WRITTEN TESTIMONY OF
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INTERNAL REVENUE
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SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT
ON
INTERNAL REVENUE SERVICE'S FY 2008 BUDGET
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Introduction

Chairman Durbin, Ranking Member Brownback, and members of the Subcommittee, thank you for the opportunity to testify today on the FY 2008 Budget Request for the Internal Revenue Service. I am accompanied this afternoon by Linda Stiff, IRSôs Deputy Commissioner for Operations and Support. She will assist me in responding to questions that Members of the Subcommittee may have.

Under the leadership of Commissioner Everson, our working equation at the IRS has been and continues to be that service plus enforcement equals compliance. A balanced program between service and enforcement leads to sound tax administration.

However, a balanced program can be successful only if the IRS is provided the resources necessary to fulfill its mission. Two years ago in the FY 2006 Budget, the Service was provided those resources when Congress approved the Presidentôs request for the IRS. This fiscal year, however, we were forced to operate under a Continuing Resolution (CR) for the first four months of the fiscal year until Congress approved the Joint Resolution (JR) in February.

I want to thank the Members of the Subcommittee for their efforts in increasing our level of funding in the JR over the levels proposed originally under a full year CR. As a result, we anticipate that there will be little or no negative impact on our taxpayer service, operations support, or our Business Systems Management (BSM) programs.

While our enforcement programs also fare much better under the JR, the increase is not sufficient to prevent some negative impacts. The JR provided $4.7 billion for enforcement, which is $55.4 million below the level requested by the President in his FY 2007 Budget request.

While we are attempting to partially offset this reduction through user fee receipts, this reduction increases the importance of providing full funding of our FY 2008 Budget request, which I will discuss later in my testimony.

Producing Results

The best case for full funding of the FY 2008 Budget can be made by looking at the results we achieved with the resources we do have. In FY 2006, we spent just 42 cents to collect each $100 of tax revenue, the third lowest figure in the last 25 years and down from 46 cents in FY 2005.

In FY 2006, we continued making improvements in both our service and enforcement programs. This claim is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards ñtransforming itself into a modern institution that provides efficient and effective tax administration services to Americaôs taxpayers.ò

Improving Taxpayer Service

According to a survey commissioned by the Board in 2006, taxpayers increasingly recognize that the IRS provides quality service through a variety of channels, such as our Web site, toll-free telephone lines, and Taxpayer Assistance Centers (TACs). This finding is supported by the metrics that we use to determine the effectiveness of our taxpayer service efforts. In category after category, we continue to see improvement in the numbers in our telephone services, electronic filing, and IRS.gov access. This improvement is demonstrated by the following FY 2006 business results:

- Electronic filing by individuals continued to increase. It rose three percentage points from FY 2005 to 54 percent of all individual returns.

- The level of service for toll-free assistance was 82 percent, about the same level of FY 2005 and up substantially from FY 2001. The level of customer satisfaction with the toll-free line remains 94 percent.

- The tax-law accuracy of toll-free responses improved to 91 percent and account accuracy increased to over 93 percent.

- Visits to the IRS Web site jumped nearly 10 percent in FY 2006 to more than 197 million visits.

- More taxpayers used the online refund status tool ñWhere's My Refund.ò In FY 2006, there were 24.7 million status checks, up nearly 12 percent from FY 2005.

At the IRS, we continue to work to improve services. Clearly, we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the completion of the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July 2005 in response to a Congressional mandate to develop a five-year plan for taxpayer service delivery. We sent Phase 1 of the Blueprint to Congress in April 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer, partner, and government value:

- Improve and expand education and awareness activities: This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.

- Optimize the use of partner services: This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.

- Enhance self-service options to meet taxpayer expectations: This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service optionsð particularly for transactional tasks.

- Improve and expand training and support tools to enhance assisted services: This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.

- Develop short-term performance and long-term outcome goals and metrics: This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

We delivered Phase 2 of the Blueprint to Congress in April. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year TAB Strategic Plan for taxpayer service.

The TAB Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder, partner, and employee engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance.

The FY 2008 Budget Request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the TAB Strategic Plan. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help. The TAB Strategic Plan also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding noncompliance, the FY 2008 budget includes funding for research to understand better the effect of service on compliance.

Expanding Enforcement Efforts

Another reason for the Oversight Boardôs positive assessment of our work in FY 2006 is that IRS enforcement efforts have increased in virtually every area. According to the Board, ñAs demonstrated by a variety of measures, the IRSô performance on enforcement has improved considerably, and real progress has been achieved over the past six years.ò One of the most obvious measures is the increase in enforcement revenue, which has risen from $34 billion in FY 2002 to almost $49 billion in FY 2006, an increase of 43 percent.

In FY 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This level is almost 75 percent more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.58 percent in FY 2001 to more than 0.97 percent in FY 2006.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over $1 million. The number of examinations in this category rose by almost 78 percent compared to FY 2004, the first year the IRS began tracking audits of individuals with income over $1 million. The coverage rate has risen from 5 percent in FY 2004 to 6.3 percent in FY 2006.

Growth in audit totals and coverage rates extend to other taxpayer categories. Preliminary estimates show that the IRS examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over $10 million, examinations rose from 8,718 in FY 2001 to 10,578 in FY 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over $250 million, examinations have increased by over 29 percent growing from 3,305 in FY 2001 to 4,276 in FY 2006.

We have also been active in the tax exempt community. Overall, examination closures for tax exempt organizations have risen from 5,342 in FY 2001 to 7,079 in FY 2006. In addition, we have an innovative program utilizing correspondence contacts to leverage our activities in the compliance area. We have used it successfully in the hospital and executive compensation areas, and will be using it elsewhere.

While examinations in the tax exempt community generally do not provide the tax collection ñreturn on investmentò that audits in other areas might, it is important that we keep a ñcop on the beatò in order to prevent abuses in the exempt sector and an erosion of the tax base. Maintaining a strong enforcement presence in the tax-exempt sector is particularly important given the role that a small number of these entities have played in the past in accommodating abusive transactions entered into by taxable parties. In appropriate cases, this results in the collection of income or excise taxes--and in the most egregious cases, revocation of exempt status.

One area to which we have paid particular attention is the credit counseling industry. Through a compliance initiative in this area, as of March 23, we had revoked or proposed revocation of the tax-exempt status of 45 credit counseling agencies, with another 16 examinations still in process. Proposed or final revocations to date represent 41 percent of the revenues of the credit counseling industry.

Using our correspondence contact techniques, we have also sent more than 700 questionnaires to all tax-exempt credit counseling organizations we know of that were not already under examination. Based on responses to the questionnaires and our independent research, we expect to examine at least 82 additional credit counseling organizations from this group.

We also have been actively reviewing seller-funded down payment assistance programs that provide cash assistance to homebuyers who cannot afford to make the minimum down payment or pay the closing costs involved in obtaining a mortgage. When properly structured and operated, down payment assistance programs can qualify as tax-exempt charitable and educational organizations. In May 2006, we issued Revenue Ruling 2006-27, which provides examples of organizations that may qualify for tax exempt status, but also makes it clear that organizations providing seller-funded down payment assistance do not qualify for tax exemption.

Seller-funded down payment assistance programs improperly benefit the home seller through circular funding arrangements that result in the home buyer paying for all or much of the down payment ñgiftò he or she receives from the organization. They also result in buyers becoming overextended as the cost of the down payment is added to the purchase price of the home. A Housing and Urban Development (HUD)-commissioned study and a Government Accountability Office (GAO) report found that seller-funded programs led to underwriting problems and resulted in an increase in the cost of homeownership.

In the audits we have conducted in this area, not only have we found improper private benefit and activities, but also that the down payment assistance organizations often provide excessive compensation to their officials. Revocation of exempt status will shut down abusive seller funded programs without harming the innocent low income home buyers who participated in these arrangements.

We will continue to look at other areas within the exempt sector that have the potential for abuse.

2007 Filing Season

The progress made in FY 2006 has continued during the 2007 filing season despite the fact that this filing season presented the potential to be one of the most challenging in recent memory. The Tax Relief and Health Care Act of 2006 (TRHCA), which passed late last year, included the extension of several significant tax benefits. Since forms and publications for Tax Year 2006 were printed and distributed prior to enactment, we were required to notify taxpayers on IRS.gov as to how to modify those forms to claim the allowable benefits. Due to separate developments in the tax law, we were faced with implementing the Telephone Excise Tax Refund Program (TETR), and this was the first filing season that we allowed taxpayer refunds to be split and deposited into separate accounts. Finally, because the normal April 15th filing date fell on a Sunday and the following Monday was a legal holiday in the District of Columbia, we had to adjust our programs to provide taxpayers an extra two days to file and pay this year. Many of these changes also necessitated significant changes in our information technology systems.

Despite these challenges, I am proud to report that the filing season has gone very well. By early February, we were able to begin processing tax returns claiming the tax benefits authorized by the enactment of TRHCA in December. We have also taken a number of steps to make sure that taxpayers understand how to claim the benefits. For example, we provided instructions on IRS.gov and conducted extensive outreach and media events to publicize these provisions. In addition, we sent a special mailing of Publication 600, which included the state and local sales tax tables and instructions for claiming the sales tax deduction on Schedule A (Form 1040), to six million taxpayers who had previously claimed the state and local sales tax deduction.

From a technology perspective, we were able to deliver the timely release of 329 of 330 information system for the 2007 filing season. The one exception to timely delivery was the enhancements to the Customer Account Data Engine (CADE). This system, one of key components of the IRSô modernization strategy, will ultimately replace the antiquated master files.

Significant functionality was added to CADE this year. We included the ability to handle married taxpayers, dependents, and a number of schedules including Schedules C, D, E, F, and SE. Due to system testing issues, the IRS did not deploy CADE into production until March 6th. To ensure taxpayers filing prior to March 6th were not negatively impacted, the IRS continued to process CADE-eligible taxpayers through the master file.

Hence, the impact to such taxpayers was a delay of a couple of days on refund processing.

The IRS originally estimated that if the enhancements were put into production on time, we would have processed 33 million individual tax returns through CADE in 2007. Given that we were late and missed many of the taxpayers that would be now be CADE-eligible, we processed only 10.4 million tax returns through CADE as of May 4th. While the 10.4 million tax returns are more than the 7.4 million posted last year, it is still disappointing because it fell well short of our estimates. CADE is now operating well in production and we expect that the full functionality intended for this year will be there for CADE going forward.

Because of the issues with getting CADE into production this year, the IRS is taking more management control of the CADE project, and working to embed additional IRS subject matters experts on the CADE team. A significant amount of the delay this year is attributable to the complexities of the interfaces between CADE and other IRS legacy systems.

In planning for next filing season, the IRS is revisiting the scope of what is to be delivered, to ensure that CADE will be in production the first day of the 2008 filing season.

I will discuss the TETR Program later in my testimony, but let me first give an update on our filing season numbers.

Numbers Thus Far

We expect to process almost 136 million individual tax returns in 2007, and as anticipated the number of those that were e-filed continued to grow. In the 2006 filing season, 54 percent of all income tax returns were e-filed. As of April 28, we have received over 76 million tax returns electronically, an increase of 8.74 percent compared to the same period last year.

This increase in e-filing is being driven by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by over 11 percent compared to this time a year ago. Over 22 million returns have been e-filed by people from their personal computers, up from over 19 million for the same period a year ago.

Overall, nearly 61 percent of the 125.7 million returns filed thru April 28 have been e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in two weeks or less. That is about half the time it takes us to process a paper return. For the IRS, the error reject rate for e-filed returns is significantly lower than that for paper returns.

More people are choosing to have their tax refunds directly deposited into their bank account than ever before. So far this year, we have directly deposited over 58 million refunds, or 63.2 percent of all refunds issued this tax filing season. This level is up from 62.3 percent for the same period in 2006.

People are also visiting our Web site, IRS.gov, in record numbers. Through April 28th, we have recorded over 137 million visits to our site this year, up over nine percent from 124.8 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the Web site. We have made it easier for taxpayers to get answers to many of their tax questions online. Important functions on the Web site provide capabilities to:

- Assist the taxpayer in determining whether he or she qualifies for the Earned Income Tax Credit (EITC);

- Assist the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);

- Allow more than 70 percent of taxpayers the option to file their tax returns at no cost through the Free File program;

- Allow taxpayers who are expecting refunds to track the status via the ñWhereôs My Refund?ò feature; and

- Allow taxpayers to calculate the amount of their Sales Tax Deduction.

As of April 21, we have received 125.7 million returns, a very slight increase (1.4 percent) over the same period as last year. We have issued 91.9 million refunds so far this year, for a total of $209.7 billion. The average refund thus far is $2,280, $63 more than last year. In addition, as of April 28th, over 26.6 million taxpayers have tracked their refund on IRS.gov, up more than 26 percent over last year.

As of April 28th, our Taxpayer Assistance Centers (TACs) are reporting a very slight increase in face- to-face contacts this filing season as compared to last year. We have seen a slight decline in the number of calls answered (-0.32 percent) as well as automated calls (-5.65 percent). The decline in the number of calls answered can be attributed to a few weather-related temporary call site closures earlier this winter and a slight decrease in overall caller demand.

Free File

Over 3.7 million people have utilized Free File as of April 28, down 1.8 percent from last year. This year, anyone with adjusted gross income of $52,000 or less is eligible for Free File, which includes 95 million taxpayers.

We think there are two major reasons for this decline. First, other websites advertising free tax preparation service siphoned off a significant number of customers. In addition, traditional tax preparation sites such as Intuit and TaxAct offered and advertised their own free services.

Second, taxpayers are inundated with advertising and promotions by major tax preparation firms such as Intuit, H&R Block, and Liberty Tax. This is in contrast with IRS' limited promotion and marketing budget for FreeFile.

A key difference in this year's Free File program is that Alliance members are no longer offering ancillary products, such as refund anticipation loans (RALs), through the Free File program. IRS data from the last filing season shows that only 0.5 percent of Free File users chose to utilize a RAL. The Free File Alliance may still offer customers the option of having their state tax return prepared for a fee, though some Alliance members are offering to do the state return along with the Federal at no cost.

In the 2006 filing season, an indicator was included for the first time on Free File returns that allows the IRS to identify those taxpayers using Free File. As a result, the Service was able to obtain important information such as customer satisfaction and demographic data that had never before been available. This information allowed us to verify that there was a high level of customer satisfaction with Free File. According to a survey conducted for the IRS, 94 percent said they intend to use Free File again next year; the same number said they found Free File very easy or somewhat easy to use; and 97 percent said they would recommend Free File to others. Convenience, not the free cost, was the most appealing factor of Free File.

VITA/TCE Sites and Other Community Partnerships

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased. In FY 2006, over 2.2 million returns were prepared by volunteers. As of April 28, volunteer return preparation is up 17 percent above last year's level. Volunteer e-filing is also up slightly, by 1.7 percent over the same period last year. This is reflective of continuing growth in existing community coalitions and partnerships.

We have also made a concerted attempt to improve outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored EITC Awareness Day on February 1 in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge them to claim the credit.

Telephone Excise Tax Refunds

In the middle of 2006, the IRS announced plans to refund at least $13 billion in telephone excise taxes to more than 160 million taxpayers. To do this task, the IRS modified every individual and business tax return form, retooled our systems to handle the forecast demand, and launched an extensive communications campaign to increase awareness and encourage people without a filing requirement to request a refund anyway.

One difficulty in administering this refund was that taxpayers could have experienced significant burden if they had been required to find 41 months of old phone bills in order to obtain the information they needed to compute their refunds. For this reason, the IRS created a set of standard amounts that individuals can claim in lieu of actual amounts. For businesses and non-profits faced with potentially more paperwork than individuals, the IRS developed an estimation method that could require significantly less paperwork than requesting an actual amount.

A review of returns filed so far this year turned up a surprising fact: over 28 percent of returns we have received did not include a telephone excise tax refund request. Though one of our communications goals was to encourage taxpayers not to overlook the telephone tax refund, it appears many taxpayers are missing out. In response to these early numbers, we consulted with tax professionals, citizens groups, and tax software companies to determine potential causes for the low take-up rate. The only logical reason we were given was that despite our best efforts, some taxpayers were still not aware of the credit and how to claim it. We then conducted additional media outreach to increase awareness of the refund and were able to generate broad national media coverage, including CNN, the Associated Press, and USA Today.

As we monitored the initial returns, we also noticed some problems. Even though 99.5 percent of all taxpayers who are requesting the refund are claiming the appropriate standard amount, some tax-return preparers are requesting thousands of dollars of refunds for their clients in instances where clients are entitled to only a tiny fraction of that amount. This behavior may indicate criminal intent on the part of the return preparer. In some cases, taxpayers requested a refund in the thousands of dollars, suggesting that the taxpayer paid more for telephone service than they received in income. While some of the large claims may be the result of misunderstandings ï a number of refund requests appear to be for the entire amount of the taxpayerôs phone bill, rather than just the three-percent long-distance tax ï others may be deliberate attempts to scam the system.

To address this problem, in late February, IRS special agents executed search warrants seeking evidence from a small number of tax-preparation businesses suspected of preparing returns on behalf of clients requesting large, improper amounts in telephone excise tax refunds. Special agents temporarily closed these businesses, seizing computers and documents to use in their investigations. In addition, IRS revenue agents (auditors) and special agents also visited other tax preparers who were suspected of preparing questionable telephone tax refund requests.

On a positive note, the number of returns with seemingly high telephone excise tax refunds dropped significantly. This change suggests our enforcement actions, along with increased communications, may be having the desired effect.

Tax Scams

Each year, we alert taxpayers about the ñDirty Dozen,ò 12 of the most blatant tax scams affecting American taxpayers. This effort is, in part, an effort to alert taxpayers so that they may be wary if approached and encouraged to participate in any of the listed schemes. It also alerts promoters that we are aware of the scam and will be taking steps to prevent them from getting away with it.

This year the ñDirty Dozenò highlights five new scams that IRS auditors and criminal investigators have uncovered. Topping the list this filing season are fraudulent refunds being claimed in connection with TETR, which I have already discussed. Other scams making the list include:

- **Abusive Roth IRAs:** Taxpayers should be wary of advisers who encourage them to shift under-valued property to Roth Individual Retirement Arrangements (IRAs). In one variation, a promoter has the taxpayer move under-valued common stock into a Roth IRA, circumventing the annual maximum contribution limit and allowing otherwise taxable income to go untaxed.

- **Phishing:** This technique is used by identity thieves to acquire personal financial data in order to gain access to the financial accounts of unsuspecting consumers, run up charges on their credit cards or apply for loans in their names. These Internet-based criminals pose as representatives of a financial institution ïï or sometimes the IRS itself ïï and send out fictitious e-mail correspondence in an attempt to trick consumers into disclosing private information. A typical e-mail notifies a taxpayer of an outstanding refund and urges the taxpayer to click on a hyperlink and visit an official-looking Web site. The Web site then solicits a social security and credit card number. It is important to note the IRS does not use e-mail to initiate contact with taxpayers about issues related to their accounts. If a taxpayer has any doubt whether a contact from the IRS is authentic, the taxpayer should call 1-800-829-1040 to confirm it.

- **Disguised Corporate Ownership:** Domestic shell corporations and other entities are being formed and operated in certain states for the purpose of disguising the ownership of the business or financial activity. Once formed, these anonymous entities can be, and are being, used to facilitate underreporting of income, non-filing of tax returns, listed transactions, money laundering, financial crimes and possibly terrorist financing. The IRS is working with state authorities to identify these entities and to bring their owners into compliance.

- **Zero Wages:** In this scam, which first appeared in the Dirty Dozen in 2006, a Form 4852 (Substitute Form W-2) or a ñcorrectedò Form 1099 showing zero or little income is submitted with a federal tax return. The taxpayer may include a statement rebutting wages and taxes reported by the payer to the IRS. An explanation on the Form 4852 may cite statutory language behind Internal Revenue Code sections 3401 and 3121 or may include some reference to the paying company refusing to issue a corrected Form W-2 for fear of IRS retaliation.

- **Return Preparer Fraud:** Dishonest return preparers can cause many headaches for taxpayers who fall victim to their schemes. Such preparers make their money by skimming a portion of their clientsô refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Some preparers promote filing fraudulent claims for refunds on items such as fuel tax credits to recover taxes paid in prior years. Taxpayers should choose carefully when hiring a tax preparer. As the old saying goes, if it sounds too good to be true, it probably is. Remember that no matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. In recent years, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others. During fiscal year 2006, 109 tax return preparers were convicted of tax crimes and sentenced to an average of 18 months in prison.

- **American Indian Employment Credit:** Taxpayers submit returns and claims reducing taxable income by substantial amounts citing an American Indian employment or treaty credit. Although there is an Indian Employment Credit available for businesses that employ Native Americans or their spouses, there is no provision for its use by employees. In a somewhat similar scam, unscrupulous promoters have informed Native Americans that they are not subject to federal income taxation. The promoters solicit individual Indians to file Form W-8 BEN seeking relief from all withholding of federal taxation. A recent ñphishingò variation has promoters using false IRS letterheads to solicit personal financial information that they claim the IRS needs in order to process their "non-tax" status.

- **Trust Misuse:** For years, unscrupulous promoters have urged taxpayers to transfer assets into trusts. They promise reduction of income subject to tax, deductions for personal expenses and reduced estate or gift taxes. However, these trusts do not deliver the promised tax benefits. There are currently more than 150 active abusive trust investigations underway and 49 injunctions have been obtained against promoters since 2001. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering into a trust.

- **Structured Entity Credits:** Promoters of this newly identified scheme are setting up partnerships to own and sell state conservation easement credits, federal rehabilitation credits and other credits. The purported credits are the only assets owned by the partnership and once the credits are fully used, an investor receives a K-1 indicating the initial investment is a total loss, which is then deducted on the investorõs individual tax return.

- **Abuse of Charitable Organizations and Deductions:** The IRS continues to observe the use of tax-exempt organizations to improperly shield income or assets from taxation. This action can occur when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund but maintains control over the assets or income. Contributions of non-cash assets continue to be an area of abuse, especially with regard to overvaluation of contributed property. In addition, the IRS is noticing the return of private tuition payments being disguised as charitable contributions to religious organizations.

- **Form 843 Tax Abatement:** This scam rests on faulty interpretation of the Internal Revenue Code. It involves the filer requesting abatement of previously assessed tax using Form 843. Many using this scam have not previously filed tax returns and the tax they are trying to have abated has been assessed by the IRS through the Substitute for Return Program. The filer uses the Form 843 to list reasons for the request. Often, one of the reasons is: ñFailed to properly compute and/or calculate IRC Sec 83-Property Transferred in Connection with Performance of Service.ò

- **Frivolous Arguments:** Promoters have been known to make the following outlandish claims: the Sixteenth Amendment concerning congressional power to lay and collect income taxes was never ratified; wages are not income; filing a return and paying taxes are merely voluntary; and being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy. Taxpayers should not believe these or other similar claims. These arguments are false and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law or else they may subject themselves to increased penalties. As part of the Tax Relief and Health Care Act of 2006 [Public Law No. 109-432], Congress amended the Code to increase the amount of the penalty for frivolous tax returns from $500 to $5,000 and to impose a penalty of $5,000 on any person who submits a "specified frivolous position." Last week, we released guidance identifying these and other frivolous claims that, when asserted by a taxpayer on a tax return filed with the Service or submitted in a collection due process request, offer-in-compromise, application for an installment agreement, or application for a Taxpayer Assistance Order, expose the taxpayer to the $5,000 penalty.

President's FY 2008 Budget Maintains the Balance between Taxpayer Service and Enforcement

The IRS and its employees represent the face of the Federal Government to more American citizens than any other government agency. The IRS administers Americaôs tax laws and collects 95 percent of the revenues that fund government operations and public services. Our taxpayer service programs provide assistance to help millions of taxpayers understand and meet their tax obligations. Our enforcement programs are aimed at deterring taxpayers inclined to evade their responsibilities while vigorously pursuing those who violate tax laws. Delivering these programs demands a secure and modernized infrastructure able to fairly, effectively, and efficiently collect taxes while minimizing taxpayer burden.

The IRS FY 2008 Presidentǿs Budget request supports our agency-wide strategic plan as well as Treasuryǿs compliance improvement strategy. These documents underscore the IRSô commitment to provide quality service to taxpayers while enforcing Americaǿs tax laws in a balanced manner. The IRSô strategic plan goals are:

- *Improve Taxpayer Service.* Help people understand their tax obligations, making it easier for them to participate in the tax system;

- *Enhance Enforcement of the Tax Law.* Ensure taxpayers meet their tax obligations, so that when Americans pay their taxes, they can be confident their neighbors and competitors are also doing the same; and

- *Modernize the IRS through its People, Processes and Technology.* Strategically manage resources, associated business processes, and technology systems to effectively and efficiently meet service and enforcement strategic goals.

Budget Request

Our total budget request for FY 2008 is for $11.1 billion in appropriated resources and represents a 4.7 percent increase over the recently enacted FY 2007 Joint Resolution (JR) level of $10.6 billion.

The IRSô taxpayer service and enforcement activities are funded from three appropriations: Taxpayer Services (TS); Enforcement (ENF); and Operations Support (OS). The total FY 2008 Budget request for these three operating accounts is $10.8 billion supplemented by $180 million from user fee revenue, for a total operating level for these accounts of $10.9 billion--a 5.5 percent increase over the FY 2007 operating level. As in FY 2006 and FY 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment, and I am pleased that the House and Senate Budget Committee marks for the 2008 Resolution include the full cap adjustment for this activity, recognizing the return on investment from these enforcement investments.

The Budget also includes $282.1 million for Business Systems Modernization (BSM) and $15.2 million to administer the Health Insurance Tax Credit program--a 32.6 percent and 2.6 percent increase, respectively, over the FY 2007 JR level.

Our FY 2008 Budget request provides $409.5 million for new initiatives and $340 million for the pay raise and other cost adjustments needed to sustain base operations.

The IRSô initiatives focus on the most significant needs for FY 2008:

- *$20.0 million to enhance taxpayer service* through expanded volunteer tax assistance, increased funding for research to determine the most effective means to help taxpayers, and implementing new technology to improve taxpayer service;

- *$246.4 million to expand enforcement* activities targeted at improving compliance; and

- *$143.1 million to improve the IRS' information technology (IT) infrastructure*, including $62.1 million for the BSM program and $81.0 million for security and infrastructure enhancements.

This request also includes several program savings and efficiencies that reflect the IRSô aggressive efforts to identify and deploy work process and technology improvements that will benefit both taxpayer service and enforcement programs. Collectively, these cost savings total $120.0 million:

- *Taxpayer Service Efficiencies -$23.4 million / -527 FTE*: These savings will result from operational efficiencies achieved through ongoing efforts to automate and enhance IRS taxpayer service programsôworkload distribution, such as the implementation of automated issuance of Employer Identification Numbers and Correspondence Imaging System. Additional efficiencies and savings are expected to be achieved through the implementation of optimal service delivery initiatives identified by the Taxpayer Assistance Blueprint.

- *Enforcement Program Efficiencies -$60.2 million / -620 FTE:* These savings will result from productivity and efficiency improvements realized through the implementation of enhanced technology and business processes, such as improved case selection tools and techniques. In addition, the completion of initial training and transition of the FY 2006 new hires back to their front-line enforcement activities will result in additional efficiencies for the examination and collection programs.

- *Shared Service Support Efficiencies* -$36.4 million / -37 FTE: These savings will result from several efforts, including the optimization and consolidation of space projects; implementation of cost-efficient government-wide contract support; and postage savings achieved through the consolidation, automation, and renegotiation of contract services for correspondence delivery.

A Strategic Plan to Improve Voluntary Compliance and Reduce the Tax Gap

The FY 2008 Budget supports our goal of improving voluntary compliance. The IRS has been working closely with the Office of Tax Policy at the Department of the Treasury to develop a strategic plan to achieve that goal. Key components of that goal and how they relate to the IRS Budget are discussed below.

Enhancing Taxpayer Service

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the IRS.gov web site, Taxpayer Assistance Centers (TACs), Volunteer Income Tax Assistance (VITA) sites, and Tax Counseling for the Elderly (TCE) sites.

Assisting taxpayers with their tax questions before they file their returns reduces burdensome post-filing notices and other correspondence from the IRS, and proactively addresses inadvertent noncompliance.

The FY 2008 Budget Request contains three significant taxpayer service initiatives. First, we are requesting $5 million to expand the VITA program, a significant component of our effort to support taxpayers eligible to claim the Earned Income Tax Credit. This taxpayer service initiative will help expand our volunteer return preparation, outreach and education, and asset building services to low-income, elderly, Limited English Proficient (LEP), and disabled taxpayers.

The budget also requests $5 million for additional resources to enhance our understanding of the role of the taxpayer service on compliance. This research will focus on understanding taxpayer burden, opportunities for enhanced service to help reduce errors made on returns, and the impact of service on overall levels of voluntary compliance.

Finally, the budget requests $10 million for four of the initiatives recommended by the Taxpayer Assistance Blueprint (TAB) Strategic Plan for taxpayer service. As part of the Blueprint effort, we conducted a comprehensive review of our current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the Blueprint, the funding for this initiative will implement the following telephone service and Web site interaction enhancements:

- *Contact Analytics* provides an analytical tool for evaluating contact center recordings for the purpose of improving business processes and lowering business costs, as well as improving customer service.

- *Estimated Wait Time* provides a real-time message that informs taxpayers about their expected wait time in queue, allowing them to make more informed decisions based on the status of their call and thus reducing taxpayer burden and increasing customer satisfaction.

- *Expanded Portfolio of Tax Law Decision Support Tools* enables taxpayers to conduct key word and natural language queries to get answers to tax law questions through the Frequently Asked Questions database accessed on IRS.gov, thereby steadily increasing customer satisfaction and operational savings.

- *Spanish "Where's My Refund?"* adds the ability to check refund status to the Spanish Web page on IRS.gov, enabling the Spanish-speaking community to receive the same level of customer service on the Web as available to the English Web page.

Continued technological advancements offer significant opportunities for the IRS to improve the efficiency and effectiveness of call center services. Web site enhancements are designed to maximize the value of IRS.gov, making the site taxpayersô first choice for obtaining the information and services required to comply with their tax obligations.

Improving Compliance Activities

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. We will continue to reengineer our examination and collection procedures to reduce cycle time, increase yield, and expand coverage. As part of our regular examination program, we are expanding the use of cost-efficient audit techniques first pioneered in the National Research Program (NRP).

We are also expanding our efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as nonfilers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

There are seven specific initiatives proposed in the FY 2008 Budget aimed at improving compliance. These initiatives provide:

- **$73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance.** This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating persons who have evaded taxes for possible criminal referral. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year, once new hires reach full potential in FY 2010.

- **$26.2 million for increasing compliance for large, multinational businesses.**

This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for noncompliance is significant in the reporting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 to 8.2 percent in FY 2008, and produce over $74 million in additional annual enforcement revenue, once the new hires reach full potential in FY 2010.

- **$28 million for expanded document matching in existing sites.**
  This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. We believe the additional resources will result in an increase in AUR closures from 2.05 million in FY 2007 to 2.64 million in FY 2010. We expect $208 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010. In addition, the budget requests $23.5 million to establish a new document matching program at our Kansas City campus. This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this new AUR site should result in over $183 million in additional enforcement revenue per year once the new hires reach full potential in FY 2010.

- **$6.5 million to increase individual filing compliance.**
  This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in FY 2008 and produce $82 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010.

- **$15 million to increase tax-exempt entity compliance.**
  This enforcement initiative will deter abuse by entities under the purview of the Tax-Exempt and Governmental Entities Division (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE compliance contacts by 1,700 (six percent) and employee plan/exempt organization determinations closures by over 9,000 (eight percent) by FY 2010.

- **$10 million for increased criminal tax investigations.**
  This funding will help us aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and

case development efforts, which include an emphasis on the fraud referral program. Our robust pursuit of tax violators and the resulting publicity is aimed to foster deterrence and enhance voluntary compliance.

- **$41 million for conducting research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance.**
  The data collected from these studies will enable the IRS to develop strategies to combat specific areas of noncompliance.

In addition to these initiatives, I would stress the importance of allowing us to continue with the private debt collection program. The Congress authorized the use of private collection agents (PCAs) in the American Jobs Creation Act of 2004. As we continue to debate the efficacy of this program, I want to take this opportunity to make a couple of points for purposes of our ongoing discussions.

One issue that has been debated is the relative efficiency of using PCAs versus IRS employees to collect the taxes owed. The most important question is not whether IRS employees or PCAs can do the job more efficiently, but rather whether PCAs collect money that would otherwise go uncollected. The IRS lacks the resources to pursue the relatively simple, geographically dispersed cases that are now being assigned to PCAs. It is not realistic to expect that the Congress is going to give the IRS an unlimited budget for enforcement, and if Congress provided the IRS additional enforcement resources, I believe those resources would be applied best by allocating them to more complex, higher priority cases that are not appropriate for PCAs.

The IRS continues to work with PCAs to ensure that the program is fair to taxpayers and respects taxpayer rights. The Treasury Inspector General for Tax Administration (TIGTA) agreed with that assessment. Earlier this month, TIGTA issued a report which noted that ñIRS has taken proactive measures to effectively develop and implement the (PCA) Program.ò

The report said that we had taken the appropriate steps to ensure contractor employees received sufficient and adequate training on applicable laws and regulations before allowing them access to Federal tax information. This process included providing contractors with an orientation and overview of the training required and conducting an onsite assessment of the contractor training.

TIGTA also recognized that we had required all contractor employees assigned to the Program contract, or who have access to Federal tax information, to undergo background investigations. We granted either interim or final approval of background investigations for each employee working on the contract at the time of our review.

We currently estimate that between now and FY 2017, our partnership with PCAs will result in approximately 2.9 million delinquent cases receiving treatment that would otherwise have gone unworked. This partnership will help reduce the backlog in outstanding tax liabilities, which has grown by 118 percent over the last 12 years.

From September 7, 2006, when cases were first assigned to PCAs, through March 22, 2007 PCAs collected $19.47 million in gross revenue. We estimate that cases worked by PCAs will generate estimated gross revenue of $1.4 billion through FY 2017.

Another reason to continue to use this tool is to evaluate whether we in the public sector can learn anything from these PCAs that will enable us to do our jobs better. Particularly over the last 20 years, government agencies at all levels have adopted many practices and ways of doing business that have been pioneered in the private sector. One need look no further than the vastly expanded use by the government of the Internet in providing services to the public as an example of a practice that was pioneered in the private sector, but adopted quickly and effectively by the government. We should not remove PCAs as a tool for addressing the problem before we have an opportunity to evaluate the potential of this initiative to help improve compliance, and perhaps even to show the government how to be more effective in its own efforts.

Reducing Opportunities for Evasion

The IRS is already aggressively pursuing enforcement initiatives designed to improve compliance and reduce opportunities for evasion. As I pointed out earlier, these efforts have produced a steady climb in enforcement revenues since 2001, as well as an increase in both the number of examinations and the coverage rate in virtually every major category.

In the budget request, the Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties in the following ways:

- *Expand information reporting* – Specific information reporting proposals would:

    - Require information reporting on payments to corporations;
    - Require basis reporting on sales of securities;
    - Expand broker information reporting;
    - Require information reporting on merchant payment card reimbursements;
    - Require a certified taxpayer identification number (TIN) from non-employee service providers;
    - Require increased information reporting for certain government payments for property and services; and
    - Increase information return penalties.

- *Improve compliance by businesses* – Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:

    - Require electronic filing by certain large businesses;
    - Implement standards clarifying when employee leasing companies can be held liable for their clientsô Federal employment taxes; and

  - Amend collection due process procedures applicable to employment tax liabilities.

- *Strengthen tax administration* – The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:

  - Expand IRS access to information in the National Directory of New Hires database;
  - Permit the IRS to disclose to prison officials return information about tax violations; and
  - Make repeated failure to file a tax return a felony.

- *Expand penalties* – Penalties play an important role in discouraging intentional noncompliance. Specific proposals to expand penalties would:

  - Expand preparer penalties;
  - Impose a penalty on failure to comply with electronic filing requirements; and
  - Create an erroneous refund claim penalty.

The Administration also has four proposals relating to IRS administrative reforms.

The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.

The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.

The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding $50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.

The fourth proposal modifies the way that Financial Management Services (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to add the fee to the liability being recovered, thereby shifting the cost of collection to the delinquent taxpayer. The offset amount would be included as part of the 15-percent limit on continuous levies against income.

Collectively, these proposals should generate $29.5 billion in revenue over 10 years. The proposed budget provides $23 million to begin implementation of these initiatives. This funding will allow the purchase of software and the modifications to IRS information technology systems necessary to implement these legislative proposals.

Enhancing Research

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line-by-line audits of random samples of returns. This study provided us with information on compliance trends and allowed us to update audit selection formulas. However, this method of data gathering was extremely burdensome on the taxpayers who were forced to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without the benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done for Tax Year (TY) 1988.

We have conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, until the recent NRP data, all of our subsequent estimates of the tax gap were rough projections that basically assumed no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program (NRP), which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 individual returns for TY 2001. This population sample was less than previous compliance studies, even though the population of individual tax returns had grown over time. Like the compliance studies of the past, the NRP was designed to allow us to estimate the overall extent of reporting compliance among individual income tax filers, and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The NRP provided updated estimates for determining the sources of noncompliance. The IRS also uses the NRP findings to better target examinations and other compliance activities, thus increasing the dollar-per-case yield and reducing ñno changeò audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among those major tax gap components, since the most recent compliance estimates were compiled (i.e., for TY 1988 or earlier).

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target resources, effectively provide the best service possible, and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts.

The FY 2008 Budget Request includes funds for two significant research initiatives. First, the budget requests $41 million to improve compliance estimates, measures, and detection of noncompliance. This funding will allow research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance. Unlike in the past, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This approach will provide fresh compliance estimates each year, and by combining samples over several years, will provide a regular update to the larger sample size needed to keep our targeting systems and compliance estimates up to date.

The second initiative funded by the request is to research the effect of service on taxpayer compliance. The budget requests $5 million for this project, which will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:

- Meeting taxpayer needs by providing the right channel of communication;
- Better understanding taxpayer burden;
- Understanding taxpayer needs through the errors they make; and
- Researching the impact of service on overall levels of voluntary compliance.

Continuing Improvements in Information Technology

Tax administration in the twenty-first century requires improved IRS information technology (IT). We are committed to continuing to make improvements in technology and the FY 2008 Budget Request reflects that commitment. The request includes $81 million to improve the IRSô information technology infrastructure. Sixty million dollars of this amount is requested to upgrade critical IT infrastructure, addressing the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in FY 2008 include procuring and replacing desktop computers, automated call distributor hardware, mission critical servers, and Wide Area Network/Local Area Network routers and switches.

The other $21 million will be used to enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRSô network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Finally, the FY 2008 Budget Request includes a total of $282.1 million to continue the development and deployment of the IRS Business Systems Modernization (BSM) program in line with the recommendations identified in the IRS Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

The development of the CADE (Customer Account Data Engine) and AMS (Account Management Services) systems is the heart of the IT modernization of the IRS. The combination of these two systems working together will enable the IRS to process tax returns and deal with taxpayer issues in a near real-time manner. Our objective is that the IRS operate similarly to what one expects from oneҫs bank-- account transactions occurring during the business day will be posted and available by the next business day. In addition, AMS will enable the IRS representatives who work with taxpayers to have access to all the information regarding that taxpayer, including electronic access to tax return data, and electronic copies of correspondence. Equipped with such comprehensive and up-to-date information, our representatives will be in a much better position to help taxpayers resolve their issues.

MeF is the future of electronic filing. It provides a standard data format for all electronic tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns, resulting in a quicker acknowledgement of the filing to the taxpayer or their representative. In FY 2007, the IRS will start development and implementation of the 1040 on the MeF platform.

CSP will provide funding for new portals, which are technology platforms that meet many IRS business needs through Web-based front-ends, and provide secure access to data, applications, and services. The portals are mission-critical components of the enterprise infrastructure required to support key business processes and compliance initiatives.

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, the business community, and government, but also contribute to operational improvements and efficiencies within the IRS.

Other Issues

In recent weeks, there has been much publicity over identity theft and the loss of IRS laptops. Please allow me to bring you up to date on these issues.

Identity Theft

Taxpayer and employee privacy is a foremost concern of the IRS. We are charged with protecting confidential information about every taxpayer. In recognition of this responsibility, we continue to update our systems and our training so that employees who have access to sensitive information are aware of the steps they must take to prevent that information from being compromised.

This job has never been tougher. According to the FBI, identity theft is one of the fastest growing white collar crimes. There has been a 4,600 percent increase in computer crime since 1997. Nearly 10 million Americans each year are affected by identity theft, according to the Federal Trade Commission (FTC). Deloitte-Touche has reported that financial institutions and U.S. banks have also experienced a significant increase in the number of computer based attacks and attempted intrusions into financial systems.

The FTC also reports, ñAbout 90% of business record thefts involve payroll or employment records, while only about 10% are generated from customer lists.ò These business record thefts also include job applications, personnel records, health insurance and benefits records, and payroll related tax documents that provide personal information that identity thieves use to steal employeesô identities. While most identity theft is use of consumerôs personal information to make purchases, almost 1.5 million victims indicated that their personal information was misused in non-financial ways to obtain government documents or tax forms.

Through our Automated Underreporter Program (AUR), we see firsthand potential instances of identity theft. The AUR matches W-2s for the same SSN to ensure that the taxpayer has reported all sources of income. If identity theft has occurred the SSN may have been used with multiple employers who have issued multiple W-2s for the SSN. In Tax Year (TY) 2004, the latest year for which we have data, there were 16,152 identity theft claims made through the AUR program. This level is far less than the 30,639 cases in TY 2002, but a few more than the 12,618 claimed in TY 2003. In these cases, if the affected taxpayer provides the necessary documentation on an identity theft claim, the income in question will not result in an additional assessment.

We have tried to take the initiative in proactively analyzing processes to identify areas of vulnerability, and in educating taxpayers and employees about identity theft. We have teamed with other federal agencies, such as the Federal Trade Commission (FTC), the Department of Justice (DOJ) and the Social Security Administration (SSA) to address identity theft crime. Treasury was also a member of the Identity Theft Task Force, created by executive order in May 2006, and which recently submitted to the President an identity theft plan entitled ñCombating Identity Theft: A Strategic Planò.

In 2005 we began an aggressive strategy to research and address this growing problem. We established an Identity Theft Program Office charged with implementing the IRSô policy on identity theft. This policy requires the IRS to take the necessary steps to provide assistance to victims of identity theft within the scope of their official duties.

Our Identity Theft Program Office works with offices throughout the IRS to implement the agenciesô Identity Theft Enterprise Strategy comprised of three componentsð Outreach, Prevention and Victim Assistance.

Outreach

The IRS has undertaken several outreach initiatives to provide taxpayers, employees, and other stakeholders with the information they need to proactively prevent and resolve identity theft issues. For example, the IRS:

- Revised the most widely used documents, such as the Form 1040 instructions and Publication 17, *Your Federal Income Tax*, to include information about identity theft.

- Launched an identity theft website on IRS.gov to provide victims with updated information and links to SSA and FTC and with information on how to contact the Taxpayer Advocate.

- Participated with Department of Treasury and the SSA in a multi-agency panel discussion on identity theft, which was held at the IRS nationwide tax forums in 2006 that reached approximately 30,000 tax preparers.

- Developed an internal web communication tool to alert IRS employees to issues of identity theft.

- Lead a multi-agency working group (Treasury, FTC, SSA, and Homeland Security) with a goal of providing consistent information and services to victims, consistent with recommendations being made by the President through the Identity Theft Task Force.

- Partnered with the Treasury Inspector General for Tax Administration (TIGTA) to develop and promote a consistent message to inform taxpayers that the IRS does not communicate with taxpayers via e-mail, with the goal of reducing the number of identity thefts accomplished by ñphishing.ò

- Jointly with TIGTA published an e-mail address on IRS.gov to serve as a repository for the fraudulent emails so they could be tracked to the source and destroyed.

Victim Assistance

We recognize that outreach alone is not enough and that we also must be prepared to assist victims when identity theft occurs. With respect to the victim assistance prong of the Enterprise Strategy:

- The IRS established a new identity theft policy that provides for consistent procedures across its functions to ensure timely resolution of identity theft issues affecting taxpayer accounts.

- The IRS has developed new standards for documentation required from taxpayers to validate the identity of the taxpayer, address, and the fact of the identity theft. These documentation standards are consistent with those required by FTC and SSA.

- The IRS has worked closely with SSA to reduce the time required to resolve cases where more than one taxpayer uses the same SSN on a tax return (called the Scrambled SSN process). The average timeframe to resolve the case is now approximately 10 months compared to 18 months previously. As of March 24, 2007, the current scrambled SSN inventory count is approximately 5,000 cases. Approximately 38,000 cases have been referred to SSA in 2003-2006.

- The IRS updated its processes and notices to help taxpayers whose name and SSN were used by an identity thief for employment purposes. When the IRS matches an identity thiefôs W-2 information with a legitimate taxpayerôs income tax return, the IRS sends the taxpayer a notice regarding the under-reported income. This notification is often the first time the victim is aware of the identity theft. To aid these victims of identity theft, the under-reporter notices were updated with specific instructions on the type of documents and information needed to validate the identity theft cases.

- The IRS is taking additional steps to reduce taxpayer burden associated with identity theft. By January 2008, the IRS will implement a new Service-wide identity theft indicator that will be placed on a taxpayerôs account upon the authentication of identity theft. Once the new process is fully deployed, taxpayers should have to provide identity theft authentication only one time, and the IRS will be able to reject returns which do not appear to be from the legitimate owner of the SSN.

Prevention

There are three types of identity theft crimes in tax administration: refund crimes, employment and income diversion.

- Refund crimes are perpetrated by criminals who use another personôs tax information to fake a return and steal a refund. The Refund Crimes Unit of the IRSô Criminal Investigation Division identifies those returns through the Questionable Refund program.

- The IRS is developing several initiatives to reduce the incidence of theft related to employment, such as working with SSA to explore initiatives to improve the accuracy of SSN reporting.

- Individuals who make false identity claims to underreport income will face additional tax and penalties, as will preparers who promote such schemes.

To augment the IRS Identity Theft Enterprise Strategy composed of outreach, assistance, and prevention, the IRS initiated a Service-wide Identity Theft Risk Assessment to qualify and quantify existing threats and vulnerabilities related to IRS processes that could directly or indirectly facilitate identity theft and/or taxpayer burden. As an output of this risk assessment, the IRS developed (and has began the implementation of) targeted remediation strategies designed to address the identified threats and vulnerabilities.

Where justified, we have referred cases of identity theft to our Criminal Investigation (CI) unit. In the past two years, CI has successfully investigated a number of cases that were successfully prosecuted in which identity theft has led to tax fraud. Just last month, two women from Ohio were sentenced to 63 and 188 months, respectively, and ordered to pay $300,000 in restitution for perpetuating an identity theft scheme. As part of this scheme, the women claimed nearly $114,000 in tax refunds to which they were not entitled.

Last November, a Florida man was sentenced to 63 months in prison to be followed by three years of supervised release for making false claims against the IRS and for identity theft. He was also ordered to pay a personal money judgment of $152,171, and to pay $152,171 in restitution to the IRS. To carry out this scheme, the man used the Internet to obtain personal information, including names and dates of birth, for at least 150 Florida inmates.

We are also continuing to review ways we can protect our employees from identity theft. The IRS Office of Privacy is identifying ways to reduce or eliminate the Service's use of employee SSNs in certain applications to minimize the risk of improper use. We are closely coupling privacy and identity theft protections with the agency security program, so that when we do need to collect SSNs ï either employee or citizen, we can ensure that they are adequately protected within our systems.

The main focus for the annual IRSô Security Awareness Week, last November, was ñIdentity Theft/Fraud.ò We focused activities on raising awareness and making employees aware of their responsibilities.

While research shows that the IRS has one of the lowest rates of identity theft in all the Federal government, we still take this situation very seriously. We have made significant progress, but additional work remains--including implementing additional mediation strategies and conducting in-depth analyses of the remaining high-priority processes.

Laptop Security

Every year, the IRS processes over $2 trillion in revenues to fund the U.S. operating budget. Although the majority of this is collected in an automated banking system throughout the year, about $300 billion is collected through 8 IRS campuses where taxpayers send their tax returns for processing. We house computing systems that hold data on all taxpayers, and also process enormous volumes of paper data in our more than 500 offices across the country. We have more than 82,000 full time and 12,000 part-time employees across the U.S. Our workforce is highly mobile, as revenue agents and officers are often in the field working directly with taxpayers.

IRS computers, networks, and databases are protected by multiple layers of security, including modern security technology devices such as firewalls, encrypted communication links, and automatic intrusion detection devices.

The IRS is one of the few government agencies operating its own 24/7 computer security incident response center (CSIRC) to monitor IRS computer and network security, and to collect and follow up on any security incidents. The IRSô CSIRC works in close coordination with the Treasury Department and the Department of Homeland Securityøs CSIRCs and the US-CERT incident reporting center.

As I mentioned earlier, the FY 2008 Budget for IRS proposes $21 million to be used to enhance CSIRC and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRSô network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

The IRS has always had policy guidance in place requiring employees to protect taxpayer information and other personal and private data. Protection of taxpayer information is emphasized and stressed in all employee orientation and refresher training as one of the Serviceøs highest priorities.

Prior to January 2007, all IRS laptops included encryption tools that IRS employees were required to use to encrypt all sensitive information. We recognize that this previous generation of encryption tools may have been technically complex and challenging for many employees and as a result some may have not have done the proper encryption. Therefore, we have recently completed installation of an automatic full disk encryption product on all IRS laptops that automatically encrypts all data on the laptop, without requiring any employee action. We have tested this encryption system and certified that it meets mandatory standards. We have also provided physical security locks for all IRS laptops.

IRS employees have reported the loss or theft of over 500 laptop computers over the last five years. Prior to May 2006, these reports primarily focused on reporting the theft or loss of IT equipment. Given the heightened awareness across the Federal Government in

2006 to the protection of sensitive personally identifiable information (PII), all government agencies now are focused more on the reporting of any sensitive information that may have been lost when a laptop is lost or stolen.

The IRS laptop losses were reported to TIGTA, which investigated these incidents and provided reports back to IRS management. We recovered very few devices, as they are quickly re-sold.

We are also working with our Federal and State partners with whom we share information to implement encryption solutions on data tapes. The encryption solutions are planned to be completed by October 1, 2007. In the interim, the IRS is using special security shipping containers and courier services to ensure that tapes shipped from IRS are protected. Recipients of the data are subject to implementing specific safeguards and complying with published standards for the protection of the data. Appropriate documentation is required for the transport of the tapes.

As the Presidentôs Taskforce on Identity Theft recommended, the Office of Management and Budget (OMB) is working closely with all agencies, including the IRS, to develop policy guidance for notification in instances where an individualôs personally identifiable information has been compromised. The IRS has everything in place to comply with this new policy. We have reviewed all incidents, and there are a few that likely will require follow up (notification).

Summary

One of the questions that the IRS is asked frequently is how much money, beyond the Budget request, we could use productively. My honest answer to that question is that while I want Congress to appropriate every cent that has been requested, our ability to absorb additional funding beyond that amount is limited by our capacity to hire and train new personnel.

The FY 2008 Budget Request includes significant increases for IRS enforcement efforts. Fully funding that request will help us make progress in greatly improving voluntary compliance. Based on our analysis, covering the most recent 11 years of collection experience, we estimate that every dollar we have spent on enforcement has generated a direct return of an average of four dollars in increased revenue to the Federal Treasury. This return can be expected to occur when the full productive benefit of the investment is realized.

This direct return on investment does not consider the indirect effect of increased enforcement activities in deterring taxpayers who are considering engaging in noncompliant behavior. Econometric estimates of the indirect effects indicate a significant impact from increased enforcement activities. Stated another way, taxpayers who see us enforcing the law against their friends, neighbors, or competitors are more likely to comply voluntarily and not risk the chance that we might audit them. We do not measure this indirect impact, but research suggests that it could be as much as three times or more the direct impact on revenue.

We also believe that dollars spent on taxpayer service have a positive impact on voluntary compliance. The complexity of complying with the nation's current tax system is a significant contributor to the tax gap, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of improving voluntary compliance. To this end, the IRS remains committed to a balanced program assisting taxpayers in both understanding the tax law and remitting the proper amount of tax.

In addition, the President's FY 2008 Budget Request contains a number of legislative proposals that provide additional tools for the IRS to enforce the existing tax law. Perhaps the most critical of these tools is greater third party reporting. An analysis of the data from the National Research Program of TY 2001individual income tax returns leads to one very obvious conclusion. Compliance is much higher in those areas where there is third party reporting. For example, only 1.2 percent of wages reported on Forms W-2 are underreported. This compares to a 53.9 percent underreporting rate for income subject to little or no third party reporting.

The FY 2008 Budget Request asks Congress to expand information reporting to include additional sources of income and make other statutory changes to improve compliance. These legislative proposals are intended to improve tax compliance with minimum taxpayer burden. When implemented, it is estimated that these proposals will generate $29.5 billion over ten years.

I appreciate the opportunity to testify today, and I will be happy to respond to any questions that Members of the Committee may have.