

**Statement of  
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**for the  
Joint Review of the  
Strategic Plans and Budget of the Internal Revenue Service**

**Before the  
Committee on Ways and Means  
Committee on Appropriations  
Committee on Government Reform  
House of Representatives**

**Committee on Finance  
Committee on Appropriations  
Committee on Homeland Security and Governmental Affairs  
United States Senate**

**Convened by the  
Chairman of the Joint Committee on Taxation**

**May 19, 2005**

Mr. Chairman and Members of the Joint Review panel:

Thank you for inviting me to testify before this joint hearing regarding the Internal Revenue Service (IRS) strategic plan and its 2006 budget request. My testimony will also discuss the importance of business systems modernization to improved taxpayer service and enforcement as well as certain taxpayer protections provided by the IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>1</sup> that the IRS has yet to implement adequately.

### **The IRS Mission Statement in Today's Enforcement Environment**

In September 1998, the IRS issued a new mission statement that was designed to reflect the priorities of the newly reorganized Service and set a tone for all of its employees in fulfilling their duties. The statement was very concise:

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.

The IRS's mission reflects some of the lessons learned from the period preceding and subsequent to the enactment of RRA 98, including the role of quality taxpayer service in maintaining and even increasing the level of taxpayer compliance. Moreover, while tax law enforcement is not explicitly discussed, the mission statement recognizes that enforcement derives from the IRS's obligation to apply the tax law "with integrity and fairness to all."

Today, as historically, the IRS struggles to maintain the appropriate balance between quality taxpayer service and enforcement. The IRS's current five-year strategic plan for 2005-2009 recognizes the need for this balance:

The mission statement describes our role, as well as the public's expectation regarding how we should perform that role. In the United States, the Congress passes tax laws and requires taxpayers to comply. The taxpayer's role is to understand and meet his or her tax obligations. Our role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share. We must meet the highest standards of service and integrity in performing our role.<sup>2</sup>

Under the IRS's controlling strategic plan, then, the IRS envisions that service and enforcement will be "poised to meet customer expectations and to respond

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<sup>1</sup> Pub. L. No. 105-206, 112 Stat. 685.

<sup>2</sup> IRS Strategic Plan 2005-2009, Pub. 3744 (Rev. 6-2004), 5.

quickly to technological and demographic changes.”<sup>3</sup> Thus, there should be no conflict between the IRS’s dual mission of providing top-quality taxpayer service and enforcing the tax laws.

### **The Decline of IRS Examination and Collection Activities**

In the late 1990s, as the IRS attempted to reverse some of the most significant erosions of taxpayer service, its traditional examination and collection activities and resources also declined. Although many commentators like to attribute this decline to the RRA 98 hearings and certain provisions enacted by Congress in that statute, I believe there are many causes for the decline and that ignoring other causes will result in many of the same behaviors that got the IRS into trouble in the first place.

Why the sudden drop in enforcement activities and resources? First, let’s look at the numbers. In FY 1995, the IRS conducted 2.1 million examinations,<sup>4</sup> filed 799,000 notices of federal tax liens, and issued 2,722,000 levies.<sup>5</sup> By FY 2000, the IRS conducted approximately 716,000 examinations,<sup>6</sup> filed approximately 288,000 notices of federal tax liens, and issued approximately 220,000 levies.<sup>7</sup>

We know that IRS examinations dropped from 2.1 million in FY 1995 to 716,000 in FY 2000. However, by FY 2000 the IRS also issued approximately 5.8 million “math error” notices which summarily assess certain adjustments to the taxpayer’s return.<sup>8</sup> Congress expanded the IRS’s math error authority effective for tax years 1996 and 1997, and as a result, math error procedures eliminated the need for millions of correspondence and even office exams. So the decline in examinations may not be as great as some observers believe, although there is no denying that field examinations declined from 2.1 million in FY 1995 to 716,000 in FY 2000.

Now, let’s examine the reasons for the drop in enforcement activities. The decline in collection actions is often attributed to the implementation of Collection Due Process (CDP) hearing procedures, by which some taxpayers unduly delay the collection of tax. However, only 1.2 percent of all IRS field and Automated Collection System liens and levies that trigger CDP rights result in a request for a hearing, and only 4 percent of those hearings result in litigation. Thus, something else must account for the drop in collection activity.

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<sup>3</sup> *Id.* at 4.

<sup>4</sup> 1995 IRS Data Book, table 11.

<sup>5</sup> *Id.* table 19.

<sup>6</sup> 2000 IRS Data Book, table 10.

<sup>7</sup> *Id.* table 16.

<sup>8</sup> IRS, Report to Congress: IRS Tax Compliance Activities (July 2003).

Employees often cite the enactment of RRA 98 Section 1203, which provides for immediate termination of employment when the employee commits one of “ten deadly sins.”<sup>9</sup> Others cite the inability to evaluate individual or small groups of IRS collection employees on quantitative measures. Still others blame the individual caseload of collection employees and their seemingly endless paperwork requirements.

I suspect that each of these factors plays a role, although I believe that Section 1203 is not, or should not be, an excuse for failing to take appropriate actions. After all, the IRS has the power – and is now vigorously wielding it – to bar tax professionals from practicing before it, and states have always had the authority to revoke licenses of attorneys and accountants for rule violations, thereby depriving these professionals of a livelihood. Should we expect less ethical conduct from – and impose lesser sanctions on – IRS employees?

The most persuasive explanation for the decline in examination and collection resources is the real decline in the IRS’s annual budget over time while the IRS’s workload continues to increase. As Commissioner Rossotti noted in his final report to the IRS Oversight Board:

Despite significant improvements in the management of the IRS, the health of the federal tax administration system is on a serious long-term downtrend. This is systematically undermining one of the most important foundations of the American economy.

. . . “Trends in Indicators of IRS Workload and Resources,” from 1992 to 2001, *weighted average returns filed*, a measure of overall

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<sup>9</sup> Section 1203(b) requires the IRS to terminate an employee for certain proven violations committed by the employee in connection with the performance of official duties. The violations include: (1) willful failure to obtain the required approval signatures on documents authorizing the seizure of a taxpayer’s home, personal belongings, or business assets; (2) providing a false statement under oath material to a matter involving a taxpayer; (3) with respect to a taxpayer, taxpayer representative, or other IRS employee, the violation of any right under the U.S. Constitution, or any civil right established under titles VI or VII of the Civil Rights Act of 1964, title IX of the Educational Amendments of 1972, the Age Discrimination in Employment Act of 1967, the Age Discrimination Act of 1975, sections 501 or 504 of the Rehabilitation Act of 1973 and title I of the Americans with Disabilities Act of 1990; (4) falsifying or destroying documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or a taxpayer representative; (5) assault or battery on a taxpayer or other IRS employee, but only if there is a criminal conviction or a final judgment by a court in a civil case, with respect to the assault or battery; (6) violations of the Internal Revenue Code, Treasury Regulations, or policies of the IRS (including the Internal Revenue Manual) for the purpose of retaliating or harassing a taxpayer or other IRS employee; (7) willful misuse of section 6103 for the purpose of concealing data from a Congressional inquiry; (8) willful failure to file any tax return required under the Code on or before the due date (including extensions) unless such failure is due to reasonable cause; (9) willful understatement of Federal tax liability, unless such understatement is due to reasonable cause; and (10) threatening to audit a taxpayer for the purpose of extracting personal gain or benefit. Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, at 50 and 51 (JCS-6-98).

IRS workload, increased by 16 percent because of the economy's growth. However, during this same period, FTEs [full time equivalents] dropped 16 percent from 115,205 in FY 1992 to 95,511 in FY 2001. Since more and more of the IRS' declining resources are required to perform essential operational functions – such as processing returns, issuing refunds and answering taxpayer mail – a disproportionate reduction occurred in Field Compliance personnel, falling 28 percent from 29,730 in FY 1992 to 21,421 in FY 2002. . . .

Looking more closely at the most recent five years . . . , we see that the number of income tax returns increased by 12 million, while 19 tax bills were passed that changed 292 tax code sections and required 515 changes to forms and instructions. On the average, IRS workload grows at a compounded rate of 1.8 percent per year. Therefore, just to handle this increased workload, the IRS would either have to add staff – which is what occurred fairly consistently for the 45-year period from 1950 through 1995 – or would have to increase productivity by 1.8 percent per year just to stay even.<sup>10</sup>

If budget limitations and increased workload are the real explanation for past declines in enforcement activities, then Commissioner Everson deserves significant credit for making a persuasive case for increases in the IRS budget. Without such increases, we may find ourselves in the same situation as we were in 1995, with declining enforcement activities and even greater deterioration in taxpayer service.

In January 1998, Commissioner Rossotti appointed three outside members of the Senior Executive Service to “objectively and independently review and assess evidence developed concerning allegations of misuse of enforcement statistics and to recommend, if appropriate, disciplinary actions.”<sup>11</sup> Attempting to explain the external pressures on the IRS to meet productivity demands, the panel described the budget environment in the years leading up to RRA 98:

The Administration through the budget process in 1994, called upon Congress and the IRS to work together on an approach to both measure and collect more of the delinquent taxes that were currently outstanding. The Administration proposed that beginning in fiscal year 1995, 5,000 full time equivalents (FTEs) be added to assist in improving tax compliance and generating additional revenues. The FY 1995 Compliance Initiatives were developed to improve compliance, generate additional revenue, and provide for

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<sup>10</sup> Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System*, (Sept. 2002), 12-13 (internal chart and footnote omitted).

<sup>11</sup> Special Review Panel Report for Charles O. Rossotti, Commissioner, Internal Revenue Service (August 1998), (response of Charles O. Rossotti dated Sept. 14, 1998).

additional staffing. Congress agreed to fund the initiatives by providing \$2.025 billion over a five-year period. However, IRS received only the first installment of \$405 million. IRS had committed to generating \$331 million for the first year and promptly hired new [Revenue Officers]. According to the IRS, that effort generated \$803.3 million during FY 1995. However, in 1996 Congress chose not to continue funding for the Compliance Initiatives. As a result, the thousands of new employees had to be funded out of an already reduced base budget. The downsizing efforts already under way because of the reduced base appropriation were made even more complicated.<sup>12</sup>

The panel found that budget cuts, along with the Government Performance and Results Act of 1993 (GPRA), the Field Office Performance Indicator (FOPI), and “IRS’s emphasis on specific statistical targets” essentially resulted in “a competitive environment that was driven by statistical data” and pressures for greater productivity from examination and collection personnel.<sup>13</sup> If we are not careful, we may find ourselves operating in a similar environment today.

### **The Role of Customer Service in Enforcement**

Customer service – the act of listening to the customer, being professional and ethical in conduct, striving to impose the least burden possible on the customer while resolving the problem – should not be limited to the IRS’s taxpayer service functions such as the phones or the Taxpayer Assistance Centers. Customer service plays an important role in enforcement activities and often makes the difference in resolving an issue. Even taxpayers who are noncompliant and are being forced to settle up can respond positively to professionalism. In fact, customer service in enforcement can save the government resources, because it helps reduce the IRS’s use of more expensive enforcement measures such as seizures and sales. Thus, one of our quality measures should track how Examination and Collection employees treat taxpayers. We currently listen in on the toll-free and other phone assistance lines to monitor both professionalism and accuracy of responses. The IRS should consider expanding the monitoring of Revenue Agents and Revenue Officers along these lines.

There are many reasons why taxpayers are noncompliant with their tax obligations. The IRS acknowledges this fact in its 2005-2009 Strategic Plan:

Noncompliance may not be deliberate and can stem from a wide range of causes, including the lack of knowledge, confusion, poor record keeping, differing legal interpretations, unexpected

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<sup>12</sup> Special Review Panel Report for Charles O. Rossotti, Commissioner, Internal Revenue Service (August 1998), 16 (internal footnotes omitted).

<sup>13</sup> *Id.*

emergencies and temporary cash flow problems. However, some noncompliance is willful, even to the point of criminal tax evasion.<sup>14</sup>

True taxpayer service involves figuring out why taxpayers don't comply before determining the appropriate IRS compliance action. To date, the IRS has not built this approach into its enforcement initiatives or its training of enforcement personnel. The IRS should create business performance measures that track the appropriateness of the enforcement response to the reasons for noncompliance. After all, Revenue Agents and Revenue Officers aren't just in the enforcement business – they are actually in the compliance business. A failure to understand the reasons why a taxpayer is noncompliant may lead to greater short-term enforcement results but reduced long-term compliance.

### **Maintaining and Improving Taxpayer Service**

The IRS faces formidable challenges in meeting the needs of a diverse taxpayer population. The IRS's current strategic plan relies heavily on self-service and electronic options and gives short-shrift to the real information and literacy gap in the United States today.<sup>15</sup> For example, the IRS's current approach to closing Taxpayer Assistance Centers (TACs) is based on the assumption that taxpayers who need face-to-face services will easily migrate to electronic or other self-service products.

The IRS overestimates taxpayers' ability or willingness to conduct complex financial transactions in an electronic or self-service format. While some in today's society are comfortable with banking on line, many are not. As I have stated elsewhere, the IRS simply does not know what services various parts of our population need delivered in a face-to-face environment.<sup>16</sup> Thus, the IRS has focused single-mindedly on closing TACs without researching taxpayer needs and identifying alternative means of delivering necessary face-to-face taxpayer service.

I recommend that Congress require IRS to conduct a comprehensive taxpayer-based needs assessment once every five years to complement an ongoing National Research Program that measures taxpayer compliance. With this taxpayer-centric data in hand, the IRS would be able to make resource and technology allocations that actually reflect taxpayer needs. Without this information, the IRS is making decisions about taxpayer service based on its own resource needs and general demographic data. A periodic Taxpayer Needs

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<sup>14</sup> IRS Strategic Plan 2005-2009, Pub. 3744 (Rev. 6-2004), 18.

<sup>15</sup> *Id.* at 14.

<sup>16</sup> See Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, The Judiciary, Housing and Urban Development, and Related Agencies, April 7, 2005; Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Committee on Finance on The Tax Gap, April 14, 2005.

Assessment would prove very helpful when the IRS has to make difficult program decisions, some of which involve irrevocable consequences such as closing the TACs. The IRS will be hard pressed to obtain the resources to reopen TACs if it decides a few years down the line that it made a mistake.

### **Decreases in Taxpayer Service Drive Decreases in Compliance**

Preliminary results from the National Research Project (NRP) indicate that the overall compliance rate in 2001 was about the same as that in 1988, the date of the last Taxpayer Compliance Measurement Program (TCMP). As discussed above, enforcement activities during this period dropped substantially. Taxpayer service, on the other hand, improved significantly. Thus, it is entirely possible that improved taxpayer service played a major role in maintaining the level of compliance over time.

We may only need a small increase in enforcement activity to capture a significant improvement in compliance. That is, if word spreads on the street that the IRS is back in some capacity, we may see a disproportionate increase in the indirect effect of enforcement – what I call the “ripple effect” and economists call the “multiplier effect.” It is also possible that a large enforcement build-up, if coupled with a decline in taxpayer service, may result in an overall reduction in compliance.

### **Modernization of IRS Business Systems**

Outmoded IRS business systems negatively impact customer service, taxpayer rights and IRS business results. By the IRS’s own assessment:

The current database architecture inhibits the IRS from delivering the customer service expected by the public and experienced in the private sector. Issues such as poor customer service to taxpayers, taxpayer non-compliance, poor productivity, and job satisfaction by the IRS workforce have received national attention in recent years.<sup>17</sup>

As the IRS acknowledges, there are many problems with IRS data systems, and to address them all would be beyond the scope of this testimony. Three examples of the technology challenges facing the IRS will demonstrate how antiquated systems can impact customer service, taxpayer rights, and business results. These examples also demonstrate that the IRS is responding to these challenges but needs continued resources and support to ensure that these technology investments reap their potential benefits.

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<sup>17</sup> IRS Business Systems Modernization Analysis.



## **The Role of Business Systems Modernization in Customer Service**

Part of the IRS's information technology problem is that its "master file" systems are based on 1960s style business architecture. For example, the age and complexity of the Individual Master File (IMF) system causes delays and inaccuracies in providing service to taxpayers. There is lag time in the current IMF system because files are updated on a weekly basis. Consequently, taxpayers often cannot obtain current account information when they contact the IRS.

Because current data is not available to IRS employees, taxpayers are often given incorrect information on their account status, through both direct contact and notices. In an era when technology allows customers access to real-time information in almost every industry, taxpayers expect and deserve some level of sophistication from the IRS.

The cornerstone of the IRS's response to this problem is the new system known as Customer Accounts Data Engine (CADE). CADE is an on-line modernized data infrastructure that is being brought on-line in stages and will run in conjunction with the Individual Master File (IMF) until it ultimately replaces it. Some of the expected benefits of CADE are:

- Refunds will be issued faster because of daily versus weekly processing;
- Taxpayers and employees will benefit because they will be working with more current information; and
- The system administers policy and legislative changes easily.

The IRS can only bring CADE on-line in stages. For example, in July 2004, CADE was used to process an initial set of 1040 EZ returns. For 2005, CADE is expected to process approximately 1.9 million 1040EZ returns. Each year thereafter, CADE will handle greater volume and more complexity until it can take the place of the existing system for processing individual returns. The benefits of CADE cannot be realized, however, unless the IRS is able to fund and properly monitor its continued development.

## **Lack of Progress in Business Systems Modernization Impacts Taxpayer Rights**

Because of the slow progress with CADE, the IRS maintained or developed other systems to provide IRS personnel with access to tax account and tax return information, such as the Integrated Data Retrieval System (IDRS). These stand-alone systems are not integrated for cross-functional use. The IDRS is also hampered by systemic limitations that prevent the IRS from keeping pace with changes to the tax law.

The failure of the IDRS systems to fully process the changes to the tax laws that affected taxpayers' collection statute expiration dates (CSEDs) demonstrates how systems limitations can impact taxpayer rights. The IRS has 10 years from the assessment date of a tax to collect that tax.<sup>18</sup> Certain actions can suspend the running of the CSED such as a taxpayer's submission of an offer in compromise<sup>19</sup> or an installment agreement.<sup>20</sup> RRA 98 made several important changes to the calculation of CSEDs, including the following:

- The IRS can no longer seek extensions of the collection statute of limitations period unless the extension is sought in conjunction with an installment agreement or in conjunction with a release of levy,<sup>21</sup>
- In the case of an offer in compromise submitted by a taxpayer, the period for which IRS could suspend the running of the CSED was changed from the time that the offer is being considered plus one year to the time that the offer is being considered plus 30 days; and
- In cases where the extensions were entered into before December 31, 1999, the extensions would terminate on the later of the running of the original CSED or December 31, 2002, except that in the case of installment agreements the extensions terminate on the 90<sup>th</sup> day after the expiration of the extension.<sup>22</sup>

These changes to the laws applicable to the calculation of CSEDs require IRS systems to perform the necessary CSED calculations to ensure that the IRS is not collecting from taxpayers after the date beyond which it is permitted by law to do so. The IRS master file systems are unable to fully process all of these changes in the law. The Taxpayer Advocate Service (TAS) detected increasing numbers of cases where IRS systems failed to properly calculate the CSED for taxpayers. TAS is working with the IRS to identify and correct thousands of inaccurate CSEDs on existing taxpayer accounts. However, these systemic problems will continue to occur if the IRS does not update its systems with functionalities that can make the necessary CSED calculations.

CSED problems also arise because the current IDRS and master file systems cannot accommodate more than one CSED per tax module. Multiple CSEDs can occur, for example, when the taxpayer files a balance-due tax return, which generates a CSED for that amount, and the IRS subsequently audits the taxpayer, resulting in a second CSED for a newly assessed amount. IRS systems will only show the most recent CSED, allowing for the possibility that

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<sup>18</sup> IRC § 6502(a)(1). See National Taxpayer Advocate 2004 Annual Report to Congress 180 (discussing the CSED problem in detail).

<sup>19</sup> IRC §§ 6331(i)(5) and 6331(k)(1).

<sup>20</sup> IRC § 6331(k)(2).

<sup>21</sup> Pub. L. No. 105-206, 112 Stat. 685.

<sup>22</sup> Pub. L. No. 105-206, § 3461(c)(2), 112 Stat. 685.

unlawful collection action could be taken against the taxpayer after the first CSED expires.<sup>23</sup>

Other CSED problems arise because IRS systems cannot separate the joint account of spouses when only one spouse files a request for relief from the liability (e.g., the spouse files an offer in compromise or requests an installment agreement). This situation requires the IRS to separate the joint account into separate accounts so that the applicable limitations period is suspended only for the requesting spouse. Inherent limitations in the IRS systems make it cumbersome to separate out the accounts of the spouses and can lead to improper collection actions.<sup>24</sup>

### **IRS Business Results and Business Systems Modernization**

The IRS's collection strategy provides one example of the potential for business systems modernization to improve business results while at the same time increasing tax compliance. Commentators inside and outside the IRS have long criticized the IRS approach to tax collection as a "one size fits all" approach that applies the same collection strategy to all taxpayers regardless of the reasons for the taxpayer's noncompliance.<sup>25</sup> Timeliness in contacting debtors is crucial to all debt collection efforts.<sup>26</sup> Yet, the IRS collection system keeps all taxpayers in a 6-month notice stream before taking any steps to make person-to-person contact, and it treats all taxpayers the same, levying on taxpayers who may comply after a phone call and ignoring chronically noncompliant taxpayers whose assets should be levied upon.

With the development of the Filing & Payment Compliance (F&PC) initiative, the IRS is making progress toward establishing a modern compliance-based collection strategy. The F&PC initiative is a multi-pronged collection strategy that would make changes to work processes, organization, and technology to increase payment compliance. The cornerstone of the technology piece of F&PC is the use of "decision analytics," which utilize data about the taxpayer to better assess the risk of the account.<sup>27</sup> While the IRS employs decision analytics

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<sup>23</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 185 (citing actual example of taxpayer's account which should reflect 2 CSEDs but only showed the later CSED).

<sup>24</sup> See National Taxpayer Advocate 2003 Annual Report to Congress 170.

<sup>25</sup> General Accounting Office, *Tax Administration – New Delinquent Tax Collection Methods for IRS*, 1 (May 1993); see National Taxpayer Advocate 2004 Annual Report to Congress 226 (discussing the history of the IRS's collection strategy and offering suggestions for implementation of a modern compliance-based collection strategy); Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003).

<sup>26</sup> On average, the passage of time results in diminishing collection returns for the IRS, such that after 6 months the IRS loses 47¢ on the dollar, after 24 months it loses 87¢ on the dollar, and after 3 years the debt is nearly uncollectible. IRS Automated Collection System Operating Model Team, *Collectibility Curve* (August 5, 2002).

<sup>27</sup> The IRS is already using decision analytics to a limited extent. See Treasury Inspector General for Tax Administration, Ref. No. 2004-30-165, *The New Risk-Based Collection Initiative Has the*

currently, the applications are limited in part because data is limited to internal IRS information about the taxpayer. F&PC plans to procure software that will use both external data (such as credit ratings) and internal data on taxpayer characteristics to assess risk. Most importantly, the new commercially developed software will then be used to select the optimal treatment for any given taxpayer based on that taxpayer's characteristics. This process should improve business results by enabling the IRS to assign the optimal collection treatment in a timely fashion. At the same time, this process should improve taxpayer payment compliance and protect taxpayer rights by applying the right collection touch to each taxpayer.

The above examples demonstrate that technology has a profound impact on customer service, taxpayer rights, and business results. In each of these examples, the IRS has plans to address the problem with enhanced technological capabilities. However, the complex nature of these problems does not allow for a one-time technological fix. The IRS will be able to steadily improve its customer service, the protection of taxpayer rights, and its business results only if it sustains a long-term commitment to modernize IRS business systems and receives adequate funding and Congressional oversight.

## **Disturbing Trends Since RRA 98**

### **Independence of Appeals**

RRA 98 requires the IRS to “ensure an independent appeals function within the [IRS].”<sup>28</sup> This requirement recognizes that independence is the critical ingredient of a healthy and successful IRS Appeals function. The Appeals Office itself has historically recognized that it must be independent of IRS enforcement in both fact and appearance.<sup>29</sup> In fact, independence is central to Appeals' mission to “resolve tax controversies, without litigation, on a basis which is fair and impartial to both the government and the taxpayer in a manner that will enhance voluntary compliance and confidence in integrity and efficiency of the [IRS].”<sup>30</sup> Without independence, taxpayers will view Appeals as an “arm of the Examination function or an adversary seeking to strengthen the government's case.”<sup>31</sup> As a result of concern about Appeals' independence, the IRS has altered the Appeals reporting structure several times over the last 50 years.<sup>32</sup>

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*Potential to Increase Revenue and Improve Future Collection Design Enhancement* (September 2004). The F&PC initiative contemplates a more comprehensive and sophisticated use of risk assessment software.

<sup>28</sup> Pub. L. No. 105-206 § 1001(a)(4).

<sup>29</sup> IRS Document 7225, “History of Appeals,” 7-8 (Nov. 1987).

<sup>30</sup> IRM 8.1.1(2) (Feb. 1, 2003).

<sup>31</sup> IRS Document 7225, “History of Appeals,” 7-8 (Nov. 1987).

<sup>32</sup> A 1987 IRS document summarized Appeals' history: “A 1952 reorganization established the structure of the Appeals organization along the lines we see today [i.e., 1987]. Prior to the 1952 reorganization, the Appeals function (Technical Staff) reported directly to the Commissioner

As I discussed in my 2004 Annual Report to Congress, several recent developments in Appeals raise concerns about its independence from the IRS enforcement function – in both perception and reality:<sup>33</sup>

- Appeals is centralizing most of its inventory (including Tax Court docketed “S” cases<sup>34</sup>) at IRS campuses – limiting taxpayer access to face-to-face Appeals conferences and reassigning cases to campus employees that have traditionally worked in enforcement;<sup>35</sup>
- Appeals participation in certain IRS settlement initiatives and various exceptions to the prohibition against *ex parte* communications by Appeals erodes the protection afforded taxpayers by that prohibition;
- Appeals actively participates with IRS enforcement in developing IRS enforcement settlement initiatives; and

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through the Head of the Technical Staff. The reorganization brought about the establishment of a system of regional administration of districts under Regional Commissioners of Internal Revenue. However, to maintain the independent status of Appeals and preserve the principle of separating the Audit and Appeals operations, the Appeals function was carved out and placed under the office of the Assistant Regional Commissioner (Appellate), who had final settlement authority. . . . In 1982, the Chief Counsel was delegated line supervisory authority over Appeals by the Commissioner. The transfer of Appeals to Chief Counsel facilitates the flow of information and assistance between appeals officers and counsel attorneys.” See IRS Document 7225, “History of Appeals” (Nov. 1987).

In 1995, the IRS moved the reporting structure of the Office of Appeals from Chief Counsel back to the Commissioner and Regional Commissioners. See *IRS Appeals to be Under Commissioner in Chief Counsel Reorganization*, 95 TNT 117-4, June 16, 1995; Linda B. Burke, *TEI Says IRS Appeals Function Should Report to Deputy Commissioner, Not Chief Counsel*, 95-TNT 108-89, June 5, 1995. (“The current structure of Appeals, reflecting the 1982 decision to shift Appeals to the Chief Counsel’s “side of the house,” has contributed to a perceived diminution in Appeals’ independence. Given Counsel’s role as the adviser to Examination personnel, it is hardly surprising that taxpayers are less than sanguine about Appeals’ reporting to Counsel. Indeed, anecdotal evidence suggests that Counsel has generally become more involved in the management and oversight of Appeals’ workload and that this involvement has affected Appeals’ attitude toward settlement.”)

In 1998, Congress enacted legislation to “ensure an independent appeals function within the [IRS]”. Pub. L. No. 105-206 § 1001(a)(4). For examples of Congressional concerns with Appeals independence, see 144 Cong. Rec. S4182 (1998) (“One of the main concerns we’ve listened to throughout our oversight initiative – a theme that repeated itself over and over again – was that the taxpayers who get caught in the IRS hall of mirrors have no place to turn that is truly independent and structured to represent their concerns. With this legislation, we require the agency to establish an independent Office of Appeals – one that may not be influenced by tax collection employees and auditors”) and 144 Cong. Rec. S7639 (1998) (“the bill mandates that the Commissioner’s restructuring of the IRS include an independent appeals function. This appeals unit is intended to provide a place for taxpayers to turn when they disagree with the determination of front-line employees. A truly independent appeals unit will assure that someone takes a fresh look at taxpayers’ cases, rather than merely rubber-stamping the earlier determination”).

<sup>33</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 264-89.

<sup>34</sup> S cases stem from compliance issues totaling less than \$50,000 under IRC § 7463.

<sup>35</sup> The Taxpayer Advocate Service is currently developing this issue as a possible Most Serious Taxpayer Problem for the National Taxpayer Advocate’s 2005 Annual Report to Congress.

- The IRS currently categorizes more than 90 percent of Appeals budget as enforcement activity.<sup>36</sup>

I also have concerns about the current state of Appeals' mediation programs.<sup>37</sup> Congress directed the IRS in RRA 98 to establish certain mediation procedures.<sup>38</sup> The legislative history states that mediation fosters more timely resolution of taxpayer problems and should be extended to all taxpayers.<sup>39</sup> However, the IRS' mediation programs, Fast Track Mediation (FTM) and post-Appeals mediation are rarely used.<sup>40</sup> Rather than improve its mediation programs to meet taxpayer concerns and educate taxpayers about the benefits of mediation, Appeals has announced that it is reallocating its FTM program resources to its popular Fast Track Settlement program.<sup>41</sup>

### **Offer-in-Compromise Program**

The "offer in compromise" (OIC) program allows for the compromise of tax liabilities based upon "doubt as to liability" or "doubt as to collectibility," or in furtherance of "effective tax administration."<sup>42</sup> The IRS' goal for the OIC program is to achieve collection of what is reasonably collectible at the least cost and at the earliest possible time and to promote future compliance by providing taxpayers with a "fresh start."<sup>43</sup> OICs also promote future compliance by requiring, as a condition of the OIC agreement, that the taxpayer file returns and pay taxes for the following five years.<sup>44</sup> In RRA 98, Congress expanded the bases for compromise to include "effective tax administration" based on its belief that OICs promote voluntary compliance.<sup>45</sup> The intended effect of this expansion

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<sup>36</sup> FY 2005 Congressional Submission.

<sup>37</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 290-310.

<sup>38</sup> See IRC § 7123(b)(1) (directing the Secretary to "prescribe procedures under which a taxpayer or the Internal Revenue Service Office of Appeals may request non-binding mediation on any issue unresolved at the conclusion of – (A) appeals procedures; or (B) unsuccessful attempts to enter into a closing agreement under section 7121 or a compromise under 7122.").

<sup>39</sup> See S. Rep. 105-174 (April 22, 1998) ("The Committee also believes that mediation... would foster more timely resolution of taxpayers' problems with the IRS. In addition, the Committee believes that the ADR process is valuable to the IRS and taxpayers and should be extended to all taxpayers.").

<sup>40</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 294.

<sup>41</sup> See *Fast-Track Settlement Now Available to Small Business*, 2005 TNT 82-2 (April 29, 2005).

<sup>42</sup> See Treas. Reg. § 301.7122-1, *et. seq.*; Form 656, Offer in Compromise (Rev. 7-2004).

<sup>43</sup> Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992).

<sup>44</sup> Form 656, Offer in Compromise (Rev. 7-2004).

<sup>45</sup> H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998) (stating that "[t]he Senate amendment provides that the IRS will adopt a liberal acceptance policy for offers-in-compromise to provide an incentive for taxpayers to continue to file tax returns and continue to pay their taxes.... The conferees believe that the ability to compromise tax liability ... enhances taxpayer compliance.").

was generally to increase the IRS' flexibility in accepting OICs.<sup>46</sup> The conference report for this legislation explained:

The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.<sup>47</sup>

Appropriate revisions to the IRS approach to evaluating offers in compromise, as I discussed in my 2004 Annual Report to Congress, would increase revenues collected and bring more taxpayers back into compliance.<sup>48</sup> IRS's own research shows that for more than half of the offers from individual taxpayers that it rejected or returned, it eventually collected less than 80 percent of what taxpayers were offering, and it collected nothing in more than 20 percent of those cases.<sup>49</sup> The same study also shows that 80 percent of the taxpayers whose offers were accepted remained in compliance with their tax obligations over the five-year period following offer acceptance, as required by the terms of the offer. Thus, the offer in compromise program converts noncompliant taxpayers into compliant ones and brings in enforcement revenue that the IRS would not otherwise collect.

In 1998, Congress authorized the IRS to compromise tax debts based upon factors such as equity, public policy and hardship in cases where doing so would promote the effective administration of the tax laws (ETA offers). However, the IRS has interpreted the congressional authorization so narrowly that, for example, the IRS group charged with evaluating such offers accepted only a single ETA offer based upon equity or public policy in FY 2004. We believe that the IRS' reluctance to compromise in inequitable situations may lead taxpayers to disregard the law or erode their faith in the fairness of the income tax system. As I described in my 2004 Annual Report to Congress, I am not confident that the IRS will, on its own, use its ETA authority in the manner I believe Congress intended. I therefore recommend that Congress provide more specific guidance to the IRS to ensure that a new "equitable consideration" standard be applied in a broader array of cases.<sup>50</sup>

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<sup>46</sup> RRA 98, Pub. L. No. 105-206 (1998).

<sup>47</sup> H.R. Conf. Rep. 599, 105th Cong., 2d Sess. 289 (1998).

<sup>48</sup> National Taxpayer Advocate 2004 Annual Report to Congress 311-341 (describing problems in the offer-in-compromise program) and 433-450 (proposing a legislative recommendation to mitigate some of the problems).

<sup>49</sup> SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program (September 2004).

<sup>50</sup> For more detail, see National Taxpayer Advocate 2004 Annual Report to Congress 433-450.

## **Taxpayer Advocate Service Mission**

The statutory mission of the Taxpayer Advocate Service is to help taxpayers resolve their problems with the IRS and make administrative and legislative recommendations to mitigate those problems.<sup>51</sup> The Taxpayer Advocate Service (TAS) was never intended to become a “shadow IRS” or to take on core IRS functions. Today, however, TAS is increasingly asked to meet taxpayer service needs that the IRS no longer wants to meet or is providing for inadequately.

I anticipate that TAS will be asked to provide more taxpayer service to fill needs that arise as a result of IRS cuts in that area. To illustrate, IRS Taxpayer Assistance Centers (TACs) last year stopped issuing transcripts to taxpayers. For the first six months of FY 2005, TAS cases involving requests for copies of tax returns and account transcripts have consequently increased by 58.4 percent as compared with the same period last year. TAS offices that are co-located with TACs subject to closure are particularly likely to see an upsurge in taxpayer requests as taxpayers seeking face-to-face assistance from IRS employees come to TAS instead. In fact, TAS cases resulting from referrals from TACs increased by 29.7 percent for the first six months of FY 2005 over the same period last year due to reduced TAC hours and reduced scope of services. Unless we turn away taxpayers who require assistance, we will increasingly be handling cases that other IRS functions have handled in the past. This situation constitutes a significant deviation from TAS’s statutory mission. It is not TAS’s role to provide core IRS services.

Instead of learning from how TAS resolves both individual and systemic problems – as was the intent of the RRA 98 restructuring and creation of TAS – the IRS is simply allowing TAS to pick up the slack for the services it doesn’t want to provide. Ultimately, either TAS may become unable to fulfill its statutory mission or it will have to pick and choose cases, which will harm taxpayers. Continued Congressional oversight and emphasis on the importance of IRS providing core taxpayer service will ensure that TAS resources are applied to its Congressionally mandated mission – to help taxpayers resolve their problems with the IRS and to recommend systemic solutions to mitigate taxpayer problems.

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<sup>51</sup> IRC § 7803(c).