

WRITTEN STATEMENT OF  
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BEFORE THE SENATE COMMITTEE ON APPROPRIATIONS  
SUBCOMMITTEE ON TRANSPORTATION, TREASURY, THE JUDICIARY,  
HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES  
HEARING ON THE  
INTERNAL REVENUE SERVICE'S FISCAL YEAR 2006 BUDGET REQUEST  
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**Introduction**

Chairman Bond, Ranking Member Murray, and Members of the subcommittee, I thank you for the opportunity to testify as you consider the fiscal year 2006 appropriations for the Internal Revenue Service. As the relatively new Treasury Inspector General for Tax Administration – having been on the job for 16 weeks – my observations are based on the body of work my organization has developed through audits and investigations of the IRS. I will focus on the major challenges facing the IRS to assist you in your consideration of the IRS' fiscal year 2006 budget.

Though I have been the Treasury Inspector General for Tax Administration (TIGTA) for only a few short months, my first experience conducting oversight of the Internal Revenue Service (IRS) dates back a number of years. In 1995, one of the initial charges I received as staff director of the House Subcommittee on Government Management, Information and Technology was to examine inefficiency at the IRS. Under then Chairman Stephen Horn's leadership, we reviewed several issues such as the IRS' tax systems modernization program, as well as ways to improve Federal debt collection practices. A decade later, I am disappointed to report that some of the same concerns Chairman Horn reviewed ten years ago continue at the IRS today.

While the IRS faces longstanding challenges, it deserves credit for making marked progress in an area that will always be a challenge: providing quality customer service to the American taxpayer. Commissioner Everson's guiding principle for the IRS is *Service + Enforcement = Compliance*. Over the past few years, TIGTA audits have shown the accuracy of information provided by the IRS to taxpayers with tax law questions has generally improved, the average time spent by taxpayers waiting for IRS assistance on the phone or in person has declined, and the general professionalism with which taxpayers were treated by the IRS has increased. Since most interactions between the IRS and taxpayers involve these types of customer services, it is encouraging to see that the IRS' focus on customer service has made headway.

## **Challenges Facing the IRS**

Despite such progress in customer service, improvements need to be made in this and other areas where significant challenges face the IRS in accomplishing its mission. The Treasury Inspector General for Tax Administration (TIGTA) has identified the following management and performance challenges that confront the IRS:

- Modernizing IRS Systems;
- Ensuring Tax Law Compliance;
- Reducing Tax Law Complexity;
- Preventing Erroneous and Improper Payments;
- Providing Quality Customer Service;
- Protecting Taxpayers and Taxpayer Rights;
- Securing IRS Employees, Facilities, and Information Systems;
- Integrating Performance and Financial Management;
- Managing Human Capital; and
- Processing Returns and Implementing Tax Law Changes During the Tax Filing Season.<sup>1</sup>

Each of these areas presents its own unique challenges, which will be addressed individually in the remaining portion of my testimony.

### **Modernizing IRS Systems**

Modernizing the IRS' computer systems has been a persistent challenge for many years, and will likely remain a challenge for the foreseeable future. As I noted above, back in 1995, under Chairman Stephen Horn's leadership, the House Subcommittee on Government Management, Information and Technology began reviewing what was then referred to as tax systems modernization.

The IRS initiated the tax systems modernization program in 1986. The purpose of the tax systems modernization program was to replace the antiquated computer systems that the IRS still relies on today to conduct tax administration. The tax systems modernization program intended to create a tax processing environment that was virtually paper-free, an environment where taxpayer information would be readily available to IRS employees to update taxpayer accounts and respond to taxpayer questions.<sup>2</sup> The program, however, was plagued by management and technical weaknesses.<sup>3</sup> After

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<sup>1</sup> The filing season refers to the period from January through mid-April when most individual income tax returns are filed.

<sup>2</sup> See General Accounting Office Report GAO/AIMD/GGD-98-54, *Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems* (Feb. 1998).

<sup>3</sup> See General Accounting Office Report GAO/T-GGD-97-79, *IRS Management: Improvement Needed in High-Risk Areas* (Apr. 14, 1997).

spending over \$3 billion on tax systems modernization,<sup>4</sup> the program was scrapped and a new effort was begun under a fresh moniker, Business Systems Modernization (BSM) program.

This latest effort to modernize the IRS' systems, the BSM program, began in fiscal year 1999. The purpose of the BSM program is to modernize the IRS' technology and related business processes. According to the IRS, this effort will involve integrating thousands of hardware and software components. Through March 2005, the IRS has received appropriations of approximately \$1.8 billion to support the BSM program, and the fiscal year 2006 budget requests an additional \$199 million. It is estimated that the BSM program will last up to 15 years and cost over \$8 billion.<sup>5</sup>

Succeeding in the modernization effort is critical – not only because of the amount of time and money at stake – but also to improve the level of service provided to taxpayers. To accomplish the modernization effort, the IRS hired the Computer Sciences Corporation (CSC) as the PRIME<sup>6</sup> to design, develop, and integrate the modernized computer systems.

The joint effort between the IRS and CSC has shown progress. In July 2004, the IRS released the first part of the Customer Account Data Engine (CADE) project. The CADE is the foundation for managing taxpayer accounts in the modernization plan. The CADE will replace the IRS' existing Master File.<sup>7</sup> Once fully operational, the capabilities of the CADE will far surpass those of the Master File.<sup>8</sup>

The first release of the CADE allowed the IRS to process some of the simplest tax returns, Form 1040EZ, using a new database of taxpayer accounts. The IRS has also deployed projects that provide value to taxpayers, such as “Where’s My Refund?,” the web-based application that allows taxpayers to check the status of their refunds. In addition, the IRS and its contractors have built the infrastructure needed to support these projects and have developed an enterprise architecture to guide the Business Systems Modernization (BSM) program.

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<sup>4</sup> See General Accounting Office Report T-GGD-97-52, *Modernization of Processes and Systems Necessary to Resolve Problems* (Mar. 4, 1997).

<sup>5</sup> *The Internal Revenue Service Has Appropriate Processes to Accept Modernization Software From Developers* (Reference Number 2005-20-028, February 2005).

<sup>6</sup> The PRIME stands for Prime Systems Integration Services Contractor.

<sup>7</sup> The Master File is the IRS database for storing taxpayer account information on individuals, businesses, employee retirement plans, and exempt organizations.

<sup>8</sup> The CADE will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer account and return data. In conjunction with other applications, the CADE will allow employees to post transactions and update taxpayer account and return data on-line from their desks. Updates will be immediately available to any IRS employee who accesses the data and will provide a complete, timely, and accurate account of the taxpayer's information. In contrast, the current Master File processing system can take up to two weeks to update taxpayer accounts, and IRS employees may need to access several computer systems to gather all relevant information related to a taxpayer's account.

Although progress is being made, the modernization program is behind schedule, over budget, and is delivering less functionality than originally planned. TIGTA, GAO and the IRS Oversight Board have expressed concerns over the IRS' ability to effectively manage its portfolio of BSM projects. Both TIGTA and GAO have recommended that the IRS slow the pace of the BSM program due to some of the risks that have surfaced. Specifically, the imbalance between the number and pace of the BSM projects and available management capabilities has added significant cost, schedule, and performance risks that have continued to escalate.

In addition, TIGTA has identified four primary challenges that the IRS must overcome for modernization to be successful:

- 1) The IRS must implement planned improvements in key management processes and commit necessary resources to succeed;
- 2) The IRS must manage the increasing complexity and risks of the modernization program;
- 3) The IRS must maintain continuity of strategic direction with experienced leadership; and,
- 4) The IRS must ensure that CSC's performance and accountability are effectively managed.

Without these four challenges being addressed, modernization will not succeed.<sup>9</sup> In addition, IRS is reassessing its relationship with the PRIME contractor. For the past six years, the PRIME contractor has performed the role of system integrator and program manager for the BSM effort. In the new operating model, the IRS assumes responsibility for overall program management. The IRS must demonstrate that it can effectively manage the BSM program before its chances for success improve.

## **Ensuring Tax Law Compliance**

The IRS continues to face challenges in ensuring that taxes owed are paid on time. The importance of this issue cannot be overstated. The nation's ability to provide for the general welfare and protect its citizens is based on the ability to raise revenue through taxes. Yet, the tax gap, which the IRS defines as the difference between what taxpayers are supposed to pay and what is actually paid, is at staggering levels.<sup>10</sup> On March 29, 2005, the IRS released updated estimates of the tax gap. For tax year 2001, the IRS estimated the annual gross tax gap<sup>11</sup> to be between \$312 and \$353 billion.<sup>12</sup>

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<sup>9</sup> *Annual Assessment of the Business Systems Modernization Program* (Reference Number 2004-20-107, dated June 2004).

<sup>10</sup> See written statement of Commissioner of Internal Revenue Mark Everson before the Committee on Finance United States Senate Hearing on "Bridging the Tax Gap," (July 21, 2004).

<sup>11</sup> The amount of tax that is imposed for a given tax year, but is not paid voluntarily and timely.

For some time, the IRS, the Congress, and other stakeholders have been concerned about the slow erosion of voluntary tax compliance. IRS tax compliance programs must ensure that noncompliant taxpayers who do not meet their tax obligations are identified and penalized. The undermining of voluntary compliance begins when honest taxpayers believe that others are not paying their fair share.<sup>13</sup>

To improve tax compliance, the IRS must fully exercise its authority under the law. The American Jobs Creation Act of 2004 enables the IRS to use private contractors to collect unpaid taxes. While the use of private collection agencies could result in significant recoveries of unpaid taxes, the potential for abuse exists. TIGTA has developed a three phase audit strategy to monitor this initiative. In the first phase, TIGTA will review the IRS' planning and initial implementation of the program. In the second phase, TIGTA will review the initiative after full implementation, which may not occur until fiscal year 2007. In the third phase, TIGTA will review the effectiveness of the program. The goal of this audit strategy is to ensure that the IRS effectively uses its new authority to use private debt collectors, while also ensuring that taxpayers' due process and privacy rights are protected.

Congress has provided other statutory tools to the IRS to increase tax compliance. The IRS has the legal authority to charge a monetary penalty, called the Failure to Pay (FTP) tax penalty, against taxpayers who fail to pay their taxes on time.<sup>14</sup> The law also requires the IRS to charge interest on FTP tax penalties.<sup>15</sup> A recent TIGTA report found that the IRS computer system would assess the FTP tax penalty on taxpayers' accounts, but would not officially charge these assessments to accounts. By not assessing these penalties periodically, the IRS has foregone the interest associated with them. If the IRS had assessed all penalty accruals at least quarterly, TIGTA estimates that for calendar year 2002 alone, over \$817 million in interest on accrued penalties would be due to the IRS.<sup>16</sup> This is one example of how the IRS could better use the tools at its disposal.

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<sup>12</sup> It is worth noting that the recently released tax gap figures noted above did not update key segments of the tax gap that are at least 15 years old, such as nonfiled tax returns and underreported corporate income tax for large corporations.

<sup>13</sup> The IRS fiscal year 2006 budget requests a significant increase in enforcement funds. As the IRS attempts to increase enforcement, it is worth considering the results of a 2003 GAO report. GAO found that the IRS' frontline enforcement employees understood – but feared – section 1203 of the Internal Revenue Service Restructuring and Reform Act of 1998. Section 1203 outlines conditions for firing IRS employees for committing any of 10 acts of misconduct. These enforcement employees also reported that, because of section 1203, their work takes longer and the likelihood of their taking an enforcement action, such as recommending a seizure has decreased. See General Accounting Office Report GAO-03-394, *IRS and TIGTA Should Evaluate Their Processing of Employee Misconduct under Section 1203* (February 2003).

<sup>14</sup> 26 U.S.C. § 6651 (2004).

<sup>15</sup> 26 U.S.C. § 6601(e)(2)(A) (2004).

<sup>16</sup> This report also found that the IRS' current practice results in inconsistent treatment of taxpayers. Some taxpayers in hardship situations, such as victims of natural disasters or military personnel serving in combat zones, have accounts that are administered by the IRS manually rather than by computer. IRS personnel periodically calculate and manually assess penalties on these accounts. Because the manually computer FTP penalties are periodically assessed, interest is charged to these taxpayer accounts but not charged to taxpayer accounts administered by computer. *Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions of Dollars in Lost Revenue* (Reference Number 2005-30-052, dated March 2005).

In addition to more fully exercising authority provided by Congress, the IRS must obtain timely and reliable data on the tax gap to improve tax compliance. To collect such data, the IRS launched the National Research Program, a study of individual taxpayer reporting compliance for tax year 2001. The National Research Program is intended to produce timely and reliable data that will allow the IRS to better target its limited enforcement resources on taxpayers who are not complying with the tax law instead of law-abiding individuals.

While timely and reliable data will help the IRS quantify noncompliant segments of the population, different approaches are also needed to determine how to most effectively address noncompliance. The Taxpayer Advocate's 2004 *Annual Report to Congress* depicts some of the complexities involved in structuring an enforcement program to address the tax gap. The Taxpayer Advocate also describes the efforts the IRS still needs to make to analyze the effectiveness of various compliance techniques.<sup>17</sup> Similarly, in two recent audit reports, TIGTA identified examination programs that the IRS implemented nationwide before obtaining results on their possible effectiveness or before implementing an effective strategy to measure the results of the program.<sup>18</sup>

Accurate measures of the effectiveness of actions taken to reduce the tax gap are critical to the IRS for strategic direction, budgeting, and staff allocation. The Department of the Treasury also needs such measures for the purpose of creating tax policy. Additionally, the Congress could use this information to develop legislation that improves the efficacy of the tax system.

In addition to gathering better compliance data, TIGTA, other oversight groups, and interested stakeholders have made a number of recommendations to close the tax gap. These recommendations include: reducing the complexity of the tax code; instituting withholding on non-employee compensation; improving compliance with estimated tax payments; using document matching to verify business income; addressing escalating levels of late filed returns; increasing resources in the IRS enforcement functions; and addressing delays in systems modernization. While reducing the complexity of the tax code lies outside the authority of the IRS, the remaining recommendations are within the IRS' discretion and should be acted upon to further tax compliance.

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<sup>17</sup> *National Taxpayer Advocate 2004 Annual Report to Congress* (Dec. 31, 2004).

<sup>18</sup> In TIGTA's judgment, the IRS implemented the High-Income Taxpayer Strategy, designed to target individuals with the financial resources to use sophisticated methods of tax avoidance, without a method and specific baselines to measure the strategy's success. In addition, the IRS introduced the Limited Issue Focused Examination (LIFE) process to reduce the length of examinations of large and mid-sized businesses. While the LIFE process has merit, the IRS implemented it nationwide before obtaining results on its possible effectiveness. *The High Income Taxpayer Strategy Was Effectively Implemented, Although Its Success Still Needs to Be Determined* (Reference Number 2005-30-012, dated November 2004) and *The Limited Issue Focused Examination Process Has Merit, but Its Use and Productivity Are Concerns* (Reference Number 2005-30-029, dated February 2005).

## Reducing Tax Law Complexity

The scope and complexity of the United States Tax Code make it virtually certain that taxpayers will face procedural, technical, and bureaucratic obstacles before meeting their tax obligations. The IRS has consistently sought to ease the process for all taxpayers, but each tax season brings new challenges, and old problems sometimes resist solution.

According to the Taxpayer Advocate's 2004 *Annual Report to Congress*, the most serious problem facing taxpayers and the IRS is the complexity of the Internal Revenue Code.<sup>19</sup> The Joint Committee on Taxation conducted a study in 2001 that demonstrates the vastness of the tax code. The study found that, in 2001, the tax code consisted of nearly 1.4 million words. There were 693 sections of the code applicable to individuals, 1,501 sections applicable to businesses, and 445 sections applicable to tax exempt organizations, employee plans, and governments.<sup>20</sup>

The complexity of the code hampers the ability of the IRS to administer the nation's tax system and confuses most taxpayers. The IRS has attempted to provide assistance to taxpayers with questions about the tax code through toll-free telephone lines, Taxpayer Assistance Centers (TACs), kiosks, and the IRS internet web site. TIGTA has performed numerous audits of the accuracy of IRS responses to taxpayer questions submitted via these methods and found that even some IRS employees cannot apply the tax code correctly.

Our most recent audit of the accuracy of responses provided to tax law questions received via the toll-free telephone lines during the 2004 Filing Season found that 62 percent of the answers given were correct.<sup>21</sup> The IRS conducted its own tests and found an accuracy rate of 79 percent. Both of these figures were well below the IRS' accuracy goal of 85 percent for this service. Tax law complexity contributes to the IRS' challenges in reaching these accuracy goals, as well as to taxpayer frustration with attempting to decipher the tax code.

Besides adding to the burden on the taxpayer and the IRS, tax law complexity also may inadvertently contribute to the tax gap. Complexity has given rise to the latest generation of abusive tax avoidance transactions, with taxpayers attempting to take advantage of the tax code's length and complexity by devising intricate schemes to illegally shelter income from taxation. Administering such a complex tax code makes the job of pursuing these abusive tax avoidance schemes challenging and costly to the IRS. For example, in 2004, the hours revenue agents spent per return on examinations

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<sup>19</sup> *National Taxpayer Advocate 2004 Annual Report to Congress* (Dec. 31, 2004).

<sup>20</sup> *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Staff of the Joint Committee on Taxation, JCS-3-01 (Apr. 2001).

<sup>21</sup> *Additional Effort Answering Tax Law Questions Would Improve Customer Service* (Reference Number 2004-40-150, dated August 2004).

increased by 23 percent for individual tax returns and 19 percent for corporate tax returns compared to 2003 figures.<sup>22</sup>

As part of its goal to improve service to taxpayers, the IRS includes simplifying the tax process as an objective in its new Strategic Plan. Simplification could incorporate a range of actions from developing legislative recommendations to clarifying tax instructions or forms. Changing tax laws, however, can be a lengthy process since the IRS only administers the tax code that is passed by the Congress. Thus, the IRS must work extensively with these stakeholders, as well as the Department of the Treasury, to identify and develop legislative recommendations that would reduce tax law complexity and taxpayer burden.

### **Preventing Erroneous and Improper Payments**

One of the goals of *The President's Management Agenda* is to reduce erroneous payments.<sup>23</sup> Further, the Improper Payments Information Act of 2002<sup>24</sup> greatly expanded the Administration's efforts to identify and reduce erroneous and improper payments in Government programs and activities. While the Administration has pushed to prevent erroneous and improper payments, stewardship over public funds remains a major challenge for IRS management.

Improper and erroneous payments include inadvertent errors, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from outright fraud and abuse by program participants or Federal employees. For the IRS, improper and erroneous payments generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors.

Some tax credits, such as the Earned Income Tax Credit (EITC), provide opportunities for taxpayer abuse. The EITC is a refundable credit available to taxpayers who do not exceed a certain amount of income per year. The EITC was intended to provide significant benefits to the working poor, but some taxpayers have abused the credit, which has resulted in a significant loss of revenue to the Federal Government. An IRS compliance study of tax year 1999 returns estimated between \$8.5 and \$9.9 billion (27 to 32 percent) of the \$31 billion in EITC claimed for tax year 1999 should not have been paid.<sup>25</sup> A TIGTA review of EITC claimed for tax year 2002 estimated that the IRS allowed over \$16 million in potentially erroneous credits because the claimed qualifying "child" was significantly older than the primary taxpayer.

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<sup>22</sup> TIGTA analysis of IRS Data Book information.

<sup>23</sup> *The President's Management Agenda*, announced in the summer of 2001, is the President's aggressive strategy for improving the management of the Federal government. It focuses on five areas of management weakness across the Government where improvements should be made.

<sup>24</sup> Pub. L. No. 107-300, 116 Stat. 2350.

<sup>25</sup> IRS report, *Compliance Estimates for Earned Income Tax Credit on 1999 Returns* (dated February 2002).

In addition to erroneous payments of credits, contract expenditures represent a significant outlay of IRS funds and are also susceptible to mistakes or abuse. The IRS approved payment of nearly a billion dollars for the Business Systems Modernization contract. Initially, neither the IRS nor the contractor could provide proper supporting documentation for approximately \$9.5 million (approximately 54 percent of the \$17.6 million sampled) in direct charges.<sup>26</sup> The contractor subsequently provided additional documentation, and TIGTA was able to verify all but approximately \$52,200. Nevertheless, to assure that its billings are adequately justified and to facilitate timely independent reviews, the IRS should strengthen its invoice review process by routinely requesting and reviewing a sample of supporting documents.

### **Providing Quality Customer Service**

Providing quality customer service to the taxpayer is not only a primary goal of the IRS, but it is also one of its major management challenges. The Commissioner has frequently stated that service combined with enforcement will result in compliance. Quality taxpayer service includes helping the taxpaying public understand their tax obligations while making it easier to participate in the tax system.

Since the passage of the IRS Restructuring and Reform Act of 1998 (RRA 98),<sup>27</sup> the IRS' focus on customer service has led to many improvements. Taxpayer satisfaction rates with the IRS have increased since the Act's passage, growing almost 2 percent in 2004 alone.<sup>28</sup> Every year, the IRS helps millions of taxpayers understand their tax obligations by answering questions on its toll-free telephone lines or in person at local offices, making information available on its Web site, and responding to correspondence.

The IRS internet site, [www.irs.gov](http://www.irs.gov), is an excellent source for forms, publications, and other guidance. Taxpayers visited the site over 139 million times last year.<sup>29</sup> The site also received an award for being the nation's most reliable government internet site.<sup>30</sup> Electronic filing of tax returns continues to grow, and the ability to check the status of tax refunds online has been a successful IRS project that is helpful to taxpayers.<sup>31</sup>

As for the toll-free telephone system, access by taxpayers to the IRS via telephone has improved. Callers were able to connect with the IRS more easily and received better, quicker service. Surveys of callers during the 2004 filing season showed that the vast majority of taxpayers were satisfied with the services they received.<sup>32</sup> While the IRS exceeded its goals in professionalism and timeliness, the accuracy of answers provided to

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<sup>26</sup> *Improvements Are Needed in the Invoice Review Process for the Business Systems Modernization Contract* (Reference Number 2004-10-117, dated June 2004).

<sup>27</sup> Pub. L. No. 105-206, 112 Stat. 683 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

<sup>28</sup> *Special Report on IRS Fiscal 2006 Budget*, IRS Oversight Board, March 15, 2005.

<sup>29</sup> *IRS.gov Cited As Most Reliable Government Web Site*, IR-2004-131, October 25, 2004.

<sup>30</sup> *Id.*

<sup>31</sup> *Free File Tops Last Year's Total*, IR-2005-36, March 23, 2005.

<sup>32</sup> *Taxpayers Experienced Improved Access to Toll-Free Telephone Services During the 2004 Filing Season* (Reference Number 2004-30-144, dated August 2004).

taxpayers on tax law questions slipped in one year from 73 percent to 62 percent. TIGTA attributed this decrease to IRS employees not always using the required Probe and Response Guide to obtain sufficient information from taxpayers or the employees were not correctly interpreting the tax law.

The IRS has obviously made strides in customer service over the past seven years. TIGTA is concerned, however, that the IRS may disrupt the balance between customer service and enforcement by closing many of its Taxpayer Assistance Centers. The TACs are walk-in sites where taxpayers can receive answers to both account and tax law questions, as well as receive assistance preparing their returns. Over the past few years, customer service at Taxpayer Assistance Centers has shown improvement.<sup>33</sup> Yet, the IRS is considering closing nearly a quarter of its approximately 400 TACs nationwide. TIGTA is skeptical that the IRS has adequate data to assess the impact that closing TACs will have on customer service.

From the information provided by the IRS to TIGTA, the IRS is using the following criteria to select TACs to close: location, labor cost, facility cost, workload, and demographics. The last criterion, demographics, falls short of capturing the information needed to make a well-informed decision. To compile information on the demographics of a particular TAC location, the IRS is collecting data, by zip code, on population size, income level, age, unemployment, and percent of population who e-file. TIGTA believes this information is insufficient to draw conclusions on the capability and likelihood that taxpayers who have used these centers in the past will be willing to use alternative methods of seeking help, such as the internet or telephone. I strongly recommend that the IRS further research these issues before closing TACs.

## **Protecting Taxpayers and Taxpayer Rights**

Congress realized the importance of protecting taxpayers and taxpayer rights when it passed RRA 98. This legislation required the IRS to devote significant attention and resources to protecting taxpayer rights. The RRA 98 and other legislation require TIGTA to review IRS compliance with taxpayer rights provisions. Our most recent audit results on some of these taxpayer rights provisions are:

- *Notice of Levy* – TIGTA reports have recognized that the IRS has implemented tighter controls over the issuance of systemically generated levies, and TIGTA testing of these controls indicated that they continue to function effectively. However, revenue officers who issue levies manually still are not always properly notifying taxpayers of their appeal rights.<sup>34</sup>
- *Restrictions on the Use of Enforcement Statistics to Evaluate Employees* – The IRS is complying with the law. A sample review of employee performance and related

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<sup>33</sup> *Customer Service at the Taxpayer Assistance Centers Is Improving but Is Still Not Meeting Expectations* (Reference Number 2005-40-021, dated December 2004).

<sup>34</sup> *Additional Efforts Are Needed to Ensure Taxpayer Rights Are Protected When Manual Levies Are Issued* (Reference Number 2004-30-094, dated April 2004).

supervisory documentation revealed no instances of tax enforcement results, production quotas, or goals being used to evaluate employee performance.<sup>35</sup>

- *Notice of Lien* – The IRS did not completely comply with the law. For example, the IRS did not always timely mail lien notices. In other cases, the IRS could not provide proof of mailing. In addition, the IRS did not always follow its guidelines for notifying taxpayer representatives and for maintaining certified mail listings.<sup>36</sup>
- *Seizures* – The IRS did not always comply with legal provisions and internal procedures when conducting seizures. The TIGTA review did not identify any instances where taxpayers were adversely affected, but not following legal and internal guidelines could result in abuses of taxpayer rights.<sup>37</sup>
- *Illegal Tax Protestor Designations* – The IRS is prohibited by law from designating taxpayers as “illegal tax protestors” but may refer to taxpayers as “nonfilers.” TIGTA has reviewed the Master File for illegal tax protestor designations. We found that the IRS has not reintroduced such designations on the Master File, taxpayer accounts that were formerly coded as illegal tax protestor accounts have not been assigned similar designations, and current IRS publications do not refer to illegal tax protestors. However, a few illegal tax protestor references still exist in manuals, job aids, computer systems, and isolated case files.<sup>38</sup>
- *Denials of Requests for Information* – The IRS improperly withheld information from requesters in 4.4 percent of the Freedom of Information Act<sup>39</sup> and Privacy Act of 1974<sup>40</sup> requests, and 14.6 percent of the 26 U.S.C. § 6103 requests reviewed.<sup>41</sup>
- *Collection Due Process* – IRS Appeals Officers and Settlement Officers substantially complied with the requirements of the law when conducting collection due process hearings. However, the Settlement Officers did not always address all the issues raised by the taxpayers.<sup>42</sup>

Neither TIGTA nor the IRS could evaluate the IRS’ compliance with three RRA 98 provisions since IRS information systems do not track specific cases. These three provisions relate to: restrictions on directly contacting taxpayers instead of authorized representatives, taxpayer complaints, and separated or divorced joint filer requests.

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<sup>35</sup> Fiscal Year 2004 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results (Reference Number 2004-40-066, dated March 2004).

<sup>36</sup> *Fiscal Year 2004 Statutory Review of Compliance With Lien Due Process Procedures* (Reference Number 2004-30-086, dated April 2004).

<sup>37</sup> *Legal and Internal Guidelines Were Not Always Followed When Conducting Seizures of Taxpayers’ Property* (Reference Number 2004-30-149, dated August 2004).

<sup>38</sup> *Fiscal Year 2004 Statutory Audit of Compliance With Legal Guidelines Prohibiting the Use of Illegal Tax Protestor and Similar Designations* (Reference Number 2004-40-109, dated June 2004).

<sup>39</sup> 5 U.S.C. § 552.

<sup>40</sup> 5 U.S.C. § 552a.

<sup>41</sup> *Improvements Are Needed to Ensure Compliance With the Freedom of Information Act* (Reference Number 2004-40-064, dated March 2004).

<sup>42</sup> *Appeals Complied With the Provisions of the Law for the Collection Due Process* (Reference Number 2004-40-067, dated March 2004).

## Securing IRS Employees, Facilities, and Information Systems

As the nation's primary revenue collector and an integral part of the nation's critical infrastructure, the IRS is a prime target for anti-government protestors, international terrorists, and other extremists. Millions of taxpayers entrust the IRS with sensitive financial and personal data, which are stored and processed by IRS computer systems. The risks that sensitive data or computer systems could be compromised and that computer operations could be disrupted have increased over the last few years due to the external threats noted above and the increased connectivity of computer systems. In addition, IRS systems and data are vulnerable to unhappy taxpayers and disgruntled employees, as well as natural disasters. Although many steps have been taken to limit risks, IRS systems and taxpayer information remain susceptible to threats that could impact the confidentiality, integrity, and availability of data and information systems.

For the past four years, TIGTA assessments have concluded that the security infrastructure and the applications that guard sensitive data are weak because of inadequate accountability and security awareness, as well as insufficient training for key security employees. The IRS has focused on technical solutions to this issue, but the primary causes are managerial and operational factors. For example, in 2004, TIGTA found that while security roles and responsibilities have been defined, we continue to identify significant security weaknesses throughout the IRS that can be attributed to employees not fulfilling their responsibilities.<sup>43</sup> This results in the IRS failing to establish an organizational culture that strongly emphasizes the security and privacy of taxpayer data. In addition, some disaster recovery plans require additional development, testing, or personnel training to ensure that the IRS can quickly recover in the event of a disaster.

TIGTA has also identified security weaknesses in a number of IRS systems. For example, the IRS envisions the Security Audit and Analysis System (SAAS) as the audit trail collection and reporting system for the IRS' modernized applications. To date, no modernization applications are employing the SAAS for this purpose. This failure to employ the SAAS for audit trail collection and reporting results in at least two weaknesses. First, the IRS could deploy modernization applications without proper audit trail controls in place. Second, the IRS may spend additional resources to employ an application-specific audit trail that is not consistent with the IRS' architecture and would, in essence, represent a double investment in audit trail controls. Furthermore, the SAAS was accepted by the IRS despite the fact that it did not meet performance requirements.<sup>44</sup>

The IRS has taken several positive steps toward improving security in the IRS. In October 2003, the IRS combined key security activities into a single organization to promote better performance and consistent customer focus. Adequate security policies

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<sup>43</sup> *Computer Security Roles and Responsibilities and Training Should Remain Part of the Computer Security Material Weakness* (Reference Number 2004-20-155, dated September 2004).

<sup>44</sup> For example, the SAAS users cannot query the audit trail information to generate reports. In addition, the functionality and software performance problems of the SAAS prevent the IRS business units from using it to identify questionable activities on modernized applications. See *The Audit Trail System for Detecting Improper Activities on Modernized Systems Is Not Functioning*, (Reference Number 2004-20-135, dated August 2004).

and procedures have been established and, in most cases, the IRS has the necessary hardware and software to provide adequate system security. While the IRS has become a leader in Government under this management structure, it must emphasize the importance of security to its employees.

For the IRS to make the largest strides in improving computer security at a relatively low cost, managers and employees must be aware of the security risks inherent in their positions and consider security implications in their day-to-day activities. Thus, IRS business unit managers should be held accountable for the security of their systems and key security employees should be adequately trained to carry out their responsibilities. It is also vital that the IRS continues to refine its plans and capabilities to manage emergency situations in a manner that protects employees and allows restoration of business operations in a timely manner. In addition, aggressive network control, monitoring, and incident response capabilities are necessary to prevent incursions into IRS systems from external and internal sources.

### **Integrating Performance and Financial Management**

*The President's Management Agenda* aims to place a greater focus on performance by formally integrating it with budget decisions. In addition, without accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people. The IRS has made some progress; however, integrating performance and financial management remains a major challenge.

The IRS has achieved mixed success in establishing long-term goals to integrate performance and financial management. During the FY 2005 budget formulation process, the IRS took the important step of aligning performance and resources requested. The IRS also modified its budget and performance plans to include more customer-focused and "end result" measures. However, TIGTA believes the IRS must continue to integrate performance into its decision-making and resource allocation processes to completely achieve an integrated performance budget.

The IRS also continues to analyze the critical data needed to develop long-term enforcement outcome measures. For example, the IRS released the first results from its National Research Program and they provide fresh data on taxpayer voluntary compliance levels – the first in more than a decade. Such data is essential to establishing enforcement measures and effectively allocating resources to related activities. The IRS, however, needs to develop a more strategic approach to the entire tax administration system. Such an effort would better identify the characteristics of an effective and efficient tax administration system, help pinpoint desired outcomes, and create a road map for the next decade that would complement the IRS' strategic, budget, and annual performance plans.

The IRS' financial statements and related activities also continue to be of concern to IRS stakeholders. The GAO audits the IRS' financial statements annually. The audit

determines whether the IRS: 1) prepared reliable financial statements; 2) maintained effective internal controls; and, 3) complied with selected provisions of significant laws and regulations, including compliance of its financial systems with the Federal Financial Management Improvement Act of 1996 (FFMIA).<sup>45</sup>

In audits of the IRS' financial statements, the GAO has concluded that the records were fairly presented in all material respects.<sup>46</sup> The GAO, however, identified some continuing serious deficiencies in the IRS' financial systems, including control weaknesses and system deficiencies affecting financial reporting, unpaid tax assessments, tax revenue and refunds, and computer security. However, the IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements. Without a financial management system that can produce timely, accurate, and useful information needed for day-to-day decisions, the IRS' financial stewardship responsibilities continue to be one of the largest challenges facing IRS management.

### **Managing Human Capital**

Like much of the Federal Government, managing the extensive human capital resources at the IRS remains a serious concern. Workforce issues, ranging from recruiting to training and retaining employees, have challenged Federal agencies for years. The GAO, the Office of Management and Budget, and the Office of Personnel Management have all made the strategic management of human capital a top priority. Specifically for the IRS, recent reorganization and modernization efforts, such as the focus on *e-filing*, have made many jobs dealing with processing paper tax returns redundant.

The Large and Mid-Size Business Division reported in its FY 2006 strategic assessment that it will continue to lose substantial experience in the Revenue Agent position through attrition. Similarly, in the Small Business/Self-Employed Division, the human capital crisis continues to intensify as employees in key occupations increasingly become eligible for retirement, are lost through attrition, or migrate to other areas. Stagnant funding allocations have impacted the ability to attract new hires and retain existing employees. Thus, potential losses in critical occupational groups (e.g., Revenue Agents, Revenue Officers, Tax Compliance Officers), coupled with concerns regarding grade and competency gaps, further emphasize the need to strategically manage human capital.

The Tax-Exempt/Government Entities Division is already understaffed to handle the current volume of customer calls. The Division's toll-free service is still maturing and acquiring new customers; however, without additional staffing or system enhancements, the level of service will deteriorate. This issue requires immediate attention because the Division relies on quality toll-free customer service to help ensure

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<sup>45</sup> Pub. L. No. 104-208, 110 Stat. 3009.

<sup>46</sup> *Financial Audit: IRS's Fiscal Years 2003 and 2002 Financial Statement* (GAO-04-126, dated November 2003).

voluntary compliance among its customers, since it has very limited resources for more traditional compliance activities like examinations.

In contrast, the Wage and Investment Division has reported that it has made significant progress in the human capital area. Examples include increased employee use of electronic learning and training by demand, and improved technical assessments for identifying skill levels and training needs of employees. In addition, the Division effectively planned and realigned its workforce as the result of reduced workload demands and technological improvements. Even so, more work needs to be completed to attract and retain high-quality employees, to increase productivity and quality, and to provide equal employment opportunities for all.

The Criminal Investigation function has also moved forward in this area. The function is implementing a computer-based knowledge management program, which can immediately identify current subject matter experts. Skill transfer programs will be implemented to provide continuity of technical subject matter expertise, and continuing education programs will provide updated training on emerging issues, strategies, and operational priority subjects.

The President's fiscal year 2006 budget may offer some relief in staffing shortages; however, the overall training and acclimation process will take some time. The IRS must devote significant attention to managing human capital to overcome the challenges noted above.

### **Processing Returns and Implementing Tax Law Changes During the Tax Filing Season**

Each filing season tests the ability of the IRS to implement tax law changes made by the Congress during the year. It is during the filing season that most individuals file their income tax returns and call the IRS if they have questions about specific tax laws or filing procedures. Correctly implementing tax law changes is a continuing challenge because the IRS must identify the tax law changes; revise the various tax forms, instructions, and publications; and reprogram the computer system used in processing returns.

This year's filing season includes significant tax law changes created by the American Jobs Creation Act of 2004.<sup>47</sup> One significant tax law change for the 2005 filing season that many taxpayers are familiar with is the ability to deduct sales tax instead of State and local income tax. Changes to the tax law can have a major effect on how the IRS conducts its activities, how many resources are required, and how much progress can be made on strategic goals. Generally, the Congress makes changes to the tax law each year, so some level of change is a normal part of the IRS environment. However, certain kinds of changes can significantly impact the IRS in terms of the quality and effectiveness of service and in how taxpayers perceive the IRS.

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<sup>47</sup> Pub. L. No. 108-357, 118 Stat. 1418 (2004).

To date, we have seen no significant problems during the 2005 filing season. During the 2004 filing season, most of the 123.1 million individual income tax returns received through May 28, 2004, (including over 60 million received electronically, an increase of nearly 16 percent from 2003) were timely and accurately processed. TIGTA determined that the IRS correctly implemented the key tax law changes that affected 2003 returns. However, TIGTA has previously identified tax law changes that have not yet been effectively implemented and could result in loss of taxpayer entitlements and erroneous tax reductions. For example, TIGTA identified taxpayers that are continuing to receive erroneous deductions for student loan interest, taxpayers with potentially unclaimed Additional Child Tax Credits, and taxpayers that were allowed questionable “dual benefits” for the tuition and fees deduction and the education credit.<sup>48</sup> These tax law changes must be effectively implemented to fairly apply the law to all taxpayers.

I hope this discussion of the major challenges facing the IRS aids you in your consideration of the IRS’ appropriation for fiscal year 2006. Mr. Chairman and Members of the Committee, thank you for allowing me to share my views. I would be pleased to answer any questions you might have at this time.

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<sup>48</sup> *The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented* (Reference Number 2005-40-016, dated Dec. 2004).