WRITTEN STATEMENT OF
THE IRS OVERSIGHT BOARD
SUBMITTED TO
THE SENATE APPROPRIATIONS COMMITTEE
SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT
HEARING ON
IRS FY2015 BUDGET REQUEST
APRIL 30, 2014

INTRODUCTION & EXECUTIVE SUMMARY

Chairman Udall and Ranking Member Johanns, the IRS Oversight Board thanks the Subcommittee for this opportunity to present its views and recommendations on the President's FY2015 budget request for the Internal Revenue Service.

However, before we discuss specific accounts, programs and initiatives, the Board would like to make some broad observations regarding the context in which the current budget debate is taking place and the possible ramifications for the IRS, taxpayers and our nation.

Last summer's controversy regarding the IRS' use of inappropriate criteria to review certain organizations applying for tax exempt status and the agency paying for lavish conferences and questionable training videos with taxpayer dollars still cast a long shadow over the IRS' budget.

The IRS was one of only a few government agencies that did not have its funding restored to pre-sequestration levels under the *Consolidated Appropriations Act of 2014*. In fact, the IRS' FY2013 post-sequestration funding level was the lowest since FY2009. For FY2014, the IRS received approximately $11.3 billion – approximately $1.6 billion less than the President's budget request and $1.8 billion less than the Board's recommendation. The Board believes that this budgetary path is unsustainable.

The Oversight Board hoped that the management controls and risk management tools that then Acting Commissioner Werfel put in place last year would dispel any lingering concerns about the IRS' ability to wisely manage taxpayer-provided resources and prevent improper behavior. And often lost in the discussion is the fact that the IRS accepted and implemented every recommendation contained in the Treasury Inspector General for Tax Administration's reports on the aforementioned incidents and then took additional steps to institute even more safeguards than proposed by TIGTA.

However, in spite of these corrective actions, there are still those who want to punish the IRS and believe the best way to do so is to slash its budget. Last year, the House Appropriations Subcommittee on Financial Services and General Government voted on party lines for a drastic 24 percent cut in the IRS' budget. Although largely symbolic, it was indicative of a sentiment that has carried over into 2014 and the FY2015 budget cycle.

The Board believes that we need to have a rational and bipartisan dialogue about the IRS' budget and the effects – good or bad – appropriated funding levels could have on customer service, enforcement, Business Systems Modernization and human capital. In spite of the often heated rhetoric, we should not shy away from the simple fact that there is a choice about the IRS' and tax administration's future.

The Oversight Board has long contended that continuing to punish the IRS by cutting its budget only punishes honest taxpayers who play by the rules and expect their neighbors and business competitors to do the same.

These taxpayers – and their return preparers – expect the IRS to answer their questions about an ever-changing and complex tax code and resolve their individual tax issues; process their returns efficiently; and promptly issue a refund if they are legally due one.

They also expect the IRS to vigorously and fairly enforce the tax laws – whether it's a tax cheat claiming illegal deductions or refunds, an identity thief engaged in refund fraud, or wealthy taxpayers not disclosing money and assets hidden in bank secrecy jurisdictions.

Taxpayers also expect a variety of customer service channels and web-based tools tailored to their needs. And increasingly, they want to be able to communicate and conduct transactions with the IRS electronically – much as they already do with other large financial institutions and commercial enterprises.

This begs the question, "How can the IRS meet these basic taxpayer expectations without adequate funding?" The inescapable conclusion is, "The IRS can't."

We are already witnessing an alarming erosion in both customer service and enforcement that shows no signs of abating. Although the 2014 filing season proceeded smoothly, projections show that telephone level of service on the IRS toll-free lines will fall to 60.5 percent by the end of 2014 – exactly the same level as last year. In other words, four out of ten taxpayers will have been unable to reach an IRS assistor. Average telephone wait times are expected to rise by 150 percent; from 10 minutes in 2010 to 25 minutes today.

IRS customer service problems are not limited to phone service. Long lines greeted taxpayers at IRS walk-in centers this filing season. Commissioner Koskinen testified before the House Appropriations Subcommittee on Financial Services and General Government that people were lining up outside these Taxpayer Assistance Centers (TACs) before they opened in the morning to make sure they got service the same day, and once inside, may have had to wait 90 minutes or more for help from an IRS representative.

Tax compliance is also suffering due to the budget cuts and sequestration. The individual audit coverage has now dropped to below 0.9 percent – an historic low. Business return audits have plummeted by 13 percent. Audit revenues are at their lowest point in a decade. Core enforcement activities, such as liens, levies and seizures are also on the decline. Additionally, although progress has been made, tax-related identity theft and tax refund fraud are still major challenges for the IRS.

The effects of budget cuts go beyond the IRS workforce – the agency's biggest expense. After a major success with the successful launch of the initial phase of the Customer Account Data Engine (CADE) 2, the IRS' Information Technology (IT) Program is threatened yet again with insufficient funding to address pressing infrastructure needs.

Meanwhile, the IRS is legally bound to implement the tax-related portions of two major pieces of legislation – the *Foreign Account Tax Compliance Act* (FATCA) and the *Affordable Care Act* (ACA). Due to budget cuts, these duties have become unfunded mandates. Commissioner Koskinen has warned that to meet these statutory responsibilities with a flat or reduced budget, he will have no choice but to pull people from both IRS customer service and enforcement functions with serious repercussions in both areas. Congress must realize that robbing Peter to pay Paul is not a viable solution to the IRS' budget problems.

Again, the Board believes that we have a choice: stay mired in the past or make the FY2015 budget debate about the future of the IRS, taxpayers and the integrity of our tax administration system. In this regard, we believe that it is time to invest in the IRS and our country's future. With taxpayer service suffering and appropriate risk management tools in place, it makes little sense to underfund the IRS. This is the time to restore funding so the IRS can improve service, increase enforcement, and continue to modernize its systems and processes.

To this end, in July 2013, the IRS Oversight Board recommended to the Secretary of the Treasury a FY2015 budget request of $13.590 billion for the IRS. The *IRS Restructuring and Reform Act of 1998* (RRA 98) requires the Board to make such an annual budget submission. Although $1.14 billion higher than the President's budget request of $12.477 billion due to different baselines as starting points, the Board strongly advocates for the Administration's IRS FY2015 budget request.

The Board believes that the President's recommended funding is appropriate for the IRS to carry out both its dual mission and new statutory responsibilities. It makes targeted and wise investments in many of the same areas suggested by the Oversight Board, such as improving telephone level of service and improving audit coverage.

Finally, the Oversight Board notes that enforcement initiatives are paid through a $475 million Program Integrity Cap Adjustment due to the more than $4–to-$1 return on investment when enforcement initiatives, such as new hires of revenue officers, are fully realized.

The Board is concerned over the recent track record of such adjustments. Although some discretionary cap adjustments were approved during then IRS Commissioner Everson's tenure, none have been passed over the past four years. The situation is further complicated by the Murray-Ryan *Bipartisan Budget Act*; it is unlikely to be amended to allow for the proposed adjustment. However, this funding mechanism should diminish from the importance and necessity of the President's request.

THE PRESIDENT'S BUDGET REQUEST

Upon taking office, Commissioner Koskinen said that adequate funding for the IRS was probably the most "intractable" and "difficult" issue he would face during his tenure. That is no overstatement, in the Board's view. The IRS is now operating with a budget at close to pre-sequestration levels; the lowest since FY2009. As the agency notes, its budget has been cut by seven percent since 2010 while the total number of individual and business tax filer has grown by four percent over the same time span.

The IRS has done its able best to deal with the underfunding by wringing out as many efficiencies and cost savings as possible. These include employee buy-outs, an exception-only hiring freeze, consolidation of office space, all but case-related travel bans, and steep cuts in training. But this budget strategy is not sustainable. The IRS is now left with no other choice but to make cuts to core programs.

The President's budget seeks to reverse this trend by restoring some of the funding lost over the past three years and putting the IRS back on a path of sustained and reliable funding. This is a reasonable and honest budget with a suite of smart, forward-thinking initiatives that address head on areas of concern that the Board has pointed out in customer service, enforcement and IT and human capital. The budget request also supports and is aligned with the IRS Strategic Plan and Treasury Department Priority Goals.

Customer Service

Customer service is both a great opportunity and challenge for the IRS. Helping taxpayers navigate an increasingly complex and changing tax code and answer tax law and account questions is a major component of the IRS' balanced mission. And taxpayers use and value this service.

The Oversight Board's 2013 Annual *Taxpayer Attitude Survey* showed that 84 percent of respondents said that they are likely to call the IRS toll-free telephone line for assistance; 83 percent said that they are likely to visit IRS.gov for help; and 74 percent said that they are likely to visit an IRS walk-in site (TAC) for help. Moreover, 89 percent of respondents said that the tax advice and information provided by an IRS representative was "very or somewhat valuable." This is equal to paid tax professionals. Such an accolade is a great tribute to the dedication, determination and professionalism of the IRS workforce.

In addition to providing traditional customer service channels, the IRS is trying to migrate taxpayers to web-based, self-serve tools, such as "Where's My Refund?" And in recognition of a diverse and evolving taxpayer base that may not be getting its tax information from traditional media sources, the IRS has been employing social media, such as YouTube and Twitter to push out important service and compliance messages. The IRS also offers a smartphone app, IRS2Go where users can receive tax news updates and check the status of their refunds.

Although it is difficult to assign a dollar value for customer service return-on-investment, we do know that if taxpayers get their returns right from the start, both the IRS and taxpayers can avoid costly back-end audits. For example, eligibility for tax credits can be extremely confusing and frustrating for taxpayers. However, speaking to an IRS representative before claiming a credit could prevent an audit for the taxpayer and potentially costly back taxes, interest and penalties down the road.

However, the funding level for IRS taxpayer assistance, education and outreach decreased by nearly 34 percent from FY2012 to FY2013. Commissioner Koskinen testified that the IRS had 11,000 fewer employees working during the 2014 filing season than it had in 2010, while at the same time processing a record number of returns.

The results were obvious in unacceptable telephone level of service (LOS), long lines and waits at IRS walk-in centers. The projected 60.5 telephone LOS falls far short of the 80 percent that the Board believes is the minimum toll-free LOS that taxpayers deserve to help them meet their tax responsibilities.

The IRS is also facing increased backlogs in its written taxpayer correspondence inventory. This is particularly worrisome since the IRS conducts about 75 percent of all examinations by mail, and sends out millions of additional notices each year to taxpayers.

The IRS faces other customer service challenges that may come as a surprise to many. For example, while the number of visits to IRS.gov continued to increase in FY2013 to more than 456 million web page visits, customer satisfaction with the website has actually declined.

According to the American Customer Satisfaction Index (ACSI), the score for IRS.gov has steadily ebbed, from 73 in 2011 to 69 in 2013. IRS.gov also received lower scores than those of other federal websites overall and those of Internet-based retail and brokerage companies; another downward trend suggesting the IRS is not keeping pace with online advances achieved by the federal government and the private sector.

The Board also heard from the Annual Taxpayer Attitude and its listening sessions at the IRS Nationwide Tax Forums that taxpayers, employees and practitioners are frustrated that they can't communicate and conduct more transactions electronically with the IRS.

Given these factors, the Board believes it is critical to fund the IRS so it can deliver a higher level of service to taxpayers who need its assistance in complying with a complex tax code. Underfunding this critical function endangers not only the IRS' mission, but could ultimately imperil voluntary compliance.

The Oversight Board believes that the President's Budget will help provide the resources to bring IRS customer service back to a level where it can meet taxpayer needs and expectations both today and in an ever changing and challenging tax environment.

The President's budget request would provide a total of $211 million for customer service, including resources from the new Opportunity, Growth and Security Initiative. This will allow the IRS not only to make up for the lost ground in customer service but will allow the IRS to answer an additional 12 million phone calls from taxpayers seeking answers to their tax law and account questions. This includes a projected high number of calls from taxpayers related to implementation of the *Affordable Care Act*. Overall telephone level of service could rise from today's unacceptable 60.5 percent to exceeding the aforementioned 80 percent goal set by the Board.

The request also includes investments in advanced technology and communications infrastructure at IRS' toll-free telephone centers. One welcomed initiative would give taxpayers the option to be called back rather than waiting on hold. Another dealing with high-speed internet connection would allow customer service representatives to call up immediately displays of taxpayer information, much as a bank or brokerage house could do.

Enforcement

To achieve its balanced mission and help ensure overall compliance across taxpayer groups and income brackets, the IRS must run a fair yet vigorous enforcement program. According to the Board's 2013 *Taxpayer Attitude Survey*, approximately 96 percent of respondents cite personal integrity as the main reason for honestly reporting and paying what they legally owe. However, 60 percent also cited the fear of an audit as a reason behind their compliance.

Our tax system is based on self-assessment, also known as voluntary compliance. It depends largely on honest taxpayers believing that their neighbors and business competitors are playing by the rules and not trying to game the system. The integrity of our tax administration system would be seriously threatened if compliant taxpayers thought tax cheats were getting away with their crimes.

That is why it is so important to maintain reasonable audit coverage for all taxpayer income classes and to create initiatives, such as the Offshore Voluntary Disclosure Program (OVDP), which act as strong deterrents against American taxpayers hiding money and assets in secret offshore bank accounts.

Moreover, although the overwhelming majority of gross revenue collected by the IRS comes in voluntarily – through withholding and estimated tax payments, for example – it is important that we do not discount the importance of enforcement revenue. It can help reduce budget deficits and narrow the tax gap.

Enforcement revenue totaled $53.3 billion in FY2013 and since its inception in 2009, OVDP has brought in $6.5 billion in back taxes, penalties and interest. It also bears noting that there is a high return of investment for enforcement activities. Every dollar invested in IRS enforcement returns four dollars and as much as six dollars and higher for some initiatives.

However, IRS enforcement has taken some heavy budget blows over the past three years. By the end of 2013, the number of revenue officers was the lowest in at least 10 years; the number of revenue agents was the lowest in nine years. Overall, there has been a 14 percent decline in key enforcement personnel since 2010.

While audits of individuals topped one million for the seventh year in a row, that figure can be misleading. As stated in the Executive Summary, the overall coverage rate fell below one percent for the first time since FY2006. And the audit coverage rate for taxpayers in the highest income bracket – $1 million and higher – showed a steady 13 percent decline since 2011. Tax refund fraud, particularly as it relates to identity theft remains a major challenge for the IRS and the honest taxpayers who have been victimized. In 2013, the IRS identified over 3.5 million identity theft "incidents" as compared 247,000 in 2011.

The President's FY2015 Budget request contains a suite of proposed enforcement initiatives that aggressively address many of these challenges. As noted, the $475 million request for these enforcement activities is paid through a program integrity cap. The initiatives are expected to generate almost $2.1 billion in additional annual enforcement revenue once the new hires reach fill potential in FY2017. Some of the more prominent programs include:

> **Address International and Offshore Compliance**: This initiative would help the IRS to ramp up its efforts to identity U.S. taxpayers not disclosing money and assets in bank secrecy jurisdictions. In addition to increasing criminal investigations of international and financial crimes, the additional funding will allow the IRS to expand data and information gathering that will help the agency root out the promoters of these abusive tax avoidance schemes.
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> **Expand Audit Coverage of Individuals**: Audit coverage for individuals now hovers below one percent for the first time since FY2006. The funding would help reverse the drain of key enforcement personnel, including revenue agents, and allow the IRS to perform an estimated 243,000 additional individual examination cases, including correspondence audits. It would also allow for greater document matching to uncover unreported or misreported income.
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> **Expand Audit Coverage of High-Wealth Taxpayers and Enterprises**: Many of these global high net-worth taxpayers are not your typical filers. Some use a web of highly sophisticated and complex financial and cross border tax arrangements. Many of these arrangements are perfectly legal; others hide abusive tax avoidance schemes. The IRS projects that the additional funding will allow it to close an additional 325 of these cases.

Prevent Tax-Related Identity Theft and Refund Fraud: The additional funding will help the IRS address the increased workload associated with ID theft and tax refund fraud and bring down the ID theft case backlog. The IRS will be able to better assist victims while protecting the revenue through investing in new technology that will help verify potentially fraudulent returns and reduce erroneous payments.

Improve Audit Coverage of Partnerships and Flow-Through Entities: According to the IRS, partnerships are the fastest growing segment of all tax returns filed. One of the reasons is that many taxpayers believe they can escape audits by choosing to operate as large, widely-held partnerships. A former IRS Small Business/Self Employed executive admitted last year that "we're a little bit behind the curve on getting around to developing the partnership strategy and being involved in the partnership strategy." The additional funding will allow the IRS to hire examiners with specialized knowledge in partnerships and close an additional 2,800 cases.

Enhance Collection Coverage: The President's budget would provide additional funding so the IRS can hire new staff, primarily revenue officers, to collect back taxes owed. With these resources, the IRS also wants to reach out taxpayers earlier in the collection process. The IRS projects that it will be able to close an additional 244,000 collection cases. The collection initiative will also provide additional funding to hire the staff to deal with the increasing number of cases involving unpaid employment taxes.

Enhance Return Preparer Compliance: The President's Budget contains a legislative proposal that would explicitly authorize the IRS to regulate all paid tax return preparers, thereby dealing with the legal objections that formed the basis of the *Loving v. IRS* decision. However, while awaiting congressional action on the proposal, the FY2015 budget request contains additional funding to bolster audits of return preparers and increase monitoring and pursuit of unscrupulous preparers engaged in fraudulent activities, including filing false EITC claims for their clients.

Human Capital and Business Systems Modernization/IT

Human Capital

The IRS confronts a number of serious human capital issues. Commissioner Koskinen has remarked on numerous occasions that he must not only rebuild public trust in the agency, but also employee morale which has suffered greatly over the past three years. The *Best Places to Work in Government* survey of federal employees reported an almost eight point drop for the IRS between 2012 and 2013 – from 66 to 54.3

The decline in morale is due to a number of factors, some of which are directly related to lean budgets and the sequestration, such as the furloughs, exception-only hiring freeze, increased workload, and drastic reductions in training. The Board thought the cuts to training budgets were extreme and unwarranted.

Last year's heated 501(c)(4) tax exempt controversy also took a heavy toll on employee morale. Although it actually involved very few employees, the entire workforce felt it was being blamed and under fire. Employees told the Board at its listening sessions at the Nationwide Tax Forums that they were subject to disparaging remarks by taxpayers, and in some instances, felt physically threatened.

The cuts in training were a major issue for IRS employees, practitioners, and ultimately taxpayers. According to the National Taxpayer Advocate's 2013 *Report to Congress*, the IRS training budget was cut by more than 85 percent from FY2009 to FY2013. In 2013, less than $250 was spent per-employee on training versus $1,450 in 2009. In some divisions, the training budget cuts were staggering. The Small Business/Self Employed operating division saw its training budget cut by 93 percent over the same time frame; Appeals was cut by 96 percent.

With travel-related training virtually non-existent, many employees are left with no other option than online training. Managers and employees told the Board at the Nationwide Tax Forums that this new approach to training is not working well for most people.

Many employees felt rushed to complete their online training in light of the increased and more complex workload. Some said that they had not received the training needed to do their jobs; others expressed concern about the quality of the training. They said that new hires especially need face-to-face training; classroom work is critical to their success as is mentoring.

Employees also said that they have limited opportunities to learn from one another and there is no peer networking. Without travel funding, teams of IRS employees working together across operating divisions may never meet each other and managers may not see their subordinates.

The Board is deeply concerned by the state of training at the IRS. The IRS simply cannot build a highly talented, knowledgeable and proficient workforce without quality training; nor can it achieve its strategic goals. Inadequate training means that employees cannot provide quality service and can in fact, create additional burden for both taxpayers and practitioners. The President's budget allows the IRS to invest once again in training. The agency must take full advantage of it.

BSM/IT

The IRS' Business Systems Modernization program was once a major area of concern and the Government Accountability Office (GAO) placed BSM on its "high-risk" list. However, almost two decades later, GAO removed BSM from the list, noting the progress made in addressing significant IT weaknesses.

The successful delivery of the initial phase of CADE2 and plans for the second phase to address financial material weaknesses involving unpaid tax assessments were cited as reasons behind GAO's actions.

Another major IT milestone occurred in 2014 when the Form 1040 Modernized e-file (MeF) system received and processed 100 percent of individual e-filed returns, enabling the IRS to retire the legacy e-file system.

However, in spite of these and other IT successes, Commissioner Koskinen warned in testimony before the House Appropriations Subcommittee on Financial Services and General Government that FY2014 funding is inadequate "to address critical technology infrastructure needs." These include improvements to IRS.gov, new tools to combat identity theft, and upgrades to IRS basic computer software.

The Board applauds the President's budget request for its solid commitment to build and deploy IT systems to improve efficiency and enhance productivity. For example, it would continue the expansion of CADE2 and complete the design, development and testing of Form 1040X (*Amended U.S. Individual Income Tax Return*) so it can be accepted and processed electronically.

In 2014, the IRS moved the Return Review Program (RRP) and Office of Online Services (OLS) under BSM. Aimed at detecting and preventing tax refund fraud, and using cutting edge technology and data analytics, RRP is one of most promising programs in the IRS' compliance toolbox. The President's Budget request would allow BSM to fully develop and deploy RRP and enable the retirement of the outmoded Electronic Fraud Detection System (EFDS).

The President's budget would also allow the development of OLS projects that will build on existing service capabilities to simplify the taxpayer's online experience, provide secure digital communications, and add more interactive capabilities to existing self-serve options.

CONCLUSION

The IRS Oversight Board believes that continuing to punish the IRS for past misdeeds and alleged misconduct only hurts taxpayers and the integrity of our tax administration. With significant risk management tools and safeguards now in place, it is time to move beyond controversy to collaboration and consensus. All interested parties must work together and take steps together to give the IRS the resources it needs to carry out at an acceptable level its balanced mission of customer service and enforcement. In this regard, the Oversight Board strongly supports the President's FY2015 budget request for the IRS. It is forward thinking and reverses years of shortsighted budget cuts to the IRS and puts it on a path of stable funding and continuous improvement. We thank the subcommittee for this opportunity to present our views and recommendations.