JOINT REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE, 2002

HEARING

BEFORE THE

COMMITTEE ON FINANCE
COMMITTEE ON APPROPRIATIONS
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

AND THE

COMMITTEE ON WAYS AND MEANS
COMMITTEE ON APPROPRIATIONS
COMMITTEE ON GOVERNMENT REFORM
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

MAY 14, 2002

JCS–4–02

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JOINT REVIEW OF THE INTERNAL REVENUE SERVICE, 2002

TUESDAY, MAY 14, 2002

The joint review met, pursuant to notice, at 10:00 a.m., in room 215, Dirksen Senate Office Building, Hon. Kent Conrad presiding.

[The press release announcing the hearing follows:]

JOINT COMMITTEE ON TAXATION PRESS RELEASE

JCT Press Release: 02-02
For Immediate Release: May 8, 2002
For Further Information, Contact: Kathleen Dorn (202) 225-3621
Kathleen.dorn@mail.house.gov

The Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") requires the chairman of the Joint Committee on Taxation to convene a joint review of the strategic plans and budget of the IRS. The joint review is to be held before June 1 of calendar years 1999 through 2003. The joint review is to include two Members of the majority and one Member of the minority from each of the House Committees on Ways and Means, Appropriations, and Government Reform, and the Senate Committees on Finance, Appropriations, and Governmental Affairs.

Pursuant to the IRS Reform Act, Senator Max Baucus, Chairman, Joint Committee on Taxation, has scheduled a joint review of the IRS strategic plans and fiscal year 2003 budget for **Tuesday, May 14, 2002, in Room 215, Dirksen Senate Office Building beginning at 10:00 a.m.** The joint review will be open to the public.

Witness List

One Panel Consisting of:

The Honorable Charles O. Rossotti, Commissioner of Internal Revenue, Washington, D.C.
The Honorable Larry Levitan, Chairman, IRS Oversight Board Washington, D.C.
The Honorable David C. Williams, Treasury Inspector General for Tax Administration, Washington, D.C.
Mr. James R. White, Director, Tax Issues, United States General Accounting Office, Washington, D.C.

JOINT REVIEW OF THE STRATEGIC PLANS AND FISCAL YEAR 2003 BUDGET OF THE INTERNAL REVENUE SERVICE

TUESDAY, MAY 14, 2002

U.S. SENATE,
U.S. HOUSE OF REPRESENTATIVES,
JOINT COMMITTEE ON TAXATION,
Washington, DC.

The joint review met, pursuant to notice, at 10:00 a.m., in room 215, Dirksen Senate Office Building, Hon. Kent Conrad presiding.

Senators present: Conrad, Grassley, Landrieu, and Reed.

Congressmen present: Houghton, Portman, Coyne, and Horn.

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. The committee will come to order.

I am not Senator Baucus. Senator Baucus, as you know, is on the floor with an amendment on the trade bill. We expected a vote around 10:45. So, Senator Baucus called me yesterday and asked me to chair this hearing, which I will do. We will break at around 10:45 for that vote.

We appreciate very much the attendance of the witnesses, and Senator Grassley has joined me here. Shortly, he, too, will have to go to the floor because he, along with Senator Baucus, is managing that bill on the floor. We appreciate his being here for the beginning of the hearing this morning.

It has been almost four years since Congress enacted IRS restructuring and reform legislation. Since then, we have seen a significant turnaround in this important agency. Although we cannot make taxpayers love the tax collector, we can eliminate some of the frustration taxpayers experience by ensuring that IRS employees conduct themselves as professionals and as public servants.

Congress insisted that the IRS put a greater emphasis on serving the public and meeting the needs of taxpayers in order to restore public confidence in the IRS. It appears that we are beginning to succeed.

Today, those charged with the oversight of the agency are presenting the annual reports that we required of them in that 1998 law. The reports we will hear today indicate that customer service and general tax administration have been improved.

Let me just go to the chart that shows tax administration reorganization has been completed, total returns up 5 percent, electronic returns filed up 110 percent, well ahead of what was predicted,

speed of refunds up 30 percent, telephone accuracy up 7 percent, and public approval ratings up 35 percent. So, significant gains in each of those areas.

As a common thread in previous appearances before the Finance Committee, we discussed with the Commissioner the reduction in enforcement efforts, a situation that has raised concerns by both Democrats and Republicans.

Let us go to that. Enforcement revenue is down 9 percent, individual audits down 52 percent, small corporation audits down 73 percent, large corporation audits down 33 percent, collection liens down 21 percent, collection levies down 82 percent, collection seizures down 98 percent, criminal convictions down 27 percent.

Finally, a common thread in today's presentations is the continuing need for modernizing IRS's aging computer systems. Let me go to that chart.

Looking at system modernization. The Y2K program has been completed. Management oversight. We get mixed reviews. Communication 2001 and CAM, completed. The CADE, the cornerstone project, has been delayed. Seven major system projects are still in development. The updated employee equipment, the new laptops, well under way. In fact, that has occurred.

So we see progress in a number of areas. Certainly, in terms of the concern that we had with public reaction, a substantial improvement.

Still, we have major concerns. IRS indicates that the compliance rate for individual taxpayers is about 83 percent, which means that roughly 1 in 6 individuals is non-compliant. The IRS estimated the individual tax gap in 1992 at $95 billion. That is the difference between what is owed and what was being paid back in 1992.

Adjusted for inflation would be $120 billion today. When the results of abusive shelters, offshore credit cards, and other current schemes and scams are added in, today's total gap has been estimated by some outside observers to run as high as $200 to $300 billion.

Why does that matter? Well, what it says to us, if people were compliant and companies were complying with the tax laws that would exist, is we would have no budget deficit. We would have no increasing debt.

Instead, we would be continuing on the path we were on, paying down debt and having budget surpluses. This is critically important when the baby boom generation is about to start to retire.

Speaking as a former tax administrator, there is nothing as frustrating as being able to identify taxes that are due and owing, but which cannot be collected. The great frustration is for all other taxpayers and the vast majority of people, vast majority of companies, are paying what they legally owe.

It is very difficult for them to accept that they are meeting their responsibilities and others are ducking theirs. That is not fair.

Speaking as chairman of the Senate Budget Committee, progress in collecting some of these obligations that we know are out there would make it easier to put our fiscal house back in order without having to make a single change in the Internal Revenue Code.

I do not want to conclude without calling attention to the fact that today's remarks by Commissioner Rossotti will mark his last appearance as Commissioner at this joint review.

Mr. Commissioner, you took on one of the most difficult and thankless jobs in government and found yourself not merely running the IRS, but turning an 85-year-old bureaucracy in an entirely new direction.

We will be forever grateful for your leadership. You and I have met many times, both publicly and privately, and I have enormous respect for the extraordinary energy and attention you have devoted to the task.

I think you can be forever proud of your public service. You have set a very high standard as Commissioner, which will make the task of finding your successor even more difficult.

With that, I will turn to Senator Grassley for opening remarks that he might make. As I understand it, the agreement was that all members would have a chance for an opening statement, then we would go to the witnesses.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Well, first of all, I thank you for chairing this meeting, a meeting that we anticipated should take place once a year because some of the problems we found pre-Charles Rossotti in the IRS was that the Congress had not been doing a very good job of oversight of the IRS.

And when any agency, not just the IRS, has such a long leash, there is an effort for people to become more dictatorial as they approach serving the American people.

This hearing—and this is the fourth one of these hearings—was to bring all of the committees of Congress, both House and Senate, appropriators as well as tax writing committees, together in an oversight role of IRS at least once a year to focus on the problems at IRS. It does not relieve any of the various committees of our ongoing responsibility throughout the rest of the year to do an adequate job of oversight.

And too often we in Congress think our only job is legislating, whereas, maybe a more important job is to make sure that what legislating we have already done throughout the decades is adequately enforced and the law is properly executed according to Congress' will by those who have that job to do it.

So I think that this is a very good forum to go in depth in one environment to look at how one agency of the Federal Government is doing.

With that background, I had the good fortune of serving on the National Commission of Restructuring the IRS with Congressman Portman and former Senator Kerrey of Nebraska.

I also had involvements over a long period of time with former Senator Pryor of Arkansas in writing taxpayers' bills of rights, particularly the first one, working with him in that effort.

These efforts on my part, both serving on the Commission and being concerned about taxpayers' rights, have been directed towards achieving a proper balance between service to the taxpayers and providing law enforcement that recognizes the rights of tax-

payers and to have the IRS be a consumer-friendly organization with the motive behind that being that constituents would not fear the IRS any more, or in fact not fear the IRS at all, as you do not fear other government organizations when you go to them for help.

The idea is that if the taxpayers get the proper amount of help and there is a proper environment, particularly for answering those first questions and getting a right answer to those questions, that is the best way to collect the money that Senator Conrad has pointed out may not be coming in.

Also, to make sure that we make proper use of all of the tools that are there to make sure that taxpayers do comply. One of the things that Senator Conrad talked about was auditing, as a percentage of the total, being down.

But also, what Commissioner Rossotti has put in place, that he has really upped the matching, technical and mechanical matching of information that is a non-personnel way of catching those who might cheat on their income tax as a way of foregoing or doing more efficiently a process of collecting taxes.

Anyway, all of those things are part of an effort to bring a balance to the taxpayers' bill of rights, but also to make sure that every dollar is collected.

Now, some believe that these twin goals cannot be achieved, that somehow they are mutually exclusive. That is not the case. I look forward to today's hearing that will discuss the progress made in achieving the goals of taxpayers' rights on the one hand, and what needs to be done about guaranteeing taxpayers get all their rights, and on the other hand collecting every dollar that is due, where we are on that, and what more needs to be done in regard to that.

And then, like my chairman pro-tem, Senator Conrad, thanking Commissioner Rossotti for his service to the people. I know some view me, as a Senator, as one of your toughest critics. It is certainly no secret that I take strong interest in the works of the IRS.

But let me say that sometimes lost in the many letters that I send to you, Commissioner Rossotti, is my belief that you do a fine job as tax commissioner.

I was a strong advocate for having a person like you with business experience as the new Commissioner and not another tax lawyer that had been the pattern throughout the history of the IRS.

I think that your tenure has shown this to be a good approach, in other words, a business administrator approach to leading the agency. I hope that the present administration nominates a new IRS commissioner that will have a very strong background in business as you did.

So, I thank you once again for your service.

Senator CONRAD. Thank you, Senator Grassley.

I should indicate that this is a joint hearing of the Senate Finance Committee, the Senate Appropriations Committee, the Senate Governmental Affairs Committee, and the House Ways and Means Committee, the House Appropriations Committee, and the House Government Reform Committee. This is an unusual joint hearing.

Representing the House Ways and Means Committee is Congressman Houghton, who is next.

OPENING STATEMENT OF HON. AMO HOUGHTON, A U.S. REPRESENTATIVE FROM NEW YORK

Congressman HOUGHTON. Thank you very much, Mr. Chairman. Good to be here. I will make this brief.

I want to thank you very much for having this hearing. I want to thank Senator Grassley. It is nice to see Senator Reed coming in here. We are going to be down in your State over the weekend with the Canadians, Jack.

Senator REED. I am going to be there to greet you.

Congressman HOUGHTON. Great. Wonderful. Wonderful.

And then also, my associate here, Mr. Coyne. He and I work very closely together on the Oversight Committee of Ways and Means Committee. Then, of course, Steve Horn, who is representing the Government Reform; all wonderful members of Congress.

You said wonderful things about Mr. Rossotti, and I would echo those. However, the true test of a man's career is really in the next phase: not what he has done, what he has put in place. I have a feeling that what you put in place is very good. You have got a new organization. You have a sense of what the auditing function should be and beefed up. You have got great plans for technology. The critical thing, obviously, is going to be who replaces you.

So I wish the IRS well. I wish the commission well. I think the fact that we are working together here is extraordinary, and I thank you very much, Mr. Chairman.

Senator CONRAD. Thank you, Congressman Houghton, very much. And thank you for the contributions that you have made, with your background. I think it has made a real difference, and we appreciate it.

It is good to have Congressman Coyne with us as well, and Congressman Horn.

Congressman Coyne, welcome. Why do you not proceed?

OPENING STATEMENT OF HON. BILL COYNE, A U.S. REPRESENTATIVE FROM PENNSYLVANIA

Congressman COYNE. Thank you very much, Senator.

Today's session is the fourth annual hearing on the Internal Revenue Service, held jointly by the House/Senate committees that have jurisdiction over aspects of the Internal Revenue Service.

In adopting our current joint House/Senate hearing mandate, we hope that this proceeding and the proceedings that follow would clarify the voice of Congress and provide the IRS with clearer direction.

I think that this process has helped to some degree in achieving our goals. The Ways and Means Committee recently approved a taxpayers' rights bill that contains a host of tax administration changes that will benefit taxpayers in their dealings with the IRS.

Enactment of this legislation should be a priority in the 107th Congress by both Houses. The Ways and Means Committee's Oversight Subcommittee has continued its tradition of holding hearings on the tax return filing season and the administration's proposed budget request.

Based on our review, I thank the IRS for an excellent 2002 filing season. I also hope that we can all support full funding for the IRS's fiscal year 2003 budget, as requested by the President. I am

convinced that the IRS must have the tools and resources to do its job well.

As we discuss the IRS's overall strategic plans and need for adequate staffing and funding, I want to thank Commissioner Rossotti and the IRS employees that he has led nationwide for their dedicated work and long-term commitment to excellence in government.

Thank you very much, Senator.

Senator CONRAD. Thank you very much, Congressman.

Next, we will hear from Congressman Horn, who is here representing the House Government Reform Committee. I know that just recently you had the opportunity, Mr. Commissioner, to spend some extended time with Congressman Horn and his associates on that committee. So, this will be another chance.

Congressman Horn, it is always good to have you on this side.

OPENING STATEMENT OF HON. STEVE HORN, A U.S. REPRESENTATIVE FROM CALIFORNIA

Congressman HORN. Well, thank you very much, Chairman Conrad. I appreciate the opportunity to represent the House Committee on Government Reform at this third important meeting.

I want to start by commending Mr. Rossotti for his outstanding service as Commissioner of Internal Revenue over the last five years.

Commissioner Rossotti's term of office expires in November, and he will be sorely missed. I hope we can find a successor of his caliber, although that will indeed be a challenge. We need to seek a chief executive officer in this job.

When Mrs. Malone, my ranking Democrat, and I talked to President Clinton, he saw the idea and he passed on the way to do it with Secretary Rubin. The next thing I knew, about six months or a year, I run into the IBM chief executive officer. He said, boy, you have sure got something for me to do. I said, that is right. Let us hope it is a good one.

That is exactly what we ought to be doing this time, is getting a chief executive officer. I said to the President, look, every Republican, every Democrat, has had either tax accountants, tax lawyers, et cetera. I do not have anything against them. But when you have an organization of over 100,000 people, we need people that are executives.

The focus of today's hearing is on the long-term strategic objectives of the Internal Revenue Service and the agency's progress in implementing them.

Commissioner Rossotti has developed an excellent strategic road map to take the Internal Revenue Service where it needs to go. However, the journey will not be easy, although there are signs of modest progress. The agency still faces daunting management challenges that must be overcome before its strategic objectives can be achieved.

The Internal Revenue Service has chronic financial management weaknesses. Its financial systems simply cannot produce reliable and timely data to support its day-to-day operations. The agency's inability to make effective use of information technology is another chronic problem.

The Internal Revenue Service appears to be recovering from past failures and has developed a sound modernization blueprint. It now faces the major challenge of implementing that blueprint.

Computer security is yet another significant challenge for the Internal Revenue Service, as it is for most federal agencies. Until these core management challenges are overcome, the Internal Revenue Service will be unable to provide first class customer service to American taxpayers and effectively enforce the tax laws for the benefit of all honest taxpayers.

As Commissioner Rossotti is well aware, I am especially concerned about the agency's abysmal performance in collecting delinquent tax debts. That is what got me into this back in 1996, and we put on the books the way to get debts around from the other agencies, the cabinet agencies.

The IRS has made no effort, though, in its own sense, to collect tens of billions of dollars in tax delinquencies. Back in 1996, it was $60 billion sitting there and nobody was doing anything about it, allegedly because of the inadequate staff resources. At the same time, however, the agency has resisted the idea of using private contractors to assist in its collection efforts.

I understand that the Internal Revenue Service is now developing legislative proposals to use private sector collection agencies. This is long overdue. Most other federal agencies have been using private collection agencies for years, and with great success.

There is no reason why the Internal Revenue Service cannot do likewise. I hope that the agency will submit its legislative proposal soon, and that my colleagues on the committees of jurisdiction will support those proposals.

Thank you, Mr. Chairman.

Senator CONRAD. Thank you, Congressman Horn. Thank you for your thoughtful comments.

Also with us today representing the Senate Appropriations Committee are both Senators Landrieu and Senator Reed.

Senator Reed, you are up.

OPENING STATEMENT OF HON. JACK REED, A U.S. SENATOR FROM RHODE ISLAND

Senator REED. I will be extremely brief, Mr. Chairman, just to welcome the Commissioner and his colleagues, and thank him for his service.

I think the second day on the job, you joined Senator John Chafee and I to brief some of our visitors from Rhode Island. Thank you, Mr. Commissioner.

Amo, we look forward to your visit. All of Rhode Island is getting ready. We have all of our trinkets ready, so we encourage you to come, stay, and spend.

Bill, it is good to see you.

Thank you, Mr. Chairman.

Senator CONRAD. Thank you, Senator Reed.

Senator Landrieu, also from the Appropriations Committee, welcome.

Senator LANDRIEU. Thank you, Mr. Chairman.

I just have a statement for the record, because I am interested in hearing the progress we are making on this very difficult challenge from the witnesses.

Senator CONRAD. The statement will be made part of the record.

[The prepared statement of Senator Landrieu follows:]

OPENING STATEMENT OF HON. MARY L. LANDRIEU, A U.S. SENATOR FROM LOUISIANA

Thank you, Mr. Chairman. It is a pleasure to be here representing the Appropriations Committee at this joint review of the Internal Revenue Service and its progress in implementing the reforms under the Internal Revenue Service Reform and Restructuring Act of 1998.

I share some concerns about ensuring that the IRS continues to operate effectively, efficiently, and most importantly with an emphasis on putting its customers first. All Federal agencies should operate with these principles in mind. This is particularly true of the IRS because every American taxpayer comes in contact with the IRS in some way every year. So customer service must be the best.

Commissioner Rossotti, you deserve our congratulations. Your five year term as Commissioner marks a turning point in the history of the Internal Revenue Service. You have led the IRS through a successful reorganization from the geographical structure of the past to one focused on taxpayer needs. According to the Roper opinion research organization customer satisfaction with the IRS has increased 44 percent in the last two years no doubt because of initiatives like the E-Filing program and the improvements you have brought to the telephone service. Forty-six million taxpayers used e-filing, six million more than last year. Over a four-week period in March, 74 percent of all callers got through on the toll-free line, exceeding the IRS's goal of 71 percent for the year. These are just a few of the many accomplishments the IRS has achieved during your tenure, Commissioner Rossotti. Certainly there is room for improvement, but you and all of the people at the IRS have built a solid foundation upon which to achieve further success.

The decline in the number of enforcement actions the agency has pursued concerns me, however. There was an increase this past year in tax levies, liens, and seizures, but the total number of enforcement actions are way below the number the agency conducted as recently as 1999. While I do not wish a tax audit on a disproportionate number of people and I certainly do not believe that they should be used in a coercive manner, effective enforcement actions help to maintain the integrity of the tax system.

I am looking forward to hearing the testimony on how the IRS plans to expand its enforcement activities with the funding it has requested for FY '03. The budget request includes funding for an additional 1,179 full-time equivalent employees for the IRS. Enforcement activities would be increased by 1,857 FTE. According to the IRS, 76 percent of the FTE will come about through the "Reapplication of efficiencies and workload savings" and not necessarily the hiring of actual revenue officers. I would like some clarification about how all of this is going to work and whether it

will allow the IRS to bring the number of audits and enforcement actions substantially closer to the levels we have seen in the past.

Mr. Chairman, on the Appropriations Committee we have a responsibility to ensure that government agencies have the resources to accomplish their goals and to fulfill their missions. Therefore, thorough and effective tax collection is necessary. The IRS has set an ambitious agenda for itself in the enforcement area and in the areas of customer service and information systems management. I want to make sure that it has the resources to continue the progress it has made.

Thank you again, Mr. Chairman. I look forward to hearing from our witnesses.

Senator CONRAD. Now we will turn to our witnesses. We have got four outstanding witnesses before the committee this morning, starting with our Commissioner, Commissioner Rossotti. Welcome. Please proceed.

STATEMENT OF HON. CHARLES O. ROSSOTTI, COMMISSIONER OF INTERNAL REVENUE, WASHINGTON, DC

Commissioner ROSSOTTI. Thank you very much, Mr. Chairman and members of the committee.

First, let me just acknowledge and express my gratitude for all the comments you made about me in the office. Your support throughout this period has been tremendous and is probably the only reason that I have managed to make it through four and a half years.

It certainly is appropriate at this point to step back, as the committee is doing, and see how well we are following the direction that we were given in the Restructuring and Reform Act.

We were given a mandate in the Restructuring Act, and even before that, as Senator Grassley noted, by the National Commission on Restructuring the IRS. The Commission articulated both the challenges and problems that the IRS faced, as well as setting the stage for passage of the act itself.

As I see it, the direction in the act and in the commission requires fundamental change in the entire way that the IRS operates and executes its mission, which includes serving compliant taxpayers, as well as ensuring compliance with the tax laws.

I strongly agree with Senator Grassley's statement we are not trying to move a pendulum, as some use the metaphor, between taxpayers rights on the one hand and enforcement on the other hand.

Instead, we are looking to improve the whole way that the IRS operates in all of its dimensions. This does mean radical change in everything about the agency, its mission, goals, the way we measure performance, organization structure, training, technology, and business practices, all of this directed towards improving our performance against our mission.

While RRA did provide a mandate for this fundamental change, it is also important to note that the ongoing job of the IRS in administering the tax system did not stop, nor did it even slow down.

In other words, we were being asked to modernize and change while still administering the world's largest, most complex, and constantly changing tax system.

I think of it a little bit like driving a race car around the race track while the pit crew is running around alongside trying to figure out how to change the engine without slowing down the car.

I have used that analogy a few times, so I decided in this hearing I would try to put some examples around it. On the first chart up there, I have listed some of the things that have been happening in the tax system as a whole over the last five years.

Federal Tax System Has Been Growing and Changing Rapidly From 1997 Through 2002

Volume of Activity Has Been Growing Rapidly

• Income Tax Returns	12	Million Increase	9.4%
• IRS Gross Collections	$527	Billion Increase	32.5%
• IRS Refunds Issued	$121	Billion Increase	61.3%

Tax Code Has Been Changing Rapidly

- 19 Public Laws passed
- 293 Tax Code provisions changed
- 171 (58%) of provisions with concurrent or retroactive effective dates
- 515 completed changes to forms and/or instructions

Special Events Created Additional Activity and Change

- Century date change required massive three year project
- Advance rate reduction credit – 126 million notices, 91 million taxpayers, $39 billion
- Returns of political organizations (section 527) – new political reporting to IRS
- September 11th terrorist attack; victims relief, IRS security response, money laundering task forces
- Anthrax threat – rapid response required prior to 2002 Filing Season

Globalization is Increasing International Tax Activity

- US controlled foreign corporations up 25%
- Foreign controlled corporations up 31%

One important point to note is that, simply because of the growth in the economy, the workload of the IRS grows every year. In five years, that accumulates to some big increases: 12 million more tax returns, $527 billion more in gross revenue to collect, and so on.

Also, we note that the Tax Code itself is constantly changing. Over this period, we had 19 laws passed and 293 Tax Code provisions changed.

Of course, there are always what we call "special projects" that we have to do, such as the century date change which occurred during this period, administering last year's advance tax refund program, providing administrative relief to the victims of the September 11th terrorist attacks, and responding to the anthrax threats.

Now, that was what was going on in the background, so to speak, in the tax system. We have put up now a couple of other charts that show some of the internal changes that were taking place in the IRS and in the tax administration system during this period. There were so many we could not fit them on one chart, but we have got two to summarize them.

Implementation of RRA and IRS Modernization Requires Massive Internal Change

RRA Required Numerous Specific Changes in IRS Activities

- 115 provisions required IRS action
- 423 amendments to Internal Revenue Code
- 1,900 implementing actions generated
- 75,000 employees received technical training
- 214 changes to forms/and or instructions

Some Provisions Generated New and Complex Workload

TYPES OF CASES/CLAIMS	TOTAL	YEAR
Innocent Spouse Claims Received	212,051	FY 99 - 02
Collection Due Process Cases	46,063	FY 99 - 02
Offers in Compromise	594,181	FY 97 - 02
Section 1203 Allegations Recorded	3,626	FY 98 - 02
Third Party Notifications	24,262,237	CY 99 - 02

Performance Management System Radically Changed

- Section 1204 abolished traditional performance measurement statistics and procedures
- Entirely new goals, measures and performance management system established

Implementation of RRA and IRS Modernization Requires Massive Internal Change

Organization Structure Radically Changed

- Districts, regions and service center structure abolished
- Management layers cut
- 2,000 senior management positions abolished and 1,700 re-competed
- Most of national office eliminated and new operating units established
- Information technology and support services consolidated
- 81 outside and 130 inside executives recruited

Business Systems Modernization Will Change All IRS Operations

- Business Systems Modernization office established
- IRS Vision and Enterprise Architecture developed and approved
- First projects delivered
- Two key building blocks – first implementation planned this year for taxpayer database and security system

Fixing Long Term Financial Management Problems Requires Major Change

- Clean audit opinion from GAO on financial statement
- Property Management centralized and tightened
- 14 Material Weaknesses being addressed step by step – 2 are strictly financial management

RRA itself had 115 provisions requiring IRS action, and some of those, such as provisions for innocent spouse relief, collection due process, offers and compromise, and notification of taxpayers about third party contacts, generated, as you can see in those numbers, hundreds of thousands of additional cases, some of them very complex cases, that we had to handle and resolve.

On top of that, of course, in order to implement the changes as noted on the chart on the righthand side there, major internal changes took place. Our entire organization structure was changed. We eliminated the old geographic structure and put in a new customer-focused organization.

As part of that, nearly every senior management and executive job in the IRS was abolished and redefined, and in most cases recompeted. Of course, following Section 1204, our entire system of measuring performance of employees and organizations was abolished and reconstructed.

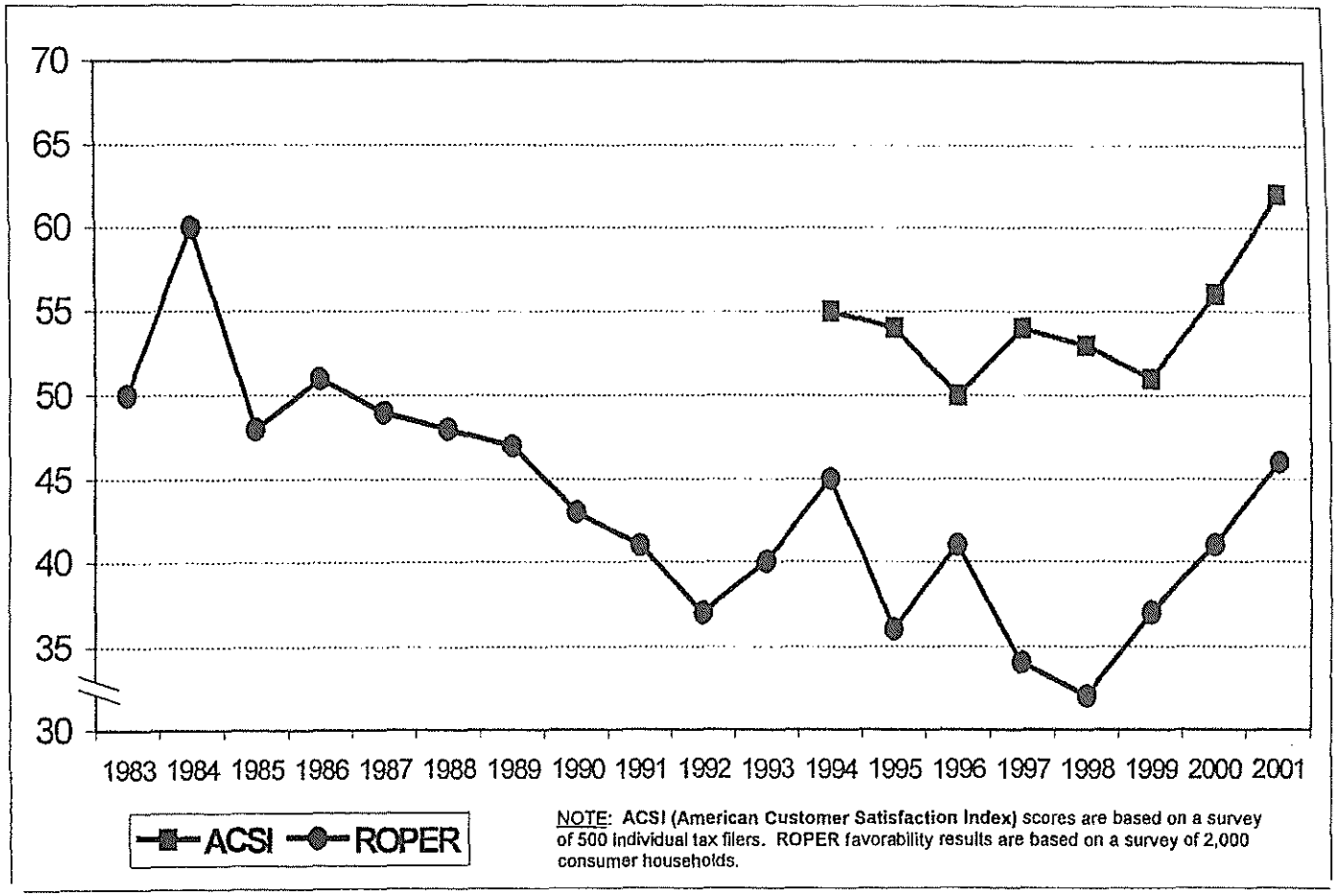
So when we take together the combination of workload and Tax Code growth on one hand, and massive change in response to RRA itself, it did pose a major challenge, as any large institution would have seen it.

I am pleased to report that all of the activities on both of these charts were executed successfully during this period without any major misstep, although certainly there were problems, setbacks, and issues that occurred along the way.

I think what is most gratifying, is that these changes have already resulted in the IRS being in a better position to serve the public more effectively. That point has been recognized, or at least has begun to be recognized, by the public.

As you can see in this next chart that is going up, there were two respected surveys that we used to track performance over time. One of them goes back to the early 1980s, and that is the Roper-Stark survey. It shows, as you can see, that our rating increased significantly in the past three years, after hitting an all-time low in 1998.

PUBLIC RATING OF THE IRS



NOTE: ACSI (American Customer Satisfaction Index) scores are based on a survey of 500 individual tax filers. ROPER favorability results are based on a survey of 2,000 consumer households.

The other survey done by the University of Michigan, which is shown by the red line, also showed considerable increase in satisfaction among individual taxpayers, in fact, the largest favorable gain of any of the 30 federal agencies that they surveyed.

Not to put too much emphasis on surveys, but I believe that the public's attitude towards the IRS is fundamentally important to the health of the tax system. I do not see how it can be acceptable for the government agency that affects more Americans than any other agency to also be the lowest rated.

So, changing that was a mandate in RRA 1998, and we are beginning—although I certainly stress beginning—to deliver on that mandate. There are some tangible indicators that back this up.

Many are in my testimony, but just to cite a few: in the 2001 filing season, we achieved—in fact, exceeded—our goal of 46 million electronically filed 1040 returns. Our Web site, irs.gov, had two billion hits.

On the questions that taxpayers ask us on tax law and accounts over the telephone, our accuracy rates were up to 83 and 89 percent respectively, which is a significant increase, as the Chairman noted, over where we used to be, although there is certainly still room for improvement.

On the compliance side, our near-term goal was to at least stop the decline. We have begun to do that by stabilizing our activity levels, audits, and collections in other areas, while also—we think this is very important—putting increased focus on the most important areas of non-compliance, such as misuse of devices like offshore accounts and trusts to hide income, use of very complex tax avoidance transactions by corporations, failure to pay employment taxes, and erroneous refund claims.

As a matter of fact, combatting what we call the actively promoted tax schemes is our highest compliance priority and we are using every strategy and every tool we have, ranging from taxpayer education to criminal investigations, to focus on that particularly important area.

Having noted that there is progress, we believe, in improving service and at least in stemming the long-term decline in compliance, I have to say that neither aspect of the IRS mission is being, today, executed at what I think any of us would consider a satisfactory level.

There are major gaps remaining in both our level of service to compliant taxpayers, and even more so, perhaps, in our ability to address even the important areas of non-compliance.

For example, every year we are unable to address millions of specific cases involving taxpayers who we know with reasonable certainty are not paying all they owe. We simply have to put them aside for lack of capacity.

I think these remaining deficiencies undermine the effectiveness and fairness of the tax system in the short run and continue to pose serious long-term risks to the government's revenue stream in the long term.

So what is the course for the future? Well, I believe that the plan is actually well laid out. In fact, planning has not been our problem. We have had, I believe, good plans.

Now we have some of the key building blocks in place, such as the new organizational structure, new management team, new performance measures, and new strategic planning process to help us put our resources where they are most needed.

So I think, with sustained and skillful management and adequate resources, it is possible for performance on all aspects of IRS's mission to improve steadily over the years to come.

One of the essential building blocks for success is our business systems modernization program. Last year and this year, the IRS plans to implement three critical pieces of this future system architecture: a new communications system for our telephone traffic, and the first new installations of a new security infrastructure, and a database to maintain taxpayer records.

Over the long run, these systems will allow us to respond more accurately and promptly to taxpayers and to increase the productivity of all of our employees, including our compliance employees.

As important as it is, however, business systems modernization by itself will not close the gap in our performance. We need, in addition, adequate, qualified staff resources. Over the last five years, while the increase in workload that we noted on those charts occurred, the number of IRS employees continued to decrease.

This year and in future years, the growth in the economy will continue. So in order to close that gap and cope with the increased workload, we do need some additional staff resources.

In the 2003 President's budget, we have asked for a net staff increase of 1,179, which, because of productivity gains, will produce about three times that much in performance.

So let me conclude by saying, Mr. Chairman, that I think the course that we have laid out, and as provided for in the 2003 budget, is the correct one. If we are given modest but consistent increases in operational resources, adequate funding of modernization, and, we hope, very good management internally of these resources, I believe we can close the gap and fulfill the mandates that you, the Congress, and the public gave us in the Restructuring Act.

Senator CONRAD. Thank you, Commissioner Rossotti.

[The prepared statement of Commissioner Rossotti follows:]

Joint Review 2002

Statement of

Charles O. Rossotti

COMMISSIONER
INTERNAL REVENUE SERVICE

Before the

ANNUAL RRA'98
JOINT HEARING ON IRS PROGRESS

CONVENED BY THE
JOINT COMMITTEE ON TAXATION

IRS

Department of the Treasury
Internal Revenue Service

www.irs.gov

May 14, 2002

PREPARED TESTIMONY
OF
COMMISSIONER OF INTERNAL REVENUE
CHARLES O. ROSSOTTI
BEFORE THE
ANNUAL JOINT REVIEW
PROGRESS REPORT ON
THE IRS RESTRUCTURING AND REFORM ACT OF 1998
MAY 14, 2002

INTRODUCTION AND SUMMARY

Mr. Chairman and distinguished Members of the Joint Review, thank you for this opportunity to provide an update of the IRS' progress in meeting the mandates set forth by the IRS Restructuring and Reform Act of 1998 (RRA 98).

Before I begin my formal testimony, let me express my gratitude for your continued support of our efforts to carry out both the spirit and letter of RRA 98. I have also welcomed your insights and suggestions on how we can improve both the management and processes that guide systems modernization and the critical services we provide to America's taxpayers.

Mr. Chairman, the IRS continues to make steady progress on the new direction set by RRA 98. At the most fundamental level, Congress directed the IRS to be more effective in meeting taxpayer needs as well as collecting the revenue. We developed and are carrying out a modernization program of short- and long-term improvements designed to achieve the overall objectives of improved service, better treatment of taxpayers, more efficient and effective compliance and greater overall efficiency. In other words, we are not just moving an imaginary pendulum one way or the other, as some have suggested. We are improving the entire way the IRS works.

Since the passage of RRA 98, returns, payments and refunds have been efficiently processed. Taxpayers are getting through on our toll-free telephone lines and their tax law and account questions are being better answered. We tore down more barriers and added more incentives to electronic filing of returns and payment of taxes. More taxpayer problems are being solved in a telephone call or visit. We offered real burden relief to taxpayers by simplifying forms and regulations. We are providing tailored service to specific groups of taxpayers, such as small businesses, through our customer-focused organization. We implemented and are better administering the 71 RRA 98 taxpayer rights. We stabilized some key compliance activities and are focused on systematic areas of non-compliance, such as combating tax scams and schemes.

Let me add, Mr. Chairman, that we achieved this progress while still administering the world's largest, most complex and constantly changing tax system. Indeed, our challenge was made all the greater by many extraordinary and unanticipated

factors, such as carrying out our highly successful century date change program, administering last year's massive advance tax refund program, providing administrative tax relief to the victims of the September 11 terrorist attacks and responding to the anthrax threats.

Successfully accommodating new tax law provisions, some of, which are retroactive, is also a major ongoing task for the IRS. In 1986, the code was rewritten for the first time in about 30 years. In the next 15 years, 84 new tax laws were enacted. Just one of these laws, the Tax and Trade Relief Extension Act of 1998, contained 25 sections of tax changes. Of these, 11 were effective retroactively and four were effective within 90 days of the end of the calendar year.

Apart from any tax law changes, the IRS workload grows every year because of the growth in the economy. From FY 1997 projected through FY 2002, the number of income tax returns received by the IRS increased by 12 million. gross collections increased by $527 billion and refunds issued increased by $88 billion.

Making major changes in the way the IRS operates while continuing to accommodate the increasing workload and tax law changes is a significant management challenge and one that inevitably creates risks that must be carefully considered. This means that change must take place step-by-step over time. While much has been accomplished in achieving the mandate set by RRA 98, much more remains to be done.

We are still are not consistently providing service at the high level that taxpayers expect or deserve. We are still not ensuring that everyone's neighbor or competitor is complying with the tax law and paying what they owe. We still have many jobs that we must perform at higher quality and efficiency.

There are no shortcuts to achieving our goals. The IRS' problems developed over a long period and are too widespread, deep and complex to yield to simple, quick remedies. We must carefully lay a foundation that will allow us to succeed in our rebuilding efforts. The early successes we have enjoyed are stepping-stones on a much longer journey to reach a higher level of performance.

We have now restructured our organization, reducing management layers and achieving more customer focus and greater management accountability. We have developed and implemented a new set of balanced performance measures.

Our biggest remaining task is to modernize all of our business processes with the enabling technology. The real tangible benefits of modernization will materialize over the next decade in carefully planned and executed projects. The first of these were delivered last year; taxpayers will see more this year.

Combined with effective operational management and a clear strategic plan, these modernization efforts will continue to move the IRS solidly year after year towards full achievement of our goals.

So, what must we do to ensure the success of IRS modernization for next year and the years beyond? I believe that we must stay focused and committed to the intent of the Restructuring Act, making adjustments as necessary; but not losing sight of the goal. If we do, I am convinced we will succeed.

MEETING RRA 98's MANDATES

RRA 98 gave us a clear mandate – do a better job meeting the needs of taxpayers as well as collecting the revenues. We expressed this direction in a new IRS mission statement: "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."

It is equally important that we define the specific goals and objectives needed to achieve our mission. They are: top-quality service to each taxpayer in every interaction; top-quality service to all taxpayers through fair and uniform application of the law; and productivity through a quality work environment. If progress is made on all three of these goals, we can be confident that we are moving toward achieving RRA 98's mandates, our mission and meeting the public's expectations.

Top Quality Service to Each Taxpayer in Every Interaction

We want to improve the entire way the IRS serves taxpayers – from filing and paying taxes to getting information and assistance to protecting their rights. More than the sum of its parts, the highly successful 2002 filing season continued to demonstrate how we can build on positive trends in service to taxpayers, especially as our major technology and organizational initiatives take effect.

As shown in the chart, two respected surveys show a strong turnaround in IRS public approval. The Roper Starch Surveys found our rating increased each of the past three years after an all time low in 1998. And the University of Michigan's American Customer Satisfaction survey showed greatly improved customer satisfaction among individual taxpayers – the largest favorable gain of the 30 federal agencies surveyed.

The turnaround in the public's rating of the IRS is fundamentally important to the health of the tax system. It is not acceptable for the government agency that affects more Americans than any other to also be the lowest rated. Changing this was a mandate incorporated in RRA 98, and we are beginning, and I stress beginning, to deliver on it. While the trend is good, much more remains to be done.

The 2002 Filing Season

The majority of individual taxpayers interact with the IRS during the filing season – that period between January and June when millions of returns, both electronic and paper, are filed and processed, payments are made, and refunds issued. It is also during this critical time that we as an organization are called upon to provide an extensive menu of critical services to America's taxpayers.

To meet this demand, we offer filing, payment, refund and tax law information through a variety of channels, and at times and locations convenient to taxpayers. These include both our automated and customer assisted toll-free telephone lines, the IRS' web site, faxes, CD-ROMS and face-to-face help at our Taxpayer Assistance Centers.

Electronic Tax Administration

The attached chart shows the strong positive trend over the last two years in a number of key indicators of the service taxpayers receive from the IRS. Some of these numbers are literally off the chart. They reflect taxpayer use of the IRS web site – *irs.gov*. In January, we introduced a newly designed, more accessible web site and taxpayer usage continues to grow dramatically. This means less time and effort spent by taxpayers getting information and forms. It also means fewer last minute trips to the post office and ultimately, more returns that are accurate.

Another important line on this chart is the growth in electronically-filed individual returns. Through May 7, 2002, over 46 million individual taxpayers filed using one of the three *e-file* options; a 16.16 percent increase over the same period last year. And the number of taxpayers *e*-filing from their home computers is up a very impressive 37.9 percent over last year. For the fiscal year, we set an aggressive goal of receiving 46 million returns electronically – a 15 percent increase over last year, and I am pleased to say that we exceeded our goal.

Mr. Chairman, in order to improve our Electronic Tax Administration (ETA) program, ease taxpayer burden and help meet RRA 98's mandated goal of 80 percent of returns filed electronically by 2007, the IRS created a series of enhancements for the 2002 filing season and the remainder of the fiscal year. These initiatives included adding 29 forms and schedules to allow for even greater taxpayer participation in the IRS *e-file* program. This meant we opened up *e*-file eligibility to over 99 percent of all taxpayers, potentially adding 38 million new *e*-filers. Indeed, we achieved a major milestone this year – virtually all 1040 forms and schedules could be filed electronically and no paper signature document was required.

We also expanded the electronic payment options available to taxpayers by accepting credit cards to pay installment agreements and delinquent taxes. In addition, we repeated a popular option from the 2001 filing season. Taxpayers who needed a filing extension could get one automatically by making a simple phone call.

In 2001, we also better served the business community's ETA needs. On September 6, 2001, we introduced EFTPS OnLine (Electronic Federal Tax Payment System), which allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. Let me stress that confidentiality and privacy of taxpayer information are our highest priorities. EFTPS OnLine users can feel confident that their private information will be protected.

Businesses can now file on-line their Form 941 (Employers Quarterly Federal Tax Return), as well as Form 1065 (Reporting Partnership Income) and Form 940 (Employers Annual Federal Unemployment Tax Return). Individual taxpayers who make quarterly estimated tax payments could also use the system, eliminating paper forms and receiving on-line access to payment history.

Mr. Chairman, in its December 21, 2001 report, "Assessment of IRS' Tax Filing Season," the GAO observed that in spite of the growth in electronic filing and our efforts to identify and eliminate impediments, the 13.7 percent growth in 2001 was still below our goal of 20 percent. Of particular concern to both the GAO and IRS, is why approximately 40 million individual income tax returns were prepared on computer but filed on paper in 2001. The IRS and the Administration are taking and proposing actions to address the problem.

This year, we focused our *e*-file marketing campaign on taxpayers who prepare their returns by computer, but file on paper, and taxpayers who use the services of tax professionals, but file on paper. We also agree with GAO on the need to further survey these filers to determine why they did not file electronically and how we can overcome these barriers.

To help us meet our goals and RRA 98's ambitious *e*-filing mandates, the President also proposed that the due date for returns filed and paid electronically be extended next year to April 30th. I was most gratified that the House Ways and Means Committee included this provision in legislation that was reported out of Committee on March 20, 2002 and is now part of the House-passed "Tax Relief Guarantee Act of 2002."

The Administration further proposed in its budget submission "an easy, no-cost option for taxpayers to file their tax return online." Unfortunately, there has been some confusion regarding this proposal. The Administration's proposal to give taxpayers the option to file their tax returns on-line without charge is based on two principles: no one should be forced to pay extra just to file his or her tax return, and the IRS should not get into the software business.

In a statement issued on January 30, 2002, Treasury Secretary O'Neill stated, "I don't intend for the IRS to get into the software business, but rather to open a constructive dialogue with those who already have established expertise in this field. In the end, this effort should come up with a better way to save time and money for both

taxpayers and the government." The IRS totally concurs with the cooperative approach enunciated by the Secretary and we will follow it to the letter.

Telephone Service

Mr. Chairman, many taxpayers prefer telephoning the IRS, and our inability to deliver this basic service contributed significantly to the public's lack of confidence in the IRS in the 1990s. During that time, up to 80 percent of taxpayer calls were met with a busy signal, and according to Roper Surveys, the public's rating of the IRS declined to an all-time low in 1998.

However, we are also making steady progress delivering quality telephone service in the face of increased customer demand, although further improvements are still needed. Primarily because of increased calls concerning refunds and the rate reduction credit, the total volume of incoming calls on our toll-free lines for the fiscal year through April 20 has been up 10 percent over last year, totaling 61.2 million calls for the first half of the fiscal year.

During February 2002, there was a particularly large volume of calls, which temporarily drove down the level of service, but it rapidly improved in March to above our goal of 71 percent and as of April 27, 2002 stands at 69.75 percent (cumulative for period of January 1 –April 27).

Of great interest to taxpayers, the average wait time for tax law calls was 2.87 minutes – down from 4.14 minutes last year. Wait time for account calls was 4.69 minutes compared to 6.32 minutes last year.

In addition, 54 million of taxpayers used our automated services to get information, such as refund status, an increase of 8 percent since last year, and the upward trend continues.

Once connected, taxpayers must get accurate and courteous answers to their account and tax questions. Here too, we made very substantial progress in improving quality. The telephone correct response rates for tax law and tax account questions showed a marked improvement in FY 2002. They were up to 83 percent and 89 percent respectively as compared to 77 percent and 88 percent over the same period last year.

Let me note too that by September 24, 2001, we established a special telephone line for the victims of the terrorist attacks and since then, provided over a 90 percent level of service on this line.

Taxpayer Assistance Centers

For those taxpayers who prefer to visit an IRS office, walk-in service was available during the filing season at more than 400 locations nationwide. At many sites,

walk-in service was offered on 12 Saturdays between January 27 and April 14. As of April 27 2002, we served over 5.03 million taxpayers at all Taxpayer Assistance Centers (TACs).

In its assessment of the 2001 filing season, the GAO noted that the IRS did not previously measure TAC quality; the 2002 filing season is the first year we will measure it. Indeed, this process is just beginning, much as it was for telephone service several years ago. The Treasury Inspector General for Tax Administration (TIGTA) was also asked by Congress to perform accuracy reviews. It is our sincere desire to work closely with TIGTA to analyze their data to help us meet the challenges we confront at our Taxpayer Assistance Centers.

Mr. Chairman, in the past, the IRS did not place as high priority as it should have on what were called, "walk-in" sites. The services offered at them was limited and often of poor quality. However, through our new Field Assistance Concept of Operations, we will better serve taxpayers at our TACs. We will help them meet their filing and paying responsibilities, including answering their tax law questions and providing forms and limited courtesy return preparation.

Throughout the year, and at a variety of locations, we also schedule the highly acclaimed Problem Solving Days – the last was held on November 3, 2001 at 46 Taxpayer Assistance Centers – to resolve long-standing taxpayer issues for those who cannot take advantage of weekday problem solving services.

Problem Solving Days have an excellent track record. However, we must bring what we learn from them to our daily operations. Every day should be problem solving day at the IRS, not just three or four times a year. That means using a cross-functional approach to resolve most tax account issues with a single visit or phone call at any time throughout the year.

To help us meet this need, we created a new job at the IRS, "Tax Resolution Representative." These IRS employees will receive the training and authority to provide "one-stop-service" for a broad range of issues ranging from answering tax questions to resolving payment problems.

The Stakeholder Partnership, Education and Communications (SPEC) branch of our Wage and Investment Operating Division is also now working to energize the VITA (Volunteer Income Tax Assistance) return preparation program. Last year, we worked at volunteer sites across the country to assist an estimated 4.3 million taxpayers wanting this service.

Working hand-in-hand with SPEC to help taxpayers understand their obligations is the Taxpayer, Education and Communications function of the Small Business/Self Employed Operating Division. Once fully realized, both of their education and pre-

filling services will greatly benefit both taxpayers and our tax administration system in two ways.

First, if we can eliminate confusion, errors and mistakes before a return or form is ever filed, America's taxpayers will be spared countless numbers of notices and communications with the IRS.

Better pre-filing services can reduce the need to fix a problem after it has occurred, or to take enforcement actions. Both are more time consuming and costly for the taxpayer and the IRS. This approach promises to be particularly helpful for America's small businesses, especially start-up businesses, which are confronted with a dizzying array of new tax and filing requirements.

Second, by helping taxpayers better understand their tax filing, payment and reporting requirements, and by giving them the information and tools they need, voluntary compliance should increase markedly. Approximately 98 percent of tax revenues come voluntarily into the Treasury. Therefore, an increase of one percent in voluntary compliance roughly translates to a 50 percent increase in enforcement revenues.

Burden Reduction

One of the ten major strategies included in the IRS Strategic Plan is "reduce taxpayer burden." Through our dual approach of short- and long-term improvements, we are working to provide taxpayers with both immediate and far-reaching burden relief. Our short-term efforts include reducing the number of taxpayers required to file specific forms. We are also simplifying or eliminating forms and notices altogether and making it easier through electronic means to file and pay.

For example, in FY 2001, we completely overhauled the rules governing the required minimum distributions from individual retirement accounts. The old IRA rules were confusing and onerous to most taxpayers. So, we made the process easier for retirees determining how much money they must withdraw from their accounts. Ed Slott, publisher of "Ed Slott's IRA Adviser Newsletter" is quoted by Associated Press with these words of praise: "The IRS did an incredible job. They pretty much thought of every mistake people could make that would cost them their retirement savings and fixed it. It's an amazing overhaul."

Some of our other initiatives involved reducing lines on forms, such as the Schedule D to report capital gains. We also expanded the check-the-box initiative to allow taxpayers to now designate a friend, family member or tax professional to talk to the IRS to correct errors during the processing of the return. We further reduced complexity and taxpayer burden by eliminating 11 lines on Form 6251 for the Alternative Minimum Tax and we are working with a contractor to redesign the Form 941, Employers Quarterly Federal Tax Return.

Second, and just as importantly, other regulatory initiatives removed entirely for some taxpayers various time-consuming reporting and record-keeping requirements. Last month, I announced that for tax years beginning in 2002, we will exempt 2.6 million corporations from filing Schedules L, M1 & M2 at a burden reduction of 61 million hours. Needless to say, this is a huge relief initiative for small businesses that was identified by our new burden reduction office in our Small Business/Self-Employed (SB/SE) Operating Division.

Allowing more businesses to use the cash method of accounting is also a standout example of this approach, and one that has been widely acclaimed by our small business taxpayers. Now, approximately 2.84 million taxpayers can take advantage of this relief. We also indefinitely suspended the requirement for taxpayers filing Schedule F of Form 5500. This will eliminate the filing of about 200,000 forms each year. In addition, we simplified determination letters for the nearly one million employee plans.

Burden reduction also means communicating with taxpayers in plain English. Last year, as part of our continuing effort to improve our correspondence to taxpayers, and following RRA 98's directions, the IRS began sending out six redesigned notices, including those dealing with math errors, balance due, overpayments and offsets. These notices affect both individual and business taxpayers. The new notices should: reduce the number of times taxpayers need to contact the IRS, be easier to understand, and help resolve inquiries. We continue to redesign 24 additional notices. We released four of them in January 2002. Seven more notices will be delivered in July 2002; the remaining 13 notices in the program will be delivered in January 2003.

Mr. Chairman, while burden reduction is important for all taxpayers, it is particularly important for those served by our SB/SE Operating Division who do their best to understand an extremely complex tax code that is constantly changing while still running and growing their businesses.

To help achieve significant burden reduction for SB/SE taxpayers, we created the aforementioned Office of Taxpayer Burden Reduction (OTBR). The OTBR will focus its efforts in four major areas: (1) informing and educating customers about their tax responsibilities; (2) simplifying forms, publications and communications; (3) streamlining internal policies, processes and procedures (including audit plans); and (4) promoting less burdensome rulings, regulations and laws.

We are certainly making burden reduction gains, but the potential is greater. With business systems modernization and a new customer-focused organization, we can provide meaningful burden reduction for all types of taxpayers – far beyond what is available today.

Advanced Refund and September 11th

Last year, the concept of service to taxpayers went far beyond what is normally expected of the IRS. Two events – the issuance of millions of advance refund checks and our response to the tragic events of September 11 – demonstrated how we could provide service to taxpayers under extraordinary circumstances.

Just six weeks after President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001, we delivered for taxpayers by getting their checks in the mail. To put in place the $39 billion advance payment provision, we began work weeks earlier so that we would be prepared to handle the first rebate in a quarter century.

The IRS coordinated an unprecedented outreach to America's taxpayers, an intricate computer programming project, a flurry of news releases, an updated *irs.gov* web site and additional assistors to handle record call volumes.

Over Memorial Day weekend, Congress gave final approval to the 2001 tax bill, which included the advance payment. The provision set a maximum amount of $300 for an individual, $500 for head of household or $600 for married couples filing jointly. The checks were an advance of a 2001 rate reduction credit and were subject, as most tax provisions are, to various exceptions and limitations.

Over 91 million taxpayers received over $39 billion as an advance of the 2001 tax rate reduction credit. The checks began arriving in mailboxes on July 23 and no checks were issued after December 31, 2001.

We decided to issue notices to all taxpayers, both those who qualified and those who did not. The notices, issued prior to the checks, helped to answer taxpayers' questions and reduce the number of telephone calls. We contracted with a private vendor to print notices for 130 million people – nearly half the population of the United States.

This is not to say the process was problem-free. In July, a computer glitch caused almost a half-million taxpayers to receive notices with inaccurate amounts of their checks. However, the error was identified and those taxpayers were sent a second notice with the corrected amount. In addition, our telephone systems were overwhelmed and many taxpayers could not at first get through to us. Here too, the IRS responded by retaining our seasonal workers and applying additional resources to address the crunch. All told, we answered 21.8 million taxpayer calls on the advanced refund.

Following the September 11 terrorist attacks, IRS and Treasury Department employees did their best to minimize the distraction of tax issues for the victims. By September 14, three days after the attack, we provided administrative relief to the victims in the form of extensions to file returns and pay taxes. We also suspended for six months many enforcement actions for the affected taxpayers. In addition, we established special

toll-free numbers to answer any questions, and we set up a special disaster relief page on our web site.

To complement these efforts, we published a brochure, "Help from the Internal Revenue Service for Those Affected by the Terrorist Attacks on America" that explains the tax relief we are providing. To reach the largest possible audience, we also placed public service advertisements in *USA Today, Sports Illustrated* and *Business Week.* Our efforts did not end there.

Our Large and Mid-Size Business Division (LMSB) worked closely with the airline industry on the Air Transportation Safety and System Stabilization Act legislation. It allowed for extension of due dates for deposits and clarification that federal loans are included in the airlines' income. LMSB also held an intensive, two-day technical meeting to discuss issues with the principal industries located in the World Trade Center.

On the law enforcement side, we are providing expertise on money laundering. We are a key part of Operation Green Quest, the multi-agency initiative targeting funding sources for terrorist organizations.

Before and after the terrorist attacks, the IRS' Tax Exempt/ Government Entities (TE/GE) Operating Division also helped educate the public on the legal requirements organizations must meet to qualify for tax-exempt charitable status.

On September 18, we placed a new, easy-to-understand publication on our web site that provided information to assist the public to make use of charitable organizations. We also announced that we would speed processing of requests for tax-exempt status from new charities formed to assist the victims. Although we expedited the process, we did not lower our standards for new organizations applying for the tax-exempt status.

In addition, we worked with the September 11 charities in getting donations to the victims' families. On November 16, we issued interim guidance that recognized the unique circumstances caused by the tragedy. The notice stated that the charities will not put their exemptions at risk by making payments to the victims and their families without first proving they are in financial need. We wanted to send a clear message that charitable groups that act in a reasonable and good-faith manner to help the victims would not endanger their tax-exempt status.

Administering RRA 98's Taxpayer Rights Provisions

As previously noted, we are now administering the Restructuring Act's 71 new taxpayer rights provisions. Many of the provisions, such as innocent spouse protection, due process in collections and offers in compromise, would individually be considered major projects. Collectively, they represent a challenge of learning new ways of doing business for nearly every one of our 100,000 employees. And during this process, we

have achieved some successes as well as encountering a number of problems and demands that we are addressing.

As described in detail below, the sheer volume and in some cases, growth in receipts from these programs, are great. Since FY 1997, we have received 594,000 Offers in Compromises and since FY 1999, we have received 212,000 innocent spouse claims and 46,000 collection due process receipts. In addition, we have sent over 24 million advance notifications to taxpayers of third party contacts since 1999.

Carrying out some of RRA 98's provisions also meant we had to add new capabilities. For example, Section 3705 requires that we provide help in Spanish over our toll-free telephone lines. Toll-free services are now provided in Spanish at eight call sites. Last year, we inaugurated our San Patricio, Puerto Rico call site that will be able to take the majority of Spanish-speaking telephone traffic. The growth in calls answered in Spanish is dramatic. For fiscal year 2001, we answered 957,496 calls – a 61 percent increase over FY 2000. We project an 86 percent increase in Spanish language calls for FY 02 to over 1.78 million calls.

Innocent Spouse

Mr. Chairman, the receipts of innocent spouse claims have been dramatic and steady. There were 51,469 innocent spouse claims in FY 99; and we project there will be 52,100 for the current fiscal year. In my testimony last year before the Annual Joint Review, I stated that as of March 1, 2001, the IRS had 40,278 innocent spouse claims affecting 21,198 taxpayers where the taxpayer had not been notified of a decision. Faced with this mounting backlog of claims, we took several steps to promote greater efficiency that have produced positive results.

As of March 31, 2002, our inventory, where the taxpayer has not been notified of a decision, decreased by 47 percent to 21,460 claims affecting 11,295 taxpayers. This reduction in inventory was the result of a number of continued and expanded initiatives, as well as a small reduction in the number of receipts.

As a first step, we placed all claim processing at the Cincinnati Centralized Innocent Spouse Operation and provided increased and specialized skills for examiners working claims. We also implemented an automated decision-making tool to lead examiners through the complex decision-making process and to assist them in making timely and accurate decisions.

In addition, we improved our service to taxpayers by reducing the time it takes to notify them of a decision on an innocent spouse claim. For example, in FY 2001, our centralized site processed non-qualifying claims 37 percent faster than in FY 1999. It also processed qualifying claims 16 percent faster over the same time period.

Our efficiencies produced another benefit. The centralization of the program in one Wage and Investment (W&I) service center location, staffed with dedicated and expert examiners, reduced the resources needed to process claims. We can now release some of these resources in SB/SE to work on important compliance activities. For FY 2002, we expect total staffing to decrease to 442 FTEs, a reduction of 50 percent from FY 2000 levels.

By FY 2003, we expect 70 percent of the resources devoted to innocent spouse to come from the W&I Operating Division. Later this year, responsibility for the innocent spouse program will be transferred to the Director of Compliance in W&I.

Mr. Chairman, we are also working hard on customer outreach. The SPEC organization now provides innocent spouse literature to Low Income Tax Clinics (LITCs) and VITA tax return preparation sites. We are also seeking opportunities to communicate information to practitioners and taxpayers to help ensure that claims are both accurate and complete and to provide a better understanding of the claims process.

Offers in Compromise

The number of Offers in Compromise (OIC) receipts also shows no signs of abating. In FY 1997, OIC receipts numbered almost 114, 000; in FY 2001, they approached 121,000.

At the end of January 2002, the total inventory of OICs was 87,533 with 40,921 offers older than six months. For cases recently closed, the average pending time was 10 months, significantly more than our goal of six months.

The Offer in Compromise (OIC) program is one of the collection programs we use to resolve delinquent tax accounts. Taxpayers who are willing to pay their tax obligation may qualify for an installment agreement with payments made over time; taxpayers who cannot afford to pay their full liability may be eligible for an offer in compromise.

However, OIC inventory and processing times ballooned due to the pressures placed on staff by program changes. These program changes, some initiated by IRS, and some mandated by RRA 98, contributed to increases in the demand for offers, the number of processing steps, and the number of staff hours needed to process a case. Some of these program changes include relaxing the criteria from nine reasons to two for a submission to be "not processable", eliminating the use of installment agreements that will not pay in full before the end of the statutory period for collection, expanding the bases for accepting an offer, and allowing for long-term deferred payment options.

We undertook several initiatives over the last year to reduce the OIC backlog. We centralized the receipt of new cases at the Memphis, TN and Brookhaven, NY service center campuses. Para-professional staff is now expected to resolve the simpler cases on

a faster basis. In order to clear out the backlog of old cases in the field, we also developed a plan to quickly resolve simple cases by streamlining the level of investigation. This will allow our professional staff in the field to focus on more complex work, or be freed for reassignment to the general collection program. In addition, we are transferring work between geographic locations to balance workload with existing staff. We also lowered the delegation authority for some types of offer decisions.

In order to better manage inappropriate demand on the program, we expanded the reasons why an offer may be returned without a full investigation to include, estimated tax payments that are not current and, the offer is not significantly different from a previously rejected or defaulted offer. We also redefined the reasons why an offer may be returned because it was submitted solely to delay collection. In addition, IRS Chief Counsel issued guidance to reduce the level of scrutiny for legal sufficiency review. We also approved the use of overtime to work OICs.

As is discussed later in my testimony, the Administration has offered legislative proposals that would address frivolous OIC filers, and remove the barriers to granting installment agreements for less than full payment. These legislative proposals can assist the IRS in reducing inappropriate OIC receipts and contribute to our overall goal of eliminating backlogs and meeting our processing time goals.

We intend to bring inventory down to no more than the number of cases received in the previous six months. This change will ensure we can meet our processing time goal of 67 percent disposed in six months or less. Because we only recently established a Collection Quality Measurement System (CQMS) for offers, we have not yet set a specific goal, although, we want to improve on our current national Collection Quality Measurement System (CQMS) score of 80 (on a scale of 100).

In FY 2003, as the centralized sites achieve full staffing levels and training is completed, we expect they will handle up to 70 percent of all the offer submissions, allowing us to redeploy a significant number of field resources to the general collection program. Our specific goals for FY 2003 will be determined during the third quarter, as we complete next year's work plans.

For the longer term, we are exploring changes that will enhance processing efficiencies and reduce taxpayer burden. These include allowing taxpayers to submit an application for offers on-line with a web-based tool. These submissions could be electronically screened with information from prior-filed tax returns and from third party sources. This screening would allow us to determine levels of risk and based on that risk, assign the offer to differing levels of investigation.

There is much potential for automating the process of monitoring accepted offers, processing offer payments by direct debits, and systemically checking for future non-compliance. By investing in automation enhancements and taking advantage of the

processing changes automation provides, we intend to improve the overall efficiency and reduce the staffing costs of the program.

Indeed, by better managing our submission processes, we can ensure that more offers are received with all the information necessary to make them "fit for use." We are exploring changes that would encourage future compliance and reduce the amount of resources spent on rejected OICs where the taxpayer is not offering his or her reasonable collection potential.

Collection Due Process

RRA 98's collection due process (CDP) provisions also presented the IRS with new challenges that resulted in a backlog of cases. In FY 1999, we had 5,365 cases in receipt; in FY 2002, the number had almost tripled to 19,119. Through April of FY 2002, we already have 14,687 cases in receipt.

Mr. Chairman, until relatively recently, IRS Appeals dealt with few collection issues. It began moving toward post-collection work in the 1990s when a number of programs were established to ensure taxpayers had the right to dispute actions, such as levies and liens. At the same time, we began hiring settlement officers (former revenue officers with collection background) to handle these cases.

However, the real change came with RRA 98. It provided taxpayers with the right to request a CDP hearing that requires Appeals to review IRS Collection actions to ensure that revenue officers stayed within the law and followed proper procedures.

This brought on a dramatic shift from Examination to Collection cases in our inventory and an increase in the number of *pro se* taxpayers (those who represent themselves). The tremendous increase in workload necessitated our assigning these procedural cases to Appeals officers. They had to become experts in areas where they had little training and less prior experience. In short, former revenue agents who were experienced in Examination work, also had to work revenue officer cases.

To handle this increase in collection-type inventory and the numerous CDP cases, we shifted resources from one business component to another. We reassigned cases to ensure that we matched the case needs to the person with the right skills. Also, we conducted extensive training for our Appeals officers, hired nearly 100 settlement officers, and developed a specific Collection Currency Initiative to monitor and assess the overall status of our collection workload.

In addition, we developed a new position to screen out cases that are not appropriate for a CDP hearing and began hiring to fill those positions. We further segmented the CDP work to ensure that those taxpayers truly interested in resolving their cases are not competing for our resources with those who are merely trying to stave off a legitimate collection action.

Through these efforts, we believe we will be able to clear up the case backlog in 2002. Improved resource allocations, case development practices, better management, communications and technology should also provide for more efficiency, greater productivity and better results. We are beginning to see the payoffs.

Disposals are now beginning to equal receipts and we expect that in the near future, disposals will exceed them. In fact, disposals did exceed receipts in both February and April. We are also projecting a larger volume of cases going into "determination letter issued" status.

Cases in "determination letter issued" status increased by 59 percent and we are expecting another 55 percent increase by the end of the fiscal year. Although we still face significant challenges in both of these areas, our direct time and improvement in our time-per-case also increased.

Mr. Chairman, I want to touch upon one last area regarding Collection Due Process. The CDP provisions require us to give taxpayers an opportunity to request a hearing with Appeals after the filing of a Notice of Federal Tax Lien and prior to proposed levy action. However, some individuals are using the hearing process to delay collection action by filing hearing requests that raise frivolous issues.

Employing a variety of arguments, unsuccessful challenges have been made about the applicability of tax laws. There have been assertions that the 16th Amendment was not properly ratified; the tax law is unconstitutional; income tax only applies to certain individuals, or violates one or more constitutional rights; taxes are voluntary; individuals are citizens of a particular State, not the United States, so they do not have to pay federal taxes; only federal employees owe taxes; etc.

Mr. Chairman, as I discussed at the April 11, 2002 Senate Finance Committee hearing, all of these patently false arguments have no legal basis whatsoever, and despite the courts having consistently rejected them, their promoters continue to expound and market them, particularly to unsuspecting taxpayers and small businesses.

These taxpayers may even incur penalties for bringing frivolous cases into court or for filing frivolous tax returns. In the 1980s, Congress, concerned about taxpayers misusing the court, enacted a law allowing the courts to impose a penalty of up to $25,000 when they deem a taxpayer's argument frivolous.

IRS Appeals has approximately 20,000 CDP cases in inventory. About 4 percent, or 800 cases involve frivolous issues taxpayers. The Area Appeals Office with the most cases has about 13 percent of non-filer/frivolous issue taxpayers. Sub-offices within that area have even more substantial percentages of taxpayers with frivolous claims.

However, the numbers alone do not account for the inordinate amount of time it takes for such cases. Frivolous claims occupy a disproportionate share of time over

claims from taxpayers having substantive issues. Frivolous issue taxpayers frequently file voluminous claims. Just reading these to ensure any valid issues presented are addressed is extremely time-consuming. A larger percentage of the frivolous issue taxpayers go to court where they raise the same frivolous issues. Also, some of these individuals file Sec. 1203 actions (mandatory employee termination violations) against IRS employees, which are very time-consuming, even when they are not sustained.

In addition to frivolous claims, taxpayers attempting to delay collection action often tend to be non-responsive in Appeals. If they do respond, before agreeing to meet with the Appeals officer, they insist on being provided certain documents, such as a copy of the Appeals officer's delegation of authority or a copy of the notice and demand for payment, or they routinely ask for more time in producing necessary records or data.

These are often the same taxpayers who will go to court, and in many instances, these taxpayers file in the incorrect court - even when Appeals has correctly advised them where to file. By statute, these taxpayers have another 30 days to file in the correct court after having been dismissed from the incorrect court; so, it seems they are exploiting every delay the system allows.

Mr. Chairman, time spent on these frivolous claims is time spent away from taxpayers who raise legitimate issues. We also suspend collection action on these accounts while the case is pending in Appeals. However, we believe that the Administration has a number of proposals that will assist us on frivolous claims.

The President proposes to increase from the current $500 to $5,000 the penalty for frivolous returns and to extend this penalty to other frivolous submissions that are designed to delay the collection of tax. The Administration also proposes to permit the IRS to dismiss requests for CDP hearings, installment agreements, OICs and taxpayer assistance orders based on frivolous claims. This would allow us to proceed with collection on these cases and enable Appeals to focus full efforts on taxpayers with legitimate claims.

Taxpayers making a hearing request would be asked to state the grounds for appealing the filing of the notice of lien or proposed levy action. The IRS would examine claims with frivolous positions carefully to determine if real tax issues are present.

The IRS will also publish a list of the known claims, positions, arguments, requests and proposals deemed frivolous. We will update this list periodically. In August 2001, the IRS Chief Counsel also prepared and published a 32-page legal summary addressing false arguments about the legality of not paying taxes or filing returns. "The Truth About Frivolous Tax Arguments" can be viewed and downloaded from our web site. It not only debunks these false arguments; it also provides a summary of the law and relevant legal decisions involving the claims.

Top-Quality Service To All Taxpayers
Through Fair and Uniform Application of the Law

Our tax system depends on each person who is voluntarily meeting his or her tax obligation having confidence that his or her neighbor or competitor is also complying. Service to all taxpayers means applying the tax law fairly and uniformly. Therefore, when taxpayers do not voluntarily meet their tax obligations, the IRS must use its enforcement powers to collect the taxes that are due.

However, we simply do not have the resources to attack every case of non-compliance. We must apply our resources to where non-compliance is greatest while still maintaining adequate coverage of all other areas. Our near-term goal in 2001 was to stabilize the level of our key compliance activities while beginning to focus on the areas of greatest risk to our nation's tax system.

Key Areas of Non-Compliance

After careful study we identified and are addressing four important areas of systematic non-compliance. They are: misuse of devices such as trusts and passthroughs to hide income; use of complex and abusive tax avoidance transactions; failure to file and pay large accumulations of employment taxes; and erroneous refund claims.

Mr. Chairman, as I testified last month before the Finance Committee, combating actively promoted tax schemes is our highest compliance priority. One reason is the money lost to the Treasury, which is clearly substantial by any measure. But, even more important, these promoted schemes are unfair and corrosive to the health of our tax system. Nothing undermines confidence in the tax system more than the impression that the average honest taxpayer has to pay his or her taxes while more wealthy or unscrupulous taxpayers are allowed to get away with not paying.

In addition, these illegal tax schemes place a major demand on IRS resources. A complex illegal offshore trust case could require several times as many hours as a typical exam, and thousands of these cases are emerging. At the same time, we cannot abandon our traditional compliance activities to focus solely on these schemes. No taxpayer should ever believe that he or she could ignore the tax law and get away with it.

Our strategy for combating these schemes includes using a full range of tools and techniques, with the specific tools tailored to each approach. We identify the promoters, the schemes and the participating taxpayers through summonses of records, audits of promoter records, systematic analysis of leads, screening of tax returns and matching of documents.

Recently, one of our initiatives, which involved obtaining records of credit cards issued by banks in certain tax haven countries, has been particularly productive and has received substantial press coverage.

Educating and warning taxpayers about the nature of the schemes and the dangers of participating in them is a very important part of our program. Our efforts in this area include issuance of official notices and press releases, active media outreach, use of our web site and working through our increasingly deep network of relationships with business groups, practitioners and other government agencies. In fact, hearings, such as the one conducted by the Senate Finance Committee, is in itself an important contribution to alerting taxpayers to the dangers of succumbing to promoters who make promises that are literally too good to be true.

Taking enforcement action against promoters, including civil injunctions, civil audits and criminal investigations is extremely important. In FY 2002, we started examination of 104 promoters. In FY 2001 and FY 2002 (April), we obtained four injunctions and we have 18 more pending in court and with the Justice Department. In addition, over the past 17 months in the criminal area, 21 promoters of abusive trusts have been indicted, 26 have been convicted, and 70 are under active investigation.

Since last year, we also have been working closely with our colleagues at the Justice Department to establish a parallel approach where we can seek civil injunctions while criminal actions are proceeding. This is a major breakthrough as these promoters often continue to operate while criminal investigations are taking place.

We also identified promoters and schemes through screening returns. During FY '01 and '02, the work of our Questionable Return Detection Teams in each of our 10 processing campuses has led to 143 indictments, 479 investigations and 152 prosecutions recommended. Our Frivolous Return Program at the IRS Ogden campus, which focuses on combating false and frivolous claims, such as the Social Security refund and slavery reparations scams, protected revenue of $3 billion for FY 2001 by stopping refund claims before they were paid.

Although we are making substantial progress rooting out and shutting down promoters and schemes, a number of challenges remain. We are grappling with a widespread and growing problem made more difficult by new, sophisticated techniques and modern technology. Given these facts, we are continually seeking innovative ways to stop these promoted schemes.

Let me also stress the importance of the support we are receiving from the highest levels of our government to combat promoters and schemes. This visible commitment not only has a big impact in deterring the activities just described. It also encourages the prosecutors, courts and front line employees to be more effective in their important work. In this regard, I want to thank Secretary O'Neill for both his support of the IRS and the initiatives he has proposed.

Identifying Non-Compliance

Although major and systematic areas of non-compliance are our top priority, it is also important that we use all available tools to detect, correct and deter non-compliance

of all kinds. Compliance is an IRS-wide program requiring that all parts of the agency work together and contribute to our strategic goal.

One of the most powerful tools that we use to ensure compliance is matching information received from employers, financial institutions and other businesses with information reported by taxpayers. In fact, third parties report approximately 80 percent of the personal income received by taxpayers. An important compliance strategy is to use this data as effectively as possible.

For example, in 2001, the IRS began capturing data from 16.8 million K-1 forms. In 2002, the IRS will change its processing procedures and begin processing and matching K-1s reporting almost $700 million of income and also, importantly, reported losses on trusts and passthroughs. This will help us to find potential problem cases and when necessary, to follow up with audits.

In addition, our Operating Divisions' performance plans reflect the new compliance strategy in examination and collection. SB/SE will focus more on business tax cases, such as those involving un-paid, in-trust taxes, including employment and withholding taxes. We are also instituting new collection processes to select cases and to realign our case inventories based on the compliance risks we identified.

In FY 2001, we implemented the first phase of a multi-year Collection Re-engineering Program. It modifies our Inventory Delivery System to ensure that we promptly assign business tax cases to Revenue Officers. The Electronic Fraud Detection System is also being enhanced to include selected Business Master File data that will permit research, analysis and evaluation of fraud detection scenarios for business returns.

Finally, we are reinvigorating the fraud referral program so that when our examiners and revenue officers find serious cases of non-compliance from any source, the taxpayers will be referred for criminal investigation. Our Criminal Investigation division is developing training material for the Small Business/Self-Employed fraud referral specialists. The number of fraud referrals increased by more than 15 percent when compared to last fiscal year.

However, no matter how effectively we bring our resources to bear and new techniques to prevent problems, some cases will still require audits by IRS compliance personnel. Although 80 percent of the individual income is reported by third parties, the remaining 20 percent, mainly business income, is not reported and often requires in-person auditing to verify. And third, business income, including that by passthrough corporations, partnerships and trusts, can only be verified through auditing.

Document matching is not useful for verifying business income, gain or loss on asset sales, or most itemized deductions. We estimate that the total personal income that cannot be verified by document matching was about $1.2 trillion in FY 1998, or 19.7

percent of total reported personal income. An important role of audits is to verify these major categories of income and deductions.

Equally important, with respect to both tax revenues and fairness, is the income reported by corporations and partnerships. While the IRS continues to audit every year the 1,100 largest corporations, the audit rate for all other corporations declined from three percent in 1992 to 1.1 percent today.

A particular source of concern is the growing number of entities, such as partnerships, trusts and S-corporations, which pay no income tax at the business level, but pass on their net income to their shareholders or partners.

In 2000, these "passthrough" entities filed 7.4 million returns, reported $5 trillion of gross revenues and $680 billion of income. However, the IRS audited only 29,057 of them, or only one of every 256 returns – the equivalent of .39 percent. Even our new K-1 matching program will not provide any verification of the income reported by the business entity itself; this still requires an audit.

Compliance Activity in FY 2001

Our goal in 2001 was to stop the long-term decline in our compliance activities while beginning to focus it effectively and efficiently on the key areas of non-compliance previously described.

In most areas, we achieved this goal. For example, enforcement revenue in FY 2001 was about level with FY 2000 stemming the decline of the past several years. Large corporate examinations and returns examined by correspondence increased by 13 percent and 65 percent respectively. We also made ten percent more determinations for innocent spouse cases and processed 40 percent more offers in compromise.

Collection activity also stabilized. The number of cases closed by telephone and in the field was about level with 2000. It is also important that when necessary, the IRS take direct enforcement action to collect amounts due. In this regard, it is noteworthy that the number of liens filed and levies issued increased by 49 percent and 103 percent respectively over the previous year.

The significant exception to achieving our compliance goals was our in-person examination rate, which declined about 20 percent. In-person examinations of individuals and corporations are the area that takes longest to turn around because of the length of time it takes to train people and to complete cases even after they are initiated.

By stabilizing the number of compliance personnel, reengineering processes and setting clear goals, we believe that compliance activity levels will increase over the next three years. We will also be able to better identify and focus on key compliance problem areas. Research and other programs will support compliance operations. Taxpayer

education, published guidance and pre-filing agreements will help us prevent compliance problems in the first place. However, compliance operations will not yet rise to the desired level of efficiency and effectiveness.

In the long term, we will rely on our Business Systems Modernization (BSM) program to increase the effectiveness and efficiency of these activities. BSM will enable us to increase coverage from audits and other income verification techniques with modest increases in staff. We also have the opportunity to allocate our compliance resources more efficiently, both in specific cases and around patterns of non-compliance. And when intervention is necessary, we can use analytically-based techniques to assist in determining the appropriate action.

National Research Program

Earlier this year, the IRS proposed to reestablish a key component of its ongoing compliance effort to help ensure fairness for America's taxpayers. The National Research Program (NRP) is designed to accurately measure tax compliance while minimizing the need to contact taxpayers during the process.

The NRP is developing innovative approaches to measure taxpayer compliance with the tax law. It will: (1) be far less intrusive and burdensome on taxpayers than previous compliance studies; (2) help the IRS build better compliance programs to more effectively catch tax cheating and help ensure all taxpayers pay a fair share; and (3) help reduce audits of taxpayers who filed an accurate return by at least 15,000 tax returns a year.

As part of ongoing compliance operations, NRP will focus on measuring three key areas of tax administration – filing compliance, payment compliance and reporting compliance. A key element involves measuring the accuracy of reporting information on tax returns. The IRS has overhauled the reporting component to minimize disruptions to taxpayers during the study.

Ultimately, this project will help all taxpayers by giving the agency timely, accurate information about tax compliance. This information will allow the IRS to replace outdated audit selection formulas and develop compliance efforts directed toward the tax returns most likely to have errors, rather than those from honest taxpayers.

In late fall of this year, the NRP will begin reviewing a small, statistically valid sample of individual returns from the 1040 family. The IRS will work closely with tax practitioners, Members of Congress and other key stakeholders to finalize the project.

MODERNIZATION AND INCREASED PRODUCTIVITY

The improvements we made since the passage of RRA 98 are significant. However, these short-term initiatives were never intended to create a tax agency of and

for the 21st century. To reach that goal and to carry out the Restructuring Act's broad mandates and, most importantly, its intent, we must rely on our long-term modernization program.

We know how to modernize the IRS. Our course is clearly laid out in our Strategic Plan and we are making important progress to achieve our strategic goals. However, the path is neither short, nor easy.

As the IRS Oversight Board correctly observed, "Accomplishing this plan will be a long and difficult process. It will require significant work by the IRS and its advisors and contractors. As importantly, it will require the continuous oversight and support of the many stakeholders that are impacted by and work with the IRS, in particular the Administration and Congress."

Organizational Modernization

Following RRA 98's directions, we designed and made substantial progress in implementing a new modernized organizational structure. It closely resembles the private sector model of organizing around customers with similar needs.

The IRS created four customer-focused operating divisions (ODs) to best serve taxpayers: Wage and Investment, Small Business and Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. There are also a number of functional units, including Appeals, the Taxpayer Advocate Service, Criminal Investigation, and Communications and Liaison. In addition, Chief Counsel established a senior attorney as the Division Counsel for each of the Operating Divisions; they will fully participate in the ODs' plans and activities.

Internally, the Modernization and Information Technology Services (MITS) organization, which includes the Business Systems Modernization Office, and the Agency-Wide Shared Services unit provide information technology and administrative support, respectively, to all divisions.

The new organization focuses on providing service to each set of taxpayers in three key program areas: pre-filing, filing, and compliance. To succeed individually and collectively, all programs and organizational units must deliver top quality services to taxpayers through these three programs.

The modernized IRS organization was officially inaugurated, or "stood up", on October 1, 2000. A top management team is in place for each of the ODs and business units and has clear, end-to-end responsibility and authority to serve a taxpayer segment.

In LMSB, for example, we now have five industry groups and entire teams of revenue agents focused on understanding the taxpayer's business problems, which can greatly vary from the financial services industry to retailing and manufacturing. We also

have specific industry advisors who bring private sector experience on a broad spectrum of industry issues.

However, many challenges and much hard work remain as the different parts of the new organization are staffed and trained. The final stages of implementation, including the redistribution of workload, will continue through FY 2002.

In the short-term, the reorganization should be largely invisible to taxpayers and tax practitioners. But in the long-term, they will see the positive changes that modernization is intended to produce.

Senior Management and Technical Positions

The objective of the IRS modernization program is to convert the IRS to an organization that functions in a manner that is comparable to the best managed service organizations in the private and public sectors. Accomplishing this objective requires pervasive change in nearly all of the long-established attributes of the IRS, including organization structure, performance measurement, business practices and technology. Underlying and guiding all of these specific changes is major change in what is popularly known as "culture" – the attitudes and often unwritten traditions that guide so much of how any large organization actually functions.

In order to effectuate such massive change, strong top-level leadership from people with a broad range of experience is required. No one individual as Commissioner could possibly accomplish this degree of change without a team of people who possess the right mix of experience. Indeed, the IRS Restructuring Commission concluded, "While institutional memory is valuable and keeping politics outside the IRS is essential, the dearth of outside thinking can limit the IRS management's ability to bring new perspectives to organizational challenges."

In the case of the IRS, it is fortunate that many of the internal senior leaders were receptive to change and had the skills to help lead it. However, none had significant top-level experience outside the IRS. In particular, it is essential that some of the people providing this high level of leadership come with relevant experience about how other successful organizations function.

In order to fill this need for top-level leaders with relevant outside management experience and professional expertise, RRA 98 provided the IRS with special authority.

"Senior management and technical positions
Streamlined critical pay authority"

As stated in the conference report to RRA 98:

"The Senate amendment provides a streamlined process for the Secretary of the Treasury, or his delegate to [. . .] appoint up to 40 individuals to, designated critical technical and professional positions, provided that: (1) the positions require expertise of an extremely high level in a technical, administrative or professional field . . . . "

The IRS has used this authority effectively to recruit individuals with successful track records outside the IRS to occupy positions with substantial impact on the agency. As further provided in RRA 98, these individuals were not intended to be permanent employees of the federal government and hence, were appointed to four-year terms. As the IRS evolved, the needs for these individuals also evolved. At present, the positions filled under this authority include the following:

- Eight are heads or deputy heads of the IRS' major operating units.
- Nine are in information technology positions.
- Five are industry advisors with expertise in specific industries.
- Ten are directors of specialized activities in the IRS operating units.
- Four are technical advisers.

Nearly all of these individuals came to the IRS from management or technical positions in the private sector and normally, would not have considered a job in the IRS, or even in the federal government. While it is customary for professionals in law, academia or politics to serve for a time in policy and staff positions in the federal government, it is much less common for people in private sector management and technical positions to accept government management positions. In most cases, the IRS engaged professional search firms to locate and help recruit these individuals.

The following is a summary of the background of some of the individuals currently occupying these positions:

- The new Deputy Commissioner Modernization/Chief Information Officer was a top executive in the technology area at Time-Warner. Eleven other individuals with successful careers in the private sector fill key Information Technology positions.
- Two of the four Division Commissioners and one of the Deputy Commissioners of our operating divisions came to the IRS after successful

careers as senior executives in major corporations and provide specific industry background and experience, change management experience, and senior leadership.

- All of the Senior Industry Advisors in the Large and Mid-Size Business Operating Division came from the industries to which they are assigned, making them uniquely suited to provide the most current technical advice to the IRS.

- The Chief, Agency-Wide Shared Services, came from a major international corporation and brings to the IRS commercial service support best practices.

Additionally, several of the critical pay executives who left made significant contributions to our modernization efforts and moved us much further along in the process than we would have been without them. For example, the previous Chief Information Officer's leadership and dedication were crucial. He provided clear, creative strategic direction in both business and technology arenas, helping us to reach successfully a number of key milestones in our efforts to modernize. He also created a consolidated Information Systems organization, where nearly 100 percent of the Information Technology resources are directed in accordance with industry standards.

Our former National Taxpayer Advocate oversaw the transformation of the Taxpayer Advocate's office to reflect the expanded powers and responsibilities granted it by RRA 98. He reorganized the field structure and took on a greater role in assisting taxpayers in tax disputes, championing taxpayer rights and providing recommendations for improving tax legislation.

Our previous Deputy Commissioner/Modernization provided the critical oversight and direction to enable us to implement the four new operating divisions. He also led the effort to completely redesign the national headquarters functions and resolved a variety of sensitive issues to ensure a smooth transition.

In conclusion, I believe that the critical pay authority has been an invaluable tool in bringing to the IRS individuals with exceptional experience and expertise not usually found at the agency. Coupled with their unique perspectives, they make an excellent balance to our cadre of senior career executives.

Proposed Modifications to RRA 98 and Cost Savings Measures

Mr. Chairman, in its FY 2003 budget submission, the Administration proposed a number of modifications to RRA 98. On March 20, 2002, the House Ways and Means Committee reported out legislation that contained five of these proposals. We commend the Committee for its actions and believe that these modifications preserve the intent of RRA 98 while allowing us to administer it more efficiently and effectively. These

proposals are now part of the House-passed H.R. 586, the Tax Relief Guarantee Act of 2002.

There are six parts to the Administration's proposed modifications. The first modifies infractions subject to Section 1203 of RRA 98 and permits a broader range of available penalties. Our ability to efficiently administer the tax code is currently hampered by a strong fear among our employees that they will be subject to unfounded 1203 allegations, and perhaps lose their jobs as a result. This proposal will reduce employee anxiety resulting from unduly harsh discipline or unfounded allegations.

The second part adopts measures to curb the large number of frivolous submissions and filings that are intended to impede or delay tax administration. The third allows IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities. *(This provision was not contained in the Committee-reported bill.)* The fourth part streamlines jurisdiction over collection due process cases in the Tax Court, thereby reducing the cycle time for certain collection due process cases.

The fifth part permits taxpayers to enter installment agreements that do not guarantee full payment of liability over the life of the agreement. It allows the IRS to enter agreements with taxpayers who desire to resolve their tax obligations but cannot make payments large enough to satisfy their entire liability and for whom an offer in compromise is not a viable alternative. The sixth and last provision would eliminate the monetary threshold for IRS Chief Counsel reviews of offers in compromise.

The Administration also proposes a number of cost-saving measures. For example, it proposes to permit the IRS to use the lower-cost option of certificates of mailing as an alternative to certified mail and registered mail for most notices and correspondence now requiring certified or registered mail.

Another proposal would eliminate the return receipt requirement for notices of a right to a pre-levy collection due process hearing. A third cost-saving proposal would eliminate the requirement that separate notices be sent to joint filers who reside at the same address.

The Administration further proposes to permit the assessment, without deficiency procedures, of fraudulent claims for certain credits, including the Earned Income Tax Credit. In addition, it proposes to allow the Financial Management Service to retain directly a portion of the levied funds as payment for FMS' fees. As previously discussed, the Administration also proposed to extend the due date for electronically-filed returns.

Strategic Plan and Balanced Measures

On January 30, 2001, the IRS Oversight Board approved the IRS Strategic Plan. It follows closely the letter and spirit of RRA 98 and reflects the new and modernized IRS.

The Strategic Plan lays out how we will use our limited resources to achieve the greatest benefits in performance. Moreover, we will meet these goals while continuing to shrink in size relative to the economy. Indeed, we are planning most of our performance improvement from internal management improvements and modernization, not increased resources.

Taken as whole, the Strategic Plan means that there is one very important difference between the IRS' situation today and when RRA 98 was enacted: the uncertainty about the future is greatly reduced. We still have much to do, but we better know how to do it and have put in place the foundation for achieving it.

All federal agencies must also have appropriate quantitative performance measures. They are required by the Government Performance and Results Act (GPRA) and are essential to any large organization's proper operation. An integral part of our overall modernization program is establishing balanced performance measures that support and reinforce our mission and strategic goals.

By the end of 2001, balanced measures in line with our strategic plan were rolled out to most of the new organization. For FY 2002, we are expanding our number of critical measures. We will deploy balanced measures to the territory, or equivalent level, for purposes of setting performance targets for field offices.

However, development of the balanced measurement system and, even more so, learning the new ways of working will take years. By focusing our attention on what is important for achieving our strategic goals, we will stay on the right path and continue our progress.

Stewardship

The IRS is the steward of massive taxpayer revenue and budget and financial resources. I am very pleased and gratified to report that the General Accounting Office issued an unqualified or "clean" audit opinion on the IRS' financial statements for FY 2001. This marks the second consecutive year that the IRS has received a clean opinion on both the Revenue and Administrative Accounts.

Such an unprecedented achievement did not come easily. As Comptroller General David Walker observed in his transmission letter to Treasury Secretary O'Neill, "Our unqualified opinions on IRS's fiscal years 2001 and 2000 financial statements were

made possible by the extraordinary efforts of IRS senior management and staff to compensate for serious internal control and system deficiencies."

Indeed, the success can be greatly attributed to the hard work and dedication of IRS staff, as well as that of our partners at the GAO, who were with us every step of the way. The clean opinion also can be traced back to the significant improvements in IRS internal controls and management focus on the financial audits. We made advancements in a number of areas and laid the foundation for sustainable gains in others.

However, we concur with GAO that there is a limit to what hard work and dedication can produce. In fact, our challenge is made all the greater by proposed new accelerated timelines to report financial statements. The Department of Treasury has established the goal of completing by November 15, 2002 all fiscal year 2002 component entity audits and the Department-wide Consolidated Performance and Accountability Report. I will not minimize the difficulty of our task. It will take an enormous effort on the part of IRS and the GAO to meet this goal, but we are committed to achieving it.

Indeed, we must meet the many challenges facing us through a combination of both short-and long-term solutions, as we are doing throughout our modernization program. In other words, we must continue to improve our processes in the near-term while implementing fundamental long-term solutions through our BSM program.

We have made a number of tangible, short-term gains. For example, in February 2002, we were able for the first time to achieve a three-day monthly closing of our books. This was an enormous milestone for the IRS. In prior years, the IRS also did not have an obligation subsidiary ledger to support undelivered orders. However, we have since developed a data warehouse for obligations that shows the full transaction history for each obligation, including open obligations and those that have been fully liquidated.

As discussed, the IRS also established a strategic planning and budgeting process that allows us to use effectively available cost information to make sound resource allocation decisions. As a part of this major change, we developed a budgeting structure that is aligned with both organizational responsibility and program delivery. In the FY 2003 budget, we identified over $200 million in costs that can be reallocated to top priority customer service and compliance enhancements.

The IRS also made strides to correct longstanding deficiencies in systems and controls over Property and Equipment (P&E). As the GAO observed, the IRS: (1) implemented a new inventory record system for its automated data processing assets; and (2) developed policies and procedures to identify and record costs incurred to develop internal use software.

A good example of the improvements we have made to ensure that assets are properly accounted for and safeguarded begins with a November 2001 TIGTA report of 2,332 missing computers at the IRS during the previous three year period. (These

computers were purchased from 1985-2001). As stated in our response to TIGTA, the IRS has been unable to account for 68 of the computers in the TIGTA representative sample of 100, and we are still attempting to locate them.

However, we have taken aggressive steps to improve inventory control and, we are now able to determine more precisely the status of each computer. For example, in March 2001, we implemented a new Asset Management Inventory Tracking System. In July 2001, we also implemented a formalized Annual Certification Process, which closely accounts for individual computer equipment. In addition, we put into use a systems management tool (Tivoli) that allows us find devices on the IRS network.

I believe that the success of our efforts is apparent when you look at the statistics for the last two fiscal years. In the years 2000-2001, the IRS installed 38,610 computers. Of these computers in our certification of inventory in October 2001, only 27 (.07%) were not located. As of April 30, 2002, of the 27 missing computers, ten have since been located or determined to have been properly disposed of and 17 (.04%) have been identified as stolen or missing or still to be located.

However, we also realize that one of the key requirements for better financial management at the IRS in the long-term is improved technology. In this regard, the IRS is scheduled to replace its current general ledger system with a general ledger that is fully compliant with the requirements of Federal Financial Management Improvement Act.

Mr. Chairman, in spite of these challenges, one fact also emerges. All of the revenue that comes into the IRS from millions of taxpayers and businesses is honestly accounted for and provided to the Treasury. It is an enormous asset to our nation that it has a tax agency, which regardless of its limitations and weaknesses, performs this task honestly and accurately. As demonstrated last year, specific violations or errors are found and corrected.

Over the past eight years, the IRS oversaw 500 million remittances without a major problem. However, in 2001, more than 74,000 taxpayer checks valued at $1.2 billion were determined to be missing at the Mellon Bank Pittsburgh Lockbox site. The Lockbox Program is a network of financial institutions that process taxpayer remittances for the IRS. Operated through an agreement with the Department of Treasury's Financial Management Service, the system helps accelerate the flow of funds to the Treasury.

Once detected, we took swift action to alert potentially affected taxpayers to the problems. More importantly, these taxpayers will not be penalized by what occurred. They will be made whole, and the Treasury will receive its funds. The incident, although isolated, will be used to improve procedures and prevent any such problem in the future.

It also bears mentioning that all of the IRS' operations are transparent to Congress and our auditors, including the GAO and the Treasury Inspector General for Tax Administration (TIGTA). These audits point out problems and identify useful ways we

can improve the entire spectrum of taxpayer services. In FY 2001, we received 162 TIGTA audit reports and 42 GAO reports containing 569 specific recommendations for changes and improvements. In addition, as of April 22, 2002, there are 136 TIGTA and 55 GAO audits underway.

Leveraging Our Limited Resources
Through Greater Efficiencies

To help create a "World Class Treasury Department," Secretary O'Neill challenged each bureau to review all programs on a continual basis and redirect resources to meet needs, rather than asking for funding increases. Budget and performance integration, as part of the President's Management Agenda, requires this kind of business review, with an emphasis on best results at the lowest total cost.

Mr. Chairman, we are making strong improvements in efficiency. By leveraging our limited resources through better management and a fundamental reengineering of business processes – not through massive infusions of new resources – we have been able to reallocate precious resources and personnel to where they are needed most, such as improving customer service and stabilizing critical compliance activities.

Let me stress the process that underlies the FY 2003 request. For the first time, we fully integrated the development of our budget with the establishment of performance measures. First, we determined the highest priority resources needed to increase customer service and compliance. In addition, as part of the budget process, IRS' senior team conducted a review and prioritization of agency-wide needs for FY 2003 and searched for the most efficient allocation of resources. The realignment of resources woven throughout the FY 2003 budget comes through reengineering, efficiencies and investment in modernized systems. To this end, the review developed 2,287 FTE that could be re-deployed to high priority areas in customer service and compliance.

As shown in the attached Chart in FY 2003, the IRS is proposing to achieve $259 million in increased program resources and program delivery at a net requested increase of only $63 million. Therefore, 76 percent of the improvement is being achieved by improved internal efficiency and redeployments. These improvements are essential to continuing the positive upward trend in programs and in making the tax system operate fairly to all. (*See Appendix for FY 2003 Budget Resource Request.*)

Crucial to our success is continued support for our Business Systems Modernization (BSM) program, for which a $58 million funding increase is requested. The increase will allow us to fund these critical projects as they move from the planning and design phase to development and implementation.

BUSINESS SYSTEMS MODERNIZATION

The IRS is saddled with a collection of obsolete and inefficient computer systems developed over a 35-year period. The most important ones that maintain all taxpayer records were developed in the 1960s and 1970s. Virtually every one of our 100,000 employees depends on these antiquated and inconsistent systems to perform his or her job.

The effect of this obsolete technology on service to taxpayers and productivity cannot be disputed. As compared to what the private sector offers, the IRS' services are deficient, and the lack of modern computer systems is one of the fundamental obstacles to providing consistent top-quality service.

Our modernization program is one of largest and most complex business systems modernization efforts ever undertaken in the public or private sector. And more than updating our antiquated technology, the modernization program changes the entire way the IRS interacts and conducts business with taxpayers and stakeholders. Indeed, we do not view systems modernization as a separate entity, but rather as one of the major ways we can achieve all of RRA 98's goals within realistic budget resources.

Our biggest challenge is to implement this massive change while still running the largest tax administration system in the world, collecting about $2 trillion per year from 130 million individuals and six million businesses.

Over the past two years, BSM graduated from strategic planning and systems design to business results. As shown in the chart – in the green blocks in FY 2001 and FY 2002 – the IRS will put in place three critical building blocks. In 2001, we established a communications infrastructure to manage the enormous volume of taxpayer phone calls. In 2002, we plan to move the records of some taxpayers out of the 1960's tape-based system to a modern, reliable database. And third, we plan to establish an IRS-wide security system providing internal and external secure access and communications to our systems. We encountered a delay in one part of the program, which I discuss later in my testimony, but we nevertheless expect to achieve these important goals.

These three deliveries are some of the most essential and difficult fundamentals of the modernization program. Their lack severely impeded our ability to modernize our systems and imposed enormous risks and costs on the entire tax administration system. As BSM progresses, these programs will continue to be enhanced and deployed on an ever-increasing scale until they eventually support the entire tax system.

Valuable lessons were learned as we developed and implemented these projects, and we are giving equal attention to improving the quality and rigor of our management processes. Completing the first two versions of the Enterprise Architecture was a major step.

Based on my 28 years experience in the Information Technology business, I believe that this Enterprise Architecture is the most complete and useful of such architectures in industry or government. We are also utilizing the rigorous management processes of the Enterprise Life Cycle, while at the same time ensuring that all BSM projects adhere to the Enterprise Architecture.

In addition, we are addressing remaining management weaknesses, including those identified by GAO. Finally, we are striving to achieve a standard known as the Software Acquisition Capability Maturity Model Level 2 – a recognized standard that has not been achieved in any Federal Agency with the exception of the Abrams Tank Division of the United States Army.

In FY 2003, we will build upon last year's achievements. For example, we will continue to phase in the deployment of the Customer Account Data Engine and move additional filers into the modernized system.

I want to stress, Mr. Chairman, that we will continue to use a formal methodology to prioritize, approve, fund and evaluate our portfolio of BSM investments. This methodology enforces a documented, repeatable and measurable process for managing investments throughout their life cycle. Investment decisions are approved by the IRS Core Business System Executive Steering Committee, chaired by the Commissioner.

Building Management Capability

A major program, such as BSM, requires a highly-developed management capability. It must include highly-qualified individuals, well-developed processes and practical experience in applying them to the program's real work. Such a capability cannot be instituted immediately in any organization, but must mature over time.

In the three years since the BSM program began, management processes have matured and will continue to show progress as more experience is gained. We now have a seasoned management team blending IRS and private sector experience.

Also, with the appointment in March 2001 of John Reece as the Deputy Commissioner for Modernization and Information Technology Services (MITS) and Chief Information Officer, we took a key step to better synchronize the transition of BSM from design orientation to delivery.

Last month, we also announced the appointment of Dr. Fred L. Forman as the Associate Commissioner of Business Systems Modernization. In this position, he will lead the agency's multi-year business and technology modernization program.

Dr. Forman brings a unique set of leadership skills and talents to Business Systems Modernization. For the last nine months, he served as the executive program adviser to the BSM program. As the Associate Commissioner for BSM, Dr. Forman will

manage the IRS partnership with private-sector technology and management firms helping to modernize the agency's tax administration processes.

During the past year, we also made significant progress in a number of areas to improve the program's overall management. The first was configuration management. During FY 2001, we defined a baseline process for each project. It spells out and helps us measure all of the different projects' functions, requirements and capabilities, technology, schedules and costs. Configuration management prevents the BSM program's complexity and the number of moving pieces from overwhelming us.

Closely related to configuration management is release management. This is the process of coordinating and managing the activities by which we plan, test and implement all BSM project releases. Release management is critical to a business systems plan as large as ours, as one release can have ripple effects throughout the larger universe of projects.

On May 8, 2001, in partnership with the PRIME, we also formally established a Release Management Board to manage all of the FY 2002 and subsequent releases. We now have a detailed quarterly plan that shows the sequencing and interdependencies of all of the different BSM projects.

Managing Risk

Due to its enormous size, complexity and sensitivity, the BSM Program involves considerable risk. However, risk in this context is often misunderstood. The fact that risk exists does not mean that the program will fail. It means that the program could fail if the risks are not adequately identified and appropriate action taken to address them on a timely basis.

We are actively identifying and managing the risks in BSM, and we have not hesitated to make changes in programs when necessary. Since April 2000, many serious program risks were reduced or eliminated, and new risks are constantly being identified. There is a critical point to understand about managing risks in this program: making constant adjustments to plans is an indication that they are being addressed and managed. It is one of the hallmarks of a successful systems program.

Mr. Chairman, we identified a risk in the schedule for the first release of one of our key projects, the project to build a database for taxpayer records. We responded with corrective action in order to adjust the schedule while maintaining our focus on quality deliverables and on meeting our important business objectives.

FY 2003 BSM Request

The proposed $450 million FY 2003 BSM budget request includes an increase of $58.4 million over last year's appropriation. Let me summarize the key BSM projects that are addressed in the funding request.

Customer Account Data Engine (CADE)

CADE is the foundation for all of IRS' tax administration systems. It will replace the tape-based Master Files that currently contains the only authoritative information on all individual and business tax accounts. The IRS dependence on this 1960s Master File system today constitutes an insurmountable barrier to efficient service and compliance operations and is a very serious risk to the whole tax system.

CADE will incrementally move individual filers from the 1960s tape system to a modernized database. CADE Individual Master File (IMF) will build the database that will replace the existing IMF processing systems. CADE will create applications for daily posting, settlement, maintenance, refunds processing and issue detection for taxpayer tax accounts and return data. The database and applications developed by CADE will also enable the development of subsequent modernized systems that improve customer service and compliance. Once implemented, modernized applications, such as Customer Account Management (CAM), will allow on-line posting of data in addition to daily batch processing.

CADE will be deployed over time in five releases, each related to a specific taxpayer segment, phased in over a period of six years. At the conclusion of Release 5, CADE will have replaced IMF.

Mr. Chairman, let me point out that due to a number of technical difficulties and schedule delays, Release 1 of CADE Production has been delayed by six months. We discovered in December 2001 a significant issue with Procurement of a Business Rules Engine (BRE). A key part of the overall CADE development strategy was predicated on the use of BRE software that would be used to generate some programming code. Unfortunately, the PRIME was unable to procure the BRE in time to be used in the development of Release 1 and we were forced to proceed using standard development language. We began mitigation on this situation.

In addition to the technical difficulties, we encountered in late March 2002 an additional one-month slippage to July 2002. We notified our Executive Steering Committee and Oversight Board of the problem and our corrective actions. The delay will provide time for the development, testing and implementation of the Release 1 pilot this summer. Currently, most of the software has been developed and testing has begun. Planning for production implementation in conjunction with the startup of the 2003 filing season has also started. The release will include both 1040EZ electronic and paper single refund filers – about 10 million taxpayers. Therefore, based on this plan our most

important business objective, which is to move the first block of taxpayers onto a new data base will be achieved.

Integrated Financial System (IFS)

IFS has three clear goals: (1) provide core financial capabilities and financial reporting; (2) meet Joint Financial Improvement Program requirements; and (3) provide an integrated framework for retirement of current financial systems.

IFS will be accomplished in two releases, each representing a distinct usable segment. Release 1 will replace the Core Financial Systems (CFS) as defined by the Joint Financial Management Improvement Program (JFMIP). In addition to CFS, Release 1 will include budget formulation as well as implementation of a Cost Accounting System to allow the IRS to move into compliance with Statement of Federal Financial Accounting Standard Number 4. Release 1 creates a logical design for the core financial applications including Cost Accounting. The core financial applications consist of General Ledger (G/L), Accounts Payable (A/P), Accounts Receivable (A/R), Cost Management, Funds Management, Core Financial Management and Financial Reporting.

Custodial Accounting Project (CAP)

GAO identified the lack of an acceptable accounting system for the $2 trillion collected in tax revenue as one of the most significant material weaknesses in IRS' financial management. CAP will provide the IRS with the critical control and reporting capabilities mandated by Federal financial management laws.

It will also support the appropriate custodial subledgers containing data from tax operations and help the IRS meet compliance issues with both the Federal Financial Management Improvement Act (FFMIA) and federal mandates related to custodial revenue management. CAP will also help us to better manage, control and focus resources.

Enterprise Data Warehouse (EDW)

The ability of the IRS to make effective use of information about its operations is limited by the numerous fragmented databases that evolved over time. EDW provides the foundation for data mining and decision analytic tools. In addition, it enables risk-based analysis for case selection and provides the tools to report on IRS balanced performance measures.

e-Services

The *e*-Services project will support our ability to meet the overall goal of conducting most transactions with taxpayers and their representatives in an electronic format, as required by RRA '98. *e*-Services will provide to third parties over the Internet

the four most requested applications: electronic taxpayer identification number matching, electronic transcript delivery, disclosure authorization and Electronic Account Resolution. *e*-Services also directly supports the President's Management Agenda's government-wide initiative to expand electronic Government.

Customer Account Management (CAM)

The Customer Account Data Engine cannot be deployed beyond its initial limited releases without Customer Account Management. CAM allows us to go into CADE and update the data and will help taxpayers to receive timely and accurate responses to requests and inquiries.

The CAM Individual Assistance and Self Assistance Operating Models will provide improved technology and business processes that will enable the IRS to: (1) better manage customer service functions; (2) maintain and utilize customer data to improve taxpayer interactions with the IRS; (3) provide comprehensive account and tax law assistance to taxpayers and practitioners; and (4) manage the case work flow of customer inquiries.

Delivering customer assistance through a live IRS Customer Service Representative (CSR) is the Individual Assistance operating model's main function. In order to provide world-class service, CSRs must be equipped with the tools to access taxpayer information quickly and accurately in response to complex customer inquiries. Individual Assistance will provide this capability from a desktop information system.

By being able to access and update comprehensive, current account information, CSRs will be able to respond quickly and accurately to customer inquiries. Workflow management tools and processes will also allow them to automatically inform relevant parties throughout the organization of actions taken on a particular customer's account and manage outstanding cases for follow-up work, or to identify the status of an inquiry for a taxpayer.

The CAM Self-Assistance operating model delivers many of the same capabilities. The main objective, however, is to provide taxpayers with the flexibility and convenience of accessing by telephone or the Internet on a 24/7 basis IRS-related information to resolve relatively simple inquiries.

Filing and Payment Compliance (FPC)

FPC is an end-to-end strategy to resolve collection issues quickly and fairly. Using industry best practices, it augments, refines and replaces existing processes and technology to enable the IRS to interact with taxpayers in a seamless and efficient manner. Protection of taxpayer rights is an important component of this strategy. The ultimate goals are to resolve all balance due cases above a minimum threshold, shorten

the filing compliance lifecycle to ensure resolution before the next filing due date and shorten the payment compliance lifecycle to six-months for non-enforcement cases.

CONCLUSION

Mr. Chairman, in conclusion, I believe we can be proud of the progress the IRS has achieved over the past year towards meeting RRA 98's mandates. We are providing improved service to America's taxpayers in key areas such as electronic filing and over our toll-free telephone lines. Compliance activities are stabilizing. Our Business Systems Modernization program has moved from planning and development to implementation of our initial projects. Although we confront many challenges, our financial house is in order. All of our key indicators are pointing in the right direction. To ensure the success of IRS modernization for next year and the years to come, we must stay focused and committed to the intent of the Restructuring Act, making adjustments as necessary, but never losing sight of our goals. If we do, I am convinced that we will succeed. Thank you and I would be happy to answer your questions.

APPENDIX A

FY 2003 RESOURCE REQUEST

Mr. Chairman, the IRS budget request for FY 2003 is $10.418 billion and full-time equivalent employment (FTE) of 101,080. The request is $482 million more than last year's $9.936 billion appropriation. The largest programmatic component of this increase is $259 million to enhance customer service and compliance, of which $196 million will be funded through a redeployment of resources within our base budget.

Overall as shown in the attached chart, the IRS is proposing to achieve $259 million in increased program resources and program delivery at a net requested increase of only $63 million. Therefore, 76 percent of the improvement is being achieved by improved internal efficiency and redeployments.

The funding increase request also maintains momentum in the IRS Business Systems Modernization projects with $58 million. The budget increase for FY 2003 will allow us to fund these critical projects as they move from the planning and design phase to development and implementation. The remaining increase would fund pay raises, and inflation, $10 million for Tier B Projects (*see p. 21*) and adjustments for Homeland Security funds appropriated in FY 2002.

In addition, $39 million of the total increase is requested as part of a legislative proposal to change the accounting of pension and retiree benefits costs. Please note that although the increase of $39 million is the incremental change from the FY 2002 appropriation (as adjusted), the actual increase to our FY 2002 base for this proposal will be $503 million. These costs are transfers of funds that were previously included in other agency budgets and do not represent any net increases in IRS programs.

OPERATIONS

HIGHEST PRIORITY RESOURCE NEEDS

Customer Service and Workload Increases (+1,595 FTE, $91M)

In FY 2003, the IRS must build on the gains it has made in customer service if we are to achieve our first strategic goal, "top quality service to each taxpayer in every interaction." We are still not providing a consistent high level of service that taxpayers expect and deserve. We must continue to improve taxpayer access to our toll- free telephone lines and the accuracy of the responses we give to tax law and account questions. We must continue to improve the service at our taxpayer assistance centers. We must further reduce taxpayer burden. We must continue to increase e-file options. We must better administer the RRA 98 taxpayer rights provisions. And we must give our employees the training and tools to meet these needs. The highlights of some of the following initiatives will help us meet our goals.

- *Increased Offer in Compromise (OIC) Cases.* This initiative is designed to address the escalating OIC inventory by centralizing and streamlining the processing. Cases sent to the field will include all background financial data needed to conduct the investigation, thereby reducing the amount of time that revenue officers must spend on gathering this information.

- *Telephone Level of Service.* Taxpayers must still speak to live assistors to answer tax law and account questions as well as Automated Collection System (ACS) inquiries. Additional FTE are necessary to address current demand and to meet taxpayers' legitimate expectations that they receive service comparable to what is offered by the best private sector companies.

- *Multi-Lingual ACS.* The Multi-Lingual Automated Collection Service (ACS) will help meet taxpayer growing demands for timely, accurate and efficient services in languages other than English.

- *Improving Correspondence.* We are improving the clarity of our communications with taxpayers through a redesign of 24 of our notices over the next two years.

- *Filing Services.* We must continue to provide filing services – from *e*-filing to submission processing to timeliness of refunds – and handle a projected increase in the number of returns filed.

Enhanced Compliance Strategies (+1,857 FTE, $125 M)

In 2001, we began to stabilize the long-term decline in compliance activities while beginning to focus effectively and efficiently on the four key areas of non-compliance and maintaining adequate coverage of other areas. However, we still must address a number of challenges. For example, from 1993 to 2001, the number of returns reporting adjusted gross income in excess of $100,000 grew by 163 percent. We must keep pace with this increase by expanding the number of these returns that are examined in IRS field and office programs. We must also tackle the $66 billion in our total potentially collectable inventory. And we must focus on the proliferation of tax scams ranging from sophisticated illegal offshore trust programs to the slavery reparations scheme being perpetrated upon African-Americans. The following are the highlights of our enhanced compliance strategies for FY 2003. A detailed description can be found in our congressional justification.

- *Stabilize Audit Rates.* The IRS will devote resources to stop the overall declining audit rates and will dedicate more resources to auditing partnerships and other passthrough entities.

- *Abusive Trusts.* Experts estimate that the revenue loss to our nation due to abusive trusts could run into the tens of billions of dollars. We now have a

coordinated strategy to deal with this growing problem using a full range of tools from public education to civil and criminal enforcement against both promoters and participants.

- *High-income Returns.* From 1993 to 2001, the number of returns over $100,000 and $1 million dollars grew by 163 and 259 percent respectively. However, IRS examination of these returns has not kept pace and we must now narrow the gap.

- *Highest Priority Collection.* To address the mounting employment and income tax gaps, the IRS will dedicate more resources to high priority compliance and collection cases involving unpaid employment taxes.

- *Fraud Referral.* Referrals and leads generated from the Lead Development Centers and the Fraud Detection Centers will produce more quality criminal investigations cases and help ensure public confidence in the fairness of our of tax administration system.

- *Automated Underreporter.* To improve voluntary reporting on individual income tax returns, the Remote Automated Underreporter Program will utilize a national rotational inventory approach for case selection.

- *Employment Tax.* To combat non-compliance with employment tax laws, the IRS will boost resources for legal source tax crime cases with a special emphasis on emerging problems, such as the use of temporary employment agencies/employee leasing agencies to evade employment and income taxes.

- *Money Laundering.* IRS Criminal Investigation (CI) was delegated primary investigative jurisdiction in all money laundering investigations where the underlying conduct is a violation of the income tax laws.

- *e-Crimes.* CI must continue to develop investigative knowledge and techniques to keep pace with the growing number of *e*-crimes, such as fraud and theft.

- *Criminal Tax Cases.* Continued development of a close relationship between Chief Counsel Criminal Tax and CI will help to ensure that legal errors in the investigative process are minimized and the chances for successful prosecution are maximized.

Contract Services (+$44M)

The IRS must also pay for a number of non-labor program increases, many of which are mandated by Executive Order or departmental regulations. For example, in response to concerns raised by GAO and TIGTA, we must provide for enhanced guard

services at our submission processing and computer centers. In addition, we are requesting funding for physical security upgrades such as more secure gates and entrances, and barriers that can be raised and lowered. Other items include the Public Transportation Subsidy, which was increased from $65 to $100/month.

RESOURCES RE-DEPLOYED THROUGH INCREASED EFFICIENCY AND PRODUCTIVITY

A combination of strategic redeployment of staff and labor saving programs will allow the IRS to improve its level of taxpayer service without commensurate increases in the number of FTE applied. Targeted improvement projects, such as Reengineering/Quality efforts and labor savings from e-file and e-Services can be reapplied to other high priority programs. Technology modernization programs will generate the bulk of the FTE savings.

Improvement Projects (Redeployment of 1,779 FTE, $107M)

The IRS identified FTE redeployments from improvement projects that are expected to come to fruition in FY 2003 and are highlighted below. The FTE will be reinvested to fund the top priority needs identified below:

- *Reengineering/Quality Improvements.* Reengineering and Quality Improvement projects and programs will focus on redesigning internal processes, policies, and procedures. Updating the antiquated workload selection system will, for example, reduce/eliminate the substantial number of returns that are ordered, classified, and never worked.

- *e-file.* In addition to the many taxpayer benefits, *e*-file also provides clear cost savings and burden reductions for the IRS, enabling us to redirect precious resources from processing to customer service and compliance programs. In addition to expanding electronic filing for individual taxpayers, the IRS will promote the electronic filing of all business tax returns in FY 2003. Our ultimate goal is to convert all business transactions with the IRS to fast, accurate, paper-free electronic methods. Through *e*-Services, we will also provide to tax practitioners easy-to–use electronic products and services.

- *Customer Relationship Management.* The funding for this project will pay for training travel, operating travel and support costs related to bringing IRS staff quickly up to speed on the newly improved Corporate Tax Analysis software. The software's main strengths are its capacity to do carryback/carryover calculations for net operating losses (and other losses), the interaction of losses and charitable contributions, alternative minimum tax calculations and the foreign tax credit calculations – including carrybacks and carryforwards.

- *Information Technology Projects.* Two projects are expected to begin realizing savings in FY 2003: the Employee Plan Determination System Redesign (EDSR)

and the Remittance Transaction Register (RTR). EDSR is expected to reduce cycle time and improve quality of determination letters. RTR is projected to improve efficiency in submission processing by providing all Lockbox payment information online soon after receipt, reducing from one month to just three days response time for reconciling payment information and responding to payment information queries.

Workload Decreases (Redeployment of 508 FTE, $50.5M)

- *Reduced Field Innocent Spouse.* The initial high inventory of Innocent Spouse cases is expected to decline to a point where they can be processed without significant delays on our part. Revenue Agents and Tax Auditor FTEs assigned to this program will be re-deployed to address compliance in other areas.

- *Reduced Filing Season Support.* We will reduce the FTEs in the Small Business and Self-Employed operating division planned for customer service details.

- *Narcotics Program.* With redeployments realized from the narcotics program realignment, 67 FTE will be used in the Fraud Referral Program and 18 FTE will be used in the Money Laundering Strategy Program.

- *Reduced Tax Court Cases.* The number of cases filed in the Tax Court is declining. Emphasis on pre-filing resolution of cases through programs such as Advance Pricing Agreements is also expected to moderate increases in Tax Court litigation in the future, as well as Refund and Appellate litigation.

Targeted Efficiency Improvements (Redeployment of $39M)

Redeployment is expected from the Treasury's approach to better business practices to remove or reduce current efforts that do not have significant programmatic value. This is targeted to produce $39 million in redeployments.

MAINTAIN CURRENT OPERATIONS

The IRS is still a labor-intensive organization and a stable work force is critical to carrying out our mission. We must maintain current operations, protect the integrity of the tax filing season, oversee tax administration programs and continue to implement organizational modernization. To do so, the IRS must have the resources to pay for the inflationary costs associated with statutory pay and other mandatory increases described below .

- *Maintaining Current Services Level (+$295 M).* Needed to maintain FY 2002 program levels in FY 2003 by funding pay, benefits, and non-labor inflationary costs.

- *Within-Grade Increases (+$37M).* To cover the costs of within-grade pay increases for on-board employees.

- *Homeland Security (+$10M).* For the enhanced security arrangements required by the Homeland Security supplemental. These funds were appropriated as a consequence of the September 11, 2001 terrorist attacks and other related security concerns.

- *Homeland Security Non-Recur (-$31M).* Funding in the amount of $31 million from the FY 2002 will be non-recurred in the FY 2003 budget.

EARNED INCOME TAX CREDIT INITIATIVES

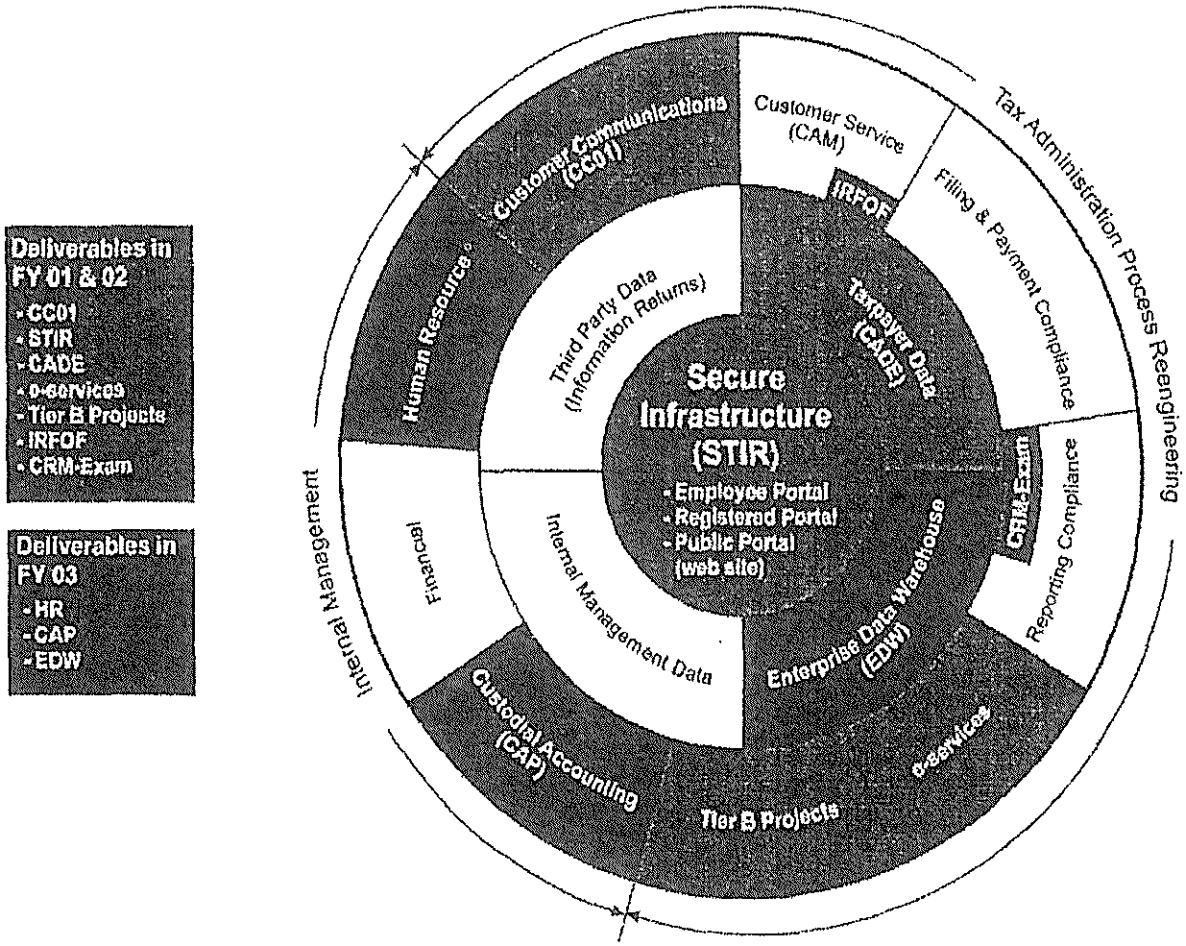
In FY 2003, funding requirements for the Earned Income Tax Credit (EITC) Compliance Initiative Appropriation are projected to be $154,346,000, an increase of $406,000 over the FY 2002 funding level of $153,940,000. The FTE level of 2,353 is unchanged from FY 2002.

This appropriation provides for customer service and public outreach programs, enforcement activities and research efforts to reduce overclaims and erroneous filings associated with the EITC.

IRS WILL MEET 76% OF NEEDS FOR INCREASED SERVICE AND COMPLIANCE FROM INCREASED PRODUCTIVITY AND COST SAVINGS IN FY 2003

	Dollars (In millions)	FTEs
Highest Priority Resource Needs		
Compliance	$125	1,857
Customer Service and Workload Increases	91	1,595
Contract Services	44	0
Total Highest Priority Needs	**$259**	**3,452**
Less Redeployed Resources and Adjustments		
Reapplication of Efficiencies and Workload Savings	$157	2,287
Targeted Cost Savings	39	0
Total Resource Reapplications and Adjustments	**$196**	**2,287**
Total Increase	**$259**	**3,452**
New Funding Requested	**$63**	**1,165**
Percent of Needs Met through Budget Request	**24%**	
Percent of Needs Met through Productivity and Savings	**76%**	

IRS BUSINESS SYSTEMS MODERNIZATION IS DELIVERING KEY BUILDING BLOCKS IN FY 02 AND FY 03



Deliverables in FY 01 & 02
- CC01
- STIR
- CADE
- e-services
- Tier B Projects
- IRFOF
- CRM-Exam

Deliverables in FY 03
- HR
- CAP
- EDW

Senator CONRAD. Now we will hear from Larry Levitan, the chairman of the IRS Oversight Board. Welcome. Please proceed with your testimony.

STATEMENT OF HON. LARRY LEVITAN, CHAIRMAN, IRS OVERSIGHT BOARD, WASHINGTON, DC

Mr. LEVITAN. Mr. Chairman and members of the Joint Committee, thank you for holding this hearing and inviting me to testify.

Mr. Chairman, the IRS is far from a perfect agency, but, as shown in the charts that you had earlier, it is making significant progress in improving itself.

The Oversight Board oversees the IRS in accordance with the responsibilities assigned to it in RRA 1998. These duties closely resemble those of a corporate board of directors, but are tailored to fit a public sector organization.

Carrying out these duties requires that the Oversight Board focuses attention on key strategic issues that can really make a difference in the long term.

Our governance efforts fall into three major categories: strategic planning, budgeting, and performance monitoring.

After reviewing the IRS's strategic plan and getting external stakeholder comments, the Oversight Board approved the IRS strategic plan and believes it is an excellent plan. The challenge is not in the planning, but in the execution of that plan.

The Board's process is more extensive than the approval of a formal plan. The Board is focused on establishing a strategic planning process and a discipline linked to critical functions such as budget formulation, executive evaluation, performance management, and operational planning. Ensuring the appropriate linkages and alignment among these efforts is critical to the successful implementation of the strategic plan.

Probably the most critical challenge that both the IRS and the Board faces this year, is finding a new Commissioner as Charles Rossotti completes his five-year term. RRA 1998 requires the Oversight Board to recommend candidates to the President for the position of IRS Commissioner.

The Oversight Board has exercised this responsibility by partnering with the Treasury Department to develop a position and candidate specifications describing the qualifications needed, and hiring a search firm to identify qualified candidates.

The Oversight Board believes the next Commissioner must have the experience and competence necessary to ensure that the IRS continues the transformation that was started under Commissioner Rossotti's leadership.

Mr. Chairman, last year I reported that the President's fiscal year 2002 budget did not adequately support the IRS's strategic plan and failed to provide enough funding for technology modernization and other vital operations.

Although much of the difference in budget requests was related to systems modernization, there was a difference of $138 million for IRS operations. This funding would have provided for 1,300 additional FTEs that would have directly impacted the IRS's ability to

implement its strategy of immediately improving customer service and enforcement levels.

In retrospect, I believe our judgment last year was correct. Neither the IRS nor the Oversight Board is satisfied with the state of the IRS's performance. Enforcement activity has fallen for many years, while at the same time several areas of non-compliance are troublesome and need more attention.

My written statement includes some examples, such as K–1 matching and offshore credit cards. The Board does not believe that the IRS will have adequate resources to follow up on many of the cases that are identified by these new programs.

During the formulation of the fiscal year 2003 budget, the Board worked closely with the Department of Treasury. Nonetheless, the Board's recommended 2003 budget is $92 million higher than the administration's proposed budget.

Because of emerging issues, the Oversight Board is now concerned that the administration's 2003 budget will not allow the IRS to make progress in enforcement activities that are necessary.

Our greatest concern is a potential $70 million negative adjustment to the IRS budget for a 4.1 percent pay raise for federal civilian employees. The Board urges Congress to fund any pay raises over the 2.6 percent proposed in the President's budget.

Collecting taxes is a thankless job, and stories of failing resources at the IRS seem to strike a sympathetic ear among taxpayers. However, the reality is much different. Honest taxpayers across the country—and they are in the vast majority—must pick up the tab for those taxpayers that cheat.

An IRS that can enforce the tax laws fairly for all serves honest taxpayers by ensuring all taxpayers are paying what they owe in accordance with the tax laws passed by Congress.

Let me close by also thanking Commissioner Rossotti for the outstanding job he has done during the past five years. We believe the country owes him a debt of gratitude for public service he has given us during this period.

Thank you.

Senator CONRAD. Thank you, Mr. Levitan, for that very strong testimony. And thank you for the role that you play. Congress wanted this Oversight Board so that we had an independent look at what was occurring, and you have certainly provided that. For that, we are grateful.

[The prepared statement of Mr. Levitan follows:]

Statement of Larry Levitan
Chairman, IRS Oversight Board

Testimony Before the Joint Committee on Taxation

Joint Hearing on the Strategic Plans and Budget of the IRS

May 14, 2002

Mr. Chairman, and members of the Joint Committee, thank you for holding this hearing and inviting me to testify. It is an honor for me to appear before your committee today on behalf of the IRS Oversight Board and to discuss the IRS' performance and the importance of the IRS Restructuring and Reform Act of 1998 (RRA 98).

On June 25th we will mark the fifth anniversary of the report of the National Commission on Restructuring the IRS, *A Vision for a New IRS*. This report led directly to the passage of RRA 98, which has changed the IRS for the better in many important ways. Let me offer the following examples:

- Commissioner Rossotti will complete the first five-year term for an IRS Commissioner in November 2002. This term, specified by RRA 98, has added stability to the position of IRS Commissioner.
- The IRS has been reorganized into four divisions, each of which is responsible for a specific segment of taxpayers, as specified in RRA 98.
- The IRS has brought over 30 outside hires with private sector experience into its executive ranks as a result of personnel flexibilities provided by RRA 98
- The IRS Oversight Board was established in September 2000 and is bringing stability, expertise, and accountability into the governance of the IRS. The Board's most significant challenges still lie ahead, however.
- Thanks to the goals established in RRA 98 for the electronic filing of tax returns, almost one of three Form 1040s was filed electronically during the last tax season.
- Taxpayers have enjoyed new rights in many areas, including innocent spouse protections, offers in compromise, and collection due process.
- The role of the National Taxpayer Advocate has been strengthened considerably.
- Low-Income Tax Clinics have been promoted to help the most needy of taxpayers seek relief from their tax problems.

Overall, RRA 98 has brought an excellent record of accomplishment towards establishing the vision for the new IRS articulated by the IRS Restructuring Commission. However, although RRA 98 has started us down the right path, let me caution that there is still a long way to go. The vision is in place, the IRS has developed a strategic plan to achieve the vision, but

implementation is still in its infancy and the IRS faces some formidable challenges to fully implement its plan.

Mr. Chairman, the IRS is far from a perfect agency, but it is making progress in improving itself. What is particularly important is that the IRS is beginning to use best practices that will enable it to continue to make progress if it can successfully implement what it is planning. Let me briefly summarize the current state of the IRS.

In its 2001 Annual Report, the Oversight Board reported that the IRS is still not effectively and efficiently serving the needs of the American taxpayers, although it has made significant progress since 1997. Customer service, although improved, has not risen to desired levels and enforcement activity has fallen for many years. These problems are compounded by outmoded computer systems that handicap IRS workers and prevent the delivery of effective service. It is not surprising that this environment has resulted in dissatisfied taxpayers, inadequate job satisfaction among IRS employees and difficulty in achieving improved performance.

On the positive side, the IRS is making progress and has put in place several key elements that establish a foundation for further progress. Under Commissioner Rossotti's leadership, the IRS has made major strides in the last few years. A well-formulated, high quality strategic management and planning process has been put in place. The Board has high praise for the IRS strategic assessment process implemented as part of the budget and performance plan formulation activities. Balanced measures are also being implemented across the IRS. Other key elements that form the foundation for further progress include a major reorganization designed to better focus on customer needs and provide clear accountability, a strengthened senior management team, and a business systems modernization program that will eventually provide modern business processes and tools for employees and taxpayers. The entire modernization effort is being conducted in accordance with a strategic plan that has been approved by the Oversight Board, and monitored by balanced performance measures that will provide Congress, the Administration, the Oversight Board and other stakeholders a quantitative means to evaluate progress.

The RRA 98 assigns the Oversight Board the responsibility for overseeing the IRS in its administration, management, conduct, direction and supervision of the execution and application of the internal revenue laws. These duties closely resemble those of a corporate board of directors, but tailored to fit a public sector organization.

Carrying out these duties in light of the IRS' many challenges requires that the Oversight Board focus its attention on key strategic issues that can really make a difference in the long term. I would characterize the Oversight governance efforts into three major categories: strategic planning, budgeting, and performance monitoring.

Strategic Planning

RRA 98 assigns the IRS Oversight Board responsibility to review and approve the IRS strategic plans, and ensuring that IRS budget requests support its annual and long range strategic plans. In 2001 the Oversight Board reviewed the IRS' Strategic Plan and, to obtain an independent review,

held a public meeting in March 2001 with IRS external stakeholders to obtain their comments on the Strategic Plan. Subsequently, the Oversight Board approved the IRS' Strategic Plan.

However, the strategic planning process is more extensive then the approval of a formal Strategic Plan. The Board is focused on establishing a strategic planning process and discipline linked to critical functions such as budget formulation, executive evaluation, performance management, and operational planning. Ensuring the appropriate linkages and alignment among these efforts is critical to successful implementation of the Strategic Plan. By its nature, the value of the strategic plan is to guide overall efforts, so the Oversight Board concentrates on ensuring that IRS programs are consistent with the strategic plan. This is analogous to the way a corporate board of directors functions in the private sector.

The Oversight Board is currently participating in the IRS' annual strategic assessment process, which provides an annual assessment on IRS' strategic needs. This activity leads to resource allocation among IRS functions and formulation of the FY2004 budget request.

Another function of strategic planning is executive succession planning. The most important task the Oversight Board must perform this year is to help identify candidates to replace Commissioner Rossotti.

RRA 98 requires the Oversight Board to recommend candidates to the President for the position of IRS Commissioner. The Oversight Board has exercised this responsibility by partnering with the Treasury Department to develop a Position and Candidate Specification describing the qualifications needed and hiring a search firm to identify qualified candidates.

The Oversight Board believes the next Commissioner must have the experience and competence necessary to ensure that the IRS continues its transformation to an organization focused on customer service driven by quantity and quality measures, and must be able to chart a steady course to balance calls for increased compliance and additional customer service, all within limited resources.

Qualified candidates must be CEO caliber executives with relevant operational experience, preferably gained within an intensive information processing and customer-service environment. Candidates must understand the leadership challenges of managing a 100,000 person organization. Qualified candidates must also possess credibility and stature, with a reputation for being a strong leader and manager, and having been an effective change agent. Additionally, candidates must be broad-based functionally, and be particularly adept at providing operational and technology leadership.

Budgeting

Mr. Chairman, last year I reported to the Joint Committee that the Oversight Board concluded that the President's Fiscal Year 2002 budget did not adequately support the IRS Strategic Plan and failed to provide enough funding for technology modernization and other vital operations. The Oversight Board based this conclusion on its collective business and professional expertise,

drawn from years of managing major corporations, small businesses, and information technology programs.

Although much of the difference in budget requests was related to systems modernization, there was a difference of $138 million for IRS operations. This funding would have provided for 1300 additional FTEs that would have been applied to the Staffing Tax Administration for Balance and Equity (STABLE) program, and would have directly impacted the IRS' ability to implement its strategy of immediately improving customer service and enforcement levels.

In retrospect, I believe our judgement was correct. Neither the IRS nor the Oversight Board is satisfied with the state of the IRS' performance as reported in the Oversight Board's 2001 Annual Report. As I mentioned earlier, enforcement activity has fallen for many years, while at the same time, several areas of noncompliance are troublesome and need attention. Let me provide some examples. The IRS is just starting to match pass-through income reported on Form K-1 to individual tax returns. The IRS estimates that perhaps $100 billion of pass-through income is unreported every year. Another example of an emerging compliance problem is offshore credit cards, which can be used to hide spending and income from the IRS. While programs are now being introduced to identify these problems, the Board does not believe that the IRS will have adequate resources to follow up on many of the cases that are identified.

During the formulation of the FY2003 budget, the Board worked very closely with the Department of Treasury. The Board's recommended FY2003 budget is $92 million higher then the Administration's proposed budget.

Because of emerging issues, the Oversight Board is now concerned that the Administration's proposed FY2003 budget will not allow the IRS to make the progress in enforcement activity that was envisioned when the Oversight Board approved this budget in August 2001. Several factors cause this growing concern:

- The cost of postage in FY2003 will be $41 million more than was originally planned.
- Additional security measures have been implemented at an expense of $19.5 million for guard services and $15 million for campus security because of needs to provide for greater security for IRS offices and especially our mail handling centers in the aftermath of the 9/11 tragedy.
- The unfunded portion of the calendar year 2002 pay raise for federal civilian employees will add $43.5 million in costs in FY2003.

The greatest concern, however, is a potential $70 million negative adjustment to the IRS budget for a 4.1 percent pay raise in calendar year 2003 for federal civilian employees. If the IRS must absorb the difference between the proposed 2.6 percent pay raise and the higher pay raise Congress is considering, the impact will be to prevent the IRS from hiring 800 enforcement personnel at a time when enforcement resources are faced with many challenges. The Oversight Board urges Congress to fund any pay raise over the 2.6 percent proposed in the President's budget. These negative impacts virtually eliminate any FTE gains envisioned as part of the STABLE initiative.

The impact of these reductions affects enforcement in a very direct way. The IRS budget is labor-intensive, with 70 percent of its budget for people. Moreover, its processes are also labor-intensive, and encompass a range of activity from processing every business and individual return filed each tax year, to the identification and resolution of individual cases. Some of this activity, such as processing of all returns, is mandatory. Discretionary activity is primarily the identification and resolution of individual cases. When resources are tight, it is the discretionary activity that suffers—audit rates fall and collection activity decreases.

Collecting taxes is a thankless job, and stories of falling resources at the IRS seem to strike a sympathetic ear among taxpayers. However, the reality is much different. Honest taxpayers across the country, and they are in the vast majority, must pick up the tab for those taxpayers that cheat. An IRS that can enforce the tax laws fairly for all serves honest taxpayers by ensuring all taxpayers are paying what they owe in accordance with the tax laws passed by Congress. I don't believe that Congress wants some taxpayers helping themselves to a de facto tax cut by cheating.

Performance Monitoring

The bottom line for the Oversight Board, as is the case for private sector boards of directors, is improved performance of the organization it is governing. As such, the Oversight Board has the responsibility of helping the IRS improve its performance. There are two aspects of this process, organizational performance and executive performance, and one objective of the Oversight Board is to ensure they are linked.

The Board has recently implemented quarterly reviews of IRS performance that focuses on three dimensions of improvement: productivity (including timeliness and quality), customer satisfaction, and employee satisfaction. In our annual report, the Board noted the deficiencies in telephone service. Progress is being made in this area and the IRS is beginning to see positive results. For example, we have seen some significant improvements in timeliness and quality of IRS telephone service over the last few years, particularly in the opening months of the 2002 filing season. Although progress is being made, it is slower in some areas. In some cases, the full range of balanced measures are in the development stage. Others have only recently established baselines. Quality levels at IRS walk-in sites are just being baselined and need attention. Because of the link between employee and taxpayer satisfaction, employee satisfaction levels for these and other operations also need improvement.

The Oversight Board is concerned that the broad decline in enforcement activity increases our reliance on voluntary compliance, and fears that the public's attitude towards voluntary compliance is beginning to erode. Because of this concern, the Oversight Board initiated a survey to obtain data on taxpayers' attitudes regarding their obligations to report and pay their fair share of taxes. The survey, taken in August 2001, asked two questions from an earlier 1999 IRS survey and three new questions.

The survey results are included in the annual report, but the most troubling result was in response to a question that asked how much, if any, do you think is an acceptable amount to cheat on your income taxes. In 1999, 87 percent of the respondents replied "not at all." In 2001, the percentage of respondents who selected that answer fell to 76 percent. In short, one fourth of US citizens

believe it is okay to cheat on their taxes. The Oversight Board intends to repeat the survey in 2002 using the same questions.

The other part of performance monitoring is reviewing the performance of IRS executives. The Oversight Board has established a process for reviewing the selection, evaluation, and compensation of senior IRS executives. It initiated this activity in October 2001 by developing a process and reviewing the proposed evaluation and compensation of senior IRS executives for FY2001. It is now extending that process to a more general process that will be used in FY2002 and subsequent years. This process will review IRS executive performance agreements and year-end evaluations and compensation to ensure they are aligned with the performance plans and results of the operating divisions managed by the reviewed executives.

The long-range solution to improve the IRS' performance is to modernize its business processes and information technology. The IRS' Business Systems Modernization (BSM) program is designed to transform both IRS' business processes and information technology into modern, efficient processes and systems that incorporate world-class best practices. The BSM program has been progressing slowly, limited primarily by the IRS' capacity to manage the program. Efforts from inception to date have focused on establishing an enterprise life cycle, a standard architecture, and low-risk projects. In 2002, however, several major deliverables are scheduled, and the upcoming year will be a test of the IRS' ability to manage this program.

The longer it takes the IRS to modernize, the longer taxpayers will be deprived of the benefits of improved IRS processes and systems, and be forced to endure the inadequacies of the antiquated systems in place today. Even under the best of circumstances, it will take the IRS far too long to complete its modernization program. The Oversight Board recommends that BSM be accomplished as quickly as possible, consistent with the IRS' ability to manage the program and absorb change. The private sector has already learned that accomplishing programs in as short a period as practical actually lessens overall cost and risk. To successfully implement the modernization program, all organizations involved in BSM must do a better job. The Oversight Board's recommendations for key organizations include:

- The IRS must improve its program management ability, work more effectively with the PRIME Contractor, and manage/implement change more effectively.

- The PRIME Contractor must understand and achieve its responsibilities to deliver business results within budget and on schedule and improve its breadth and depth of skills.

- The Administration must understand the importance and critical nature of the situation, support the long-term plan, including increased investment levels, and hold the IRS responsible for meeting the plan.

- The Congress must accomplish the same tasks as the Administration, and, in addition, speed up the process for review and release of BSM funding.

The Oversight Board recognizes that the IRS still has a long way to go to reach the level of performance envisioned by both the IRS Restructuring Commission and the IRS Restructuring

and Reform Act. However, failure to provide adequate funding will deprive the IRS of resources it needs to make improvements in customer service and compliance.

Let me conclude my testimony by recognizing the contribution of Commissioner Charles Rossotti. During his five-year tenure Commissioner Rossotti has provided the IRS with the leadership it needed as it went through the most dramatic change in its history. The changes he implemented while Commissioner will have a positive impact on the IRS for many years into the future. His accomplishments have placed the IRS on the right track to provide top-quality service and fairness to all taxpayers, and he should be commended for what he has done to transform the IRS into a performance-based organization. We believe the country owes him a debt of gratitude for the public service he has given us in the last five years.

Senator CONRAD. Next, we have Mr. David Williams, who is the Inspector General of the Treasury Department.

Let me indicate that a vote has started on the Senate floor. It just started, so we have got about 14 minutes left. My intention is that we will have Mr. Williams complete his testimony, and then those of us that have to go to the floor to vote will do that. Then we will continue with Mr. White.

Mr. Williams, welcome.

STATEMENT OF HON. DAVID C. WILLIAMS, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, WASHINGTON, DC

Mr. WILLIAMS. Thank you, Mr. Chairman and members of the committees. I appreciate the opportunity to appear before you today to discuss the changes and reforms that have taken place at the IRS since the passage of the IRS Restructuring and Reform Act of 1998.

In 1998, the IRS undertook a course of dramatic change. These changes were prompted both by issues that the Congress identified in a series of hearings, and through opportunities imagined by the new Commissioner and the Secretary of Treasury, who worked closely with key congressional committees.

The changes consisted of reforms, fundamental organizational design alterations, and a desperately needed modernization plan for the IRS's outmoded computer systems.

The organizational design plan would take the IRS from an old line governmental hierarchy to a modern, customer-focused organization. The forms were designed to address taxpayers rights and to strike at abuses. The modernization effort was to catch up with technology to support the emerging organization in an imaginative fashion.

These important and fundamental changes faced serious challenges. The culture of the organization for good and bad reasons, was very resistant to sudden change. Second, these decisive changes needed to occur within an organization that was nearly blinded by a lack of management information systems, meaningful research capacity, and performance metrics.

Thus far, the early course of the reforms have had successes: a comprehensive strategy for the future was constructed and a broad-fronted implementation plan was set in motion.

Through this effort, problems were honestly identified and solutions constructed. Also, I believe that credibility was restored and a positive, constructive relationship was established between the agency and the Congress, largely as a result of the efforts and leadership of the Commissioner.

During his tenure, the IRS succeeded in achieving an unbroken record of successful filing seasons, despite a growing workload. However, some of the change initiatives stalled and others have occurred at an agonizingly slow pace.

For example, enforcement actions against individuals and businesses that purposefully conceal tax liabilities, or even refuse to submit tax returns, have fallen dramatically, despite concerns that tax cheating remains at high levels. Also, customer service, especially in the area of tax law guidance, needs major improvement.

The IRS has made progress in modernization of its information technology systems and some benefits to taxpayers have been delivered, such as improvements in the capacity to handle and route taxpayer telephone calls.

However, most modernization projects have experienced cost and schedule overruns and have delivered less than expected. These setbacks are particularly threatening in light of the fact that so many other reforms are dependent on modernization of the computer systems.

In addition, computer security has often taken a back seat to other priorities and has left the quest for adequate security levels a distant one.

TIGTA's audits and investigations indicate that, despite some impressive recent progress, the IRS is still vulnerable to outside hackers and internal abuse.

For example, TIGTA has identified significant weaknesses in controls over external access to Internet gateways and weaknesses to the IRS network operating systems.

In addition, during fiscal year 2001, TIGTA conducted 446 investigations of IRS employees improperly accessing confidential tax information.

In regard to the reform efforts outlined in RRA 1998, there were 71 provisions that impacted taxpayer rights. TIGTA auditors have assessed the IRS's compliance with 22 taxpayer rights provisions and found that the IRS has fully implemented 3 provisions, and is generally compliant with 2 additional provisions.

Notable RRA 1998 provisions that have not been fully implemented include informing taxpayers of their rights when liens or levies are planned; providing notices of tax liabilities to each spouse noted in a joint return; and ensuring that collection statute extensions are only obtained with an installment agreement or levy release.

These issues were among those that served as the impetus for reform legislation, and TIGTA believes the taxpayer rights provisions are important and will continue to oversee the IRS's efforts to comply. Encouragingly, allegations of 1203 violations have dropped significantly.

In closing, I would like to say that the IRS is now entering a very challenging period. Much of the IRS's progress and credibility and unwavering march toward reform is attributed to the leadership of the Commissioner, whose term will expire in November.

It is particularly essential that his replacement continue his legacy and possess outstanding qualifications as a change manager and reformer.

Thank you.

Senator CONRAD. Thank you very much for that excellent testimony.

[The prepared statement of Mr. Williams follows:]

JOINT HEARING BEFORE THE COMMITTEES OF THE

UNITED STATES SENATE

AND

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 14, 2002

"THE STRATEGIC PLANS AND BUDGET OF THE IRS"

STATEMENT FOR THE RECORD

DAVID C. WILLIAMS
INSPECTOR GENERAL
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Mr. Chairman and Members of the Committees, I appreciate the opportunity to appear before you today to discuss the progress made by the Internal Revenue Service (IRS) in complying with the IRS Restructuring and Reform Act of 1998 (RRA 98). My comments will also address several significant challenges facing the IRS including its ability to modernize computer systems, improve customer service and increase productivity.

The mission of the IRS is critical. It processes over 233 million tax returns and collects over $2 trillion annually to fund the nation's government. The IRS also implements tax law changes and must enforce tax laws to ensure that the taxpaying public pays the proper amount of tax. To accomplish these responsibilities, the IRS relies on extensive computer-processed data. Substantial damage to IRS computer systems security, and employee safety or security can cause disruption in tax administration and adversely affect the United States economy.

In 1998, the IRS undertook a course of dramatic change. The changes were prompted both by issues the Congress identified in a series of hearings and through opportunities imagined by the new Commissioner and the Secretary of Treasury who worked closely with key congressional committees. The changes consisted of reforms, fundamental organizational design alterations and a desperately needed modernization plan for the IRS' outmoded computer systems. The organizational design plan would take the IRS from an old-line governmental hierarchy to a modern customer-focused organization. The reforms were designed to address taxpayer rights and to strike at abuses. The business modernization was to catch up with technology and to support the emerging organization in an imaginative fashion.

These important and fundamental changes faced serious challenges. The culture of the organization, for good and for bad reasons, was very resistant to sudden change. Secondly, decisive changes needed to occur despite the fact that the organization was nearly blinded by a lack of management information systems, meaningful research capacity or performance metrics. The early course of the changes, to date, has had some success. A comprehensive strategy for the future was constructed and a broad fronted implementation plan was set in motion. Through this effort, problems were honestly identified and solutions were constructed. Also, credibility was restored and a positive and constructive relationship was established between the agency and the Congress, largely as a result of the efforts and leadership of the Commissioner. The IRS succeeded in achieving an unbroken record of successful filing seasons, despite a growing workload and fewer resources. However, the changes did not repair all of the problems and some of the changes have occurred at an agonizingly slow pace.

The IRS has made substantial progress on one front. TIGTA audits showed that all four IRS business units substantially completed the five critical elements needed for putting into effect (or standing up) their respective organizational structures. Although the IRS has reorganized structurally, additional actions are needed in the areas of staffing and modernization initiatives. For example, the Government Entities (GE) organization, although officially created in December 1999, is still trying to reach its projected optimal staffing levels. Responsible IRS executives have expressed concerns with the resource levels and acknowledged that the full implementation and establishment of the GE organization is being delayed through Fiscal Year (FY) 2003. As a result of the resource limitations, the GE organization is still in the process of identifying its customers and their unique customer service issues. The Taxpayer Education and Communication organization within the Small Business/Self-Employed operating division is also only at two-thirds of its projected staffing level.

TIGTA has also expressed concerns as to the IRS' ability to address taxpayer issues involving more than one operating unit. During FY 2001, TIGTA reported the need for the IRS to coordinate among its functional areas to implement the IRS-wide workforce-planning model that would identify strategic workforce requirements and be used in developing the strategic plan and budget. TIGTA also identified other reorganization/human resource issues including program managers that did not have direct control over field employees in another IRS functional area. For example, the lack of direct workload control in the Innocent Spouse Program contributed to significant inventory backlog and the possibility of misdirected program resources, inaccurate measurement of program accomplishments and reporting of inaccurate program results.

Filing Season

Many programs, activities and resources have to be planned and managed effectively for the IRS filing season to be successful. For the 2002 filing season, TIGTA determined that the IRS appropriately addressed significant issues prior to commencement of the filing season. Specifically, tax law changes emanating from the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Taxpayer Relief Act of 1997 were implemented. This included updating computer systems, revising the Internal Revenue Manual (IRM) and preparing training materials for employees.

IRS data show that, overall, the 2002 filing season has been successful. Through April 19, 2002, the IRS received approximately 118 million returns and processed approximately 89 million tax returns. Approximately 46 million of these returns were filed electronically, up from approximately 40 million electronic returns received during last year's filing season. The average dollar amount of refunds issued was $1,937 up from an average refund amount of $1,714 last year. In addition, the number of refunds deposited directly into taxpayers' accounts increased by nearly 17 percent from this same time last year.

Business Systems Modernization

The IRS has made progress in modernizing its systems, but at a much slower pace than originally planned. For example, some benefits to taxpayers have been delivered, such as improvements in the capacity to handle and route taxpayers' telephone calls. In addition, the IRS has continued to increase the level of detail in its Enterprise Architecture blueprint, which will help guide the modernization as it progresses. However, most modernization projects have experienced cost and schedule overruns and have delivered less than expected. These setbacks are particularly threatening in light of the fact that so many other reforms are dependent on modernized computer systems.

TIGTA has seen some improvements in the management of systems modernization, particularly in the recognition of deficiencies that need to be addressed, and in the formulation of plans or steps to address the deficiencies. The IRS Business System Modernization Office has taken steps to improve processes such as configuration management, risk management, schedule and cost estimation, requirements management, and quality assurance. Holding the PRIME contractor accountable will be another critical success factor in the modernization effort. To that end, the IRS is becoming more proactive in requiring certain types of skills at the highest levels in the PRIME organization. This essential step is coming late in the overall business modernization initiative and the Chief Information Officer has had to take remedial action.

TIGTA has not yet seen major improvements in the actual implementation of these actions at the project level. Lessons learned in previous projects are not being consistently applied to other projects that are experiencing the same issues or problems. It appears that the project teams are still focused on trying to meet promised delivery dates rather than implementing improvements in the development processes. The IRS will have invested approximately $1 billion in systems modernization by the end of 2002. Several major deliverables are planned for later this year or early next year, including the first iteration of replacing the antiquated taxpayer account master file. If weaknesses in management disciplines are not overcome in the next several months, these deliverables could be in jeopardy.

Security of the IRS

The terrorist attacks on September 11, 2001, and the subsequent anthrax scares highlighted new vulnerabilities in many businesses and government agencies. Although the IRS has traditionally been security conscious because of the very nature of its work, security of IRS employees, facilities, and information systems is now considered a major challenge facing IRS management.

Employees and Facilities - The IRS has long recognized that physical threats to its employees and infrastructure could be detrimental to tax administration and had developed disaster recovery plans. However, these plans generally addressed the risk of only one site shutting down and did not address the potential loss of key personnel. The terrorist attacks of September 11 and subsequent anthrax hoax mailings and bomb threats to IRS facilities caused the IRS to realize that multiple sites could go down simultaneously. Since the terrorist attacks of September 11, TIGTA has investigated a total of 56 incidents involving suspicious biological or chemical substances identified or received at an IRS lockbox or facility. TIGTA special agents have arrested 2 individuals in separate cases involving anthrax hoax mailings to IRS facilities.

Since September 11, the IRS has worked to gain an understanding of, and plan for, these new risks. A new high-level committee headed by the Deputy Commissioner has been convened to focus on security issues. The committee took swift actions to mitigate the threat of bio-terrorism during the current tax-filing season at its major processing centers. For example, mail opening and sorting processes were relocated away from IRS main facilities, security screening of persons was heightened, and vehicles were inspected more thoroughly. In addition to these short-term actions, the IRS is developing plans to combat terrorism and maintain continuity of operations going forward. Completing these actions is important because the IRS is the nation's primary revenue collector and any disruption of collection activities could have a detrimental effect on the economy.

TIGTA continues to participate in IRS security efforts to combat terrorism. TIGTA meets daily with the Federal Bureau of Investigation (FBI) to stay abreast of new threats and is acting as the primary conduit of threat information to the IRS. Although it received no supplemental funding to do so, TIGTA participates in dozens of FBI Joint Terrorism Task Forces around the country. TIGTA has also created a headquarters unit to coordinate investigations and to be a centralized repository and dissemination point of threat information to the IRS. TIGTA, and its predecessor agency, the IRS Inspection Service, has a 50-year history of investigating threats to the IRS and its employees. Since October 1998, TIGTA's Office of Investigations (OI) has completed an average of 675 investigations each year involving written or oral threats directed at the IRS or its employees. For example, five individuals were recently charged in connection with an arson at an IRS office. TIGTA's Office of Audit is also working in coordination with the General Accounting Office to provide a comprehensive evaluation of IRS security initiatives. Interim briefings are being provided to interested congressional groups.

Information Systems – Another consequence of the organizational redesign has been that computer security has often taken a back seat to other priorities and has left the quest for adequate security levels a distant one. TIGTA's recent

audits and investigations indicate that, despite some impressive recent progress, the IRS is still vulnerable to outside hackers and to internal abuses. TIGTA identified significant weaknesses in controls over external access to Internet gateways, and weaknesses in the IRS' network operating system controls, physical security, and systems access privileges. In addition, 68 percent of the IRS sensitive information systems have not been certified as meeting the minimum security standards outlined by the Department of Treasury.

Since October 1997, TIGTA's OI has investigated an average of 425 cases per year involving IRS employees who have allegedly improperly accessed confidential taxpayer information. For the same period, 78 IRS employees have been prosecuted and another 515 employees have been removed or resigned for misusing taxpayer information. Unauthorized accesses to tax information (UNAX) violations continue despite training and knowledge of criminal penalties.

TIGTA attributes these computer security weaknesses to:

- Policies and procedures to address most aspects of security have often been ineffectively implemented.

- A reluctance of functional managers to take responsibility for the security of the systems they operate. The CIO's Office of Security has primary accountability, contrary to Office of Management and Budget policy and law, which states that functional managers are responsible for the security of the systems they operate.

- Many IRS employees with key security responsibilities do not have the requisite knowledge and skills.

- Many IRS employees are not aware of security risks and their attendant responsibilities. For example, posing as Help Desk employees, we telephonically contacted 100 employees and asked them to temporarily change their password to one that we had created. Of the 100 employees contacted, 71 agreed to compromise their password. This means that rank and file IRS employees and managers are potentially the weakest link in protecting the security of IRS computer systems and data.

Although aggressive actions discussed previously have been taken or initiated to address the security risks posed by terrorism, the IRS needs to address the weaknesses cited above to reduce the risk of data loss, theft or unauthorized disclosure of taxpayer information.

Tax Compliance Efforts

The IRS' goal of providing world-class service to taxpayers hinges on the theory that, if the IRS provides the right mix of education, support, and up-front problem solving to taxpayers, the overall rate of voluntary compliance with the tax laws will increase. The compliance program (examining tax returns and collecting tax liabilities) would then address those taxpayers who purposefully did not comply. The challenge to the IRS management is to establish a tax compliance program that identifies those citizens who do not meet their tax obligations, either by not paying the correct amount of tax or not filing proper tax returns.

Enforcement actions against individuals and businesses that purposefully conceal tax liabilities or even refuse to submit tax returns have fallen dramatically low, despite concerns that tax cheating remains at high levels. The following chart exhibits the fact that, since FY 1996, the level of IRS enforcement activities has significantly declined.

Enforcement Action	Overall Decline FY 1996 - FY 2001
Face-to-Face Audits	72%
Correspondence Audits	56%
Liens	43%
Levies	86%
Seizures	98%

The overall decline in enforcement actions has been primarily attributed to a long-term reduction in enforcement staffing, to redirection of resources to customer service functions during the filing season, a decline in direct examination time, and to IRS employees' concerns over the mandatory termination provision in Section 1203 of RRA 98.

IRS management and many stakeholders have been concerned about the decline in enforcement activities. However, the IRS has not conducted Taxpayer Compliance Measurement Program audits since 1988. Therefore, it currently has no reliable method to measure voluntary compliance or the effect that increased customer service and diversion of compliance resources are having on voluntary compliance. TIGTA believes that the planned National Research Program is a much-needed first step for providing the information necessary to gauge compliance levels and direct IRS compliance resources towards areas where attention is most needed.

Customer Service

Customer service, especially in the area of tax law guidance, needs major improvement. When taxpayers have a problem with their account or need assistance in interpreting tax laws they have two primary vehicles for contacting

the IRS. They can speak with an IRS representative either in person at one of the IRS' 414 Taxpayer Assistance Centers (TAC) or over the telephone. During this year, TIGTA assessed the service provided by representatives at the IRS' TACs and through its Toll-Free Telephone System. Customer service continues to be below expectations and the IRS still has several challenges ahead before it reaches the world-class level of service it strives to deliver. During our review of the TACs, TIGTA personnel visited 77 centers and posed 314 questions to IRS representatives. Results of our review are synopsized in the following chart:

	Response Rate	Percentage
Correct Answers	158	50
Incorrect Answers	91	29
No Answer Provided – Referred to Publication In Lieu of a Response	63	20
Service Denied	2	<1

The IRS' performance on the Toll-Free side was relatively better. Our reviewers performed on-line monitoring of 736 taxpayer calls and determined that the IRS representative correctly answered the taxpayer's question in 78 percent of the cases.

IRS Performance Measures

In the past year, TIGTA has conducted reviews of the IRS' business results measures and found that the IRS' critical performance measures do not address all of the major components of tax administration. The IRS' performance measures were selected due to their direct relation to the taxpaying public. This emphasis by the IRS on serving the taxpayer has resulted in a December 2001 customer satisfaction rating report which showed that the IRS' customer satisfaction rating has increased by 22 percentage points over the last 2 years. While we do not discount the IRS' emphasis on customer satisfaction, the IRS should also continue to develop its balanced measures program to ensure that its critical performance measures cover all of the major components of tax administration. For example, the IRS breaks down its budget by appropriation[1] and within some of the appropriations by budget activity. We found that three of the five appropriations do not have performance measures linking results to the money requested. Those appropriations are Information Systems, Business System Modernization (BSM), and Earned Income Tax Credit. In the remaining two appropriations, there were no performance measures for three of the six budget activities within those appropriations. Those budget activities are Shared

[1] The five appropriations are Processing, Assistance, and Management; Tax Law Enforcement; Information Systems; Business Systems Modernization; and Earned Income Tax Credit Compliance.

Services Support, General Management and Administration, and Research. The funds budgeted to these areas should have performance measures to justify the budgeted amount or the costs should be associated with the program that it benefits, thus giving a truer cost of that particular program.

Furthermore, performance measures that the IRS reports to the Congress do not address 5 of the 10 strategies listed in the IRS' FY 2000-2005 Strategic Plan. For example, two strategies with which we could not link critical performance measures were "Deal Effectively with the Global Economy" and "Recruit, Develop, Retain a Quality Workforce." The IRS is in the process of developing measures that would address its strategy relating to the global economy. The lack of performance measures prevents the IRS from reporting its overall level of success in achieving its mission.

The IRS Restructuring and Reform Act of 1998 (RRA 98)

Due to the comprehensive nature of this reform law, the IRS has dedicated significant attention and resources toward implementing the RRA 98 provisions. The RRA 98 included fundamental changes to tax law procedures and 71 provisions that increase or help protect taxpayers' rights. The IRS has taken several actions to improve compliance with these provisions. For example, in some instances the IRS added a higher level of managerial review of work, implemented new computer controls to prevent certain violations from occurring, and provided additional training and guidance to help employees and managers understand the requirements of the provisions. The RRA 98 required TIGTA to review 10 of the 71 taxpayer rights provisions, as well as 2 other taxpayer rights provisions in prior legislation. TIGTA is currently in the fourth review cycle assessing the mandatory RRA 98 provisions. In addition to the mandatory reviews, TIGTA has reviewed other taxpayer rights provisions within the RRA 98.

The IRS' compliance with the RRA 98 provisions varies from achieving full compliance to significant non-compliance. TIGTA has reported that the IRS has fully implemented three taxpayer rights provisions - *Mitigation of Failure to Deposit Penalty, Seizure of Property and Taxpayer Advocate-Hardships.* The IRS is generally compliant with two other provisions – *Illegal Tax Protestor Designation and Collection Due Process for Liens and Levies.*

Additionally, the IRS needs to improve its compliance with the RRA 98 provisions by completing actions recommended in TIGTA audit reports issued in FY's 2000, 2001 and 2002. We found the IRS is not yet compliant with the following taxpayer rights' provisions:

- *Notice of Levy* – The systemic control designed to ensure that taxpayers receive the required 30-day notification before levy can be circumvented. All revenue officers have the capability to revise the final notice date. As a result, the IRS cannot be certain that all taxpayers were provided the required 30-day notice before levy actions were taken.

- *Restrictions on the use of enforcement statistics to evaluate employees* – TIGTA determined that the performance or related supervisory documentation could contain violations of RRA 98 Section 1204 (a) for an estimated 452 enforcement employees in the continental United States, and violations of RRA 98 Section 1204 (b) for an estimated 3,170 enforcement employees, out of an estimated population of 45,300 enforcement employees in the continental United States.

- *Notice of Lien* – An estimated 11,500 lien notifications, out of a population of 137,258 lien notices, were not mailed to the taxpayer, the taxpayer's spouse, or to the taxpayer's business partners; or were not mailed to the taxpayer's or spouse's last known address. Taxpayer rights could be potentially affected because the taxpayer not receiving a notice or receiving a late notice might not be aware of the right to appeal or could have less than the 30-day period allowed by the law to request a hearing.

- *Collection Statute of Limitations* – TIGTA identified 16 taxpayer accounts where the IRS obtained collection statute extensions without also securing the related installment agreement or levy release as required by law. In addition, the IRS is at risk of writing off approximately 7,300 taxpayer accounts with $291 million in tax liabilities because of incorrect statute calculations or not following internal procedures.

- *Assessment Statute of Limitations* – An estimated 460 taxpayer accounts nationwide do not include documentation that the IRS advised taxpayers of their rights regarding assessment statute extensions, out of an estimated population of 9,800 taxpayers, for the period April to September 2000.

- *Innocent Spouse* – The IRS is effectively educating taxpayers about the requirements that need to be met to qualify for Innocent Spouse relief. The IRS also has made significant improvements in the Innocent Spouse Program at the Cincinnati site; however, problems continued to exist in managing the resources that evaluate the claims assigned to the field. Additionally, the receipt of open claims continues to grow and old claims remain in inventory for extended periods of time.

- *Offer in Compromise Determinations* – The IRS has taken several steps to expand access to the offer in compromise program and has complied with the RRA 98 provision. However, the IRS could do more to educate taxpayers about the verification process used to evaluate an offer, provide additional flexibility regarding the consideration of taxpayers' equity in assets, revise guidelines to encourage taxpayer access to the appeal process, and establish a management information system to monitor

offers accepted based on special circumstances and on the independent administrative review process.

- *Denials of Requests for Information Under the Freedom of Information Act* – TIGTA identified an estimated 615 responses to Freedom of Information Act or Privacy Act requests where information was improperly withheld, out of 5,725 requests for information that were denied in whole or part, or where the IRS replied that responsive records were not available. There was also an estimated 733 responses to Internal Revenue Code (I.R.C.) Section 6103 requests where information was improperly withheld out of an estimated population of 10,539 requests that were denied or partially denied or requesters were told that records could not be located.

- *Dual Notices for Joint Filers* – Separate notices were not being sent to joint filers as required by the law.

- *Uniform Asset Disposal Mechanism* – This provision was effective July 22, 2000. In TIGTA's first review of this provision, there were three seizure cases in which it was not clear whether revenue officers participated in prohibited activities during the sale of the property.

Prior to July 2000, IRS management became concerned that not all requirements could be met by the effective dates imposed by the RRA 98 and informed the Congress that additional time would be needed to implement three provisions. The Congress extended the deadlines for these three requirements with the passage of the Community Renewal Tax Relief Act of 2000.[2] For one of the three provisions, *Annual Installment Agreement Statements,* the deadline was extended to September 1, 2001, to provide annual statements to taxpayers with active installment agreements. The IRS has indicated it is now in compliance with this provision. TIGTA has not yet validated the IRS' compliance with this provision.

Additional actions are still needed before two provisions will be fully implemented. These two provisions are:

- *Notice of Penalties Imposed* – Deadline extended to July 1, 2003, for providing the detailed notice. TIGTA reported that the IRS computer programming was not in place to send notices to 8.7 million taxpayers.

- *Notice of Interest Assessed* – Deadline extended to July 1, 2003, for providing the detailed notice. TIGTA reported that the IRS computer programming was not in place to send notices to the same 8.7 million taxpayers that also had penalties imposed.

[2] Pub. L. 106-554 (December 21, 2000).

Finally, because the IRS did not have management information systems to track the specific cases, neither TIGTA nor the IRS could evaluate the IRS' compliance with the following four provisions.

- Restrictions on directly contacting taxpayers instead of authorized representatives.
- Taxpayer complaints.
- Separated or divorced joint filer requests.
- Fair Debt Collection Practices Act (FDCPA) Violations – the IRS does track potential FDCPA violations on its computer systems; however, we determined that data on one system may not always be complete and accurate.

Section 1203 Violations

In addition to our audit responsibilities, the RRA 98 charges TIGTA with investigating Section 1203 violations. Section 1203 provides that the IRS Commissioner shall terminate the employment of any IRS employee found guilty of misconduct as defined by ten acts or omissions. TIGTA assists in the protection of taxpayers and their rights by investigating allegations of misconduct by IRS employees. Since the passage of Section 1203, approximately 5,000 complaints involving an allegation of a Section 1203 violation have been received.

Shortly after the passage of the RRA 98, there was initial uncertainty in what the public and IRS employees thought constituted a true violation of Section 1203. Since February 1999, TIGTA has seen a high of 94 complaints in August 1999 to only 12 complaints received in February 2002. This is a significant decline and is credited, in part, to:

- Public and employee education in Section 1203;
- The IRS' aggressive response to implement Section 1203 legislation; and
- Decline in IRS enforcement activity.

The vast majority of Section 1203 complaints received by TIGTA have alleged an IRS employee violated a provision of the IRM or I.R.C. in order to retaliate against, or harass someone. The second category, by volume, involves constitutional and civil rights/Equal Employment Opportunity (EEO) violations. The IRS receives and adjudicates numerous Section 1203 allegations where no TIGTA investigation is needed. Where TIGTA involvement is warranted, our focus is to determine the intent. As of February 2002, the IRS has notified us that 54 employees have been fired and 106 employees have resigned or retired as a result of TIGTA and IRS investigations.

TIGTA and the IRS are working together to re-engineer the 1203 process. Beginning March 1, 2002, a streamlined process was implemented which will enable an early determination to be made in order to separate the valid 1203 allegations from those that are not. As a result, TIGTA will be able to devote its resources to the investigation of bona fide 1203 allegations and other misconduct.

In closing, I would like to comment that the Commissioner's approach in identifying risks associated to IRS business operations and his attempt to encourage IRS personnel to embrace cultural changes that, in the past, detracted from the agency's ability to provide effective customer service, are extremely noteworthy. During the past four years, the IRS has made considerable progress in the implementation of some of the taxpayer rights provisions. As a result, taxpayer rights have been addressed and better protected, and IRS employees and stakeholders are engaged in addressing critical tax administration issues. The IRS is now entering a very challenging period. Much of the IRS' progress, credibility and unwavering march toward reform is attributed to the leadership of the Commissioner, whose term will expire in November. It is particularly essential that his replacement continue his legacy and possess outstanding qualifications as a change manager and reformer. The IRS needs to continue to focus its limited resources on making long-term improvements that ultimately affect the American taxpaying public.

Senator CONRAD. We are going to go now to vote, as we have seven and a half minutes remaining.

I am going to ask Congressman Coyne to assume the gavel. Mr. White, if you would proceed with your testimony, then we will go to questions. We will return as promptly as we can.

Congressman COYNE. Mr. White, you can proceed.

STATEMENT OF JAMES R. WHITE, DIRECTOR, TAX ISSUES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY STEVEN SEBASTIAN, ACTING DIRECTOR, GENERAL ACCOUNTING OFFICE

Mr. WHITE. Thank you.

Mr. Chairman and members of the committees, we are pleased to participate in this joint review of IRS's progress since the passage of the IRS Restructuring and Reform Act.

As requested, our statement includes a series of figures giving an overview of IRS's recent performance. The figures are in the appendix.

In the interest of time, I will briefly summarize what the figures illustrate.

Since 1995, as has already been discussed, IRS's workload, measured by tax returns filed, has increased, while staffing has decreased.

At the same time, IRS reallocated these shrinking resources with a disproportionate decline in compliance and collection staffing and more emphasis on both service to taxpayers and information systems' operations and investment.

The reallocation of resources shows some signs of beginning to improve taxpayer service and accuracy of telephone assistance has improved, but the compliance and collection programs have seen large and pervasive declines. For example, in audit rates, collection cases closed, uses of liens and levies, and raw productivity without adjusting for quality.

Mr. Chairman, IRS is at a critical juncture. Commissioner Rossotti has said he will be stepping down in November, about halfway through the 10 years he estimated would be necessary to modernize IRS.

During his tenure, IRS has made important progress at laying the management foundation for a more modern agency, able to respond to taxpayer needs faster, more accurately, and at lower cost.

Progress includes the transition to a new organizational structure and a new strategic planning, budgeting, and performance management process which IRS used to identify 2,300 positions for reallocation to higher priorities.

Progress also includes a new employee evaluation system aligned with the mission of the agency. In addition, IRS has made progress developing a sorely-needed measure of voluntary compliance, establishing the system's infrastructure, delivering systems applications, and establishing the controls and capabilities needed to effectively acquire and deploy modernized systems.

I said earlier that IRS is at a critical juncture. While progress has been made, the foundation for a modernized agency is not complete, and neither is the structure to be built on top, the reengineered business processes that would deliver better service.

To continue modernizing, IRS must successfully manage some significant risks that threaten progress. One area of risk is IRS's compliance and collection programs which, as noted, have declined, sometimes dramatically, since 1996.

Many view these programs as critical for maintaining the public's confidence in our tax system. If honest taxpayers believe that large numbers of their neighbors or business competitors are not paying their fair share, then voluntary compliance could be adversely affected.

A decline in voluntary compliance would undermine IRS's modernization efforts, and the commissioner has emphasized the need to reverse these trends.

Another risk area is systems acquisition and deployment. Since 1999, Congress has provided almost $1 billion for investment in IRS's business systems. Despite the progress in building management capacity, IRS is not where it needs to be in implementing management controls and capabilities, which increases the risk of not delivering systems capabilities on time and within budget.

Timing is critical. As IRS goes forward, the risk of not having all these controls grows because systems interdependencies and complexity increase dramatically during the later stages of projects. That is, during detailed system design, development, and implementation. IRS is now in this stage on several large projects.

Certain aspects of performance management are another risk area. IRS needs to have comparable performance measures over time and a date suitable for assessing performance. IRS needs to more routinely conduct evaluations of its programs.

IRS needs to better link performance and resource use. Current inadequacies and missed opportunities limit IRS's understanding of the reasons for its performance and ability to identify cost-effective improvements.

A final risk area is financial management. While IRS has received unqualified audit opinions, it has not been able to generate financial management information in a timely manner. This leaves management less informed in making decisions about how to improve performance.

Mr. Chairman, IRS is partway through what is intended to be a major reorganizational transformation. Real progress has been made laying a foundation. To avoid delays, realizing the promise of modernization for improved service to taxpayers while ensuring compliance with tax laws, the new Commissioner should be willing to work within the existing general framework for modernization and will also have to successfully manage the risks I have outlined.

This concludes my statement. I would be happy to answer any questions.

[The prepared statement of Mr. White follows:]

United States General Accounting Office

GAO

Testimony

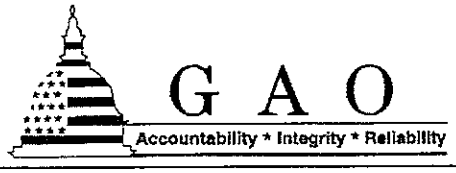
Before Congressional Committees

For Release on Delivery
Expected at 10:00 a.m.,
Tuesday, May 14, 2002

TAX ADMINISTRATION

Continued Progress Modernizing IRS Depends on Managing Risks

Statement of James R. White, Director, Tax Issues
Randolph C. Hite, Director, Information Technology Architecture and Systems Issues
Steven J. Sabastian Acting Director, Financial Management Issues



GAO-02-715T

Mr. Chairman and Members of the Committees:

We are pleased to be here today as we approach the fourth anniversary of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998, which established Congress' expectation that IRS modernize to better meet taxpayer needs. As you requested, our statement gives an overview of IRS's current performance and resources and then assesses the progress that IRS has made modernizing and the risks to continued progress. Our overview and the rest of our statement are based primarily on issued reports or ongoing work for the committees holding this hearing.

Overall, since the mid-1990s IRS has seen increased workload, decreased staffing, and significant changes in the allocation of resources between taxpayer assistance programs and its compliance and collection programs. Any overview of a large agency must condense and summarize a great deal of information. We selected data, presented in seven figures in the appendix to this statement, to illustrate some of the key trends at IRS since the mid-1990s. As our figures show

- Between 1995 and the end of 2001 IRS's workload, measured by returns filed, increased by about 10 percent while aggregate staffing declined by about 14 percent. (See figure 1.)

- Over the same time, there was a significant internal reallocation of resources with a disproportionate decline in compliance and collection program staffing to accommodate more emphasis on taxpayer service, such as telephone assistance, and to information systems operation and investment. (See figure 2 in comparison with figure 1.)

- Electronic filing of returns increased but not enough to reduce paper returns sufficiently to free significant processing resources for use elsewhere. (See figure 3.)

- The reallocation of resources shows signs of beginning to produce more accurate service for taxpayers, but the compliance and collection programs have seen large and pervasive declines in performance indicators such as audit rates, collection cases closed, enforcement actions such as liens and levies, and raw productivity (measured by cases closed per unit of staff time without adjusting for possible quality changes). (See figures 4, 5, 6 and 7.)

Mr. Chairman, IRS is at a critical juncture. Commissioner Rossotti, who has led IRS's modernization efforts for the past 4-1/2 years, has said that he will be stepping down in November. That will be about half way through the 10 years that he estimated would be needed to modernize IRS. During his tenure, IRS has made important progress at laying the management foundation for a more modern agency able to respond to taxpayer needs faster, more accurately, and at lower cost. However, at this time, the foundation is not complete and neither is the structure to be built on the foundation – the reengineered processes that would deliver better service to taxpayers. To continue modernizing, IRS must successfully manage some significant risks that threaten progress. Areas of risk include IRS's compliance and collection programs that have seen large declines, systems modernization where several large systems are moving into deployment and performance management where new measures and systems are being implemented.

The following summarizes our main points regarding the progress IRS has made and the risks that need to be managed.

- Some of the most important steps that IRS has taken to lay the foundation for ultimately providing better service to taxpayers and ensuring compliance with the tax laws are in the areas of organization and management of performance, systems acquisition and development, and financial management.

  - After much planning, in October 2000, IRS transitioned to a new organizational structure with four operating divisions focused on different types of taxpayers.
  - About the same time, IRS implemented a new strategic planning, budgeting, and performance management process, designed to reconcile competing priorities with the realities of available resources. Using that process, IRS has determined that almost 2,300 staff positions could be redirected toward higher-priority needs. In addition, IRS now has an evaluation system for front line employees that is aligned with the mission and goals of the agency and is developing a sorely needed measure of voluntary compliance.
  - With respect to systems modernization, IRS has made important progress in establishing the systems infrastructure, delivering systems applications, and establishing the controls and capabilities needed to effectively acquire and deploy modernized systems.
  - Finally, with respect to financial management, IRS has for 2 consecutive years prepared financial statements that received unqualified opinions.

Many of these steps increase IRS's management capacity. Some are beginning to deliver better service to taxpayers or more efficient use of resources.

- To realize the promise of modernization to deliver better service to taxpayers while ensuring compliance with the tax laws, IRS must finish building a strong management foundation and must use this foundation to make the substantive business practice changes that could improve its efficiency and service to taxpayers. There are risks in several areas that threaten continued progress.

  - One area of risk is IRS's compliance and collection programs that have declined, sometimes dramatically, since 1996. Many view these programs, such as audits to determine whether taxpayers have accurately reported the amount of taxes they owe and collection followup with taxpayers who have not paid what is owed, as critical for maintaining the public's confidence in our tax system. The commissioner has emphasized the need to reverse the trends in these programs.
  - Another area of risk is systems acquisition and deployment. Since 1999, Congress has provided almost $1 billion for investment in IRS's business systems. Despite the important progress in building management capacity, IRS is not where it committed to be in acquiring infrastructure and business application systems and is not where it needs to be in implementing management controls and capabilities. This increases the risk of not delivering promised systems capabilities on time and within budget. As IRS moves forward, this risk is amplified because system interdependencies and complexity increase dramatically during the later phases of system projects.
  - Certain aspects of performance management are another risk area. IRS needs to ensure that it has comparable performance measures over time and sufficient data to assess performance. IRS needs to routinely do better evaluations of its programs to determine the factors that affect performance and identify ways to improve.
  - A final risk area is financial management. Although it received an unqualified audit opinion, IRS has had to assign staff to manually analyze and correct the data generated by its financial systems. This approach, which takes months to complete, does not produces timely information for managing the agency.

Improved Foundation for Tax Administration

The following highlights some of the most important steps that IRS has taken to lay the foundation for ultimately providing better service to taxpayers and ensuring compliance with the tax laws.

New Organizational Structure

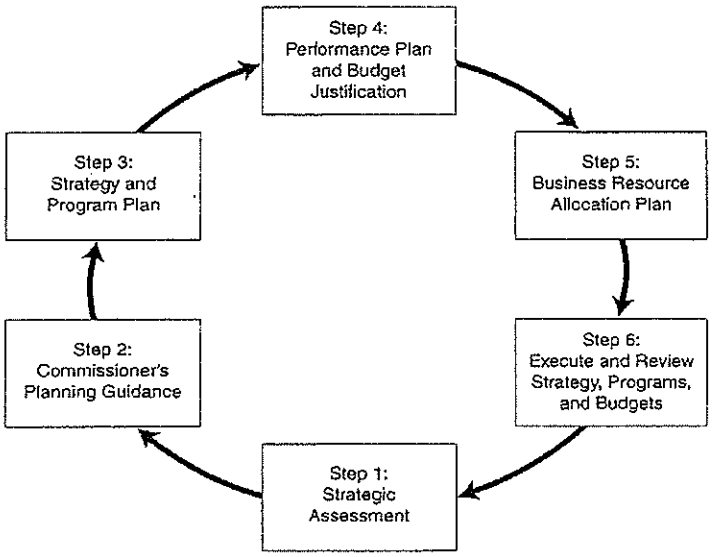
First, during fiscal year 2001, IRS transitioned to a new organizational structure with four divisions having responsibility for administering tax law for a set of taxpayers with similar needs. By reorganizing in this manner, IRS sought to establish clearer lines of responsibility and accountability for improving service to taxpayers and resolving their problems. Through such improvements, IRS expected to better enable taxpayers to comply with the tax laws.

Because many major reengineering efforts were to be led by the new divisions, it is too early to judge the impact that the reorganization has had in improving service. The widescale reorganization was accomplished with no serious disruption of recent filing seasons. The filing season for most individual taxpayers extends from January 1st to April 15th. It is during that time when most taxpayers file their returns, call IRS with questions, and make other contacts with IRS related to filing. To its credit, IRS was able to reorganize while managing the challenges associated with the sheer scope of filing season activities, including the year 2000 transition.

New Budgeting and Planning System

To make decisions for fiscal year 2002 and subsequent year operations, IRS implemented a new strategic planning, budgeting, and performance management process during fiscal year 2000. The process begins, as outlined in figure 1, with the operating divisions preparing strategic assessments that describe significant trends, issues, and problems and identifies proposals for dealing with them. After receipt and review of the strategic assessments, the commissioner provides detailed guidance (step 2) to the operating divisions for developing their strategy and program plans (step 3). These plans are then incorporated (step 4) into an IRS-wide performance plan (which sets out measurable objectives such as the number of audits to be done). These plans are, in turn, incorporated into IRS's budget justification (which sets out its resource requests to Congress). The remaining steps (5 and 6) involve allocating resources across IRS divisions and programs and monitoring division adherence to the planning and budgeting decisions.

Figure 1: IRS's Strategic Planning Process



Source: GAO's review of IRS's planning documentation

This process provides IRS senior management with a means to reconcile competing priorities with the realities of available resources. Through the use of this process in developing its budget request for fiscal year 2003, IRS identified a myriad of expected efficiency improvements, technological enhancements, labor-saving initiatives, and workload decreases that it projects will enable it to redirect about $158 million (about 2,300 staff positions) to higher-priority areas. This accounted for two out of every three additional staff that IRS believed was needed.

New Employee Evaluation System

In February 2000, IRS implemented a new evaluation system for its managers and in October 2001 implemented a new evaluation system for front-line employees. These systems were developed to structurally align performance expectations for managers and employees with IRS's strategic goals. An employee evaluation system can be a powerful tool in

helping an agency achieve its mission and ensuring employees at every level of the organization are working toward common ends. Evaluation systems should help employees understand their responsibilities and how their day-to-day work contributes toward meeting their agency's strategic goals as well as providing a mechanism for giving employees candid, specific feedback on how well they are meeting their rater's expectations. For agencies like the IRS that are undergoing a cultural change, the employee evaluation system helps reinforce behaviors and actions that support the agency's mission. IRS recognizes that it may take a while before the new evaluation systems achieves the intended results of balancing taxpayer needs while at the same time enforcing the tax laws. These expectations may appear to conflict so managers and employees may need time to better understand what the new performance expectations mean in terms of their daily work and which behaviors they should change in order to put IRS's new operational environment into practice.

Progress in Measuring Voluntary Compliance

IRS has made progress in developing a way to measure the voluntary compliance of individual taxpayers without placing an undue burden on them. Each year billions of dollars in taxes are not voluntarily reported and paid. To understand the overall extent of noncompliance, IRS plans to implement its study of tax reporting compliance later this fall. The study should provide IRS with data to update the criteria it uses to select tax returns for audit and thereby reduce the number of compliant taxpayers selected. Also, the study is intended to provide detailed information about compliance, such as why taxpayers fail to comply with a specific tax law provision. Having such information should enable IRS to make operational changes such as modifying tax forms and instructions or to recommend tax law changes that could improve compliance.

Business Systems Modernization

Over the past 3-plus years, IRS has made important progress in establishing the infrastructure systems that are to provide the platforms upon which future business applications will run. Establishing this infrastructure is a necessary prerequisite to introducing the business applications that are in turn intended to provide benefits to taxpayers and IRS. During this time, IRS has also made important progress in delivering two system applications—Customer Communications 2001 and Customer Relationship Management Exam—that are producing benefits as of today. For example, Customer Communications 2001, which is software improvements to IRS's customer service telephone system, was implemented last summer and is now routing taxpayer calls with common

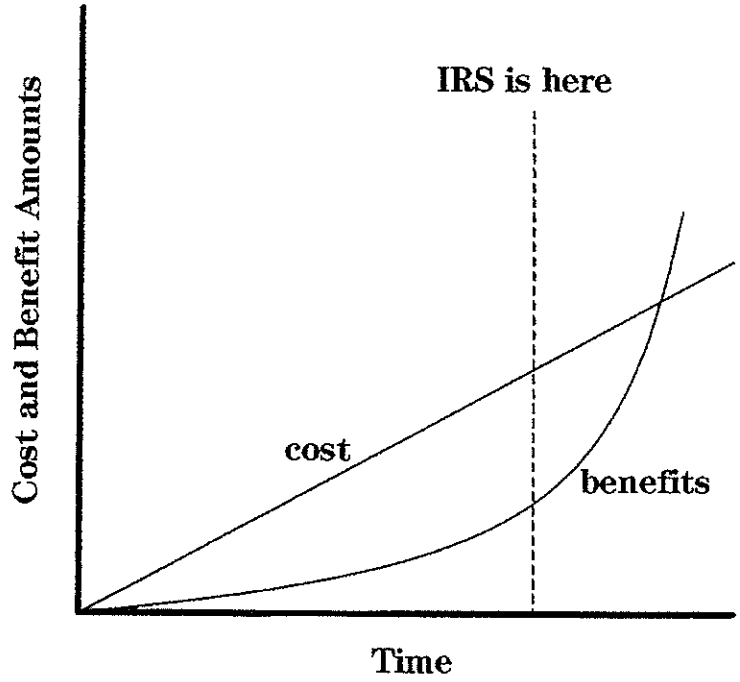
questions to automated menu driven information services, thereby freeing IRS customer service representatives to answer complex or less common inquiries.

IRS has also made progress in building and readying for deployment, business applications to, among other things, replace existing antiquated information technology systems that have hampered IRS's ability to improve customer service to taxpayers. In particular, IRS has been building and is planning to pilot in July 2002, the first release of its Customer Account Data Engine (CADE)—a modern relational database designed to replace IRS's tape-based data management system—for taxpayers with simple tax returns. IRS plans to implement this release in January 2003 in time for the 2003 filing season and plans to implement four additional CADE releases, each for progressively more complex tax returns, over the next 4 years with the goal of having CADE fully implemented by 2006.

In addition, IRS has made progress in addressing our recommendations to establish the modernization management controls needed to effectively acquire and implement major systems. For example, we have consistently recommended since 1995 that IRS develop and implement an enterprise architecture (modernization blueprint) to guide and constrain the acquisition of business systems modernization (BSM) systems; IRS recently issued an updated a version of its Enterprise Architecture for how it wants to transition its business systems environment, thus giving a high-level roadmap to manage and control business and technological change.

The nature of IRS's progress thus far should not be viewed solely in the context of what taxpayer service and IRS efficiency benefits are being realized today. Rather, this progress should also be viewed in terms of laying the necessary foundation from which the benefits of future applications can be realized. As a matter of fact, at this point in time, the level of tangible mission-related benefits that have been realized from modernization investments are not yet commensurate with costs incurred. In our view, this is not unreasonable because as depicted in figure 2, the expected return on these and future investments are to materialize later when new business applications are brought on line.

Figure 2: Notional BSM Benefits Versus Costs



Source: GAO

Financial Reporting

For 2 consecutive years, IRS has produced financial statements that present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, net position, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial account activity. This unqualified opinion was achieved through the extraordinary efforts of IRS's senior management and staff to compensate for serious internal control and system deficiencies discussed in the risk section of this statement. Additionally, IRS continues to make progress on several significant internal control and compliance issues that contribute to its difficulties in producing reliable and timely information.

Risks to Continued Modernization Progress

IRS faces risks in several areas that if not successfully managed could threaten the agency's ability to continue making progress modernizing.

Compliance and Collection Declines

The first area of risk involves the declines in compliance and collection programs. Taxpayers' willingness to voluntarily comply with the tax laws depends in part on their confidence that their friends, neighbors, and business competitors are paying their share of taxes.

To help provide that assurance, IRS operates six major compliance programs. These programs (1) check for math errors and unpaid balances during returns processing, (2) determine taxes due from apparent nonfilers detected through computer matching, (3) determine taxes due from apparent underreporters detected through computer matching, (4) audit tax returns filed by individuals, (5) audit tax returns filed by corporations, and (6) audit other tax returns such as estate and gift returns.

IRS also operates two separate collection programs for dealing with taxpayers who are delinquent in paying the taxes they owe. These programs pursue collection through (1) telephone contacts with the taxpayers and (2) personal visits with the taxpayers by IRS field staff.

As part of our ongoing work for the House Ways and Means Subcommittee on Oversight, we identified large and pervasive declines across the compliance and collection programs, except for returns processing, between fiscal years 1996 and 2001. For example, individual and corporate audit productivity as measured by cases closed per unit of staff time declined 31 and 47 percent, respectively, while field and telephone collection productivity declined over 20 percent. These productivity declines coupled with reduced staffing has translated to declines in coverage. That is, the proportion of individual and corporate tax returns that were audited declined 63 and 60 percent, respectively, and the percentage of delinquencies closed by telephone and field collection declined by 15 and 45 percent, respectively. Figures 2, 5 and 6 in the appendix provide additional data.

The decline in collection coverage reflected the collection programs' inability to work a growing proportion of the delinquent cases referred from the compliance programs. In response, by fiscal year 2001, IRS was deferring collection action on about one out of three assigned

delinquencies. By the end of fiscal year 2001, we estimate that IRS had deferred collecting taxes from about 1.3 million taxpayers[1] who owed about $16.1 billion.[2] Absent significant operational change, IRS officials said that they had little expectation of reopening many deferred collection cases.

The declines in IRS's compliance and collection programs affected taxpayers in several ways.

- The likelihood that taxpayer noncompliance would be detected and pursued by IRS declined. For example, coverage in the nonfiler program declined by 69 percent by the end of fiscal year 2001.
- The length of time that taxpayers owed back taxes at the time they were assigned to collection increased between 1996 and 2001 although IRS intended that by deferring collection action on some older collection cases it could get to newly assigned cases quicker.
- The amount of penalties and interest continued to accumulate on deferred collection cases, making future payment increasingly demanding if subsequently pursued by IRS.
- The likelihood that delinquent taxpayers would experience enforced collection such as through levies placed on their wages or bank accounts declined about 64 percent from 1996 to 2001, although there has been some upturn from 2000 to 2001 (see figure 6 in the appendix).

Taken together, changes such as these have reduced the incentives for voluntary compliance. Also, some available, but very limited, data suggest that voluntary compliance may have begun to deteriorate. For example, the number of apparent individual nonfilers increased about three and one-half times faster than the individual tax filing population.

IRS managers are concerned about the decline in compliance and collection programs and the extent that this threatens voluntary compliance. A significant decline in voluntary compliance would undermine IRS's modernization effort.

[1] Estimate is from a random sample. The 95-percent confidence interval is 1.25 million to 1.35 million taxpayers.

[2] Estimate is from a random sample. The 95-percent confidence interval is $14.8 billion to $17.4 billion.

Business Systems Modernization Risk

Since the start of IRS' modernization program in late 1999, the program has received almost $1 billion and expects to need about another $2.5 billion over the next 5 years. In fiscal year 2002, this funding supports 20 ongoing system acquisition projects, currently at different life-cycle stages along with initiatives to develop the capabilities for managing the acquisition projects.

Despite the important progress discussed above, IRS is not where it committed to be in acquiring both infrastructure and application systems and not where it needs to be in implementing modernization management controls. This is because IRS's first priority and emphasis has been to get the newer, more modern systems—with their anticipated benefits to taxpayers—up and running. In so doing, however, the establishment of management capacity to ensure that these systems are introduced successfully has not been given equal attention and thus has not kept up. Simply stated, proceeding without these controls increases the risk of not delivering promised system capabilities on time and within budget. Moreover, these risks are amplified as IRS moves forward because interdependencies among current ongoing projects and the complexity of associated work activities to be performed, have and will continue to increase dramatically as more system projects move into the latter stages of their life cycles and are deployed. More recently, IRS has acknowledged this risk and initiated efforts to better balance controls with project pace and workload.

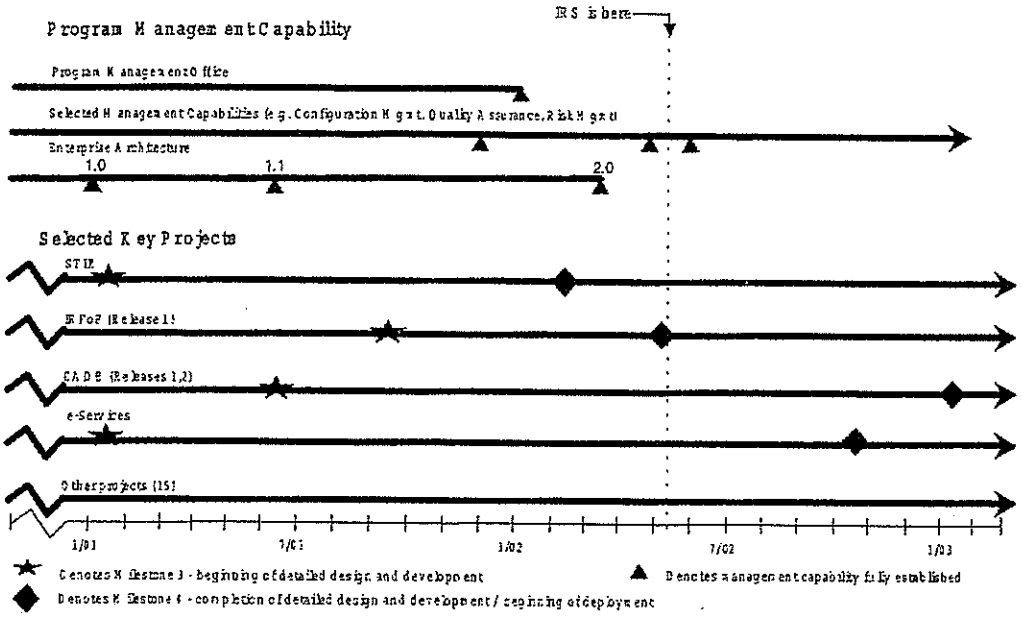
Testimony before you last spring outlined the same general concern that we are stating today.[3] At that time, we feared that systems workload and pace were getting too far ahead of the agency's ability to deal with them effectively, i.e., having proper management controls and capacity in place. Since then, IRS has continued to move forward with its ongoing infrastructure and business application projects while simultaneously taking steps to implement missing management controls and capabilities. During this time, however, the imbalance in project workload and needed management capacity has remained a concern. More recently, our report of this past February[4] recommended that the commissioner of internal

[3] U.S. General Accounting Office, *IRS Modernization: Continued Improvement in Management Capability Needed to Support Long-Term Transformation*, GAO-01-700T (Washington, D.C.: May 8, 2001).

[4] U.S. General Accounting Office, *Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload*, GAO-02-356 (Washington, D.C.: February 28, 2002).

revenue reconsider the scope and pace of the program to better strike a balance with the agency's capacity to handle the workload. The commissioner agreed, promising action in these areas. In particular, the commissioner agreed to align the pace of the program with the maturity of IRS' controls and management capacity. The commissioner also made correcting remaining management controls weaknesses a priority. Figure 3 illustrates IRS's approach to developing projects and controls and the degree to which projects have gotten ahead of controls.

Figure 3: Concurrent Development of Program-Level Controls and Projects



Source: GAO.

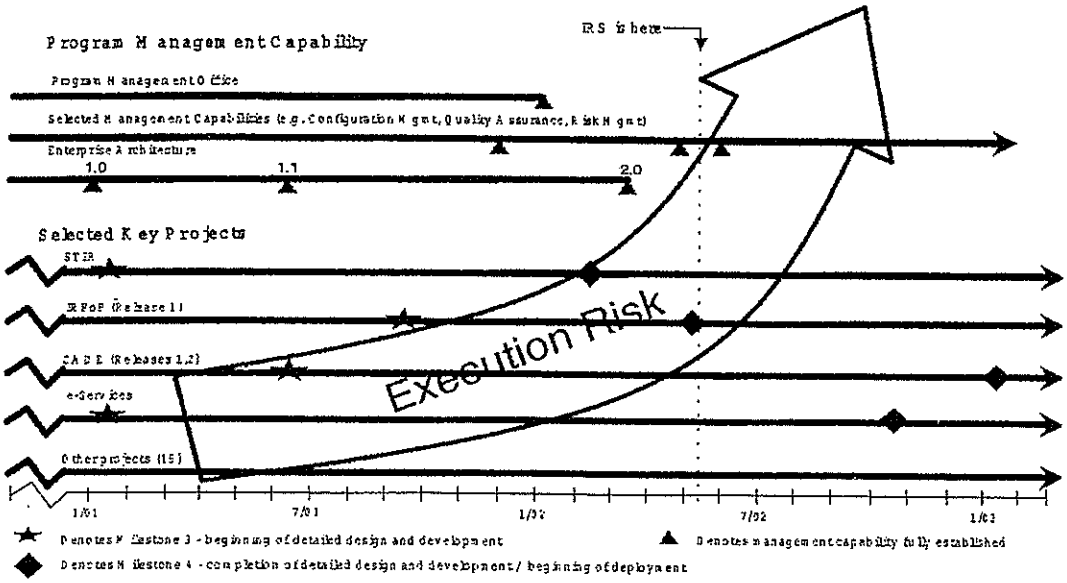
We nevertheless remain concerned because projects are entering critical stages and not all essential management controls are in place and functioning. In particular, in our ongoing work for the appropriations

subcommittees, we found that IRS is proceeding with building systems—including detailed design and software development work and deploying others—before it has (1) fully implemented mature software acquisition management processes, (2) developed and deployed a human capital management strategy, and (3) established effective cost and schedule estimating practices.

Weaknesses in any one of these modernization management controls introduces an unnecessary element of risk to the BSM program, but the combination of these weaknesses introduces a level of risk that increases exponentially over time. IRS has reported that BSM projects have already encountered cost, schedule, and/or performance shortfalls. Our analysis has showed that weak management controls contributed directly to these problems, or were the basis for prudent, proactive IRS decisionmaking not to start or continue projects.

Given that IRS' fiscal year 2002 BSM spending plan supports progress towards the later phases of key projects and continued development of other projects, it is likely that BSM projects will encounter additional cost, schedule, and performance shortfalls. Figure 4 depicts this combination of circumstances.

Figure 4: Current Time Line Depicting Escalating Program Execution Risk



Source: GAO.

IRS acknowledges these risks and is committed to addressing them. For example, we recommended to IRS that it make implementing missing controls a management priority[5] and as we recently reported,[6] the commissioner in 2001 hired an executive—with extensive private-sector experience—to lead the BSM program office and this official has developed plans to address each missing control, assigned responsibilities and milestones for their completion, and is managing IRS's progress in executing the plans. These plans address all of our outstanding major recommendations on human capital management, software acquisition,

[5] See, for example, U.S. General Accounting Office, *Tax Systems Modernization: Results of Review of IRS' Third Expenditure Plan*, GAO-01-227 (Washington D.C.: January 22, 2001).

[6] U.S. General Accounting Office: *Business Systems Modernization: Results of Review of IRS's March 2001 Expenditure Plan*, GAO-01-716 (Washington D.C.: June 29, 2001), and GAO-02-356.

information technology risk management, and enterprise architecture compliance.

Timing is critical. While the lack of controls can be risky in projects' early stages, it is essential that such controls be in place when projects enter detailed system design, development, and implementation. To mitigate this added risk, IRS needs to fully implement the remaining management controls that we have recommended.

Performance Management Risks

As noted, IRS has made progress in revamping its performance management system. However, several aspects of the system put IRS's ability to effectively measure, assess, and improve organizational and employee performance at risk.

First, IRS needs to ensure that it has comparable performance measures and sufficient data to assess performance. As part of its agencywide efforts to develop balanced performance measures, IRS continues to revise some measures and develop new ones to judge its performance. Although we recognize the need to improve measures, changes interrupt the possibility to establish trends and compare performance between periods. In past years,[7] our assessment of IRS's filing season performance included comparisons of various performance measures against IRS's goals and prior years' performance. We have been unable to make such a comparison for some measures[8] because IRS (1) revised some measures that it had been using to assess performance and established some new measures and (2) had not established targets for new or revised measures. For example, during the 2001 filing season, IRS made numerous changes, such as renaming measures and revising formulas, to its measures for processing paper returns, refunds, and remittances. Specifically, of 12 measures,[9] 5 were new, 3 were revised, and 1 did not have a set target. Similarly, of the 15 telephone measures in place,[10] 7 were either new or

[7] U.S. General Accounting Office, *Tax Administration: Assessment of IRS' 2000 Filing Season*, GAO-01-158, (Washington, D.C.: Dec. 22, 2000).

[8] U.S. General Accounting Office, Tax Administration: Assessment of IRS' 2001 Filing Season, GAO-02-144, (Washington, D.C.: Dec. 21, 2001).

[9] There were 12 measures listed in IRS's Strategy and Program Plan, dated July 25, 2001 and October 29, 2001.

[10] There were 15 measures listed in the Strategy and Program Plan as of July 25, 2001. As of October 29, 2001, one measure, "Toll-Free Automated Completion Rate," was deleted.

revised and 4 did not have targets set. Measures of telephone accuracy are examples of how new and revised measures make it difficult to assess IRS's performance in providing quality telephone assistance over time. Also, figure 4 of the appendix shows that because of changes made to its telephone measures, IRS does not have sufficient time-series data for each of its four measures of telephone accuracy to make a thorough assessment of how well IRS is meeting its goal of providing "world class" telephone service.

As a result, managers, Congress and other stakeholders may have difficulty using information from new or revised measures. Although some IRS managers may be aware of these changes to measures, we found little or no documentation that disclosed the changes for outside stakeholders. All in all, IRS officials agreed with our assessment that it is difficult to put the reported results into context because of the absence of performance goals and trend data. However, while the officials understood the importance of such information, they also said they rely heavily on other information, such as workload indicators and other management information, that they have used for years to identify and correct problems that could affect activities and help judge IRS's overall success.

In addition to having comparable measures to gauge performance, IRS needs to do more and better evaluations of its business practices so that it can determine the factors that affect program performance and identify ways to more effectively use resources and improve service. Over the past year, we have reported on several of IRS's efforts to improve the efficiency of its programs that were hindered by insufficient program evaluation efforts. These programs dealt with the Offer in Compromise Program, telephone assistance accessibility and accuracy, and employment tax compliance

- In our report on IRS's Offer in Compromise Program, which allows taxpayers to settle their tax liability for less than the full amount,[11] we pointed out that IRS lacked program evaluation plans for various initiatives it undertook to try to reduce the offer inventory and processing time. In addition, IRS lacked performance and cost data needed to monitor program performance and had not set goals for offer processing time that were based on taxpayer needs, other benefits, and costs.

[11] U.S. General Accounting Office, *Tax Administration: IRS Should Evaluate the Changes to its Offer in Compromise Program*, GAO-02-311 (Washington, D.C.: Mar.15, 2002).

- Our report on IRS's telephone assistance[12] showed that IRS missed some opportunities to analyze data to better understand the factors affecting telephone performance, including the actions it took to improve performance. IRS collected and analyzed a variety of data about the key factors affecting telephone access and accuracy. However, IRS officials sometimes reached conclusions about these key factors without conducting analyses to test their conclusions.
- In our report on IRS's efforts to improve the compliance of small businesses with requirements that they report and pay employment taxes,[13] we noted that IRS had developed several new programs designed to prevent or reduce employment tax delinquencies by speeding up or enhancing the notification to certain groups of businesses. However, IRS had not successfully followed through on its plans to evaluate new early intervention programs.

In responding to our recommendations on these programs, IRS recognized the necessity and importance of evaluating program performance and agreed with our recommendations on ways to better assess and measure program results.

As IRS moves forward with modernization, the capacity to conduct sound performance evaluations on its current and planned operations will be one building block for success. The Government Performance and Results Act (GPRA) of 1993, IRS's guidance, and our prior work all stress the need for analyses of program performance to determine the factors affecting performance and to identify opportunities for improvement.[14] We recognize that some analysis can be costly, and thus, the costs need to be balanced against the benefits. Considering that IRS devotes considerable resources to many of its programs, the benefits of analysis —identifying ways to more effectively use resources and improve service —could be substantial.

[12] U.S General Accounting Office, *IRS Telephone Assistance: Limited Progress and Missed Opportunities to Analyze Performance in the 2001 Filing Season*, GAO-02-212 (Washington D.C.: Dec. 7, 2001).

[13] U.S. General Accounting Office, *Tax Administration: IRS's Efforts to Improve Compliance With Employment Tax Requirements Should Be Evaluated*, GAO-02-92 (Washington, D.C.: Jan. 15, 2002).

[14] U.S. General Accounting Office, *Managing for Results: Challenges Agencies Face in Producing Credible Performance Information*, GAO/GGD-00-52 (Washington, D.C.: Feb. 4, 2000).

Another performance management risk deals with IRS's ability to link its budget requests with program results. GPRA requires agencies to establish linkages between resources and results so that the Congress and the American public can gain a better understanding of what is being achieved in relation to what is being spent. As we recently reported,[15] IRS has made progress in linking some of its budget justification to performance goals, but in other instances the budget justification lacked performance goals or contained inconsistencies between the budget request and performance goals.

- IRS's congressional justification has several good links between the resources being requested and IRS's performance goals. For example, IRS's budget includes an increase of 213 full-time equivalents and $14.1 million to improve its telephone level of service, and its performance measures show an expected increase in toll-free telephone level of service from 71.5 percent in fiscal year 2002 to 76.3 percent in fiscal year 2003.
- In some instances, IRS's congressional justification contained no performance goals against which the Congress can hold IRS accountable. For example, the budget request includes increased resources for systematic noncompliance problems identified by the commissioner of Internal Revenue, such as for abusive corporate tax shelters and failure to pay large accumulations of employment taxes, yet it is unclear from IRS's budget justification how many resources IRS intends to devote to each of these problems. And, for none of these areas does the budget justification include performance measures and goals that Congress can use to assess IRS's progress in addressing these major compliance problems. In recent testimony, we suggested that the House Ways and Means Subcommittee on Oversight ask IRS for more specifics on its goals, performance measures and resource plans.

A major purpose of GPRA and IRS's strategic planning, budgeting, and performance management system is to support better-informed decisions on allocating scarce resources by focusing on the results likely to be achieved and then supporting subsequent oversight and accountability by establishing transparent measures to assess performance. IRS's new planning process and the linkages in its budget justification between some

[15]U.S. General Accounting Office, *Internal Revenue Service: Assessment of Budget Request for Fiscal Year 2003 and Interim Results of 2002 Tax Filing Season*, GAO-02-580T (Washington, D.C.: Apr. 9, 2002).

of its resource requests and expected results are commendable steps to implement this management approach. Improved linkages in IRS's budget justifications would better enable Congress to make difficult resource allocation decisions and to hold IRS accountable for achieving results with the resources it is provided.

Financial Management Risks

Although for the second consecutive year, IRS was able to produce financial statements covering its tax custodial and administrative activities in fiscal years 2001 and 2000,[16] that were fairly stated in all material respects, this was only achieved because of the commitment of significant staff resources, time, and the use of compensating processes to overcome serious internal control and system deficiencies.

The major control and system deficiencies that we identified during our most recently completed financial audit included:

- An inadequate financial reporting process;
- Weaknesses in controls over unpaid assessments;
- Weaknesses in controls over the identification and collection of tax revenues due the federal government and issuance of tax refunds;
- Inadequate controls over property and equipment;
- Weaknesses in controls over its budgetary activity; and
- Weaknesses in computer security controls.

To overcome these problems, IRS relied on costly, time-consuming processes; statistical projections; external contractors; substantial adjustments; and monumental human efforts that extended nearly 4 months after the September 30, 2001, fiscal year-end. These costly efforts produced tens of billions of dollars of adjustments and would not have been necessary if IRS's systems and controls operated effectively.

IRS's current method of producing financial statements is not a workable long-term solution to meeting its financial reporting responsibilities for two basic reasons. First, the extent of manual review and changes to financial records is so substantial, and requires so much commitment from both management and the employees who do this time-pressure work, that it is questionable whether this effort is sustainable year after year. Second,

[16] U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

the time frames acceptable for year-end financial reporting are being compressed. The Office of Management and Budget has announced that, by 2004, government agencies will be required to produce financial reports within 6 weeks of year-end. The Treasury Department has established a goal of meeting such a compressed schedule during 2002. Without significant and systemic changes in how IRS processes transactions, maintains its records, and reports its financial results to accompany its extensive compensating processes, IRS's ability to meet this accelerated reporting deadline while sustaining an unqualified opinion on its financial statements is questionable.

Moreover, weaknesses in controls and systems deficiencies threaten modernization efforts.

- First, qualified staff whose input is critical to developing a modernized financial management system are the same individuals responsible for implementing the compensating processes to generate the annual financial statements. The tremendous time and effort it takes to derive the financial statements may make it impractical for these individuals to effectively devote the time needed to ensure the new system meets ongoing reporting needs.
- Second, because of the extent of adjustments to prevent misclassification of financial data, unverified data extracts are of questionable utility to IRS management. For example, without timely and reliable data on unpaid tax assessments IRS is unable to promptly identify and focus collection efforts on accounts most likely to prove collectible. Also, IRS has difficulties in relating taxpayer accounts that may be jointly responsible for unpaid taxes so that the correct liability of each taxpayer is readily discernable. This has contributed to instances of both taxpayer burden and lost revenues to the federal government.]

The challenge for IRS is to balance its short-term goals of improving its compensating processes with its long-term needs of overhauling its financial systems.

Concluding Observations

IRS is part way through what is intended to be a major organizational transformation. Real progress has been made laying the foundation for a more modern agency. To avoid delays in realizing the promise of modernization for improved service to taxpayers while ensuring compliance with the tax laws, the new commissioner should be willing to work within the existing general framework for modernization and be

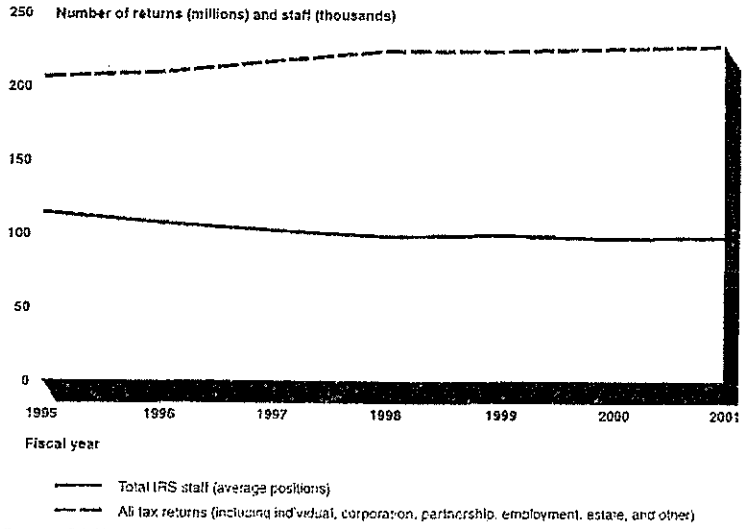
willing to build on the foundation that has been laid. Progress will also require successfully managing the risks outlined in our statement.

Mr. Chairman, this concludes our statement. We would be pleased to respond to any questions that you or other committee members may have.

Appendix: Overview of Trends in Tax Administration

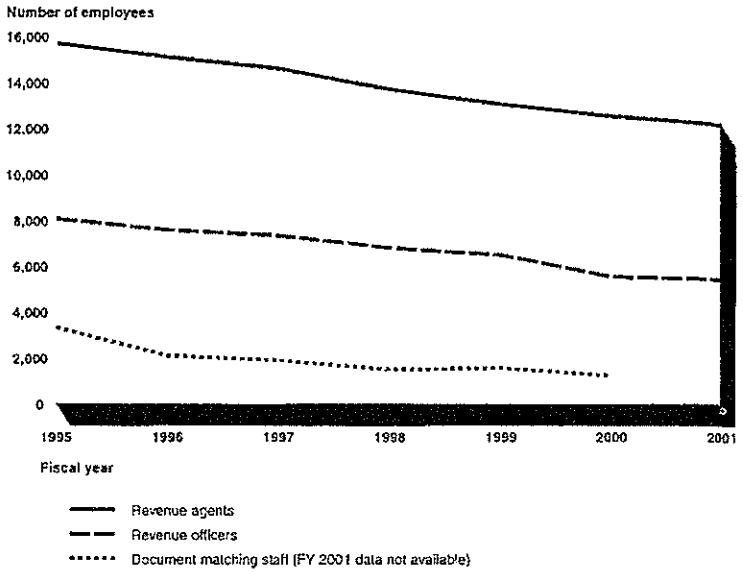
Overall, since the mid-1990s IRS has seen increased workload, decreased staffing, and significant changes in the allocation of resources between taxpayer assistance programs and its compliance and collection programs. We selected data, presented in the following seven figures, to illustrate some of the key trends at IRS since the mid-1990s.

Figure 1: IRS Workload as Measured by Returns Filed Has Increased While Total Staffing Has Decreased



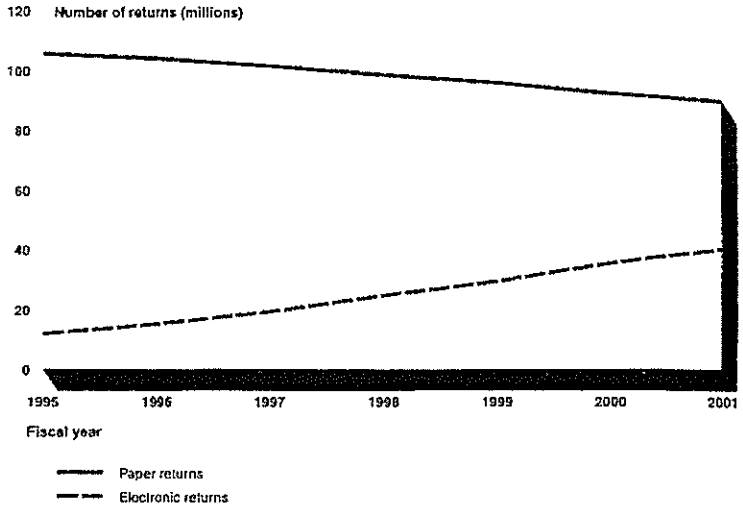
Source: GAO's analysis of IRS's data.

Figure 2: Enforcement Staffing Has Declined Proportionately More Than Total Staffing



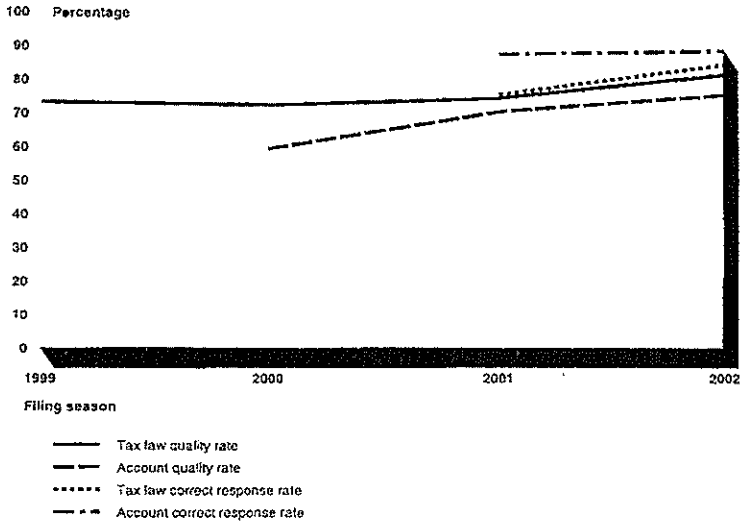
Source: GAO's analysis of IRS's data.

Figure 3: Individual Electronic Returns More Than Tripled While Paper Returns Decreased by About 15 Percent



Source: GAO's analysis of IRS's data.

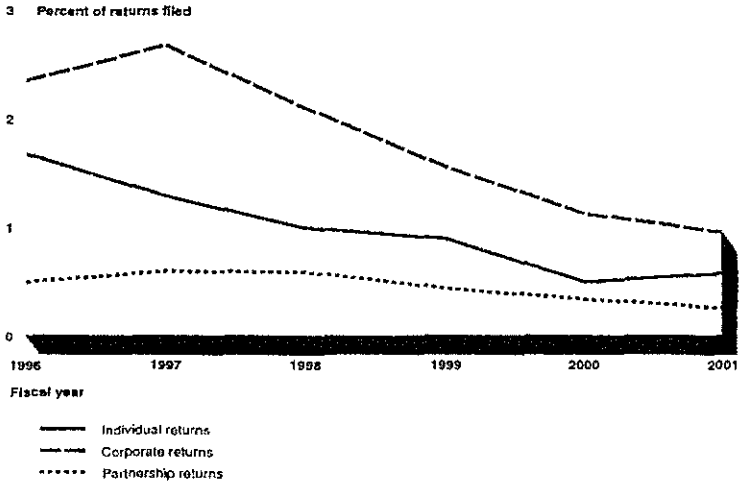
Figure 4: Telephone Accuracy Is Increasing



Note: IRS has two types of measures for assessing the accuracy of its responses to taxpayer calls concerning (1) tax law issues and (2) IRS's records on their accounts. The quality rate is the percentage of calls in which assistors followed all IRS procedures for the call type and provided correct answers. The correct response rate is the percentage of calls in which assistors provided correct answers for the call type, discounting procedural errors. IRS has comparable data only for the years shown.

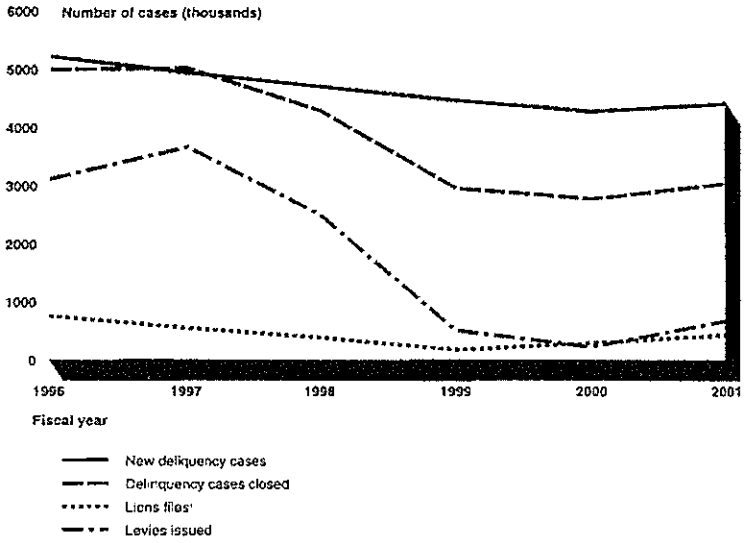
Source: GAO's analysis of IRS's data.

Figure 5: Audit Rates Have Declined



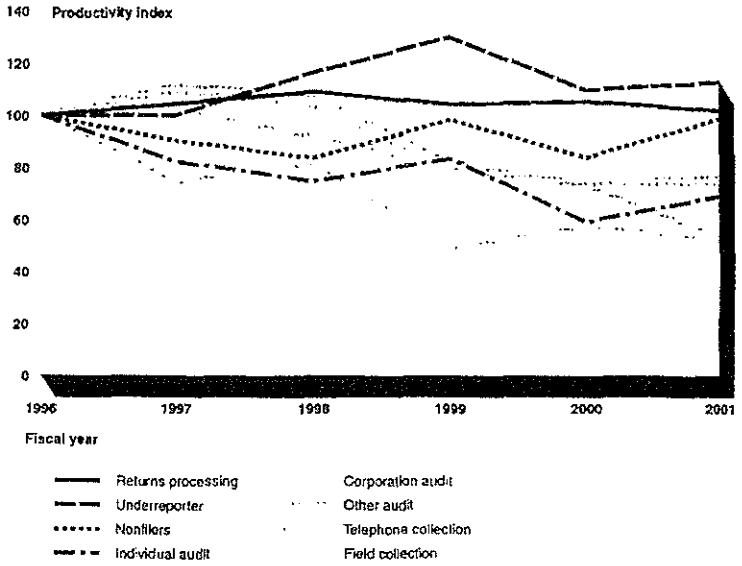
Source: GAO's analysis of IRS's data.

Figure 6: Gap Between New Delinquency Cases and Delinquency Cases Closed; Declines in the Use of Liens and Levies



Source: GAO's analysis of IRS's data.

Figure 7: Raw Productivity Declined for Six of Eight Compliance and Collection Programs



Source: GAO analysis of IRS data.

Congressman COYNE. Well, I would like to thank all of the panelists for their testimony here today, and yield to Mr. Houghton for any questions he might have.

Congressman HOUGHTON. Thank you, Mr. Chairman.

While all these wonderful comments have been made about you, Mr. Rossotti, I would sort of capsulate this in saying that you are the most successful tax official since St. Paul. [Laughter.]

Now, I wonder, if St. Paul had had a $10 billion budget and 100,000 employees, whether he would ever have written his epistles. But, anyway, we are delighted to be with you, and Mr. Levitan, Mr. Williams, and Mr. White. Thank you very much.

I want to talk about money a little bit because you have suggested approximately $500 million to $1 billion increase this year in your budget. That goes from $9.9 to $10.4 billion. You have got a lot on the plate. Obviously, you have put in process some of the things which will continue after you have left.

But in order to help us, can you tell us a little bit about what you see as your swan song as you move off, and what some of the money needs are going to be? I mean, you are talking about moving to 80 percent electronic filing by 2007.

Is that going to cost money, is it going to save money? In terms of increasing your auditing, is that going to cost money or is it going to save money? The difficult thing is, there will be a new person in your chair that will not have the confidence, the associations, and the background that you have had, and it is going to be difficult when you look ahead.

So rather than just going on a year-to-year basis, maybe you can take a look over the next hill and share with us some of your thoughts.

Commissioner ROSSOTTI. Yes. I think that is an excellent question and it is one that the Oversight Board has asked and we have tried to answer as best as we can. I think we are getting some better answers.

I think, while it gets to be very complicated in the budgeting and so forth, you can really boil it down to two things that are going to be needed on a consistent basis. I am going to refer to this chart in minute, but let me just summarize them.

What we need is some modest, on the order of 1 to 2 percent a year, real growth in our operational resources, which is primarily our staff. It could be, in some cases, contracts, as Mr. Horn has noted. But whichever way it is, it is about a 1 to 2 percent increase in resources.

The other piece, is the funds to modernize the technology which will produce productivity gains. The combination of those two will allow us to both meet the increasing workload and, I believe, close the gap to increased productivity.

If you look at this chart, you can see what we have proposed in 2003 in the President's budget. At the top, you notice that there is a requirement for 3,452 full time equivalent personnel at a cost of $259 million, which we will apply, if we get those, directly to the top priority tax administration programs, predominantly in compliance, but some of them to meet customer service needs.

However, we are also projecting in this budget a net savings, if you will, or a reapplication, a productivity gain equivalent to about

2,287 personnel, which are the result of our internal management and modernization improvements. So, we are really only asking for a net increase that would be funded by the Congress of 1,165.

Another way to put it is, with a funding increase that pays for 1,165, we get about a three times multiple in terms of effective delivery of services.

If we can continue to do that year after year, which is an aggressive assumption because that involves significant productivity growth higher, by our calculations than what the private sector and the financial world has accomplished. But if we can continue to do that for year after year, we believe that we can eventually close the gap.

Now, the other piece of it, which is not in here, is funding the modernization itself because that is what generates, for the most part, the growth in productivity.

So if you put those two pieces together and you do them consistently means that you are successful in your internal management, on the one hand, and on the other hand we achieve some relatively limited net growth in our operational resources, I believe we can succeed.

Now, let me just say that I think there is a problem here with this, not in the planning and not in our ability to carry it out, but in what actually happens in some cases.

Even though we propose this and it is in the President's budget and it appears to be funded, in actuality it turns out not to be funded, at least not the way that it appears to be. The best example I have about this is the pay raise.

Last year, the Congress passed a pay raise—this is in 2002—that was one percentage point higher than what was in the President's budget. It was in order to make civilian pay equal to military pay, which is a fine thing to do, but there were no funds provided for that. Therefore funding the pay raise was equivalent to basically putting the money into one pocket and taking the money out of the other pocket. For any one year, you might be able to do that, but now there is a potential for even a bigger difference, 1.5 percent, this year.

Should that happen, that would be a total of 2.5 percent. That is $115 million a year. That basically offsets the net increase that we were proposing, and we end up essentially treading water and not going anywhere.

Also, in the President's budget there were some legislative proposals that would help us to achieve productivity gain. Some of those were passed by the House, but they have not yet been acted on.

We are basically banking on very aggressive productivity gains, as you can see here, very successful implementation of new systems, however the margin is very thin.

So if things happen that undermine even that thin margin, what we end up with, is basically making some progress, but really not closing the gap that we have. That is where I think the biggest risk is.

Congressman HOUGHTON. Can I just follow up, just for a minute?

Congressman COYNE. Sure.

Congressman HOUGHTON. Well, in other words, you are saying that you will be asking maybe for 1,000 people a year for the next few years.

Commissioner ROSSOTTI. Yes, 1,000 to 2,000.

Congressman HOUGHTON. And that will take care of not only what you need in terms of your internal organization, but also increasing the auditing.

Commissioner ROSSOTTI. Right. I mean, most of those people would go to compliance, which is auditing and collections. The people that we would save would be from things like electronic filing, reducing the submissions processing, the back office, or just leveraging the productivity of the people in auditing.

Congressman HOUGHTON. And the investment for electronic filing and the efficiencies will sort of take care of itself. But you are worried about these other things coming in, where the ideas are great but the funding is a little shallow.

Commissioner ROSSOTTI. Well, I think that what we end up with in the 2003 budget that is sort of summarized in this chart, if that funding were truly provided that would enable us to do the things there, hire the 1,165 people and also get enough money for the modernization, if that were really done and if we were very successful—and I do not disagree with Mr. White—these challenges in making these things happen and making these systems actually go in and getting these productivity gains are not a small thing. They are very, very hard.

But if you could achieve those things, and if you did it consistently year after year, you would be able, I believe, to cope with the increasing workload and gradually close the gap, which we have a very, very large gap right now in our compliance, in our enforcement, and to some degree in our customer service.

So I think there is a formula there. There is a plan that could work, but it does not have a lot of leeway in it. In fact, it has a lot of risk in it. But it is at least a feasible plan.

I think part of the risk is internally what we have to manage, but part of it is external because, when we get the money assigned for these activities, but then you get things like unfunded pay raises, you are blocked.

Congressman HOUGHTON. Thank you very much.

Congressman COYNE. Thank you, Mr. Houghton.

Commissioner, can the IRS improve customer service, while at the same time adequately enforcing the tax law?

Commissioner ROSSOTTI. Mr. Coyne, I, after four and a half years here, absolutely believe that not only can it do that, but it has to do that if we want to have a successful tax administration system.

I think that the basic fundamental point about the American tax system is that most of the money comes in from people who are honest people paying their taxes voluntarily. Even if we do, as we do, estimate that there is $200 billion-plus that is not being paid, that still leaves $2 trillion that is being paid by people who are paying voluntarily.

It is only reasonable that they should be treated properly and get the rights that they are entitled to, and if they need help, that they should be able to get it. They also, I believe, are well served by our using our enforcement powers to make sure that those people who

are the minority that are not paying are not allowed to get away with that.

So I think the charts that I showed earlier, and the response to the public, show that the public will not always hate the tax collector. I think that if you treat people properly, they have reasonable expectations and they will respond.

The only conflict, if there is a conflict, is in resources. It does take some resources to answer phones and it takes some resources to do audits. So, to some degree, you have a conflict in terms of resources.

But even there, if you are efficient in serving your compliant taxpayers, you may reduce the number of cases of people getting behind, and even reduce the load on your compliance resources.

So as a matter of good public policy, as well as a matter of efficient management of the tax system, I am one who believes that there is no way that you can effectively, over the long run, run a tax system that depends on voluntary compliance when you have 78 percent of the public, as they said in 1998, basically not having any respect for the agency. I do not think that can be acceptable.

So my answer is, unequivocally, you not only can, but I think you have to. The only qualification I make on it, is it does pose a need for having adequate resources to cover both ends of the mission.

Congressman COYNE. As you prepare to end your tenure, and very successful tenure, as Commissioner, what two or three main points do you plan to share with the new Commissioner to ensure that the IRS stays on the course that you have so successfully set during your time?

Commissioner ROSSOTTI. Well, I would mention a couple of things right off the top of my head.

One, is the question you just asked, and which Senator Grassley teed up in his comment, really is a fundamental point. There are people who believe that people will always hate the tax collector, and that is inevitable.

I think if you accept that, you have lost the battle before you start. You really then cannot even respond to people's complaints properly because you can dismiss any complaint as being just driven by the fact that people will always hate the tax collector.

I think you have to set a goal, which is proper in any business organization, to keep your customers happy, your good, paying customers, collect your receivables, and do both halves of the mission. So, that is a basic point. If you lose sight of that dual objective, that, I think is a mistake.

The other thing, on a more tangible level, is having a strategy that determines how you get out of the hole that we are in, because we are most certainly in a hole in terms of inability to fully execute our compliance, and even our service, mission.

The plan that we have come up with that has been endorsed by the Oversight Board and was endorsed in the President's budget, is not asking for massive increases in the size of the agency, but asking for modest increases and trying to do most of it through internal productivity.

That is a basic strategy. I believe it will work, but that is a difficult strategy to pull off. It is a real challenge for the Commis-

sioner and the whole leadership of the agency. Certainly it requires some budgetary support on a sustained, ongoing basis.

I think those are two very important strategic points that are very uppermost in my mind.

Congressman COYNE. Thank you very much.

Mr. Horn?

Congressman HORN. Thank you, Mr. Chairman.

I would like all of the witnesses to answer this. As you know, the audits and the other tax law enforcement activities have declined dramatically in recent years. What does the IRS need to do to improve tax law enforcement? Let us start with Mr. White down there. Has GAO got a feeling on this?

Mr. WHITE. I agree with the Commissioner's emphasis on productivity. One of the problems in the area of compliance and collections has been a decline in raw productivity. That is measured by cases closed per unit of staff time, per staff hour, per staff year, without adjusting for the quality, the length of time it takes to work cases.

The Restructuring Act imposed some additional requirements, but IRS has not done a quantitative analysis to get a good handle on what is behind these declines in raw productivity. So one step is understanding what is behind this decline in raw productivity and turning that around.

Congressman HORN. Mr. Williams.

Mr. WILLIAMS. The small business and self-employed element of the organization is conducting a reengineering effort right now of exam and collection effort. I think it is important to look at reengineering.

Certainly, there has been an incremental fall in productivity of each employee and of the cases, and that needs to be better understood. If reengineering can help, that would be great.

I think also consideration of focusing on issues rather than entire returns would have a huge payoff, focusing on a certain line in the 1040 rather than on a group of people's 1040s.

Research. There is some real hope that we have for the National Research Program, that it will provide the kind of intelligence that will allow us to target lawbreakers in big payoff areas.

The IRS has done a good job, CI particularly, of publicizing successes. That is important. Many enforcement initiatives are dependent on computer programs. There are things that we can do right now, to write computer programs that will cause violators to just fall out of the sky, but the big payoff is coming when the modernization completes itself.

Congressman HORN. Mr. Levitan.

Mr. LEVITAN. At the risk of repeating some of the points, I think they are right on target. First, we need to send a message. We need to send a message that the IRS is following up, that we are successfully prosecuting many cases and that needs to be publicized so the public does hear that.

We need to do a better job of identifying where to put the limited resources that we have, and there the National Research Program is going to provide valuable information. We strongly support that.

New initiatives in high-priority areas such as foreign credit cards and K–1 matching should provide significant information.

Modernization over the long term—and I emphasize long term, unfortunately—is going to help significantly. So there are many things that the IRS can do. I think, though, as I have said before, to some extent that is playing around the edges. None of that is going to make a material difference unless the administration and Congress does some important things.

There are two things I think that are critically important. Number one, is the complexity of the Tax Code. The complexity of the Tax Code invites errors. Errors take significant resources from the IRS that then cannot be used for enforcement.

I think also complexity invites cheating. If we can simplify the Code, we can make a major impact in both of those areas.

Finally, you have heard this over and over again, I think, from all of the panelists here, we need to have adequate resources to accomplish our task.

Congressman HORN. Commissioner Rossotti, you have heard your colleagues. What does the Internal Revenue Service still need to do to improve tax law enforcement?

Commissioner ROSSOTTI. Well, I think that all of the comments that have been made by my colleagues here are correct and they reiterate a lot of the things that we are doing to focus resources, increase productivity, make sure that we are working the right cases and the right issues as opposed to just diluting our resources. So, those are all part of our strategies.

I do want to recap, though, by pointing out that none of this, by itself, will work, will solve the gap without some level of increase in qualified staff. I mean, when we have thousands of cases of taxpayers who are high income taxpayers who are hiding substantial amounts of income in offshore accounts, we are now getting the information that is telling us who they are.

There is not any way that we can effectively deal with those taxpayers without having a very skilled person with a considerable amount of training go out and deal with that taxpayer or the representative, or a special agent if it is a criminal case. We need those skilled people. We really have a very, very thin line right now in the enforcement area of those people.

Just to quantify one example. I will give this to quantify how big this gap is. If we only take individual taxpayers with incomes over $100,000 a year, and these are taxpayers who have reported, never mind those who did not file or did not report, but if we take those that are over $100,000 income, there about 9 million of those returns.

Well, we know of about 1.2 million of those returns which, with reasonable degree of accuracy, we believe, have a sufficiently understated tax, that they should be audited by a field auditor—not by document matching, but a field auditor. So there are 1.2 million that we know of of high-income taxpayers that should be audited.

Our capacity today to do those is 54,000. That is 54,000 out of 1.2 million, not total, but of those that we know of. That leaves 1,150,000 that should be audited that we are simply putting aside for lack of resources every year. That is a big gap. That is before we ever get to special programs like offshore credit cards. We have a long way to go to have adequate resources to deal with those cases.

Congressman HORN. I will wait until the Chairman sits. We will have another round. I just got my five minutes over, but I take it we will have another round.

Senator CONRAD. We will. Congressman Portman has arrived, I am told.

Congressman, if you would like to make an opening statement, it would certainly be appropriate, or if you would like to proceed with questioning, whichever you prefer.

OPENING STATEMENT OF HON. ROB PORTMAN, A U.S. REPRESENTATIVE FROM OHIO

Congressman PORTMAN. Thank you, Senator. I think I will do a little of both. First of all, thank you very much for chairing the joint hearing. This is very important, and is done every year since the Restructuring and Reform Act was enacted.

In fact, it was almost five years ago to the day that the report was issued by the Commission on Restructuring and Reforming the IRS, and many veterans are here with us in the room today. We were in this very chamber many times during the Commission's deliberations, having hearings and talking to some of the same people.

I think we have made considerable progress since that time five years ago, and since four years ago when we passed the Restructuring Reform Act, which was largely based on the Commission's work. I do think we have a number of challenges. I think those have been identified today.

The primary challenge, of course, is in the area of compliance, enforcement, audits. We have seen the rate drop off. I think what we have heard today is a list of at least a half dozen different things that the IRS is currently doing to address that. Those are all appropriate.

I could not agree more that it is not mutually exclusive to have good enforcement and good taxpayer service. In fact, the theory behind the Commission's report, and I still believe it even with the evidence of the drop-off, is through good taxpayer service, we can increase compliance.

This has been the experience of all of the service organizations in America over the last couple of decades and it can be the experience of the IRS, but we do need to devote more technology, more resources, and among other things, have better data and better analysis.

Mr. White talked about the fact that we do not have good analysis currently of what is going on. It is true. TCMP was discontinued after 1988. So when the Commissioner talks about $200 billion that we know is not being collected, we do not know that number. I am very supportive of moving ahead for that reason with the NRP, despite some of the risks.

And those 50,000 taxpayers—I hope I am not one—who have to undergo that will have a much less obtrusive experience with the IRS than we had with TCMP. But it is necessary to get that data to begin to address what I view is the largest challenge facing the IRS.

I have a couple of questions, if I might, Mr. Chairman.

First, to Mr. Levitan and if the Commissioner would be willing to chime in as well, that would be helpful. The purpose of setting up the Oversight Board was really threefold: one, to bring expertise that you bring, Mr. Levitan, from the private sector and others on your board; second, was to provide for more accountability so that you had a body that actually was accountable for the reforms or lack of reforms; but third was continuity.

This is significant, with the Commissioner's departure at the end of the year. As you know, we have five-year staggered terms. Although it took us a while to get the Board up and going, the Board has now been intimately involved in the reengineering and restructuring of the IRS.

Do you believe that the continuity is there for us to have a smooth transition to the next Commissioner, and could you give us a status report on your process that I know you are undergoing to select a list of candidates which you will then provide to the President and to the Treasury Department?

Mr. LEVITAN. Yes. First, let me talk about where we stand with finding a new Commissioner. The Board worked very closely with the Treasury Department, first, to put together a set of specifications for the position. So everybody—the Board, the Treasury Department, the Secretary of the Treasury and the White House—were all in agreement with what we were looking for.

From the comments I heard from each of the members earlier, I think you would be very pleased with what that statement said and the kind of capability and experiences that we expect the next Commissioner to have.

We then hired a search firm. The search firm brought to us a number of candidates who met qualifications and have expressed some interest in the position. The Board did some further work in vetting those individuals, and then we have sent to the President a number of candidates that the Board believes are both qualified and interested to serve in this position.

The ball is now in the President's court. I know the Secretary of the Treasury is very much involved to make a final selection to nominate an individual.

Congressman PORTMAN. And just to clarify for a moment, that list of candidates you sent forward is to be considered by the administration, but they may go outside that list, I understand, to choose a Commissioner.

Mr. LEVITAN. Yes, that is exactly correct. It is a Presidential appointment, therefore, it is up to the President to make that decision.

However, I am encouraged in that I think the most important thing we may have done is develop, and then have agreement, on the specifications because we can now all turn to that and say, does the individual meet those specifications.

Second, I think the Board will be very involved as a new Commissioner is both nominated and approved by the Senate. We will work with that individual to help provide that continuity.

Most importantly, I think it is the processes that have been put in place at the IRS under the Commissioner's leadership that will provide, really, the mechanism to help ensure that we do have continuity.

The question was asked of the Commissioner of what advice he would give to the next Commissioner. The advice I would give, and will give, is really, stay the course. We have an excellent plan in place. It is very well documented. We have a good team. We just need to execute that plan ferociously and make it work.

Congressman PORTMAN. Commissioner.

Commissioner ROSSOTTI. Well, I think that what Larry said is excellent. I mean, they have fulfilled the mission that was given to them, as far as I can see from serving on it to assist in identifying a new Commissioner.

It was very carefully thought through in terms of the specifications. They made complete sense to me. Obviously, there is still more to do. You have got the Secretary, the President, and the Congress that have to actually make a selection. But I think, as it was envisioned by your Commission and legislation, it seems to me that it is working pretty well.

Congressman PORTMAN. One other question, quickly, Mr. Chairman, if I might, that has to do with the overall direction of the IRS. As you know, we were strongly supportive in the Commission of a reengineering and restructuring of the IRS along taxpayer lines with some pain and some dislocation that has now occurred.

There has been discussion recently about some of the frustrations that have resulted, not just with employees learning to live with the new system, but also the fact that some taxpayers would fall in different categories. For instance, a corporate taxpayer that also has individual tax issues.

Looking back, Mr. Commissioner—and Mr. White and Mr. Williams, you may want to comment on this as well—do you think it was a good idea to undertake the restructuring of the IRS along taxpayer lines? Do you think it is something that ought to be continued, and how do you think it can be improved?

Commissioner ROSSOTTI. Well, obviously, I do think it was. I think some of the, we call them growing pains, that you are talking about are inevitable when you make that much of a change. Actually, a lot of those have actually settled down already in the last year. I think what you are left with, is a structure that really will allow a Commissioner to, first of all, have people who are really accountable and for dealing with major blocks of the performance of the agency.

One of the things that amazed me when I started to look into it, was everything came together at the Commissioner and the Deputy Commissioner. It was essentially everything coming together through many, many layers of management. It did work, because for years people had gotten used to it, but it was not something any business organization would have really countenanced.

Now, the transition to get there was quite difficult, but we are basically behind that now and we are into fine tuning. So, I think that it will work. I do not think anybody is saying, go back to an old structure.

It is one of the building blocks that I think the new Commissioner is not going to have to worry about, other than in any organization, no matter what you do to divide an organization that is very large into pieces, you then have the issue of how you coordi-

nate across the pieces. I do not care what you do, you would have that issue.

But I think, as a way of dealing with accountability internally and customer focus externally, it is a good situation to leave to the new Commissioner.

Congressman PORTMAN. Mr. White or Mr. Williams, quickly, any comments?

Mr. WHITE. GAO believes that it was very appropriate to try to achieve a better balance between service to taxpayers and enforcement. We think that the plan—and we have said this for years—there is, as the Commissioner said, a well-laid plan. One of the advantages, one of the strengths of this plan, is that it integrates a number of different aspects of tax administration.

So it is an integration of performance management, performance measures, better information systems, the organizational structure of IRS. The fact that it is attempting to integrate all of this is a strength of the plan. It also makes it more difficult to implement. Any one of those aspects of the plan would be very difficult alone. Trying to do it all in a coordinated fashion is more difficult.

IRS, as I said in my statement, has made real progress over the last four and a half years in implementing the plan, beginning to implement it and developing the plan.

There are a number of risks going forward: the decline in compliance and collection programs, putting in place the capabilities to better manage systems' investment, performance management including financial management issues that a new Commissioner is going to have to deal with, and deal with soon.

Congressman PORTMAN. But you would say, stay the course with regard to the restructuring, with a caveat that, on the compliance side, you have a list of initiatives.

Mr. WHITE. Absolutely. Yes. If you do not stay the course, if a new Commissioner does not stay the course, there is a real strong likelihood that that would significantly delay realizing the benefits of modernization.

Congressman PORTMAN. Mr. Williams.

Mr. WILLIAMS. I think there is always a lag time between the time you make an investment and the time you begin to experience the payoff. Certainly, IRS felt that. When the ship first began to turn, there was a degree of chaos and not much return for a huge investment. That really has turned around, and I feel very confident in the decision that was made and the course that was taken.

If I was concerned at this moment, it would be that, because of some unforeseen investments that had to be made, the units are not being able to complete staffing up. There was the pay raise. I am hearkening back to some of the things Larry said.

There was also the shift of resources that were required post–9/11. The paradigm for a security threat completely changed from an insider or one or two people to an organized, sophisticated assault that could close us down in collecting the several trillion that it takes to operate the government. That left the IRS short and it left completion of RRA '98 a bit short.

Congressman PORTMAN. You were generous to leave out tax law changes in there.

Mr. WILLIAMS. That is a really good point as well.

Congressman PORTMAN. Thank you, Mr. Chairman.

Senator CONRAD. I would like to ask each member of the panel, what is your single greatest concern about the Revenue Service going forward, and what should be done to address that concern?

I will start with you, Commissioner.

Commissioner ROSSOTTI. Well, I think that the huge gap that we have that I think we all acknowledge between what we know we should be doing, especially in the compliance area but it is also there in the service area, that gap, together with the fact that the workload compounds, if that situation continues, if we do not make progress in closing that gap, and the only way we could do that is some combination of increased resources and increased productivity, if we do not close that, I really think we have a serious threat to the tax system.

I always look at the glass being half full, and I do think it is half full because we have made progress and we know how to fix it. But if you just kind of stayed where we are, let the workload grow as it has been growing over the last five years, that we are not able to close the gap that we have in compliance, that we just get bigger, at some point people begin to, lose confidence, and the whole confidence that the tax system is based on is threatened.

So I think that, while we know how to fix it and I think we can fix it, the other side to it is, it is not in a stable situation. I mean, it just simply is not in a stable situation.

If we kind of keep where we are, stay where we are from a funding and productivity standpoint and continue to add all the things that we added over the last five years, at some point you are going to have a real breakdown.

Senator CONRAD. What would be the single most important indicator that you would look to to determine whether or not serious progress was being made?

Commissioner ROSSOTTI. Whether serious progress is being made? Well, I think that on a day-to-day basis you can look and see whether the effectiveness of our operational indicators, whether we are doing the day-to-day things that need to be done—processing returns, answering phones, getting better accuracy, auditing the people that should be audited, which is not only how many we do, but doing the right ones, collecting the overdue debts, which Congressman Horn always reminds me of every time I see him—those things, we can measure. I think, if they are going in the right direction, at least on a trend, then ultimately I think we are making some progress in closing the gap.

I do think that our compliance study, our National Research Program which Congressman Portman mentioned, we will get in about two years from now. That will give us a very important point of measurement as to the degree of compliance and where the noncompliance is.

So we will have the measurements, I think. Some of them are more current on a day-to-day basis and some of them come periodically, like the NRP. We will know. But I think if what happens is that we continue to have even more and more cases that we know of that people are not paying their taxes and we cannot do anything about it, we still are not able to fully satisfy even the people

who we are sending notices and letters to, and we cannot even answer them, I think that you have a real deterioration of the basic revenue stream of the country.

Senator CONRAD. Let me ask Mr. Levitan the same question. What is your greatest concern?

Mr. LEVITAN. While I am very concerned about the status of enforcement, as the Commissioner has talked about, I think the thing that I am focused on now is the execution and implementation of the modernization program. The IRS has to be modernized. It is not a question of, should it be, will it be. It has to be.

Senator CONRAD. And what is your assessment of where we are with the modernization?

Mr. LEVITAN. We have an excellent plan in place. We have been working at that plan now for about three years. Performance of that execution has been mixed, at best. We have accomplished a lot, but we have missed target dates, we have been over budget, we do not have all of the capabilities.

Our prime contractor performance has been disappointing. We need to get better at executing and making modernization work. The IRS has to get a lot better in managing the process. I think GAO has done a superb job in laying out exactly what they need to do, and we support that entirely.

The prime contractor has got to get a lot better at meeting their targets, at delivering quality results on budget and on schedule. We need to improve our capability to accomplish that.

Senator CONRAD. Mr. Williams, what would you say? What is your greatest concern for the Revenue Service going forward, and what needs to be done about it?

Mr. WILLIAMS. I would also say, Senator, the business systems modernization concerns. There are so many reforms and so many abilities to contain costs that are dependent upon the success of that, that no matter what its status, it becomes very important.

It is troubled. We are now three years into it. We have spent $1 billion. I think there are some legitimate doubts that we have $1 billion in value as a result of that investment.

We have checked eight projects through the development phase. They have been, on average, 89 percent more costly than was projected and one year behind in the schedule. The customer communications project, which is great—it took us out of the human router business—was 31 percent over cost and 9 months behind. The IRS needs to develop a project management process that is repeatable and is much better at estimation of both costs and time. The prime contractor was hired primarily to help us, to help the IRS strengthen in those areas where we had been traditionally weak. They did not deliver. They are not good at estimating time and cost, and we are having to jettison functionality as the projects come onstream. That worries me a lot.

As far as a fix, I think we need to slow down, do a few projects well. I think there is agreement that that is to be done.

With regard to prime, there has already been a shoot-out with regard to CADE failures. A very strong warning shot was sent off by the Commissioner and the CIO to the prime to try to understand IRS better, to try to understand the core business processes.

Senator CONRAD. When you talk about CADE, there are people listening who have no idea what that means. That is the Customer Account Data Engine. Is that not what that stands for?

Mr. WILLIAMS. It is, Senator. That is going to contain everyone's account.

Senator CONRAD. Information. That is the single most important piece of modernization, is it not?

Mr. WILLIAMS. It is. A second one is STIR, and those are two important ones to watch.

Senator CONRAD. And STIR stands for?

Mr. WILLIAMS. I can better tell you what it is for. It is to provide the infrastructure, and especially the security, for the entire operation to go forward with. If those stumble, so many of the good reforms and initiatives are held up and we will have to just continue to invest in manpower.

Senator CONRAD. Let me go back to the Commissioner. The Customer Account Data Engine was supposed to start Phase 1 of 5 last fall, but the project has been delayed twice. Why was it delayed, and will that have a ripple effect on other projects? When do you believe it will be completed?

Commissioner ROSSOTTI. Actually, the original schedule when we passed the design milestone last June, was that it was supposed to be delivered in a pilot phase in February, and then in a live phase in July. Basically, compared to that, we are six months behind.

Our current target is to put a pilot phase in the third quarter, in the July-August timeframe, and to actually go live with the next filing season in January. But it did lose six months.

I do note that with the renegotiation we have with the prime, that they did agree to absorb essentially all of the cost increase of that delay. So, that was an important thing that we were able to work out.

As to why it was delayed, the design phase of this requires not only designing a new database, but figuring out how to integrate it into the old system, and we have two of these co-existing at the same time. Frankly, that is the harder part. Designing the new database is hard, but it is a question of how you make it work with the old one.

I think that the biggest single thing that caused the delay was just a slower than expected understanding—and this is not an easy thing to do—on the part of the project team of some of the intricate details of how they were going to make the new system work with the old system.

So when we got into the design phase, there were some holes, there were some things that were missing, and there were just some complexities that were overlooked.

Senator CONRAD. Are you confident that the new schedule will hold?

Commissioner ROSSOTTI. Well, having been in the systems business for 28 years and having usually been on the other side and being asked that question, I always add a little bit of qualification.

Will they deliver this system, will we get it into operation, will it be the first building block of CADE, I think there is nothing about this that says that is not going to happen. Will it hit the pre-

cise milestones there on the target now? I would not want to stand up and guarantee that that is going to happen month by month.

But the two big things that Mr. Williams noted that really are the two key building blocks that we are trying to put in place here, one is the security infrastructure, the other the customer database, those are really the foundational elements of this whole thing.

Getting them in the first time is really quite tough. I was in the business myself for 28 years. My former CIO, who was there for the first two and a half years, was in it about 25 years. I have got a very experienced CIO now, and some other people who have come in from the outside.

We all look at this and say, this is really hard. It pushes the boundaries of a lot of things, not so much in the fact that a taxpayer database is such an extraordinary thing, but as in the scale that we deal with, and most particularly——

Senator CONRAD. Interaction.

Commissioner ROSSOTTI [continuing]. Really tangled system that we are coming with from the past. You put those things together, and that is where we are having our problems. We are not having our problems designing the new system.

Now, the good news to this, and I guess I am sometimes criticized as being an eternal optimist, and maybe that is a good thing or I would have never taken this job in the first place. [Laughter]. But the one thing about this, is getting these two pieces in place for the first release is awfully tough, and we have had some delays.

I will say, when we get done with those—and we will get through them. We do have people working. They do provide a tremendous amount of learning that has never been available in the past.

I mean, we can say CADE is six months late, or we can say it is 25 and a half years late. It was really in the late 1970s—and this is not exaggeration—that the first designs and proposals were put in place to replace what was then already in the late 1970s a more than 10-year-old system.

Ten years is pretty long in the computer business. So, 25 years ago we had a 10-year-old system that we were proposing to replace. Now we are 25 years past that, and that is basically where we are.

I think what is going to happen, is that we are going to slog our way through. That is really the word I would use. We are going to slog our way through to getting these first releases up. We absolutely are following the lessons that we have learned from doing this.

We have slowed down our plans numerous times and readjusted them when we needed to. We will do that again, and we will take advantage of that to improve some of the things that we need to in internal management. GAO has been excellent in identifying those.

I will say, we have made some improvements. The Enterprise architecture, which was the real blueprint of how the whole thing fits together, was a critical component that was not easy to do. GAO noted that many times. That is in really good shape. We have that in place now.

The release planning that coordinates different pieces that go in together is improved. The scheduling cost estimating, that area, and some of the contracting certainly needs more work.

So, bottom line, it is a tough, high-risk area. You would never take on this project unless you absolutely had to. But the IRS is 30 years behind, and there is not much I know of you can do except make it work.

Senator CONRAD. Let me just say, as a former tax administrator, I think I have some understanding of the extraordinary complexity of migrating from the system that was to what is going to be. When one looks at the extraordinary complexity, frankly, I was never too concerned about the design of a new system, new database management system for going forward.

The concern I always had was the migration. For anybody that knows, the systems that were in place trying to go from that to what is being fashioned is absolutely an extraordinary undertaking. I think all of us are concerned about meeting these deadlines, but more than that, of having a system that functions and functions efficiently. The jury is still out.

I think that would be the fair thing to say. But all of us have got a high interest in making certain that this functions for the taxpayers of the country and maintains the revenue system of this country. That is at the heart of the ability to defend this Nation. It is at the heart of the ability to improve homeland security, improve the education of our people, and all of the other things that the Federal Government has a responsibility for.

So, we understand the importance of this. This is not just a matter of some computer system, this is a matter of the functioning of the government to do the things that the people of this country want done.

Commissioner ROSSOTTI. I agree, Senator. Could I just finish up with one point that maybe I think is important going forward for Congress, as well as our oversight group?

Senator CONRAD. Yes.

Commissioner ROSSOTTI. There are a lot of different kind of mistakes you can make in the systems business, and I probably made most of them in the 28 years that I was in the business. But there is one mistake that, as Yogi Berra used to say, is the wrong mistake.

The wrong mistake is to say, if we do not make this schedule, we are going to lose credibility and we are going to lose our money, or we are going to be fired, or whatever people are worried about, so we are going to make this schedule come hell or high water.

Usually what happens, is you end up with hell or high water when you do that. When you are dealing with these complex things, the most important thing that you always have to keep in mind is that, if you do not deliver something that is actually a quality product, you have really lost completely.

So if you are behind schedule, which you frequently become in this business, the thing that the top management has got to give as direction is, all right, we do not like that, we are going to figure out how to get better schedules in the future, but we have got to focus on quality and make sure we actually deliver what needs to be delivered.

As long as I have been here and the people who have worked with me, we have taken that approach. I think it is extremely important that everybody involved recognize that nobody likes to have

a project that is behind schedule or an over-cost, and you try to avoid that in every way. But there is an even worse thing than that, which is to put in something that does not work at all or that is not really solving the problem.

Senator CONRAD. I could not agree more.

Congressman Horn?

Congressman HORN. Thank you, Mr. Chairman.

Mr. White, does the General Accounting Office have a figure for the uncollected taxes that are in the Internal Revenue Service?

Mr. WHITE. We do. I can have Steve Sebastian, who is from our financial management group, come up and answer that question.

Congressman HORN. I would just like a fast answer as to how many billion is uncollected, then I will let everybody else get into it. But that has to be the base.

Mr. SEBASTIAN. I will try and make this as quick as possible. As of the end of fiscal year 2001, the IRS had $239 billion in unpaid taxes, penalties and interest. About $20 billion of that is estimated to be collectible.

Congressman HORN. You say how many?

Mr. SEBASTIAN. Twenty billion.

Congressman HORN. Twenty billion. In the predecessor to Commissioner Rossotti, the figures that I saw then were that there were $60 billion. Then when the Commissioner noted that, oh, yes, we also have $110 billion, I said that I think it is a scandal, as far as I am concerned. That is what led me to put the debt collection bit in there. We are doing that now throughout the executive branch, and we need to do it and make it more effective in the Internal Revenue Service.

Now, Commissioner Rossotti and I have gone over that for five years together, and you are doing a great job. But why is it that we cannot use private collectors and get the job done?

If I was sitting out there listening to this now on C–SPAN, I would say, good heavens. I do my taxes. Why are we not doing those people that have $20 billion, $239 billion? We are looking for dollars everywhere we have. We have a war going on and we cannot find all the money for all the appropriations, and so forth, and so on.

I just think I would say, what are they trying to do, just let their cronies that are middle class and up get away with murder? I think it is outrageous. I could not understand why Ways and Means and Finance did not do that years ago. What are they hiding?

I think, gentlemen, for those of you that are on Finance and Ways and Means, you ought to get the private collectors in to get the taxes. That is my last point on this.

Senator CONRAD. Thank you, Congressman Horn.

Let me just say, that is a deep concern. I will tell you my foremost concern going forward, aside from the systems questions. Those are fundamental management questions. That is obviously a key to any operation.

But my overriding concern is, we have got $200 to $300 billion of taxes that are owed and due that are not being collected. At least, that is the best estimate. We do not have a clear idea of how big it is, but we know it is big. That goes right at the heart of the fairness and the credibility of the system, because the vast majority

of taxpayers, individuals and companies, are paying what they legitimately owe.

It is unacceptable that others skate by. It is unacceptable that people are engaged in tax scams, tax avoidance, tax fraud, these offshore operations, to shove the tax burden onto the honest people.

We have got an obligation to go after those that are dishonest, whether they are individuals or corporations, and insist that they pay their fair share of this tax burden. Now, that is a fundamental requirement of government.

Mr. Rossotti, what needs to be done to assure the vast majority of taxpayers that they are not being played for chumps?

Commissioner ROSSOTTI. Well, I think that what we are trying to do in the short term, within the limits of our resources, is to make sure we apply our resources where they will do the most good. We really do not have the resources to go after every case or to collect every receivable. We just do not. So what we are focusing on, with, I think, better information than we used to have and more that we're collecting, is the top priority areas.

Of the top priority areas, the number one category, are what we call the promoted tax schemes. This is deliberate, systematic tax evasion. It covers the wide spectrum of the tax system. This includes use of these devices like offshore credit cards and trusts to hide income. It does include the manipulation of the corporate tax code to defer or eliminate income, but it also includes people that are just filing erroneous refund claims.

Senator CONRAD. Where do you think the biggest problem is? In these things that you have mentioned, if you had to prioritize these five things that you have mentioned, what is the biggest?

Commissioner ROSSOTTI. The biggest one, in dollars, is the use of the devices to hide income. It is not all offshore. Some of it is offshore. These are trusts, credit cards, things of that kind. We have enough information now to say that, in terms of the promoted tax schemes, the systematic, deliberate tax evasion, that is the biggest one. I would say that the corporate-type shelters are the second biggest one.

Senator CONRAD. All right.

And what is being done? What is being done to go after these things?

Commissioner ROSSOTTI. Well, that is where we are focusing our efforts within the limits of our resources.

Senator CONRAD. Do you need more resources to do these things?

Commissioner ROSSOTTI. Well, let me just put it this way. In the very short term, since this is our top priority, we are simply devoting our resources to it. What that does, is undermines our ability to handle every other kind of compliance problem, such as collecting overdue debts, such as auditing even $100,000-a-year income taxpayers.

So the answer is, yes, we do need more resources in order not to undermine other aspects of compliance, but for the moment, for this particular area, we are handling this by simply reallocating our resources to it. As I mentioned, we have a whole strategy for each one of these that basically boils down to, first of all, systematically identifying both the promoters and the taxpayers.

Our top priority in enforcement is with the promoters. I have the numbers here. We have gotten much more active in doing injunctions, together with the Justice Department, against promoters. Prior to 2001, I think there had only been one injunction against a promoter for years. Now I think the number is 14 that we have done in the last year or so, and several more that are actually pending.

The other thing we are doing, in addition to the injunctions, is working with the Justice Department to figure out a way to pursue, in some cases, both criminal and civil activity at the same time. This is a great problem that we always had, because as soon as something appeared that had criminal potential, it put a freeze on doing everything else, and it can take two or three years to do criminal proceedings. So, now we are doing parallel investigations.

With respect to the participants, we have been using devices such as audits of the promoter records, as well as subpoenas—or summonses, as they are called—from other parties like the credit card companies to get data regarding who the participants are in these schemes. Then we are farming the information out to both our criminal and civil people.

Now, we are also using a lot of communication devices to try to warn people off from these schemes. What we want to try to do, is not only go after the people that are doing them, but try to prevent more people from coming in. There are a certain set of people who are sort of willing to be sucked——

Senator CONRAD. Persuaded.

Commissioner ROSSOTTI. Persuaded. That is right. And we are working with a lot of industry groups and business groups to do that. So, we are definitely on the case here. We are also using certain disclosure initiatives.

The Treasury has recently come forward with a package of proposed disclosure initiatives, some of which are legislative and some of which are regulatory, for forcing promoters and taxpayers to disclose some of the more complex corporate returns.

Our basic philosophy that we have, is if people are claiming they are engaging in "legitimate" tax planning, then they should not have any objection to disclosing it to us so we can take a look at it and see if we agree that it is legitimate tax planning. So, we think disclosure is a very important thing. I know there are some legislative considerations in the Senate Finance Committee about that.

Senator CONRAD. Thank you. I am going to have to go.

Congressman Portman has an additional question or two. I am going to turn it over to Congressman Houghton. First of all, I want to thank him very much for being here throughout the hearing. We appreciated very much your being here.

Congressman Portman, thank you very much for coming over as well, and for all the work you have done in this area. We appreciate it.

I want to thank all of the witnesses. We very much appreciate your contribution to the work of the committee and the Congress in this area.

Finally, to Commissioner Rossotti, thank you for your public service. I know very well it would have been much easier for you

to stay in your very successful business and to continue in all of the things that you were involved with in the community as well. You rose to the challenge. You came at perhaps the single most difficult moment for the Revenue Service, and I think everybody here owes you a debt of gratitude for taking this challenge on. We appreciate it.

Congressman Houghton?

Congressman HOUGHTON. Thanks very much.

Congressman Portman?

Congressman PORTMAN. Thank you, Chairman Houghton, and thank you, Senator Conrad, for holding this hearing and for bringing focus to these issues. These hearings are supposed to be an opportunity for the Senate and the House to come together, which is rare, on a bicameral basis, but also for the nine different committees and subcommittees to come together with their staffs—staffs are still represented here in the room—to be able to make sure that we are within the congressional oversight function, communicating and coordinating well with each other. I think these hearings have been extremely helpful in doing that and, again, bringing focus to some of these very tough issues we face at the IRS.

So, I thank the organizers, and I thank the panel for being willing to come before us. This is at least one where you can deal with a lot of different committees and subcommittees at once, which I know is a frustration for you as well. This came out of the restructuring legislation, as well as the five-year term for the Commissioner. In the past, there had not been a specified term. There was a concern that the turnover at the IRS, both at the level of Commissioner, the Deputy Secretary, and the Secretary, where many reforms were begun but not completed, was one of the problems at the IRS. There was not that continuity of reform.

We appreciate the fact, Commissioner Rossotti, that you were willing to step up to the plate four and a half years ago, now, and take on this very difficult task, and that you were willing to fill out your entire five-year term. I told Chairman Houghton, I think we should have made it a seven-year term. We could always pass legislation along those lines. [Laughter.] We cannot do it today.

But when you look back, we really began this seven years ago. We are five years into the legislation. I have heard it said that it is really a 10-year process. Many of us hoped it would be more like a five-year process. Are we halfway there? Probably. But I do not think we are seeing the fruits yet of the work.

I think the marginal fruit increase from the burdens placed on the system and from the changes, I think, will begin to be seen over the next several years, only if we keep our eye on the ball.

In hearing some of the concerns today raised about the challenges we face, particularly on the compliance side, we do need to redouble our efforts in terms of enforcement, auditing, being sure that the proper amount is coming in to the IRS.

On modernization, it is worse than we said it was. Seven years ago, many of us were making the statement that we had spent $3 billion in the previous decade on modernization for little or no result.

In a sense, we underestimated the challenge, because we are really not talking about a problem that existed seven years ago,

but one that dated back really to the 1960s, with 1970s technology. So, we are paying the price now of years and years of neglect.

Again, we need to be sure that we are keeping the pressure on. Chairman Levitan brings very important experience to bear on this, and I appreciate his unwavering commitment to this.

I know he is going to serve his entire five-year term, and I hope to continue that continuity, as well as your other board members. But this is something where you have got to keep our feet to the fire here in Congress and at the IRS.

The final comment I want to make, is with regard to all these issues, the modernization, but of course the performance measurements, I think they are very important. We did not get a chance to get into those as much today as I wish we had. But this is a sea change at the IRS and a culture shift.

You need to be sure that you are keeping their feet to the fire, Mr. White, on your comments on performance measurements that are seen over the years. The Commissioner has started something very unique in the Federal Government where, instead of measuring how much money an enforcement person brings in, you are measuring competence, professionalism, and courtesy to the taxpayers, and other measures of performance that are more like business measures.

In terms of electronic filing, we set, on a task, to have 80 percent electronic filing. As you know, we are at about 50 percent now, I understand, maybe the high 40s, but we seem to have a lag there and we seem not to be making the marginal gains. So, we need to look at some changes there. Chairman Houghton has focused some on that with our recent legislation.

There are other issues that you need to come to us on. The deadly sins, for instance. The House passed legislation, H.R. 386, recently which adjusted the deadly sins to give the Commissioner some more discretion, and added one for browsing. We did that on the recommendation of the IRS to try to improve morale and to try to improve enforcement and collections.

With regard to tax complexity, Mr. Levitan wisely raised that as an issue. It always gets unsaid at these hearings, yet in the Commission's report we ended up, as Mr. Houghton will remember, making that one of the strong recommendations, even though it was really outside of our ambit.

We pushed the envelope and said, here are 60 specific changes. We have not done those. In fact, we have increased the complexity of the Code during the last five years rather than making it easier for the IRS. So, you need to keep our feet to the fire on that.

Mr. Rossotti, I know you are leaving at the end of the year. But the other three gentlemen here, and I hope you in your private sector capacity, will continue to come to us and tell us what we need to do to refine the Restructuring and Reform Act from 1998 and to look at the underlying Code, particularly on the complexity side, and with regard to specific problems that you face, because Congress sometimes tends to focus on a problem and then forget about it and to leave it behind.

I will tell you that Mr. Houghton, myself, Mr. Conrad, and others, will not leave this behind. We will keep at it, despite other distractions that come up. The latest concern and the latest issue, we

are absolutely committed to making this work. And whether it takes 8 years, 10 years, or 12 years, we need your continued input and we appreciate your giving us that today.

Thank you, Mr. Chairman.

Congressman HOUGHTON. Well, thank you very much. Thank you for all you have done in setting up the Commission, the board, and all your interest in the whole structure here.

So, Mr. White, Mr. Williams, Mr. Levitan, and particularly you, Mr. Rossotti, thank you very much. Unless there are any other questions, the hearing is adjourned.

[Whereupon, at 12:02 the hearing was concluded.]

[The prepared statement of Senator Baucus follows:]

Committee On Finance

Max Baucus, Chairman

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Contacts: Michael Siegel, Lara Birkes
202-224-4515

Statement by Chairman Max Baucus
Joint Committee on Taxation
Joint Review of the Internal Revenue Service

Five years ago, Congress and the Administration determined that it was time for the IRS to stop spinning its wheels and start advancing with the rest of the world – in technology, customer service, and enforcement, so that, ultimately, honest taxpayers would have more confidence in the system.

The IRS Restructuring and Reform Act of 1998 addressed the concern that Congress was part of the problem. Too often Congress sent the IRS in completely opposite directions in the same year. The solution was to bring together the six congressional committees with jurisdiction over the IRS so that the Members of Congress could hear the same information from the Administration and from the General Accounting Office and so that the Members could start to work together to ensure a more consistent message. Today's joint review marks the fourth year Congress has met that requirement of the legislation.

To that end, we will hear testimony today from four witnesses: Mr. Charles Rossotti, Commissioner of the IRS; Mr. Larry Levitan, Chairman of the IRS Oversight Board; Mr. David Williams, Treasury Inspector General for Tax Administration; and Mr. James White, Director of Tax Issues at the General Accounting Office.

In the 1990s, the IRS demonstrated an inability to modernize its computer systems. It also increasingly placed collection statistics ahead of fairness and failed to provide consistent, quality service to taxpayers. These inadequacies in tax administration led to the creation of the National Commission on Restructuring the IRS and the enactment of the 1998 Act to reform the agency. The new law required the IRS to re-engineer its business practices, upgrade its computer systems and provide taxpayers with better service. Commissioner Rossotti was brought in to implement the most sweeping changes to the IRS in 50 years. He was also the first Commissioner to serve under the five-year term enacted as part of the 1998 Act. This November, he will complete his five-year term. Commissioner Rossotti has stopped the wheels from spinning and has pulled most of the wagon out of the mud. The nation has been well served by his efforts.

Under Commissioner Rossotti's leadership, the agency has a new mission statement, a new organization structure, a new strategic plan and a new senior management team. Unfortunately, the IRS carries a heavy load – and the wagon is prone to being stuck in the mud. Significant progress has been made since 1998. Perhaps the most significant facts are that electronically filed returns are up 110% and public approval of the IRS is up 35%. But there is much more work to be done. The IRS is still in the technological dark ages. Only two major projects have been completed with the others having delays and cost overruns. I realize that the Commissioner said it would take 10 years to complete the modernization projects, but Congress expected that more would be accomplished on the technology front during Commissioner Rossotti's tenure.

It is also troubling that enforcement statistics have dramatically declined. Collection seizures are down 98%, levies are down 82%, and liens are down 21%. Examinations of small businesses are down 73%, examinations of individuals are down 52%, examinations of large corporations are down 33% and revenue from enforcement is down 9%. Taxpayer behavior in response to congressional and IRS actions is complicated and difficult to analyze. But I am concerned that these enforcement statistics are more of a reflection of the IRS's reaction to the 1998 legislation than a change in taxpayer behavior. And, in light of the Senate Finance Committee hearing in April on abusive tax scams, the government must have a coherent plan for addressing deliberate tax cheating so that honest taxpayers don't carry more than their fair share of the burden.

Properly focused tax enforcement is critical to a sound tax system. The current evidence of increasing noncompliance and declining IRS audit and collection activities threatens that system. We may get the wagon out of the mud but it won't go anywhere if it is missing one of its wheels – and the tax system won't work without enforcement.

Commissioner Rossotti leaves the IRS with many accomplishments. Unfortunately, some of his top level executives have decided to leave as well. The 1998 Act also addressed the dearth of accountability and continuity within the IRS. The IRS Oversight Board was part of the solution to this problem. It is my hope that the Board has a plan to meet Congress's expectations and ensure that the IRS moves the wagon completely out of the ditch rather than letting it slide further down in the mud.

In 1998, Members of Congress shared a vision for a restructured IRS. We shared a vision where taxpayers could ask questions and get quick and accurate responses, where paperwork was reduced and more taxpayers filed electronically, where taxpayer data was readily available on computer screens so accounts could be adjusted promptly, where honest taxpayers were treated with respect, and where tax cheats were brought to justice. In other words, we shared a vision of a modern professional organization that provides quality customer service while still collecting its accounts receivable. I am committed to working with the Administration and the IRS to achieve that vision.

QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR LANDRIEU FOR DAVID WILLIAMS, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Coordination with Homeland Security Office

Mr. Williams's written statement notes the security challenges the IRS faces in the wake of the terrorist attacks of September 11. I am pleased with the cooperation between TIGTA and the FBI. You apparently meet with them on a daily basis. What is less clear is the extent to which TIGTA and the IRS works with the Office of Homeland Security, headed by Governor Ridge. Could you describe the role the Office of Homeland Security has played in TIGTA's security planning?

Compliance and Enforcement Activities

Every witness at the Joint Review discussed their concerns with the declines in enforcement actions by the IRS. From FY '96 to FY '01, the number of face to face audits have declined 72 percent, correspondence audits have declined by 56 percent, liens have declined by 43 percent, levies by 86 percent, and seizures by 98 percent. Mr. Williams's written statement attributes this overall decline to a long-term reduction in enforcement staffing, the redirection of resources to customer service functions, and fear of section 1203 allegations.

Has the IRS established criteria for how many audits it needs to conduct to have reasonable confidence in the integrity of the tax system? How many additional enforcement personnel does TIGTA believe the IRS needs in order to conduct enough enforcement actions to ensure the integrity of the tax system?

I understand that the IRS has requested an additional 1,179 Full Time Equivalent positions for FY '03 for the entire agency, but will add 1,857 FTE for compliance and enforcement activities. According to material my office received from the IRS, about 76 percent of these 1,857 FTE will come about through the "Re-application of Efficiencies and Workload Savings." Does TIGTA believe that the administrative and management savings in other areas of IRS will actually result in more enforcement actions? If so, how many more enforcement actions will be conducted?

RESPONSE TO QUESTIONS FOR THE RECORD
SUBMITTED BY SENATOR LANDRIEU
FOR DAVID WILLIAMS
TREAURY INSPECTOR GENERAL
FOR TAX ADMINISRTATION

Coordination with Homeland Security Office

Could you describe the role the Office of Homeland Security has played in TIGTA's security planning?

Since the creation of the Office of Homeland Security (OHS), TIGTA has recognized the importance of educating OHS about the TIGTA investigative mission and how it pertains to the activities of the Internal Revenue Service (IRS).

On November 27, 2001, TIGTA Office of Investigations personnel met with General Bruce M. Lawlor from the Homeland Security Council. During this meeting, the significance of IRS' revenue collection activities were highlighted as well as TIGTA's investigative mandate to identify and pursue all attempts to corrupt or otherwise interfere with the Nation's tax administration system through acts of violence or terrorism. General Lawlor was advised that TIGTA was available to provide any contributions to OHS deemed appropriate concerning the security of the United States and maintaining the integrity of the IRS.

To support Department of Treasury interaction with the OHS, TIGTA has coordinated with the IRS to determine law enforcement and economic crime protocol concerning information sharing and emergency preparedness. These efforts with the IRS include establishing roles and responsibilities consistent with the OHS to ensure that both the TIGTA investigative responsibilities and IRS business resumption plans are in place in the event of an incident that directly affects the IRS tax administration process.

To maintain consistency with the OHS, both TIGTA and the IRS have created emergency response and continuity of operations plans that will incorporate the Homeland Security Advisory System (HSAS) in the implementation process. TIGTA has subsequently tailored response activities, such as the evacuation plan, to be consistent with the HSAS conditions identified in the OHS five-tier threat level model. Specifically, TIGTA mission assurance efforts will be directly related to the current HSAS threat level at the national or localized level, as appropriate.

TIGTA continues to remain involved in many forms of intelligence gathering activities, to include nationwide participation at the Federal Bureau of Investigation (FBI) Joint Terrorism Task Force (JTTF) and the newly created

National-JTTF coordinator position at FBI Headquarters, as well as the United States Attorney's Office Anti-Terrorism Task Force in each judicial district. A presence on these task forces will ensure information regarding potential threats to the IRS is received and processed in a timely and effective manner.

Compliance and Enforcement Activities

Has the IRS established criteria for how many audits it needs to conduct to have reasonable confidence in the integrity of the tax system?

We are unaware of any current criteria used by the IRS to determine the volume of audits needed. In particular, the IRS has not conducted a measurement of the tax compliance levels since the Tax Compliance Measurement Program of 1988. The IRS is planning to begin a National Research Program this fall and will conduct approximately 50,000 audits to help measure compliance levels. This will be a necessary first step in this area, and could provide information to help the IRS determine not only the overall compliance level and types of non-compliance, but also the optimum level of returns for audit.

How many additional enforcement personnel does TIGTA believe the IRS needs in order to conduct enough enforcement actions to ensure the integrity of the system?

TIGTA cannot provide a specific number of additional enforcement personnel necessary to ensure the integrity of the system. In our view, to do this the IRS would first need to define the level of enforcement actions needed (similar to your first question), and then define how many enforcement personnel it would take to produce that level of activity, given current productivity rates.[1] The IRS would need to determine:

- The optimal number of audits that would need to be conducted. The examination rate has dropped significantly in recent years, to a level that appears to have already been detrimental to the system. Specifically, the examination rate for individual taxpayers has dropped from 1.67 in Fiscal Year (FY) 1996 to .58 in FY 2001. The January 2002 IRS Oversight Board report correlated this to the finding of their taxpayer survey that there had been an 11-point drop in the percentage of people who believe it is inappropriate to cheat on their tax returns.

- How many delinquent accounts it cannot fully work while still maintaining the integrity of the system. The number of cases in the IRS Queue[2] increased from 754,983 in FY 1996 to 1,722,662 in FY 2001, and the

[1] Productivity rates are an important consideration in this dialogue, since changes (either positive or negative) in productivity affect the number of actions taken, regardless of the level of staffing.
[2] The Queue is an electronic "holding area" for accounts awaiting assignment to revenue officers.

number of cases shelved[3] increased from 92 to 792,325 during the same period of time.

To our knowledge, the IRS has always scheduled its workload (i.e., the number of audits to be conducted and the number of delinquent accounts to be worked) based upon the number of resources available, instead of by some specific criteria designed to ensure the integrity of the system.

According to material my office received from the IRS, about 76 percent of [the 1,857 additional compliance FTEs for 2003] will come about through the "Re-application of Efficiencies and Workload Savings." Does TIGTA believe that the administrative and management savings in other areas of IRS will actually result in more enforcement actions? If so, how many more enforcement actions will be conducted?

TIGTA has reviewed neither the sources of data nor the calculation methodology for the anticipated savings presented in the IRS' FY 2003 Congressional Budget Justification, to which your question refers. We imagine that the IRS believes its efforts to "reengineer" its collection and examination processes would be major sources of the anticipated savings, and we have been monitoring these two efforts. However, it is too early to determine whether the changes proposed by these "reengineering" efforts will produce any significant workload savings.

Any increase in the number of enforcement actions would depend upon where the IRS puts the additional resources generated by the anticipated savings. The IRS plans to use most of the Full Time Equivalents to hire revenue agents, but how many more audits would be done depends upon which types of additional returns the IRS plans to audit. For example, partnership and corporation tax returns take longer to audit than individual returns. Therefore, if the IRS plans to use the additional resources to increase the number of partnership and corporation returns audited, fewer additional returns could be examined than if it used the extra resources to audit individual returns.

[3] "Shelving" cases refers to removing them from inventory without being worked.

QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR LANDRIEU FOR LARRY LEVITAN, CHAIRMAN, IRS OVERSIGHT BOARD

Enforcement Actions

Every witness at the Joint Review discussed their concerns with the declines in enforcement actions by the IRS. From FY '96 to FY '01, the number of face to face audits have declined 72 percent, correspondence audits have declined by 56 percent, liens have declined by 43 percent, levies by 86 percent, and seizures by 98 percent.

You note in your testimony that the enforcement work the IRS does is extremely labor intensive. The Administration has proposed increasing the staffing for enforcement actions by 1,857 FTE, largely through the re-application of resources. Does the Oversight Board believe that the Administration's budget plan to increase the FTE for IRS enforcement actions by re-applying resources will actually result in an increase in the number of enforcement actions?

05/31/02

Response to Senator Landrieu
Question for the Record
from
Larry Levitan, Chairman, IRS Oversight Board

Question

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Response

The Administration's FY2003 budget request for the IRS included the following combination of redeployments and increases:

• Customer Service and Workload Increases	+1,595 FTEs
• Enhanced Compliance Strategies	+1,857 FTEs
• Improvement Projects (redeployments)	-1,779 FTEs
• Workload decreases	-508 FTEs
Net increase	+1165 FTEs

The budget recommended by the IRS Oversight Board was approximately $92 million higher than the Administration's budget and included an increase of 1844 FTEs instead of the Administration's request of 1165 FTEs. Although the Board believed its request would have provided more improvement in IRS performance, it recognized that under the Administration's request that the IRS would be able to hire additional staff for important customer service and enforcement programs.

However, as I pointed out in my testimony to the Joint Tax Committee, the increase in budget intended to fund additional FTEs at the IRS has been eroded by other costs out of the control of the IRS. The Oversight Board is now concerned that the Administration's proposed FY2003 budget will not allow the IRS to make the progress in enforcement activity that was envisioned when the Oversight Board approved this budget in August 2001. Several factors cause this growing concern:

- The cost of postage in FY2003 will be $41 million more than was originally planned.
- Additional security measures have been implemented at an expense of $19.5 million for guard services and $15 million for campus security because of needs to provide for greater security for IRS offices and especially our mail handling centers in the aftermath of the 9/11 tragedy.

- The unfunded portion of the calendar year 2002 pay raise for federal civilian employees will add $43.5 million in costs in FY2003.

The greatest concern, however, is a potential $68 million negative adjustment to the IRS budget for a 4.1 percent pay raise in calendar year 2003 for federal civilian employees, if the IRS must absorb the difference between the proposed 2.6 percent pay raise and the 4.1 percent pay raise Congress is considering. The net effect of these unforeseen cost pressures is to put the IRS at a position in FY2003 where it cannot hire any additional staff and the only growth that will occur in enforcement actions will be a result of internal productivity gains.

While the IRS should be expected to increase its productivity from one fiscal year to the next, the Oversight Board believes the performance level at which the IRS operates needs to be considerably higher, and that staffing increases are necessary to bring the IRS up to the performance level the American taxpayers deserve. As I pointed out in my testimony, enforcement serves the vast majority of honest taxpayers who pay what they legally owe. It is an injustice to these taxpayers not to take action against those that cheat and expect the honest taxpayers to pick up the tab for their cheating.

There is also evidence that taxpayer non-compliance is on the rise. The Oversight Board survey that I described in my testimony showed an erosion of taxpayer attitudes about cheating on taxes between the years of 1999 and 2001. When asked what was an acceptable amount to cheat on their taxes, in 1999, 87 percent of the respondents replied "not at all." In 2001, the percentage of respondents who selected that answer fell to 76 percent. In a second example, the Bureau of National Affairs reported on May 28, 2002 that a recent initiative offering penalty waivers to taxpayers who revealed their tax shelters to the Internal Revenue Service has generated about 1,600 disclosures, far more disclosures than the agency expected.

Concern about rising non-compliance has resulted in very appropriate demands for the IRS to significantly increase enforcement activities. However, the Oversight Board believes that the Administration request is inadequate and will not enable the IRS to perform significantly more enforcement. If Congress wants adequate enforcement to ensure a fair system for all it will need to appropriate more than the Administration requested.

I would be remiss if I didn't add that the decline in enforcement took place over a number of years, and that a one-year increase in FTEs will not immediately restore enforcement activity to where it needs to be to ensure that all taxpayers pay what they legally owe. It will take a sustained commitment over a number of years to achieve this objective, but we need to start immediately.

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