

**PREPARED TESTIMONY
OF
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COMMISSIONER, INTERNAL REVENUE
BEFORE THE
ANNUAL JOINT REVIEW
PROGRESS REPORT ON
THE IRS RESTRUCTURING AND REFORM ACT OF 1998
MAY 20, 2003**

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).

I want to express my appreciation for your continued support of the IRS' efforts to carry out both the spirit and letter of RRA 98. As I begin my tenure as IRS Commissioner, I look forward to a productive relationship with you. I will certainly seek your counsel as to how we can improve both the management and processes that guide systems modernization and the critical services we provide to America's taxpayers.

Although I have been officially on the job as Commissioner for two weeks, I have some initial views about where the Agency stands today and what it must do in the future to succeed.

We are rapidly approaching the fifth anniversary of the enactment of this landmark legislation. But we are nowhere near realizing the full benefits of RRA 98. The modernization of the IRS is still very much a work in progress – and one that will require a great deal of hard work if we're to continue that progress.

In its January 2003 Performance and Accountability Report on the IRS, the GAO acknowledged that the IRS made progress laying the foundation for a modern agency that can respond to taxpayer needs in a more timely, accurate and cost efficient manner.

However, the GAO also warned that the "IRS must successfully manage several significant challenges that threaten continued modernization. Challenges include reversing the decline in compliance and collection programs, managing the deployment of several large business systems and implementing new performance measures and management processes."

The IRS has yet to provide the level of service that taxpayers, Congress and the IRS agree is necessary; however, progress was made this filing season, particularly in electronic tax administration. Electronic filing, while still short of the 80% RRA 98 goal, showed impressive gains. The IRS cracked the 51 million individual taxpayer mark, thanks in part to the new, innovative Free File program which attracted 2.7 million e-

filers. Filing from home computers rose by 27%. IRS web site hits increased by another 25 percent. Telephone service also improved, with assistor level of service up 20% over the previous filing season.

The GAO also cited the collection of unpaid taxes as a major management challenge, and “because of the potential revenue losses and threat to voluntary compliance this is also a high-risk area.” It is no secret that the IRS poached from enforcement to improve customer service and we are paying the price today with unacceptable enforcement levels that erode taxpayer confidence, and corporate audits that can take on average 5 years to complete. We must dig ourselves out of a very deep ditch.

As we work to improve taxpayer confidence in the fairness of our tax administration system, we must continue to respect taxpayer rights and work to improve the administration of RRA 98’s taxpayer rights provisions. The IRS made progress on the Innocent Spouse program where centralization of receipts and better administration reduced case backlogs and processing time. Other programs, such as Offers in Compromise, are far more difficult to administer.

Business Systems Modernization (BSM) also presents many challenges. On the plus side, the IRS addressed a number of high-risk areas previously identified by GAO. First, it established the infrastructure systems on which future applications will run. Second, it began to deliver applications with tangible benefits to taxpayers, such as the “Where’s My Refund” Internet-based service. Third, progress was made in establishing the modernization management controls needed to effectively acquire and implement information technology systems.

However, we are entering a critical phase of BSM and the program remains at high risk for two reasons. First, the program’s scope and complexity continue to grow. Second IRS’ modernization management capacity is still maturing.

Mr. Chairman, I believe the IRS is making progress implementing the letter and spirit of RRA 98, particularly on the customer service side. But we are certainly not out of the woods. There is still an enormous amount of work ahead to complete the job of modernization.

To meet these challenges and fully realize the benefits of the RRA 98, we must focus on three key areas.

One, we must continue the reorganization begun by Commissioner Rossotti to improve customer service. We must stay the course. Employees and managers at all levels of the organization must fully embrace and be engaged in the changes he launched.

Two, we must continue the information technology modernization program. Its success is critical to establishing a more efficient and effective IRS.

Three, we must strengthen the integrity of our Nation's tax system through enhanced enforcement activities. The IRS must deter those who might be inclined to evade their legal tax obligations and appropriately pursue those who actually do. I want to be clear that enforcement will be a principal responsibility of the IRS and we must bring a laser like focus to it.

Let me now describe in greater detail the progress IRS has made since the 2002 Joint Review hearing and the challenges that remain in the key areas of customer service, burden reduction, enforcement, taxpayer rights and business systems modernization. I also want to comment on the proposed modifications to RRA 98 contained in the President's FY 2004 budget.

IMPROVED CUSTOMER SERVICE

Mr. Chairman, I am pleased to report that service to taxpayers continues to improve. As demonstrated by the 2003 filing season results, key customer service indicators, such as *e*-filing and telephone assistor level of service went up. However, there is still a gap between the service the IRS delivers to taxpayers and what they expect and deserve. Clearly, the IRS has not met RRA 98's mandates if almost 20 percent of callers are not getting the correct answer to their tax law questions. As GAO recommended, the IRS has taken steps to improve management of the customer service functions, including improved performance measures, more program evaluation and the establishment of explicit goals.

I want to stress that top quality customer service also serves to improve voluntary compliance. In fact, the entire modernization program is premised in part on the principle that helping taxpayers to understand and meet their obligations under the law will improve compliance and result in fewer and less costly enforcement actions.

Electronic Tax Administration (ETA)

The President's Management Agenda states that "E-government initiatives will make it simpler for citizens to receive high quality service from the federal government, while reducing the cost of delivering those services." Electronic tax administration is an excellent example of this approach. E-file's benefits are clear and compelling. Taxpayers and the IRS find it more convenient and economical and less time consuming to do business electronically rather than sending paper through the mail. Moreover, the government saves money, but the real benefits are conveyed to the taxpayer. They include reduced preparation time, faster refunds, accuracy of returns and acknowledgment of return receipt.

Indeed, the American Customer Satisfaction Index shows a very high satisfaction rate among electronic filers. For 2002, it was 78 points (out of 100), compared with a mark of 53 for individual paper tax filers.

In 2002, more than 46.7 million taxpayers (36%) filed electronically – a 16.4% rise over the previous year. This filing season, all individual e-file is up by 12.4% and e-filing online has grown by 27%. It is projected that when all is said and done for this filing season that e-filing will constitute approximately 41% of individual returns filed. Part of the recent surge can be attributed to the Free File program, which clearly has been a success story.

As of April 18, Free File Alliance members have processed and transmitted more than 2.7 million tax returns. This represents approximately 22% of the total 9.2 million online e-filed returns. I do recognize some concerns about pop-up ads and we will work with the Alliance to address them.

The following key 2003 filing season e-file statistics through May 2, 2003 provide greater detail about individual e-file components and programs.

- Over 36 million taxpayers have e-filed their tax returns through an IRS-authorized Electronic Return Originator (ERO), a 10.4% increase over the same period last year.
- More than 11.7 million taxpayers have filed their tax returns on-line via their home computer through a third party transmitter. Online filing is running 26.8 percent ahead of last year and exceeds by 2.5 million the 2002 total volume of 9.4 million.
- Over 32 million individual taxpayers have chosen to use the Personal Identification Numbers (PINS) in lieu of a written statement when e-filing on-line.
- Over 4 million taxpayers have filed their returns over the telephone using the TeleFile system.
- Over 42 million taxpayers have chosen direct deposit of their federal tax refund, an 11% increase from the year before.
- Over 22 million taxpayers have chosen to file both their federal and state tax returns simultaneously in a single electronic transmission, up 16% from last year's 16.2 million.

The popularity of e-file and its continued growth can be attributed to both its value to taxpayers and efforts to make it simpler, more attractive and available to more taxpayers. Since its modest beginnings as a pilot in 1986, more options were added each year, ranging from payment by credit card, direct deposit of refunds, self-select PINs, more forms and the joint filing of federal and state returns.

In addition, a group of employees within the IRS identify regulatory and administrative impediments to electronic filing and then systematically work to remove those impediments through changes to regulations, forms, etc.

For the 2003 filing season, new options, in addition to Free File were offered. This year, taxpayers were able to electronically file seven new forms related to their Individual Income Tax Returns. They also had several options for checking on the status of a refund, including the aforementioned “Where’s My Refund?” service. Taxpayers can get the information they need quickly, efficiently and safely. For FY 2003, we expect 15 million uses of “Where’s My Refund?”

The IRS web site at www.irs.gov also continues to be extremely popular with taxpayers. For the week ending March 15, 2003, it was listed as Number 2 in the Lycos Top 50 searches. In FY 2002, it posted 3.11 *billion* hits with more than 437 million forms and publications downloaded. For FY 2003 through April 25, there were 2.55 billion web site hits, up 25.59% over the same period last year.

A strong ETA program may be even more important for reducing burden for businesses than for individual taxpayers. In addition to their annual income tax returns, businesses also have to file various employment tax returns and information returns. Businesses also make many payments to the federal government, such as withholding and unemployment taxes. In fact, payments are a business’ most frequent transaction with the IRS.

We want to convert all of these transactions to fast, accurate, paper-free electronic methods. And the IRS is making progress on a number of fronts.

During FY 2002, over 3.2 million taxpayers made \$1.5 trillion in electronic tax payments through the Electronic Federal Tax Payment System (EFTPS), which now includes an online option. For 2003, IRS expects more than 4 million taxpayers to pay their taxes using the EFTPS System.

In FY 2002, the IRS also received more than 2.5 million 941 *e-file* program returns (Employer’s Quarterly Federal Tax Return) and 855,000 returns for 941 TeleFile and On-Line Filing Programs. In CY 2002, over 320,000 businesses used the 940 *e-file* Program (Employers Annual Federal Unemployment Tax Return), and more than 24,000 partnerships chose 1065 *e-file* (U.S. Return of Partnership Income) in FY 2002.

In 2003, the IRS plans to better serve business’ electronic tax administration needs. For example, tax professionals are able to file employment taxes for business clients for the first time as part of a new Employment Tax e-filing System. The IRS also expects that coming e-file upgrades will continue to reduce the paperwork burden on small businesses. The enhanced e-file system is part of an ongoing effort to reduce small business burden and barriers to electronic filing. This e-file option will replace outdated technology that was a burden to both businesses and the IRS. Key benefits of the new system include:

- More flexible filing – Forms 941 and 940 can be filed in a single transmission;
- Faster acknowledgements – Transmissions are now processed upon receipt and acknowledgments are returned in near real-time; and
- Integrated payment options – Eligible filers may submit a required payment along with their return, subject to limitations imposed by the Federal Tax Deposit Rules.

Businesses will also soon be able to apply for an employer identification number (EIN) by using the IRS' new on-line EIN Application at *irs.gov*. When a business applies, its EIN will display on the SS-4 for printing and record keeping and each applicant will receive their formal validation letter.

Mr. Chairman, to build practitioner interest, the IRS will offer later this year a suite of electronic services, such as disclosure authorization, transcript delivery and account resolution, to tax practitioners who file a certain number of returns electronically.

E-Services are web-based products for third parties to use over the Internet. Third parties include electronic return originators, software developers, transmitters, reporting agents, service providers, tax practitioners, payers, and states. There are two releases related to e-Services.

- Release 1 includes Registration, Preparer Tax Identification Number (PTIN) Application and Interactive Taxpayer Identification Number (TIN) Matching. (Scheduled to be released the last week of June 2003.)
- Release 2 includes e-file Application, Disclosure Authorization, Electronic Account Resolution, Transcript Delivery System and Bulk TIN Matching. Disclosure Authorization, Electronic Account Resolution and Transcript Delivery System are incentives available for authorized e-file providers who e-filed 100 or more individual returns. (Scheduled to be released in late August 2003.)

Telephone Assistance

The IRS continues to provide various services through its toll-free telephone lines and service is improving. Through April 26, 2003 approximately 83.1 % of taxpayers who wanted to talk to a customer service representative got through, compared to 69.7% percent last year. The IRS set a goal of 72% for FY 2003.

The IRS is better identifying taxpayers' needs through tax law screening and then getting them to the right person to answer their question. This process has reduced the abandoned rate from 15.3% to 7.5%. In addition, the transfer rate was reduced from 22.1% to 17.2%. These two indicators illustrate that a higher percentage of taxpayers are reaching the right Customer Service Representative (CSR) without being transferred and/or having to call back while waiting to speak to a CSR.

Once connected, taxpayers must get prompt, accurate and courteous answers to their account and tax questions. The telephone correct response rates for tax law and tax account questions are about even with last year – 82.5% and 87.7% respectively – as compared to 83.4% and 89.4% over the same period last year.

Taxpayer Assistance Centers

Taxpayers needing face-to-face help solving individual or business tax problems can get it every business day at every IRS Taxpayer Assistance Center (TAC). For the fiscal period beginning October 01, 2002 through April 26, 2003, the IRS served 5.92 million taxpayers at all TACs. For the 2003 filing season beginning January 01, 2003 through April 26, 2003 we served over 4.48 million taxpayers in all TACs. The customer satisfaction rate is 88% satisfied and 7% dissatisfied, which is on target for the FY 2003 performance plan.

Individual taxpayers with incomes of \$35,000 or less can also receive free income tax return preparation and e-file help at TACs. The IRS extends this courtesy return preparation service to all taxpayers qualifying for the Earned Income Tax Credit, without placing the government in competition with private industry. All of these returns are e-filed.

Free tax preparation and e-file are also available in many communities through the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. To better serve low-income taxpayers, the IRS' Stakeholder Partnership, Education and Communication (SPEC) organization is establishing extensive partnerships with external groups such as local governments, non-profit organizations, private for-profit businesses, and others to create community coalitions. The IRS is also focusing its limited resources on providing technical expertise and training while encouraging the community partners to supply resources such as volunteers, space and computer equipment.

The IRS wants to make its partners as self-sufficient as possible and to identify those organizations that could make available needed resources. This new approach allows the IRS to expand access to low-income taxpayers, provide greater free tax return preparation and filing, and sustain these services over time.

BURDEN REDUCTION

Mr. Chairman, our goal is to create the least amount of burden for taxpayers to meet their responsibilities under the tax law. That is a guiding principle for the IRS' Office of Taxpayer Burden Reduction, which is the lead organization for our efforts in this critical area. I think we have made some progress, but more remains to be done.

Since last year's hearing, the IRS made progress on a number of fronts. For example, by raising the threshold for separately reporting interest and dividend income, an estimated

15 million taxpayers no longer have to file a Schedule B. In addition, because of our Industry Issue Resolution Program, family day care providers no longer have to keep detailed records and receipts of food purchased for use in their businesses. They may now choose instead to use a standardized rate to claim the deduction for meals provided to children in their care. These small businesses will save an estimated 10 million hours a year.

In addition, over 2.7 million taxpayers enjoyed the benefits of the innovative Free File initiative discussed previously in my testimony. Businesses are also finding that they can unburden themselves of even more paper and perform more of their reporting and payment transactions on line. Soon, they will even be able to apply for an Employer Identification Number by going to www.irs.gov. The IRS is also simplifying forms and notices to make them clearer and more easily understood. And the agency is tackling the major redesign of those schedules and forms with a huge impact on individual and business taxpayers, such as Schedule K-1 and Form 941.

Mr. Chairman, for many taxpayers, particularly business taxpayers, burden takes the classic form of time and money – the time and expense it takes to resolve an issue or problem that may affect one business or even, an entire industry. Ideally, we want to shift from addressing taxpayer problems well after returns are filed to addressing them as early as possible in the process, and in fact preventing problems wherever possible. To this end, the IRS created a number of programs in its operating and functional divisions to address issue management and problem resolution.

The Industry Issue Resolution (IIR) program began more than two years ago as an initiative under the Large and Mid-Size Business (LMSB) Operating Division's Issue Management Strategy. The IIR program provides guidance on frequently disputed or burdensome business tax issues. Benefits of the program include reduced costs and burden, and eliminating uncertainty regarding proper tax treatment, for both taxpayers and the IRS. The IRS estimates that it has provided millions of hours in taxpayer burden reduction.

The pilot program was evaluated and determined to be successful. In 2002, Notice 2002-20 was issued to announce the decision to make IIR a permanent program, expand the program to include SB/SE business issues, establish burden reduction as an issue criterion and invite issue submissions. For 2002, 38 issues were submitted from businesses, tax practitioners and associations and seven were accepted for the IIR program.

Fast Track Mediation (FTM) evolved from the Modernization/Re-Engineering process. It is designed to help SB/SE taxpayers resolve disputes resulting from examinations and collection (offer in compromise, trust fund recovery penalty, and certain collection due process) actions. FTM reduces taxpayer burden by resolving disputes in a fair and impartial manner, as well as on a timely basis. Disputes will be resolved within 30 to 40 days compared to several months through the regular appeals process.

FTM began as a pilot program in June 2000, in four cities. Based on the success of the pilot, on June 1, 2002, FTM was rolled out nationwide. A revenue procedure on FTM is being finalized by Chief Counsel and Treasury to expand this program. Publication 3605, Fast Track Mediation-A Process for Prompt Resolution of Tax Issues, lists cases excluded from the program.

The LMSB Fast Track Settlement (FTS) Program has reduced taxpayer burden in important ways. A recent survey of taxpayers who completed the process asked them to identify what they expected to gain from the Fast Track process. The three top expectations (in order of number of responses) were: (1) quicker resolution of their cases, (2) lower non-tax costs, and (3) reduction in staffing demands. When asked if their expectations had been substantially met, the average agreement rate was 4.21 on a five-point scale where five is “strongly agree.”

The IRS estimates that the overall case resolution cycle time is reduced by approximately 920 days for cases participating in the Fast Track process. A revenue procedure on FTS is being finalized by Chief Counsel and Treasury to expand this program.

The LMSB Division is implementing a new streamlined examination process called the Limited Issue Focused Examination, or LIFE. This initiative will involve a formal agreement, a Memorandum of Understanding (MOU), between the IRS and taxpayer served by LMSB to govern key aspects of the examination. The MOU will contain dollar-limit thresholds, established on a case-by-case basis, below which the IRS will agree not to raise issues and the taxpayer will agree not to file claims. Our goal is to create an atmosphere where the examination process is less difficult, less time-consuming, less expensive and less contentious for all involved.

Clearly, the IRS has made some progress, but clearly too, reducing unnecessary taxpayer burden in all its many shapes and forms is an enormous challenge, especially when seen within the context of an extremely complex and ever changing Tax Code.

Indeed, even as the IRS seeks to cut lines, simplify or eliminate forms altogether, and reduce the number of taxpayers having to file forms and schedules, it often must add lines to other tax forms to reflect new changes in the Tax Code that may benefit millions of taxpayers. For example, the IRS added three lines to the Form 1040 for tax year 2002 to accommodate statutory tax law changes relating to retirement, deductions for educators’ supplies, and tuition and fees.

Frequent changes to the tax code and tax law complexity are perhaps the greatest hurdles to overcome as the IRS works to reduce unnecessary taxpayer burden. There is even anecdotal evidence that tax law complexity may be a cause of non-compliance, and even non-filing. Confounded and confused by the complexity, some taxpayers just give up. Moreover, the IRS estimates the cost to taxpayers for complying with the Code to exceed \$80 billion – 8 times the cost of the IRS budget.

In a speech delivered in March 2003 to the Federal Bar Association, Assistant Treasury Secretary for Tax Policy, Pam Olson, pointed to the fundamental problem that we as tax administrators and a nation of taxpayers face:

“A key way that companies have raised productivity is by simplifying. Take every process down to its constituent parts, and cut out the inefficiencies, the points of friction, the drags that prevent the most streamlined operation and the standardization of transactions. Instead of simplifying to increase productivity in tax compliance and administration, we keep adding complexity – more rules, more limitations, more terms, more conditions, more qualifiers, more provisos, more exceptions. The result is that our system gets slower and slower and more inefficient. We burn more fuel, and emit ever more heat and smoke, and yet with all that burning, there’s less and less light to show for it.”

That is a fair and correct assessment of our present situation. Our myriad efforts to reduce unnecessary taxpayer burden are producing tangible benefits to taxpayers, but we must still address tax law complexity in a meaningful way. If we fail to, we will have failed in our mission to reduce taxpayer burden. Most importantly, we will have failed America’s taxpayers.

ENFORCEMENT

Mr. Chairman, the IRS is committed to ensuring everyone pays his or her fair share, including those who have the resources to move money offshore or engage in abusive schemes or shelters. We must focus our efforts on achieving greater corporate accountability and ensure that high-end taxpayers fulfill their responsibilities. Honest taxpayers should not bear the burden of others who skirt their responsibility. It’s as simple as this. Taxpayers should pay what they owe.

However, the poaching of enforcement personnel to bolster customer service contributed to a steady and disturbing decline in enforcement. As I stated in my introduction, the GAO identified the collection of unpaid taxes as a major and growing management challenge as reflected in the “large and pervasive declines in IRS’s compliance and collection programs.” Moreover, “because of the potential revenue loss and the threat to voluntary compliance this is also a high-risk area.”

Although there have been improvements in some enforcement numbers; they are modest and spotty across the broad spectrum of enforcement activities. It is unacceptable that a corporate audit still takes on average 5 years to complete. The Service must examine its enforcement priorities and reduce the cycle time in its enforcement processes, albeit without compromising taxpayer rights. We must bring the same commitment and focus to improving and administering our enforcement programs as the IRS has in improving customer service.

The IRS is now working to identify and refocus its resources on the biggest areas of risk to the tax system. Toward the end of FY 2002, the IRS began realigning its resources to

concentrate on key areas of non-compliance with the tax law, primarily among higher-income taxpayers and businesses. These include:

- The promotion of abusive tax schemes.
- The misuse of devices such as offshore accounts to hide or improperly reduce income.
- The use of abusive tax avoidance transactions.
- The underreporting of income by higher-income individuals.
- Non-filing by higher-income individuals.
- Earned Income Tax Credit program.
- The National Research Program.

Indeed, the principal focus of the President's proposed FY 2004 budget is strengthening enforcement in these and related areas. We are most encouraged by the new money requested to help us address these difficult issues.

The IRS Small Business/Self-Employed (SB/SE) Division is leading the new civil enforcement effort on issues affecting individuals and businesses. However, enforcement efforts will continue in other parts of the agency, such as the abusive tax avoidance transaction initiative in the Large and Mid-Sized Business (LMSB) Division. IRS Criminal Investigation also continues its investigative efforts regarding abusive schemes and promoters.

Key to the fight against abusive tax scams and schemes is better identifying their promoters; we must go the source and cut off the supply. In April 2002, SB/SE established a Lead Development Center (LDC) with the following purposes:

- To centralize the receipt and development of leads on promoters of abusive tax schemes;
- To authorize and monitor on a national level abusive tax promoter investigations (also called 6700 investigations) assigned to the field; and
- To promote and effect the coordination of parallel investigations with IRS Criminal Investigation.

Because of the LDC, the IRS has a better handle on the universe of the problem. The current receipt of new leads is averaging approximately 82 per month. As of May 2, 2003, 372 civil promoter investigations are being worked in the field, and 491 are being evaluated for further action. The leads can also be broken down into promoter brackets or "buckets," with domestic trusts, offshore transactions and frivolous constitutional arguments being the largest.

Since October 2000, the IRS has also issued a series of summonses to a variety of financial and commercial businesses to obtain information on U.S. residents who held credit, debit, or other payment cards issued by offshore banks.

And in January 2003, the IRS launched an initiative aimed at bringing taxpayers who used “offshore” payment cards or other offshore financial arrangements to hide their income back into compliance with tax law. The Offshore Voluntary Compliance Initiative led to more than 1,200 people stepping forward to participate. A partial analysis of some of the cases has already identified more than \$50 million in uncollected taxes and 80 new offshore promoters.

Mr. Chairman, critical to the agency’s efforts are new expedited procedures developed with the Justice Department to obtain timely injunctions. In the past, many of the scams and schemes continued to operate even when the IRS had identified them as being abusive. However, with these new procedures in place, the agency and its partners at the Justice Department are in a better position to shut these scams down before they can do any more harm.

As of May 2, 2003, the IRS had 27 promoter injunctions granted, 6 promoter injunctions pending in District Court and 24 pending at the Department of Justice, 372 civil promoter investigations in the field, and 464 ongoing criminal investigations of promoters of various tax schemes.

The IRS also emphasized abusive shelters and transactions. The Office of Tax Shelter Analysis (OTSA) provides centralized data collection and analysis on all aspects of the tax shelter program, including information required to be disclosed by regulation, developed by field agents and obtained during the course of our disclosure and settlement initiatives.

LMSB currently has 89 promoters under investigation; 245 summonses have been issued to obtain relevant information from promoters (including investor lists), of which 77 have been referred to the Justice Department for enforcement. IRS has obtained investor lists from 25 promoters covering multiple transactions. DOJ on behalf of the IRS has filed summons enforcement actions against four promoters to obtain information to which the IRS is entitled.

When a transaction is determined to be abusive, IRS and Treasury publish legal guidance as early as possible. This process is designed to deter subsequent promotion and investment in abusive transactions and to facilitate identification of investors and promoters. It also ensures consistent treatment of such transactions by IRS agents in the field. The IRS and Treasury have identified 25 abusive transactions through formal guidance.

The IRS Disclosure Initiative also brought many taxpayers into compliance and provided leads on promoters and emerging abusive transactions. Conducted from December 2001 to April 2002, it resulted in 1,664 disclosures from 1,206 taxpayers. Taxpayers have disclosed transactions in which they claimed deductions or losses amounting to billions of dollars. The IRS is analyzing the new transactions to determine whether they are abusive and warrant published guidance or other administrative response.

Reduce Inappropriate Payments in the EITC Program

The EITC program benefits millions of low-income workers. It lifts nearly 4 million people, especially single mothers, out of poverty each year. However, the current error rate for the EITC program is too high. In 1999, between 27 and 32 percent of EITC claims – or between \$8.5 billion and \$9.9 billion – were paid in error.

Again this January, the GAO included the EITC as one of two dozen “high-risk” areas across the federal government. The GAO stated, “The IRS has to balance its efforts to combat non-compliance with its efforts to help ensure that qualified persons claim the credit.” I fully agree with GAO’s assessment.

Some have also claimed that the audit rate for the EITC is disproportionately high. However, a better comparison would be to other benefits programs which verify a significantly higher percentage of claimants for eligibility.

The FY 2004 Budget requests an additional \$100 million to begin a new strategy for improving the EITC program. Mr. Chairman, the Administration’s EITC proposal became an issue during my confirmation process. I want to stress that in the coming weeks, I intend to closely review the proposed program. I pledge to work with all interested parties to ensure that any new controls put in place do not unnecessarily discourage participation in this important program.

Use of Private Sector Contractors for Collection of Taxes Due

There is a significant and growing backlog of cases involving individual taxpayers who are aware of their tax liabilities but are not paying them. In this regard, the budget contains an important legislative proposal that would authorize the IRS to contract with private-sector collection agencies – or PCAs – to supplement current tax collection efforts for a targeted category of debt. I would like to emphasize that this proposal is totally distinct from competitive sourcing and will not result in the loss of a single job at the IRS. While federal employees could do this work, as you know, appropriated resources are scarce. And I would like to point out that for 8 out of the last 10 fiscal years, the IRS has actually received less than its full budget request. The proposed use of PCAs is a realistic approach. As the National Taxpayer Advocate states, “PCAs appear a limited but reasonable option.”

For the purposes of this initiative, the Treasury Department and the IRS identified over \$13 billion in individual tax debt designated as currently “non-collectible.” The cases the IRS would refer to PCAs are those where the taxpayer would likely pay the outstanding tax liability if contacted by telephone. These include situations where a taxpayer filed a return indicating an amount of tax due but did not also send in payment for that full amount. These cases also would include situations where the taxpayer has made three or more voluntary payments of tax that was assessed by the IRS.

The IRS would not refer to PCAs cases for which there is any indication that enforcement action would be required to collect the tax liabilities. The IRS will avoid referring cases that would require IRS expertise or the exercise of discretion.

I want to stress in the strongest possible terms that PCAs would be prohibited from threatening or intimidating taxpayers. Indeed, the PCAs would be governed by all of the same rules by which IRS employees are held accountable. The taxpayer protections woven throughout this proposal have also been thoroughly reviewed by the National Taxpayer Advocate who will be testifying this afternoon.

From my previous perch as Deputy Director for Management at OMB, I am also acutely sensitive to the need for proper supervision of outside contractors. I want to assure the Subcommittee that PCAs and PCA employees will receive close supervision by the IRS to insure compliance with taxpayer protections and applicable policies and procedures. The National Taxpayer Advocate will continue to be involved in this process.

Mr. Chairman, I want to make one final point. The President's initiative builds on a record of success at both the state and federal level. PCAs are common across more than 40 states, including those represented on the Subcommittee. We will work to take the best from these different approaches and we will also benefit from their lessons learned.

In the federal arena, I would like to point out that PCAs are being successfully used by both the Financial Management Service within the Treasury Department and the Department of Education. Under the Debt Collection Improvement Act of 1996, nontax debts of a certain age owed to federal agencies, such as defaulted loans, must be referred to FMS. The collection of the debt is the responsibility of PCAs and this system is working very well. In addition, I have confirmed with the Deputy Secretary of Education that the Department's experience with PCAs is also very positive.

National Research Program

Mr. Chairman, also key to successfully executing an enforcement program is better data. The IRS failed to detect new areas of non-compliance in part because of a reliance on increasingly obsolete data from the old Taxpayer Compliance Measurement Program. (TCMP was last conducted in 1988.) The agency designed and is implementing a National Research Program that will obtain the essential information with far less burden on the taxpayer. New scoring models are being developed using 21st century techniques, with interim models already deployed.

ADMINISTERING RRA 98'S TAXPAYER RIGHTS

Mr. Chairman, the IRS continues to work to administer more efficiently and effectively RRA 98's 71 taxpayer rights provisions. We clearly made progress in the Innocent Spouse program where greater efficiencies have dramatically reduced case backlogs. However, the Offers in Compromise (OIC) Program and Collection Due Process have proved to be the two most difficult RRA 98 expanded taxpayer rights to administer.

Nonetheless, we believe that we are now making real progress addressing these challenges. In addition, the proposed changes to RRA 98 contained in the President's budget would go a long way to helping us ensure that these important programs work in the manner Congress intended.

Innocent Spouse

The Innocent Spouse provisions implemented as part of RRA 98 were in response to concerns that the former law was not providing proper relief to innocent spouses. The new provision affords four types of relief:

- Innocent Spouse Relief - IRC section 6015(b)
- Separation of Liability – IRC section 6015(c)
- Equitable Relief – IRC section 6015(f)
- Equitable Relief for Community Property Issues – IRC section 66(c)

Each category of relief has different requirements. IRS employees processing the claims initially had difficulty reaching a determination – whether to fully grant, partially grant, or fully deny the requested relief. To address these concerns, we developed training courses and a computer-based application that took employees through a series of questions to aid them in making an accurate determination.

In addition, because of the legislation's complexity, requisite administrative procedures and the enormous number of claims initially received, the IRS could not respond to the claimants in a timely manner. To be more accurate, timely, and consistent, a centralized site was established at the Cincinnati Campus to process the claims. As a result, inventory levels have steadily decreased from FY 2000 when they stood at over 40,000 to approximately 20,000 in FY 2002.

Innocent spouse claims are determined to be “merit” or “non-merit.” A claim is determined to be non-merit if it does not meet the basic eligibility requirements, such as no return filed or the claim is not signed. To date, 35.5 % of innocent spouse claims were determined to be non-merit. Of the merit claims, 29.3% were allowed; 10.6% were partially allowed and 60.1% were disallowed.

Offers in Compromise

Taxpayers who do not pay their full tax liability are subject to the IRS' collection process. It begins when we send the taxpayer a bill demanding full payment. For those unable to pay, or when payment would create a hardship, we defer payment of their liability by placing the account in an “uncollectible” status. While these debts are classified as “uncollectible,” the debt is not written off until the statute of limitations expires.

For taxpayers who are unwilling to pay, the IRS may take enforcement action, such as a lien, levy, or seizure of property. Taxpayers who are willing to pay may qualify for an

installment agreement that allows for full payment to be made over time. The vast majority of accounts are resolved through one of these methods.

Taxpayers who cannot afford to pay their full liability may be eligible for an offer in compromise. An offer in compromise is an agreement between a taxpayer and the IRS to settle or “compromise” the taxpayer’s tax liability for less than the full amount owed. Upon acceptance of an offer, the remainder of the debt is forgiven. Approximately one percent of accounts are resolved through an OIC.

Section 7122 of the Internal Revenue Code gives the agency authority to settle tax debts through compromises. However, compromise authority was historically limited to cases where there was doubt about liability or whether the debt could be collected. Provisions in RRA 98 modified the OIC program so that the IRS could not reject an offer from a low-income taxpayer based solely on the amount offered.

In July 2002, IRS issued final regulations adopting the temporary regulations of 1999 with only minor changes. The final regulations established a third type of compromise – one that promotes effective tax administration. IRS can now accept the following types of compromises:

- Doubt as to Liability – Doubt exists that the assessed tax is correct.
- Doubt as to Collectibility – Doubt exists that the taxpayer could ever pay the full amount of tax owed.
- Effective Tax Administration – There is no doubt the tax is correct and no doubt that the amount owed could be collected, but an exceptional circumstance exists that allows the IRS to consider the taxpayer’s offer. To be eligible for a compromise on this basis, the taxpayer must demonstrate that collection of the tax would create an economic hardship or would be unfair and inequitable.

However, the following major problems placed the OIC program at risk:

- A large case inventory of about 125,000 receipts-per-year with a projected 10 percent annual growth.
- Processing time/delays.
- High cost of the program relative to the number of taxpayers served.
- Critics have also called into question the high rejection rate of offers. The National Taxpayer Advocate stated that the IRS “needs to better train its employees to make correct determinations of who is submitting a viable offer.”
- External perceptions and opinions about the viability of processing offers in a centralized environment. Many practitioners prefer to deal with their local offer

specialist rather than deal by telephone or correspondence with a centralized bulk processing operation.

Case inventory levels and processing delays increased for a number of reasons. In a March 2002 report, GAO observed that the IRS was unable to keep pace with program changes even with increased staff:

“Program changes, some initiated by IRS and some mandated by the Restructuring Act, increased the demand for offers, the number of processing steps, and the number of staff hours needed to process a case. During the same period, staff hours charged to the OIC Program more than doubled, growing to 18 percent of total staff hours charged to all of IRS’s programs for collecting tax debts. Yet, the demand for offers exceeded staff’s capacity to process them.”

There are other reasons for the large case inventory. The proliferation of electronic media marketing by firms promising settlement of IRS taxes for “pennies on the dollar” give taxpayers unrealistic expectations about the OIC program. A large number of taxpayers also seek refuge in the program to circumvent imminent or ongoing collection action. Under current policy, the mere act of submitting a processable offer (without any supporting financial documentation) is sufficient to stay collection.

Despite the fact that the latest revision (5-2001) of the Offer in Compromise package, Form 656, includes specific instructions to attach certain financial documentation when submitting an offer, we receive relatively few complete submissions. Furthermore, a large number of taxpayers lose interest when they realize that they must submit substantiation of their finances to enable the IRS to evaluate their offers.

In this regard, we believe that the OIC program will benefit from some proposed legislative changes. In its FY 2004 Budget, the Administration offered legislative proposals that would: (1) address frivolous OIC filers by establishing a \$5,000 penalty for a frivolous submission, and (2) 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.

The number of days to close an offer case also reached unacceptable levels, but we have made improvements in this area. In addition, OIC program staffing costs grew. On top of the sheer number of offers received, some program changes increased the complexity of the offer process, resulting in more processing steps and staff hours to process a case. Between FY 1997 and 2001, the number of direct collection field hours charged to the OIC program more than doubled.

To address the growing workload issue, the IRS centralized the receipt and processing of offers into two locations – Brookhaven, New York and Memphis, Tennessee. It allowed for efficiencies of scale as well as the opportunity to better focus training efforts and standardize procedures. We project that about 70 percent of all offers can be worked to

completion in the centralized sites. Only the most complex cases involving business taxpayers are assigned to local field offices.

Other program enhancements enabled us to concentrate resources on those taxpayer accounts where the offer is the most appropriate collection method to resolve a longstanding liability. We accelerated the identification and resolution of inappropriate offers – those where the taxpayer has a clear ability to pay fully the liability, and/or submits an offer solely to delay the collection process. The more complex cases – those requiring assignment to field collection personnel – are now screened much earlier in the process and transferred out to field specialists. We are also automating labor intensive procedures.

These process changes improved productivity at the centralized sites and the field offices, with a corresponding positive impact on customer service. The inventory is becoming more current and the number of aged cases – those more than six months old – has decreased. The move toward centralization has allowed us to return a significant number of field employees to other collection priorities.

While productivity gains have contributed to the declining inventory, we have also seen a significant increase in the number of cases that must be closed as “not processable” or “return.” We have begun an educational effort with taxpayers and tax practitioners to draw attention to the qualifications that appear in the OIC application package. The IRS Office of Performance Evaluation Research and Analysis will also conduct a study of offers that were closed (regardless of disposition), to identify areas for improvement.

Processing time has declined from an average of 317 days during FY 2002 to an average of 272 days for the first 6 months of FY 2003. In addition, the average age of open inventory dropped from 265 days at the end of FY 2002 to 240 at the end of March 2003. This is due in part to the continuing maturation of the Centralized Offer in Compromise (COIC) sites. These numbers are still too high but we are heading in the right direction.

Mr. Chairman, we continue to view the Offer in Compromise program as an effective tool to resolve tax liabilities for those taxpayers who qualify. While we have taken steps to reduce taxpayer burden and improve customer service through work process standardization and reducing the level of financial documentation required from taxpayers, we continue to seek the cooperation of tax practitioners and the general public to ensure that offers are submitted only in appropriate circumstances.

Collection Due Process

The collection due process (CDP) provisions require that taxpayers be given an opportunity to request a hearing with Appeals after the filing of a Notice of Federal Tax Lien and prior to proposed levy action. Some taxpayers use the hearing process to delay collection action by filing hearing requests that raise frivolous issues.

There are approximately 17,500 CDP cases currently in inventory in Appeals. About 5% or 896 cases, involve frivolous issue taxpayers. The Area Appeals Office with the most cases has about 25% of non-filer/frivolous taxpayers. Sub-offices within that area have even more substantial percentages of taxpayers with frivolous claims.

However, the actual number alone does not account for the amount of time it takes for such cases. Frivolous claims occupy a disproportionate share of time over claims from taxpayers having substantive issues. In addition, some of the representatives of these claims also file Section 1203 actions against IRS employees. These section 1203 actions are very rarely sustained but can be resource intensive to respond to.

Time spent on these frivolous claims is time spent away from taxpayers who raise legitimate issues. Collection action is also suspended on these accounts while the case is pending in Appeals. The proposed legislative change which would permit the IRS to dismiss frivolous claims, would allow us to proceed with collection on these cases and enable Appeals to focus full efforts on taxpayers with legitimate claims.

BUSINESS SYSTEMS MODERNIZATION

Critical to IRS' success in meeting all of RRA 98's goals is better managing our massive technology and Business Systems Modernization program. BSM has finally begun to deliver the first projects with tangible benefits to taxpayers, such as the new Internet Refund/Fact of Filing (IR/FoF) application that allowed them to check on the status of their return and refund 24 hours a day, 7 days a week. Of paramount importance, IRS implemented the first project on its new security system, which provides one standard for ensuring the security of all IRS data and systems.

However, this is not the time for complacency; the stakes are too high. I want to bring a strong management focus and accountability to the BSM program to ensure its success.

Chairman Houghton recently commented: "This year and next will be critical to determining whether the modernization effort will succeed. Many systems that have been under development for years – such as the new IRS database of tax records – are entering the final stages of development."

As previously noted, the GAO continues to characterize the BSM program as "challenged" and at high risk for two reasons:

"First, the scope and complexity of the program are growing. Specifically, the number of projects underway continues to expand and the tasks associated with those projects that are moving beyond design and into development are by their nature more complex and risky. Second, IRS's modernization capacity is still maturing."

Strategically, the most important objective over the next year is to increase the overall confidence in the modernization program by meeting most of the delivery goals: the

initial CADE release; a new core accounting system; the first part of a new custodial accounting system; a new e-filing system for large business; and a number of electronic enhancements for third party providers. In other words, we must focus on meeting the commitments that we have in front of us for the next year.

Once that confidence is restored, we will then be able to move ahead with the broader agenda, hopefully, with the increased funding level requested in the President's FY 2004 budget and doing a better job of meeting cost and schedule targets.

It is also critical that the entire IRS leadership team works together to ensure the modernization program's success. The Business Systems Modernization Office, Modernization, Information Technology and Security Services (MITS) and the business units, must partner cohesively in planning, building and implementing modernized systems. As an organization, we must cooperate to reduce and eliminate internal impediments that could inhibit the success of the PRIME. I will also make sure that the PRIME contractor is clear on its commitments and my expectations for improvements in its track record to date.

Mr. Chairman, I want to stress that modernization does not have a clear end point that we can call completion. At some point, modernization will no longer be a specialized, separately funded program. Rather, as new business processes and enabling information technology are deployed, systems modernization planning and implementation will become a routine IRS business practice. Indications that we have done most of the heavy lifting will be when:

- The Master Files have been replaced by the Customer Accounts Data Engine (CADE) project;
- New internal management systems have been deployed and all financial material weaknesses closed;
- E-filing is pervasive for both individuals and businesses;
- New customer service and collections capabilities are in place; and
- Better systems are available to support compliance.

The FY 2003 delivery plan will move the BSM Program into a wide spectrum of critical new areas:

- Customer Account Data Engine (CADE) R1. In July 2003, CADE will begin processing single 1040EZ filers (both electronic and paper). Taxpayers covered under CADE will receive their refunds about 40% faster than under Master File processing, if they use direct deposit. More importantly, we will have taken the first of many steps to replace the 40-year old Master Files.

- Custodial Accounting Project (CAP). We will continue development and testing of CAP Release 1 scheduled for deployment in the first quarter of FY 2004. CAP will create a repository for modernized Individual Master File data and will address documented financial material weaknesses.
- Enterprise Architecture (EA) and Tax Administration Vision and Strategy (TAVS). TAVS focuses on creating a long-term vision of how the agency should work in the future. Delivery and acceptance of EA Release 2.0 was a significant achievement. We also conducted a planning effort called “TAVS Refresh” to identify gaps and outdated information in TAVS which we plan to address in FY 2003.
- e-Services. e-Services sub-releases will provide: registration of electronic return originators, Taxpayer Identification Number (TIN) matching, initial partner relationship management capabilities, electronic account resolution, transcript delivery, secure e-mail, and bulk TIN matching.
- Infrastructure (STIR and Infrastructure Shared Services [ISS]). This project provides the basic secure infrastructure necessary to support the modernization effort including e-Services R1, IR/FoF, Internet Employer Identification Number (EIN), and subsequent FY 2003 releases.
- Integrated Tax Administration Business Solutions (ITABS). Projects to ensure we understand requirements and select COTS (commercial off-the-shelf) solutions that can effectively integrate business processes in IRS functions.
- Internet EIN. This application will automate Employer Identification Number (EIN) requests over the Internet. Currently, the EIN request process is cumbersome and people-intensive, often resulting in unacceptable delays for those starting new businesses.
- Integrated Financial System (IFS). Although the first release of the new financial system will not go live until October 1, 2003 (therefore, an FY 2004 delivery project), it is likely to be our most work-intensive project during FY 2003.
- Modernized e-file. The Modernized e-file project will be in pre-deployment testing for all of FY 2003, with initial deployment in early CY 2004, with Forms 1120 and 990 e-file capabilities.

I feel fortunate to have major deliverables in the coming months, rather than a year from now. This timetable affords me the opportunity to assess whether real progress is being made.

MODIFICATIONS TO RRA 98

Mr. Chairman, in the FY 2004 budget submission, the Administration again proposed modifications to RRA 98. Last year, the House passed legislation that contained five of these proposals; the Senate did not act before adjourning. We commend the House for its actions and believe that these modifications preserve the intent of the Act while allowing us to administer it more efficiently and effectively. We urge the Congress to take similar action this year.

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, while still subjecting violations to appropriate sanctions that may include termination.

The second part mentioned above adopts measures to curb the large number of frivolous submissions and filings that are made to impede or delay tax administration.

The third, as is mentioned above, permits the IRS to enter into installment agreements with taxpayers 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 fourth allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.

The fifth streamlines jurisdiction over collection due process cases in the Tax Court, thereby reducing the cycle time for certain collection due process cases.

The sixth and last provision would eliminate the monetary threshold for IRS Chief Counsel reviews of offers in compromise.

The Administration also has two proposals to improve IRS efficiency and performance from current resources. The first would modify the way that Financial Management Services (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to retain a portion of the amount collected before transmitting the balance to the IRS, thereby reducing government transaction costs. The offset amount would be included as part of the 15-percent limit on levies against income and would also be credited against the taxpayer's liability.

The second proposal would encourage growth in electronic filing by extending from April 15 to April 30 the return filing and payment date for the filing of individual income tax returns, if the return is filed electronically and any balance due is paid electronically.

All of the proposals discussed above, with the exception of the fourth concerning installment agreements, have been included in the Taxpayer Protection and IRS Accountability Act of 2003, which was reported by the Ways and Means Committee in April. We appreciate the Committee's attention to these proposals.

Let me mention two provisions that have Treasury support, but were raised too late to be considered in the Taxpayer Protection and IRS Accountability Act of 2003.

The first is a proposal to modify the interest and penalty notification requirements such that the interest and penalty notification requirements would apply only to the first notice sent to the taxpayer. Subsequent notices would include a general description of how interest and penalties are computed, as well as a telephone number that taxpayers can call to obtain detailed account information. This proposal would appropriately balance the benefits of providing taxpayers with a full explanation of how any interest and penalties due were computed, with the burden and cost to the IRS of providing this information with each notice.

The second provision would permit the IRS to send a portion (up to 50 percent) of its notices by first class mail, instead of registered or certified mail, for a one-year test period. This would allow the IRS to determine whether it could save money on its mailings while still assuring that taxpayers receive adequate notice.

We would appreciate consideration of these proposals at some point during Congressional consideration of the Taxpayer Protection and IRS Accountability Act of 2003.

CONCLUSION

Mr. Chairman, in conclusion I believe that the IRS has made progress achieving the goals and intent of the Restructuring Act, but there is a lot more to do. On the service side, things are getting better, but much more must be accomplished. And it is not totally clear that modernization is reaching its promised results. We need and must vigorously pursue a renewed focus on enforcement but I expect the Service will make progress in all three key areas: customer service, enforcement and information technology.