

**IRS OVERSIGHT BOARD
STATEMENT FOR THE RECORD
HEARING ON
INTERNAL REVENUE SERVICE FY2014 BUDGET REQUEST
SENATE APPROPRIATIONS
SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT
MAY 8, 2013**

INTRODUCTION AND EXECUTIVE SUMMARY

The IRS Oversight Board welcomes this opportunity to provide the subcommittee with its views and recommendations on the President's Fiscal Year (FY) 2014 Budget Request for the Internal Revenue Service (IRS) and the risks and challenges the agency is confronting in today's austere budget environment.

One of the Board's most important statutory responsibilities under 26 U.S.C. §7802(d) is to review and approve the annual IRS-prepared budget request submitted to the Department of the Treasury. The Board must ensure that the approved budget and related performance expectations: (1) support the IRS' mission and annual and long-range strategic plans; (2) are consistent with the IRS' goals, objectives and strategies; and (3) properly align with the IRS' strategies and plans.

In June 2012, the IRS Oversight Board recommended to the Department of the Treasury a FY2014 budget of \$13.074 billion for the IRS. This is \$213.6 million more than what the President put forth in his FY2014 budget request. After careful examination and deliberation of the President's Budget Request, the Board believes that the President's recommended level is appropriate for the IRS to carry out its statutory responsibilities.

The IRS' budget has been reduced since FY2010, with the biggest cuts occurring now in FY2013 due to the budget sequestration. Although the IRS has sought and implemented cost savings and efficiencies wherever it could, that path is, in the Board's opinion, no longer sustainable. Performance will ultimately suffer. We have already seen the erosion of toll-free telephone level of service and projected lower revenue collection. The effects of the cuts will be even more pronounced in 2014. For every dollar invested in IRS services, enforcement, operations support, and Business Systems Modernization, there is at least a \$4- to-\$1 return, which translates into more than \$4 in additional revenue for every dollar invested in the IRS.

The Board recommends that investments above the current FY2013 enacted level be made in IRS Taxpayer Services, Enforcement, and Operations Support. The Board's budget does exactly that and does not take funding from one category to bolster another. The Board believes that the IRS' budget must reflect the intent of the IRS Restructuring and Reform Act of 1998 (RRA 98) where both customer service and enforcement are funded at appropriate levels, and not to the detriment of either.

Although slightly lower than what the Board initially recommended, the President's budget request makes targeted investments in the same areas, such as strengthening telephone level of service. The President's budget also has a number of proposed revenue-generating enforcement initiatives that the Board supports which will increase both enforcement revenue and overall compliance. In addition, it provides funding so the IRS can effectively implement new responsibilities, such as the tax portions of the Affordable Care Act (ACA) and merchant credit card and stock basis reporting. Approximately one-half of the one billion dollar increase the President seeks for the IRS would be financed by a program integrity cap adjustment. Treasury Secretary Jacob Lew has made a compelling case for this suite of enforcement programs and their average \$6-to-\$1 return on investment when fully realized. The Board believes these initiatives could play an important role in closing the tax gap, while producing revenues to reduce the deficit and creating funding for other programs that are critical to our nation and America's taxpayers.

BUDGETARY CHALLENGES

The IRS confronts a number of formidable budgetary challenges. Funding uncertainty and budget cuts loom largest and present the highest risks to the IRS and our nation's tax administration system. The inability to pass federal budgets for the past several years has forced Congress and the Administration to increasingly rely on Continuing Resolutions (CR) to avoid a full or partial federal government shutdown, but often at a lower, or stagnant funding level.

Today, the IRS is operating under a CR, plus sequestration rules, that fund the agency at just under \$11.2 billion, well below both the President's and the Board's FY2013 recommendations. This level is also more than \$600 million less than the FY2011 level, and almost \$1 billion less than FY2010.

Together, these budget cuts have forced the IRS to find major cost efficiencies and implement significant spending cuts. This has led to dramatic curtailments in training, travel, office space and outside contracts. The IRS has also been forced to significantly reduce the size of its workforce. In FY2012, the agency offered buyouts to 7,000 of its employees, with more than 1,200 accepting. The IRS also instituted an "exception-only" hiring freeze early in FY 2011, leaving most positions lost to attrition unfilled.

All told, approximately 8,000 full time permanent IRS positions have been lost since 2010, with about 5,000 coming from front-line enforcement personnel. In 2012, the IRS workforce (as measured in average full-time equivalent, or FTE) stood at just under 90,300; its lowest level in more than a decade. That number could go even lower given the large pool of IRS employees now eligible to retire.

The immediate effects of absorbing these budget cuts have been most apparent in customer service, especially during the past two filing seasons when toll-free telephone Level of Service (LOS) hovered around 70 percent – far below the Board's and IRS' desired level of 80 percent. Many IRS Taxpayer Assistance Centers are also understaffed and offer reduced hours and limited tax preparation services.

However, stagnant funding provided through the CRs was only the beginning of the IRS' funding shortfalls. Today, the IRS' budget has been reduced by a total of \$618 million from the \$11.8 billion it

would have received under the FY2013 Continuing Resolution with \$594.5 million coming from the sequestration and \$24 million in rescission cuts.

The resulting \$11.198 billion budget is \$1.6 billion less than the President's FY2013 budget request. This also marks the third consecutive year that the IRS' annual appropriation has declined. Since FY2010, it has seen reductions to its appropriated funding totaling almost \$1 billion.

To meet the mandatory spending cuts for FY2013 under sequestration, the IRS plans to furlough all employees for five to seven specific days beginning in late May until the end of the fiscal year. All IRS operations will be closed on these uniform dates, including toll-free operations and Taxpayer Assistance Centers.

Although the furloughs will occur after the conclusion of the 2013 filing season, legitimate concerns have been expressed about the sequestration's potential effect on the IRS' long-term performance, especially if more budget cuts continue in the out-years. A continuing budget sequestration will reduce the enforcement revenue the IRS collects. The effects from the budget cuts will also become more apparent as time goes on, with more significant reductions in revenues and performance beginning to show in 2014.

The IRS has already had to adjust its FY2013 Operating Plan to reflect the sequestration's drain on funding. For example, to apply the employee furloughs evenly across the organization, the IRS proposed to transfer up to \$75 million from its Enforcement Appropriation to its Taxpayer Services and Operations Support Appropriations.

The Department of the Treasury asked the Board to review and comment on the IRS Operating Plan. We believe the plan will most likely result in significantly reduced performance results and the erosion of taxpayer service and compliance programs in FY2013 and future years. It should also be noted that a reduction of this size and scope will most likely impact voluntary compliance and IRS efforts to close the tax gap.

The Board is also concerned that these drastic budget cuts and subsequent staffing reductions come at a time that the IRS is faced with increased responsibilities and workload. For example, administering the tax portions of the ACA presents large challenges in both customer service and enforcement. In FY2014, the IRS must also implement the merchant card and stock basis matching initiatives and the Foreign Account Tax Compliance Act, all of which will require increased funding and staff. In addition, stolen identity refund fraud continues to be a major problem for tax administration.

Given all these factors, the Oversight Board believes that this is not the time to make shortsighted budget cuts that can erode the many important gains the IRS has achieved since the enactment of RRA 98, including better customer service, an overall increase in enforcement revenue, and success in modernizing major information systems. It is important to restore continuity and make the needed investments in three key areas: (1) Taxpayer Services; (2) Enforcement; and (3) Operations Support.

IRS OVERSIGHT BOARD BUDGET RECOMMENDATIONS

The President's FY2014 budget requests \$12.861 billion in direct appropriations for the Internal Revenue Service. This represents an 8.8 percent funding increase over the FY2012 enacted level. However, the budget request is \$213.6 million below the \$13.074 billion initially recommended by the Oversight Board for the IRS to meet its statutory responsibilities in FY2014. The \$213 million difference is related primarily to additional savings the IRS has identified in the President's Budget. It should be noted that the President's FY2014 budget request does not reflect the \$594 million (five percent) sequestration and \$24 million (0.2 percent) rescission cuts that the IRS had to make in FY2013. At present, the IRS does not know the impact of sequestration in FY2014.

Nonetheless, the Board believes that the President's FY2014 Budget Request is credible and reasonable. It is aligned with and supports IRS Strategic Plan goals and objectives and Treasury Department priority goals. Moreover, it makes up for much of the loss in resources and FTE over the past few years when the IRS was funded at FY2012 enacted levels.

The Board also strongly supports a permanent extension of the Streamlined Critical Pay Provision contained in RRA 98. The President's request supports extending this provision through September 30, 2018. The Board has found the provision to be a valuable and effective tool in bringing specialized expertise to IRS initiatives. It has proven to be successful in not only information technology, but also in sophisticated and complex areas of international taxation, such as transfer pricing. The Board recommends the provision's permanent extension.

The Board appreciates that the FY2014 budget request is but the beginning of a long process that can be affected by a number of other factors, including the larger continuing debate over deficit reduction. However, that should not prevent us from beginning a productive dialogue about how to fund the IRS so it may achieve its mission. Following are more detailed discussions on various budget items.

Investing in Customer Service

Providing taxpayers with quality customer service is an essential part of the IRS' balanced mission and delivers on its strategic goal: "Improve Service to Make Voluntary Compliance Easier." Taxpayers need assistance to navigate and understand a highly complex tax code and file a correct return. Getting it right the first time benefits both taxpayers and the IRS as it helps prevent inadvertent non-compliance and costly and burdensome post-filing actions, such as audits and penalties. In addition to raising its telephone LOS to acceptable levels, FY2014 also presents a major customer service, outreach and taxpayer education challenge for the IRS as major tax-related portions of the ACA take effect, including those related to health insurance exchanges.

The Board Recommends

The Board strongly supports the President's requests of \$2.4 billion for Taxpayer Services in FY2014. This request includes an additional \$177 million to improve taxpayer service and meet increased demand. The Board believes that this funding level is necessary for the IRS to reach the LOS goal of 79

percent stated in the budget request. Otherwise, providing an acceptable LOS will continue to be a challenge for the IRS; one that the Board hopes the Congress will help the IRS overcome for the sake of all taxpayers.

Investing In Enforcement

Enforcement is a top priority in the IRS Strategic Plan. In recent years, the IRS has made some significant achievements and advancements in enforcement, such as the successful Offshore Voluntary Disclosure Programs that not only collected \$5 billion in back taxes, penalties and interest but sent a strong deterrence message to those considering illegally hiding income and assets in overseas tax havens. And last year, the IRS managed to maintain and deliver most of its key enforcement priorities, such as audits in the upper-income brackets. However, the IRS still faces a number of enforcement challenges in FY2014. The IRS must ramp up its efforts to address offshore non-compliance and abusive tax avoidance schemes, and expand its audit coverage of high-wealth individuals and enterprises. And on a broad scale it must increase the overall audit and collection coverage for all taxpayers.

The Board and other observers from both the private and public sectors also question why the approximate \$4 to \$1 return on investment (ROI) for IRS enforcement activities is not recognized in the budgetary process. These investments pay for themselves many times over. They can deter noncompliance, provide greater revenues to fund essential government services, and help reduce the deficit and national debt.

The Board Recommends

The Board strongly supports the President's request for \$5.67 billion for Enforcement activities in FY2014. The President's budget request also includes a number of high ROI tax enforcement and compliance initiatives which would receive above-base funding by a program integrity cap adjustment through 2018, with additional cap adjustments to sustain these revenue-producing initiatives from FY2018 through FY2023. The \$407 million in IRS program integrity cap adjustment funding for FY2014 will generate more than \$1.6 billion in additional annual enforcement revenue, achieving a FY2016 ROI of \$6.0 to \$1.0. Absent a cap adjustment, these initiatives would go unfunded. The Board believes that the suite of enforcement initiatives funded in the President's budget request represent a strategic and sound approach to effective and fair tax administration. They will help bolster IRS compliance efforts and provide balanced audit coverage rates across taxpayers with expanded coverage of high-wealth individuals and enterprises and partnership entities. However, as earlier discussed, the Board is concerned that some of these high-ROI enforcement initiatives are proposed to be funded via a program integrity cap that has not been provided through the authorization process in recent years. We hope that this year is not a repeat of the past.

Investing in Operations Support

The successful launch of the Customer Account Data Engine (CADE) 2 was a major milestone in the IRS' technology modernization program. It will allow for the retirement of the antiquated legacy system and enabled the IRS to move from a weekly to a daily processing cycle for individual accounts and conveys

numerous benefits. In another development, Modernized e-File (MeF) now accepts both individual and corporate returns and processed over 115 million returns last year.

However, the Board wants to be sure that a sense of complacency does not set in and that funding for future releases of CADE and other IT programs is not reduced or delayed. Such a mindset could affect both customer service and enforcement initiatives, such as producing more web-based applications and driving forward the agency's innovative data analytics program that can expose not only noncompliance but criminal activity, including tax refund fraud.

The risk of complacency is not limited to technology.

The IRS' employees are its greatest asset but are placed at heightened risk during these uncertain budget times. An engaged workforce is essential if the IRS is to function at a high level and deliver on its mission and strategic goals. Last year, the IRS ranked third amongst the 15 largest federal agencies and departments on an employee engagement scale. However, the Board is concerned that ranking could slip, especially if further staffing reductions take place and the exception-only hiring freeze continues.

The Board Recommends

The Board strongly supports the President's request for \$4.48 billion in Operations Support and \$300.8 in Business Systems Modernization activities in FY2014.

The President's budget proposal would increase staffing to support a number of enforcement and customer service initiatives previously described. The Board believes that is a wise investment in human capital and could provide the IRS workforce with new career opportunities that have been unavailable for the past two years. However, the President's budget also assumes that the IRS will continue to seek efficiencies in personnel and non-labor costs, including training. And it is not clear whether the exception-only hiring freeze will continue in programs outside of those marked for increased staffing.

Moreover, while the Board believes that the IRS must continue to explore and use more cost-efficient means to deliver training, such as over the IRS intranet, it also wants to be sure that employees receive quality training that may require live interaction with trainers and peers. As previously noted, the Board also recommends a permanent extension of the Streamlined Critical Pay Provision contained in RRA 98.

CONCLUSION

The IRS Oversight Board thanks the subcommittee for this opportunity to present its views and recommendations on the IRS' FY2014 budget. With at least a \$4-to-\$1 ROI for the IRS, every dollar invested in the IRS results in more than \$4 in additional revenue. That revenue is needed to reduce our national deficit and fund other important programs for our country. Should the IRS receive the full amount requested in the President's Budget Request for FY2014, the agency would be positioned to resume its momentum in tackling some of our nation's most serious challenges in tax administration. However, should the IRS not be properly funded in FY2014, voluntary compliance will suffer, as will taxpayers who rely on the IRS to help them understand and meet their tax responsibilities.