

**Report to the IRS Oversight Board
Assessment of the IRS and
the Tax System**

Commissioner Charles O. Rossotti

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As the Board requested, and as my term of office draws to a close, I want to share with you my thoughts on the current state of the IRS, our tax administration system, as well as the opportunities and challenges that the agency and new commissioner will face.

The IRS is today capable of executing its mission with increasing effectiveness and efficiency. We made measurable progress on a number of high priority areas, such as e-filing, telephone and in-person taxpayer service, protection of taxpayer rights and burden reduction. We stabilized and refocused our key compliance activities to make the best use of our limited resources and are identifying and attacking systematic areas of non-compliance, such as the promotion and use of abusive tax devices. Financial management improved, as evidenced by unqualified audit opinions. Internal morale, which was heavily affected by criticism and internal and external change, turned around. Perhaps most importantly, we regained the confidence of the public and other stakeholders.

For the longer term, the IRS created a firm foundation upon which to make further progress. It includes: a modern organization structure with clear accountability for meeting the widely varying needs of specific taxpayer segments; information systems and support organizations capable of supporting operations efficiently while managing modernization; and a planning and management process for allocating resources, assigning goals to managers and measuring progress.

Our Business System Modernization Plan is beginning to deliver tangible benefits to taxpayers and practitioners. Equally important, we have a complete vision and architecture to guide the continuing modernization of every IRS business process and supporting technology.

The plans in place for FY 2003 and FY 2004 reflect aggressive but achievable productivity gains, exceeding those that were historically achieved in the private financial sector.

Taken together, these achievements demonstrate the progress we made over the past five years in the entire way we serve taxpayers, although finishing the job will still take the full decade I originally projected.

However, amidst what I believe is justified optimism for continued improvements in the performance of the IRS lies a critical problem. We are winning the battle, but losing the war. Over the last ten years, the size and complexity of the tax system increased enormously. Beyond the simple increase in number of taxpayers and revenue dollars, the majority of tax revenues now come from sources that are more subject to manipulation by those who wish to pay less than the law requires and much more difficult and time

consuming for our agents to uncover. Meanwhile, the size of the IRS declined, not just relatively but in absolute terms, because of budget constraints.

The cumulative effect of these conflicting trends over a 10-year period has been to create a huge gap between the number of taxpayers whom the IRS knows are not filing, not reporting or not paying what they owe, and our capacity to require them to comply.

Recognizing the IRS' diminished capacity, promoters and some tax professionals are selling a wide range of tax schemes and devices designed to improperly reduce taxes to taxpayers based on the simple premise they can get away with it. When this perception becomes increasingly widespread, the essential pillar of our tax system is lost – namely, the belief of honest taxpayers that if someone does not pay what he or she owes, then the IRS will do something about it.

If the trend of the last ten years is allowed to continue, it is only a matter of time until this problem will emerge into the forefront of public consciousness, likely leading to an eruption of criticism such as has occurred periodically in the last 50-year history of the IRS.

Fortunately, it is not too late to solve this problem, nor is it an open-ended problem. In fact, in the past year we succeeded in quantifying better than ever the resources we need. Modernization and internal productivity improvements will provide a major part of the needed gains. However, these alone will not be sufficient to close the gap, even if we assume greater productivity gains than the private sector was able to achieve over a decade.

To succeed, we need more trained personnel to close the known compliance gap while continuing to protect taxpayer rights and provide essential services. Specifically, we must add approximately 2 percent annual net increase in staffing over five years. Even with this increase, the size of the IRS by 2010 would be smaller than it was 20 years earlier in 1990 while the economy will have increased 86 percent.

Over the same period, we must also fund adequate increases for computer modernization programs to accelerate the delivery of key projects and benefits that will provide for greater service, efficiency and productivity.

Together with effective management of the IRS, this modest level of resources can reverse the dangerous trend the tax system is currently taking – but only if it is consistently provided. If, on the other hand, the trend of the past ten years is maintained, in which the demands on tax administration increase and the capacity of the IRS declines, the eventual cost for our nation is certain to be enormous.

Starting Point

Before I discuss the opportunities and challenges that lie ahead, it is helpful to place them in their proper historical context.

By the mid-1990s, the public, Congress and most key stakeholders had lost confidence in the IRS. According to the Roper Starch surveys, favorable public opinion of the IRS steadily declined since the early 1980s, reaching an all-time low of 32 percent in 1998. The results of the American Customer Satisfaction Index of key federal agencies were similarly alarming. The IRS measured the lowest of any agency or institution in both surveys.

Taxpayers were not alone in their negative perceptions. Congress and many of our stakeholders also lost confidence in the agency's ability to do its job at an acceptable level. In 1995, the Tax Systems Modernization program was terminated after several billion dollars were spent. Handling complaints about IRS treatment of constituents became a time-consuming duty in many congressional offices, and many stakeholders, especially those representing small business, had an adversarial relationship with the agency.

Poor quality service to taxpayers over the telephone or in person contributed to the public's low perceptions. At the nadir in the mid-1990s, the IRS registered 400 million busy signals a year on its toll-free lines, and when taxpayers did reach the IRS, the likelihood of getting an accurate answer or resolution to a problem was low.

A number of external factors also buffeted the IRS. Budget and staff cuts, rapid economic growth and the shift in the tax base from middle-income wage earners and domestic corporations to upper-income entrepreneurs, passthrough entities and global corporations, all contributed to a diminished capacity to cope with service and compliance demands.

The IRS responded to this pressure by emphasizing enforcement revenue and statistics as a way of justifying its budget. The IRS measured the success of its compliance activities by direct enforcement revenues. This is like a police department assessing its success by the number of traffic tickets written rather than by the safety and security of the community it serves. As we well know from the ensuing fallout, this grave mistake further alienated the public, yet failed to address the systematic, emerging compliance and budget problems.

While emphasizing enforcement statistics, the IRS was also slow to update its compliance practices, such as models used to select returns for audits and the management of the exam and collection processes. Until we changed it recently, \$100,000 was the highest income class used by the IRS in assigning exam cases, although people with incomes over \$100,000 pay more than 60 percent of the income tax.

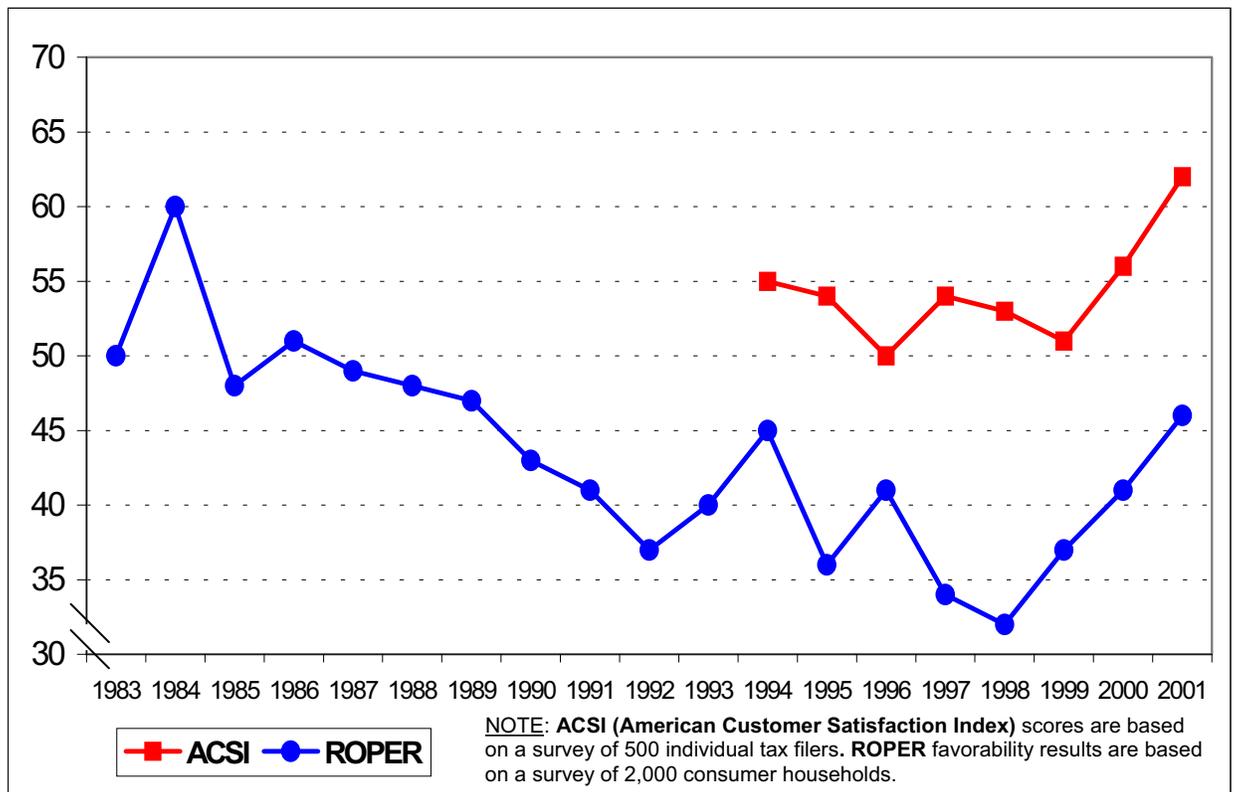
Moreover, although exam coverage was declining, many of these examinations concentrated on relatively straightforward issues of deductions or timing differences, such as the use of cash versus accrual accounting by small businesses. Very little emphasis was placed on partnerships and trusts, high-income individuals or offshore accounts, although vast sums of income flow through these entities. There was no specific program to identify and combat promoters of abusive tax devices. The IRS succeeded in winning some tax shelter court cases, but there was no overall strategy for dealing with corporate tax shelters.

Achieving a Turnaround

The IRS addressed, although certainly not completely solved, the major problems and internal constraints it faced five years ago. Some are resolved; clear plans are in place to correct the remaining ones over the next five years. This work provided the foundation for steady improvement in the effectiveness and efficiency with which the IRS carries out its mission.

Public confidence in the IRS rebounded. The Roper Starch surveys found our rating increased each of the past three years after 1998's historic low. The University of Michigan's American Customer Satisfaction Index survey released in December 2001 showed greatly improved customer satisfaction among individual taxpayers – the largest favorable gain of the 30 federal agencies surveyed.

Public Rating of the IRS



In May 2002, the Federal Performance Project, a collaboration of Government Executive Magazine and George Washington University's Department of Public Administration, released its scorecard on federal agencies. The IRS earned a "B-", as compared to a "C" three years ago. While the trend is good, much more remains to be done. The IRS can be and should be managed at the "A" level and is on its way to achieving this.

This turnaround in public confidence reflects the clear progress in five distinct areas: (1) customer service, (2) stakeholder relations, (3) compliance, (4) internal management, and (5) technology and modernization.

Customer Service

The customer service improvements were the most visible to individual taxpayers. The upward trend in telephone service was particularly important given how far we had to climb. By the end of the 2002 filing season, taxpayers were receiving correct responses to 83.6 percent of tax law questions and 89.9 of account questions. Access to service and time spent waiting, while still below private sector standards, improved substantially. Average wait time is down 26 percent from the previous year. Assistor access rose from 56 percent only two years ago to nearly 70 percent this year.

Last year, Web site usage smashed all records with 2.7 billion hits and 336 million files downloaded. We are well on our way to a new record this year. Also, in January 2002, we introduced a newly designed and more accessible Web site.

E-filing tripled over the past five years, and this filing season, was up 16 percent over the previous one. We are systematically removing the remaining barriers to e-filing. For example, this year, virtually all 1040 forms and schedules could be filed electronically, and no paper signature document was required. Improved electronic tax administration is also critical to better serving business taxpayers, especially given the number of forms and payments they must file and make. In September 2001, we launched Electronic Federal Tax Payment System On-Line that allows businesses large and small to save precious time by making their federal payments on-line.

We are also building a new e-file system that will grow and serve taxpayers for years to come. Scheduled to start in 2004, it will address the current system's problems. For example, it will accept complex business returns, such as 1120s, eliminate software barriers and resolve standardization issues, such as reject codes and validations.

Service in local taxpayer assistance centers, which was extremely poor in many places, improved in both quality and consistency. However, it will still take several more years to reach fully acceptable standards. Taxpayers can now schedule appointments in more than 400 locations for face-to-face meetings with IRS employees to resolve account or case problems. This helps make the well-received idea of "Problem Solving Days" a regular part of IRS everyday operations. While making these improvements, we are also requiring fewer personnel details from the compliance functions to filing season duty – an expensive and very unpopular practice.

Within the limits of a complex and changing Tax Code, the IRS acted to reduce taxpayer burden. For example, we simplified forms, such as the Schedule D for reporting capital gains. We also rewrote and simplified procedures, such as those for distributions from qualified retirement plans. We removed 2.6 million small business taxpayers from the

time-consuming reporting and record-keeping requirements of reconciling tax returns with balance sheets. We eliminated the need for most small businesses to use the more burdensome accrual method of accounting for tax purposes. We implemented a new and much more reliable way of measuring taxpayer burden. In the newly created Office of Taxpayer Burden Reduction, we also have an organization dedicated to continuously measuring and reducing burden.

The IRS implemented 71 taxpayer rights provisions of RRA 98, including such major provisions as collection due process, expanded innocent spouse relief, third party notification and expanded opportunities for offers in compromise. The Taxpayer Advocate Service was established as an effective independent entity within the IRS. It assists taxpayers with hardship cases and makes recommendations to improve the way IRS works for them. Because of these efforts, the number of taxpayers with serious unresolved cases, such as those that generate a need for intervention by a congressional office, declined. More generally, our improved service helped to reduce the numbers of cases needing TAS intervention. In 2002, case receipts fell from 194,790 to 169,390 compared with the same 9-month period in 2001.

Stakeholder Relations

In the past, relations with IRS stakeholders were often strained and adversarial. Through improved communications and frequent, substantive meetings, our relationship with Congress, oversight bodies and business groups – especially small businesses – greatly improved. Congressional hearings, once contentious, have been almost universally positive and constructive – although not without tough questioning. Much closer relationships were formed with organizations representing practitioners and small businesses. A consortium was forged with the software industry on the thorny issue of no-cost e-filing.

One of our basic strategies is to develop the kind of stakeholder relationships that can improve the efficiency and effectiveness of our services. Over the past few years, we developed a method of engaging stakeholders as part of our decision-making process. We call the new approach, “Engage and Then Decide” as contrasted with “Decide and Then Explain.” Seriously engaging key stakeholders as a regular part of the decision-making process has shown that it improves the final product, shortens the time for decisions and implementation, and strengthens relationships.

Although we successfully used this engagement approach, and have much experience with the hazards and costs of the opposite approach, IRS top management must continue to work hard to ensure that it is employed in all decision-making processes because it is so different from traditional practice in the federal government.

Compliance

As the Board is well aware, we do not have the resources to attack every case of non-compliance. Therefore, we must apply our resources to where non-compliance is greatest while still maintaining adequate coverage in other areas. We must also use carefully, but effectively, the enforcement tools available to us.

After careful study, we identified some of the most serious and current compliance problem areas. These include: (1) promoters of tax schemes of all varieties, (2) the misuse of devices such as trusts and offshore accounts to hide or improperly reduce income, (3) abusive corporate tax shelters, (4) underreporting of tax by higher-income individuals, and (5) accumulation and the failure to file and pay large amounts of employment taxes by some employers.

To address these problems, we revamped our compliance programs to refocus our resources and to use a full scope of tools and techniques. They range from educating the public, to systematically identifying promoters and participants, to reinvigorating enforcement actions such as summons enforcement, injunctions and criminal investigation of promoters.

If we can eliminate confusion and errors before a return or form is ever filed, America's taxpayers will be spared countless numbers of notices and communications with the IRS. If we can warn taxpayers not to participate in "too good to be true" tax schemes, we can save taxpayers from penalties and more. Moreover, the agency will be in a better position to use its limited compliance resources on the most serious cases of non-compliance.

To achieve these purposes, we created dedicated taxpayer education and pre-filing organizations in our operating divisions, e.g., TEC and SPEC in SB/SE and W&I respectively, and pre-filing technical staffs in LMSB and TEGE. We also created new pre-filing tools, such as pre-filing agreements and industry issue resolution published guidance. We greatly stepped up our output of traditional forms of published guidance, including revenue rulings and notices, by increasing their emphasis in Chief Counsel and forging an effective working relationship with Treasury's Office of Tax Policy.

For example, this past year, both the TEC and SPEC organizations worked to raise public awareness about the slavery reparation schemes. Materials were distributed nationally and locally to African-American churches and religious coalitions, fraternities, sororities and associations, including the NAACP and the Urban League. As a result, the average weekly number of incoming slavery reparation claims declined from 1,538 in CY 2001 to 63 this year.

Although these preventive measures hold great promise, we must still detect, correct and deter non-compliance. We must focus resources, improve efficiency and use our enforcement powers appropriately, all of which we are doing.

As identified through our research and strategic planning, both SB/SE and LMSB are directing their examination resources at the most important cases and issues. Exam and collection reengineering are focused on improving the efficiency with which these cases are carried out. For example, SB/SE is tackling business tax cases, such as unpaid, in-trust taxes, including employment and withholding taxes, much earlier than in the past.

Within two years, our new Filing and Payment compliance modernization program will begin to reduce from several years to six months or less the time required to resolve most collection cases.

Other initiatives, first outlined in our Strategic Plan, are taking effect. Earlier this year, we began matching information reported on Schedule K-1 with income or losses reported on Form 1040 and other schedules. We also reinvigorated the use of long dormant enforcement tools that are needed to deal with serious cases of non-compliance, and especially, promoted tax schemes. For example, we are aggressively identifying promoters and schemes through summonses of records, including John Doe summonses on credit card accounts in offshore tax havens and vendor summonses to refine that data.

Multiple approaches were taken to aggressively attack the use of abusive tax shelters. The LMSB organization initiated 43 contacts of promoters to uncover lists of taxpayers participating in their shelters. In addition, a tax shelter disclosure initiative was launched earlier this year. As of August 1, 2002, the IRS processed 1,664 disclosures from 1,206 taxpayers who came forward. These disclosures cover 2,264 tax returns and involved more than \$30 billion in claimed losses or deductions. Moreover, we announced a new policy in June 2002 to request tax accrual work papers when we audit returns that claim a tax benefit from certain tax avoidance transactions that we identified as abusive.

Civil and Criminal Lead Development Centers (LDC) were also established to identify cases of abusive tax promoters. For example, the Civil LDC works leads received from within the IRS, or from external sources, and conducts Internet searches looking for abusive tax promoters and promotional materials.

Also, the Webster Report gave a detailed blueprint for making Criminal Investigation a more effective component of tax administration. The need to refocus CI's resources on tax cases was the centerpiece of this report. CI's top priority is now investigating promoters and participants in illegal tax schemes. We also established a closer working relationship between field counsel and the operating divisions on compliance work.

This new emphasis on action against promoters has already shown results. The numbers of actions related to promoters went from "none" to a vigorous program. As of July 8, 2002, we had nine promoter injunctions granted, 11 promoter injunctions pending in District Court and three pending at the Department of Justice, 150 promoter exams and information requests underway, and 51 ongoing criminal investigations (*numbers are for FY 01 through 02*).

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

Obviously, our success in compliance also depends on a cadre of highly qualified trained individuals to perform tasks that require a high level of judgment. After a freeze of nearly six years, recruitment for professional occupations, such as revenue agent and revenue officer, restarted; training was completely revamped and improved; and employee engagement became part of balanced measures and everyday management.

Internal Management

The IRS successfully made the transition to a modern customer-focused organization in which a management team has clear responsibility for meeting the needs of a specific set of taxpayers. The service needs and compliance issues of the 90 million taxpayers with wage and investment income are vastly different from those of large and mid-sized businesses, which in turn are different from those of small businesses and tax-exempt organizations. One team now works full time to understand and meet the needs of each set of taxpayers and has nationwide authority to execute its plans, eliminating the historically deep and counterproductive organizational separation between the “field” and the “national office.”

Supporting these operating divisions are specialized functional units and shared services organizations to provide information technology and common support services throughout the organization.

As part of the reorganization, the number of management layers was reduced and the role of executives and senior managers is being redirected towards substantive engagement in tax administration, rather than predominantly administrative duties. A new model of executive recruitment was successfully established, which includes a recruitment of a limited number of highly experienced top executives from private industry and other government agencies to complement our internally-developed executives.

Many specialized programs, ranging from processing business returns to handling innocent spouse claims to answering tax law calls, are being consolidated into fewer locations with fewer management layers. This enables greater standardization and faster implementation of improvements.

An entirely new system of balanced measures has been designed and implemented, aligning goals throughout the organization down to the territory and site level.

The gains in service and the widespread redirection of compliance programs over the last two years reflect the benefits of a more customer-focused and accountable organization. The major benefits are still to come, in the form of continuous improvements in productivity and quality in every major program.

The improvements in customer service and other programs can also be linked to increased employee engagement in our mission and goals, increased and improved training and heightened focus on employee concerns. Among the most important of these concerns was the fair and careful administration of Section 1203 – the so called ten deadly sins – so that no employee was wrongly disciplined under this section. In addition, legislative proposals were formulated and are under consideration by Congress to alleviate employee anxiety over Section 1203.

Because of these actions and focus, and according to a recent Gallup survey of IRS employees, the level of engagement within the Service increased from 49th to the 56th percentile of all public sector organizations tracked by the organization.

The IRS is also the steward of massive taxpayer revenue and budget and financial resources, and we are expected to properly account for the government's money and property. To this end, internal accounting standards were raised to a higher level. For the past two fiscal years, we received unqualified GAO opinions on our financial statements for both the Revenue and Administrative accounts. This year, we have plans in place to close the books months earlier than in prior years and to address remaining material weaknesses over the next two years.

As our FY 2003 and 2004 budget requests demonstrate, strategic planning, budgeting, resource allocation and performance goals were aligned. For the first time, we fully integrated development of our budget with the establishment of performance measures.

Technology and Modernization

Critical to our success was better managing our massive technology and Business Systems Modernization program. From 15 separate information systems operations, we created one MITS organization that has the job of serving all of our operating units and managing our modernization program.

As part of this major transition, standards were established and largely implemented for hardware and software. We consolidated mainframes from 12 centers to three and established one standard for desktop and laptop hardware and software. We implemented a nationwide e-mail and voice messaging systems, standard office automation software, and security certifications and standards. We deployed important interim applications systems, including Intelligent Call Routing, Integrated Case Processing and the Integrated Collection System.

Business Systems Modernization laid the foundation for success of this massive program. Both the long-term vision and enterprise architecture were established and embedded as a living blueprint for all business and technology improvement programs.

BSM began delivering projects with tangible and meaningful benefits to taxpayers, such as moving the first set of taxpayers to a modern, reliable database early next year. Over the next five years, all individual taxpayers will be moved to it, cutting times for refunds on e-filed returns to less than a week and allowing us to provide taxpayer and employees with up-to-the-minute accuracy on their accounts. Of paramount importance, we implemented the first project on our new security system, which provides one standard for ensuring the security of all future IRS data and systems.

All major management processes, which are needed to manage this program on a continuing basis, were improved. Our goal is to obtain certification in the near future as only the second agency in the federal government to reach Level Two in the Software Engineering Institutions Capability Maturity Model.

Steady Progress Can Continue Year after Year

The aforementioned progress and achievements do not mean that the IRS solved all of its problems, or that there are no more opportunities to improve. Rather, it means that the IRS addressed the major impediments and obstacles that previously stood in the way of progress and has a clear committed plan to continually reach even higher levels of performance. There should be no doubt that the IRS can be raised to a level of quality and efficiency comparable to the best managed financial services organizations.

Winning the Battle but Losing the War

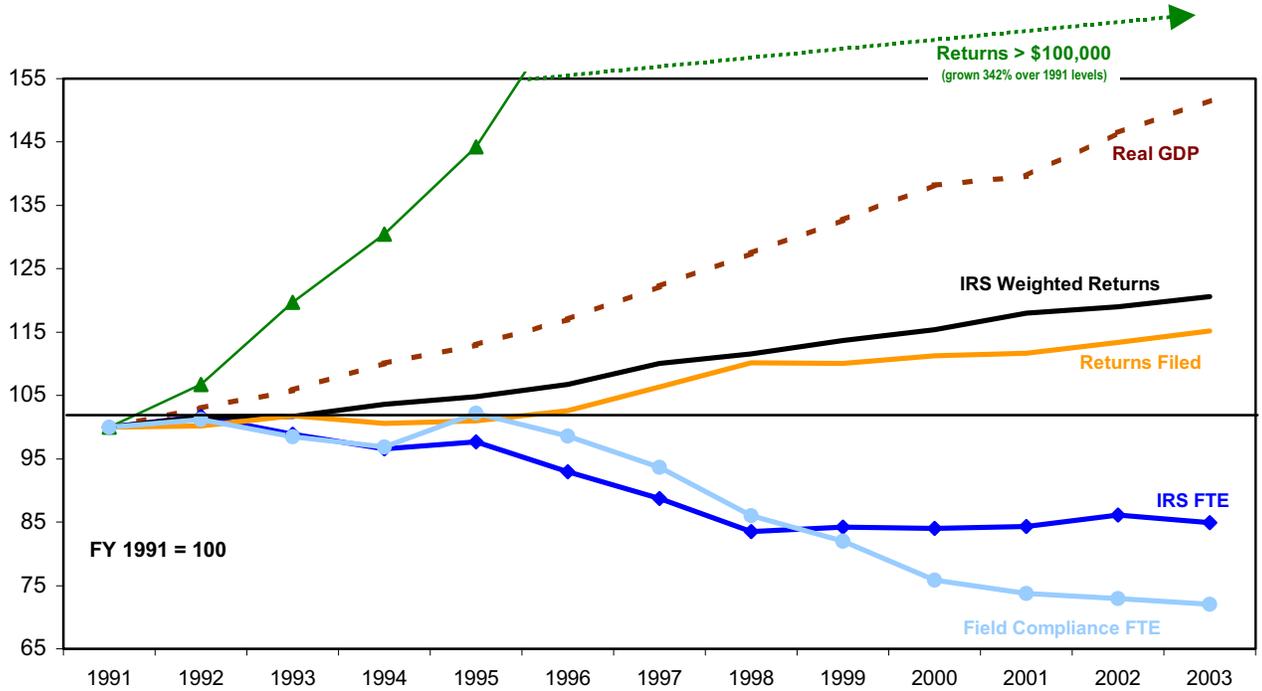
Despite significant improvements in the management of the IRS, the health of the federal tax administration system is on a serious long-term downtrend. This is systematically undermining one of the most important foundations of the American economy.

The source of this problem is two conflicting long-term trends: one, ever increasing demands on the tax administration system due to rapid growth in the size and complexity of the economy; and two, a steady decline in IRS resources due to budget constraints. The cumulative effect of these conflicting trends over a 10-year period has been to create a huge gap between the number of taxpayers who are not filing, not reporting or not paying what they owe, and the IRS' capacity to require them to comply.

As seen in the next chart, "Trends in Indicators of IRS Workload and Resources," from 1992 to 2001, *weighted average returns filed*, a measure of overall IRS workload, increased by 16 percent because of the economy's growth. However, during this same period, FTEs 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.

Trends in Indicators of IRS Workload and Resources



1991 to 2001 GDP data from the Bureau of Economic Analysis. 2002 & 2003 projections from OMB. 1991 to 2001 IRS FTE from the Budget of the United States Government, OMB. FY 2002 from AFS Month 04 Current Financial Plan. FY 2003 reflects IRS current financial plan. IRS FTE excludes FTE associated with the EITC program. Field Compliance FTE from IRS Databook, Pub 55B.

In assessing these trends, it is extremely important to recognize a critical fact: tax administration workload increases every year because of increased filings by taxpayers related to the long-term growth of the economy. These workload increases affect every facet of tax administration, from processing returns to answering correspondence to collecting delinquent returns to accounting for payments and refunds. In addition to this growth related to the economy, tax legislation often adds additional workload.

Looking more closely at the most recent five years (see chart), 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.¹

¹ By comparison, during the decade of the 1990s, the overall economy increased productivity at a rate of about 2 percent per year. The private financial services industry, in its best decade ever, increased productivity at about 2.3 percent per year.

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

Volume of Activity Has Been Growing Rapidly

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

Tax Code Has Been Changing Rapidly

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

Restructuring and Reform Act Added Many Taxpayer Rights

- 71 taxpayer rights
- 1,900 implementing actions
- Hundreds of thousands of new transactions per year
 - Innocent spouse
 - Collection due process
 - Offers in compromise
 - Third party notification
 - Section 1203 allegations

Special Events Created Additional Activity and Change

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

Globalization Is Increasing International Tax Activity

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

Resources Have Been Shrinking

- IRS full-time equivalent personnel  -2,952

This is no different from a car company producing 1.8 percent more cars or a hospital servicing 1.8 percent more patients. But, rather than increasing staff, IRS staff decreased during this period, creating a major gap in IRS capacity to administer the tax system.

In addition to growth in raw numbers, the tax revenue stream is now dominated by sources that provide greater opportunities for manipulation by those who wish to take advantage of the decline in IRS compliance resources. For example, returns for taxpayers with incomes exceeding \$100,000 grew by 342 percent over 1991 levels. The enormous amounts of money that flow through “passthrough” entities – such as partnerships, trusts and S-corporations – also adds to the complexity of tax administration and increases the opportunities for underreporting of income. In Tax Year 2000, these “passthrough” entities filed 4.78 million returns with gross revenue of \$6 trillion and income to partners/shareholders of more than \$660 billion.

The IRS Restructuring and Reform Act of 1998 added major new or expanded taxpayer rights programs, such as innocent spouse relief, third party notification and collection due process. The rights are very important to taxpayers but created very substantial additional resource demands on the IRS to process hundreds of thousands of new transactions and additional steps in existing audits and collection actions.

Business globalization creates another administration complexity and more opportunities for reducing U.S.-reported income. From 1997-2002, U.S.-controlled foreign corporations and foreign-controlled corporations grew respectively by 25 and 31 percent.

Looking at this imbalance, one fact emerges. The IRS is simply out-numbered when it comes to dealing with the compliance risks. As noted, IRS employment (FTEs), and in particular, Field Compliance FTE steadily declined. With the decline in personnel came a decline in the coverage of all types of returns (see chart). Even after we refocus on the most egregious non-compliance cases, we can only handle a small fraction of them.

Coverage of All Types Plummeted 60 – 70%

Number of Cases Per Thousand Returns				
Fiscal Year	Document Matching	Correspondence Exam (Non-EITC)	In Person Exam Of Individuals	Exam of Passthrough Entities*
1992	33.1	4.0	5.8	5.1
1993	23.7	2.6	6.3	5.5
1994	23.3	2.0	6.8	5.0
1995	23.6	3.5	6.0	4.6
1996	16.6	2.6	5.6	4.7
1997	7.9	3.5	5.8	5.5
1998	14.3	2.8	4.7	5.7
1999	14.4	1.1	3.1	4.5
2000	10.8	0.9	2.0	3.6
2001	9.1	1.2	1.5	2.9

*Primarily Partnerships, S-Corporations and Fiduciaries

The effect of these trends was to create a gap in what work the IRS should be doing and what it had the capacity to do. In the last two years, the IRS made progress in quantifying this gap, which is summarized below. As noted, the majority of the workload gap is in compliance.

**Selected Tax Administration Programs
Work Done and Not Done**
(\$ in millions)

	Known Workload in Contacts or Cases/Yr				Direct Revenue Loss Per Year	Direct Cost to Fill Gap	
	Required	Done	Gap	%Gap		FTEs	Dollars
Service To Compliant Taxpayers							
▶ Phone Service Level of Service	87.5%	71.5%	16.0%	18%	NA	2,274	\$114.8
▶ In-Person Service	NA	NA	NA	NA	NA	3,084	196.7
Total	NA	NA	NA	NA	NA	5,358	\$311.5
Collection of Known Tax Debts							
▶ Field and Phone Accounts Receivable (TDA)	4,506,060	1,816,713	2,689,347	60%	\$9,470	5,450	\$296.4
Identification and Collection of Taxes from Non-Filers							
▶ Non-Filer Cases (TDI)	2,490,749	625,025	1,865,724	75%	\$1,693	2,016	\$101.5
Collection of Underreported Tax							
▶ Document Matching	13,300,000	2,926,980	10,373,020	78%	\$6,960	4,740	\$229.2
Identification and Collection of Underreported Tax							
▶ Cases of Abusive Devices to Hide Income	82,100	17,000	65,100	79%	\$447	3,418	\$272.1
▶ Individuals Over \$100,000 Income	123,006	54,468	68,538	56%	\$266	2,603	\$207.2
▶ Individuals Under \$100,000 Income	843,380	296,986	546,394	65%	\$4,492	7,435	\$430.1
▶ Small Corporations	39,659	29,721	9,938	25%	\$54	640	\$50.9
▶ Mid and Large Corporations	24,523	17,684	6,839	28%	\$6,526	1,812	\$180.0
Total	1,112,668	415,859	696,809	63%	\$11,786	15,908	\$1,140.3
Tax Exempt							
▶ Reporting Compliance	20,690	6,780	13,910	67%	NA	1,192	\$101.6
Grand Total	NA	NA	NA	NA	\$29,909	34,664	\$2,180

For each category of compliance, the IRS computed the number of known cases of taxpayers who did not file or pay, or who substantially underreported their taxes. These numbers, therefore, represent not general estimates or assumptions, but specific taxpayer cases. Based on the information available to the IRS, they should and could be treated as cases of non-compliance through collection, audit or other actions.

However, as can be seen from the chart, only a fraction of each category of case, even the most serious, can be worked with available resources. The “gap” represents the number of cases that should be, but cannot be worked because of resource limitations. These cases represent tens of billions of dollars per year that could be, but are not collected. More importantly, they represent a failure of fairness to the millions of honest taxpayers whose commitment to paying their taxes is based on the assumption that the IRS will act if they or their neighbors do not pay their fair share.

Tax professionals, promoters, sophisticated taxpayers and even some ordinary taxpayers are becoming more aware of our deteriorating ability to deal with compliance. Increasingly, this issue is being reported by publications ranging from *The Wall Street Journal*, the *New York Times*, *Fortune* and *Forbes*, and even on national television.

Recognizing the IRS’ diminished capacity, promoters and some tax professionals are selling a wide range of schemes and devices to taxpayers based on the simple premise they can probably get away with it. When this perception becomes increasingly widespread, the essential pillar of the fairness of our tax system is lost.

Our John Doe summonses of records for credit cards issued by offshore banks in tax haven countries revealed one facet of the problem. Just one of these summons, issued in 2000 to MasterCard, yielded a large database of transactions by those using cards issued by banks in Antigua, Barbuda, the Bahamas and the Cayman Islands. Many of these taxpayers were solicited through various channels by a variety of promoters.

Indeed, some sophisticated tax professionals, including those in accounting and law firms and investment banks, are aggressively marketing tax shelters to their clients. Some of these turn out to be abusive tax avoidance transactions prohibited by the Treasury Department.

Demand is also driving up supply. There is widespread anecdotal evidence from honest practitioners about clients demanding that their return preparer find a way to reduce reported income, to the point of refusing advice from honest professionals to comply with required reporting and disclosure. In effect, they are saying, “Get me one of these deals or I will take my business elsewhere.” This has reached the point where recently a former IRS Commissioner was faxed a solicitation from a "Senior Investment Manager" that began, "As we approach December 31st, you may have a large income tax liability for the year 2002. The amount you pay could be up to you."

Although it is impossible to prove conclusively that attitudes towards tax compliance shifted, we must make informed judgments about behavior and trends. The only responsible conclusion I can draw is that the trend in attitudes of taxpayers and tax professionals poses a real threat to the health of the tax system and ultimately to the American economy.

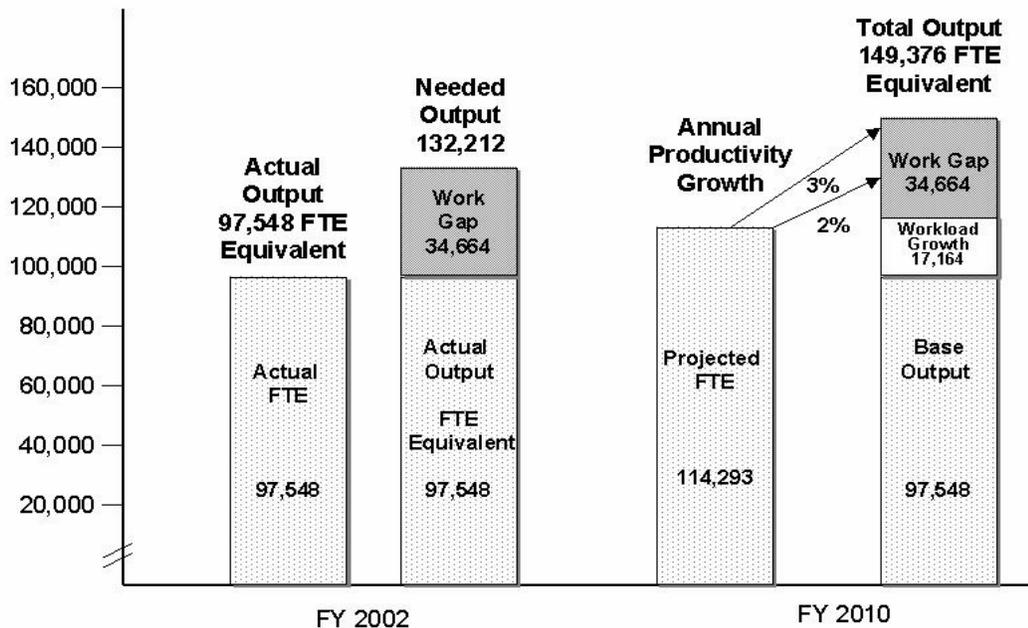
If these problems and conditions are left unaddressed, we could face an enormous crisis in confidence in the tax administration system. It would not be surprising if this problem emerged into the forefront of public concern, causing an eruption about the IRS similar to those that occurred periodically over the last 50 years. The long-term impact on the economy and our nation of not reversing this trend will be extremely high.

What Is Needed

What is the answer? Fortunately, the problem is not open-ended and can be solved with a reasonable amount of resources. We need what the National Commission on Restructuring the IRS argued for five years ago: a steady and consistent budget. It must consist of two items over the next five years. The first is a steady growth in staff in the range of 2 percent per year. The second is steadily increased funding for modernization until this program levels off several years from now.

Together with aggressive increases in productivity, as called for by the IRS Strategic Plan, this combination can solve the problem by the end of this decade. In fact, as shown in the "Closing the Gap" chart below, a combination of 2 percent per year staff growth with 3 percent per year productivity growth will keep up with increasing demand and close the gap by 2010. But without both elements – modest but steady staff growth and aggressive productivity increases – the trend will not be reversed.

IRS Capacity to Administer the Tax System: Closing the Gap



Assumption: 2% per year annual staff growth
 Productivity Scenarios: Annual productivity growth of 2-3% per year
 Benchmark: Private Financial Sector (1900's) growth 2.3% per year

Computer systems alone, even with the most aggressive reasonable assumptions about the productivity gains from modernization, cannot solve the problem. Trained and effective staff is also required. However, modernization will allow the IRS to perform the tax administration function with proportionately fewer staff than in the past. If the IRS staff grew by 2 percent per year through 2010, the total staff would still be smaller than it was 20 years earlier (1990), while the economy is projected to be 86 percent larger in real GDP and the tax system far more complex.

There is another critical point. Sufficient funding must be provided to fund the actual projected staffing. There is no “extra” funding lying around to “absorb” items that are mandated, but not paid for. As shown below, the IRS dollar budget consistently under-funded advertised staffing levels. The actual number of FTEs is lower every year than proposed in the budget. This is the effect of making unrealistically optimistic assumptions about such items as pay raises, inflation and other mandates, including specific mailing and notification requirements.

**IRS Dollar Budget Has Consistently Under-funded Advertised Staffing Level
(Full Time Equivalent [FTE] Personnel without EITC)**

	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004
FY 2000 President's Budget	96,767				
FY 2001 President's Budget	95,523	98,051	99,873*		
FY 2002 President's Budget	95,155	97,273	99,116		
FY 2003 President's Budget		95,511	97,548	98,727	
FY 2004 Treasury Submission			97,423	96,182	98,182

* Includes 1,822 FTE for STABLE Annualization

Our plan already requires very rapid and sustained productivity growth of over 3 percent per year – in excess of the 2 to 2.4 percent achieved in the private sector. It supposes complete success of BSM, aggressive reallocation of internal resources, such as eliminating some submissions processing centers, rapid growth of e-filing, and use of productivity enhancing techniques, such as competitive sourcing for some activities. These items make it possible to cope with growth in filings and filling the gap in required workload with very limited staff growth, but do not make it possible in addition to “absorb” unfunded but required line items.

Simplifying the Tax Code

Most informed observers are justifiably horrified at the complexity of the Tax Code. The cost of taxpayer compliance with this code is over \$80 billion per year, more than eight times the cost of the IRS budget. The sheer size and complexity in itself can be a source of disrespect for the law. Therefore, it is a worthy, though difficult and uncertain, challenge to pursue simplification to the maximum extent possible.

However, there is no proposal that has been seriously advanced for simplification that would have any significant effect in the foreseeable future on the problem of IRS resources.

Apart from the fact that even simplifying changes take time and effort to develop, pass in Congress and to implement, the reality is that the gap in IRS resources is so large that nearly all of our resources are required to perform the basic operations of the tax system and to pursue the clearest and most important cases of non-compliance.

With the exception of some resources in the large corporate sector, the IRS redirected nearly all compliance resources away from less significant technical tax issues to cope with current operational requirements and the most serious cases of non-filing, non-payment or underreporting of income. Even then, resources are far below what is required.

The only reasonable course is to pursue parallel paths: to address the practical problem the tax administration system faces by gradually closing the gap in the capacity of the IRS to perform its essential tasks, while pursuing a parallel path attempting tax simplification.

Conclusion

Five years ago, the IRS embarked on a new direction. Following it, we achieved much progress for America's taxpayers, although we have much more left to do to improve the entire way the IRS works. Today, we are faced with a growing crisis – in our ability to do our job and the fairness of our tax system. We cannot turn our back on this crisis or believe that it will go away, because it will not. But like five years ago, I believe the problem is solvable. We know the right course of action and we should have the courage and resolve to take it.