44] National Taxpayer Advocate, *2004 Annual Report to Congress*, at 2.

[45] *Id*.

[46] *Id*. at 51.

[47] TIGTA Semiannual Report at 13.

[48] *Id*.

[49] *Id*.

C. Second Strategic Goal: Enhance Enforcement of the Tax Law

1. In general

The Government Accountability Office describes the IRS's fiscal year 2006 budget request as reflecting a "continuing shift in priorities by proposing reductions in taxpayer service and increases in enforcement activities."[50] In outlining the IRS's second strategic goal, enhancing enforcement of the tax law, the IRS states:

> We will ensure that taxpayers meet their tax obligations, so that when Americans pay their taxes, they can be confident that their neighbors and competitors are doing the same. Therefore, we must use our enforcement authority to collect the taxes that are due from people who do not fulfill their tax obligations.[51]

To achieve this strategic goal, the IRS has implemented the following objectives: (1) to discourage and deter noncompliance, with an emphasis on corrosive activity by corporations, high-income individual taxpayers, and other contributors to the tax gap; (2) to ensure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law; (3) to detect and deter domestic and off-shore based tax and financial criminal activity; and (4) to deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance or other unintended purposes.[52]

The IRS outlined the following six benchmarks for measuring its success in enhancing enforcement of the tax law: (1) the rate of reporting compliance; (2) the rate of filing compliance; (3) the rate of payment compliance; (4) the percentage of priority guidance list items published; (5) the percentage of Americans who think it is acceptable to cheat on taxes; and (6) the average cycle time, i.e., the length of time from receipt of a case for audit until the audit is completed.[53]

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[50] Government Accountability Office, *Internal Revenue Service: Assessment of the Fiscal Year 2006 Budget Request* (GAO-05-566), April 27, 2005, at 4. The report expresses concern about how these shifting priorities will affect taxpayers in the short term. *Id*. The IRS Oversight Board has similarly expressed concern about the need for both quality service and strict enforcement and about the potential effects of planned reductions in funding for service. IRS Oversight Board, *Special Report: FY2006 IRS Budget* (March 2005) at 5.

[51] IRS Strategic Plan at 18.

[52] *Id*. at 19-25.

[53] *Id*. at 25.

2. Taxpayer survey results

A recently released survey shows that most taxpayers believe it is important to ensure compliance with the tax laws. When asked, for example, how much, if any, is an acceptable amount to cheat on income taxes, survey participants responded as follows:

Table 4.–Taxpayer Attitude Survey: Views on How Much Is an Acceptable Amount to Cheat on Taxes

	2004	2003	2002	1999
A little here and there	8	12	10	8
As much as possible	4	5	3	3
Or, not at all	86	81	86	87
NK/NA/Ref.	2	3	1	2

SOURCE: Reproduced from Taxpayer Attitude Survey, Question 1.

Another series of survey questions reveals that taxpayers broadly agree that Americans have a duty to pay their fair share of taxes, and that those who cheat should be held accountable:

Table 5.–Taxpayer Attitude Survey: Attitudes Regarding Compliance

	Completely agree/%				Mostly agree/%				Mostly disagree/%				Completely disagree/%				DK/NA/NR			
	04	03	02	99	04	03	02	99	04	03	02	99	04	03	02	99	04	03	02	99
It is every American's civic duty to pay their fair share of taxes	73	68	72	81	21	27	23	14	4	3	2	2	1	2	2	2	2	1	1	*
Everyone who cheats on their taxes should be held accountable	62	60	65	64	29	28	25	25	5	8	6	7	3	3	3	3	1	1	2	1
It is everyone's personal responsibility to report anyone who cheats on their taxes	24	19	21	18	29	29	25	30	22	25	24	25	20	24	26	24	6	3	4	3
Taxpayers should just have to pay what they feel is a fair amount	13	12	15	11	17	18	14	15	29	24	23	26	38	44	45	47	3	2	3	2
The more information and guidance the IRS provides, the more likely people are to correctly file their returns	45	44	NA	NA	39	38	NA	NA	8	12	NA	NA	4	5	NA	NA	5	2	NA	NA

SOURCE: Reproduced from Taxpayer Attitude Survey, Question 2.

3. Tax gap study

The "tax gap" – i.e., the difference between what taxpayers owe and what taxpayers voluntarily pay on a timely basis – is composed of three components: (1) underreporting of income; (2) underpayment of taxes; and (3) non-filing of returns. Commissioner Everson recently noted that the tax gap does not arise solely from tax evasion or cheating. A portion of the tax gap, for example, is attributable to complexity of the laws, which results in ignorance, confusion, and carelessness.[54] In addition, estimates of the tax gap include assessed amounts that will never be recovered, because the taxpayer ultimately succeeds in challenging the assessment. For these reasons, there will always be a tax gap; the IRS's goal is to reduce the size of the tax gap. Notwithstanding the existence of a tax gap, the IRS believes that the voluntary system of tax assessment is working and should be retained.[55]

As of 2001, the IRS estimate of the tax gap was $311 billion, based on research conducted in 1988 and earlier. In 2001, the IRS launched a study called the National Research Program ("NRP") to update estimates of the tax gap. To collect data for the NRP, the IRS audited 46,000 individual income tax returns for tax year 2001. On March 29, 2005, the IRS released its preliminary findings from the NRP, which suggest that the tax gap has increased slightly to between $312 billion and $353 billion as of tax year 2001.[56] The NRP did not collect data regarding taxes other than individual income taxes. Therefore, the tax gap estimates for other taxes, such as the corporate income tax and the estate tax, continue to be based on older data. The preliminary NRP results also do not include updated estimates for the individual income tax non-filing gap (as opposed to the underreporting gap), although the IRS anticipates having such estimates later in 2005. The 2001 "underpayment gap," i.e., the amount that was reported on timely filed returns but not paid on time, is based on actual 2001 figures, not estimates, and thus will not be revised.[57]

Because late payments and IRS enforcement activities recover about $55 billion of the tax gap, the IRS estimates that the "net tax gap" (i.e., the gross tax gap minus amounts subsequently recovered) is between $257 billion and $298 billion.[58] Estimates of noncompliance

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[54] Statement of Mark Everson, Commissioner of Internal Revenue, Before the Senate Committee on Finance, *The $350 Billion Question: How to Solve the Tax Gap* (April 14, 2005) (hereinafter "Everson Tax Gap Testimony") at 4.

[55] *Id*. at 11.

[56] See IRS News Release, *New Study Provides Preliminary Tax Gap Estimate*, IR-2005-38 (March 29, 2005).

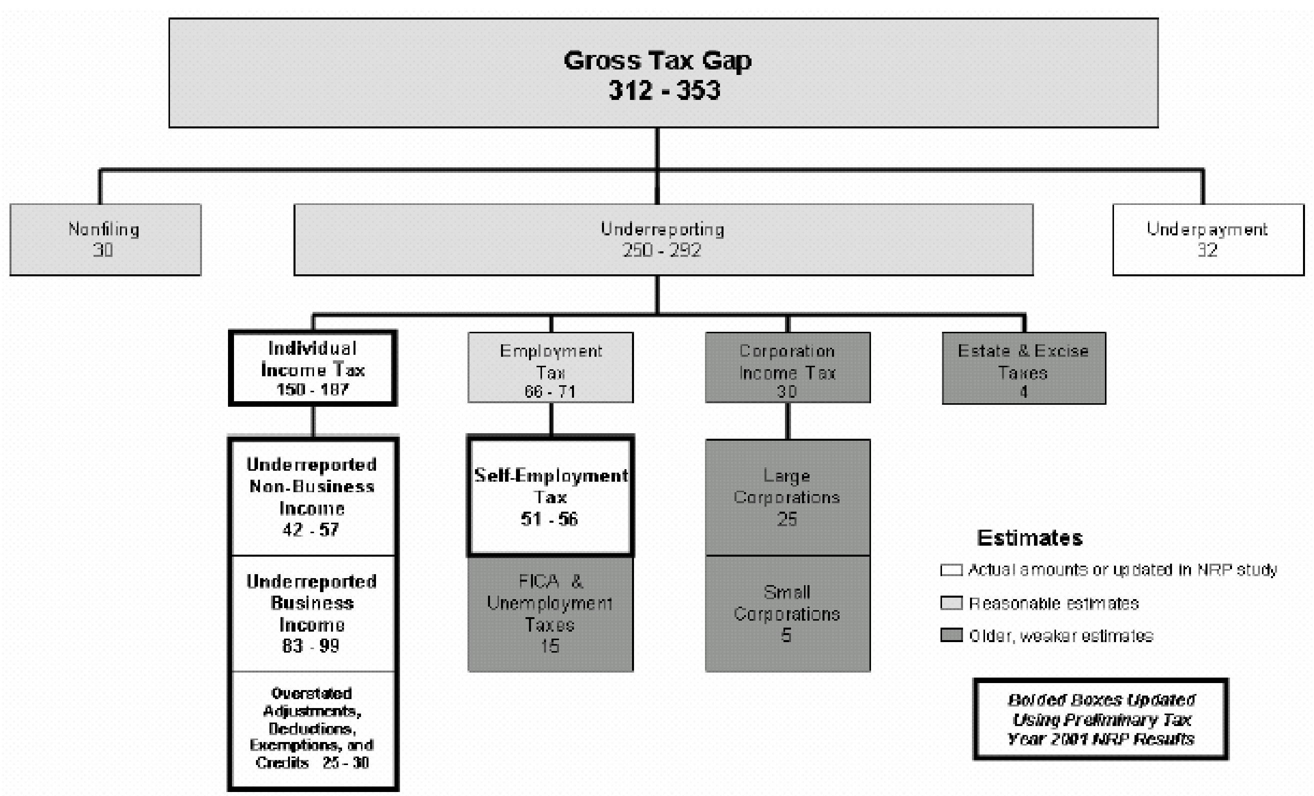
[57] Everson Tax Gap Testimony at 3-4.

[58] See IRS News Release, *New Study Provides Preliminary Tax Gap Estimate*, IR-2005-38 (March 29, 2005).

range from 15 percent to 16.6 percent.[59] Commissioner Everson testified that, "although American taxpayers remain substantially compliant with the tax laws, the tax gap is nonetheless quite large in dollar terms."[60]

Underreporting of income is the largest component of the tax gap, accounting for more than 80 percent of the total. Underreporting of income by individuals is the largest sub-component of underreporting, representing approximately half of the total tax gap. Such understatement by individuals includes not only excluding income from a return or underreporting income on a return, but also taking improper deductions, overstating business expenses, and erroneously claiming credits.[61] Figure 1 details the components of the tax gap.

Figure 1.–2001 Federal Tax Gap
[Billions of Dollars]



SOURCE: Reproduced from Internal Revenue Service, *Tax Gap Facts and Figures*, available at *www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf*.

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59 See IRS Fact Sheet, *Understanding the Tax Gap*, FS-2005-14 (March 2005).

60 Everson Tax Gap Testimony at 1.

61 Everson Tax Gap Testimony at 3-4.

The IRS expects to finish its analysis of the NRP data and to refine the tax gap estimate by late 2005. In addition, the IRS plans to update estimates for areas of the tax gap other than compliance by individual taxpayers.[62]

In recent testimony, Comptroller General David M. Walker noted that the IRS has not committed to collecting compliance data on a regular basis because of the associated costs.[63] He stated that the IRS has indicated that it will not begin another NRP study of individual income tax returns before 2008, if at all, and that no such study would be completed until at least 2010. He concluded that, although the IRS's cost concerns are legitimate, compliance studies such as the NRP are "good investments," and that without current compliance data, the IRS is less able to identify and address areas of noncompliance.[64]

4. Enforcement activity

Overview

In January 2005, the Government Accountability Office added "enforcement of the tax laws" to the Office's list of high-risk areas.[65] Prior to 2005, only specific areas of tax noncompliance were included on the Office's high-risk list. In broadening the risk category to cover all areas of noncompliance, the Government Accountability Office reasoned that "the focus of concern on the enforcement of tax laws is not confined to any one segment of the taxpaying population or any single tax population."[66]

Since 2001, the year upon which the new estimates of the tax gap are based, the IRS has taken a number of steps to improve enforcement. For example, the number of audits of high-income taxpayers conducted in 2004 was more than double the 2001 number, and the total number of taxpayer audits in 2004 (more than one million) represented a 37 percent increase over 2001.[67] Such enforcement efforts have yielded results. Between 2001 and 2004, for

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[62] See IRS News Release, *New Study Provides Preliminary Tax Gap Estimate*, IR-2005-38 (March 29, 2005).

[63] Statement of David M. Walker, Comptroller General of the United States, Before the Senate Committee on Finance, *Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies* (GAO-05-527T), April 14, 2005 (hereinafter "Walker Tax Gap Testimony") at 22.

[64] *Id*.

[65] *Id.* at 12-13.

[66] *Id*. at 13.

[67] IRS News Release, *New Study Provides Preliminary Tax Gap Estimate*, IR-2005-38 (March 29, 2005).

example, the agency's enforcement revenues increased from $33.8 billion to $43.1 billion, a jump of nearly 28 percent.[68] Overall, IRS enforcement efforts generated $5.5 billion more in revenue in fiscal year 2004 than in the prior year, representing a 15 percent increase.[69] Although the level of liens, levies, and seizures against noncompliant taxpayers has begun to increase, it remains significantly lower than the levels in the 1990s. The IRS, for example, issued just over 2 million levies in 2004, compared to 3.5 million in 1997. The number of seizures dropped from over 10,000 in 1997 to only 440 in 2004.[70]

On February 28, 2005, the IRS released its annual listing of notorious tax schemes, referred to as the "Dirty Dozen," to highlight certain of the IRS's enforcement priorities.[71] Among the schemes included on the 2005 Dirty Dozen list are arrangements that manipulate charitable organizations and abuse credit counseling agencies. The list also targets schemes in which taxpayers claim exemptions using previously refuted legal arguments and identity theft schemes that involve the use of e-mail, the Internet, or the telephone. In addition, the list highlights illegal offshore transactions, noting that taxpayers continue to undertake such transactions, notwithstanding a crackdown by the IRS and State agencies on illegal offshore activity.[72]

Initiatives to reduce corrosive activity by corporations, high-income individual taxpayers, and other contributors to the tax gap

The IRS continues to focus attention on abuse of the tax laws by high-income individuals and corporations, most notably abuses involving illegal tax shelters. Indeed, Commissioner Everson recently described combating abusive tax shelters as the "centerpiece" of the IRS's enforcement strategy, both for individual and corporate taxpayers.[73]

In May 2004, the IRS made a settlement offer regarding the Son of Boss tax shelter, which has been used by wealthy individual taxpayers to eliminate multi-million dollar gains.[74]

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[68] *Id*.

[69] IRS Oversight Board, *Special Report: FY2006 IRS Budget* (March 2005) at 10.

[70] Statement of J. Russell George, Treasury Inspector General for Tax Administration, Before the Senate Committee on Finance, *The $350 Billion Question: How to Solve the Tax Gap* (April 14, 2005) (hereinafter "George Tax Gap Testimony") at 20.

[71] IRS New Release, *IRS Announces the 2005 Dirty Dozen*, IR-2005-19 (February 28, 2005).

[72] *Id*.

[73] Everson Tax Gap Testimony at 6.

[74] *Id*. at 6-7.

As a condition of participating in the settlement program, the IRS required a total concession by the taxpayer of artificial losses claimed. The IRS also required the payment of penalties in most cases. As of April 14, 2005, 1,165 taxpayers (of the over 1,800 believed to have employed the Son of Boss technique) had participated in the settlement initiative, yielding $3.2 billion in taxes, interest, and penalties. The IRS anticipates that this figure will rise to approximately $3.5 billion when the program concludes in the coming months.[75]

In February 2005, the IRS implemented a separate settlement initiative relating to an illegal tax shelter transaction under which taxpayers transferred executive stock options or restricted stock to family-controlled entities, sometimes at the expense of public shareholders.[76] The IRS coordinated closely with the Securities and Exchange Commission and the Public Company accounting Oversight Board on the initiative. The settlement offer required full payment of taxes owed plus a penalty. Commissioner Everson notes that some taxpayers have an incentive to accept tough settlement offers to avoid the high financial costs and public humiliation of litigation.[77]

In 2004, the IRS announced the formation of the Joint International Tax Shelter Information Centre to fight the use of abusive tax shelters in the international arena.[78] The effort provides for an exchange of information concerning abusive transactions among various countries. Commissioner Everson describes the results as promising, and notes that activities of the Centre have resulted in discovery of a number of transactions that, without the Centre, would have been discovered only over the course of many years.[79]

In addition, the IRS has been working closely with the Department of Justice to obtain civil injunctions against abusive tax shelter promoters and abusive tax return preparers.[80] Commissioner Everson testified that the courts have issued permanent or preliminary injunctions against more than 100 promoters, as well as 17 permanent injunctions against return preparers.[81] The Department of Justice has filed an additional 49 suits – 28 against promoters and 21 against return preparers – seeking injunctions.[82] As of April 14, 2005, the IRS was conducting another

[75] *Id*. at 7.

[76] *Id*.

[77] *Id*.

[78] *Id*.

[79] *Id*.

[80] *Id*. at 7-8; see generally Statement of Eileen J. O'Connor, Assistant Attorney General, Tax Division, Before the Senate Committee on Finance, April 14, 2005 (hereinafter "O'Connor Testimony").

[81] Everson Tax Gap Testimony at 8.

[82] *Id*.

1,000 investigations for possible referral to the Department of Justice, as well as individual examinations of thousands of scheme participants.[83]

Initiatives directed toward tax practitioners

Another of the IRS's enforcement priorities is ensuring that attorneys, accountants, and other tax practitioners follow professional standards and adhere to the law. Commissioner Everson recently testified that competitive pressures are causing even once-honest practitioners to "suffer from the sad and steep erosion of ethics in recent years."[84] He described three specific events that occurred in the last year that he believes will enhance compliance by practitioners: (1) the issuance of new rules regarding tax shelter opinions; (2) several government court victories regarding privilege; and (3) the adoption of new and increased tax shelter penalties.[85]

First, on December 20, 2004, the Treasury Department published final regulations amending Circular 230, which governs practice before the IRS. The new regulations tighten the rules practitioners must follow when providing advice to clients regarding tax shelters.[86] They provide: (1) "aspirational" best practice standards for practitioners; (2) requirements for certain opinions that are "covered opinions";[87] and (3) practice standards for other written tax advice.[88] The new regulations are effective for any advice issued 180 days after publication of the final regulations, i.e., on June 20, 2005.[89] In response to numerous comments from practitioners regarding the regulations, the Treasury Department has indicated that it will issue clarifications to the regulations before the regulations go into effect.[90]

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[83] *Id*.

[84] Everson Tax Gap Testimony at 8.

[85] *Id*.

[86] Regulations Governing Practice Before the Internal Revenue Service, 69 Fed. Reg. 75,839 (December 20, 2004) (to be codified at 31 C.F.R. secs. 10.33, 10.35, 10.36, 10.37, 10.38, and 10.52); Arthur L. Bailey & Alexis A. MacIvor, *New Circular 230 Regulations Impose Strict Standards for Tax Practitioners*, Tax Notes (April 18, 2005) at 341-350.

[87] A covered opinion is generally written advice that covers Federal tax issues relating to: a listed transaction; an arrangement with a principal purpose of avoiding or evading tax; or certain arrangements with a significant purpose of avoiding or evading tax. 69 Fed. Reg. at 75,842.

[88] *Id*. at 75,839.

[89] *Id*. at 75,842-75,845.

[90] Letter from Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), 2005 T.N.T. 86-22 (May 2, 2005).

Second, the government won a number of court cases on practitioner privilege issues in the last year. According to Commissioner Everson, "[t]he cases confirm that promoters who develop and market generic tax shelters can no longer protect the identity of their clients by hiding behind a false wall of privilege."[91] As a result of such court victories, tax shelter promoters have turned over lists of clients who participated in tax shelters, as well as transaction documents.[92] This has caused certain purchasers of tax shelters voluntarily to seek a resolution of their cases and to pay billions of dollars in taxes, interest, and penalties.[93]

Third, last fall, Congress enacted and the President signed into law the American Jobs Creation Act of 2004, which increased existing penalties and added new penalties for failure to disclose shelter information or making false statements with regard to shelters.[94] Commissioner Everson described the increases in penalties as converting "speed bumps" into "speed traps" for tax shelter promoters.[95]

Initiatives targeting criminal activity

The IRS has also identified detecting and deterring domestic and offshore-based criminal tax activity as an enforcement priority. In 2004, the IRS referred over 3,000 cases to the Department of Justice for possible criminal prosecution. This represented a 20 percent increase over 2003.[96] Department of Justice prosecutors have become increasingly experienced in gathering evidence from foreign countries, including banking and business records pertaining to off-shore entities.[97] Prosecutors are also pursuing illegal tax protest activities, including: claims that an individual is a "sovereign citizen" and not subject to U.S. laws; claims that the Federal income tax is unconstitutional; the taking of sham vows of poverty by taxpayers; and harassment of judges and government employees.[98]

In addition, the IRS's Criminal Investigation Division employs nearly 600 investigative personnel in Fraud Detection Centers to detect and deter fraudulent claims for refund, which

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[91] Everson Tax Gap Testimony at 8.

[92] O'Connor Testimony at 5

[93] *Id*.

[94] See, e.g., new sec. 6707A.

[95] Everson Tax Gap Testimony at 8.

[96] *Id*. at 9.

[97] O'Connor Testimony at 9.

[98] *Id*. at 10.

enabled the IRS to stop nearly $4 billion in false refund claims between 1999 and April 2005.[99] Between fiscal year 2002 and March 31, 2005, the Division initiated 1,885 criminal investigations and recommended that 1,230 individuals be prosecuted for refund and return preparer fraud.[100]

<u>Initiatives to reduce abuses within the tax-exempt sector and misuse of tax-exempt organizations by third parties</u>

Another of the IRS's enforcement priorities is reducing abuses within the tax-exempt sector and the misuse of exempt entities for personal gain. Problems have arisen in the exempt sector for a variety of reasons, including inadequate enforcement and the increase in size and complexity of the sector.[101] Abuses involving tax-exempt organizations now occupy four spots on the IRS's "Dirty Dozen" list of abusive transactions.[102]

Despite a greater than 40 percent increase in the number of exempt entities between 1995 and 2003, the staffing of the IRS's exempt organizations function steadily declined during that period.[103] However, Commissioner Everson recently noted that staffing levels have begun to increase, and he projects that, by September 2005, the IRS will have realized a 30 percent increase in exempt organizations enforcement personnel over 2003 levels.[104] The following chart illustrates these staffing trends:

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[99] Statement of Nancy J. Jardini, Chief, Criminal Investigation, Internal Revenue Service, Before the Senate Committee on Finance (April 14, 2005) at 2.

[100] *Id*. at 4.

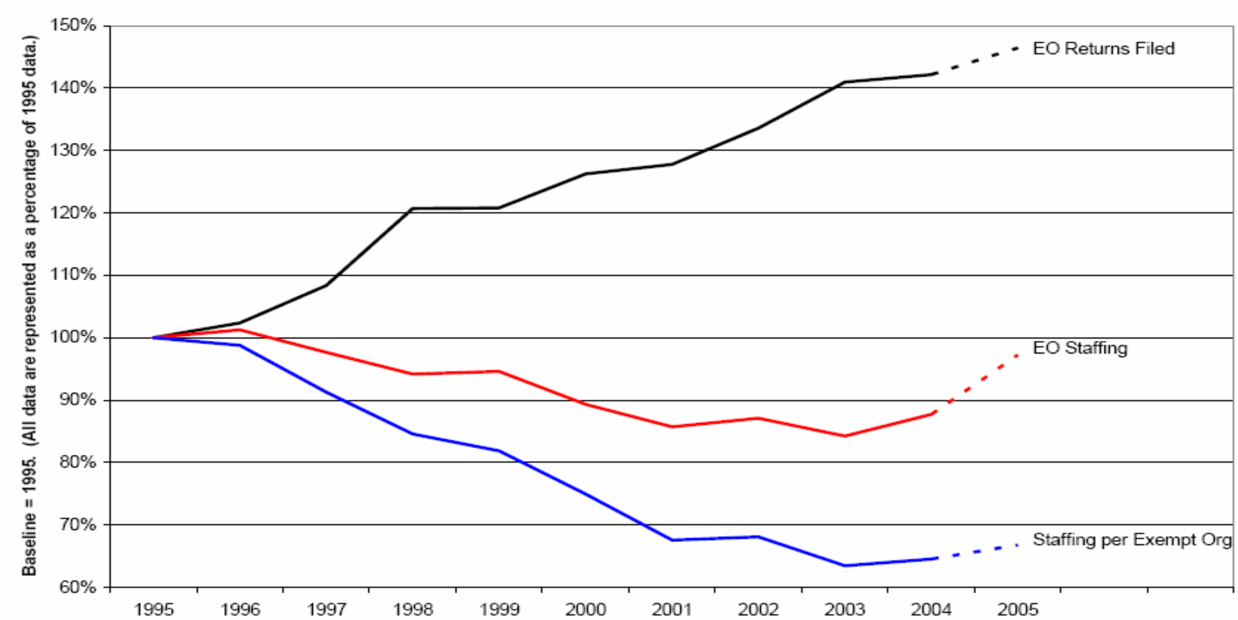
[101] Statement of Mark W. Everson, Commissioner of Internal Revenue, Before the Senate Committee on Finance, *Exempt Organizations: Enforcement Problems, Accomplishments, and Future Direction* (April 5, 2005) (hereinafter "Everson Exempt Organizations Testimony") at 3.

[102] IRS New Release, *IRS Announces the 2005 Dirty Dozen*, IR-2005-19 (February 28, 2005).

[103] Everson Exempt Organizations Testimony at 2.

[104] *Id*.

Figure 2.–IRS Exempt Organizations Staffing and Workload Trends



SOURCE: Reproduced from Everson Exempt Organizations Testimony at 2.

The IRS has identified a number of abuses in which charities are established to benefit specific donors, including improper uses of donor-advised fund[105] arrangements and certain supporting organizations (i.e., organizations that are treated as public charities by virtue of supporting another publicly supported organization). With regard to donor-advised funds, the IRS is examining over 200 returns of donors, as well as several sponsoring charities. The IRS is currently pursuing approximately 100 examinations involving supporting organizations, including three cases that are being considered for criminal investigation.[106]

The IRS is also targeting abuses involving tax-exempt credit counseling agencies, in particular abuses involving insiders and related for-profit entities. The IRS currently has under audit credit counseling agencies representing over 50 percent of the industry's gross receipts. The IRS has also revoked or proposed revoking the exempt status of agencies representing over 20 percent of the industry's gross receipts.[107] The IRS has modified Form 1023 (the application

[105] The IRS provides that a donor-advised fund "is maintained if [organizations] establish separate accounts for a donor whereby the donor may exercise a right to make a recommendation on either uses of the account . . . or distributions from the account." Internal Revenue Service, Instructions to Form 1023, Part VIII, line 4e.

[106] Everson Exempt Organizations Testimony at 5-7.

[107] *Id*. at 8.

for exemption) and Form 990 (the exempt organization annual information return) to collect better information regarding the activities of credit counseling agencies.[108] The IRS is coordinating with States and the Federal Trade Commission to combat abuses involving credit counseling agencies.[109]

The IRS has also identified and is targeting the misuse of charities by third parties, which abuses sometimes occur with the charity's knowledge. Such targets have involved: (1) improper conservation easement contributions and transactions; (2) inflated valuations of non-cash property contributed to charity; (3) tax shelters in which charities are used as accommodation parties; (4) excessive executive compensation; (5) financing of terrorist activities; and (6) prohibited political activity.[110]

Both the House Committee on Ways and Means and the Senate Committee on Finance recently held hearings regarding the tax-exempt sector.[111]

5. Audit activity

An important role of audits is to verify major categories of income and deductions. In a recently released survey, 51 percent of taxpayers identified fear of an audit as having either a great deal of influence or somewhat of an influence on whether they report and pay their taxes honestly.[112] IRS audit rates declined steeply from 1995 to 1999, but the audit rate has slowly increased since 2000.[113] However, the following chart shows that the increase in the audit rate for individual returns is attributable to an increase in correspondence audits, while the rate of more complex field audits has continued to decline:

[108] *Id*.

[109] *Id*.

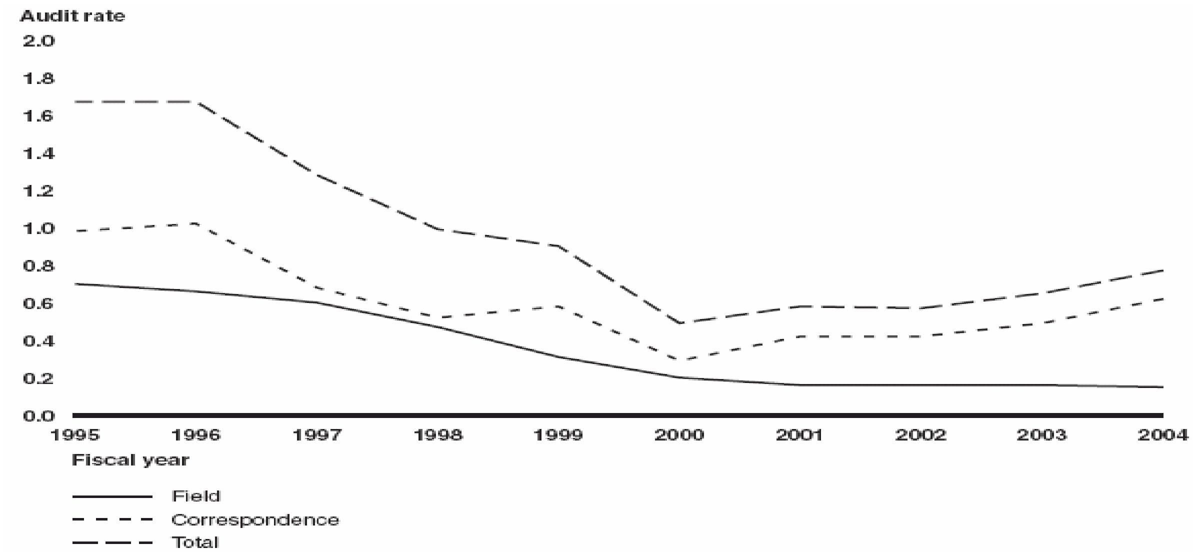
[110] *Id*. at 9-14.

[111] See Joint Committee on Taxation, *Historical Development and Present Law of the Federal Tax Exemption for Charities and other Tax-Exempt Organizations* (JCX-29-05), April 19, 2005.

[112] Taxpayer Attitude Survey, Question 4.

[113] Government Accountability Office, *Internal Revenue Service: Assessment of the Fiscal Year 2006 Budget Request* (GAO-05-566), April 27, 2005, at 11.

Figure 3.–Audits of Individual Returns



SOURCE: Reproduced from Government Accountability Office, *Internal Revenue Service: Assessment of the Fiscal Year 2006 Budget Request* (GAO-05-566), April 27, 2005, at 11.

With the continuing loss of experienced personnel to retirement, discussed below, it may become more difficult to increase the number of field audits. The loss of experienced field personnel to perform audits represents a significant risk to the enforcement efforts.

The audit rate for corporate returns experienced a steep decline between 1997 and 2003, from one out of every 52 returns to one out of every 182 returns.[114] However, in 2004, the number of audits of businesses with assets of $10 million or more increased after several years of decline.[115]

In addition to performing field and correspondence audits, the IRS has an Information Returns Program in which it uses computer technology to match Forms W-2 and 1099. This allows the IRS to verify income items reported on individual returns against third-party statements of wages, interest, dividends, and other payments. In fiscal year 2004, the IRS collected approximately $2.7 billion as a result of document matching and closed in excess of 3.7 million document matching cases.[116]

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[114] TIGTA Semiannual Report at 8.

[115] Everson Tax Gap Testimony at 6.

[116] *Id.*

6. Private debt collection

In fiscal years 1996 and 1997, the Congress earmarked $13 million for the IRS to test the use of private debt collection companies. There were several constraints on the pilot project. First, because both the IRS and the Office of Management and Budget considered the collection of taxes to be an inherently governmental function, only government employees were permitted to collect the taxes. The private debt collection companies were utilized to assist the IRS in locating and contacting taxpayers, reminding them of their outstanding tax liability, and suggesting payment options. If the taxpayer agreed at that point to make a payment, the taxpayer was transferred from the private debt collection company to the IRS. Second, the private debt collection companies were paid a flat fee for services rendered; the amount that was ultimately collected by the IRS was not taken into account in the payment mechanism. The pilot program was discontinued because of disappointing results.[117]

In 2004, the Congress passed and the President signed the American Jobs Creation Act, which addresses the growing inventory of uncollected taxes by authorizing the IRS to use private collection agencies ("PCAs"). PCAs will contact delinquent taxpayers to arrange voluntary installment payment agreements. PCAs will not, however, have enforcement authority. PCAs will be given only less complex, "balance due" cases, allowing the IRS to focus its resources on more complex cases.[118] The IRS will also implement a Filing and Payment Compliance ("F&PC") computer system to analyze collection cases and separate the more complex cases requiring IRS attention from simpler cases that can be assigned to PCAs.[119] The IRS plans to award contracts to an initial group of PCAs in summer 2005 and to begin a limited release of the uncollected tax inventory in January 2006.[120]

The IRS has pledged to implement the following safeguards designed to protect taxpayers as part of the PCA program:

- Fair Debt Collection Act protections;
- protections against unauthorized disclosures;
- assistance from the National Taxpayer Advocate; and

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[117] Government Accountability Office, *Tax Debt Collection: IRS Is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources* (GAO-04-492), May 2004, at 2.

[118] Everson Oversight Testimony at 13-14.

[119] *Id.*

[120] *Id.*

- protections with respect to third-party contacts, installment agreements, and communications.[121]

In addition, the Treasury Inspector General for Tax Administration has implemented a three-phase strategy to monitor the PCA initiative. The first phase will involve review of the IRS's planning and implementation of the program. The second phase will involve a review of the program after full implementation, which is not scheduled to occur until 2007. The third phase will involve a review of the program for effectiveness.[122]

In its 2004 annual report, the Taxpayer Advocate Service noted that the IRS has failed to develop a consistent and comprehensive collection strategy. The report urges that such a strategy must harmonize the goals of compliance and collection by:

- Prompting human contact with delinquent taxpayers;
- Understanding the "why" of taxpayer noncompliance;
- Identifying the appropriate collection touch for the particular cause of noncompliance;
- Taking a research-based approach; and
- Reducing opportunities for noncompliance.[123]

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[121] *Id*.

[122] Statement of J. Russell George, Treasury Inspector General for Tax Administration, Before the Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development and Related Agencies of the Senate Committee on Appropriations, *Hearing on the Internal Revenue Service's Fiscal Year 2006 Budget Request* (April 7, 2005) (hereinafter "George Appropriations Testimony") at 3.

[123] National Taxpayer Advocate, *2004 Annual Report to Congress*, at 226.

D. Third Strategic Goal: Modernize the IRS Through Its People, Processes, and Technology

1. In general

The IRS's third strategic goal is to modernize the IRS through its people, processes, and technology. Because many of the IRS's tax administration systems are obsolete or difficult to maintain, modernization of the IRS has become increasingly important in recent years. With regard to the IRS's workforce, many key IRS employees are nearing retirement age, making recruitment, retention, and training of employees critical to the agency's future success. Certain of the IRS's processes are similarly in need of attention. Increased threats, for example, have necessitated the development of new and enhanced procedures to ensure the security of the IRS's employees and of taxpayer information. Last, the IRS's information technology systems are antiquated and inadequate in light of the size and complexity of the IRS's functions.

The IRS's new strategic plan outlines a number of benchmarks the IRS will use to measure its progress in meeting its modernization goal, including: (1) the level of employee engagement, as measured by employee surveys; (2) measures of employee perceptions of the performance management system; (3) progress in implementing the President's Management Agenda; (4) the proportion of IRS staff assigned to mission-critical areas, such as tax processing, administration, and enforcement; (5) comparisons of business systems modernization performance in budgeting, cost controls, and program requirements stability to industry standards; (6) variances in obligated dollars to the original contract amount, and variances in schedules based on task orders and subsequent modifications; (7) variances in contracted task order requirements and modifications from the original task order requirements; and (8) the percentage of total requirements delivered to total requirements contracted.[124]

2. Personnel

<u>Recruiting, retention, and training</u>

The IRS Oversight Board states that "human capital is the IRS' greatest resource and strength, and one of its greatest challenges."[125] However, the Large and Mid-Size Business Division recently reported that it has lost and will continue to experience losses of experienced Revenue Agents through attrition.[126] Similarly, retirements of key employees and other losses

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[124] IRS Strategic Plan at 31.

[125] IRS Oversight Board, *Annual Report* (2004) at 21.

[126] George Appropriations Testimony at 9.

through attrition have resulted in a "crisis" for the Small Business/Self-Employed Division.[127] Because of the unusually high attrition rate among IRS employees, the agency risks critical losses of institutional memory. Accordingly, the IRS Strategic Plan emphasizes recruiting, training, and retaining workers.[128] Various steps the IRS has taken or anticipates taking to improve the recruiting, training, and retention are discussed in detail in section I.F below.

Section 1203 and the "10 deadly sins"

The IRS Reform Act contained a provision (section 1203) that established 10 acts or omissions by an IRS employee that will result in mandatory termination, also known as the "10 deadly sins." These acts are:

1. willful failure to obtain the required approval signatures on documents authorizing a seizure of a taxpayer's home, personal belongings, or business assets;

2. providing a false statement under oath with respect to a material matter involving a taxpayer or taxpayer representative;

3. violation of the rights protected under the Constitution or the civil rights established under six specifically identified laws with respect to a taxpayer, taxpayer representative, or other employee of the IRS;[129]

4. falsifying or destroying documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or taxpayer representative;

5. assault or battery on a taxpayer, taxpayer representative, or employee of the IRS, but only if there is a criminal conviction, or a final judgment by a court in a civil case, with respect to the assault or battery;

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[127] *Id*.

[128] IRS Strategic Plan at 26-27.

[129] These laws are: (1) title VI or VII of the Civil Rights Act of 1964; (2) title IX of the Education Amendments of 1972; (3) the Age Discrimination in Employment Act of 1967; (4) the Age Discrimination Act of 1975; (5) section 501 or 504 of the Rehabilitation Act of 1973; or (6) title I of the Americans with Disabilities Act of 1990. IRS Reform Act sec. 1203(b)(3)(B).

6. violations of the Code, Department of Treasury regulations, or policies of the IRS (including the Internal Revenue Manual) for the purpose of retaliating against, or harassing, a taxpayer, taxpayer representative, or other employee of the IRS;

7. willful misuse of the provisions of section 6103 of the Code for the purpose of concealing information from a Congressional inquiry;

8. willful failure to file any return of tax required under the Code on or before the date prescribed therefor (including any extensions), unless such failure is due to reasonable cause and not to willful neglect;

9. willful understatement of Federal tax liability, unless such understatement is due to reasonable cause and not to willful neglect; and

10. threatening to audit a taxpayer for the purpose of extracting personal gain or benefit.[130]

Between 1998 and 2000, the number of section 1203 allegations regarding taxpayer and employee rights increased. Section 1203 allegations concerning retaliation or harassment declined from 1,000 in year 2000 to 143 in 2003. Allegations of employee noncompliance with tax filing and reporting requirements, on the other hand, have steadily increased since 1998. Approximately 88 percent of allegations filed between July 1998 and April 2004 were completely investigated, and 13 percent of such investigations substantiated the allegations. Of 582 substantiated cases in which penalty decisions were complete, 126 resulted in employee firings, 257 resulted in penalty mitigation, and 50 were closed when the employee separated for other reasons. Most substantiated allegations, and consequently most terminations and other penalties, were for noncompliance with Federal tax laws.[131]

Some have questioned whether section 1203 has had a chilling effect on IRS employees charged with taking enforcement actions against noncompliant taxpayers, particularly given that few substantiated section 1203 allegations have involved contacts with taxpayers.[132] The

[130] IRS Reform Act sec. 1203(b).

[131] See, e.g., Letter from James R. White, Director, Tax Issues, Government Accountability Office, to the Honorable Bill Thomas and the Honorable Amo Houghton (GAO-04-1039R), September 27, 2004, at 2-3.

[132] *Id*. at 1.

Treasury Inspector General for Tax Administration has attributed a decline in enforcement actions at least in part to the existence of Section 1203.[133]

The President's budget proposal for fiscal year 2006 would remove two actions from the list of 10 deadly sins – (1) the late filing of a return where an employee is entitled to a refund; and (2) employee versus employee acts – and would add the unauthorized inspection of returns and return information to the list of violations. Additionally, the proposal requires the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific types of wrongful conduct covered by section 1203. The Commissioner would retain the non-delegable authority to determine whether mitigating factors support a personnel action other than that specified in the guidelines for a covered violation.[134]

3. Safety and security

The IRS Strategic Plan provides that the IRS's modernization efforts will continue to emphasize the safety and security of its employees, facilities, and information systems. In general, the IRS's security processes and procedures have been described as adequate, although weaknesses remain.[135]

With regard to the security of IRS personnel, the Treasury Inspector General for Tax Administration notes that the IRS is a prime target for terrorists, anti-government protestors, and other extremists.[136] During the six-month period ended September 30, 2004, the Treasury Inspector General, who manages a program to identify threats against IRS personnel and facilities, issued 46 advisories to IRS management of potential threats and completed 531 investigations of threats and assaults directed at IRS employees and facilities.[137] In its strategic plan, the IRS states that it will implement an automated system to enhance reporting capabilities and hazard recognition to significantly reduce workers' compensation claims. The IRS will also partner with the General Service Administration and local law enforcement to ensure the safety of IRS personnel.[138]

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[133] George Tax Gap Testimony at 20.

[134] See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2006 Budget Proposal* (JCS-3-05), March 2005, at 269.

[135] George Appropriations Testimony at 7-8.

[136] *Id*.

[137] TIGTA Semiannual Report at 21.

[138] IRS Strategic Plan at 29.

The IRS is similarly committed to ensuring the security and integrity of its information and processes. The IRS has experienced numerous external attempts to corrupt its operations, such as through bribes of its employees. In his September 30, 2004, semiannual report, the Treasury Inspector General for Tax Administration noted that, since April 1, 2004, the office had conducted 27 investigations into bribery allegations involving taxpayers, 93 investigations of attempts to corrupt IRS systems or operations, and 335 investigations into non-tax fraud and other related activities.[139]

Because the IRS maintains a large amount of sensitive data on its computer systems, such systems are also a likely target of external threats, particularly in light of the increased connectivity of computer systems.[140] The Treasury Inspector General for Tax Administration notes that the IRS's security infrastructure and the applications that guard sensitive data display weaknesses and criticizes the IRS for failing to create a culture that strongly emphasizes the security and privacy of taxpayer data.[141] With regard to specific systems, as of April 2005, no modernizations applications were employing the Security Audit and Analysis System ("SAAS"), even though the SAAS is intended to serve as the audit trail collection and reporting system for modernization applications. In addition, the SAAS was accepted by the IRS from the vendor even though the system did not meet performance requirements.[142]

The Treasury Inspector General for Tax Administration does, however, note some positive security developments. For example, in October 2003, the IRS consolidated important security functions into a single unit to improve focus.[143]

4. Technology resources

Commissioner Everson recently testified that "[t]he IRS tax administration system, which collects $2 trillion in revenues annually, is critically dependent on a collection of 40-year-old, obsolete computer systems."[144] Accordingly, the IRS has committed to modernizing its information technology systems. The total cost of Business System Modernization ("BSM") project is expected to reach approximately $8 billion.

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[139] TIGTA Semiannual Report at 22.

[140] George Appropriations Testimony at 7.

[141] *Id*.

[142] *Id*.

[143] *Id*. at 7-8.

[144] Everson Oversight Testimony at 11.

Over the years, the BSM effort has been plagued by cost increases and schedule delays.[145] Fiscal year 2004, however, saw a number of successes in the modernization program, including: deliveries of projects; successes in hitting schedule and cost targets; and improvements in program management. For example, the IRS delivered the first release of the Customer Account Data Engine ("CADE") project in July 2004. CADE is intended to replace the IRS's antiquated Master File system, which is the main repository of taxpayer information. CADE is thus the centerpiece of the modernization effort and the IRS's highest-priority technology project.[146] As of March 16, 2005, the IRS had processed over 842,000 1040-EZ returns using CADE; the IRS anticipates that CADE will process approximately 2 million returns during the 2005 filing season.[147] It is also anticipated that future releases will allow for faster processing of more complex returns.

The IRS launched a new Integrated Financial System ("IFS") in 2004, which is a more efficient and accurate financial accounting system for the IRS.[148] The IRS also released a suite of e-services products, including Web-based tools that will improve the interface between tax professionals and the IRS, and Modernized e-File, which will allow corporations and tax-exempt organizations to file annual information and tax returns electronically.[149]

With regard to program management, the IRS has similarly made progress. The IRS is resizing its modernization efforts to better align such efforts with the skill and capacity of IRS management. Under this new approach, the IRS will focus on fewer, higher-priority projects in order to improve management and ensure successful delivery. This streamlined approach is consistent with the decrease in the BSM budget for fiscal years 2005 and 2006. The Government Accountability Office notes that the effects of this new approach and the accompanying budget reductions remain unclear, but that the reduction in funding is not without risk, as it could affect future budget requests and will delay the implementation of certain functionality.[150]

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[145] George Tax Gap Testimony at 17. Although the IRS recently asserted that it has seen a marked improvement in reducing cost variances in the BSM program, the Government Accountability Office has taken issue with the methodology the IRS employed to support this claim. See Government Accountability Office, *Internal Revenue Service: Assessment of the Fiscal Year 2006 Budget Request* (GAO-05-566), April 27, 2005, at 17.

[146] Everson Oversight Testimony at 12-13.

[147] Government Accountability Office, *Internal Revenue Service: Assessment of the Fiscal Year 2006 Budget Request* (GAO-05-566), April 27, 2005, at 16.

[148] Everson Oversight Testimony at 11.

[149] *Id*. at 11, 13.

[150] Government Accountability Office, *Internal Revenue Service: Assessment of the Fiscal Year 2006 Budget Request* (GAO-05-566), April 27, 2005, at 20.

The IRS has also assigned a business unit leader to each project and has taken steps to improve accountability of the prime contractor, such as by restructuring BSM contracts to shift financial risk to the contractor and to tie costs to performance. The IRS has recruited seasoned executives from outside the agency to help manage complex BSM projects.[151]

During fiscal year 2005, the IRS expects to focus its BSM resources on the following three projects: (1) CADE; (2) Modernized e-File; and (3) Filing and Payment Compliance ("F&PC"). The F&PC system will allow the IRS to analyze collection cases and separate more complex cases requiring IRS involvement from simpler cases that can be assigned to private collection agencies, or PCAs.[152] The IRS plans two initial sub-releases of the F&PC project for fiscal years 2005 and 2006.[153]

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[151] Everson Oversight Testimony at 12.

[152] *Id*.

[153] George Tax Gap Testimony at 18.

E. Use of Performance Measures

1. In general

In its 2004 annual report, the IRS Oversight Board discussed the IRS's "mixed success" in establishing long-term goals and urged that "the IRS . . . take on the more challenging and important task of setting long-term, strategic, and measurable goals that focus on outcomes and end results."[154] In recent Congressional testimony, an official from the Government Accountability Office expressed a similar sentiment:

> The [fiscal year 2006 budget] request does not provide details about how the reductions [in the service budget] will impact taxpayers in the short-term. Nor does the IRS have long-term goals; thus the contribution of the fiscal year 2006 budget request to achieving IRS's mission in the long-term is unclear.[155]

The IRS Oversight Board has noted, however, that the IRS has taken the important step of aligning its performance with its requests for resources. The IRS Oversight Board further stated that the IRS's new strategic plan for fiscal years 2005-2009 will represent a significant step toward the development of measurable goals.[156] The benchmarks the IRS will use to measure its success in meeting its three strategic goals are summarized in each of subsections I.B through I.D above.

2. Eighty percent e-filing requirement

The IRS Reform Act established one statutory performance measure for the IRS: a goal of 80 percent electronic filing by the year 2007.[157] As is outlined above, the data in Table 3 show an overall increase in the number of individual returns filed electronically of 10.73 percent from 2004 to 2005 and a nearly corresponding decline in the number of paper returns filed of 8.73 percent. Of the total number of individual returns filed as of May 6, 2005, approximately 53.91 percent were filed electronically. The most significant increase, 46.60 percent, was in the number of taxpayers taking advantage of the Free File initiative, which allows taxpayers to file

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[154] IRS Oversight Board, *Annual Report* (2004) at 24.

[155] Statement of James R. White, Director of Tax Issues, Government Accountability Office, Before the Subcommittee on Oversight of the House Committee on Ways and Means (April 13, 2005) (hereinafter "White Oversight Testimony") at 3.

[156] IRS Oversight Board, *Annual Report* (2004) at 24.

[157] IRS Reform Act sec. 2001.

their tax returns electronically at no charge via the IRS website. In its 2004 report to Congress on e-filing, the IRS Oversight Board noted that business return e-filing rates remained relatively low for 2004, ranging from 3.5 percent for Forms 1065 to 45.1 percent for Forms K-1 (1041).[158]

The IRS Oversight Board recently stated that the IRS has made "remarkable progress" in achieving e-filing growth, but noted that the current rate of growth will not allow the IRS to reach the 80 percent goal by 2007 unless new e-filing incentives are implemented.[159] The President's Fiscal Year 2006 budget proposes a 15-day extension for taxpayers who file and pay electronically to provide additional incentive for individuals with a balance due in April to file electronically.[160]

3. Proposals for additional statutory benchmarks

Agency performance goals are important, because they allow for measurement of the agency's progress and for a more precise allocation of resources among the agency's functions. Without clear performance measures, it is more difficult for an agency, or for parties exercising oversight responsibility, including Congress, to assess the agency's performance.

Notwithstanding the need for clear benchmarks to measure the IRS's performance, there are few statutorily-mandated performance measures that relate to the IRS. As a result, some have suggested a need for legislation that would formalize IRS performance measures by establishing clear statutory benchmarks, along the lines of the 80 percent e-filing requirement established by the IRS Reform Act. For example, some have suggested that Congress could establish a quantitative goal to achieve with respect to one or more of the enforcement benchmarks the IRS outlined in its new strategic plan. These benchmarks are: (1) the rate of reporting compliance; (2) the rate of filing compliance; (3) the rate of payment compliance; (4) the percentage of priority guidance list items published; (5) the percentage of Americans who think it is acceptable to cheat on taxes; and (6) the average cycle time, i.e., the length of time from receipt of a case for audit until the audit is completed.[161]

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[158] IRS Oversight Board, *Electronic Filing Annual Report to Congress* (2004) at 11.

[159] *Id*. at 10.

[160] See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2006 Budget Proposal* (JCS-3-05), March 2005, at 281. The House Committee on Ways and Means adopted such a provision in the 108th Congress, and it was included in the Taxpayer Protection and IRS Accountability Act as passed by the House of Representatives in 2003.

[161] IRS Strategic Plan at 25.

F. Employee Training, Recruiting, and Retention

1. Training requirements of the IRS Reform Act

The IRS Reform Act placed a greater emphasis on taxpayer service and included significant expansions of taxpayer rights. These changes, as well as subsequent changes in the law, necessitated increased training of IRS employees.

In recognition of this need, the IRS Reform Act placed an emphasis on training, and required the Commissioner to implement a training program within 180 days of the date of enactment of the IRS Reform Act. The Commissioner was also required to submit a training plan to the Senate Committee on Finance and the House Committee on Ways and Means. Such plan was required to: (1) detail a comprehensive employee training program to ensure adequate customer service training; (2) detail a schedule for training and the fiscal years during which the training will occur: (3) detail the funding of the program and relevant information to demonstrate the priority and commitment of resources to the plan; (4) review the organizational design of customer service; (5) provide for the implementation of a performance development system; and (6) provide for at least 16 hours of conflict management training during fiscal year 1999 for employees conducting collection activities.[162]

The mandated reform plan was submitted to Congress on March 9, 1999, and by the end of that year, 50,000 IRS employees had received new customer service training relating to the IRS Reform Act.[163] The Commissioner reported that the objectives of the training were to provide formal training with clear learning objectives, testing, and evaluation. Specific training courses included due process, installment agreements, offers in compromise, seizures, relief from joint and several liability, and section 1203 of the IRS Reform Act (the "10 deadly sins"). Later training related to integrating specific changes into the day to day operations of the IRS.[164]

The need for the IRS to recruit qualified personnel and revitalize the workforce was also recognized by the IRS Reform Act. The Act included a variety of "personnel flexibilities" to give the Commissioner greater tools with respect to personnel issues.[165]

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[162] IRS Reform Act sec. 1205.

[163] Government Accounting Office, *Restructuring Act's Personnel Flexibility Provisions* (GAO/GGD-00-81), April 2000, at 6.

[164] Testimony of the Honorable Charles O. Rossotti, Commissioner, Internal Revenue Service Before the Annual RRA '98 Joint Hearing on IRS Progress Convened by the Joint Committee on Taxation (May 25, 1999) at 6, 14.

[165] IRS Reform Act secs. 1201-1204.

2. Current training, recruitment, and retention issues

Training and related issues continue to be a factor for the IRS, although the issues and emphasis have changed to some extent since the early days following the enactment of the IRS Reform Act. The IRS Oversight Board has stated that human capital is the IRS's greatest resource and strength, and one of its greatest challenges. The Board has stated that it has serious concerns regarding the IRS approach to human capital and recommended that the IRS focus on the way it hires, trains, and retains employees. The Board has called upon the IRS to develop an agency-wide human capital strategic plan that keys on five areas: (1) replace lost critical talent; (2) build skills for complex work; (3) manage change; (4) enhance performance; and (5) engage the entire workforce.[166] The current strategic plan addresses at least some of these areas.

The Treasury Inspector General for Tax Administration has reported that limited funding has made it difficult to attract new hires and retain other employees.[167] The IRS has committed to an "aggressive recruitment effort" that will involve partnerships with colleges, universities, and private businesses, and the IRS will strive to be recognized as an "employer of choice." The agency also plans to identify high-quality applicants interested in management positions and intends to use technology to improve the retention and transfer of knowledge to employees. The IRS has begun to link pay to performance for senior and department managers and plans to expand this program to front-line managers.[168]

With the increasing turnover rate comes a greater need for strong training programs. The IRS has indicated that it will implement a "needs-based, demand-driven" employee education program that makes use of e-learning opportunities.[169] The Wage and Investment Division, for example, has increased use of electronic learning and training by demand, and it has improved its ability to identify skill levels and, in turn, training needs of employees.[170] The IRS also plans to tailor training programs to the needs of newly hired employees in order to "fast-track" them into the field.[171]

An annual IRS employee satisfaction survey conducted by The Gallup Organization found that the IRS made "steady progress increasing employee engagement" between 2001 and 2003. Specifically, the percentage of IRS employees who felt engaged increased from 21

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[166] IRS Oversight Board, *Annual Report* (2004) at 21-22.

[167] George Appropriations Testimony at 9.

[168] IRS Strategic Plan at 27.

[169] *Id*. at 26.

[170] George Appropriations Testimony at 9.

[171] IRS Strategic Plan at 27.

percent to 31 percent. The same survey found that IRS's ranking among comparable organizations rose from the 34th percentile to the 50th percentile.[172] Nevertheless, challenges remain, as 69 percent of IRS employees did not feel engaged, and only 43 percent strongly agreed that they know what to expect at work.[173]

[172] IRS Oversight Board, *Annual Report* (2004) at 22.

[173] *Id*.

II. IRS BUDGET

A. The President's Fiscal Year 2006 Budget Request for the IRS

1. In general

For fiscal year 2006, the IRS budget request totals $10.679 billion and 97,010 full-time equivalent employee positions.[174] The budget request reflects an increase of $443 million (4.3 percent) over the fiscal year 2005 appropriated level of $10.236 billion. It also represents an increase of 576 full-time equivalent employees (0.6 percent) from the fiscal year 2005 estimated operating level of 96,434 full-time equivalent employees.[175]

The IRS fiscal year 2006 budget request proposes a consolidated appropriation for IRS operations. The proposed budget is divided into three broad categories: (1) tax administration and operations; (2) health insurance tax credit administration; and (3) business systems modernization.[176] With respect to the IRS's strategic goals, the 2006 budget request reflects a shift in resource allocation from taxpayer service and modernization to enforcement. The following table illustrates this shift:

Table 6.–Allocation of IRS Budgets to Service, Enforcement, and Modernization
[Dollars in Thousands]

	FY 2004 (Enacted)	FY 2005 (Enacted)	FY 2006 (Proposed)	Change from FY 2005	Change from FY 2004
Service	$3,709,647	$3,605,978	$3,567,455	-1.07%	-3.83%
Enforcement	$6,052,377	$6,392,187	$6,892,596	7.83%	13.88%
Modernization	$387,699	$203,360	$199,000	-2.14%	-48.67%

SOURCE: Prepared by Joint Committee on Taxation using data from FY 2006 Budget in Brief at 1.

[174] Department of Treasury, *Internal Revenue Service: Fiscal Year 2006 Congressional Budget Submission* (February 7, 2005) (hereinafter the "IRS FY 2006 Submission") at 22, available at *http://www.treas.gov/offices/management/budget/budget-documents/cj/06/irs.pdf*.

[175] *Id.*

[176] Internal Revenue Service, *The Budget in Brief FY 2006* (2005) ("FY 2006 Budget in Brief") at 2.

2. Tax administration and operations

In its fiscal year 2006 budget request, the IRS has proposed restructuring its budget allocation by combining into a single appropriation for Tax Administration and Operations three major budget categories used in prior years: (1) processing, assistance, and management; (2) tax law enforcement; and (3) information systems. This change is intended to facilitate a more accurate assessment of the overall value of IRS programs, simplify the full costing of programs, and allow the IRS to demonstrate incremental increases in an initiative's effectiveness based on the level of funding received.[177] The new category of Tax Administration and Operations can be broken down into eight subcategories: (1) assistance; (2) outreach; (3) processing; (4) research; (5) examination; (6) collection; (7) investigations; and (8) regulatory compliance. The first three subcategories represent expenditures for taxpayer service, while the remaining five are enforcement related.

Taxpayer service

The IRS's fiscal year 2006 budget request allocates $3.57 billion to taxpayer service.[178] This represents a decrease of $38.5 million from fiscal year 2005 and $142.2 million from fiscal year 2004.

The category of taxpayer service is composed of three subcategories: assistance, outreach, and processing. The assistance subcategory includes resources allocated to responding to various tax-related questions. It also includes resources allocated to account inquiries via correspondence, face-to-face meetings, telephone calls, and electronic communications.[179]

The outreach subcategory funds proactive programs for taxpayers, businesses, non-profit organizations, tax practitioners, and others to ensure that taxpayers understand their tax obligations and have the information and materials necessary to fulfill their responsibilities. Outreach resources are used to develop understandable notices, produce tax forms and publications, provide media services, and develop published information for the visually impaired. They are also used to manage education programs such as Tax Counseling for the Elderly and Volunteer Income Tax Assistance, provide multi-lingual services, and develop stakeholder partnerships.[180]

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[177] IRS FY 2006 Submission at 10.

[178] IRS FY 2006 Submission at 14; FY 2006 Budget in Brief at 1.

[179] IRS FY 2006 Submission at 46.

[180] *Id.* at 51.

The processing subcategory includes resources to track, process, and resolve all electronic and paper returns. It also includes funding for the issuance of refunds, payments, and tax notices, and the receipt and processing of the information returns that permit the IRS to match data to that provided on a taxpayer's return.[181]

The following tables provide further details on the IRS's proposed allocation of funding for taxpayer service activities.

Table 7.–Comparison of Dollar Expenditures for Taxpayer Service Activities for Fiscal Years 2004 through 2006
[Dollars in Thousands]

Taxpayer Service Activities	FY 2004 (Enacted)	FY 2005 (Enacted)	FY 2006 (Proposed)	Change from FY 2004	Change from FY 2005
Assistance	$1,828,373	$1,829,190	$1,805,965	-1.23%	-1.27%
Outreach	$544,146	$500,329	$466,217	-14.32%	-6.82%
Processing	$1,337,128	$1,276,459	$1,295,273	-3.13%	1.47%
Total	$3,709,647	$3,605,978	$3,567,455	-1.07%	-3.83%

SOURCE: Prepared by Joint Committee on Taxation using data from IRS FY 2006 Submission at 14 and FY 2006 Budget in Brief at 1. Numbers may not add due to rounding.

Table 8.–Comparison of Full-Time Equivalent Employees for Taxpayer Service Activities for 2004 through 2006

Taxpayer Service Activities	FY 2004 (Enacted)	FY 2005 (Enacted)	FY 2006 (Proposed)	Change from FY 2004	Change from FY 2005
Assistance	21,739	20,798	20,160	-7.26%	-3.07%
Outreach	2,871	2,473	1,905	-33.65%	-22.97%
Processing	17,418	15,695	15,516	-10.92%	-1.14%
Total	42,028	38,966	37,581	-10.58%	-3.55%

SOURCE: Prepared by Joint Committee on Taxation using data from IRS FY 2006 Submission at 14. Numbers may not add due to rounding.

Enforcement

The IRS's fiscal year 2006 budget request allocates $6.89 billion to enforcement activities, including examination, collection, investigation, regulatory compliance, and research.[182] This represents an increase of $500.4 million from fiscal year 2005 and $840.2 million from fiscal year 2004. The budget request provides for increased staffing to continue the

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[181] *Id.* at 56.

[182] IRS FY 2006 Submission at 14; FY 2006 Budget in Brief at 1.

positive enforcement trend begun in fiscal year 2003, and continuing through fiscal years 2004 and 2005. About 95 percent of this increase will be used to detect and deter noncompliance, with an emphasis in noncompliance by corporations, high-income individuals, and other contributors to the tax gap.[183] The remaining five percent will be used to detect and deter noncompliance within tax-exempt and government entities.

The enforcement category is composed of five subcategories of IRS activities: (1) research; (2) examination; (3) collection; (4) investigations; and (5) regulatory compliance. Research activities include analyses of the IRS's operations and performance, economic and demographic comparisons related to taxpayer behavior, statistical evaluations of the IRS's program activities, and specialized studies in all areas of tax administration. Research ranges from multi-year studies to short-term program evaluations. The research subcategory includes funding for data provided to the Treasury Department, the Joint Committee on Taxation, and other Federal agencies. It also includes published tax data available for the general public and research and reference tools for use by front-line IRS employees.[184]

The examination subcategory includes funding for the verification of information provided on tax returns as well as for conducting audits. It also funds tax litigation activities and provides resources to support cooperation with treaty partners and international organizations.[185]

The collection activities subcategory includes resources to collect income tax due from all sources. Collection activities involve the use of a variety of approaches and techniques, including full-payment demands, installment agreements, offers-in-compromise, liens, levies, bankruptcy procedures, and property seizures.[186]

The investigation activities subcategory funds the exploration of potential criminal violations of the tax law. Resources are dedicated to combating abusive schemes and scams, curtailing fraudulent refund crimes, enforcing money laundering statutes, documenting financial transactions related to narcotics trafficking, dismantling the financial infrastructure of terrorists, exposing Bank Secrecy Act violations, and participating in various intra-governmental task forces.[187]

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[183] IRS FY 2006 Submission at 22.

[184] *Id*. at 61.

[185] *Id.* at 65.

[186] *Id.* at 72.

[187] *Id.* at 77.

The regulatory compliance subcategory includes resources for the interpretation of and guidance on tax laws; the development of published guidance materials; the enforcement of regulatory rules, laws, and approved business practices; and the monitoring of currency transaction reporting requirements for financial institutions. These resources also support the IRS's increased focus on offshore credit cards, abusive schemes, technical tax shelters, and high-income taxpayers.[188]

The following tables provide further details on the IRS's proposed allocation of funding for enforcement activities.

Table 9.–Comparison of Dollar Expenditures for Enforcement Activities for Fiscal Years 2004 through 2006
[Dollars in Thousands]

Enforcement Activities	FY 2004 (Enacted)	FY 2005 (Enacted)	FY 2006 (Proposed)	Change from FY 2004	Change from FY 2005
Research	$146,355	$153,876	$157,872	7.87%	2.60%
Examination	$3,214,410	$3,477,623	$3,711,889	15.48%	6.74%
Collection	$1,779,233	$1,825,715	$1,990,562	11.88%	9.03%
Investigations	$656,131	$681,980	$767,418	16.96%	12.53%
Regulatory Compliance	$256,248	$252,993	$264,855	3.36%	4.69%
Total	$6,052,377	$6,392,187	$6,892,596	13.88%	7.83%

SOURCE: Prepared by Joint Committee on Taxation using data from IRS FY 2006 Submission at 14 and FY Budget in Brief at 1. Numbers may not add due to rounding.

Table 10.–Comparison of Full-Time Equivalent Employees for Enforcement Activities for 2004 through 2006

Enforcement Activities	FY 2004 (Enacted)	FY 2005 (Enacted)	FY 2006 (Proposed)	Change from FY 2004	Change from FY 2005
Research	1,144	1,119	1,119	-2.19%	0.00%
Examination	30,329	31,498	32,284	6.45%	2.50%
Collection	18,390	18,023	18,815	2.31%	4.39%
Investigations	5,001	4,899	5,250	4.98%	7.16%
Regulatory Compliance	2,146	1,912	1,944	-9.41%	1.67%
Total	57,010	57,451	59,412	4.21%	3.41%

SOURCE: Prepared by Joint Committee on Taxation using data from IRS FY 2006 Submission at 14. Numbers may not add due to rounding.

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[188] *Id.* at 83.

3. Health insurance tax credit administration

The health insurance tax credit administration appropriation funds the cost of administering a refundable tax credit for health insurance to qualified individuals, commonly referred to as the health coverage tax credit or HCTC. Under the Trade Act of 2002,[189] in the case of taxpayers who are eligible individuals, the refundable tax credit is provided for 65 percent of the taxpayer's expenses for qualified health insurance of the taxpayer and qualifying family members for each eligible coverage month beginning in the taxable year. Eligible individuals include certain individuals receiving a trade readjustment allowance and certain individuals receiving benefits from the Pension Benefit Guarantee Corporation. Since August 1, 2003, the credit has been available on an advance basis (i.e., prior to the filing of the taxpayer's return).

For fiscal year 2006, the IRS budget requests funding of $20,210,000 for health insurance tax credit administration. This represents a decrease of 41.5 percent from fiscal year 2005 and 41.9 percent from fiscal year 2004.

4. Business systems modernization

The business systems modernization appropriation provides for the planning and capital asset acquisition of information technology systems to modernize the IRS's antiquated 40-year-old computer system. For fiscal year 2006, the IRS budget requests funding of $199 million. This represents a decrease of 2.1 percent from fiscal year 2005 and 48.7 percent from fiscal year 2004. The budget request includes funding for the continuation of the IRS's Customer Account Data Engine ("CADE"), Modernized e-File, and Filing and Payment Compliance projects.[190]

As is discussed in Part I, CADE is the IRS's highest priority technology project. It is intended to be a modern database that will house tax information for more than 200 million individual and business taxpayers. The IRS deployed the first installment of CADE in August 2004. When completed, CADE is intended to provide a variety of benefits to taxpayers, such as faster refunds (by more than 50 percent) along with daily postings of transactions and updating accounts, which (with other technology elements) are intended to improve customer service.[191]

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[189] Pub. L. No. 107-210 (August 6, 2002).

[190] IRS FY 2006 Submission at 89.

[191] *Id.*

B. User Fees and Excise Taxes

Section 7528 authorizes the IRS to charge taxpayers user fees for ruling letters, opinion letters, determination letters, and similar requests.[192] The IRS collected $62.5 million in user fees during fiscal year 2004 and estimates that it will collect $100 million in such fees during each of fiscal years 2005 and 2006.[193]

The funds raised from user fees and other IRS-related excise taxes are not automatically appropriated to the IRS. Some have suggested that such fees and excise taxes should be automatically appropriated to the IRS to offset costs of the programs to which they relate. For example, section 4940 imposes an excise tax on the net investment income of private foundations. Although the tax has been collected since 1969, the funds raised from the tax are not automatically appropriated to the IRS.[194] Some have suggested that a portion of this excise tax revenue be allocated to the oversight of tax-exempt organizations. Alternatively, it has been suggested that a tax return filing fee dedicated to such oversight be imposed on tax-exempt organizations. It is unclear whether a dedicated source of funding would increase the IRS's budget on a net basis, since the existence of such funding could result in the reduction by Congress of other discretionary IRS appropriations.

[192] This authority was recently extended through September 30, 2014, by section 891 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

[193] IRS FY 2006 Submission at 26 and 143.

[194] Section 1101 of the IRS Reform Act removed the provision in the Code authorizing such an appropriation.

C. IRS Oversight Board Budget Recommendation

The IRS Oversight Board recommended a budget that provides $950 million more than the Administration's requested IRS budget of $10.679 billion.[195] This amount is 8.9 percent over the Administration's recommendation and a 13.6 percent increase over the amount appropriated by Congress for 2005.

The IRS Oversight Board, in justifying this increase, noted that for the past five years, the proposed IRS budgets and appropriations have not adequately taken into account a number of anticipated expenses, such as Congressionally mandated pay raises, inflation, and rent increases.[196] The IRS Oversight Board further noted that it "is greatly concerned that [the President's IRS budget request] will result in additional reductions in taxpayer services or modernization initiatives if budgets are cut or unanticipated costs arise."[197]

The IRS Oversight Board's recommendation calls for additional funding to enhance tax law enforcement and customer service, as well as additional funds for Business Systems Modernization to replace the IRS's archaic computer system.[198] The recommendation also covers anticipated pay raises of 3.5 percent, rather than the 2.3 percent contained in the Administration request.[199]

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[195] IRS Oversight Board, *Special Report: FY2006 IRS Budget* (March 2005) (hereinafter "IRS Oversight Board Report") at 9.

[196] *Id.* at 13.

[197] *Id.* at 6.

[198] *Id.* at 9

[199] *Id.* at 13.

D. Government Accountability Office Findings

On April 27, 2005, the Government Accountability Office released its assessment of the IRS's fiscal year 2006 budget request.[200] The Government Accountability Office's IRS Budget Assessment reached the following conclusions:

- "IRS's 2006 fiscal year budget request reflects a continuing shift in priorities from improving taxpayer service to strengthening enforcement efforts, but the potential impact of these changes on taxpayers in both the short- and long-term is unclear. ... IRS has not finalized the details on where reductions in taxpayer service would occur. In addition, IRS is developing, but currently lacks, long-term goals that can help IRS inform stakeholders, including the Congress, and aid them in assessing performing and making budget decisions. In light of the current budget environment and IRS's improvements in taxpayer service over the last several years, this is an opportune time to reconsider the menu of services it provides. It may be possible to maintain the overall level of assistance to taxpayers by changing the menu of services offered, offsetting reductions in some areas with new and improved service in other areas such as on IRS's Web site."[201]

- "IRS has taken important steps forward towards implementing the BSM program by delivering the initial phases of several modernized systems in 2004 and early 2005. Nevertheless, BSM continues to be high risk because, in part, its projects have incurred significant cost increases and schedule delays, and the program continues to face major challenges. As a result of funding reductions and other factors, the IRS has made major adjustments to the BSM program, including reducing the management reserve and changing the mix and roles of contractor versus Federal government staff used to manage the program. It is too early to tell what effect these adjustments will ultimately have on the BSM program, but they are not without risk, could potentially impact future budget requests, and will delay the implementation of certain functionality that was intended to provide benefit to IRS operations and taxpayers. Finally, the BSM program is based on visions and strategies developed years ago, which, coupled with the already significant delays the program has experienced and the changes brought on by the budget reductions, indicates that it is time for the IRS to revisit its long-term goals, strategy, and plans for BSM, including an assessment of when significant future functionality would be delivered."[202]

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[200] See Government Accountability Office, *Internal Revenue Service: Assessment of the Fiscal Year 2006 Budget Request* (GAO-05-566), April 27, 2005.

[201] *Id.* at 2-3.

[202] *Id.* at 3.

- "IRS has made progress toward implementing investment management best practices that would improve its budget development and support for its IT [information technology] operations and maintenance funding requests."[203]

[203] *Id.*

E. Financial Audit of IRS Fiscal Year 2003 and 2004 Financial Statements

In November 2004, the Government Accountability Office published its financial audit of the IRS for fiscal years 2003 and 2004.[204] The audit report concluded that the IRS's financial statements fairly presented the IRS's assets and liabilities and conformed with generally accepted accounting principles. However, the report also observed that, because of material weaknesses in internal controls, the IRS did not maintain effective controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations. Thus, the IRS did not provide reasonable assurance that losses, misstatements, and noncompliance with laws affecting financial statements would be prevented or detected on a timely basis.[205] Despite these material weaknesses in internal controls and other system deficiencies, the Government Accountability Office report noted that the IRS was able to prepare, primarily through compensating processes and approaches, financial statements that were fairly stated in all material respects for fiscal years 2003 and 2004.

[204] See Government Accountability Office, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements* (GAO-05-103), November 2004.

[205] *Id.* at 8-9.