

**HEARING BEFORE THE  
SUBCOMMITTEE ON FINANCIAL SERVICES  
AND GENERAL GOVERNMENT  
COMMITTEE ON APPROPRIATIONS  
U.S. SENATE**



**April 16, 2008**

**Washington, DC**

**The Honorable J. Russell George  
Treasury Inspector General for Tax Administration**

**STATEMENT OF  
THE HONORABLE J. RUSSELL GEORGE  
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION**  
*before the*  
**SUBCOMMITTEE ON FINANCIAL SERVICES  
AND GENERAL GOVERNMENT  
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Chairman Durbin, Ranking Member Brownback, and Members of the Subcommittee, thank you for the opportunity to testify today. My comments will focus on the Internal Revenue Service's (IRS) Fiscal Year 2009 budget and, at your request, the Treasury Inspector General for Tax Administration's (TIGTA) Fiscal Year 2009 budget request. I will also briefly comment on the status of the 2008 Filing Season.

The IRS administers America's tax laws and collects approximately 95 percent of the revenues that fund the Federal Government. The IRS has four major components: the Wage and Investment Division, the Small Business/Self-Employed Division, the Large and Mid-Size Business Division and the Tax Exempt and Government Entities Division. Together, these divisions are largely responsible for collecting more than \$2 trillion in tax revenues each year. At a time when our nation is at war, it is imperative to identify the resources required to support the IRS's role as steward of the country's tax administration system.

The IRS must continue to address management and operational issues, including modernization of its computer systems, addressing the tax gap, protecting taxpayer rights, and ensuring the security of its resources. To that end, the IRS has requested \$11.4 billion to fund the agency's operations for Fiscal Year 2009. This is a 4.3 percent increase over the 2008 enacted budget. The IRS's Fiscal Year 2009 budget request for systems modernization is \$40 million less than the Fiscal Year 2008 enacted amount. The IRS does not specify which programs will absorb these costs, only that the requested amount will allow continued progress on key modernization projects. However, millions of taxpayers entrust the IRS with sensitive financial and personal data stored and processed by its computer systems. The IRS faces enormous challenges in securing this vast amount of personally identifiable information, including ensuring that all systems have sufficient controls to prevent and detect intrusions and improper accesses.

The budget request includes a 7 percent increase for enforcement and less than a 1 percent increase for taxpayer service. In 2007 the IRS finalized strategies to reduce the tax gap and improve customer service.<sup>1</sup> The IRS is in the preliminary stages of both strategies. Determining what role taxpayer service plays in increasing voluntary

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<sup>1</sup> *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (Washington, D.C.: Aug. 2, 2007); *The 2007 Taxpayer Assistance Blueprint Phase 2* (Washington, D.C.: 2007).

compliance and reducing the tax gap will continue to be a challenge in the near future. The IRS must strive to enforce the tax laws fairly and efficiently while balancing service and enforcement to promote voluntary compliance and reduce taxpayer burden.

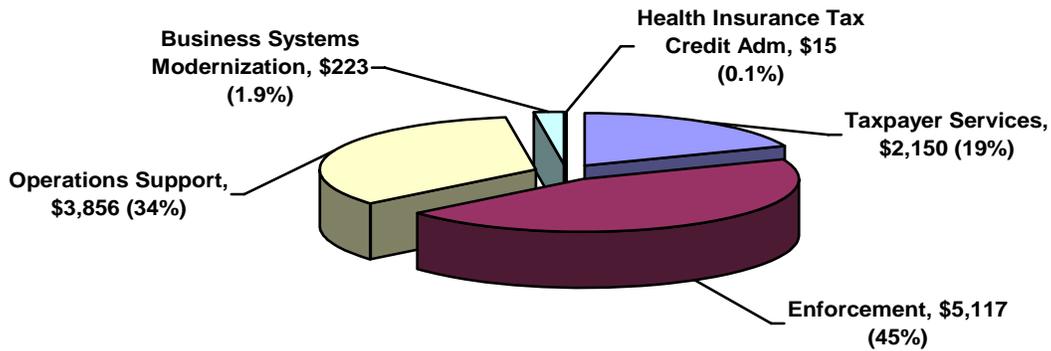
**Overview of the IRS’s Fiscal Year 2009 Budget Request**

The proposed Fiscal Year 2009 IRS budget requests approximately \$11.4 billion in direct appropriations, \$107.9 million from reimbursable programs, and \$177.7 million from user fees. The direct appropriation is approximately a \$469.1 million increase (4.3 percent) over the Fiscal Year 2008 enacted level of \$10.9 billion.

In Fiscal Year 2008, the IRS requested a budget of approximately \$11.1 billion, an increase of \$498 million (4.7 percent) over its Fiscal Year 2007 spending authority. The amount enacted by Congress for Fiscal Year 2008 was \$203 million (1.8 percent) less than the budget request. Congress also made substantial changes in budget priorities in Fiscal Year 2008 by increasing the Taxpayer Services appropriation by \$46.9 million above the IRS’s request while cutting the Administration’s Enforcement and Operations Support appropriation requests by a total of \$235 million. The budget request also included a net increase in the overall size of the IRS of nearly 1,800 Full-Time Equivalent<sup>2</sup> employees.

The Fiscal Year 2009 IRS budget request includes appropriations for five IRS budget accounts (categories): Enforcement, Operations Support, Taxpayer Services, Business Systems Modernization, and the Health Insurance Tax Credit Administration (see Figure 1).

**Figure 1: IRS Fiscal Year 2009 Budget Request (in millions)**



Source: TIGTA analysis of Fiscal Year 2009 IRS Budget Request by IRS Budget Accounts.

Within these appropriation accounts, the IRS seeks to increase funding for Enforcement, Operations Support, and the Health Insurance Tax Credit Administration while decreasing funding for Business Systems Modernization (Modernization). The budget request seeks an Enforcement Appropriation of \$5.12 billion, an increase of

<sup>2</sup> A Full-Time Equivalent is a measure of labor hours. One Full-Time Equivalent is equal to eight hours multiplied by the number of compensable days in a particular fiscal year.

\$337 million (7.1 percent) over the current Fiscal Year 2008 appropriation of \$4.78 billion. The funding for Taxpayer Services remains the same as the Fiscal Year 2008 enacted level.

The Modernization program is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system.

The Modernization program is in its 10th year and has received approximately \$2.5 billion for contractor services. Additionally, the IRS had spent \$265 million through Fiscal Year 2007 for internal IRS costs, and plans to spend an additional \$223 million on the program in Fiscal Year 2008. According to the IRS's original plan, the Modernization program should be past the halfway point in Calendar Year 2008. However, the IRS has not completed as many Modernization projects as planned because it has received less funding than initially anticipated and has had difficulties in managing the scope and complexity of the work. For example, the Customer Account Data Engine (CADE) is the foundation of the Modernization program. The IRS originally planned to complete replacement of its Individual Master File with the CADE in 2005.<sup>3</sup> The current estimated completion date for this replacement is 2012.

Although the IRS has made advances in its Modernization effort, it has not progressed as anticipated. TIGTA has reported that inconsistent compliance with project development controls has contributed to delays in project deliveries, increased development costs, and reduced capabilities.<sup>4</sup> Since Fiscal Year 2002, TIGTA's Modernization program annual assessments have cited the following four specific challenges the IRS needs to overcome to deliver a successful modernization effort:

1. Implement planned improvements in key management processes and commit necessary resources to enable success;
2. Manage the increasing complexity and risks of the Modernization program;
3. Maintain the continuity and strategic direction with experienced leadership; and
4. Ensure that contractor performance and accountability are effectively managed.

Accordingly, because solutions to the IRS's serious and intractable financial management problems largely depend upon the success of its Modernization efforts, in January 2005 the financial management risk was combined with the Modernization risk into the Business Systems Modernization high-risk area.<sup>5</sup> Modernization remains a high risk for the IRS. One reason is that all of its new systems need to include adequate audit trails.

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<sup>3</sup> The Individual Master File is the IRS database that stores individual taxpayer account information.

<sup>4</sup> *Annual Assessment of the Business Systems Modernization Program* (Reference Number 2007-20-121, dated August 24, 2007).

<sup>5</sup> In January 2005, the Government Accountability Office (GAO) combined its two previous high-risk areas, IRS Business Systems Modernization and IRS Financial Management, into one Business Systems Modernization high-risk area. See U.S. Government Accountability Office, GAO-05-207, *High Risk Series: An Update* (2005).

For Fiscal Year 2008, the IRS requested funding of approximately \$222.7 million for Modernization, a cut of 16.6 percent (\$44.4 million from the \$267.1 million enacted). This cut is expected to eliminate at least 25 employees. However, the Fiscal Year 2008 enacted amount was an increase of \$54.4 million (25.6 percent) from the \$212.7 million enacted for Fiscal Year 2007.

The Fiscal Year 2009 budget request does not specify which programs will absorb the cuts, although it states that the requested amount will allow continued progress on key modernization projects, including the CADE, Accounts Management Services (AMS), and Modernized e-File (MeF). However, the Government Accountability Office (GAO) recently issued a report that included proposed spending by major project.<sup>6</sup> Figure 2 shows the funding proposed for major Modernization projects in Fiscal Year 2009 compared to the amounts enacted for Fiscal Year 2008:

**Figure 2: Business Systems Modernization Projects  
in Fiscal Year 2009 IRS Budget Request**

<b>Project</b>	<b>Fiscal Year 2008 Enacted (Millions)</b>	<b>Fiscal Year 2009 Budget Request (Millions)</b>	<b>Change from Fiscal Year 2008 Enacted (Millions)</b>
Customer Account Data Engine	\$58.5	\$58.8	\$0.3
Accounts Management Services	29.0	26.2	(2.8)
Modernized e-File	55.8	25.0	(30.8)
Core Infrastructure Architecture, Integration, and Management	39.2	32.0	(7.2)
Management Reserve	35.1	35.0	(0.1)
	4.3	2.3	(2.0)
<b>SUBTOTAL: Capital Investments</b>	<b>\$221.9</b>	<b>\$179.3</b>	<b>\$(42.6)</b>
Business Systems Modernization Labor	44.0	42.0	(2.0)
<b>SUBTOTAL: Program Request</b>	<b>\$265.9</b>	<b>\$221.3</b>	<b>\$(44.6)</b>
Maintaining Current Levels	1.2	1.4	0.2
<b>TOTAL Business Systems Modernization Budget</b>	<b>\$267.1</b>	<b>\$222.7</b>	<b>\$(44.4)</b>

Source: TIGTA analysis of GAO Report, Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season (GAO 08-567, dated March 2008).

TIGTA requested information from the IRS on the impact of the proposed funding on the projects above, which the IRS declined to provide. The IRS also declined to provide this information to GAO for its report.

Customer Account Data Engine

The IRS states that the CADE is the lynchpin modernization project to replace the antiquated master file. The master file currently requires two weeks to update taxpayer

<sup>6</sup> Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season, (GAO 08-567, dated March 2008).

tax accounts. The CADE consists of current and planned databases and is designed to post information to taxpayers' accounts daily rather than weekly, which will facilitate faster refunds to taxpayers and provide IRS employees with more up-to-date and accurate account information.

The latest release of the CADE, Release 3.0, was originally developed to deliver 17 new functions and capabilities. The IRS divided Release 3.0 into two sub-releases. CADE Release 3.1 contained four major functions and was deployed between August and October 2007. CADE Release 3.2 included seven major functions and was delivered in February 2008. The major functions delivered include the capability of processing tax returns with a disaster area designator; processing tax returns claiming the Earned Income Tax Credit, Credit for Child and Dependent Care, and requests for Split Refunds; providing address change service requests; and validating tax balances. The remaining six functions will be determined for delivery in future releases of the CADE. These additional capabilities were expected to significantly increase the volume of returns posting to the CADE from the approximately 11.2 million returns posted during Calendar Year 2007. As of March 28, 2008, about 21.1 million tax returns had been posted to the CADE.

In 2009, the IRS plans to continue the development of the CADE in stages, and its Fiscal Year 2009 budget request includes \$58.8 million for the project. TIGTA's review of CADE Release 2.1 found that tax return information was accepted and generally posted accurately to CADE accounts during the 2007 Filing Season.<sup>7</sup> However, several programming problems were affecting the accurate posting of Itemized Deductions, Adjusted Gross Income, and Taxable Income amounts. TIGTA reported this issue to the IRS, and it promptly corrected the programming. TIGTA is currently reviewing the accuracy of the expanded capabilities offered by the most current release of the CADE.<sup>8</sup>

#### Accounts Management Services Project

The IRS is continuing to modernize its databases to provide immediate access to account data, enable real-time transaction processing, and ensure daily account settlement to improve customer service and business results. The Accounts Management Services (AMS) project, initiated in May 2006, was chartered to address these needs. The project objective is to provide an integrated approach to view, access, update, and manage taxpayer accounts. This is accomplished by providing IRS employees with the tools to access information quickly and accurately in response to complex customer inquiries and to update taxpayer accounts on demand. The Fiscal Year 2009 budget request includes \$26.2 million for the AMS project.

In March 2008, TIGTA determined that the AMS project team successfully implemented project management processes and activities, which included project justification, contract management, risk management, configuration management,

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<sup>7</sup> *The Customer Account Data Engine Release 2.1 Generally Posted Tax Return Information Accurately* (Reference Number 2007-40-131, dated August 10, 2007).

<sup>8</sup> Customer Account Date Engine Release 3, (Audit Number 2008-20-009).

performance management, and transition management.<sup>9</sup> The AMS project team successfully planned work schedules, identified and addressed potential risks to project development, and coordinated with appropriate staff to implement initial release capabilities. Although the AMS project team is on schedule to make the proposed processing capabilities available, its implementation is dependent on the IRS's Modernization and Information Technology Services organization's abilities to integrate these project capabilities into taxpayer account processing.

The IRS, however, does not collect all transactions and audit logs on its modernized systems, including CADE and AMS. Without audit logs, the IRS cannot conduct proper intrusion investigations and hold individuals accountable for unauthorized transactions and disclosures.

### Modernized e-File

The MeF project provides a standard filing structure for all types of IRS tax returns and can meet performance and capacity needs with enhanced and up-to-date technologies, therefore providing greater appeal to external customers and stakeholders. The MeF project's goal is to replace the IRS's current tax return filing technology with a modernized, Internet-based electronic filing platform.

In Fiscal Year 2009, the IRS will continue development of Release 7, which was initiated in Fiscal Year 2008. Release 7 will roll out an additional 90 supporting schedules and forms that will expand the reach of MeF to 99 percent of the e-File population, or approximately 93.7 million filers. The IRS's Fiscal Year 2009 budget request includes \$25 million for the MeF project.

Previous TIGTA audits of the MeF project found that the IRS's plans for processing additional tax forms using the MeF system were uncertain, including plans to schedule development of the U.S. Individual Income Tax Return (Form 1040) family. In addition, the IRS can improve its management of requirements development and testing activities to assure that the requirements expected and approved for deployment are the requirements that are actually deployed.<sup>10</sup>

Furthermore, TIGTA continues to be concerned that the IRS is developing its modernized systems and bringing them online without adequately contemplating the security implications.

### Human Capital

The IRS, like many organizations, is concerned about an impending retirement wave, or brain drain. According to the IRS, 30 percent of its current employees will be

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<sup>9</sup> *The Account Management Services Project Is Meeting Its Development Goals* (Reference Number 2008-20-053, dated March 3, 2008).

<sup>10</sup> *The Modernized e-File Project Can Improve the Management of Expected Capabilities and Associated Costs* (Reference Number 2007-20-005, dated December 27, 2006); *The Modernized e-File Project Can Improve Its Management of Requirements* (Reference No. 2007-20-099, dated July 9, 2007).

eligible to retire by 2010 and nearly 40 percent of its executives are currently eligible to retire. The GAO has designated human capital as a “high risk” government-wide concern and recently reported that ample opportunities exist for agencies to improve. TIGTA has also designated the strategic management of human capital as one of the IRS’s major management challenges.

Due to the potential loss of institutional knowledge, the IRS has several critical projects underway, such as a five-year strategic plan for enhancing the services it provides to taxpayers and a complex, multiyear, multibillion dollar effort to modernize its technology and related business processes. The IRS is also battling a tax gap,<sup>11</sup> as well as implementing and adjusting to changes in its managerial and executive pay structure.

It is critical that the IRS effectively implement the human capital strategies listed in the IRS’s Fiscal Year 2009 budget request. While acting to replace those employees lost through retirement and other attrition, the Fiscal Year 2009 budget request seeks more than 3,000 additional Full-Time Equivalents. The IRS states that additional employees will lead to increased revenue of more than \$2 billion by the time new employees reach their full potential in Fiscal Year 2011. Not only will the IRS need to place a significant focus on recruiting, it will need to ensure that new employees reach their full potential. At this same time, the IRS will need to retain its more experienced employees and capture the knowledge of those who leave the IRS.

If the IRS is not able to effectively accomplish the human capital strategies:

- There might not be a sufficient number of qualified employees to adequately administer the tax code. In addition, fewer qualified employees may be on the front-line to assist taxpayers.
- The tax gap could increase if high-performing, well-trained taxpayer service and enforcement personnel cannot be hired and retained.
- The IRS might not be able to replace its leadership cadre and ensure that significant projects remain on track.
- The aging workforce could retire before its vast knowledge of tax administration is transferred to younger workers.

TIGTA has an ongoing Human Capital audit strategy reviewing these areas and will continue to monitor the IRS’s efforts to strategically plan and monitor human capital resources to ensure having the right resources in the right place at the right time to achieve its mission and goals.

### **Security of the Internal Revenue Service**

Privacy and security are growing concerns in nearly every organization, both private and public. As technology advances, the IRS’s ability to protect sensitive information must advance to meet new threats. In addition to the IRS’s commitment to

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<sup>11</sup> The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year.

protect sensitive taxpayer data and personally identifiable information, a robust security program also requires adequate financial and human capital resources.

Each year, millions of taxpayers entrust the IRS with their sensitive financial and personal data that are stored in and processed by IRS computer systems. The risk that this sensitive data could be compromised and computer operations disrupted continues to increase. Both internal factors, such as the increased connectivity of computer systems and greater use of portable laptop computers, and external factors, such as the volatile threat environment related to increased phishing scams and hacker activity, contribute to these risks.

### Network Security

Because the IRS sends sensitive taxpayer and administrative information across its networks, routers and switches on the networks must have sufficient security controls to deter and detect unauthorized use. In March 2008, TIGTA reported that access controls for IRS routers were not adequate and reviews to monitor security configuration changes were not conducted to identify inappropriate use.<sup>12</sup> Of 374 accounts for employees and contractors to access routers and switches in performing system administration duties, 141 (38 percent) did not have proper authorization to access the routers. Of particular concern, 27 employees and contractors had accessed the routers and switches to change security configurations.

To authenticate users, the IRS relies on a security application that requires users to enter an account name and password. Users circumvented this control by setting up unauthorized accounts that appeared to be shared-user accounts. Any person who knew the password to these accounts could have changed configurations without accountability and with little chance of detection. For this reason, the IRS requires that shared accounts be used only on a limited basis and that they be subjected to special authorization controls. However, during Fiscal Year 2007, 4.4 million (over 84 percent) of the 5.2 million accesses to the routers were made by the 34 user accounts. Audit trail reviews necessary to detect security events were also not being conducted. The IRS agreed with TIGTA's findings and is taking corrective actions to address the recommendations made to correct these weaknesses.

### Database Security

The IRS stores its taxpayer, financial, and other data in more than 2,100 databases. TIGTA reported in Fiscal Year 2008 that high-risk weaknesses continue to exist and sufficient corrective actions have not been taken.<sup>13</sup> TIGTA scanned IRS networks and determined that 11 percent of the approximately 1,900 databases scanned had one or more installation accounts with a default or blank password. A total of 369 installation accounts had default or blank passwords, including 26 containing powerful database administrator privileges.

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<sup>12</sup> *Inadequate Security Controls Over Routers and Switches Jeopardize Sensitive Taxpayer Information* (Reference Number 2008-20-071, March 26, 2008).

<sup>13</sup> *Internal Revenue Service Databases Continue to Be Susceptible to Penetration Attacks* (Report Reference Number 2008-20-029, dated December 14, 2007).

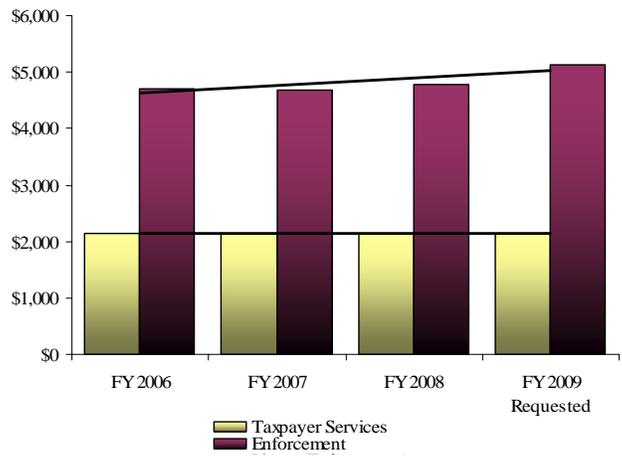
Databases found with default or blank passwords during the scans included those that contained personally identifiable tax information. Malicious users can exploit accounts with default or blank passwords to steal taxpayer identities and carry out fraud schemes.

TIGTA made several recommendations, including ensuring that security training is provided to employees with key security responsibilities and improving the process for identifying and correcting accounts with blank or default passwords by expanding the scanning criteria. IRS management agreed with all of the recommendations in the report and plans to take appropriate corrective actions.

**Improve Taxpayer Service**

Since the late 1990s, the IRS has increased its delivery of quality customer service to taxpayers. The first goal in the IRS’s current strategic plan is to improve taxpayer service. However, since the late 1990s, the IRS has allocated more resources to its collection, examination, and criminal investigation functions and fewer resources to taxpayer service functions. See Figure 3 for a comparison of funding for taxpayer service and enforcement since Fiscal Year 2006.

**Figure 3: Comparison of the Taxpayer Service and Enforcement Appropriations (in millions)**



Source: TIGTA analysis of IRS budgets.

As a result of this resource shift and other factors, in July 2005, Congress requested that the IRS develop a five-year plan, including an outline of which services the IRS should provide and how it will improve services for taxpayers. The IRS developed the plan, the Taxpayer Assistance Blueprint, in two phases.

The IRS is already facing challenges with its Blueprint. For the Phase I report, the conclusions and strategic improvement themes were valid; however, not all

information was accurate or consistent.<sup>14</sup> Given the importance of this plan as the IRS moves forward, inaccuracies and inconsistencies will put the plan at risk of improperly aligning service content, delivery, and resources with taxpayer and partner expectations. In Fiscal Year 2007, the IRS issued its Taxpayer Assistance Blueprint Phase 2 report that details the research and analyses efforts of the IRS and outlines the Blueprint Strategic Plan for taxpayer services. The Phase 2 report contains information from over 100 data sources and represents the first large-scale effort to attempt to collect data specific to Taxpayer Assistance Center customers. In February 2008, TIGTA reported that the data in the Phase 2 report was for the most part accurate.<sup>15</sup>

A second review of the Phase 2 report focused on the Taxpayer Assistance Center<sup>16</sup> Geographic Footprint – the IRS’s step-by-step process for future decisions regarding Taxpayer Assistance Center locations – and found that inaccurate and incomplete management information continues to delay its implementation.<sup>17</sup> The IRS has yet to determine the optimum locations for the Taxpayer Assistance Centers and which taxpayers they most effectively serve. Additionally, of the 41 criteria used for the Taxpayer Assistance Center Geographic Blueprint, 19 (46 percent) contained inaccurate or incomplete data. Without accurate and complete data, the IRS cannot measure the effectiveness of the Taxpayer Assistance Center Program or determine where to best offer its face-to-face services.

The IRS is also still unable to measure how closing Taxpayer Assistance Centers might affect taxpayers and compliance. The IRS does not have the means to capture all interactions between a Taxpayer Assistance Center employee and a taxpayer to determine why the taxpayer visited the Taxpayer Assistance Center, what service he or she received, and, most importantly, the effect the service or action had on the taxpayer’s future compliance.

The President’s Fiscal Year 2009 budget request for the Taxpayer Service Program is \$2.15 billion. The Fiscal Year 2009 funding for the direct appropriation maintains the Fiscal Year 2008 enacted level. The Operations Support budget provides an additional \$1.5 billion to support taxpayer services.

- Fiscal Year 2009 program decreases include funds provided in the Fiscal Year 2008 enacted. Specifically, \$31 million is being used for long-term investments that would not be duplicated in 2009, and \$8 million from the Community Volunteer Income Tax Assistance (VITA) Matching Grant Program that was provided in Fiscal Year 2008 and is still available through Fiscal Year 2009.

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<sup>14</sup> *The Strategic Improvement Themes in the Taxpayer Assistance Blueprint Phase I Report Appear to Be Sound; However, There Were Some Inaccurate Data in the Report* (Reference Number 2007-40-078, dated March 18, 2007).

<sup>15</sup> *The Taxpayer Assistance Blueprint Phase 2 Was Generally Reliable, but Oversight of the Survey Design Needs Improvement* (Reference Number 2008-40-059, dated February 5, 2008).

<sup>16</sup> Taxpayer Assistance Centers are walk-in sites where taxpayers can receive answers to account and tax law questions, as well as assistance in preparing their tax returns.

<sup>17</sup> *Inaccurate and Incomplete Data Has Adversely Affected the Implementation of the Taxpayer Assistance Center Geographic Footprint* (Audit # 200740042), Draft issued March 20, 2008.

- Fiscal Year 2009 increases include an additional 426 Full-Time Equivalents and \$14.8 million to fully fund postal costs.

The budget request does not include funding to support any taxpayer service initiatives that increase its 2009 request over the 2008 enacted amount. The IRS has expended considerable resources to develop the Blueprint and many of its initiatives would provide its customers with the same services currently available to them from private financial organizations. Most of the Blueprint initiatives have not been funded. The IRS must continue to find out what assistance taxpayers want and need, and ensure that the Blueprint Strategy Plan is effectively implemented.

The IRS is implementing a new matching grant program for the Community VITA Grant Program with \$8 million in Fiscal Year 2008 funding. The IRS's Volunteer Program, including the VITA and the Tax Counseling for the Elderly Programs,<sup>18</sup> plays an increasingly important role in the IRS's efforts to improve taxpayer service and facilitate participation in the tax system. TIGTA recently reviewed the Tax Counseling for the Elderly Program and found that it has not been effectively administered. The IRS does not have effective controls or monitoring processes to ensure that funds are appropriately spent, and management information is not sufficient to provide adequate oversight for the program. The IRS is using TIGTA's audit results to develop the VITA grant program.<sup>19</sup>

### **Enhance Enforcement of Tax Laws**

A compelling challenge confronting the IRS is tax compliance. Tax compliance initiatives include the administration of tax regulations, collection of the correct amount of tax for businesses and individuals, and oversight of tax-exempt and government entities. Late in Fiscal Year 2007, the Department of the Treasury and the IRS issued a report on improving voluntary compliance.<sup>20</sup> The report outlines steps that the IRS plans to take to increase voluntary compliance and reduce the tax gap.

The Fiscal Year 2009 IRS budget request seeks nearly \$361 million in program increases for IRS enforcement initiatives, which account for 77 percent of the agency's overall funding increase of \$469 million. Part of the enforcement initiative funding is intended to hire 3,057 new IRS Enforcement and Operations Support employees who are expected to help generate over \$2 billion<sup>21</sup> in additional annual enforcement revenue, once the new hires reach full potential in Fiscal Year 2011. The \$361 million increase is split between three appropriation accounts: Enforcement (\$261 million), Operations Support (\$97 million), and Taxpayer Services (nearly \$3 million). Many of the same or similar enforcement proposals described in the Fiscal Year 2009 budget request were

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<sup>18</sup> The Tax Counseling for the Elderly Program is a grant program that provides free tax help to people age 60 and older using grants appropriated. The Tax Counseling for the Elderly Program appropriation was \$3.95 million for each of Fiscal Years 2005 through 2007 and \$3 million in Fiscal Year 2008.

<sup>19</sup> *Oversight and Administration of the Tax Counseling for the Elderly Program Need Improvement* (Audit # 200740041), Draft Report issued March 10, 2008.

<sup>20</sup> Internal Revenue Service, U.S. Department of the Treasury, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (2007).

<sup>21</sup> Amount does not include annual \$3.6 billion expected from legislative proposals.

included in the Fiscal Year 2008 IRS budget request but not funded by Congress in the final appropriations bill, the Consolidated Appropriation Act of 2008.<sup>22</sup> The programs included in the enforcement initiatives in the Fiscal Year 2009 IRS budget request are shown in Figure 4:

**Figure 4: Enforcement Initiative Programs in Fiscal Year 2009 IRS Budget Request**

<b>Program</b>	<b>Cost (Millions)</b>	<b>Expected Revenue Fiscal Year 2011 (Millions)</b>	<b>Staffing Increase (Full-Time Equivalents)</b>	<b>Included in Fiscal Year 2008 IRS Budget Request</b>
Reduce the tax gap for small business/self-employed taxpayers	\$168.5	\$981	1,608	Yes
Reduce the tax gap for large businesses	69.5	544	519	Yes
Improve tax gap estimates, measurement and detection of non-compliance	51.1	16	393	Yes
Increase reporting compliance of U.S. taxpayers with offshore activity	13.7	102	124	No
Expand document matching	35.1	359	413	Yes
Implement legislative proposals to improve compliance	23.0	3,600	0	Yes
<b>Totals</b>	<b>\$360.9</b>	<b>\$5,602</b>	<b>3,057</b>	

*Source: TIGTA analysis of Fiscal Year 2008 and Fiscal Year 2009 IRS Budget Requests.*

### **Addressing the Tax Gap**

Tax compliance initiatives include administering tax regulations, collecting the correct amount of tax for businesses and individuals, and overseeing tax-exempt and government entities for compliance. Increasing voluntary compliance and reducing the tax gap are currently the focus of many IRS initiatives. Nevertheless, the IRS is facing significant challenges in obtaining more complete and timely data, and developing the methods necessary for interpreting the data. The IRS must continue to seek accurate measures for the various components of the tax gap and the effectiveness of the actions taken to reduce it. Broader strategies and better research are needed to determine what actions are most effective in addressing non-compliance.

#### *Unreported Self-Employment Taxes Contribute to the Tax Gap*

According to the GAO, outlays from the main trust funds of the Social Security and Medicare programs are projected to exceed revenues in the next decade. As the tax collector for these programs, the IRS must ensure that self-employed taxpayers meet their

<sup>22</sup> Consolidated Appropriation Act of 2008, Public Law 110-161.

tax responsibilities by assessing and collecting the proper amount of self-employment taxes. Self-employment tax is estimated to make up about \$39 billion (72 percent) of underreported employment taxes, or 11 percent of the total gross tax gap, making it one of the largest components of the tax gap.

TIGTA's Fiscal Year 2007 review of the self-employment tax found that IRS procedures were inconsistent for identifying Form 1040 reporting income on line 21 that is potentially subject to the self-employment tax.<sup>23</sup> Also, there was a significant problem with assigning an audit code to tax returns with potentially unreported self-employment taxes.

TIGTA recommended that the IRS: (1) improve processing of those tax returns with potential self-employment tax liabilities and provide additional training to tax examiners; (2) strengthen reviews of tax returns for potential unpaid self-employment taxes; and (3) reconsider the decision to cancel TIGTA's previous recommendation to immediately work significant unreported self-employment tax cases with refunds available and no response or an inadequate response to any letter issued by the IRS.

IRS management agreed with the first two recommendations and disagreed with the third. The IRS planned to explore the possibility of expanding existing returns processing training material issued in January 2008. However, IRS management stated that the parameters could not be accurately identified to ensure that the IRS would not be withholding the refunds of taxpayers who were not subject to self-employment taxes. Based on the findings of this and previous audits, TIGTA maintained that it was feasible for the IRS to begin examining the tax returns of taxpayers who appear to owe a significant amount of self-employment tax, have an available refund, and have not responded to contact letters from the IRS.

#### *Schedule C Hobby Losses Contribute to the Tax Gap*

About 1.5 million taxpayers, many with significant income from other sources, filed Form 1040 Schedules C (Profit or Loss From Business) showing no profits, only losses, over four Tax Years 2002 – 2005; 73 percent were assisted by tax practitioners. By claiming these losses to reduce their taxable incomes, about 1.2 million of the 1.5 million taxpayers potentially avoided paying \$2.8 billion in taxes in Tax Year 2005. Changes are needed to prevent taxpayers from continually deducting losses in potential not-for-profit activities to reduce their tax liabilities.

The "hobby loss" provision and related regulations do not establish specific criteria for the IRS to use in determining whether a Schedule C loss is a legitimate business expense without conducting a full examination of an individual's books and records.<sup>24</sup> The purpose of the hobby loss provision was to limit the ability of wealthy individuals with multiple sources of income to apply losses incurred in "side-line" diversions to reduce their overall tax liabilities. TIGTA reported in September 2007 that

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<sup>23</sup> *Identification of Unreported Self-Employment Taxes Can Be Improved* (Reference Number 2008-30-001, dated October 11, 2007).

<sup>24</sup> Internal Revenue Code Section 183 (Activities not engaged in for profit); related Treasury Regulation Section 1.183-1.

332,615 high-income taxpayers received the greatest benefit by potentially avoiding approximately \$1.9 billion in taxes for Tax Year 2005.<sup>25</sup>

The law does not require a taxpayer to have a reasonable expectation of profit; rather, the taxpayer needs only the “objective” of making a profit. Internal Revenue Code (I.R.C.) §183 makes it difficult for the IRS to efficiently administer tax law that ensures taxpayers are not deducting not-for-profit losses to reduce their taxes on other incomes year after year.

TIGTA recommended that the IRS provide a copy of the report to the Department of the Treasury, Office of Tax Policy, to consider legislative changes to I.R.C. § 183. The proposal should include establishing a clearly defined standard or bright-line rule for determining whether an activity is a business or a not-for-profit activity. Due to the large number of these tax returns being prepared by tax practitioners, TIGTA also recommended that the IRS continue coordinating with practitioner organizations to encourage compliance with existing provisions.

In their response to the report, IRS officials stated that they agreed with the recommendations and planned to take appropriate corrective actions. The IRS plans to coordinate with the Office of Legislative Affairs to forward a copy of the final report to the Department of the Treasury, Office of Tax Policy, and to include key messages and talking points about I.R.C. §183 tax obligations as a Fiscal Year 2008 outreach initiative directed to practitioner organizations.

### **Legislative Proposals**

The Fiscal Year 2009 IRS Budget Request includes 16 legislative proposals – 13 submitted in prior budget requests – that are expected to generate \$36 billion in additional tax over 10 years as a result of improving tax compliance and administration. Of the 13 proposals in prior budget requests, 12 await some form of congressional action. Many of these proposals also represent a significant part of the IRS strategy to improve tax compliance and reduce the tax gap described in the IRS’s August 2, 2007, report, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*.

### **2008 Filing Season**

The 2008 Filing Season appears to be progressing without major problems. As of March 29, 2008, the IRS reported that it had received approximately 86.8 million tax returns. Of those, approximately 62.2 million were filed electronically (e-filed) (an increase of 9.3 percent from this time in 2007), and approximately 24.6 million were filed on paper (an increase of 4.8 percent from this time in 2007). Additionally, nearly 69.8 million refunds totaling approximately \$172 billion had been issued. Of these, 50.8 million (73 percent of all refunds) were directly deposited to taxpayer bank accounts, an increase of 7.3 percent compared to 2007.

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<sup>25</sup> *Significant Challenges Exist in Determining Whether Taxpayers With Schedule C Losses Are Engaged in Tax Abuse* (Reference Number 2007-30-173, dated September 7, 2007).

Use of the IRS's free online filing program had been declining in prior years. However, based on the current volume, it appears that taxpayers are increasingly taking advantage of this option, as the number has increased by 17.4 percent from 2007. Additionally, the number of taxpayers who e-file from their home computers increased by 17.3 percent this filing season.

So far this filing season, over 2 million tax returns have been prepared by volunteers, an increase of 22 percent over the 2007 Filing Season. TIGTA's accuracy rate at the Volunteer Program sites has improved from 56 percent last year to 67 percent this year. The IRS is reporting a 76 percent accuracy rate. Volunteers are doing a better job using the tools and information available when preparing tax returns.

As of March 29, 2008, use of IRS.gov is up over 19 percent, with almost 122 million visits to the Web site. Nearly 26 million taxpayers went to IRS.gov to obtain their refund information via the "Where's My Refund?" option, a 19.7 percent increase over the same time period last year.

Additionally, calls to the toll-free assistance lines are up from the 2007 Filing Season and the Level of Service<sup>26</sup> is lower, primarily because taxpayers are calling about the stimulus payments. The IRS had planned to provide an 82 percent Level of Service for Fiscal Year 2008, but has projected that the Level of Service could be as low as 74 percent. For the 2008 Filing Season (as of March 29, 2008), the IRS had already answered about 112 percent of the planned 10.9 million assistor-answered calls. Its 80 percent Level of Service is 4.5 points lower than the actual 2007 Filing Season Level of Service of 84.5 percent. Additionally, the IRS had planned to answer 14.8 million automated calls but has answered 16.1 million automated calls.

### **Economic Stimulus Act of 2008<sup>27</sup>**

In keeping with the intent of the Economic Stimulus Act of 2008, the IRS expects to issue more than \$100 billion in stimulus payments (often referred to as rebates) and is trying to ensure that everyone who is entitled to a rebate knows what to do to receive it. The IRS sent Economic Stimulus Payment Notices (Notice 1377) to more than 130 million taxpayers who filed a Tax Year 2006 income tax return. Beginning in May, an additional notice will be mailed to those taxpayers eligible for the payments to explain the payment amount and how it was calculated. The IRS believes it will receive significantly fewer calls to its toll-free telephone information line as a result of issuing the advance notices.

As of March 28, 2008, the IRS had received an estimated 1.4 million tax returns from individuals who filed them solely to receive the rebates. Because these are tax returns that would generally not be filed, the normal IRS refund controls are not designed for this situation. The IRS is evaluating alternatives to identify any of these tax returns that are fraudulent so it can prevent any associated fraudulent stimulus payments.

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<sup>26</sup> The Level of Service is the primary measure of service to taxpayers. It is the relative success rate of taxpayers who call for services on the IRS toll-free telephone lines.

<sup>27</sup> Economic Stimulus Act of 2008, Pub. L. No. 110-185 (2008).

TIGTA is currently evaluating the controls over the processing of these tax returns and monitoring their volume and effect on the 2008 Filing Season.

Since the Economic Stimulus Act of 2008 was enacted, the IRS has been receiving an average of more than 63,000 calls per day above normal volume to its toll-free telephone lines related to the upcoming rebates. The IRS is using over 1,000 Automated Collection System<sup>28</sup> telephone assistants to take rebate telephone calls during their regular tours of duty and has also trained more than 500 tax examiners and assistants who normally work taxpayer correspondence and paper casework to answer general rebate calls.

The IRS stopped the issuance of Automated Collection System enforcement tools (systemic notices and letters were stopped on February 22 and systemic levies were stopped on February 29). However, issuance of regular delinquency notices on accounts not yet assigned to the Automated Collection System has not been stopped, and the IRS expects to reserve 40 percent to 50 percent of the available Automated Collection System staff to answer calls from taxpayers who respond to these notices. The IRS plans to restart the notices when telephone demand decreases. The IRS reports that the foregone revenue associated with these actions could be as high as \$666 million.

### **Treasury Inspector General for Tax Administration Fiscal Year 2009 Budget Request**

TIGTA was created by Congress to provide independent oversight of the IRS. TIGTA's audits and investigations protect and promote the fair administration of the nation's tax system. Responsibilities include ensuring that the IRS is accountable for more than \$2 trillion in tax revenue received each year. Audit recommendations aim to improve IRS's systems and operations while maintaining fair and equitable treatment of taxpayers. Investigations are focused on IRS employee misconduct and infrastructure security, as well as external attempts to corrupt Federal tax administration.

TIGTA's Office of Audit (OA) conducts audits that advise Congress, the Secretary of the Treasury, and IRS management of high-risk issues, problems, and deficiencies related to the administration of IRS programs and operations. Audits not only focus on the economy and efficiency of IRS functions but also ensure that taxpayers' rights are protected and the taxpaying public is adequately served. Overall, as of March 31, 2008, audit reports potentially produced financial accomplishments of \$172.5 million, and potentially impacted approximately 1,217,000 taxpayer accounts in areas such as taxpayer burden, rights, and entitlements. OA develops an annual audit plan that communicates oversight priorities to Congress, the Department of the Treasury, and the IRS. Emphasis is placed on mandatory coverage imposed by the IRS

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<sup>28</sup> The Automated Collection System is an integral part of the IRS process for collecting unpaid taxes and securing unfiled tax returns from both individual and business taxpayers. When taxpayers do not comply with the IRS's computer-generated notices, Automated Collection System tax examiners attempt to contact them by telephone to secure payments or unfiled returns. The Automated Collection System is the computer system that assigns these cases to the individual tax examiners.

Restructuring and Reform Act of 1998<sup>29</sup> and other statutory authorities, as well as issues impacting computer security, taxpayer rights and privacy, and financial-related audits. OA's work focuses on the IRS's major management challenges, the progress in achieving its strategic goals, the elimination of the IRS's systemic weaknesses, and the IRS's response to the President's Management Agenda initiatives.

TIGTA's Office of Investigations (OI) conducts investigations that protect the integrity of IRS employees, contractors, and other tax professionals; provides for infrastructure security; and protects from external attempts to threaten or corrupt the administration of Federal tax laws.

TIGTA's OI investigates employee misconduct involving unauthorized access (UNAX) of confidential taxpayer records, theft, false statements, financial fraud, taxpayer abuses, and extortion.

OI assists in maintaining IRS employee and infrastructure security by investigating incidents of threats or assaults made against IRS employees, facilities, and data infrastructure. As mentioned previously, the IRS's Fiscal Year 2009 budget request seeks a 7.1 percent increase in its enforcement appropriation. This continued focus on enforcement has resulted in OI receiving higher levels of reported assaults and threats against IRS personnel. Additionally, the IRS's increasing reliance on electronic processes has resulted in an increased need for OI to investigate and respond to cyber attacks.

TIGTA also investigates allegations involving external attempts to corrupt tax administration, such as bribes offered by taxpayers to compromise IRS employees, the use of fraudulent IRS documentation to commit crimes, taxpayer abuse and misconduct by tax practitioners, impersonation of IRS employees, and the corruption of IRS programs through procurement fraud.

TIGTA faces major human capital challenges in delivering and adapting its oversight activities to the increasingly complex and high-risk issues associated with IRS operations. Some of these issues include detection and investigation of fraud and electronic crime, procurement activities, taxpayer privacy, and an increasing number of requests for IRS program reviews from Congress and other IRS stakeholders. While adapting to this changing environment, approximately 37 percent of TIGTA employees are eligible for retirement by Fiscal Year 2011.

Additionally, in order to accomplish its mission, TIGTA employees need to possess the appropriate skills. As the IRS continues to modernize and operate in an automated environment, it is essential that TIGTA auditors and investigators are appropriately trained to operate in this environment.

To help address these challenges, TIGTA has initiated or is initiating the following actions in Fiscal Year 2008:

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<sup>29</sup> Pub. L. No. 105-206, 112 Stat. 685 (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.).

- Created the Office of Inspections and Evaluations whose mission is to provide TIGTA with additional flexibility, capacity and capability to provide value-added products and services to improve tax administration and promote good government. This function was created and staffed by a realignment of existing resources.
- Implementing a bureau-wide electronic learning management system containing a skills assessment program that identifies the critical skills needed for each of TIGTA's major occupations and provides a means to assess resident skill levels. Based on the results, TIGTA will develop a strategic recruitment program to fill critical vacancies with the skills necessary to carry out its increasingly complex oversight activities and align future hiring in critical geographic areas.
- Building its first Senior Executive Service Candidate Development Program. The objective of the program is to promote a greater understanding of the mission and culture of the Federal Government and to train outstanding leaders and prepare them for the Senior Executive Service.

Mr. Chairman, as you requested, I will discuss TIGTA's 2009 budget needs. From Fiscal Year 2001 to Fiscal Year 2007, TIGTA's labor expenses have grown 20 percent from \$88 million to \$106.3 million, despite a substantial reduction in Full-Time Equivalents (a decrease of 16 percent from 938 to 792). Labor costs currently account for 80 percent of TIGTA's annual budget. As the number of TIGTA employees covered under the more expensive Federal Employees Retirement System increases, labor costs will continue to rise, reducing the funds available to TIGTA for non-labor spending.

Since Fiscal Year 2001, TIGTA has only been able to meet its financial obligations through Full-Time Equivalent losses and implementation of cost-cutting initiatives in non-labor expense categories. From Fiscal Year 2001 to Fiscal Year 2007, non-labor spending (such as training, travel, equipment, etc.) fell 9 percent from \$19.5 million to \$17.7 million. These costs currently consume 13 percent of TIGTA's annual budget.

The Fiscal Year 2009 President's budget request for TIGTA will be used to continue to provide critical audit and investigative services, ensuring the integrity of tax administration on behalf of the nation's taxpayers. While there are a number of critical areas in which TIGTA will provide oversight, highlights of TIGTA's investigative and audit priorities include:

- Adapting to the IRS's continually evolving operations and mitigating intensified risks associated with modernization;
- Addressing the tax gap and enforcement efforts;
- Responding to threats and attacks against IRS employees, property, and sensitive information;
- Improving the integrity of IRS operations by detecting and deterring fraud, waste, abuse or misconduct by IRS employees;

- Conducting comprehensive audits, inspections, and evaluations that include recommendations for cost savings and enhancing the IRS's service to taxpayers; and,
- Informing Congress and the Secretary of the Treasury of problems and progress made to resolve identified issues.

The total resources needed in Fiscal Year 2009 to support TIGTA's mission are \$146,636,000, including \$145,736,000 from direct appropriations and approximately \$900,000 from reimbursable agreements. This is a \$5.2 million (3.7 percent) increase over the Fiscal Year 2008 spending authority compared with the IRS's 4.3 percent increase.

I hope my discussion of the continuing challenges that face the IRS and TIGTA will assist you as you consider the Fiscal Year 2009 budget. Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to share my views.