

Statement of Nancy Killefer, Chair, Internal Revenue Service Oversight Board

Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means

March 30, 2004

Hearing on 2004 Tax Return Filing Season and the IRS Budget for Fiscal Year 2005

Introduction

Mr. Chairman, thank you for the opportunity to testify before the House Ways and Means Subcommittee on Oversight. The Internal Revenue Service (IRS) Oversight Board is required by 26 U.S.C. Section 7802(d) to review and approve the budget request prepared by the IRS, submit a request to Treasury, and ensure that the approved budget supports the annual and long-range strategic plans of the IRS.

This year, the IRS drafted a special report presenting its recommended FY2005 IRS budget, comparing it to the Administration's request, and explaining why the Board believes its recommended budget is needed to support the annual and long-term needs of the IRS. My testimony today will discuss that report. The complete version is available on the Board's web site at www.irsoversightboard.treas.gov.

The IRS Oversight Board Budget Recommendation

Mr. Chairman, the IRS budget is more than dollars and cents. It represents the choices that we as a nation make about the future of our tax administration system and how we help over 100 million American taxpayers deal with an increasingly complex tax code while ensuring that everyone pays his or her fair share of taxes.

The IRS Oversight Board acknowledges that the IRS's budget has increased in each year of President Bush's Administration, and that the Administration's request for FY2005 is significant against other non-defense, non-homeland security discretionary funding. That commitment is commendable, and the Board recognizes and thanks Secretary Snow for his efforts, especially at a time when the nation must balance many important and competing priorities.

However, the Board believes that now is a critical time for our tax system to be strengthened, not merely maintained at current levels. Enforcement activities are still at unacceptable levels. Our nation's tax gap is estimated at \$311 billion,¹ leaving billions of dollars on the table simply because the IRS does not have the resources to do its job.²

The Board's own research shows that each year, more Americans believe it is acceptable to cheat on their taxes. At the same time, our already complex tax code continues to be a changing, tangled mystery to most honest taxpayers — and an asset to those intent on skirting the law. Every effort must be made to provide quality service to honest taxpayers who want to comply with the law.

In crafting its FY2005 budget for the IRS, the Board addressed these concerns head on by reinvesting in the IRS to produce tangible benefits and results for America's taxpayers and our nation. It is a sensible and pragmatic budget that reflects the real world in which the IRS must operate and be funded.

The Board recommends a 10 percent increase in funding from FY2004 to \$11.204 billion, with a significant increase of 3,315 full-time equivalents (FTEs) to boost enforcement efforts. If enacted, the Board's budget would increase our nation's revenue by approximately \$5 billion each year once the IRS has hired and trained additional enforcement personnel.³

Under the Board's budget, the IRS would have the additional resources to:

- Close over an additional 1,000 cases involving high risk/high-income taxpayers and promoters who avoid paying income taxes by using offshore credit cards and abusive trusts and shelters.
- Boost audit rates by 42 percent from FY2004 to examine companies that use aggressive tax avoidance tactics, such as offshore transactions and flow-through entities.
- Contact an additional 200,000 taxpayers who fail to file or pay taxes due; a 40 percent boost from FY2004 and a 27 percent increase from the Administration's request. This alone will allow the IRS to collect \$84 million more in revenue owed than the Administration's request would allow.
- Sustain the one-on-one assistance that millions of Americans rely on at tax time. The Board's budget will ensure that the IRS will be able to maintain its improved service to taxpayers by answering eight out of ten phone calls.

IRS Must Stay the Course on Customer Service

Mr. Chairman, the vast majority of Americans want to file their returns and pay their fair share, yet our nation's tax code continues to become more complex. Resources must be available so the IRS can answer taxpayers' questions and promptly and accurately, whether it is over the phone, through the IRS web site, by mail, or at walk-in center.

Under the board's proposed budget, customer service funding will remain at about the same level as FY2004; however, service should improve due to the deployment of self-service technology.

For taxpayers, that means eight out of ten phone calls will be answered. For tax practitioners calling the IRS toll-free hotline to resolve problems regarding clients' accounts, hold-time will remain at current levels.

The IRS call-routing systems as well as web-site applications that allow

taxpayers to check the status of their tax refunds have already shown dramatic benefits in speeding service to taxpayers. New systems, such as e-Services, will soon be available, providing additional automated services to tax practitioners.

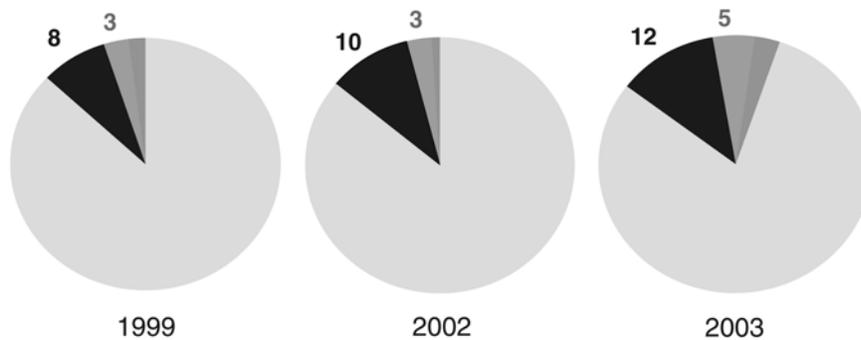
Clearly, service to taxpayers has improved in the past five years. Such improvements make it all the more imperative that we sustain them and not allow this positive trend to languish, or worse, decline. The agency must stay the course.

Days of “Outmanned and Outgunned IRS Must End

The IRS is doing a better job of identifying egregious noncompliance — now it needs the resources to fight back. In the past two years, the IRS sharpened its compliance focus to identify and pursue promoters and participants of abusive tax shelters and tax evasion schemes. For example, the agency is now targeting its resources on promoters of illegal tax schemes that are often marketed to high-income individuals, but are also finding their way to middle-market businesses.

Despite this focus, enforcement activities are still at an unacceptable level simply because the IRS does not have the resources needed to accomplish its mission. It continues to be outmanned and outgunned. In FY2003, the agency was able to pursue

only 18 percent of known cases of abusive devices designed to hide income, leaving an estimated \$447 million uncollected.⁴



How much, if any, do you think is an acceptable amount to cheat on your income taxes?

- Not at all
- A little here and there
- As much as possible
- Don't know/NA

Tax Cheating: Alarming Trends

Public attitudes towards tax cheating show some alarming trends, particularly among young Americans. The Board’s 2003 Survey on Taxpayer Attitudes found that support for total tax compliance diminished by four points over the previous year to 81 percent. In other

words, nearly one out of five Americans now believe that it is acceptable to cheat at least a little on their taxes. Almost one-third (30%) of young adults age 18-24 are among those most likely to feel that any amount of cheating is acceptable, an increase of six points since last year. Yet ironically, “fear of being audited” has the greatest

impact on these non-compliers at a time when actually being audited is near historic lows.⁵

The IRS must prove to the public that it can and will identify and pursue those who show contempt for the tax code. The Board's proposed budget allows the IRS to begin to reverse this disturbing trend.

The Board's recommendation would increase our nation's revenue by almost \$5 billion each year once the IRS has hired and trained additional enforcement personnel. The Board believes the additional revenue achieved makes a strong business case for the recommended additional enforcement resources. While this is a modest boost in closing our compliance gap, it will also send a message to those contemplating tax avoidance: the IRS' hands are no longer tied.

Modernization Critical to Tax Administration

In December 2003, the Oversight Board released an independent analysis of the IRS Business Systems Modernization (BSM) program. The Board called for nine specific recommendations for turning around the critical but troubled program that has experienced significant and unacceptable delays and cost overruns.

However, the Board still believes that the overall Modernization plan is sound and well-designed. Moreover, it is critical to the future of tax administration. As a nation, we must remain committed to the IRS' computer modernization program. The Board testified before the House Ways & Means Subcommittee on Oversight on Feb 12, 2004:

The IRS Oversight Board firmly believes that the IRS Modernization program cannot be allowed to fail. The IRS cannot continue to operate with the outmoded and inefficient systems and processes it uses today. Over time, the existing systems will become impossible to maintain and at that point, the ability to administer our country's tax system will be in grave danger. Such a risk to our nation is unacceptable. We remain convinced that the overall Modernization plan is sound and well-designed. The challenge is executing that plan. The IRS and the Prime must get it right this time.⁶

The Board's proposed budget provides the stable resources needed to focus and stabilize the steady stream of funding for the IRS' computer modernization initiative. Special controls are in place to ensure that no funding in this account is spent until the IRS has the capability to spend it effectively. If the IRS does not correct the weaknesses in the BSM program by FY2005, the Board advocates that the funds earmarked for modernization should not be spent. However, the Board does not believe the IRS should plan for failure. The agency must be poised to move forward with BSM once it has demonstrated that it has corrected the program's weaknesses. The funding level recommended by the Board sets the foundation for genuine progress for the program in FY2005.

The Board expects that the Customer Account Data Engine (CADE) Release 1 will occur in 2004. Over the next year, the IRS will test and build upon that system. The IRS should continue to strengthen its ability to manage the program and the Prime to deliver projects on budget and on time. By the end of FY2005 and early FY2006, the IRS should be able to proceed with the remaining releases of CADE as quickly as possible. This will minimize future risk and the long-term cost of modernization while providing a basis to deliver tangible results for taxpayers.

If the IRS' FY2005 BSM funding is reduced to \$285 million, as it is in the Administration's budget, future funding likely will be adversely affected. If that happens, the projects will drag on, risk will increase, and ultimately, the program will cost taxpayers much more.

For that reason, the Board believes FY2005 BSM funding should be set at \$400 million, with only \$285 million put into the FY2005 spend plan. This will allow the IRS' Business Systems Modernization fund to operate like a multi-year fund, as originally envisioned by Congress and as the Board has recommended each year since its inception.

Further, as its archaic, tape-based computers begin to give way to modern business systems, the IRS must plan for a smooth transition. The Board's budget recognizes that need. As new systems are incorporated, the IRS must plan to operate both the old and new systems in parallel for some time. The IRS must also retain employees with critical skills while training existing and new employees to use new systems. This will allow the IRS to reduce the risk of a catastrophic disruption to the system.

In addition, the Board believes that the transition to modernization is a real cost that must be incurred. There are no short cuts to successful modernization — the IRS' budget must reflect the real cost of maintaining legacy systems while simultaneously supporting modernized systems. Accordingly, the Board recommends an additional \$25 million to cover these costs. The Administration's budget fails to acknowledge them.

The Administration's FY2005 Budget Request

By comparison, the Board believes the Administration's FY2005 budget cannot achieve its stated goal to add almost 2,000 personnel to bolster the IRS' enforcement efforts, and will threaten hard-earned improvements in customer service. This year's request will lead to a \$230 million shortfall in the IRS budget because it fails to budget adequately for the anticipated \$130 million of congressionally-mandated civilian pay raises, rent increases, and at least \$100 million of unfunded expenses.

In its FY2005 budget recommendation, the Board anticipates a 3.5 percent pay raise for civilian employees, which achieves parity with the Administration's call for a 3.5 percent military pay raise. The Administration, but contrast, calls for a 1.5 percent civilian pay raise. While discussions are now underway in Congress regarding parity, the Board believes that the 1.5 percent civilian pay increase fails to recognize recent history.

In fact, FY2005 is the fourth year in a row in which the Administration has called for IRS staff increases, while not covering pay raises or required expenses.

As a result, the Administration's proposed increase in the IRS' FY2005 budget will erode before new employees can be hired, more taxpayer phone calls can be answered, or new audits of possible tax cheats can be conducted.

Impact of \$230 Million Budget Shortfall on Three Major IRS Functions

Function	Performance Measure	FY2005 performance goal	Revised goal after \$230M cut
Field Collection	# of tax delinquent account cases resolved	981,000	463,000
Toll-free Telephone Level of Service	Calls answered	32 million	17 million
Field Exam	Exams of individual taxpayers <\$100K AGI	118,840	73,000

Board Cites Complexity as Fundamental Flaw

The IRS Oversight Board is precluded by law from addressing tax policy issues, but it would be remiss not to address the cost of our nation's complex tax system; a cost ultimately borne by taxpayers and the IRS. The Administration's legislative proposals contained in its budget request only begin to address the problems caused by complexity. The approach so far to tax simplification fails to address a fundamental flaw in our tax system: its costly, confusing, and debilitating complexity. The Administration has, however, requested that Congress provide some relief in FY2005 on the Alternative Minimum Tax, but has not yet identified a long-term solution.⁷ In her annual report, IRS National Taxpayer Advocate Nina Olson recommended repeal of the AMT, saying:

The AMT is extremely and unnecessarily complex and results in inconsistent and unintended impact on taxpayers....[T]he AMT is bad policy, and its repeal would simplify the Internal Revenue Code, provide more uniform treatment for all taxpayers, and eliminate the oddity of dual tax systems. AMT repeal would also allow the IRS to realign compliance resources to facilitate more efficient overall administration of the tax code.⁸

The Board fully concurs with her assessment, and urges the Administration and Congress to consider accepting this recommendation in future legislation.

Conclusion

The Board was established to bring to bear its collective expertise and familiarity with private sector best practices on the IRS' problems. To the private-life Board members, investments in enforcement pay for themselves many times over, not only in revenue dollars but by the deterrence value of reinforcing the belief that all taxpayers are paying their fair share. A strong business case can be made for providing the IRS with several hundred million dollars so it can collect billions in revenue. At a time when federal revenue as a percentage of the economy has shrunk to 1950s levels and we face a \$500 billion deficit, the Board believes it imperative that we strengthen our tax collection system.

For that reason, the Board recommends that both Congress and the Administration reevaluate their methodology by including the revenue value to the country when estimating budget requests for the IRS. Indeed, considering the positive impact of additional resources provides a better framework for making informed decisions and will lead to a more effective IRS.

In conclusion, the Board calls for Congress to stay the course it set more than five years ago with the passage of the IRS Restructuring and Reform Act. The IRS has made progress in carrying out the spirit and letter of the Act; we must now give it the resources to finish the job.

**Attachment 1:
IRS Oversight Board FY2005 IRS Budget Recommendation and
Administration Request: Program Summary Comparison**

Administration FY2005 Budget Request Program Summary
(dollars in millions)

Appropriation Title	FY2004 Enacted	FY2005 OB request	Increase	
			\$millions	Percent
Processing, Administration and Management	\$4,009	\$4,148	\$139	3.5%
Tax Law Enforcement	\$4,171	\$4,564	\$393	9.4%
Information Systems	\$1,582	\$1,642	\$60	3.8%
Business Systems Modernization	\$388	\$285	-\$103	-26.5%
Health Insurance Tax Credit Administration	\$35	\$35	\$0	0.0%
Appropriation	\$10,185	\$10,674	\$490	4.8%

IRS Oversight Board FY2005 Budget Request Program Summary
(dollars in millions)

Appropriation Title	FY2004 Enacted	FY2005 OB request	Increase	
			\$millions	Percent
Processing, Administration and Management	\$4,009	\$4,291	\$282	7.0%
Tax Law Enforcement	\$4,171	\$4,770	\$598	14.3%
Information Systems	\$1,582	\$1,708	\$126	8.0%
Business Systems Modernization	\$388	\$400	\$12	3.1%
Health Insurance Tax Credit Administration	\$35	\$35	\$0	0.3%
Appropriation	\$10,185	\$11,204	\$1,019	10.0%

Attachment 2: Unfunded IRS Costs, FY2002-2003
(in millions, rounded)

Unfunded IRS Costs, FY2002-2004 (dollars in millions)			
Detail	FY 2002	FY 2003	FY2004
Labor Inflation			
Unfunded Pay Raise Increase (President's Request to Congressional Action)	\$42.3	\$128	
	\$42.30	\$128	
Non-Labor Inflation			
Rent Shortfall	\$32	\$54.0	
Postage	\$16	\$53.0	
Corporate & Electronic Contracts		\$23	
Health Service Contract	\$3	\$2	
Interpreter's Contract	\$0.5	\$0.3	
Child Care Subsidy	\$1		
Increased Department of Labor EFAST Contract Processing Costs	\$2		
	\$55	\$132.00	
Added Requirements			
Background Investigations		\$4	
Increase Cash Awards from 1.24% to 1.42%	\$8	\$16	
Competitive Sourcing		\$8	
Campus Security Response	\$15		
Congressional Mandates	\$5		
Guard Services	\$20	\$16	
Public Transportation Subsidy	\$9		
	\$56	\$44	
Total	\$153	\$304	
Total less pay raise and rent	\$79	\$122	

Attachment 3:
Where the Additional Enforcement Resources Are Applied
(in thousands rounded)

Enforcement Initiatives	Oversight Board Recommendation		Administration Recommendation		Difference	
	Budget	FTE	Budget	FTE	Budget	FTE
SBSE-2 Curb Egregious Non-Compliance	159,264	1,408	90,161	874	\$69,103	534
SBSE-3 Select High-Risk Cases for Examination	5,500	0	0	0	\$5,500	0
SBSE-7 Savings through Consolidation - Case Processing	16,085	200	14,469	144	\$1,616	56
SBSE-8 Savings through Consolidation - Insolvency Processing	7,656	69	5,531	65	\$2,125	4
WAGE-2 Increase Individual Taxpayer Compliance	46,406	521	15,469	175	\$30,937	346
WAGE-9 Improve ITIN Application Process	15,484	50	0	0	\$15,484	50
WAGE-10 Eliminate Erroneous EITC Payments	18,000	0	0	0	\$18,000	0
LMSB-1 Combat Corporate Abusive Tax Schemes	60,017	394	36,100	207	\$23,917	187
TEGE-1 Combat Diversion of Charitable Assets	3,914	44	3,914	44	\$0	0
TEGE-5 Stop Abusive Transactions in the TEGE Community	11,140	100	11,140	100	\$0	0
CI-1 Combat Financial Fraud in the Corporate Sector	25,600	98	25,600	98	\$0	0
CI-2 Dismantle International and Domestic Terrorist Financing	12,208	80	0	0	\$12,208	80
CI-3 Reinforce Core Mission Tax Enforcement Resources	34,086	130	34,086	130	\$0	0
CI-7 Forensic Electronic Evidence Acquisition and Analysis	3,104	4	3,104	4	\$0	0
CI-10 Leverage/Enhance Special Agent Productivity	2,500	28	2,500	28	\$0	0
APPEALS-1 Resolve Appeals	13,945	112	7,000	56	\$6,945	56
COUNSEL-1 Combat Abusive Tax Avoidance	10,852	75	5,426	38	\$5,426	37
NHQ-2 Deliver Strategic Compliance Data	2,712	2	0	0	\$2,712	2
FY2005 Enforcement Increases	448,472	3,315	254,500	1,963	\$193,972	1,352

Endnotes

¹ Nina Olson, National Taxpayer Advocate's 2003 Annual Report to Congress, (Washington, DC- December 31, 2003) p. 20-21. This is based on a July 2001 IRS Office of Research report.

² Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System (Washington, DC: September 2002), p. 16.

³ These estimates are based upon the projected revenue anticipated by hiring and training full-time employees who would audit or collect owed taxes in known cases of taxpayers who did not file or pay, or who substantially underreported their taxes, as described in former IRS Commissioner Charles O. Rossotti's Report to the IRS Oversight Board: Assessment of the IRS and the Tax System, p. 16.

⁴ Rossotti, p. 16.

⁵ Roper ASW, 2003 IRS Oversight Board Annual Survey on Taxpayer Attitudes, September 2003, p.17.

⁶ Larry R. Levitan, IRS Oversight Board Testimony before House Ways and Means Oversight Subcommittee Hearing on IRS BSM Program, February 10, 2004.

⁷ Recent public remarks by Treasury Secretary Bodman noted that the President's budget extends through 2005 the temporary increase in the AMT exemption and the provision that allows certain personal credits to offset the AMT. These temporary provisions will keep the number of taxpayers affected by the AMT from rising significantly in the near-term. More importantly, they will allow the Treasury Department the time necessary to develop a comprehensive set of proposals to deal with the AMT in the long-term. Treasury Press Release JS-1250 contains the full statement of his remarks.

⁸ Olson, p. 16.