

WRITTEN STATEMENT OF

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HEARING ON

INTERNAL REVENUE SERVICE FY 2012 BUDGET REQUEST

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SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT

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Chairman Durbin, Ranking Member Moran, and distinguished Members of this Subcommittee:

Thank you for inviting me to submit this written statement regarding the proposed budget of the Internal Revenue Service for FY 2012.¹ As the National Taxpayer Advocate, the statutory voice for taxpayers and taxpayer rights inside the IRS, I submit the following thoughts for your consideration:

1. The IRS requires additional funding to collect the revenue that supports the federal government and to better meet the service needs of the taxpaying public.
2. The IRS, in particular, requires more funding to improve taxpayer services. Both the quality of taxpayer services, like answering taxpayer phone calls and responding to correspondence, and the quantity of taxpayer outreach and education have diminished in recent years. At this point, only five percent of the IRS budget is allocated for pre-filing taxpayer assistance and education. In addition, the combination of increased IRS enforcement actions and the recession has created substantially greater taxpayer need for assistance from the Taxpayer Advocate Service and the Low Income Taxpayer Clinic program.
3. The existing IRS budget structure does not accurately portray the activities of the IRS. In particular, a significant percentage, and perhaps the majority, of funding included in the "Taxpayer Services" account is not spent on programs commonly viewed as taxpayer service.
4. The "program integrity allocation adjustment" mechanism has been used in a manner that enables the IRS to receive extra funding for enforcement but not for its taxpayer service activities. Under the proposed FY 2012 budget, the IRS would receive an additional \$936,000,000 in enforcement funding through this mechanism (which amounts to 16 percent of the \$5,966,619,000 enforcement total), while receiving \$0 in additional taxpayer service funding through this mechanism.² This is true despite the fact that taxpayer service indisputably plays a significant role in promoting tax compliance.
5. The IRS desperately needs to conduct or commission better research so it can allocate its service and enforcement resources more efficiently.

¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

² IRS FY 2012 Budget Request, *Congressional Budget Submission 77* (Feb. 14, 2011), available at http://www.treasury.gov/about/budget-performance/Documents/CJ_FY2012_IRS_508.pdf.

6. The IRS should revise its mission statement to acknowledge explicitly that its traditional role as the tax collector has expanded in recent years so that it is now both (i) collecting taxes and (ii) administering social and economic benefits programs. This dual role should also be recognized explicitly in the budget to ensure the IRS receives sufficient funding to staff and perform both roles effectively.

Before I delve into these issues, I want to take a moment to acknowledge the extraordinary work of the IRS workforce and its leadership. In FY 2010, the IRS collected more than \$2.3 trillion to support the financial commitments of the federal government.³ It processed about 2.7 billion information returns⁴ and about 230 million tax returns, including 141 million individual returns, seven million corporation returns, and 30 million employment tax returns.⁵ Customer service representatives answered 47 million calls,⁶ and IRS enforcement personnel ramped up examination and collection activities.⁷ At the same time, the IRS launched major initiatives to regulate federal tax return preparers and combat noncompliance by taxpayers utilizing offshore bank accounts. There are always tasks the IRS could perform better – and I will address some of them below – but I think it is important to place these comments in context by acknowledging how much the IRS does very well.

I. The IRS Requires Additional Funding to Maximize the Collection of Tax Revenue and to Better Meet the Service Needs of the Taxpaying Public.

As I have testified previously, I view the IRS as the Accounts Receivable Department of the Federal government. If the Federal government were a private company, its management would fund the Accounts Receivable Department at whatever level it believed would maximize the company's bottom line. Since the IRS is not a private company, maximizing the bottom line is not – in and of itself – an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Studies show that if the IRS were given more resources, it could collect substantially more revenue.

In my 2006 Annual Report to Congress, I recommended that Congress provide the IRS with after-inflation increases of about two percent to three percent a year for the

³ IRS Data Book, FY 2010, Table 1.

⁴ *Id.* at Table 14.

⁵ *Id.* at Table 2.

⁶ IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2010).

⁷ See IRS FY 2010 Enforcement Results, *available at* http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

foreseeable future. I continue to believe that increasing the IRS budget at this rate is an excellent financial investment.

Most Federal expenditure programs are just that – expenditure programs. The funds are intended to be spent on worthwhile programs, but the expenditures generally do not directly generate more Federal revenue. The IRS is different. The IRS collects well over 90 percent of all Federal revenue.⁸ On a budget of about \$12.1 billion,⁹ the IRS collected about \$2.35 trillion in FY 2010.¹⁰ In other words, every \$1 appropriated for the IRS produced about \$194 in Federal revenue.

In evaluating the likely revenue benefits of additional funding, the average return on investment (ROI) of 194:1 is less important than the marginal ROI that can be achieved for each additional dollar spent. While the marginal ROI is considerably less than 194:1 and will differ by program, studies generally show that, within reasonable limits, each additional dollar appropriated to the IRS generates substantially more than an additional dollar in Federal revenue, assuming the funding is wisely spent. (As I discuss below, however, the IRS needs to develop improved methods to measure the ROI of its activities.)

Because of our national fiscal challenges, there has been considerable discussion recently about freezing or reducing all domestic discretionary spending. In my view, the IRS as the tax collector should be exempt from any such freeze or reduction. Reducing funding for the IRS will almost surely increase the deficit, because the reduction in revenue collected by the IRS will exceed the reduction in funding. A decision by Congress to address our budget problem by cutting IRS funding would be akin to a private business attempting to address a spending shortfall by cutting its Accounts Receivable Department. In other words, it would be penny-wise but pound-foolish.

Recommendation

- In light of the IRS's unique role as the federal revenue collector, I recommend that Congress develop new budget procedures to ensure that the IRS is funded at whatever level will maximize tax compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Over the long term, this approach may include exempting the IRS from spending ceilings or even taking the IRS off-budget. In the short run, this approach should include carving out the IRS from discretionary budget freezes intended to reduce the deficit, as cuts to the IRS budget are likely to increase the deficit.

⁸ See IRS Fact Sheet, FS-2011-09, *IRS FY 2012 Budget Proposal Summary* (Feb. 2011), available at <http://www.irs.gov/newsroom/article/0,,id=235959,00.html>.

⁹ Department of the Treasury, *FY 2012 Budget in Brief* (showing FY 2010 enacted levels).

¹⁰ Government Accountability Office, GAO-11-142, *Financial Audit: IRS's Fiscal Years 2010 and 2009 Financial Statements* at 59 (Nov. 2010).

II. The IRS Especially Requires More Funding To Improve Taxpayer Services.

The IRS's FY 2005-FY 2009 strategic plan was based on the slogan, "Service + Enforcement = Compliance," and the IRS in FY 2006 proposed to restructure its budget so that the two principal categories would be "Taxpayer Services" and "Enforcement." In both cases, service is listed before enforcement. Although we view this formula as simplistic,¹¹ it reflects the indisputable premise that both taxpayer service and enforcement contribute to tax compliance. Despite the intended implication that there is some rough equivalence between taxpayer service and enforcement in bringing about tax compliance, however, there is no equivalence in the IRS budget.

For FY 2012, the proposed budget would spend \$701 million on "Pre-filing Taxpayer Assistance and Education," which is what most taxpayers think of as taxpayer service. This amounts to only five percent of the IRS budget. The last few years have been particularly challenging for the IRS and many taxpayers, as the recently enacted Economic Stimulus Payments, First-Time Homebuyer Credits, and Making Work Pay Credits, among other tax benefits, have proven complex to claim or substantiate and have led to a significant increase in taxpayer inquiries and problems. As I will describe below, the IRS has been unable to keep up with taxpayer needs.

Significantly, the IRS has been ramping up spending for enforcement programs in recent years while holding taxpayer service spending flat. If the proposed FY 2012 budget is adopted without change, spending for the Enforcement account will have increased by 15.4 percent while spending for the Taxpayer Services account will have declined by 0.3 percent since FY 2006 on an inflation-adjusted basis.¹²

Not surprisingly, key IRS performance measures have improved for enforcement but declined for taxpayer service. For example, the IRS's FY 2010 Management Discussion and Analysis included in the GAO's financial audit of the IRS states: "Collection related to enforcement activities totaled \$57.6 billion, a 34% increase over FY 2004."¹³ By contrast, I note that the IRS answered 74 percent of all calls from taxpayers seeking to speak with a telephone assister in FY 2010 as compared with 87

¹¹ See, e.g., *Internal Revenue Service FY 2008 Budget Request: Hearing Before the Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations*, 110th Cong. (2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Internal Revenue Service FY 2006 Budget Request: Hearing Before the Subcomm. on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies of the S. Comm. on Appropriations*, 109th Cong. (2005) (statement of Nina E. Olson, National Taxpayer Advocate).

¹² Compare Department of the Treasury, *FY 2012 Budget-in-Brief with Department of the Treasury, FY 2008 Budget-in-Brief*. (The FY 2006 budget was adopted using a different budget structure. The proposed FY 2008 budget shows the enacted FY 2006 totals as translated into the current budget structure.) Inflation adjustments were made using the Bureau of Labor Statistics inflation calculator, available at <http://data.bls.gov/cgi-bin/cpicalc.pl>.

¹³ Government Accountability Office, GAO-11-142, *Financial Audit: IRS's Fiscal Years 2010 and 2009 Financial Statements* at 23 (Nov. 2010).

percent in FY 2004, a decline of 13 percentage points, or 15 percent.¹⁴ The IRS's ability to timely process taxpayer correspondence has also declined. Comparing the final week of FY 2004 with the final week of FY 2010, the backlog of taxpayer correspondence in the tax adjustments inventory has jumped by 76 percent (from 357,151 to 628,016), the percentage of "uncontrolled" correspondence received but not yet entered into IRS computer systems has increased by 134 percent (from 8.3 percent to 19.4 percent of correspondence), and the percentage of taxpayer correspondence classified as "overage" has increased by 135 percent (from 11.5 percent to 27.0 percent).¹⁵

A. Taxpayer Service Contributes to Higher Rates of Tax Compliance, and Outreach and Education in Particular Should Be Increased.

Despite general agreement that both service and enforcement contribute to greater tax compliance, policymakers seeking to improve compliance and close the tax gap tend to focus almost exclusively on new enforcement measures – more audits, more collection actions, and more third-party information reporting to facilitate data-matching. The central role that service plays in promoting tax compliance is all too often overlooked.

At the most basic level, there would be no compliance if the IRS did not publish forms and publications, provide instructions on how to file returns, and answer filing-related questions. However, taxpayer service goes beyond merely publishing forms and answering telephone calls.

Taxpayer outreach and education are critically important to achieving voluntary tax compliance, which is the cheapest type of compliance for the government. In my view, the IRS is not conducting nearly enough outreach and education to taxpayers, especially self-employed and small business taxpayers, to maximize voluntary compliance. According to the IRS's most recent estimate of unpaid taxes, \$148 billion, or 43 percent of the aggregate tax gap, is attributable to unreported income earned by unincorporated businesses and the associated unpaid self-employment tax.¹⁶

To be sure, a portion of the small business tax gap reflects a willful failure to report income. However, another portion reflects lack of knowledge about how to comply. For example, consider an individual without a college degree who becomes a successful plumber or electrician with a growing customer base. If he hires employees, he will face a host of employment, immigration verification, and local, state and federal tax requirements, including the need to withhold and pay over payroll taxes with respect to

¹⁴ See IRS FY 2010 Enforcement Results, *available at* http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

¹⁵ *Compare* IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 25, 2010) *with* IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 25, 2004).

¹⁶ See IRS News Release, IR-2006-28, *IRS Updates Tax Gap Estimates* (Feb. 14, 2006) (accompanying slide 1), *available at* <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>.

his employees and to file employment tax and income tax returns on behalf of his business. Moreover, he likely will need to grapple with complex rules such as those dealing with automobile and transportation expenses, inventory, and depreciation of equipment and other fixed assets. For most taxpayers, these requirements would seem daunting or even impenetrable, and some taxpayers inevitably do not comply simply because they have no idea where to begin.

The IRS's current compliance strategy, which consists largely of posting general information on its website and auditing a tiny fraction of small business returns,¹⁷ can be improved. The IRS can increase compliance in the small business community efficiently if it expands its outreach and education efforts through a more robust field function and commits more resources to meeting proactively with small businesses that are starting operations.

In FY 2006, the Appropriations Committees directed the IRS, the IRS Oversight Board, and the National Taxpayer Advocate to collaboratively develop a five-year strategic plan for taxpayer service.¹⁸ In response, the IRS developed a plan known as the Taxpayer Assistance Blueprint (TAB). The IRS conducted extensive research on the needs and preferences of individual taxpayers in the course of developing the TAB. Pursuant to annual Appropriations directives, the IRS is continuing to provide the Appropriations Committees with annual progress reports.

As I have recommended before – and as the Appropriations Committees urged two years ago¹⁹ – the IRS should expand the scope of its TAB research studies to include self-employed and small business taxpayers and then should apply the knowledge it acquires through the studies to all of its interactions with those taxpayers. The IRS should also expand its outreach to tax-exempt organizations to improve compliance in that sector.

B. Taxpayer Services Should Be Strengthened To Meet the Service Needs of U.S. Taxpayers.

Beyond compliance, I believe the IRS has an obligation to provide high-quality service to its taxpayers simply as a matter of good government. When we ask people to pay

¹⁷ In FY 2010, the IRS audited 0.58 percent of all business returns, including 0.94 percent of small C corporations (under \$10 million in assets), 0.37 percent of Subchapter S returns, and 0.36 percent of partnership returns. See IRS FY 2010 Enforcement Results, *available at* http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

¹⁸ H.R. Rep. No. 109-307, at 209 (2005) (Conf. Rep.).

¹⁹ The House report “urge[d] the IRS to continue to expand upon its TAB-related work with regard to small business and self-employed taxpayers and tax-exempt and government entities, and to include these additional categories in the annual IRS update to the TAB.” H.R. Rep. No. 111-202, at 21-22 (2009). The Joint Explanatory Statement of Managers accompanying the conference report made clear that the House language was approved by the conference committee. H.R. Rep. No. 111-366, at 892 (2009) (Conf. Rep.).

over a large percentage of their income to the government each year, the least we can do is make the process as simple and painless as possible.

In important respects, IRS taxpayer service is falling short. Consider the following four examples:

Telephone Service. Each year, tens of millions of taxpayers call the IRS seeking help with a wide variety of issues, including account questions and tax-filing questions. Yet the IRS is unable to answer a large percentage of these telephone calls. The Customer Account Services (CAS) Customer Service Representative Level of Service, or “LOS,” generally measures the percentage of calls that get through to a representative among all callers seeking to do so. By this measure, as noted, the IRS answered 87 percent of its calls in FY 2004. Since that time, the LOS has been declining, plummeting to a low of 53 percent in FY 2008. In other words, IRS telephone assistants in FY 2008 were unable to answer nearly half the calls they received.

In FY 2010, the LOS rebounded somewhat to about 74 percent, and it is running at about that level so far in FY 2011.²⁰

While answering 74 percent of calls is a vast improvement over 53 percent, it means the IRS is still failing to answer one out of every four calls it receives from taxpayers who need assistance. Equally concerning, among calls that do get answered, the average wait time in FY 2010 was nearly 11 minutes,²¹ up from about four and one-half minutes in FY 2007.²²

Although hard to quantify, the impact of the IRS’s inability to answer taxpayer calls is significant and has considerable downstream consequences:

- When taxpayers call the toll-free line with tax law questions and cannot get through, some will just give up and not bother to file their tax returns. Others will file inaccurate returns that require IRS follow-up action and taxpayer response.
- When taxpayers receive notices proposing additional tax, many have questions and try to reach the IRS by phone. If they cannot get through, they remain unsure about what to do and some will not respond, requiring the IRS to take further steps and potentially exposing those taxpayers to enforced collection action. Others will write letters to the IRS, requiring IRS employees in the Accounts Management (AM) function to respond.

²⁰ See IRS FY 2010 Enforcement Results, *available at* http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf; IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (week ending May 21, 2011).

²¹ IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (week ending Sept. 30, 2010).

²² IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (week ending Sept. 30, 2007).

In his book, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America*, former Commissioner Charles Rossotti addressed the importance of maintaining a high level of service on the IRS's toll-free lines:

Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money.²³

Let me be clear that I am not being critical of the IRS's handling of the increased telephone volume – it generally is applying its current resources appropriately and is seeking new ways to use those resources more productively. However, to meet taxpayers' needs, to improve taxpayers' ability to comply with the law and respond to IRS notices, and to reduce the aggregate burden on the IRS when those who cannot get through by phone contact the IRS through multiple channels with the same question, I believe the IRS must be able to answer at least 85 percent of taxpayer calls and keep taxpayers on hold for no longer than an average of five minutes.²⁴

Taxpayer Correspondence. The IRS's responsiveness to taxpayer correspondence is also lagging. Some Accounts Management employees shuttle back and forth between working with paper correspondence (including the processing of amended returns) and answering telephone calls. When IRS employees dedicated exclusively to answering taxpayer calls cannot handle the volumes, AM employees are shifted from handling paper correspondence to help out. Not surprisingly, as call volumes have increased and AM employees have been moved to answer telephone calls, paper correspondence inventories have increased as well. The correspondence inventory rose from approximately 480,000 at the end of FY 2007 to approximately 628,000 at the end of FY 2010 – a 31 percent increase.²⁵

To some degree, the combination of poor telephone service and slow correspondence processing creates a vicious cycle: Taxpayers who cannot get through to the IRS by telephone send letters, causing more work for employees assigned to paper correspondence and leading to correspondence backlogs and delays in processing amended returns, while taxpayers who write to the IRS and do not receive timely responses call the IRS to try to figure out what happened. The IRS requires taxpayers to file their returns and respond to notices on a timely basis. Taxpayers have a right to expect comparable timeliness of the IRS.

²³ Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 285 (2005).

²⁴ For a more detailed discussion of the IRS's toll-free telephone service, see National Taxpayer Advocate 2009 Annual Report to Congress 4-16 (Most Serious Problem: *IRS Toll-Free Telephone Service Is Declining as Taxpayer Demand for Telephone Service Is Increasing*).

²⁵ IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (weeks ending Sept. 29, 2007 and Sept. 25, 2010, respectively).

Taxpayer Advocate Service (TAS). The workload facing my own organization, the Taxpayer Advocate Service (TAS), has increased substantially in recent years. Although TAS has other important responsibilities, we are primarily the case-working operation of the IRS for taxpayers who are experiencing a significant hardship. We assist taxpayers who are experiencing a current or imminent financial hardship as a result of an IRS action or inaction (e.g., where an IRS levy against a taxpayer's paycheck will lead to eviction or a shutoff of utilities) or who are experiencing a systemic hardship because the IRS has not served them on a timely or accurate basis (e.g., where the IRS has failed to issue a refund or process a taxpayer's response to an audit or collection notice). By statute, Congress has required that TAS make at least one advocate available for each state,²⁶ and we currently have 74 offices that serve taxpayers. Many of you are familiar with our Local Taxpayer Advocates, because TAS handles congressionally referred taxpayer cases as well.

TAS's annual case receipts rose from 168,856 in FY 2004 to 298,933 in FY 2010 – an increase of 77 percent. For the first half of FY 2011, TAS case receipts have risen by an additional 4.3 percent as compared with the first half of FY 2010. There are two main drivers of this increase. First, the majority of TAS's cases stems from IRS compliance actions, and the IRS has substantially increased the number of these actions in recent years.²⁷ Second, TAS receives more cases during economic downturns, when more taxpayers cannot pay their tax bills and get into trouble with the IRS.

To date, TAS has managed to handle the increased caseload. After several years of declining staffing, TAS has been able to hire three new categories of employees over the past few years to assist our case advocates in doing their jobs. We now have 116 "intake advocates," who answer telephone calls, respond to simple taxpayer questions, and assist with case-building by identifying key facts and issues and requesting necessary documentation. We also have 127 "lead case advocates," who mentor and assist case advocates with unusually challenging cases, maintain partial caseloads of their own, and help develop TAS best practices. Finally, we have 18 "campus technical advisors," who provide technical guidance and support on complex cases worked by the IRS in each of its ten campuses. These additional specialty positions have freed up our case advocates to spend more direct time resolving taxpayer cases and have given them helpful resources when they get stuck on technical issues. TAS management has also taken steps to improve efficiencies.²⁸

²⁶ IRC § 7803(c)(2)(D)(i)(I).

²⁷ From FY 2004 to FY 2010, levies rose from 2,029,613 to 3,606,818, liens rose from 534,392 to 1,096,376, and seizures rose from 440 to 605. See IRS FY 2010 Enforcement Results, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

²⁸ One important current project is the development and deployment of a new, fully integrated system for TAS, which will automate many manual operations and integrate case advocacy, systemic advocacy, and all other TAS activities. This system, known as the Taxpayer Advocate Service Integrated System, or TASIS, will replace more than ten stand-alone systems and databases and improve efficiency by enabling employees to work across IRS systems, maintain and search case files electronically, and handle the intake, screening, and distribution of work electronically. TASIS will also enable management to ensure a

As a result of these measures, I am pleased to report that TAS has continued to perform well. In FY 2010, TAS obtained full relief for taxpayers in 69 percent of our cases and partial relief for taxpayers in an additional five percent. (In other cases, taxpayers generally are not entitled to relief.) These levels are consistent with historical norms. In addition, ongoing surveys conducted by an independent polling firm among taxpayers assisted by TAS show that customer satisfaction stood at 84 percent in FY 2004 and at 85 percent in FY 2010.

Despite these positive results, the significant increase in case inventories is beginning to strain TAS's capacity. In FY 2004, TAS case advocates annually handled an average of 135 cases, and their caseloads have been steadily increasing since that time. In FY 2010, the average annual caseload per advocate rose to 240 cases, and in FY 2011, it is projected to reach 249 cases.²⁹

Because cases generally come to TAS only when a taxpayer is suffering from a financial hardship or the IRS's regular processes have not worked as they should, TAS as a practical matter is often a taxpayer's last resort. As the IRS's "safety net" for taxpayers, TAS has had a policy of assisting all taxpayers who meet our case-acceptance criteria since Congress created our organization in 1998. If the imbalance between our resources and the demand for our services widens much further, however, we will have no choice but to decline to accept certain categories of cases, leaving taxpayers to fend for themselves. I have served as the National Taxpayer Advocate for ten years, and this is the first time I have felt compelled to sound this alarm. But I am deeply concerned that if TAS is subject to spending freezes and does not have adequate resources, we will be forced to turn away cases and taxpayers will suffer significant hardships as a consequence.

Low Income Taxpayer Clinics. In 1998, Congress established a grant program to fund low income taxpayer clinics (LITCs).³⁰ LITCs primarily represent low income taxpayers in federal tax controversies with the IRS for free or for a nominal charge.³¹ For FY 2010, Congress provided \$10 million for the LITCs.

more even distribution of workload because it will provide information not merely on the number of cases per case advocate but also on case complexity, required skills, and anticipated time required for case completion. Assuming the funding committed to the project is not cut or deferred, we anticipate that much of TESIS will be operational in 2013.

²⁹ Average annual caseloads represent aggregate TAS case receipts divided by the sum of Case Advocates, Intake Advocates, and half of TAS's Lead Case Advocates. (Lead Case Advocates spend approximately 50 percent of their time on non-case-specific work, including training and non-evaluative reviews).

³⁰ See IRC § 7526.

³¹ Some LITCs provide tax education and outreach for taxpayers who speak English as a second language.

Largely because of the recession and consequent job losses, LITC case inventories have risen substantially. The LITCs collectively worked 16,374 cases in 2008 and 21,801 cases in 2009, an increase of 33 percent. During the first six months of 2010, LITCs worked 17,293 cases – more than the number they handled during all of 2008. Low income taxpayers who face IRS audits or collection action have few alternative options for assistance. With roughly a doubling of cases in the last two years, it is critical that LITCs receive sufficient resources to deal with these caseloads.

In its FY 2011 budget recommendation, the IRS Oversight Board recommended a \$2.3 million initiative to expand coverage of the LITC program. The Oversight Board noted:

The current economic environment presents significant challenges as the number of taxpayers who cannot pay their liabilities is increasing while available assistance from tax professionals is declining.

Taxpayers who want to comply with their tax obligations and responsibilities must have access to information, assistance, and, when appropriate, representation. Low income taxpayers who cannot afford representation can be at a disadvantage in resolving tax disputes with the IRS. For example, a recent TAS research study found that taxpayers who were represented in Earned Income Tax Credit (EITC) audits by attorneys, accountants, enrolled agents, or even unenrolled return preparers, were nearly twice as likely to receive the EITC, and received almost twice as much EITC, as taxpayers who were unrepresented. Thus, LITCs ensure that low income taxpayers receive the correct outcome in controversies with the IRS and pay the correct tax amount.³²

The Administration's proposed FY 2012 budget would reduce funding for LITCs by \$500,000. I believe the LITCs need additional funding to provide assistance to low income taxpayers whom the IRS has targeted for enforcement action.

Recommendations

- Both to improve tax compliance and to meet the needs of the taxpaying public, I recommend that Congress provide additional funding for taxpayer service activities, including increased funding for LITCs.
- To enable the IRS to better meet the needs of small business taxpayers and tax-exempt organizations, I recommend that Congress direct the IRS to conduct comprehensive TAB-like research studies of those populations.

³² IRS Oversight Board, *FY 2011 IRS Budget Recommendation 23-24* (March 2010).

III. The IRS Budget Structure Does Not Accurately Portray the IRS's Activities and Probably Overstates Spending for Taxpayer Service.

As discussed above, the IRS since FY 2006 has been proposing its budget by classifying most activities as either "Taxpayer Services" or "Enforcement." For a number of reasons, including the availability of program integrity allocation adjustments for Enforcement initiatives (discussed below) and how the IRS approaches a program, the classification of an activity as taxpayer service or enforcement has consequences.

One threshold challenge in dividing the budget in this way is that there is no universal agreement on where to draw the line between service and enforcement. For the most part, I think people view "taxpayer service" as including IRS activities that assist them in voluntarily complying with their tax obligations. I think most people view enforcement as including activities the IRS undertakes to collect tax liabilities that have not been fully and timely paid.

The current budget follows what I view as a fairly arbitrary division of the IRS's activities into the Taxpayer Services and Enforcement buckets. A few examples will illustrate:

Processing Tax Returns. The budget treats the processing of tax returns entirely as a taxpayer service. In a response included in the National Taxpayer Advocate's 2010 Annual Report to Congress, the IRS wrote: "The millions of taxpayers who each year voluntarily file and pay their taxes likely would not view the processing of their refunds as anything other than a service activity."³³ The thinking behind this statement is not self-evident. It is true, as the IRS has pointed out, that refunds are issued to many taxpayers in the course of returns processing, and it is understandable that taxpayers receiving a refund may see that activity as a service.

It is also true, however, that taxpayers filing returns with balances due are required to remit payment with their returns and that the IRS uses the information provided on all tax returns to help it determine which taxpayers to audit. As I observed only somewhat facetiously in my report, if collecting tax payments and facilitating audit selection are the types of services the IRS provides, I believe most taxpayers would choose to take a pass. In my view, returns processing is best classified as neither service nor enforcement. It is simply an overhead or support function that enables the IRS to collect taxes.

Accounts Management. Funding for the Accounts Management program, which includes the toll-free phone lines and correspondence processing, is included in the Taxpayer Services account, even though most of the AM budget is allocated toward working with taxpayers by phone or letter after the IRS has proposed a tax adjustment. If the IRS generates a notice telling a taxpayer he or she has underreported income and

³³ National Taxpayer Advocate 2010 Annual Report to Congress 65-66 (Most Serious Problem: *The Wage & Investment Division Is Tasked With Supporting Multiple Agency-Wide Operations, Impeding Its Ability to Serve Its Core Base of Individual Taxpayers Effectively*).

owes additional tax, it is far from clear that the follow-up costs should be viewed as a “service” rather than “enforcement.”

Field Assistance. Funding for the Field Assistance program, which includes the IRS walk-in sites, is also included in the Taxpayer Services account. As with Accounts Management, more than half the work performed in the walk-in sites relates to account and notice work, so the decision to classify these activities as services is questionable.

Small Business/Self-Employed Operating Division. The Small Business/Self-Employed Operating Division (SB/SE) is tasked with serving all small businesses and self-employed taxpayers. For reasons I have described above, outreach and education are particularly important for this population. First-time business owners face a daunting array of employment tax requirements in addition to recordkeeping and other business income tax requirements. Growing businesses may not recognize tax issues that arise as they become more successful. Businesses experiencing financial difficulties may not understand that ignoring tax issues can further impair their economic viability in the short and long terms. Yet SB/SE is funded almost exclusively from the Enforcement account. Only one percent of its funding comes from the Taxpayer Services account.³⁴

TAS and Appeals. Under the current budget structure, TAS is funded entirely under the Taxpayer Services account, while the Office of Appeals is funded entirely under the Enforcement account. I am discussing TAS and Appeals together because they share similar characteristics. Neither function initiates contact with taxpayers. Rather, both functions become involved in a case when a taxpayer is dissatisfied with actions another IRS function has taken and seeks us out for assistance. This similarity raises questions about the underlying rationale for the difference in budget classification.

There are other reasons to question the distinction as well. Most important, sound accounting principles generally require that revenues be matched with the expenses that generate them. If the IRS enforcement functions propose and collect additional tax amounts, downstream costs associated with the revenue the IRS receives arguably should be treated as part of the costs of enforcement. If the IRS treats revenue generated by the collection function as “Enforcement” revenue but apportions the costs of working with the affected taxpayers to the Taxpayer Services account – as it currently does by treating TAS as a service expense – the net amount of IRS enforcement revenue will be overstated, perhaps considerably so. This will result in an inflated ROI on enforcement spending and has the potential to distort funding decisions.

In addition, the Office of Appeals is constantly seeking to reassure skeptical taxpayers and practitioners that, despite its placement within the IRS, it is independent from the IRS Examination and Collection functions and will provide taxpayers with an impartial hearing. The decision to fund Appeals entirely from the Enforcement account along

³⁴ IRS, Integrated Financial System, *Status of Available Funds Report* (FY 2010).

with the Examination and Collection functions may undermine Appeals' effort to persuade outsiders that it is not simply another IRS enforcement function.

With respect to the foregoing examples, there is no objectively "correct" answer, so the existing budget categories are not necessarily wrong. But neither are they necessarily right, and that is the source of my concern. Using the terms "Taxpayer Services" and "Enforcement" implies a bright-line distinction that cannot accurately be drawn. In that sense, the labels are arbitrary and somewhat misleading. In addition, because of the significant number of programs placed within the Taxpayer Services account that do not clearly belong there, I believe the budget may substantially overstate the amount of funding provided for programs that a layman would consider to be Taxpayer Services. This is significant as a matter of truth in packaging because it may paint an exaggerated portrait of how much emphasis the IRS places on taxpayer service activities. As discussed below, it is also significant because programs assigned to the Enforcement account may have more funding flexibility due to the operation of program integrity allocation adjustments.

Recommendations

I recommend the following steps:

- Move the funding associated with returns processing into the Operations Support account.
- Divide the funding associated with Accounts Management and Field Assistance activities between the Taxpayer Services account and the Enforcement account based on the underlying activities to which they relate.
- Divide funding for the Taxpayer Advocate Service between the Taxpayer Services account and the Enforcement account based on the percentage of TAS cases that are service-related and the percentage of TAS cases that are enforcement-related.
- Consider for the longer term devising a set of budget categories that do away with the artificial distinction between taxpayer service and enforcement.

IV. The "Program Integrity Allocation Adjustment" Mechanism Has Been Used in a Manner That Enables the IRS to Receive Extra Funding for Its Enforcement Activities But Not for Its Taxpayer Service Activities, Despite the Fact That Taxpayer Service Activities Also Contribute to Compliance.

During the last few years, the IRS budget has utilized a mechanism that makes it relatively easy to provide increases for Enforcement spending, but the procedure is not used for the Taxpayer Services account. Under this mechanism, known as a "program integrity allocation adjustment," new funding appropriated for IRS

enforcement programs generally does not count against otherwise applicable spending ceilings provided (1) the IRS's existing enforcement base is fully funded and (2) a determination is made that the proposed additional expenditures will generate a return-on-investment (ROI) of greater than 1:1 (*i.e.*, the additional expenditures will reduce the deficit on a net basis).

These conditions reflect the fact that the IRS is able to project the direct ROI of its enforcement activities – it can measure to the dollar the amounts collected by its Examination, Collection, and document-matching functions – but faces a much harder task in measuring the ROI of taxpayer services. As discussed above, it seems intuitively clear that the ROI of taxpayer service activities is greater than 1:1. Basic services like publishing tax forms, providing guidance, and answering taxpayer questions are essential for enabling taxpayers to file returns and enabling the IRS to collect revenue. Yet because the IRS cannot quantify either the overall ROI of taxpayer service spending or the ROI of specific taxpayer service initiatives, Taxpayer Services spending is not currently considered eligible for program integrity allocation adjustments.

As a consequence, the IRS has been able to request larger increases each year for Enforcement than for Taxpayer Services, and it is increasingly becoming more of an enforcement agency with a relatively smaller focus on taxpayer service. If the proposed FY 2012 budget is adopted without change, as noted above, spending for the Enforcement account will have increased by 15.4 percent while spending for the Taxpayer Services account will have declined by 0.3 percent since FY 2006 on an inflation-adjusted basis.³⁵ In essence, the 15.4 percent increase in Enforcement is entirely attributable to program integrity allocation adjustments. Under the proposed FY 2012 budget, the IRS would receive an additional \$936,000,000 in enforcement funding through this mechanism, which amounts to 16 percent of the \$5,966,619,000 enforcement total.

Moreover, the recent trend is likely to continue. The Administration's FY 2012 budget proposal contains spending projections for future years. Over the next five years (from FY 2012 to FY 2016), it projects that Enforcement spending will rise by another 28 percent while Taxpayer Services spending will slightly decline.³⁶

³⁵ Compare Department of the Treasury, *FY 2012 Budget-in-Brief with Department of the Treasury, FY 2008 Budget-in-Brief*. (The FY 2006 budget was adopted using a different budget structure. The proposed FY 2008 budget shows the enacted FY 2006 totals as translated into the current budget structure.) Inflation adjustments were made using the Bureau of Labor Statistics inflation calculator, available at <http://data.bls.gov/cgi-bin/cpicalc.pl>.

³⁶ Budget of the United States Government: Analytical Perspectives, Supplemental Materials Fiscal Year 2012: Federal Programs by Agency and Account, at 317-318, available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/33_1.pdf. Taxpayer service spending is shown on page 317 (see line labeled "Taxpayer Services: Appropriations, discretionary . . . 803"). Enforcement spending is the sum of the line on page 317 labeled "(Federal law enforcement activities): Appropriations, discretionary . . . 751" and the line on page 318 labeled "(Central fiscal operations): Appropriations, discretionary . . . 803."

I am deeply concerned about the widening resource gap between the agency's taxpayer service and enforcement programs. First, for reasons discussed in the prior section, I think the distinction between service and enforcement can be highly artificial and arbitrary. To provide substantial additional funding to any program that gets classified as "enforcement" while reducing or holding flat spending for any program that gets classified as "taxpayer service" will not result in a balanced agency and may even encourage game-playing to classify priority programs as enforcement. Moreover, the classification of a program as "enforcement" rather than "service" has significant implications for the way the IRS treats taxpayers.

Second, as I have also discussed, it is widely acknowledged that taxpayer service contributes significantly to compliance. In some cases, service may contribute even more than enforcement to improved compliance. Because the IRS currently is unable to compute an ROI for service activities, however, service activities by themselves do not qualify for allocation adjustments.

Third, Congress has given the IRS an increasing number of social and economic benefit programs to administer, and as I will discuss below, both of these types of benefits programs typically require more service.

The use of program integrity allocation adjustments has enabled the IRS to receive more funding than would otherwise be the case, and I think that is positive. But I strongly encourage the IRS and this Subcommittee to consider ways to modify the way allocation adjustments are used so that taxpayer needs are met and the IRS remains a balanced agency. One possibility is to define new compliance initiatives more broadly, so that they include both an enforcement component and a service component. Because the projected ROI of some types of enforcement initiatives is high, a more broadly constructed initiative could still produce an ROI of greater than 1:1 (*i.e.*, the service components would piggyback on the high-ROI enforcement activity). That could satisfy the requirements for an allocation adjustment while giving the agency more flexibility to meet taxpayer needs and improve compliance in obvious yet currently immeasurable ways.

Example of a Broader Compliance Initiative

Assume the IRS is planning a new enforcement initiative to improve compliance among small business taxpayers. The initiative will cost \$50 million and is projected to produce an ROI of 6:1 (or \$300 million in additional revenue). The IRS intends to request \$50 million for this initiative as a program integrity allocation adjustment.

Assume further that the IRS has identified taxpayer service activities that would also improve small business compliance, such as new or additional types of outreach and education. The cost of the service initiative would be \$25 million, but the IRS cannot quantify the ROI.

If the IRS defines new compliance initiatives more broadly to include service activities, it could package the enforcement measures with the outreach and education measures and request \$75 million for the combined initiative as an allocation adjustment. The ROI would still be positive (the \$75 million cost and projected revenue of \$300 million would produce an ROI of 4:1). Most important, the IRS would be operating a more integrated, effective, and balanced compliance program.

Recommendation

- I recommend that the IRS and Congress consider ways to broaden the use of program integrity allocation adjustments so that compliance initiatives include taxpayer service components.

V. The IRS Desperately Needs to Conduct or Commission Better Research So It Can Allocate Its Service and Enforcement Resources More Efficiently.

The IRS would be able to allocate its resources more effectively if it had a better understanding of the causes of noncompliance and could test alternative compliance approaches. At present, the IRS has a tendency to treat all noncompliance as willful and to treat taxpayers who do not fully comply as “bad” taxpayers.

If all noncompliance reflected a willful decision by taxpayers to cheat the government, a compliance approach that emphasizes hard-core enforcement measures might make sense. But much, if not most, noncompliance occurs for different reasons. In some cases, taxpayers do not know the rules. In some cases, taxpayers find complying with the rules excessively burdensome or confusing. In other instances, significant life events arise (*e.g.*, illness, unemployment, or divorce) and taxpayers do not file returns. (This cuts both ways from a revenue standpoint. Some taxpayers who owe tax do not file returns, but many taxpayers who are due refunds each year also do not file returns and thus overpay their taxes.) In still other cases, taxpayers are too intimidated to file returns. For example, an individual who loses his job and cannot afford to pay may decide against filing a return because he fears what may happen if he reports a tax liability and cannot pay it.

In large part, the IRS’s one-size-fits-all approach reflects the absence of data on which to base better resource-allocation decisions. It bears emphasizing that “direct enforcement revenue” constitutes only about two percent of the revenue the IRS collects.³⁷ Ninety-eight percent of the revenue the IRS collects is paid voluntarily due to a combination of its taxpayer service programs and the indirect, deterrent effect of its

³⁷ In FY 2010, the IRS collected \$2.345 trillion. See IRS Data Book, FY 2010, Table 1. The amount of enforcement revenue it collected was \$57.6 billion. See IRS FY 2010 Enforcement Results, *available at* http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

enforcement activities. However, the IRS does not have adequate data to determine the relative contribution to compliance of taxpayer service and enforcement, let alone which components of taxpayer service and enforcement are most effective. Without these critical pieces of information, resource-allocation decisions are necessarily made more on the basis of best guesses and hunches than empirical evidence.

I suggest that Congress consider directing the IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its ROI estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions. The IRS should also improve its methods of verifying, retrospectively, the *marginal* ROI it has achieved for each category of work. ROI estimates should include costs relating to the downstream consequences of the various categories of IRS work, including increased phone calls and correspondence, Appeals conferences, Taxpayer Advocate Service cases, and Tax Court litigation.

I acknowledge that developing reasonably accurate modeling is a significant challenge and will require a commitment of resources. Nonetheless, I have recommended in the past and continue to believe that this information will aid the IRS enormously in making resource-allocation decisions and will provide Members of Congress with additional information on which to base future funding decisions.³⁸

Recommendation

- I recommend that Congress direct the IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its ROI estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions.

VI. The IRS Should Revise Its Mission Statement to Explicitly Acknowledge That Its Traditional Role as the Tax Collector Has Expanded in Recent Years So That It Is Now Both (i) Collecting Taxes and (ii) Administering Social and Economic Benefit Programs.

Historically, the IRS's mission has been to collect taxes imposed by Congress to fund federal spending. In recent years, however, Congress has increasingly been using the tax code to provide economic incentives or social benefits for taxpayers.

³⁸ The congressional budget rules currently prohibit the Congressional Budget Office or the Office of Management and Budget from treating changes in discretionary appropriations to the IRS as giving rise to scorable increases in tax receipts. See H.R. Conf. Rep. No. 101-964 (1990). See also Office of Management and Budget, *OMB Circular No. A-11*, Part 8, Appendix A, Principle 14 (2006). Because changes to IRS funding levels undoubtedly have an impact on tax collections, this prohibition seemingly reflects the practical difficulty of devising accurate estimates. Yet accurate estimates would be helpful to Congress, and we believe the IRS should make developing better estimates a priority objective.

In 1975, Congress enacted the Earned Income Tax Credit, which allows low income, working taxpayers to receive, through the tax code, government payments that exceed their income tax liabilities. In 2008, Congress directed the IRS to make Economic Stimulus Payments. Also beginning in 2008, Congress made available the first of three iterations of the First-Time Homebuyer Credit. Beginning in 2009, Congress provided the Making Work Pay Credit. Then last year, Congress enacted the Hiring Incentives to Restore Employment (HIRE) Act, which provides incentives for small businesses to hire additional workers, and the Patient Protection and Affordable Care Act, which contains numerous provisions that will require interaction between the IRS and businesses or individuals.

In many cases, there are compelling reasons for administering these programs through the tax code. Absent adequate planning, however, I am concerned that directing a law enforcement agency to administer such programs could be problematic. While enforcement measures are required to prevent inappropriate claims in benefits programs, the overriding objective of agencies that administer benefits programs has traditionally been to help as many eligible persons qualify for the benefits as possible. That requires extensive outreach and even working one-on-one with potentially eligible individuals.

There are significant differences between benefits agencies and enforcement agencies in terms of culture, mindset, and the skill sets and training of their employees. Benefits agencies like the Social Security Administration and the Department of Veterans Affairs, despite some shortcomings, are primarily trying to get to yes – to help as many eligible persons qualify for benefits as possible. Enforcement agencies are more in the business of saying no. As the IRS prepares to administer large portions of the health care legislation, including approving claims by low income persons for health care tax credits and imposing a penalty tax on those who are required to purchase health insurance but fail to do so, I believe the IRS should hire and train a new category of caseworkers – employees with social welfare-type backgrounds or similar training who will work one-on-one with taxpayers to resolve legitimate disagreements, instead of merely sending out notices saying, in effect, "you owe us."

In addition, the IRS will require more funding to perform effectively both its traditional tax collection role and its expanding role as a benefits administrator. I am convinced that with adequate planning and funding, the IRS can do the job. But if the IRS does not recognize the importance of improving its benefits administration capacity or does not receive adequate funding, there are likely to be significant violations of taxpayer rights and significant taxpayer burden. In this regard, the trend toward increased funding for the IRS's Enforcement account relative to the Taxpayer Services account, as discussed above, is concerning and should be carefully evaluated.

To help ensure that the IRS focuses on these challenges and that its needs are recognized in the budget process, I believe the IRS should revise its mission statement to make explicit that its mission is both to collect taxes and to deliver

economic and social benefits authorized by the Congress. In this connection, the IRS should (i) revise Revenue Procedure 64-22 to include the IRS's responsibility as a benefits administrator; (ii) create a new program office and deputy commissioner position to provide strategic direction for all benefits programs; and (iii) conduct a comprehensive evaluation of the administration of previous and existing benefits programs to aid in the planning and implementation of future programs.

Recommendation

- I recommend that the IRS revise its mission statement to make explicit that its mission is both to collect taxes and to deliver economic and social benefits authorized by the Congress.

VII. Conclusion

In this statement, I have attempted to describe six issues that this Subcommittee may wish to consider. Some require immediate attention, while others would benefit from consideration over the longer term. In the near term, my overriding concern relates to the overall funding of the IRS. As the nation's tax collector, the IRS is part of the solution to the problem of budget deficits, not part of the problem. There has been considerable discussion about freezing all domestic discretionary spending, which would presumably include funding for the IRS. I believe freezing or restricting IRS funding – either for taxpayer service activities or for enforcement activities – would be a mistake and would undermine the goal of closing the tax gap and reducing the deficit. I strongly encourage this Subcommittee and the Congress to find a way to exempt the IRS from any such cuts.