IRS BUDGET PROPOSAL FOR FISCAL YEAR 1996 AND 1995 TAX RETURN FILING SEASON

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

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MONDAY, FEBRUARY 27, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in room B-318, Rayburn House Office Building, Hon. Nancy L. Johnson (chairman of the subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
February 15, 1995
No. OV-3

CONTACT: (202) 225-7601

JOHNSON ANNOUNCES HEARING ON INTERNAL REVENUE SERVICE BUDGET PROPOSAL FOR FISCAL YEAR 1996 AND 1995 TAX RETURN FILING SEASON

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will conduct a hearing on the Internal Revenue Services's budget proposal for fiscal year 1996 and the 1995 tax return filing season. **The hearing will be held on Monday, February 27, 1995, in room B-318 Rayburn House Office Building, beginning at 10:00 a.m.**

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

The fiscal year 1996 budget request for the Internal Revenue Service totals $8.2 billion and will support the activities of almost 115,000 employees. These resources will support the IRS's operations in collecting nearly $1.3 trillion in revenue and in administering the federal tax laws. The $8.2 billion budget request includes $830 million to process the tax returns which taxpayers will file in 1996; $1.6 billion to examine tax returns; $909 million for collection activities; and $1.9 billion for information systems.

The 1995 tax return filing season refers to the period of time between January and April 15th when American taxpayers are expected to file 116 million tax returns. Approximately 82 million taxpayers are expected to receive an average refund of over $1,100 in 1995.

The Subcommittee on Oversight held two hearings last year on the subject of income tax refund fraud. The Subcommittee learned that criminals were exploiting the tax system to receive fraudulent refund payments from the IRS. Two factors appear to have fueled a rapid expansion of refund fraud schemes. First, the refundable nature of some tax credits, such as the earned income tax credit (EITC), make them particularly susceptible to refund fraud. The U.S. General Accounting Office has said that the EITC is a factor in over 90 percent of fraudulent refund claims. Second, the advent of the electronic filing of tax returns has led some tax return preparers and banks to provide what are generally called "refund anticipation loans" (RALs) to taxpayers who file electronically. With RALs, banks lend money to a taxpayer based on his or her anticipated tax refund and not on the credit worthiness of the person as a borrower. Criminals sometimes can exploit the rapid turn-around time of a RAL to receive a refund before the IRS can complete its cross-checks and identify a fraudulent refund claim. At an October 6, 1994, Subcommittee hearing, Ronald K. Noble, the Under Secretary for Enforcement at the Department of the Treasury, testified that the refund fraud problem could be as high as $5 billion.

The Adminstration has taken several steps to curb income tax refund fraud during the 1995 filing season.

In October 1994, the IRS announced that it would suspend the issuance of direct deposit indicators (DDIs) to tax return preparers who file returns electronically. The DDI informs the tax return preparer that the taxpayer's refund is not subject to offset for delinquent government loans or child support. In the past, the receipt of a clean DDI often was a pre-condition for a bank to issue a refund anticipation loan.

The IRS also has increased its scrutiny of EITC claims. In particular, it is performing extensive cross-checks of all names and social security numbers to determine whether or not they match. A taxpayer's failure to supply accurate social security numbers could result in a delay of the person's tax refund.

DISCUSSION:

The IRS fiscal year 1996 budget request represents an increase of 888 employees and $726 million over the comparable levels in fiscal year 1995. The Subcommittee will review how these resources will be applied to carry out the mission of the IRS. In particular, it will review the status of the Tax System Modernization (TSM) program which is earmarked to receive over $1 billion in fiscal year 1996. TSM is the program to upgrade the computer and information handling capability of the IRS.

The Subcommittee also will review the staus of the 1995 tax return filing season. Special attention will be paid to the steps which the IRS is taking to curb refund fraud. It will review the consequences of the decision to suspend the issuance of DDIs and the closer scrutiny of EITC claims. It also will examine ways to reform the EITC to reduce fraud.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business, Monday, March 13, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

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Chairman JOHNSON. Good morning, Commissioner, and welcome everyone to this morning's hearing on the fiscal year 1996 budget proposal for the IRS (Internal Revenue Service), and on the 1995 tax return filing season.

The size of the budget increase sought this year is noteworthy. The budget will move from $8.2 billion and almost 115,000 employees to collect $1.3 trillion in revenue to a 10-percent dollar increase and a 922-person increase in the work force.

The size of the increase is noteworthy for several reasons: First, the increase is much larger than the inflation rate. Therefore, the budget proposal goes far beyond keeping pace with inflation and, instead, contains real growth in spending.

Second, the increase in the work force comes at a time when the overall Federal work force is undergoing a major downsizing. The fact that the IRS budget runs counter to the prevailing trend in Federal budgeting is no accident, but the expression "it takes money to make money" applies to the IRS as it applies to the business world.

This morning we want to learn how the IRS intends to use its resources in fiscal year 1996. Most IRS programs show only small changes but a few programs have significant increases. The budget proposal proposes a $441 million, or a 67-percent increase in the TSM (tax systems modernization) program.

The modernization program is supposed to upgrade and expand the IRS' computer and information handling capability. While it is absolutely essential to do so, it is important to understand the enormity of the challenge that the IRS faces year after year. Without this modernization program, it would certainly be crushed by the burden of processing over 1 billion documents every year.

Something I read mentioned that if you put the documents the IRS processes end to end you could circle the globe 36 times. It is a powerful amount of paper that has to be processed accurately, and so, Commissioner, we are very interested in the tax systems modernization program and in the progress you are making, as well as the problems you are encountering. Unfortunately, it is one of those programs that must be done, but a small mistake, as in the space program or other complex programs, could also have catastrophic consequences.

Second, the 1995 tax return filing season is now well under way and one major feature of this year's filing season is the activity of the IRS to curb fraudulent refund returns. The administration's testimony before the subcommittee in October 1994 revealed that refund fraud could be a $5 billion problem. We could fund most of the IRS' budget out of money the government is currently failing to collect.

Furthermore, a lot of the refund fraud is associated with the electronic filing program. In addition to the fact that 43 percent of the fraud is associated with electronic refunds, as I understand it, a large percentage of that fraud is associated with the EITC (earned income tax credit). It is important for this subcommittee to understand, because refundable tax credits are apparently turning out to be much more vulnerable to fraud than other kinds of taxes. With a number of refundable credits before us, this hearing today is not only relevant to the IRS' efforts to curb this fraud but also to decisions that we might make in coming weeks.

The action to delay refunds for 16 percent of the tax returns, that is one out of every six returns, has created some problems and we will get into those problems today.

Commissioner, with you and later in the hearing with those affected by them, we hope to understand the problems that have been created by your antifraud efforts and look at whether there are any ways that we could alleviate some of those problems as well as understand fully the rationale for your actions.

I welcome you, Commissioner Richardson. It is a pleasure to have you and your staff before us, and I yield to my colleague, Mr. Matsui, the ranking member of this subcommittee, for an opening statement.

Mr. MATSUI. Thank you very much, Madam Chairwoman.

I want to endorse the statements that you made in your opening comments. I would like to just make a couple observations, some are redundant from what you have indicated.

The IRS is asking for a budget increase of $739 million from the last fiscal year, and that would include a 922-person increase in employment. I think, as you said, however, that whenever the IRS seeks additional funds, it is usually to increase collections, and so certainly we will support an effort such as that.

In addition, we have the tax systems modernization program that the Commissioner has been pursuing for several years. This is something that I support. One issue I think that we need to resolve, however, is just what kind of savings we will see out of this. The service says approximately $9 billion will be achieved over a period of 5 years, and the GAO (General Accounting Office), who we will be hearing from today, has indicated that they are not able to make that determination. We need to find out about what we will actually save.

Of course the third area, I think, is the area of fraud. I think the earned income tax credit and others have created some problems, and I think the Service is attempting to deal with those.

With that, I would also like to tell the Commissioner that we look forward to hearing her testimony and of course working with her throughout this tax filing period and throughout the year. Thank you.

Chairman JOHNSON. Do other members of the subcommittee wish to make opening statements?

Commissioner.

STATEMENT OF HON. MARGARET MILNER RICHARDSON, COMMISSIONER, INTERNAL REVENUE SERVICE, ACCOMPANIED BY MIKE DOLAN, DEPUTY COMMISSIONER; LARRY WESTFALL, MODERNIZATION EXECUTIVE; PHIL BRAND, CHIEF COMPLIANCE OFFICER; BOB WENZEL, CHIEF STRATEGIC PLANNING AND COMMUNICATIONS; AND JUDY VAN ALFEN, CHIEF TAXPAYER SERVICE

Ms. RICHARDSON. Thank you, Madam Chairwoman, and other distinguished members of this subcommittee.

I would like to introduce the people who are with me today. Mike Dolan, who is the Deputy Commissioner is on my right, your left;

Larry Westfall, who is the modernization executive for the Internal Revenue Service and in charge of the TSM program; I also have with me Judy Van Alfen, the chief, taxpayer service; Phil Brand, who is our chief compliance officer; and Bob Wenzel, who is the chief, strategic planning and communications.

We really do appreciate the opportunity to be here today to talk about our 1996 budget request and also the 1995 filing season.

I believe that the United States currently has the best tax administration in the world, but we at the Internal Revenue Service do recognize we can no longer do business as usual. We believe that American taxpayers have a right to fair and efficient tax administration from a customer service-oriented organization. For that reason, we feel we must be able to take advantage of technology and business system innovation to collect the revenue owed at the least possible cost and with as little burden as possible for taxpayers. The challenges that face us today—a growing population, rapid changes in technology, a global economy, and increasing sophistication in business practices—require innovative and creative approaches to achieve efficient and effective tax administration.

Fiscal year 1996 is a pivotal year for us. Our fiscal year 1996 appropriation will not only shape the agency's future, but, in my opinion, it will affect the quality and the effectiveness of tax administration in this country for many years to come.

Madam Chairman, this morning, I would like to give you and your colleagues a sense of the range of our business and what we are doing to operate more effectively and efficiently today and on into the next century. The progress toward a more effective tax administration system today, however, including the steps that we took to get ready for the 1995 filing season, will pale in comparison to the potential the tax systems modernization program will offer us when it is completed in a timely fashion.

In a few minutes, I am going to ask Mr. Westfall to talk to you a little more about our tax systems modernization program, but before he does, I would like to tell you a little bit about how we accomplish our mission today, and also our plans for accomplishing our mission in the year 2001.

I often say that the IRS is like a large multinational corporation—and we are larger than all but a handful of corporations—and like other large multinationals, we engage in many lines of work in order to accomplish our mission. We are in the financial services business—like a bank or a credit card company—but unlike most banks and credit card companies, we have to maintain and service approximately 200 million taxpayer accounts. We respond to taxpayers' account questions, we adjust accounts, we send out bills, and we process payments. We also process tax returns and payments.

For instance, during this filing season, during 1995, we will process approximately 1.1 billion information documents and approximately 208 million returns. Our gross receipts, if you will, are close to over $1.2 trillion. To accomplish the monumental processing task, we currently use an assembly line-like process.

Today, processing takes place at 10 service centers and 2 computing centers, and, during the height of the filing season, we work round-the-clock, 7-day-a-week shifts. In those days just before and right after April 15, mountains of mail arrive at our service centers brought by convoys of tractor trailers.

Between 1986 and 1994, the number of tax returns filed increased by almost 15 million, while the staff processing these returns decreased—a real productivity improvement of 12.6 percent during that 8-year period. The result of this focus on productivity is that our 10 service centers today are currently operating at virtually their maximum levels of efficiency and quality within the limits of the current system. There is little or no further room for productivity increases at the service centers without technological enhancements.

TSM has already begun to help us meet the increased demands on our other burdened infrastructure by providing alternative methods of filing and receiving tax returns and payments. Today, a paper return must travel by mail to the service center, be processed through our mailroom, transported to a data entry clerk, and then keypunched into the system. This process is not only outdated and labor intensive, but it is also proned to errors by both taxpayers and by the Internal Revenue Service.

In contrast, nearly 16 million electronically filed documents, including 14,000,000 individual tax returns, bypassed these costly and inefficient steps last year. As a result, these electronically filed documents were processed with an accuracy rate of 99.5 percent, significantly higher than the accuracy rate for paper returns. Errors, by both IRS and taxpayers, represent rework at a significant cost and burden to the Service and possible cost and burden to taxpayers if we have to contact them in order to correct the errors.

By changing the way we do business through increased productivity and various alternative electric filing methods, we are already processing some tax returns and payments more efficiently. Although we are making significant progress by modernizing the way we conduct our business, we do need your continued support to completely transform our sixties assembly line processing operation into an automated, efficient operation worthy of the 21st century. Funding for our fiscal year 1996 budget request will help to ensure that the TSM program is completed in a timely fashion.

Another way we are changing the way we do business is by finding new and better ways to interact with taxpayers. Recognizing that correspondence is labor intensive, costly, and burdensome, the IRS has focused on making significant, meaningful improvements to our telephone operations. We do believe that taxpayers should be able to get through to the IRS on the first call and they should be able to have their issues resolved on that call.

To improve the way we interact with taxpayers, we have studied and are implementing some of the best practices of private industry. For example, today we can now transfer telephone traffic among 27 sites nationwide that helps us balance our workload and maximize the service availability to taxpayers.

Even though we have made progress in the way we interact with taxpayers, we are acutely aware of the fact that we can and must do more. Much of the progress to date can be credited to tax systems modernization, but to continue this process, we must fully implement the modernization program by the year 2001.

Future tax systems modernization improvements planned specifically to help the IRS better interact with taxpayers include adding interactive capabilities with our telephone system, which will provide taxpayers with secure, self-help account information capabilities, much like those available today with other financial institutions in the private sector.

For example, taxpayers will be able to use their telephone keypad 24 hours a day to access their accounts, to determine any outstanding balances, receive refund status, or arrange for a tax payment plan, in addition to being able to file their tax returns using their touch tone telephones, as some taxpayers in 10 States can actually do this year.

In making our tax administration system as effective and as efficient as possible, we understand that it is not enough just to modernize our information systems and business systems without updating our 40 year old structure. We are beginning to consolidate the returns processing operations that are now done in 10 service centers into 5 submission processing centers, and we are consolidating the 44 locations where we had 70 phone and correspondence operations into 23 customer service centers. We will be operating with 3 computing centers instead of 12. We are very close to finalizing recommendations about the number and primary functions of our district offices.

The combination of organizational streamlining, business change, and state-of-the-art technology will move us from a paper-based, labor-intensive system to an electronic filing and payment system.

In addition to our financial services and processing lines of business, the IRS is also charged with enforcing the law, both civil and criminal, and collecting taxes that are not paid voluntarily. Although it is only one of our lines of business, our compliance function is probably the best known part of what the IRS does. We estimate that about 83 percent of the taxes due are paid voluntarily, another 3½ percent, or a total of 86.5 percent, is collected annually through compliance and enforcement efforts.

In fiscal year 1994, total enforcement revenue collected by the Internal Revenue Service was $33.7 billion, of which $23.5 billion was a direct result of IRS collection efforts. Total revenue collected last year through compliance was more than four times as much as our entire budget.

We also know that examinations, collection actions, and criminal investigations are, and I fear always will be, essential to demonstrate to those who do comply with the tax law that those who do not comply will be caught. The IRS is continuing to improve its compliance efforts to maximize the revenue collected. Enhancing our research capabilities, the linchpin of future compliance efforts, will enable us to measure voluntary compliance levels nationally and locally to identify broad market segments in industries that are noncompliant and affect taxpayer behavior through a combination of information, education, and enforcement.

Research is helping our compliance employees select the most productive cases for examination, and it is increasing their effectiveness during those examinations, improvements which will not only produce additional revenue but will also reduce taxpayer burden caused by an inefficient audit process.

We also have other tax systems modernization projects under way to increase compliance and reduce taxpayer burden. In addition to automation and compliance efforts, carefully crafted statutory changes relating to the administration of the tax law can also dramatically affect the amount of revenue collected by the IRS.

For example, the 1993 tax legislation changed the point of taxation for diesel fuel from the distributor to the terminal and authorized the dyeing of tax-exempt diesel fuel which reduced fraud and increased dramatically the amount of excise taxes collected. Through the first three-quarters of calendar year 1994, the tax dollars from taxable diesel fuel sales reported on excise tax returns increased by 34.6 percent over the same period in calendar year 1993, even after adjustment for the recent rate increase. That was an additional $1.09 billion.

Although some of the increase in sales reported may be attributable to improved economic conditions, we believe that almost all of the increase is due to greater compliance achieved by moving the collection point from the distributor to the terminal rack, from the dyeing of diesel fuel used for nontaxable purposes, and from greater enforcement efforts.

We could increase collection of excise taxes even more with your help. Diesel fuel fraud, particularly when it involves organized crime, must be addressed through undercover operations that are initiated by our criminal investigation activity. As I testified before this subcommittee last October, undercover fraud operations, particularly diesel fuel fraud investigations, are expensive and currently they must be paid for with appropriated funds.

The Department of Treasury supports giving the IRS authority to use the proceeds of undercover operations to finance them. We had this so-called "churning" authority at one time but the statute lapsed and we think it needs to be reinstated. We are currently the only Federal law enforcement agency without this authority.

Last year with the support of this subcommittee, Congress funded a 5-year compliance initiative for additional compliance programs that have afforded us the first opportunity since 1991 to undertake a multiyear effort to collect the revenue that is owed. Over a 5-year period we estimate conservatively that tax revenue from this initiative will be $9 to $10 billion. This initiative is focused heavily toward the collection of delinquent accounts, with special emphasis on reaching taxpayers quickly by telephone if we have an indication of a delinquency.

I should add that even with the additional compliance initiative staffing in 1995, in the fiscal year we are in now, we are operating with about 3,800 FTE (full-time equivalent) positions fewer than we had in 1992. So we actually have come down over the years in staffing.

We have set an ambitious goal to increase overall compliance to 90 percent by the end of 2001, a goal that will provide an additional $40 billion in tax revenues by 2001 and every year thereafter. With your continued support of the 1995 compliance initiative and tax systems modernization, we are convinced that we can achieve this goal.

I would like now to turn briefly to this year's filing season.

The filing season begins with taxpayers filling out their returns and sending them to the IRS. Earlier, I described what we are already doing to process some returns more efficiently. I also want to describe some steps we have taken to make filling out forms and complying with the law less burdensome for taxpayers.

We recognize that an easier filing season starts with simpler, more understandable forms and instructions. We have concentrated especially on making improvements in forms for small businesses. Examples of those improvements to date include a new streamlined schedule C–EZ for sole proprietors and a much simpler form 940, which is the Federal unemployment tax return, that can be used by two-thirds of all the form 940 filers.

Last year I created an Office of Small Business Affairs, run by Barbara Jenkins, who I believe is here with me today. Her office is working with small businesses to address paperwork and regulatory problems and looking for opportunities to apply technology and increase communications with small business communities.

We are also working with the Social Security Administration and the States to simplify the tax and wage reporting system to eliminate the need for multiple reporting. Last year, the Social Security Administration extracted wage information from the W–2s submitted from 12 States and redistributed this information not only to us, but also to some of the States, eliminating the need for employers to send paper W–2s to those States. This filing season, 28 States have enrolled in the program.

Where we can, we are using technology to get information to taxpayers as quickly and as easily as possible. For example, we now can provide the public with a CD–ROM version of tax forms, publications, and instructions. This means that copies of forms, publications, and instructions, even seemingly hard to find ones, can be printed on demand without having to leave your home or your office. This year forms and instructions, as well as up-to-date information, are available on the information superhighway through FEDWORLD, which is an electronic bulletin board service. That gives the public access to files of tax forms, instructions, and publications which they can print out on their own computers.

This year we expect to respond to 70 million taxpayers through our phone centers. Our telephone assisters will respond to 36 million taxpayer inquiries over our toll-free system, but regrettably this is still only 52 percent of the customers who will request the services of an assister. We want to be able to serve those other 48 percent, too.

Because we understand and feel very strongly that taxpayers must be informed if they are going to file accurate and complete returns, I often say that the front end of compliance really is our taxpayer service function. We are planning to answer 1.3 million more calls this year than we were given the money to do. Unfortunately, as you will hear later from the General Accounting Office, this is still far short of the demand.

We have also expanded our hours of service this filing season. Our telephone lines are now open at least 10 hours a day each work day, and all IRS telephone sites will provide telephone help during three Saturdays in April.

TSM funds are allowing us to replace our equipment with a state-of-the-art telephone system that provides the capability to transfer calls among our toll-free sites so that we can reduce delays and answer more calls. Where that system has been installed, we are already improving productivity by 10 percent, allowing us to answer more taxpayer calls. We also have after hours routing to our automated Tele-Tax system that can address 140 tax topics, as well as provide refund status information.

We are going to be responding to more than 22 million pieces of correspondence this year, and we expect to help more than 7 million taxpayers at our walk-in assistance sites. To further our goal to reduce the burdens on taxpayers, we have expanded the number of our assistant sites this year, offering no-cost electronic filing from the 42 we had last year to 232 this year. Electronic filing at no cost is also available at over 1,000 volunteer income tax assistance sites.

Clearly, our biggest challenge this filing season has been to put in place better methods to protect the tax revenue from those who want to commit fraud. Although the IRS has addressed tax refund fraud through its questionable refund program for many years, technology has significantly improved the capabilities of both government agencies and private financial institutions to deliver money faster. Those shorter payment cycles, coupled with the capacity for electronic payments, require both public and private institutions to be more vigilant than ever in guarding against fraud.

Since 1990, the IRS has steadily increased its efforts to control refund fraud. Significantly more fraud has been identified and stopped by the IRS and more new schemes have been identified. In May 1993, shortly after I was confirmed, I appointed an IRS executive, Ted Brown, right behind me, to coordinate our refund fraud prevention and detection efforts, and we established a coordinating group to assure that our entire organization worked in concert to address problems contributing to refund fraud.

Last spring, in consultation with this subcommittee, the Secretary of the Treasury established a special task force to further study the problem of refund fraud and propose additional preventive actions. In reporting to the Congress last October, the task force estimated that erroneous and fraudulent returns could be costing the Treasury between $1 and $5 billion a year. Since the hearing on the subject of refund fraud before this subcommittee last February, we have taken many steps as part of an agencywide strategy to protect the revenue.

For example, we established new qualification criteria for electronic return originators. We have used both IRS and outside expertise to analyze patterns indicative of erroneous or fraudulent refunds, and we have reprogrammed a series of filters and screens into our processing system. Also, we have made additional staff available to our processing criminal investigation and examination activities to reinforce our refund protection strategy.

One thing all experts on fraud will tell you is that fraud is everchanging. We will continue to use the knowledge we gain about fraud to identify indicators of questionable refunds.

With the Los Alamos National Laboratory, the premier authority in computerized pattern protection, we are building even more sophisticated screening techniques than we have today. Obviously, we cannot discuss the specific screens without compromising the effectiveness of these new tools.

This filing season we are carefully reviewing all returns, paper and electronic, to ensure that only those taxpayers who are entitled to refunds receive them. We have spent a lot of time, both before the filing season began and since it got under way, urging taxpayers to use accurate Social Security numbers for themselves and for their dependents, because we are verifying those numbers on all returns.

If you think about an ATM machine at the bank, you cannot get your money out if you do not use the correct PIN number and refunds should be subjected to the same kinds of scrutiny.

We are, as we have repeatedly said we would be doing, slowing down the process to allow us additional time to verify claims before we issue refunds. We estimate that as many as 8 percent of all refunds may be delayed this year. Although some refunds are being delayed in whole or in part, the vast majority of the refunds claimed to date have been paid, and I want to emphasize that they have been paid within the customer service standards that we spelled out in our tax packages: 21 days for electronically filed returns and 40 days for paper returns.

We regret that for some taxpayers, perfectly legitimate refunds will be delayed this year because the initial screening criteria will flag their returns. But I want to emphasize that taxpayers who are entitled to refunds will receive them and those refunds will be sent out as soon as possible. When we have delayed a refund in whole or in part, we are letting taxpayers know why. Our notice explains that the full refund or remaining refund amount will be sent within 8 weeks unless we determine additional contact with the taxpayer will be necessary to verify the claim.

I also want to point out that for true hardships we have our problem resolution program, which is available to provide assistance to taxpayers.

At our hearing before this subcommittee last February, we outlined our four-part refund fraud strategy. First, we felt we needed to develop a better understanding of patterns of fraud and our work with the Los Alamos National Laboratory is an example of this. They are using the same kinds of pattern detection techniques that they did in developing some of the Star Wars technology.

Second, we wanted to prevent recurrences of error or fraud. Checking the accuracy of the Social Security numbers and tightening our policies and procedures for screening electronic return originators are examples of fraud prevention.

Third, we wanted to detect fraud before refunds are paid.

Fourth, we wanted to take vigorous action when we uncover fraud. Working with the Department of Justice and the U.S. Attorneys, we are actively pursuing criminal violations. As I state, we have spent a lot of time this filing season urging taxpayers to be very careful to file accurate returns using correct Social Security numbers for themselves and for their dependents.

In addition to including this cautionary information in our tax packages and all of our filing season publicity, we also worked extensively with the tax preparer community, with financial institutions, before the 1994 season even ended, to let them know we would be taking additional steps this filing season to protect tax revenues against fraud. We also would be soliciting their assistance about how to better accomplish this goal in a way that would be less burdensome to taxpayers.

One subject that I would like to touch briefly on is one we have worked very hard to promote, and that is claiming the earned income tax credit on an advanced basis. Workers who qualify for the advanced earned income tax credit can get up to $105 a month in their paychecks. They can get it whether they are paid weekly, biweekly, monthly or whatever, and they can do it by filling out a simple form W–5, the Earned Income Tax Credit Advance Payment Certificate, and providing it to their employers.

By claiming the earned income tax credit in advance, eligible taxpayers can have the use of the additional money throughout the year. They can also avoid potential delays when they claim the credit after the yearend. In other words, they do not have to wait until they file their returns to get that credit.

Turning to modernization, a fully implemented tax systems modernization program is an integral and necessary part of the IRS' future. For that reason, I understand and all of us at the IRS understand that it is essential that tax systems modernization be effectively managed.

In addition to the progress that we have made toward modernizing the tax system, the IRS has also made significant improvements in our overall management of TSM. Because of the very large financial commitment we are asking for TSM, we understand the need to assure Congress and the American taxpayers that the IRS can indeed implement this program.

In recent testimony before our House Appropriation Subcommittee, the General Accounting Office expressed three basic concerns it had about the successful completion of TSM. The first concern focused on technical and management expertise and skills.

Madam Chairman, we have worked very, very hard to assure that we not only have the IRS personnel necessary to do that job, but that we are also including outside experts in the project.

Probably the most important step I have taken as Commissioner in connection with TSM has been the appointment of Larry Westfall as the modernization executive. On June 30, 1994, I issued a memorandum throughout the Internal Revenue Service detailing his role in managing TSM. He reports directly to me, and my memorandum made it very clear that everyone in the IRS reports directly to him in all matters concerning tax systems modernization. In other words, he is our TSM program manager and has the responsibility for overseeing every aspect of modernization, including the use of outside contractors.

About 75 percent of the proposed TSM budget would pay for contractor-provided products and services. Two major support contractors, the Illinois Institute of Technology and the TRW Corporation, have worked with us for some time to develop and manage our TSM effort. We are also relying heavily on oversight and guidance from the National Research Council and from the General Accounting Office.

GAO's second concern was that new technology would be introduced without making improvements in underlying business processes. We recognize that upgrading information systems alone is not the answer to meeting current and future challenges. Consequently, we have rethought the fundamental way we carry out our mission.

As I briefly touched on a few minutes ago, we are not only redesigning our business systems, but are also reorganizing to take full advantage of modern technology. Taxpayers are already benefiting from the combination of new business approaches and applied technology, for example, with more filing and payment choices and, I think, improved customer service is also out there.

Addressing the GAO's third concern that the IRS set system development priorities and establish performance measures, under Mr. Westfall's leadership, we are establishing management control processes for modernization that demonstrate our commitment to change and our understanding of what it takes to make change happen. We now have schedules for implementing TSM, monitoring the program, and measuring its success. We have plans and schedules against which our performance can be monitored and the success of TSM determined.

Madam Chairman, I stated at the outset that fiscal year 1996 is a pivotal year for us as we continue with our plans to acquire and implement major new systems. What happens to our fiscal year 1996 budget will impact the tax administration system of the future, shaping our ability to effectively administer the tax law and collect all the revenue that is due. TSM will influence most every aspect of this business: Our processing capabilities and the filing season, the effectiveness of our customer service efforts, and our compliance capabilities, including fraud detection and prevention.

I would also like to reemphasize a point that I have made to you and Chairman Archer and many of your colleagues on this subcommittee as I have met with you. I realize that the 104th Congress is considering making changes to the Internal Revenue Code and one of my concerns is that before any legislation becomes final, we be given an opportunity to advise you about issues relating to any burden possible changes may have on taxpayers as well as on the tax administration system. Particularly when legislative changes occur late in the year, the effect on the next filing season can be very significant. Some of that burden that is placed upon taxpayers might be avoided if we could consult with you during the formative stages of the legislation.

I know, Madam Chairman, that you and members of the subcommittee have many questions, but if it fits with your schedule, I would like to ask Mr. Westfall to give you just a brief overview of where we are with TSM and then we would also be delighted to answer your questions.

Chairman JOHNSON. Commissioner, if I may, thank you very much for your thorough overview of the challenges that face the IRS and the great variety of initiatives that you and your staff have developed to address them.

[The prepared statement and attachment follow:]

STATEMENT OF

MARGARET MILNER RICHARDSON
COMMISSIONER OF INTERNAL REVENUE

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS AND MEANS

FEBRUARY 27, 1995

Madame Chairman and Distinguished Members of the Subcommittee:

With me today are Mike Dolan, Deputy Commissioner; Larry Westfall, Modernization Executive; Phil Brand, Chief Compliance Officer; Bob Wenzel, Chief Strategic Planning and Communication; and Judy Van Alfen, Chief Taxpayer Service. We appreciate the opportunity to be here today to discuss the Internal Revenue Service's FY 1996 Budget request and the 1995 Filing Season.

The United States currently has the best tax administration system in the world. But government at every level is facing new and different challenges. We at the IRS recognize that we can no longer do business as usual. American taxpayers have a right to fair and efficient tax administration from a customer service-oriented organization. To provide this, the IRS must be able to take advantage of technology and business system innovation to effectively collect the revenue owed at the least possible cost and with as little burden as possible for taxpayers. The challenges facing the IRS today -- a growing population, rapid changes in technology, a global economy, and increasing sophistication in business practices -- require innovative and creative approaches to achieve efficient and effective tax administration.

The IRS is at a crossroads, and FY 1996 is a pivotal year for us. Our FY 1996 appropriation will not only shape the agency's future, but, in my opinion, it will affect the quality and effectiveness of tax administration in this country for many years to come.

OUR BUSINESS AND THE NEED TO MODERNIZE

Madame Chairman, this morning, I would like to give you and your colleagues a sense of the range of the IRS's business and what we are doing to operate more effectively and efficiently today and into the next century. The progress toward a more effective tax administration system today, including steps we took to get ready for the 1995 filing season, will pale in comparison to the potential the Tax Systems Modernization program (TSM) will offer us when it is completed in a timely fashion.

Several years ago, with the strong bipartisan support of Congress, the IRS embarked on a plan to update its technology and change its business practices to meet the challenges of tax administration for the rest of the decade and into the next century. That plan, Tax Systems Modernization, is an integrated program to upgrade the IRS's technology and systems in ways that most effectively and efficiently allow us to accomplish our mission which is to collect the proper amount of taxes at the least cost while reducing the burden on taxpayers.

TSM will revolutionize three central processes: 1) capturing data from tax returns and other documents as completely and economically as possible; 2) storing and analyzing data to improve IRS's ability to maintain accurate taxpayer accounts and correct errors; and 3) providing access and information to authorized employees to improve customer service and compliance.

TSM is an integrated approach that combines updated business practices with updated technology to improve the current tax administration system. Some TSM projects are already a reality. Without this integrated approach to modernization, the IRS will be forced to merely replace in a piecemeal fashion the antiquated system we have today without overall improvement. Despite the progress made so far, we recognize that we have more work to do. As I am certain each of you recognizes, taking full advantage of technology and business system innovation is not an easy task; it takes much careful planning and investing over time.

Before turning to specific details about TSM, I would like to share with you how we accomplish our mission today, and our plans for accomplishing our mission in the year 2001. The IRS is like a large multi-national corporation -- larger than all but a few Fortune 50 companies -- and, like other large multi-nationals, the IRS engages in many different lines of work to accomplish its mission.

We are in the financial services business -- like a bank or credit card company -- and we maintain approximately 200 million taxpayer accounts. As part of this line of business, the IRS responds to taxpayers' account questions, adjusts accounts, sends out bills and processes payments.

PROCESSING RETURNS AND PAYMENTS

In addition to our financial services business, we process tax returns and payments. During 1995, we will process approximately 1.1 billion information documents and approximately 208 million returns, and our "gross receipts" will be over $1.2 trillion. To accomplish this monumental task, the IRS currently uses a factory assembly line-like process. Today processing takes place at ten Service Centers and two Computing Centers by round-the-clock, seven-day-a-week shifts during the height of the filing season. In the days just before and right after April 15th, mountains of mail arrive at our Service Centers by convoys of tractor trailers.

To reduce the burden on taxpayers and enhance voluntary compliance, the IRS must accurately and promptly accomplish this massive processing job. Between 1986 and 1994, the number of tax returns filed increased by almost 15 million, while the staff processing these returns decreased. As a result, the IRS recognized a real productivity improvement of 12.6 percent during that period. The result of this eight-year focus on productivity is that our ten Service Centers are currently operating at virtually their maximum levels of efficiency and quality. With the limitations of our current system, there is little or no further room for productivity increases at the Service Centers.

By the year 2002, the IRS will be receiving 27 million additional tax returns, more than the entire workload of one of our 10 Service Centers today. We are concerned that this increased volume could put at risk our ability to accurately and promptly process returns and payments, particularly since our current system cannot be modified quickly to adjust to tax law changes.

TSM has already begun to help us meet the increased demands on our overburdened infrastructure by providing alternative methods of filing and receiving tax returns and payments. A paper return must travel by mail to the Service Center, be processed through our mail room, transported to a data entry clerk and key punched into the system. This process is not only outdated and labor intensive, but also prone to errors by both taxpayers and the IRS. In contrast, nearly 16 million electronically filed documents, including 14 million individual tax returns, bypassed these costly and inefficient steps last year. As a result, these electronically filed documents were processed with an accuracy rate of 99.5 percent -- significantly higher than the accuracy rate for paper returns. Errors, by both IRS and taxpayers, represent re-work at a significant cost and burden to the Service and possible cost and burden to taxpayers if we have to contact them to correct errors.

By changing the way we do our business through increased productivity and various alternative electronic filing methods, the IRS is already processing some tax returns and payments more efficiently. But without full implementation of TSM, we will be severely limited in our ability to achieve additional breakthroughs due to the age and capacity of our current systems. The current systems used for receiving and processing returns and payments are nearing or beyond their life expectancy. In contrast, the IRS's modernized system will use fewer resources and accurately capture up to 100 percent of return information that will be available immediately.

Although we are making significant progress modernizing the way we conduct our business, we need your continued support to completely transform our current 1960's assembly-line processing operation into an automated, efficient operation worthy of the 21st century. A fully implemented TSM program will enable us to fundamentally change the way we manage taxpayer accounts, and funding our FY 1996 Budget request will help to ensure that the TSM program is completed in a timely fashion.

TAXPAYER ASSISTANCE

Another way we are changing the way we do business is by finding new and better ways to interact with taxpayers. Recognizing that correspondence is labor- intensive, costly, and burdensome, the IRS has focused on making significant, meaningful improvements to its telephone operations. Taxpayers should be able to get through to IRS on the first call and have their issues resolved. We have already enhanced our systems through TSM, so today IRS representatives anywhere in the country can research and update taxpayers' accounts regardless of where taxpayers live. Future TSM enhancements will include expanded safeguards designed to protect access to taxpayers' accounts and a fuller access to available data.

To improve the way we interact with taxpayers, we have studied and are implementing the best practices of private industry. Our actions will result in better service and increased revenue collection. For example, we can now transfer telephone traffic among 27 sites nationwide to balance workload and maximize service availability to taxpayers.

Although we have made progress in the way we interact with taxpayers, we know that we can and must do more. Much of the progress to date can be credited to Tax Systems Modernization, and, to continue this progress, we must fully implement the modernization program by the year 2001.

Future TSM improvements planned specifically to help the IRS better interact with taxpayers include adding interactive capabilities to our telephone system which will provide taxpayers with secure, self-help account information capabilities, much like those available today with other financial institutions. For example, taxpayers will be able to use their telephone keypad 24 hours a day to access their accounts to determine any outstanding balances, receive refund status, or arrange for a tax payment plan.

ORGANIZATIONAL CHANGE

In making our tax administration system as effective and efficient as possible, we understand that it is not enough to modernize our information systems and business systems without updating the organization's 40-year old structure. A structural change is essential to capitalize on the modern technology and the way we want to do business. In 1993 and 1994, we restructured our Headquarters and Regional Office organizations, and redesigned our methods of supporting compliance and customer service operations. This reorganization has reduced layers of supervision, increased management spans of control, reduced overhead, consolidated support operations (personnel, automation support, training, facilities support), and focused line executives on improving compliance and service to taxpayers.

These efforts are part of our Business Vision -- consolidating functions that were previously dispersed and making the optimum use of technology. We are beginning to consolidate the returns processing operations now done in ten Service Centers into five Submission Processing Centers, and to consolidate the 44 geographic locations where we had 70 phone and correspondence operations into 23 Customer Service Centers. We will be operating with three computing centers responsible for centralized mainframe computing instead of twelve, and we are very close to finalizing recommendations about the number and primary functions of our district offices. The combination of organizational streamlining, business change and state-of-the-art technology will move us from a paper-based, labor intensive system to an electronic filing and payment system.

COMPLIANCE

In addition to our financial services and processing lines of business, the IRS is also charged with enforcing the law -- both civil and criminal -- and collecting taxes that are not voluntarily paid. Although it is only one part of our business, our compliance function is probably the best known part of what the IRS does.

Our research estimates that about 83 percent of taxes due are paid voluntarily. Another 3.5 percent (for a total of 86.5 percent) is collected annually through compliance and enforcement efforts. In FY 1994, total enforcement revenue collected by the IRS was $33.7 billion, of which $23.5 billion was a direct result of the IRS collection organization. Total revenue collected last year was more than four times as much as the entire IRS budget. And while compliance is not directly responsible for the generation of revenue which is voluntarily paid, examinations, collection actions and criminal investigations are, and always will be, essential to demonstrate to those who do comply with the tax law that those who do not comply will be caught.

As part of our efforts in FY 1994 we:

- Increased the number of examinations of foreign controlled corporations and proposed over $8 billion in adjustments, thus making sure that income is taxed in the proper jurisdictions;

- Initiated over 5,340 criminal investigations and recommended prosecution in over 3,740. These investigations covered motor fuel excise taxes, failure to file income tax returns, money laundering, bankruptcy, and other financial crimes;

- Examined 1.4 million income, employment and excise tax returns, proposed additional tax and penalties of $24.4 billion, and disallowed $3.3 billion in claims against the Treasury;

- Examined over 77,700 exempt organizations and 29,300 employee benefit plans; and

- Made determinations on over 62,000 exempt organizations and 53,400 employee benefits plans.

The IRS is continuing to improve its compliance efforts to maximize the revenue collected. Enhancing the IRS's research capabilities -- the linchpin of future compliance efforts -- will enable the IRS to measure voluntary compliance levels nationally and locally; identify broad market segments and industries that are noncompliant; and affect taxpayer behavior through a combination of information, education and enforcement.

As part of TSM, we have acquired the hardware and software needed for our National Office Research and Analysis site, as well as the 31 local District Office Research and Analysis sites. These sites have been staffed and training is underway. This research is helping our compliance employees select the most productive cases for examination and is increasing their effectiveness during those examinations. These improvements will not only produce additional revenue but will also reduce taxpayer burden caused by an inefficient audit process.

We also have other TSM projects underway to increase compliance and reduce taxpayer burden. The Integrated Collection System (ICS) and Totally Integrated Examination System (TIES) automate the examination and collection activities. These systems increase the productivity of field revenue agents, office tax auditors, service center tax examiners and field revenue officers. The TIES and Automated Underreporter (AUR) systems assist compliance personnel by automating previously manual tasks such as report writing, tax and penalty computations and a host of other required actions. These automated systems reduce the time period to complete an examination by as much as several months. ICS, which assists collection personnel with the field collection process, increased revenue officer productivity in the test site by 26 percent and reduced by 20 days the time it took a revenue officer to complete a case. The TSM systems are producing immediate benefits, while at the same time, building the foundations for the fully integrated system of the future.

Automation of Criminal Investigation (CI) is also underway. During FY 1995, we are piloting the initial phase of the new Automated Criminal Investigation (ACI) system that, when fully implemented, will permit CI employees to use information from sources throughout the law enforcement community. In addition, on a broader scale, Tax Systems Modernization will provide enhanced capabilities for detecting and stopping those who try to circumvent the tax system fraudulently.

We have set an ambitious goal to increase overall compliance to 90 percent by the end of 2001 -- a goal that will provide an additional $40 billion in tax revenues by 2001 and every year thereafter. With your continued support of the FY 1995 Compliance Initiative and TSM, we will be able to achieve this goal.

I would like to note that in addition to automation and compliance efforts, carefully crafted statutory changes relating to the administration of the tax law can dramatically affect the amount of revenue collected by the IRS. For example, in the 1993 Omnibus Budget Reconciliation Act, Congress changed the point of taxation for diesel fuel from the distributor to the terminal and authorized dyeing of tax- exempt diesel fuel. This change has reduced fraud and abuse and increased dramatically the amount of excise taxes collected.

Through the first three quarters of calendar year 1994, the tax dollars from taxable diesel fuel sales reported on excise tax returns increased by 34.6 percent over the same period in calendar 1993, adjusted for the recent rate increase -- an additional $1.09 billion. Although some of the increase in sales reported may be attributable to improved economic conditions, we believe almost all the increase is due to greater compliance achieved by moving the collection point from the distributor to the terminal rack, dyeing of diesel fuel used for non-taxable purposes, and greater enforcement efforts.

The IRS could increase collection of excise taxes even more with the help of this Subcommittee. Diesel fuel fraud -- particularly when it involves organized crime -- must be addressed through undercover operations initiated by our Criminal Investigation activity. As I testified in a hearing before this Subcommittee last October, undercover fraud operations, particularly diesel fuel fraud investigations, are expensive and currently must be paid for with appropriated funds. The Department of the Treasury supports giving the IRS authority to use the proceeds of undercover operations to finance them. IRS had this so-called "churning" authority at one time but the statute lapsed and needs to be reinstated. We are currently the only federal law enforcement agency without this authority.

THE FY 1995 COMPLIANCE INITIATIVE

The IRS has an ambitious goal to raise the overall compliance rate to 90 percent by the year 2001. As I stated, accomplishing this goal will increase the revenue collected without any change in the tax rate. Last year, with the support of this Subcommittee, Congress funded a five-year compliance initiative that provided for an appropriation of $405 million and 6,238 FTEs for additional compliance programs. That initiative affords IRS the first opportunity since FY 1991 to undertake a multi-year effort to collect the revenue owed. Over the FY 1995 - FY 1999 period tax revenue from this initiative is estimated at $9-10 billion. The return on this investment builds each year as new employees become fully productive and additional cases are closed.

As part of the initiative, the IRS has already hired more than 3,300 permanent compliance employees. With further hiring underway, the IRS is poised to fully utilize all of the much needed resources provided in this initiative. This initiative is focused heavily toward the collection of delinquent accounts, with special emphasis on reaching taxpayers quickly by telephone if we have an indication of a delinquency.

Even with the additional staffing, in FY 1995 IRS is operating with about 3800 FTE fewer than we had in FY 1992. Because of improvements in management and the impact of our early TSM projects, we have placed more FTE in compliance and accounts maintenance work and proportionately fewer in processing returns and correcting errors. As part of TSM, we have a number of projects underway to increase compliance and reduce taxpayers' burden. These systems are producing immediate benefits, while at the same time, building the foundations for the fully integrated system of the future.

TAX SYSTEMS MODERNIZATION

A fully implemented Tax Systems Modernization program is an integral and necessary part of the IRS's future. For that reason, I understand, and all of us at the IRS understand, that it is essential that TSM be effectively managed. In addition to the progress that we have made toward modernizing the tax system, the IRS has also made significant improvements in our overall management of Tax Systems Modernization. Because of the very significant financial commitment we are asking for TSM, we understand the need to assure Congress and American taxpayers that the IRS can implement this program.

In our recent testimony before the House Appropriations Subcommittee on Treasury, Postal Service and General Government, the GAO expressed three basic concerns it had about the successful completion of TSM. The first concern focused on technical and management expertise and skills. Madame Chairman, we have worked hard to assure that we not only have the IRS personnel necessary to do the job, but that we are also including outside experts in the project.

About 75 percent of the proposed TSM budget would pay for contractor provided products and services. Two major support contractors, the Illinois Institute of Technology and the TRW Corporation, have worked with us for some time to develop and manage the TSM effort. We also are relying heavily on oversight and guidance from the National Research Council, as well as the GAO.

The second concern was that new technology would be introduced without making improvements in underlying business processes. We recognize that upgrading information systems alone is not the answer to meeting current and future challenges. Consequently, we have rethought the fundamental way we carry out our mission. We are not only redesigning business systems but are also reconfiguring our organization to take full advantage of modern technology. Taxpayers are already benefitting from the combination of new business approaches and applied technology, for example, with more filing and payment choices and improved customer service.

Maybe the most important step I have taken as Commissioner in connection with TSM has been the appointment of Larry Westfall as the Modernization Executive. On June 30, 1994, I issued a memorandum throughout the IRS detailing his role in managing TSM. He reports directly to me and my memorandum made it very clear that everyone in the IRS reports directly to him in all matters concerning TSM. In other words, he is the TSM program manager and has the responsibility for overseeing every aspect of modernization, including the use of outside contractors.

Under his leadership, we have also established management control processes for modernization that demonstrate our commitment to change and our understanding of what it takes to make change happen. We believe this addresses GAO's third concern -- that the IRS set system development priorities and establish performance measures.

As part of this new approach, we have conducted a number of critical project reviews to ensure the early identification and resolution of issues. These reviews will enable us to better identify and control risks involving modernization and ensure that we remain on track.

We now have schedules for implementing TSM, monitoring the program and measuring its success. Our Business Master Plan, Integrated Transition Plan and Schedule, and the Concepts of Operations were prepared this past year and these documents provide the program and project level priorities for TSM. They clearly identify the milestones and accountability for development of the operational capabilities that create the modernized IRS. They also form the baseline set of plans and schedules against which our performance can be monitored and the success of TSM may be determined.

The Modernization Executive is working with the Infrastructure Project that was established in the Chief Information Officer organization to complete delivery of the remaining architectural and integrated design components of TSM by summer 1995. Next month, as we committed to the Subcommittee on Treasury, Postal Service, and General Government, we will provide Congress a timetable for the systems architecture and integration requirements and comprehensive data standards.

The Chief Financial Officer has established a new Office of Economic Analysis to certify annual budget estimates for TSM, oversee an independent cost analysis for TSM, and develop a new economic analysis process for determining TSM costs and benefits.

THE FILING SEASON - MAKING COMPLIANCE EASIER

I would like to turn to this year's filing season. The filing season begins with taxpayers filling out their returns and sending them to the IRS. I have already described to you the things the IRS is doing to process these returns more efficiently. I would also like to describe some steps we have taken to make filling out forms and complying with the law less burdensome for taxpayers.

An easier filing season starts with simpler, more understandable forms and instructions. We have concentrated especially on making improvements in forms for small businesses. Examples of improvements to date include a new streamlined Schedule C-EZ for sole proprietors and a much simpler Form 940 (Federal Unemployment Tax Return) that can be used by two-thirds of all Form 940 filers. Last year, I created an Office of Small Business Affairs, run by Barbara Jenkins who is with me here today. This Office is working with small businesses to address paperwork and regulatory problems and looking for opportunities to apply technology and increase communication.

We are also working with the Social Security Administration and the states to simplify the tax and wage reporting system. This concept calls for all federal and state wage and employment taxes to be reported to a single point which will distribute information, eliminating the need for multiple reporting. Last year, the Social Security Administration extracted wage information from the W-2s submitted from 12 states and redistributed this information to IRS and the states eliminating the need for employers to send paper W-2s to those states. This filing season, 28 states have enrolled in this program.

Reducing a taxpayer's burden in meeting his or her tax obligations is one of our three business objectives -- along with improving compliance and enhancing productivity. We want to make it easier for taxpayers to get the information they need to file accurate returns; we want to make the returns themselves easy to understand and file; and after taxpayers file, we want to make it simple to resolve account problems.

Wherever we can, we are using technology to get information to taxpayers as quickly and easily as possible. For example, we now can provide the public with a CD-ROM version of tax forms, publications and instructions. This means that copies of forms, publications and instructions -- even seemingly hard to find ones -- can be printed on demand without leaving your office. We are also making forms and instructions as well as up-to-date information available on the Information Superhighway. Tax forms are now available electronically on FEDWORLD, an electronic bulletin board service operated by the National Technical Information Service, an agency of the Department of Commerce. This service gives the public direct dial-up access to files of official IRS tax forms, instructions and publications which they can download onto a computer for printout.

Taxpayers must be informed if they are going to file accurate and complete returns. This year, we expect to respond to 70 million taxpayers through our phone centers. Our telephone assistors will respond to 36 million taxpayer inquiries over the toll-free system, but this is still only 52 percent of the customers who will request the services of an assistor -- we would like to be able to serve the other 48 percent, too. The FY 1996 Budget will allow us to answer an additional 1.3 million callers -- still far short of demand.

This filing season we have expanded our hours of service. Our telephone lines are now open at least 10 hours a day each work day within the continental U.S., and all IRS telephone sites will provide telephone help during three Saturdays in April. TSM funds have allowed us to replace our equipment with a new state-of-the-art telephone system that has provided us the capability to transfer calls among our toll-free sites so that calls can be transferred from those sites that are at or over capacity. This new system is already improving productivity by 10 percent where implemented, allowing us to answer more taxpayer calls. In addition, we have after-hours routing to our automated Tele-Tax system that can address 140 tax topics as well as automated refund status information.

We also provide other types of assistance. We will respond to more than 22 million pieces of correspondence and this year we expect to help more than seven million taxpayers at IRS walk-in assistance sites. To further our goals to reduce the burdens on taxpayers, we have expanded the number of our assistance sites offering no cost electronic filing from 42 last year to 232 this year. Electronic filing at no cost is also available at over 1,000 Volunteer Income Tax Assistance (VITA) sites.

THE FILING SEASON - REVENUE PROTECTION

Our biggest challenge this filing season has been to put in place better methods to protect the tax revenue from those who want to commit fraud on the system. IRS has addressed tax refund fraud through its Questionable Refund Program for many years. Teams of trained personnel in each of the Service Centers have used both manual techniques and computerized criteria to determine which returns need review. However, technology has significantly improved the capabilities of both government agencies and financial institutions to deliver money faster. But shorter payment cycles and electronic payments require both public and private institutions to be more vigilant than ever in guarding against fraud.

Since 1990, the IRS has steadily increased its efforts to control refund fraud -- significantly more fraud has been identified and stopped by IRS and more new schemes have been identified. In May 1993, I appointed an IRS executive to coordinate our refund fraud prevention and detection efforts and established a coordinating group to assure all components of the IRS worked in concert to address problems contributing to refund fraud. Since the hearing before this Subcommittee last February, we have taken many steps as part of an agency-wide revenue protection strategy. We established new criteria for qualifying Electronic Return Originators. We used both IRS and outside expertise to analyze patterns indicative of erroneous or fraudulent refunds and programmed a series of filters and screens into our processing system. Also, we have made additional staff available to our processing, criminal investigation and examination activities to reinforce our Refund Protection Strategy. Last spring, in consultation with this Subcommittee, the Secretary of the Treasury established a special task force to further study the problem of refund fraud and propose additional preventive actions. In reporting to the Congress last October, the task force estimated that erroneous and fraudulent returns could be costing the Treasury between one and five billion dollars.

This filing season, we are carefully reviewing all returns -- paper and electronic -- to ensure that only those taxpayers who are entitled to refunds receive them. We have spent a lot of time both before and during this filing season urging taxpayers to be very careful to use accurate Social Security Numbers (SSNs) for themselves and for their dependents because we are verifying those numbers on all returns. Refunds are being delayed on returns with missing or incorrect SSNs and on some returns claiming refundable credits to allow us additional time to verify claims prior to issuing the refunds. We are using the knowledge gained in recent years to identify indicators of questionable refunds. With the Los Alamos National Laboratory -- the premiere authority in computerized pattern detection -- we are building more sophisticated screening techniques. Obviously, we cannot discuss the specific screens without compromising the effectiveness of these new tools.

We regret that for some taxpayers, perfectly legitimate refunds will be delayed this year because the initial screening criteria flag their returns. But I want to emphasize that taxpayers who are entitled to refunds will receive them -- as soon as possible. For true hardships, the Problem Resolution Program is available for assistance. We estimate that up to eight percent of all refunds may be delayed this year.

When we have delayed a refund in whole or part, we are letting taxpayers know why. Our notice explains that the full refund or remaining refund amount will be sent within eight weeks unless we determine additional contact with the taxpayer is necessary to verify the claim.

At our hearing before this Subcommittee last February, we outlined our four- part refund fraud strategy:

- First, we are developing a better understanding of patterns of fraud -- our work with the Los Alamos National Laboratory is an example of this.
- Second, we want to prevent occurrences of error or fraud. Checking the accuracy of SSNs is an example of this. Assuring that we have policies and procedures for screening Electronic Return Originators before permitting them to access the IRS electronic filing system is another example of fraud prevention.
- Third, we want to detect fraud before refunds are paid.
- The fourth part of our strategy is that we will take vigorous enforcement action when we uncover fraud. Working with the Department of Justice and the U.S. Attorneys, we are actively pursuing criminal violations. In the federal system, approximately 98 percent of the indictments involving refund fraud result in conviction, and the average incarceration is 17 months.

As I stated, we have spent a lot of time this filing season urging taxpayers to be very careful to file accurate returns using the correct SSNs for themselves and their dependents. In addition to including this cautionary information in our tax packages and in all of our filing season publicity, we also worked extensively with the tax preparer community and with financial institutions before the 1994 filing season even ended, to let them know we would be taking additional steps this filing season to protect tax revenues against fraud and soliciting their assistance about how to better accomplish this goal in a way that would be the least burdensome to taxpayers.

ADVANCED EARNED INCOME CREDIT

I could not conclude without mentioning a subject that I, the Treasury Department and the Administration have worked hard to promote -- the Advanced Earned Income Tax Credit (AEITC). Workers who qualify for the AEITC can get up to $105 per month in their paychecks -- whether they get paid weekly or bi-weekly -- by filling out a very simple Form W-5, Earned Income Tax Credit Advance Payment Certificate and providing it to their employers. Sixty percent of the total credit available to workers with a qualifying child is distributed as an addition to their paychecks; the other 40 percent is paid in a lump sum when they file their returns. By claiming the earned income credit on an advanced basis, taxpayers who are eligible for the Earned Income Tax Credit can avoid potential refund delays and use the funds during the year. They don't have to wait until they file their return to get the credit.

CONCLUSION

In conclusion, Madame Chairman, I stated at the outset that FY 1996 is a pivotal year for the IRS as we continue with our plans to acquire and implement major new systems. What happens to our FY 1996 Budget will impact the tax administration system of the future, shaping our ability to effectively administer the tax law and collect all the revenue that is due. I have highlighted for you today the progress the IRS has made in changing the way we do business. TSM will influence most every aspect of that business -- our processing capabilities and the filing season, the effectiveness of our customer service efforts and our compliance capabilities including fraud detection and prevention. It is essential now that we have the funding needed to capitalize on the progress that we have already made. Without adequate funding, TSM will not simply be delayed. Only modest, incremental improvements in business processes could be achieved, and the IRS would in any event have to begin replacement of obsolete equipment that would otherwise fail over the next few years. Investing in TSM makes good business sense and will enable us to effectively meet the challenges of tax administration in the next century.

In closing, I would like to reemphasize a point that I have made with Chairman Archer and many of you in our recent meetings. I realize that the 104th Congress is considering changes to the Internal Revenue Code. One of my concerns is that the Department be given an opportunity to advise you before legislation is finalized of any burden possible changes may have on taxpayers as well as the cost to the Service before legislation is finally adopted. Particularly when the legislative changes occur later in the year, the effect on the next filing season can be significant. Some of the burden that is placed upon taxpayers might be avoided if the Department is able to consult with you during the formulative stages of the legislation.

Madame Chairman, I know that the members of the Subcommittee have many questions to ask. If it fits your schedule, I would now like to ask Mr. Westfall, our Modernization Executive, to give you a brief overview of where we are going with TSM. We then would be delighted to answer any questions you might have for us. For your reference, I have included as an appendix a summary of the 1996 Budget request.

Internal Revenue Service

BUDGET OVERVIEW
FY 1996

Prepared by:
Chief Financial Officer
Budget Division

The President's Budget for FY 1996

The 1996 President's Budget enables the IRS to continue its overall mission by funding basic ongoing operations and programs and providing additional resources for specific initiatives. The attached Appendix is a comparison of the FY 1994, FY 1995, and FY 1996 IRS budgets by budget activity.

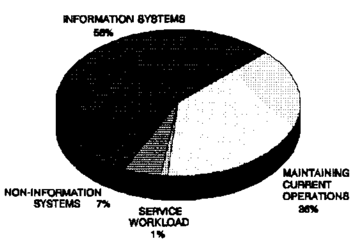
Overview

The FY 1996 resource requirements for the IRS are 114,885 FTEs and $8.228 billion.

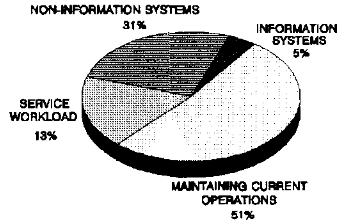
The Service's net increase in resources over FY 1995 is $739 million and 922 FTE. The total proposed increases for the Service are $844 million and 1,930 FTEs in the following:

-- Tax Systems Modernization (TSM)
-- Non TSM Systems: Storage Peripheral Replacement Unisys Computer Equipment (SPRUCE)
-- Revenue Protection/Tax Refund Fraud
-- Tax Account Telephone Resolution
-- Automated Criminal Investigation (ACI)
-- Service Center Workload Growth
-- Maintaining Current Operations

FY 1996 BUDGET INCREASES
($844 Million)



FY 1996 BUDGET INCREASES
(1,930 FTE)

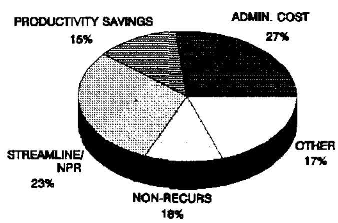


These increases are partially offset by proposed reductions of $105 million and 1,008 FTE.

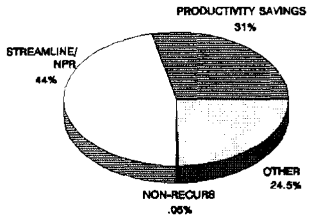
These reductions include:

-- Productivity Savings
-- Administrative Support Costs
-- Streamlining/NPR Staffing
-- One-Time (Non-Recurring) Costs

FY 1996 BUDGET DECREASES
($105 Million)



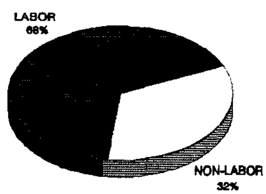
FY 1996 BUDGET DECREASES
(1,008 FTE)



Labor Costs

Labor costs are the single largest component of the IRS budget, representing almost 70 percent of the FY 1996 request. Adjustments to labor costs for FY 1996 total over $235 million.

LABOR VS. NON-LABOR COSTS



Annualization of FY 1995 Pay Raise

Because the FY 1995 pay raise took effect in January 1995, the base budget includes only enough resources to fund those pay raises for three quarters of the year. It will cost the IRS an additional $32 million to pay the FY 1995 pay raises for a full year in FY 1996.

FY 1996 Pay Raise/One More Day's Pay

The Administration estimates that there will be a 2.4 percent pay raise effective in January 1996. For three quarters of the year, this pay raise will cost the IRS $92 million. FY 1996 has 261 workdays, one more than FY 1995. The Service requires an additional $20 million, the average daily labor cost.

Benefits

The FY 1996 budget includes $11 million for projected changes for the government's share of health insurance, retirement, and workers compensation.

Non-Pay Raise Labor Costs

While the budget process regularly addresses the labor cost changes discussed above, the Service also experiences other cost growth resulting from promotions, step increases, and upgrades. These costs can be offset if there is a high turnover in the workforce. However, the low attrition rates of the last few years have given the Service a workforce with more seniority, requiring an additional $79 million for higher salaries and benefits.

Other Adjustments

The FY 1996 budget includes some non-labor cost adjustments which modify our ongoing operations rather than support new or expanded programs. These are a net reduction of $28 million and 67 FTE.

Administrative Cost Reduction

In 1993, the President issued Executive Order 12837, which required all agencies to reduce administrative costs by not less than 14 percent between 1994 and 1997. The mandated reduction for FY 1996 is three percent (as it was in FYs 1994 and 1995) which will reduce the Service by $34 million.

Streamlining/NPR Reductions

As part of IRS' implementation of the recommendations included in the Vice President's National Performance Review (NPR), IRS is reducing 442 FTE and $27 million to reduce the overall size of government. These FTE will be supervisors and oversight personnel.

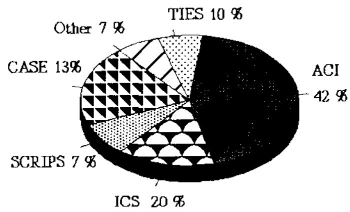
Non-Recurring Costs

When resources are no longer needed by the Service for the purposes for which they were originally provided, they are removed from our budget. For FY 1996, this includes $22 million and 9 FTE, including $11 million for expected telephone savings and $9 million for furnishing/equipment in our new office building.

Productivity Savings

As new automated systems are brought on-line, Service activities realize productivity savings which are removed from our budget. For FY 1996, productivity savings are associated primarily with Automated Criminal Investigation (ACI), Totally Integrated Examination Systems (TIES), Integrated Collection Systems (ICS), Service Center Recognition/Image Processing System (SCRIPS), and Counsel Automated Systems Environment (CASE).

FY 1996 PRODUCTIVITY SAVINGS
(Total Savings = $19.2M and 313 FTE)



Postage

A postal rate increase went into effect in January 1995. This budget includes an additional $5 million to fully fund postage costs in FY 1996.

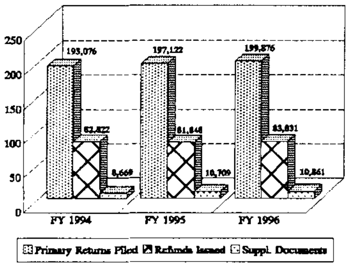
Inflation

Each year, our budget request includes an increase based on expected cost growth (inflation) over the current year. The IRS budget includes $59 million for inflation for FY 1996.

Service Center Workload Growth

In FY 1996, the IRS will need to process an additional 2.8 million primary tax returns and issue 1.2 million more refunds than in FY 1995. We also expect that supplemental documents (amended returns, extensions to file, etc.) will increase by 0.2 million. This workload increase is directly related to the growth in the taxpayer population. In order to process this additional workload without jeopardizing timeliness, quality, or customer service, our budget includes an increase of $12 million and 243 FTEs.

RETURNS PROCESSING WORKLOAD
(# in 000s)



Initiatives

In addition to labor and non-labor cost adjustments to ongoing operations, our FY 1996 budget also includes $533 million of real program growth.

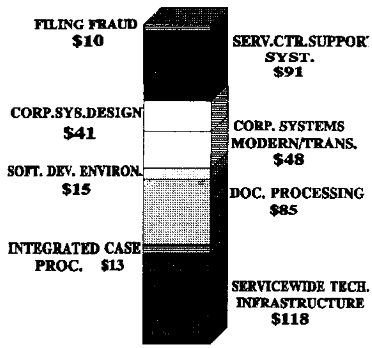
Tax System Modernization (TSM)

The FY 1996 budget includes an increase for TSM of $421 million and 95 FTE, bringing the total TSM request to over $1 billion. The increase will be used to:

-- provide automated tools for our front-line compliance and customer service staff. These tools allow us to close cases up to ten weeks sooner while improving revenue results ($118 million);

-- provide imaging and scanning equipment at our processing centers to process paper tax returns by making a digital image of the document. This will significantly reduce the staff needed to process tax returns while capturing 100 percent of the document data (versus 40 percent today) ($85 million);

FY 1996 TSM PROGRAM INCREASE BY PROJECT
($421 Million and 95 FTE)



-- acquire hardware and software applications to store and analyze data captured through electronic filing and imaging of paper documents. This will enable us to identify and resolve all relevant issues in a single contact with taxpayers ($138 million);

-- build the hardware and telecommunications infrastructure necessary to support TSM and to protect the systems against violations of taxpayers' privacy and fraudulent returns ($80 million).

Storage Peripheral Replacement Unisys Computer Equipment (SPRUCE)

Until TSM is fully operational, our current systems must continue to be maintained. The FY 1996 increase of $51 million is essential to replace the overage and undependable tape and disk environment which was placed into service between 1981 through 1987 and represents tape subsystem technology which is over 20 years old.

Tax Account Telephone Resolution

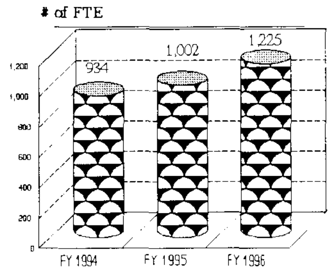
As the IRS increases its customer satisfaction focus, telephones have become a major contact between taxpayers and the IRS. Each year we answer more calls, but the total number of calls from taxpayers (answered and unanswered) grows even faster. Productivity improvements alone will not enable us to keep up with the demand. This initiative provides $17 million and 239 FTE to handle an additional 1.3 million telephone calls.

Revenue Protection/Refund Fraud

The IRS is requesting additional support for a cross-functional effort to combat tax refund fraud. This effort identifies and stops the payment of fraudulent refunds, detects schemes, and investigates fraud. Over the past few years, the dollar value of fraudulent refund claims detected has increased dramatically from $43 million in 1991 to $461 million in 1994 (through 12/31/94).

To help combat this increased fraud, IRS is requesting an additional $28 million and 323 FTE to detect and stop fraudulent refunds; identify and refer for audit those Earned Income Tax Credit (EITC) cases with audit potential; handle the rapidly increasing volume of calls associated with fraud; and investigate and prosecute at least the most flagrant cases.

LEVEL OF RESOURCES DEVOTED TO IDENTIFYING AND INVESTIGATING FRAUDULENT REFUND SCHEMES



Automated Criminal Investigation (ACI)

The Service is requesting an increase of $3.5 million for the purchase of investigative equipment, including laptop computers, desktop workstations, and necessary software.

Crime Bill

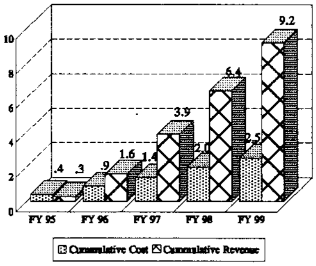
The Violent Crime Control and Law Enforcement Act of 1994 (commonly known as the Crime Bill) provided $7 million to the IRS in FY 1995 for combating public corruption and enhancing illegal tax enforcement activities. The Service requests additional funding in FY 1996 of $12 million for a total of $19 million.

The FY 1996 funds will be used to supplement current efforts for Revenue Protection/Refund Fraud and the Automated Criminal Investigation System.

Compliance Initiative

In FY 1995, IRS worked with Congress on a budget strategy that permitted funding of $405 million and 6,238 FTEs in additional compliance programs. Tax revenues from these initiatives are estimated at between $9 and $10 billion over the FY 1995-1999 period. The budget strategy was to devote $405 million in each of the next five years to these compliance initiatives. The FY 1996 budget again includes $405 million for the initiatives. In addition, one-time costs in FY 1995, which would normally be non-recurred, have instead been reinvested in an additional 546 FTE, bringing the total FY 1996 compliance initiative FTE to 6,784.

FY 1995-1999 COMPLIANCE INITIATIVES
($ in Billions)



The FY 1995 initiative is the first step in a long-term strategy to improve voluntary compliance by investing streamlining and modernization savings into front-line compliance and customer service activities.

The key areas are:

-- Income Tax Underreporting: Increase the number of correspondence audits and contacts; improve compliance by Federal Government payers; correct wage reporting by the military; and reduce the number of unmatchable documents.

-- Excise Tax Fraud/Pension Plans: Increase resources dedicated to detecting motor fuel excise tax evasion schemes, bankruptcy fraud in pension plans, and insurance fraud, and investigating refund fraud.

-- Foreign Controlled Corporations: Expand coordination and litigation, concentrate resources on the development and implementation of Advance Pricing Agreements, and increase enforcement based on identified market segments by targeting foreign business activity in the U.S.

-- Underpayment/Non-Filing: Increase the collection of delinquent accounts by improving case selection and prioritization, faster case assignment, and accelerated taxpayer contact, and by obtaining delinquent returns and collecting delinquent taxes.

User Fees

In the FY 1995 budget, the IRS proposed three user fees to raise $147 million to supplement appropriated resources. The Congress changed our approach, allowing us to charge and collect any user fees that we were otherwise authorized to initiate and to spend up to $119 million of the collected fees to supplement appropriations. For FY 1996, the IRS budget proposes no changes to Congress' direction.

Conclusion

FY 1996 is a critical year for tax administration, and the Service's budget request responds to this challenge. Continued modernization of our existing overaged tax systems, timely and effective enforcement of the tax laws, and strong support for customer service are the bases of this budget. As the IRS re-engineers itself for tax administration in the 21st Century, we are committed to fair, effective, efficient and constantly improving revenue collection.

FY 1996 CONGRESSIONAL SUBMISSION
SUMMARY
($ in millions)

	FY 94		FY 95		FY 96		+/- FY 95/96	
	$ AMT.	FTE	$ AMT.	FTE	$ AMT.	FTE	$ AMT.	FTE
TOTAL	$7,245	110,665	$7,489	113,963	$8,228	114,885	$739	922
Processing, Assist. & Mgmt.	1,674	32,331	1,704	33,141	1,805	33,528	101	387
- Returns Processing	770	20,828	777	21,366	830	21,599	53	233
- Taxpayer Service	305	8,206	297	8,273	329	8,510	32	237
- Inspection	104	1,315	109	1,410	112	1,364	3	-46
- Management Services	297	1,784	315	1,907	320	1,850	5	-57
- Resources Management	198	198	206	185	214	205	8	20
Tax Law Enforcement	4,212	69,304	4,397	71,339	4,543	71,871	146	532
- Examination	1,534	27,599	1,580	28,025	1,635	28,267	55	242
- International	42	596	46	616	46	618	0	2
- Tax Fraud	412	4,895	416	5,013	446	5,078	30	65
- Counsel	388	5,450	408	5,585	419	5,652	11	67
- EP/EO	130	2,283	134	2,370	140	2,367	6	-3
- SOI/Compliance Research	59	845	62	874	63	876	1	2
- Collection	853	18,188	885	18,562	909	18,651	24	89
- Document Matching	113	3,264	116	3,354	122	3,385	6	31
- Compliance	-	-	30	561	30	564	0	3
- Resources Management	681	6,184	720	6,379	733	6,413	13	34
Information Systems	1,359	9,030	1,388	9,483	1,880	9,486	492	3
- TSM	573	2,363	622	2,489	1,032	2,572	410	83
- Non-TSM	786	6,667	766	6,994	848	6,914	82	-80

Note: FY 1994 and FY 1995 adjusted to reflect new budget structure

Chairman JOHNSON. I certainly do want to hear from Mr. Westfall, but I think we might as well hear from him in the context of a first question. Because while you have quoted the GAO's concerns about the tax modernization system, I would like to quote from their testimony more specifically because I think it is very important that the subcommittee get a better understanding of what the problems are, what you are trying to do, and what you think you are accomplishing versus some of those who are looking to see what they think you are accomplishing or concluding.

The GAO does say that the IRS has realized only marginal improvements in its operations. They go on to say that the changes are not built to be an integrated part of the comprehensive TSM program and they have not delivered the large increases in capability and customer service that the IRS hopes to be able to deliver in the future. They then go on to say that the IRS has not defined a consistent focus for making TSM investment choices.

In other words, they draw a picture of your not having a clear road map of where you are going and of your expenditure of the first $2 billion of the $8 billion allocated for tax modernization, having spent those first $2 billion in ways that have resulted in only marginal improvements, but almost more seriously they have not been chosen in a way so that they then become building blocks and pieces of the ultimate system.

So, Mr. Westfall, we do invite your comments and appreciate your being here.

Ms. RICHARDSON. I would just like to say, before turning it over to Mr. Westfall, that we do disagree with the General Accounting Office in their assessment of where we are. I will say that we would like to be providing even better customer service, and I think that statement is one we do agree with, but we are at the beginning of the process of modernization, and as I think Mr. Westfall will be able to describe to you, we have made some significant improvements in the way we are able to serve taxpayers even today. I think that, as I say, we do not agree with their characterizations.

So, Larry, you may want to——

Chairman JOHNSON. Mr. Westfall, I have forgotten from Commissioner Richardson's testimony how long you have been on board.

Mr. WESTFALL. I have been assigned here in the Washington office on this tour for 4 years. I have been in the present position as program manager for TSM since last June.

Chairman JOHNSON. Thank you.

Mr. WESTFALL. I think that there is perhaps a fundamental issue associated with whether we are building a long-term unique new system or are we transitioning the Internal Revenue Service through a critical number of filing seasons that have to be successful and headed toward a totally new way of operating in the future, which we will reach at a point in time.

GAO has referred to a perceived marginal progress. We believe that we have made substantial progress in beginning to take actions that transition us toward the system that we have to operate in in the future. I will give you an example or two of that.

Essentially——

Chairman JOHNSON. Mr. Westfall, if you will yield for just a moment. It occurs to me that I think it would be useful to the subcommittee if after you finish, we all question you on the issue of the tax systems modernization program. Then we can go on as a subcommittee to some of the other issues because there are some equally important issues, but this one is complicated. So after you have finished, we will proceed in that way.

Mr. WESTFALL. Madam Chairman, if you do not mind, I would like to stand and answer this first question from an overhead.

With the Commissioner's indulgence, I may put this smack in front of her for purposes of presentation—perhaps the easel will work better here.

Chairman JOHNSON. Actually, if you put it over there, it is all right or even back further where you have more room.

Mr. WESTFALL. You are saying work from back here?

Mr. LEVIN. We are using the same old systems here.

Ms. RICHARDSON. We are sympathetic to that.

Chairman JOHNSON. If we were state of the art, you would be able to press a button and it would have gone overhead and we would have screens on both sides of the room.

Mr. WESTFALL. That is exactly what this is, a state-of-the-art presentation.

I think people sometimes get confused about TSM. They think it is too long, too complicated, and not happening. We keep building something which people have difficulty understanding is taking place. What I want to do is just take a couple of minutes from a business standpoint to communicate to you what TSM is, first of all, as a backdrop against which to answer the question.

Through a series of projects over a number of years, what we seek to do is take a very large paper-based and old batch-oriented operation into the future. It is very simple. It simply involves a business terminology seeking to capture data, to store and analyze data, and to distribute and use data in this large information system in a state-of-the-art environment, instead of the environment that we are in today.

It goes to four or five fundamental business objectives. You have to understand that we seek to operate as much like a business as we can in the future. We are one of the largest, if not the largest, information organizations in the world and we cannot find our information many times.

You made the point, Madam Chairman, of the paper trailing the world, and that paper-based environment causes us to be ineffective and inefficient in serving our customer, the taxpaying public in this country. The objectives of the system go like this.

The first one, just as a large bank or other financial institution, a credit card company or a large insurance company, we seek to take our business, to the extent that we can in the future, electronic. They are going electronic. It is an electronic commerce that exists in the business environment of information today, and we need to become electronic as well.

So as the first major phase of change for the future, we seek to take returns electronic, to the extent possible; to take remittances electronic, to the extent possible. Electronic in this context goes beyond just electronic transmission in the form of computer to computer. It also addresses the issue of things like tax returns being filed by telephone. That is a major component, to take as much of the paper activity in the future electronic, as we can, for the obvious business value that you get out of that.

Second, we recognize that in the year 2000 to 2001, we will still have large amounts of paper in the system. The preponderance of the system will still be paper in many respects. We seek to use image technology, character recognition technology in ways that allow us to reduce the labor-based environment that we now use to put information in the system. By using scanning, using character recognition, and using more sophisticated systems, we can get much more of the information from tax returns into the system than we can afford to manually key stroke in today. We are already proving that we have the ability to massively take the errors out of the system through this kind of technology. So the first thing we do is go electronic.

The second thing we do is become much more efficient and effective at processing the residual paper that exists. Through a combination of this, we pick up much more information both in the form of computer-based information and also images of documents and tax returns and get that into a computing environment which does not exist today. Our master files can be enhanced by considerably more information and also made available online by workstation accesses throughout the system. We can be more responsive to the public and the public can get access to the information that it needs in connection with its tax account records.

All this enables that corporate computing center database to drop information into, No. 1, our customer service operation. In our customer service operation for the future, there is a basic fundamental thing that we seek to do that we have never been able to do effectively as we feel we must. It involves doing business with the taxpaying public by telephone.

We simply have to use the telephones in the business of taxation much more extensively than we do or we have in the past. We have to be able to get access to information on a 24-hour-a-day basis, instead of a 9 to 5 basis. We have to be able to reduce the cost of a personal contact with a taxpayer or the necessity of burdensome notices and letters that cross in the mail by acting quickly on a tax account issue and doing it, wherever possible, with a telephone contact with the taxpayer that will much more quickly and much more effectively close the issue out.

Finally, we also need to put information in our field compliance activities so that our revenue officers, our revenue agents, our tax auditors can get faster access to more information with more computer assistance. This will enable us to better segment the taxpaying public, better segment compliance zones, focus our compliance resources on education and assistance in compliance actions designed to impact a particular industry that has a significant compliance issue, and impact that industry industrywide, instead of doing one audit at a time with a lot of manual work that we have to do in the system today.

From a business perspective, that is the environment that we seek to create in the future. I will make about 30 seconds' worth of points from this second overhead to complete the presentation.

In this overhead, which is also in your information packet, we seek to demonstrate progress made to date toward the ultimate business objective that we are moving toward. The first point I make from this is that during the years 1992–95, with the systems that we have already put online, we have generated productivity savings in excess of 11,000 full-time equivalent positions that have been declared and given up from the IRS budget base. That is also a large amount of money.

To show progress made in one particular area, we seek to make 80 million tax returns and essentially all of the remittance activity in our system electronic. To date we have 16 million returns that are active electronically in the system, nearly 1 million of which this year will be filed by telephone for taxpayers capable of filing the simple 1040–EZ return utilizing telephone access.

This year, we also will have 2.2 million taxpayers in 29 States who will be capable of filing a single tax return electronically that will satisfy both the Federal and the State obligation simultaneously. This is a major burden reduction issue for the taxpaying public. It is something that we do not view as marginal, in terms of the progress being made and putting a choice in front of taxpayers to file electronically, to get access in some cases to telephone filing, and to be able to satisfy both a Federal and State obligation at one time.

The other thing that we will do this year is put about $160 billion electronically in the Federal tax deposit system. Essentially, that is a major step toward the $1.2 trillion total amount of revenue that we handle each year.

In closing, we believe that the progress made has been major, not marginal. Although it may not in some cases be the full future system in terms of the ultimate TSM integrated environment, we believe that the progress made thus far is essential. We cannot wait until TSM is fully implemented at a point in the future to be more responsive to the public, to satisfy the problems, and to improve the system incrementally over the years.

That is probably a substantial amount of the issue as it relates to the GAO observation—whether we are building the ultimate system and putting all of our resources there or transitioning the existing system by moving through a series of phased steps to get to where we will go with TSM at approximately the year 2000 to 2001.

Chairman JOHNSON. Thank you very much for your presentation, Mr. Westfall. It was very interesting.

In thinking about modernization and the presentation that you just made, I was interested in a letter that came to my attention recently from Commissioner Richardson's predecessor to my predecessor, Mr. Pickle. In it she comments that in 1990, they identified 128 fraud schemes affecting 411 returns. This is all in regard to electronic filing. Since that is clearly one of the directions you are going and must go and have begun to get people together to focus on how to eliminate fraud, I am curious that as early as—her letter is 1992—she comments that in 1990 there were 128 fraud schemes affecting 411 returns against a population of about 4 million returns filed electronically. In 1992, just 2 years later, they projected that they would identify 1,400 fraud schemes affecting 12,000 returns against a population of 11 million electronically filed returns.

You are now up to 16 million returns.

As you have developed your system, have you worked from that base of fraud schemes that the IRS identified early? How has that work gone? Why is it that, in spite of that work, we should be up to such extraordinarily high rates?

My understanding is that 43 percent of all fraud is committed via electronic returns and that 90 percent of the EITC returns are involved. I may not be remembering these figures accurately. I am not claiming they weren't given to me accurately. I may not be restating them accurately, but the implications are certainly there.

Ms. RICHARDSON. I think, Madam Chairman, as we developed TSM—and one of the reasons it is so important, I think, that we move ahead with modernizing our system—is that it will provide us the ability to prevent fraud and prevent fraudulent returns from entering into the system.

We can come back to that in just a moment.

I think it is fair to say that not finding fraud does not mean that it doesn't exist. As your ability to detect it becomes more sophisticated and better, you find more fraud and that is—so sometimes finding more can be a good sign because it at least means your detection capabilities are working.

Our goals, as we stated 1 year ago and will continue to be, were to understand enough about fraud and the patterns of fraud so we could build into our systems, as a stopgap from here to the end of this decade, filters for screening out potentially fraudulent returns, questionable returns, and also to take steps that we could build into our ultimate system the ability to prevent fraud.

Mr. Brown, who is with me today, is our refund fraud executive; and I know he would be happy to answer more specific questions. He has been a person who, for almost 2 years now, has overseen our capabilities, not just working with each filing season, but also working with our modernization people to assure that we have long-term solutions to fraud built into our TSM plans.

Chairman JOHNSON. We will get into fraud issues more specifically later on, but——

Ms. RICHARDSON. I think the important thing to remember is that it has really been the advent of electronic filing and electronic processing of information that has allowed us to detect patterns of fraud, and it is important that we continue being able to process even those paper returns electronically, as Mr. Westfall was demonstrating, so that we can detect patterns of fraud. We are much better able when we have access to full return information to detect and then ultimately prevent fraud.

Chairman JOHNSON. Later on, as we do get into a discussion more specifically of fraud and prevention, it would be useful to us to have more detailed information about what kinds of patterns you have detected in the past. I would ask you about the work you are doing now and tip off those who you might be after, but there are a number of issues in the fraud area that we want to go into in more depth. But, at this point, I am going to yield to my colleague, Mr. Matsui from California.

Ms. RICHARDSON. I think the real important thing to remember is with a more modern system and better capabilities built in through the electronic filing and processing systems, we will be in a better position to address fraud.

Mr. MATSUI. Thank you, Madam Chairwoman.

I have a question directed to the Commissioner from Representative McDermott who is not able to be here today. May I direct this to the Commissioner and perhaps the Service can answer it.

Chairman JOHNSON. Certainly.

Mr. MATSUI. I want to make two observations before I ask a question of Mr. Westfall, one is that I have not really kept up with the tax system modernization program. This is my first year on the Oversight Subcommittee and so my support of it is, basically, upon the representations of the Commissioner who I greatly respect in this area.

I would like to ask Mr. Westfall some questions, however, regarding it. You have indicated, in response to the question from the chairwoman, that you have been doing this now for approximately 4 years, this TSM system?

Mr. WESTFALL. I think what I indicated is that in this particular tour I have been back here in the Washington office for 4 years. I have served as program manager for TSM since last June when the Commissioner announced the major change in how the program would be managed for the future.

Mr. MATSUI. Now, it is my understanding—and I have only started really getting into this by reviewing the GAO document and also the testimony today and some documents from the staff—but I understand since approximately the mideighties this program has been kind of conceptualized by the IRS. Is this correct?

Mr. WESTFALL. That is correct.

Mr. MATSUI. You were not involved in it at that time?

Mr. WESTFALL. I was involved in it only as an executive in the field who was interested in modernization and had input into the original formulation.

Mr. MATSUI. But it wasn't until the early nineties that we really started getting into this program and actually coming up with a scheme, is that correct?

Mr. WESTFALL. That, essentially, is correct, yes.

Mr. MATSUI. OK. Now how many managers have been involved in this since then?

Mr. WESTFALL. The program for the most part——

Mr. MATSUI. You?

Mr. WESTFALL. I am the first program manager for TSM in the form that we have it today. The program was previously managed by the CIO (chief information officer) more as a technology agenda. It has become a business agenda in a very large sense, and so the CIO and that large information systems organization remains very, very active and dominant in a lot of this, but it has now come under the management of a business approach.

Mr. MATSUI. Because prior to your taking over, which is a few months ago, this was basically setting up the system conceptually and on paper, is that correct?

Mr. WESTFALL. A lot of the original investment was in that, yes, but there have also been systems delivered as early as 1992.

Mr. MATSUI. OK. One of the criticisms that the GAO has is that there is a lack of vision in what you are trying to do, and I am trying to understand this from your graphs. I can think of three reasons why you want to do this—and you probably can add more.

One is that everybody likes computers so why aren't you doing it? Two, the code has become much more complex over the last 15 years or so or 10 years or 5 years—whatever. It may be you need a computerized system in order to deal with it. Three, of course there is just an increase in the amount of work because there are just filings being done.

Now those three reasons—and it seems to me that what you have just described in terms of your system being put in place now it seems like you are talking about the easier returns. If somebody can do it over the telephone, it sounds like you can—that is a pretty easy one it seems to me.

Now, perhaps you can kind of explain when we are going to get to the more complex ones. Am I correct in my analysis so far?

Mr. WESTFALL. I guess the three rationales I would give for why we do this—stated a little bit differently. I think that we recognize that we have to be able to take actions within the tax system much faster than we take them today. The fact that it takes 6 weeks to get a tax refund, the fact that it takes us 1½ years to match information documents to verify that the information you claimed on your return was correct, these are actions that are terribly slow in the business environment of the country today. That is one.

The second is errors. Speed is one thing. Frequency of error is another. Because a paper return has to flow through a factory environment, be handled more than two dozen times between all of our handlings and those of the taxpayer before the return was sent to us, an error rate results of between 15 and 20 percent of the returns. To correct these errors is terribly costly and terribly unsatisfying both to us and to the public. We seek to reduce that error rate as much as possible, and in the electronic environment, it is less than 1 percent. Speed is one thing; error frequency is another.

The third is the fact that we don't have access to enough information to effectively administer the system. We seek to put much more information in our database and then electronically access that information in order that we can properly manage the account and be responsive to the public relative to the account.

Now, the 1040. I think I mentioned the form 1040 EZ as being a return that is currently capable of being filed over the telephone in some States now. That is a simple return. There is an enormous range of complexity across the whole return set, and we are moving incrementally with different approaches on different levels of complexity.

We are, for instance, taking 1040 returns, the more complex returns, through the electronic side of the system. But that particular return, it currently exceeds our complexity range for what we think we can effectively control and handle through a telephone approach. So there are different stage solutions in this for different ranges of complexity and types of documents over time.

Mr. MATSUI. OK. One last question. In terms of your management of putting the system in place and the oversight of it, are you using outside vendors as well or is this something that is all inhouse? We are talking about $20 billion perhaps over the period of years.

Mr. WESTFALL. We are extensively using contract resources and consulting expertise outside of government, probably on a dimension that is pretty comparable to what the large defense agencies use in connection with some of their larger technology pursuits. The 1996 resource estimate that we make is that an excess of 75 percent of the budget in TSM would be expended for products and services that are contractor based.

This ranges from the fact that the Commissioner consults with the National Research Council on a personal basis to have them monitor and provide her consulting assistance relative to the program to the fact that the TRW Corporation acts as our integration support contractor on a long-range contract, the fact that the Illinois Institute of Technology serves us from a research and development consulting expertise, and then down to such things as a very large image and character recognition contract that will facilitate our paper processing for the future has been awarded to the Grumman Corp.

There are just a host of very, very large corporate entities that have various roles in the overall program. Yes, Loral Federal Systems is also involved in our document processing system development.

Mr. MATSUI. Thank you.

Chairman JOHNSON. Thank you.

Mr. Herger.

Mr. HERGER. Thank you very much, Madam Chair.

Commissioner, if you could tell us—now that the 1994 filing season year is 1 year old, could you tell us perhaps what the profile was for the refund fraud during 1994?

Ms. RICHARDSON. I guess one of the things that we are reluctant to do is to be too specific, because many of the filters and screens that we built into our system this year were based on what those profiles were.

About this time last year I think we testified to a number of different types of schemes in which people were engaging, but the specific profile I would be reluctant to talk about other than in a closed session because that really is how we determined what our filters would be for this year.

Mr. HERGER. Could you perhaps give us an idea of how much was involved with the paper returns and those filed electronically?

Ms. RICHARDSON. I am going to ask Mr. Brand if he might join us at the table. He is our chief compliance officer and I think has most of those numbers probably committed to his memory many times over.

The one thing I would like to say, though, a lot of the concerns did involve use of duplicate Social Security numbers, erroneous Social Security numbers, inaccurate Social Security numbers. So that has been a main focus of ours for this filing season, to encourage taxpayers—to urge taxpayers to use accurate Social Security numbers, not just for themselves and their spouses but also for their dependents.

Mr. BRAND. I might be able to size this a little bit for the subcommittee.

First off, last year during 1994 we believe what we identified were 77,000-plus fraudulent—actually fraudulent returns. I will come back and talk about the difference a little bit between fraudulent and erroneous. About 33.6 thousand of these were ELF returns; 42.2 were, in fact, paper. So you see the spread between the types of—and, again, I am talking about outright fraudulent returns here. There was $160 million claimed in this amount.

Additionally, we disallowed another $450 million of questionable refunds. We haven't made a determination that they are fraudulent, but they are at least problematic because of some instance on the return or some result of correspondence. So we are talking someplace in the neighborhood last year of $567 million or $0.5 billion of this range that I talk about between fraudulent and erroneous that we, in fact, deleted last year.

There were 413 prosecutions last year for refund fraud that were actually prosecutions that occurred and, obviously, a number of starts of prosecution cases that will continue to occur as we come through the year. So that is sort of the way we sized what our part is. The problem is, about fraud, you only know what you detect, of course. You don't know what you don't detect.

Mr. HERGER. Well, knowing what you did detect, is there anything in hindsight that you feel we might have been able to have done differently?

Mr. BRAND. I think in hindsight what we tried to do, I guess, is take the hindsight and apply it to 1995.

One of the things we know to be very problematic, as the Commissioner mentioned, is this whole area of Social Security numbers—making sure that the Social Security numbers are present and they are correct, that they match up with the taxpayer, et cetera. So that is one of the areas that we have paid close attention to for this coming year.

Again, a number of the lessons that we have learned we would be glad to share with you, furnish you that in closed session because it does impact on the way that we detect fraud and also just abuse.

Mr. HERGER. OK. Maybe one other question.

Chairman JOHNSON. Certainly.

Mr. HERGER. A different issue, has to do—on page 9, Commissioner, in your testimony you stated that taxpayers should be able to get through to the IRS on the first call. I think it also mentions about how expensive it is through correspondence. Evidently, you are alluding to the fact that it is less expensive to be able to take care of these questions by phone rather than through correspondence.

Ms. RICHARDSON. Our goal is for people to be able to get through on the first call and, ultimately, to handle 95 percent of the account inquiries in that telephone call on the first call.

Right now, if you were to receive a letter from us that said we have a question about a deduction that was claimed or something may have been omitted, we would send you a letter. You could write back to us. Perhaps before you got back to us a second letter might have gone out. So, in the meantime, interest and penalties might be building up on an amount. The correspondence crosses in the mail; a check crosses in the mail because we don't have the capacity today to do online posting of accounts.

It isn't like your being able to call your credit card company or your bank and if there is a question about your account, you can resolve it typically right there on that telephone call. We can't do that today.

Mr. Westfall mentioned 15 to 20 percent of our paper processing or paper returns end up with errors. If you apply 15 to 20 percent against 100 million paper returns, that is a lot of errors, a lot of contact; and it is a very labor intensive process.

We feel like if we can handle that account question or handle that account matter over the telephone and resolve it right there, we have probably saved ourselves a lot of correspondence but also, ultimately, maybe some compliance issues down the road which are also expensive if you have to have a revenue agent or revenue officer involved.

Mr. HERGER. Now GAO says that the chances of a taxpayer getting through to the IRS on his phone call is only 13 percent—in other words, less than one in five times——

Ms. RICHARDSON. That was based on weeks earlier in this filing season. We don't have precise agreement, I think, with the GAO about how you measure access to our system but, in any event, it was based on a 1-week look early in the filing season.

Mr. HERGER. That 1 week was less than one out of five times they were able to get through to you. Is it——

Ms. RICHARDSON. I think it was based on a number of calls placed, not the number of taxpayers who got through. We actually use a system, the unique number report, with which you can identify where people have actually been able to get through on a system.

Mr. HERGER. So you are saying that that 13 percent is not characteristic of——

Ms. RICHARDSON. Correct, it is not characteristic of what we are experiencing at this point in the filing season.

Mr. HERGER. What would you say it is at this point? Thirteen percent, I am sure, we all have to agree, is certainly something we have to improve quite dramatically.

Ms. RICHARDSON. I am sorry. It is averaging around 50 percent, which our goal for this filing season was to try to answer 52 percent of the calls—of the taxpayers' calls. That is basically what we feel we are able to do based on what funding levels we had for our taxpayer service function. We are running about at that level now for the season.

Mr. HERGER. I was speaking with a CPA only in the last week who indicated that—and I don't know where his statistics came from—two-thirds of the answers that they did receive when they did contact the IRS were correct. One-third were not. One out of three were not correct, and yet that taxpayer was held responsible—accountable for that one-third that weren't correct. Would you like to comment on that?

Ms. RICHARDSON. I would. I think that our numbers show that our accuracy is a little bit higher than that. Our goal is to have it—I mean, obviously, you would like to have 100 percent, but I think we have been running right around 90 percent the last couple of years, and we expect to have that same standard for this year as well.

Chairman JOHNSON. Excuse me, Commissioner. Is that 90 percent accuracy?

Ms. RICHARDSON. Correct. There are some areas, quite frankly, that are gray.

Mr. HERGER. Is there a reason why—now 90 percent is certainly far better than 66 percent, but yet is there some reason why a taxpayer should not be able—is the system so complicated that we can't be answering correctly almost, say, 98, 99 percent?

Ms. RICHARDSON. Our goal—we would like to be able to answer every single question accurately.

Mr. HERGER. Is there some allowance that is given during this——

Ms. RICHARDSON. I was going to say we published this year in the tax package for the first time our customer service standards, and if a taxpayer can demonstrate that any penalties or interest are imposed because of an erroneous answer they have received from us, we will be in a position to not charge them with that.

I agree with the premise of your earlier question. People shouldn't be penalized if we have made a mistake.

Mr. DOLAN. Mr. Herger, if I might amplify slightly.

We have watched the quality of taxpayer service operation very intensively for the last 4 or 5 years. I think we report to this subcommittee and others quite regularly on a week-to-week monitoring process where we watch every site for their individual quality performance.

We break it down into three particular areas: the technical tax law answer, the quality of answers on procedural questions, and the quality of answers on account questions. We give immediate feedback to the sites who show any slippage. We have put in place a very standardized probe and response guide so when you call in to site 1 or site 13, you ought to be received the same way.

We go through, basically, the same algorithmic approach to getting the right answer to the taxpayer; and we have tried to make a passion out of offering a quality service.

As the Commissioner said, the last couple of years on the filing season basically it averaged 90 percent. Last week's results were 86 percent. We would like that to be higher, but we are also doing a tremendous amount of reconfiguration this filing season and putting our people to probably as much challenge as we have in the last 4 or 5 years to be onsite and be prepared to give a quality answer.

Mr. HERGER. Thank you.

Chairman JOHNSON. Mr. Hancock, we will have to try to move along because there are a number of other issues to cover with the Commissioner.

Mr. HANCOCK. Just a real brief question—I think it will be brief, anyway.

I noticed in the testimony that on the accounts receivable and uncollectibles, the percentage that you are collecting hasn't been going up very much. I also noticed in 1990 you had roughly 87 billion accounts receivable, now there are 156 billion, which is an 80-percent increase. As a small businessman and a business advisor, accounts receivable is one of the things that you look at real quickly.

Ms. RICHARDSON. Absolutely.

Mr. HANCOCK. I am wondering what your projections are. Are we going to continue to see these increases? I would think that you would have this broken down into ages and what have you, just like a business would. I wonder if we might be able to get that information, the numbers of accounts and the age on them like a business would?

Ms. RICHARDSON. Absolutely.

Probably the biggest single factor contributing to that dramatic growth was a change in the law that required us to keep accounts receivable on the books for 10 years instead of 6 years. So, unlike a business and ones that you probably are most familiar with where you write them off after a certain point when people are dead or bankrupt or whatever, we are not in a position to do that. But we do have that breakout and can get you that information.

Mr. HANCOCK. Pardon me. You mean if you find that this individual is no longer around and that the estate is settled, you still have to keep it on the books?,

Ms. RICHARDSON. Yes, sir. We can break it out in great detail because it is not the way you would keep your accounts receivable in a business day in and day out—at least in a realistic way. But the largest single increase has been attributable to the fact that we had to account for them or keep them on the books for 10 years.

Now the 10th year is just ending this year, so next year you will see a different number. We are working to try to enhance collections and collect those amounts that are collectible. But there are some things that are carried in that figure that are not collectible and will never be collected, and we would be happy to give you a very detailed breakdown of that.

Mr. HANCOCK. Thank you.

Thank you, Madam Chairman.

[The following was subsequently received:]

Breakdown of ARDI Statistics

In 1990, Congress extended the time the IRS is required to keep accounts receivable on the books from 6 to 10 years. Thus, unlike businesses in the private sector, IRS accounts receivable cannot be written off even if they are not collectible. This change alone increased IRS accounts receivable by 20%. The Accounts Receivable Inventory carried by the IRS is not a reflection of an annual underpayment of taxes, but includes current receivables, plus a ten year carryover of unpaid taxes, along with accrued interest and penalties.

At the end of FY 94, IRS gross receivables equalled $156 billion, of which 30% or $46.8 billion reflected accrued interest and penalties. At the end of FY 90, gross receivables were $87 billion. The IRS gross receivables, like the receivables of a private business, are divided into two components: (1) currently not collectible; and (2) active accounts receivable. An analysis of these two categories as of the end of FY 94 reflects:

- Currently Not Collectible (CNC) - $76.5 billion is currently not collectible; 38.3% ($29.3 billion) of this amount is comprised of accrued penalties and interest. Over 86% ($65.79 billion) of the CNC inventory is not collectible due to defunct (no asset) corporations; bankruptcy (after adjudication by the bankruptcy court); hardships; or the taxpayer did not respond to contacts or could not be located.

- Active Accounts Receivable - $79.5 billion is potentially collectible. Of this amount:

  - 20.7% ($16.46 billion) is comprised of accrued penalties and interest;
  - 18% ($14.5 billion) are lower value cases that will be collected through systemic monitoring;
  - 18.4% ($14.63 billion) of the inventory is inactive, either awaiting adjudication by a court of acceptance of an offer in compromise;
  - 13.6% ($10.81 billion) are reported by notices;
  - 42% ($33.4 billion), the largest portion of the active account has been assigned for enforcement action.

In FY 94 alone, the IRS collected $1.2 trillion in net tax receipts. Also in FY 94, the active accounts receivable increased 7% ($5.1 billion), the smallest growth in active accounts receivable in 4 years.

Chairman JOHNSON. Just to pursue that, what about the more recent years? I mean, there is a way of factoring out—you have the 6- to 10-year problem. In the last 3 years have you increased the amount of uncollected taxes you have been able to collect?

Mr. BRAND. Let me give you a little bit of overview.

Chairman JOHNSON. This also goes to the figures that we have before us about erratic audit numbers.

Mr. BRAND. Let me give you a bit of overview, if I can, of the accounts receivable that Mr. Hancock referred to. About $79.5 billion of that is currently under active collection. The other portion of that has been determined as uncollectible. It has either been adjudicated as bankrupt, the taxpayer is deceased, we have contacted the taxpayer and determined there is some type of hardship or some type of reason not to make the collection—a whole variety of reasons there.

Over the past 3 years our collections, in fact, declined. However, we are really pleased about the fact that during 1994 and so far for the first 5 months in 1995, we had a substantial turnaround in terms of the portion of the accounts receivables that we are, in fact, collecting dollar amounts.

I think there is another thing to keep in mind when you look at accounts receivables and that is the fact that the percentage of accounts receivables to the total net revenues deposited to the Treasury of the United States has remained constant. We have been someplace in the area of 6 to 7 percent.

Accounts receivables in and of themselves are neither good nor bad. I think Mr. Hancock asked the magic question of what is the age of them and what is the collectibility of them, and those are the types of questions that we should provide for the record for you.

[The following was subsequently received:]

AGE AND COLLECTIBILITY OF ACCOUNTS RECEIVABLE

Our RACS (Revenue Accounting Control System) does not currently allow the IRS (Internal Revenue Service) to age the accounts receivable inventory. However, RACS is currently being redesigned to provide more accurate information about the nature of the accounts making up the receivables inventory. The IRS will begin implementing the redesigned system in fiscal year 1996.

At the end of fiscal year 1994, the active accounts receivable inventory was $79.5 billion. After taking into account an allowance for doubtful accounts, IRS estimates that $26.7 billion is potentailly realizable.

Ms. RICHARDSON. Madam Chairman, I think one of things that we can attribute the increased collections to is the fact that we applied additional staffing now to the issue. We have also taken some management steps which we can provide you for the record. As I mentioned in my testimony, from 1991 until the fiscal year we are in now, we actually have declined in staffing; and so some of that really has had its impact on the collections as well.

[The following was subsequently received:]

MANAGEMENT STEPS CONTRIBUTING TO INCREASED COLLECTIONS; ARDI STAFFING STATISTICS

For the three years prior to FY 94, collection yield had declined between 4% and 6%. Although some of this decline was attributable to a decrease in front-line collection staffing, it was also the result of a decline in productivity. In FY 94, however, IRS' collection yield increased 3% with over a 9% decrease in front-line collection staffing. Through the first quarter of FY 95, collection yield has continued to increase by 3.8% over the first quarter of FY 94. When the hiring and training of the additional collection staff from the FY 95 Compliance Initiative is completed, the increase in yield should grow.

Management changes under way to improve collection include:

- Enhanced cooperation with state taxing authorities. The State Income Tax Levy Program involves agreements with states (Maryland, Virginia, North and South Carolina) whereby they accept IRS levies on state income tax refunds. This resulted in collections of $108 million from FY 92 to FY 94.
- Proper use of certain collection tools. In FY 92, the Offer in Compromise policy and procedures were streamlined resulting in additional collections of $281 million in FY 94 by enabling field personnel to finally resolve many accounts that previously would have remained uncollected. The use of seizures in appropriate situations. In FY 94, $125 million was collected from over 10,000 seizures, a 5.6% increase in seizure activity over FY 93. Effective use of levies resulted in $2 billion in revenue in FY 94. Expanding installment agreement authority to all contact employees increased the dollars secured through installment agreements from $2.28 billion in FY 92 to $4.75 billion in FY 94.
- Decreasing the number of notices, shortening the notice period and instituting earlier intervention by telephone. During FY 94, the IRS tested "early intervention" in two Automated Collection System (ACS) sites with positive results. In January 95, using 770 staffyears of the FY 95 Compliance Initiative in ACS sites, early intervention was implemented nationwide. We project, based on the experience during the pilot, that early intervention will results in additional revenues of $3 billion over 5 years.
- Increasing emphasis on and monitoring of payment of agreed tax assessments at the conclusion of the examination process. In FY 92, Examination secured payment of 8.1% of agreed tax assessments. In FY 94, as a result of the emphasis on payment at the conclusion of the examination process, Examination had secured payment of 31.7% of agreed tax assessments.

Chairman JOHNSON. Mr. Levin of Michigan.

Mr. LEVIN. Thank you.

Let me continue the Chair's discussion of TSM, and I very much agree with her that every hearing doesn't have to be entirely adversarial. We do have a stake in an IRS that collects. It is the basis of compliance. We want to be sure others pay. So let's focus for a few more minutes on the GAO report.

You have responded about marginal improvements, but they then go on to say that you seem to be focusing on automating old processes, and you need to focus better. They say they are concerned about potential management problems. You don't have the management skills to handle it.

By the time you do so, new systems will take over the present systems. All of us I think know about that. New processes occur faster than we can update our own. Again, you should direct your attention to a small number of projects that address critical gaps in mission performance.

Try to get to the nub of this. I am not sure—if you read your testimony and the GAO's report, it is really hard to understand what is the gist of all this. I mean, forget all the kind of fancy language. What are they saying and what are you saying in response?

Mr. WESTFALL. I believe that a significant amount of this issue goes to current systems improvements, as opposed to those that might be focused on the fully integrated solution. I will give you an example.

There is a system that is developed and basically, for the most part, is an automation of existing processes as opposed to being a major business reengineering endeavor. It is called the integrated collection system. That system is programmed, and it is prototyped and proven. We have spent money and would hope to continue to spend some amount of money in rolling that system out nationwide.

Now, in doing that, we don't do it recklessly. There is a nearly 10 percent productivity implication in that system going online based on the fact that having the access to a laptop and the information stored in laptop form when a revenue officer goes to the field significantly improves the efficiency of a revenue officer.

It has also been proven in prototype that a revenue officer, working in this automated environment and with access to the additional information as they work in the field, is producing more than 20 percent additional average revenue per case closed, per case worked. So not only are the cases being worked faster, but the revenue generation out of the cases is greater.

We have made a decision in that particular case that this short-term system is worthy of spending TSM funds, investing in the gains that are there today in that particular system as we move forward toward the ultimate system of the future.

That is an example I think of some of the contention—I believe GAO might assert. It might be an example of a system that they would view as not worthy of continuation; that they believe that our money would be better spent on the longer term TSM initiative. GAO can speak for themselves. I believe that is a fair translation of where they might come out on that particular system.

We disagree. We think we can't afford not to spend that money. We think that it is directly pertinent to where we want our collectibility to go for the future and is an appropriate transition step to take.

To get to the nub of the issue. I think it is a question of are you building the ultimate system or are you spending money transitioning your current system over time to where you want to go.

I believe GAO would have us go more to build a fully integrated system and dedicate and build resources. We agree we have to engage those resources and deliver that integrated solution. But, in doing it, we also believe that we have to improve operations today, especially with systems that are proven and already developed, and that we can make those systems consistent with the future.

For instance, these systems that we are putting online today, we are attempting to use hardware and, where possible, the standard approaches that will make that system as consistent with our ultimate vision as we can. We might have to throw the software away, but where we can, we want to at least be able to work the workstation in the longer term environment as we change.

Mr. LEVIN. I want to ask one other question, and I think we are now anxious to talk to the GAO. Unfortunately, we have these panels and you don't get people talking to each other who disagree. So let me just ask you, because we have such a stake in this, I think if any system needs to be automated it is the tax filing system, right? I mean, there has to be more paper going through there than even here.

Now, do you talk to experts? I mean, are you—this disagreement about short term, long term, are you doing this of your own notions or are you consulting wise people outside? How are we supposed to sit in here and have any idea of who is right? We haven't heard from GAO yet, but what are we supposed—there is a lot at stake here. So you talk to people before you do these things?

Ms. RICHARDSON. We most definitely do. I wanted to mention that Mr. Bowsher, the Comptroller General, and I will be meeting some time this week to really talk about what the facts are, what our differences are, if any, and where we can go about reaching common ground so we can move on with this together.

We very much appreciate the oversight role of the General Accounting Office, and I think it is important that we have oversight. I have engaged the National Research Council to help us. That is part of the National Academy of Science, National Academy of Engineering. We have a number of people from the private sector who sit gratis on a panel to help us with this. As Mr. Westfall testified, we are using a number of outside contractors as well.

I think it is important that we all do work together to accomplish this goal because good tax administration is vital to this country. It has nothing to do with political issues or anything else. It is terribly important that we work together.

So our staffs actually met last week primarily to talk about some of the issues. We are going to be talking about what we can do. I think it is only fair that we keep you apprised of where we are because, obviously, you all do not have the time to get into these matters as deeply as we do, and I don't have as much time as Mr.

Westfall does to get into these matters. We want it to work. We want it to work well. I think we will be working with the GAO to try to find out how we can make this system work.

Mr. LEVIN. Do you report back to the Chair after your discussion?

Ms. RICHARDSON. Most definitely.

Chairman JOHNSON. We may get ourselves all together to talk about that after they have discussed it.

Ms. RICHARDSON. The other thing I would like to say is that part of the disagreement may well be in whether or not you are here in the Dark Ages and have people using a pen and paper to do their work when you know that the ultimate system is going to look somewhat different in the year 2001. But there are tools such as these laptops that can make our people more productive, more effective, raise additional revenues. Should we sit here doing nothing for the next 5 years or for the last 10 years doing nothing until we have an ultimate system in place?

I guess we felt that any prudent businessperson would say no. We have got to keep enhancing our productivity and enhancing the collections as we move along.

What we have tried to do is assure that the decisions we make are not decisions that are irrevocable or would mean that we have to throw out something altogether and start over. We are transitioning, as Mr. Westfall said, to our new system. You just aren't going to turn the switch on one day and have a whole new tax system. It is something—it is a massive system, and we have to transition to it. I think that is where a lot of the disagreement lies.

The idea about focusing more effectively is one that we do agree with. We do know we have to focus, and that is one of the reasons I did appoint Mr. Westfall to be the project manager—not just for the technological side but for every single thing in our organization that has to do with modernization.

The operations people report to him on this issue. The technical people do. We did not want a system that when it was built nobody could use, it didn't meet the requirements of our business people. That happens very often I think in the private sector as well as the public sector, and we didn't want that to happen.

Chairman JOHNSON. Thank you, Commissioner.

Mr. Ramstad.

Mr. RAMSTAD. Thank you, Madam Chair.

Commissioner, I appreciate your coming to my office.

Chairman JOHNSON. I am sorry. I was leaning forward, and I thought our colleague from Texas had left.

Mr. RAMSTAD. I would be glad to yield to my good friend from Texas.

Mr. JOHNSON of Texas. Go ahead.

Mr. RAMSTAD. I am not going anywhere, and I am sorry I was late because of a flight.

Let me just ask you, Commissioner, I know we have spent zillions of dollars in upgrading the computer capability at the IRS. If some of our colleagues have their way—I know the distinguished Minority Leader, Mr. Gephardt, was here a couple of weeks ago advocating a flat tax. Our Majority Leader, Mr. Armey, advocates flat tax. It is gaining momentum here in the Congress.

If the flat tax becomes law, a simplified card like this is used to file our taxes, and everybody does it at 11:30 on the evening of April 15, what about the computer resources? I mean, isn't this expenditure going to go for naught?

Ms. RICHARDSON. I don't think so. The reason is, no matter what system we have, whether it is an income tax, a consumption-based tax, and whether the income tax is flattened out or whatever, someone in some organization has to administer it. What we are doing today to bring us really into the 20th century—maybe not even into the 21st—is going to be vital no matter what kind of tax system you enact.

One of the biggest concerns I have, quite frankly, is that our system cannot be responsive enough to try to make the quick changes that we may be called upon to do. I think that—as I have encouraged everyone, both on the subcommittee as well as your staff, to join us at one of our service centers, especially this time of the year, I think you would really be amazed at how well the system works, not that we do have a few errors. I think it is important that we continue with this project because, whatever happens in terms of the tax law, we will need that upgraded and updated equipment to administer it.

Mr. RAMSTAD. For some reason, I am not surprised you didn't say we are spending too much money on computers.

Ms. RICHARDSON. Those postcards will be coming in. We will have to process those, too.

Mr. RAMSTAD. Let me ask you about the work force person power there. Now there are over 113,000 employees, and 5,000 additional employees were funded last year as I recall—$405 million per year for 5 years to fund 5,000 new agents to improve compliance and collections.

In view of the resources that we put into the computer system, are we at some point going to see a dividend in terms of decreased employees? Isn't there some correlation? The more you automate, shouldn't we see the need for employee decrease?

Ms. RICHARDSON. Absolutely. One of those charts that Mr. Westfall was showing indicates that from fiscal year 1992 through 1995, we have productivity savings of 11,000 FTE that we have given up as a result of tax systems modernization.

Now we have been given backstaffing, and I might add that 5,000 was on top of a 109,000 base, I believe. So we are now, I think, around 114,000 FTE.

It wasn't 5,000 on top of the 113,000 or 114,000. But, in 1992, we had 117,000 full-time equivalents. We have been able to enhance our productivity, and we will continue to do that.

But our customer base is growing, we hope. As we are taking on additional workloads with more filings, the population increases, and we need to be working on some of those compliance issues we talked about. We need to address the accounts receivable issue. So some of the increase in staffing that we would be looking to—not increase in staffing but some of the productivity savings we would like to reinvest in compliance-related positions.

Mr. RAMSTAD. So, really, you are not willing at this point to correlate the increased expenditures, increased appropriations for computers to at some point seeing a reduced work force.

Ms. RICHARDSON. I am sorry. We can do that. We have done that. We will give you the precise numbers of exactly what we can save as a result of what we have done and what we will be doing.

[The following was subsequently received:]

The following table provides additional documentation on the 11,819 cumulative FTE savings from automation achieved through FY 1995:

FY 1996 PRESIDENT'S BUDGET, FEBRUARY 6, 1995
CUMULATIVE PRODUCTIVITY SAVINGS
FY 1992-1995 (FTE)

	FY 1992 FTE	FY 1993 FTE	FY 1994 FTE	FY 1995 FTE	FY 92-95 Total
CURRENT SYSTEMS:					
ICS-Connectivity		303	303	303	909
Automated Workload Management System			98	98	196
Replace Automatic Call Distributors		101	101	101	303
Exam Laptop Replacement	0				
End of Extension to File Form		72	72	72	216
ICS Replacement			36	36	72
Sub-total, Current Systems	*0*	*476*	*610*	*610*	1,696
TAX SYSTEMS MODERNIZATION:					
Totally Integrated Exam. System (TIES)		116	505	993	1,614
Corporate Files On Line (CFOL)	423	782	1,054	1,054	3,313
Automated Underreporter (AUR)	148	385	654	782	1,969
Electronic Filing	479	634	634	634	2,381
Cash Management System (CMS)			3	385	388
Automated Criminal Investigation (ACI)					0
Counsel Automated Systems Environment (CASE)				67	67
Integrated Collection System (ICS)			36	36	72
Service Ctr Recognition/Image Process Sys (SCRIPS)			55	99	154
Telephone Routing Interactive System (TRIS)			61	61	122
Inspection Systems Development				24	24
Corporate Systems Modernization/Transition (CSM/T)				19	19
Sub-total, TSM	*1,050*	*1,917*	*3,002*	*4,154*	10,123
Total, FTE Savings	**1,050**	**2,393**	**3,612**	**4,764**	**11,819**

For the FY 1996-FY 2000 period, an additional 22,703 FTE of Tax Systems Modernization savings are projected based on full funding of the FY 1996 President's budget. These savings, which accrue by year, are proposed to be reinvested in compliance and detection activities made possible by the capabilities that TSM will provide. Additional revenue in the amount of $2.546 billion can be generated from this reinvestment for the same time period.

Mr. WESTFALL. We estimate, approximately, an additional 12,000 FTE over the term of implementing TSM that will be capable of being given up as backroom jobs—a lot of clerical positions, paper handling positions, control positions that can be—for which we will have a choice. The choice that you will have is either to remove those positions from our funding base or to authorize us to reallocate those positions into compliance jobs at a 5-to-1 or greater revenue generating capability.

One of the things we get out of TSM is a lot of new compliance opportunities that are generated by the additional information ability to analyze the information and, in the end, potentially apply some resources to work that particular compliance agenda.

Mr. RAMSTAD. Well, I appreciate your responses, and I certainly hope that the thrust is to reduce the Federal work force. I understand you have a difficult job and certainly as many critics as we do in Congress. IRS isn't everyone's favorite agency—I know that—but, nonetheless, I think all of us have to be very diligent in trying to cut expenditures as we are downsizing government. We need to do what the private sector has done for a long time.

I think it is clear the American people want us to reduce the size and scope of the Federal Government. It seems to me that, at least based on our visit and what you are saying now, that you are getting that message like all of us, hopefully, are getting that message; and we will continue to work toward that end.

Ms. RICHARDSON. Not only are we getting it, I think we got it at least several years ago.

In my testimony, I mention the fact that we are actually reducing the number. We now have 10 service centers. We are moving to five submission processing centers. So there will only be five centers out there where people will be filing their returns. We will have 3 computing centers instead of 12—10 service centers and 2 computer sites.

We are moving about a thousand employees out of our headquarters operation. I think over 500 are out now. By the end of the year, another 500 will be out on the front lines. The same with our regional structure.

We are in the process of looking at our district office and regional office missions and operations, and we will be making some recommendations later this spring about how we want to have those structured.

So we are acutely aware of the importance of using our resources wisely. We understand the importance of streamlining.

But what modernization has allowed us to do is to really reengineer the way we do our business. To be able to reengineer our business without having the technology to go along with it would really not, I think, be the prudent thing to do in terms of the tax administration system. The two do go hand in hand.

Mr. RAMSTAD. Thank you, Madam Chair.

Chairman JOHNSON. Mr. Johnson of Texas.

Mr. JOHNSON of Texas. I didn't mind yielding to my friend from north Texas.

I would like to ask a couple of questions. First, it seems to me that maybe we are reinventing the wheel taking so long—to the year 2008—to get this job done.

I am pleased to know that you are consulting with TRW. That is a good company, and they have just made a conversion themselves. They moved their equipment—they changed their whole computer system and moved the equipment in overnight without hampering customer service one iota.

I know in the Air Force it takes us 10 years to develop an airplane and here you are taking 12 years or more just to get a new computer system going. Can you explain that to me?

Ms. RICHARDSON. Well, I am going to let Mr. Westfall handle the more technical details, but this might be a good time for a plug about the Federal procurement process, too.

Mr. JOHNSON of Texas. Well, then let me ask you another question. Can you privatize this conversion and get it out of the government control? That is what you just said you could do.

Ross Perot used to say—and I don't quote him very often—he said, "Why don't you just pull it over to the side of the road, lift the hood and fix it?"

Ms. RICHARDSON. Let me say if we could have done it, it probably would have been done long before my watch, too. It is a massive undertaking. The year—really, I hope, before the year 2001—and I will let Mr. Westfall address that.

But I do think that when you talk about technology acquisition you need to have a long, hard look at what the procurement rules do. They were very well suited to the time when we were buying jeeps and tanks and things that weren't changing very rapidly, and it is a very fair system. A lot of people can put in their bids. But technology is rapidly changing, and we need to be able to respond much more quickly.

That has been part of the problem with the delays. We have an extremely competent contracting staff. We have done a very good job in the procurement area withstanding protests, and I think we have done as well as we could and probably better than most other agencies in terms of procurement process working with what we have today, but it is still cumbersome.

Mr. WESTFALL. We have awarded——

Chairman JOHNSON. Let me just say we do have a number of other panels, so we will have to try to keep the answers focused.

Ms. RICHARDSON. One thing I might add also. We would be more than happy to meet with you or meet with some of the members of the subcommittee—with Mr. Westfall.

Mr. JOHNSON of Texas. That is fine. I would like to know why it has taken so long.

Let me bring one more question into focus here before we quit. I am going to quote a quick paragraph from the Dallas Morning News which said, "According to wire reports, the IRS plans to collect credit reports, news stories, tips from informants, information from real estate, motor vehicle, and child support records as well as conventional government financial data. Aside from civil liberties concerns, citizens also fear the IRS is acknowledging that some of the data may be inaccurate but that taxpayers will not be allowed to review it or correct it."

Now I know in the case of TRW they do allow their consumers to correct their records, and I would hope the government doesn't get into that position. Can you tell me with a straight face that our taxpayers are not going to be allowed to keep their records straight?

Ms. RICHARDSON. I can also tell you that that article was erroneous. There is—it was filled with significant amounts of erroneous information. I would be happy——

Mr. JOHNSON of Texas. But somebody in the IRS gave the press those reports.

Ms. RICHARDSON. Well, I think there is even dispute about how that was handled, quite frankly, but we are not collecting individual taxpayer information as they suggested. I can give you the specifics of what we are doing.

I had long conversations with Senator Pryor, and I know he is satisfied that we do have concerns about taxpayer's rights of privacy and the information we collect. I would be delighted to provide you with precisely what we were doing. The article was inaccurate in many, many ways——

Mr. JOHNSON of Texas. OK.

Ms. RICHARDSON. Not the least of which is——

[The following was subsequently received:]

Extent and Types of Information IRS Collects on Individuals

On December 20, 1994, the IRS published notice of an amended Privacy Act system of records: "Compliance Programs and Projects File - Treasury, IRS 42.021." Based on comments received and media articles, the notice may not have adequately distinguished among the various users and uses of the compliance system, as well as the data it is to contain.

The system will not be used to support large scale data matching in order to identify specific individuals for contact by IRS personnel. The IRS has developed procedural safeguards to prevent data used in the compliance research programs and projects that engage in large scale data manipulation techniques to determine levels of compliance in particular market segments from being used for enforcement purposes as to specific taxpayers.

The compliance research system is being redesigned to identify causes and trends of noncompliance and to generate and test new approaches to increasing voluntary compliance. The enhancements will not include maintenance of records with individually identifying information. The personnel who use and access the research system will not be enforcement personnel. The system will not be used to select individuals for enforcement actions.

This system of records has always on a limited basis and with legal authority contained information from various third-party sources. The enhancements to this system will add more information from more sources. However, use of these enhancements for the purposes of compliance research will adhere to the operating principles of such research: it will be group-focused rather than individually focused and not directly used to select individuals for enforcement actions.

Mr. JOHNSON of Texas. You don't like the GAO, and you don't like the press. Do you like anybody in Federal Government?

Thank you. I appreciate the responses.

Thank you, Madam Chairman.

Chairman JOHNSON. Thank you.

Mr. Zimmer will inquire.

Mr. ZIMMER. Thank you.

Mr. Westfall and Commissioner Richardson, as I walked by the Congressional Federal Credit Union on my way over here I saw their newsletter, and the headline says, get your tax refund weeks faster, and in the fine print it says up to 5 weeks faster if you file electronically.

My question is, if you are eligible for earned income tax credit, is that an accurate promise this year?

Ms. RICHARDSON. Yes, it is, if you are eligible for the earned income tax credit. If you are not, it is not accurate. We have been very concerned, as has this subcommittee in prior years, about people claiming a credit who are not eligible. There has been some fraud, and we have stepped up our efforts this year to police the whole refund program.

The vast majority of the people are getting their refunds in a timely fashion or timely in the sense of the customer service standards that we published. Only if people have questionable—or we have reason to question a refund or a credit claim are we holding it up.

Mr. ZIMMER. So what percentage of those EITC returns are being held up more than they were last year?

Ms. RICHARDSON. Mr. Zimmer—as of this morning we didn't have that information. I will be able to provide it to you, I think, in about another week.

[The following was subsequently received:]

Because the tax filing season is coming to a close, IRS does not yet have a final report on the number of EITC refunds delayed, but we will be happy to provide that report as soon as it is available.

Mr. ZIMMER. Is it a larger percentage? Because we understand from our constituents that it has gone up considerably.

Ms. RICHARDSON. It has certainly gone up over last year. As I said in my opening statement, I regret that there are people who are legitimately entitled to refunds and to the credit who are being caught in the initial screens and filters. But we have been very concerned about promoting integrity in this system and wanting to make sure that people who are eligible do get the credit and people who aren't don't.

One of the things that we have also encouraged is the advanced earned income tax credit which people can get throughout the year in their paychecks and wouldn't have to wait until they file their return to get at least the majority of the credit.

Mr. ZIMMER. At the end of your testimony, you said that you would appreciate it if we in Congress gave you some advance notice as to when we were going to change the Tax Code because of the impact it has on administration by the IRS. I certainly understand that.

Ms. RICHARDSON. We would certainly like to work with you.

Mr. ZIMMER. Obviously. That is a very good idea. But, by the same token, do you not feel that it is your obligation to inform taxpayers of a change in the procedures so that they can put their financial affairs in order?

There are a large number of taxpayers who applied for loans in anticipation of their refund. There were banks and other financial institutions that lent them the money, and now they find that a portion of the refund is being sent directly to the taxpayer by check—by paper check rather than by electronic transmission to the lender. This is not only a problem for the lenders but for the taxpayers as well.

If I get a check from the IRS, I am going to cash it. Sometimes my wife asks me what it is for, but I usually—the first impulse is to cash that check. That is money that is owed to the financial institution they borrowed from in anticipation of the refund. These taxpayers, by definition people of modest means, are really imperiling their credit rating as a result of that portion of the loan not being repaid.

Now, could you tell me what steps were taken in 1994 by the IRS to inform the taxpaying public and the relevant financial institutions that this change was about to take place?

Ms. RICHARDSON. Maybe you aren't aware, we are currently in litigation over many of the issues you have just talked about, so I am not in a position to comment other than fairly generally.

But, beginning even before the end of the filing season last year, as the concerns about refund fraud were voiced by this subcommittee, by other committees, the Treasury Department set up a task force; and we announced and worked with a number of the practitioner groups, the public.

Any time I have ever spoken and had the opportunity, I have indicated that we were going to be changing our procedures and processes for this filing season, that we would be taking whatever steps we thought would be prudent and appropriate to assure the integrity of the refund system.

In the tax package this year we indicated the importance of filing accurate information, accurate Social Security numbers and that we might have to do some compliance reviews on certain returns. So I think we have worked—my filing season press conference, we had a significant amount of publicity about the fact that we were going to be changing our approaches this year and stepping up our efforts.

So, as I said earlier, I am sorry that there are some people who have legitimate claims who are going to have their refunds held up, but we really do think it is important to promote integrity in the system.

Mr. ZIMMER. When did the IRS inform the public that it would issue some of the refunds in two installments, one that could be electronically transferred to the lender and the second is a paper check? When was that information made public?

Ms. RICHARDSON. I believe that was in December, perhaps.

Mr. ZIMMER. How was it promulgated?

Ms. RICHARDSON. I will have to get you the specific information. Again, this is a subject of a court proceeding and—but I will——

[The following was subsequently received:]

WAYS AND MEANS OVERSIGHT HEARING ON FEBRUARY 27, 1995

IRS Budget Proposal for FY 1996 and 1995 Filing Season

Insert for the Record

QUESTION: When did IRS highlight the bifurcation of refund returns?

ANSWER: Attached is a chronology dating back to 1992 that details the actions taken relating to the Revenue Protection Strategy. Highlights include activities in December 1994 and January 1995 that directly relate to bifurcated refunds.

QUESTION: Did the October 1994 notification covering elimination of the DDI also include notification of the bifurcated return system of the refunds that were going to be electronically filed?

ANSWER: The bifurcation of refunds was not discussed when we made notification of the DDI changes.

REVENUE PROTECTION STRATEGY

1992

October Commissioner and Deputy Commissioner, Assistant Commissioners (RP) and (CI) and Chief Counsel met with representatives from H&R Block, Beneficial Corp., Jackson Hewitt, Mellon Bank, Greenwood Trust, NATP and others to discuss plans to remove the Direct Deposit Indicator (DDI) in the 1994 filing season. The Industry presented IRS with a briefing document entitled, "The Direct Deposit Acknowledgement Issue and Its Relationship to Electronic Filing Fraud."

1993

April Banks submitted a supplement to the October 1992 paper entitled "Electronic Filing: Industry Led Initiatives to Combat Fraud and Improve Electronic Filing."

Creation of the Council of Electronic Revenue and Commerce Advancement (CERCA) to review security of data and privacy issues, and increase the value of electronic filing commerce with all agencies to ensure consistent standards of software and data elements.

June Deputy Commissioner, Assistant Commissioner (RP), Deputy Assistant Commissioner (RP), Director, Office of Refund Fraud and members of their staff met with industry representatives regarding the DDI issue.

IRS announced the decision to retain the DDI for the 1994 filing season along with steps to strengthen fraud detection/deterrence and expectations of the industry. Explained to industry that we will review this decision each filing season based on ongoing trends.

1994

June Presentation to CERCA on changes to Suitability, RAL advertising and Form 8453 requirements.

Refund Fraud Strategy approved by Treasury.

1994 (cont'd)

General Accounting Office briefed on fraud initiatives by the Director, Office of Refund Fraud.

July **IRS Nationwide Tax Forum - Baltimore (attendance 1,600). Opening executive remarks emphasized refund delays related to inaccurate SSNs. Seminar on 1995 Changes to the Electronic Filing Program emphasized importance of TIN accuracy for both paper and ELF. Seminar on Earned Income Credit - Advanced Earned Income Credit emphasized educating the public, compliance initiatives and future plans. Handout on preventing fraudulent filing, prepared by Fraud Task Group, provided to attendees. IRS Nationwide Tax Forum - Sacramento (attendance 1,150), same structure as Baltimore forum.**

Issued News Release IR-94-73 announcing new fraud control measures and need to verify the accuracy of SSNs prior to release of refunds.

August IRS Nationwide Tax Forum - Albuquerque (attendance 770), same structure as Baltimore forum.

IRS Nationwide Tax Forum - Kansas City (attendance 1,200), same structure as Baltimore forum.

Presentations to NAEA, ABA and NATP by the Director of Practice, discussing filing fraud initiatives, emphasizing DDI, SSN accuracy and refund delays.

Presentation to FTA Technology Workshop, including description of the Revenue Protection Strategy, ERO requirements, SSN accuracy and refund delays.

Presentation to North Eastern Tax Officials Association, including a brief overview of the Revenue Protection Strategy.

September IRS Nationwide Tax Forum - Orlando (attendance 2,000), same structure as Baltimore forum.

IRS Nationwide Tax Forum - Salt Lake City (attendance 690), same structure as Baltimore forum.

1994 (cont'd)

Briefing of SSA by the Director, Office of Refund Fraud and staff outlining filing fraud initiatives and potential impact on SSA, stressing coordination efforts.

Advance notification of ERO changes to states with joint electronic filing and national practitioner associations.

National press contacted and News Release (IR-94-100) issued, addressing ERO changes, SSN accuracy and refund delays.

Tax Symposium - Ogden, Utah: brief overview of the Revenue Protection Strategy emphasized SSN accuracy and refund delay.

Meeting with Commissioner's Advisory Group (CAG) members discussed general issues on filing season strategies, including potential for two payments and potential refund delays due to additional filters.

October Under Secretary Noble testified before the Oversight Subcommittee - recommended IRS take the time necessary to review refunds before issuance.

CERCA meeting discussed Revenue Protection Strategy.

Meeting with representatives from the Fraud Service Bureau (FSB) to discuss Revenue Protection issues.

Press Conference conducted by Treasury Secretary Lloyd Bentsen, Under Secretary for Enforcement Ronald K. Noble, and IRS Commissioner Richardson regarding EITC and DDI.

Calls made to industry stakeholders explaining reasons for elimination of DDI.

Correspondence mailed to notify EROs of changes and application procedures.

FTA Board of Trustees meeting discussed ELF strategies, emphasis on DDI and Revenue Protection Strategy, emphasis on SSN validity and refund delay.

A news release on SSN accuracy and refund delays, developed jointly with SSA, was distributed to 1300 SSA field offices for local use.

1994 (cont'd)

November Commissioner Richardson met with AICPA, discussed Rev. Proc. 94-63 with emphasis on DDI.

Presentation to Texas Society of Certified Public Accountants (TSCPA)/IRS Liaison on changes to Rev. Proc. 94-63, and Revenue Protection Strategy with emphasis on SSN accuracy and refund delays.

Meetings with NATP, NAEA, NSPA - changes to Revenue Procedure 94-63 and filing fraud initiatives discussed SSN accuracy and refund delays emphasized.

Discussion with H&R Block, requested clarification on Responsible Official signature and suitability checks.

Discussion with Bank One on extension of Filing Form 8633.

Fraud Service Board met with Office of Refund Fraud representatives to discuss screening criteria for potentially problematic refunds.

SSA and IRS issued an article on SSN accuracy and refund delays in the "SSA Courier" which is distributed to 14,000 organizations.

Sixty second public service radio spot on SSN accuracy and refund delay provided to over 8,800 radio stations. Through February 20 this spot was aired 92,910 times, by 1,495 outlets, in 828 markets, and 51 states/possessions.

December Presentation to American Institute of Certified Public Accountants (AICPA) on changes to Rev. Proc. 94-63 and Revenue Protection Strategy, emphasis on SSN validity and refund delay.

Federation of Tax Administrators (FTA)/Commissioner's Liaison Meeting discussed Revenue Protection and Electronic Filing, emphasis on SSN accuracy and refund delays and new ERO rules.

Meetings with H&R Block and Bank One.

Instructions for tax packages revised to include SSN accuracy and refund delay messages.

Statistician from Office of Refund Fraud met with FSB to discuss statistical data in developing screening criteria.

1994 (cont'd)

IRS Executives briefed local Congressional Representatives on Revenue Protection Strategy.

Tax Counseling for the Elderly sponsoring organizations were provided a brief overview on revenue protection initiatives, emphasis on SSN validity and refund delays.

The Commissioner's filing season media and public service campaign kickoff; issuance of Fact Sheet 94-10, "Refund Protection Procedures" and News Release IR 94-119 stressing correct SSNs, refund delays, possibility of split refunds on returns claiming refundable credits. This information was made available on the ELF Bulletin Board and distributed to 43 representatives from general print media, technical tax press, electronic media, financial press and professional associations. Q&As, including information on the split refund and second payment by check, were made available on the ELF Bulletin Board (available to ELF practitioners) and the Public Affairs Bulletin Board (available to IRS offices nationwide). The press conference was attended by 41 media representatives, such as CNN, Cox Broadcasting, ABC, NBC, CNBC, Fox-TV, U.S. News and World Report, Tax Notes, Tax Analysts, New York Times, Washington Post, Associated Press, Dow Jones News Service, Knight-Ridder Financial News, Standard News Radio Network, McNeil/Lehrer and Scripps-Howard. The conference and video news release were sent via satellite and picked up in 47 major markets, with 67 stations within those markets. The Commissioner also held interviews via satellite with about 15 media markets nationwide.

A poster on SSN accuracy and refund delays was published in the SSA/IRS Joint Reporter and distributed to 7 million employers.

Notices issued to taxpayers with known invalid SSNs in the prior filing period.

1995

January Commissioner's interview with freelance reporters for "Good Housekeeping" and "Working Women" addressed SSN accuracy and refund delays. Publication scheduled for April.

1994 (cont'd)

Communication print products addressing overall accuracy, correct SSN and refund delay message include:

• Eighteen different Form 1040 series tax packages (forms and instructions) made available to 86 million taxpayers, also available through FEDWORLD on the INTERNET.

• 1995 Tax Supplement (English and Spanish). This supplement is carried by approximately 3,000 daily and weekly newspapers in its entirety and portions of it are carried by approximately 7,000 other newspapers throughout the filing season.

• 1995 Filing Season "Ask the IRS" question and answer columns (English and Spanish), used year-round by approximately 10,000 small newspapers as a regular column or filler.

• Public service filing season print drop-in ads are carried by approximately 10,000 newspapers and magazines and over 4300 billboard displays are available.

• 1995 International Clipsheet placed with international companies and overseas media.

• Publication 910, "Guide to Taxpayer Services," six million copies are made available to taxpayers.

CAG Meeting stressed SSN validity and refund delay and discussed emerging areas of fraud.

Presentation to the American Bar Association (ABA) of ELF changes to Rev. Proc. 94-63.

Presentation to IRS field employees responsible for the Congressional Affairs Program (local Congressional liaison) on Electronic Filing, Suitability, Monitoring, Education and Outreach.

Commissioner Richardson, Deputy Commissioner Dolan, Chief Taxpayer Service, and Electronic Filing Executive met with H&R Block.

AICPA meeting, IRS assisted in preparation of procedural guidelines and addressed the removal of the DDI and SSN validity.

1994 (cont'd)

Electronic Filer's Report, ELF Executive provided responses to questions posed by reporter Rob Hamel on RALs, EITC returns, DDI and split refunds with the second payment by paper check.

Industry telephone contacts with NELCO, Drake, Electronic Filing Coalition of America and Beneficial Corp.

Numerous telephone conversations with outside stakeholders re: Revenue Protection and general Electronic Filing. These external stakeholders were primarily practitioners from across the country calling in regards to the DDI decision.

IRS Executives briefed local Congressional Representatives on Revenue Protection Strategy.

February Commissioner's letter to Industry providing background on Revenue Protection Strategy and delay of refund.

Commissioner's letter to Members of Congress providing background on Revenue Protection Strategy.

Communication audiovisual products addressing overall accuracy, correct SSN and refund delay message include:

• PBS Tax Clinic aired February 5th on 176 PBS stations; 116 other PBS stations, numerous cable stations and Armed Forces Television are scheduled to air it later. The February 5th airing resulted in over 35,000 calls to the Taxpayer Service Toll Free area.

• Public Service Announcements have been distributed to over 8,800 radio stations and 2,400 television stations.

• Videoguide to Taxes - approximately 5,000 have been distributed to libraries, 2,500 copies to video outlets, such as Blockbuster, and 2,600 copies to IRS field Public Affairs Officers and Taxpayer Education Coordinators for local use. GEMSTAR Development Corp. also made it available to VCR Plus users in three regional markets and several smaller markets.

Chief Compliance Officer interviewed by Associated Press and Washington Post reporters about the Revenue Protection Strategy. News Release IR 95-16 issued, urging accuracy to avoid

1994 (cont'd)

delays and addressing the potential for split refund payments on returns claiming tax credits. The news release was distributed to 43 representatives from general print media, technical tax press, electronic media, financial press and professional associations. The news release and Q&As, which addressed the split refund and second payment by check, were also made available on the ELF Bulletin Board and the Public Affairs Bulletin Board.

Subcommittee on Oversight, Committee on Ways and Means Hearing, "The 1995 Filing Season and IRS's FY 1995 Budget Request."

Mr. ZIMMER. This is a fact.

Ms. RICHARDSON. It was in December we put out press releases. We met with the people in the industry.

Mr. ZIMMER. Can you tell me why you send the second check as a paper check?

Ms. RICHARDSON. I can say that the taxpayer is entitled to the refund, and we send the refund to the taxpayer.

Mr. ZIMMER. But the taxpayer has requested that the entire refund go to the lender. Can you explain why you are disregarding the taxpayer's request?

Ms. RICHARDSON. This is the subject of a lawsuit so I have been advised not to discuss it.

Mr. ZIMMER. So you can't—OK.

At what point did you inform the public that you would delay refunds on so-called questionable returns?

Ms. RICHARDSON. Again, before the end of last year's filing season we said we were going to take steps to do that. Throughout all of our meetings last summer I think with the industry groups, from the time we began focusing on this issue, we made it very clear that we would delay refunds, take any other steps necessary to make sure that only the people entitled got them.

Mr. ZIMMER. How do you define questionable as in questionable returns?

Ms. RICHARDSON. I beg your pardon?

Mr. ZIMMER. How do you define a questionable——

Ms. RICHARDSON. Where, on the face of it, it appears that someone may not be eligible for a refund.

Mr. ZIMMER. How long a delay can a taxpayer anticipate if there is something——

Ms. RICHARDSON. Where we have held up the refund funds, we have sent letters to taxpayers informing them that it could be up to as long as 8 weeks.

Mr. ZIMMER. Do you have enough——

Ms. RICHARDSON. If there is additional information that we need from them, it may even be longer, but we are trying to process things as quickly as possible and get the money out as quickly as possible to the people who are eligible.

Mr. ZIMMER. Do you have enough experience to know how long the average delay is at this point?

Ms. RICHARDSON. We don't.

Mr. ZIMMER. OK. Thank you very much, Madam Chair.

Ms. RICHARDSON. Thank you.

Chairman JOHNSON. Thank you.

Mr. Hancock.

Mr. HANCOCK. Yes. I had a question asked to me over the weekend that I just remembered, and I figured that maybe we can get it on the record right now. This particular question was the State of Missouri now is requiring a copy of the Federal income tax return to be submitted with their State income tax return if it is itemized. The question is, since the Federal return is supposed to be confidential, can a State legally require a copy of the Federal return?

Ms. RICHARDSON. We will get you an answer.

I can tell you that the best advice I would take is, if I don't know the answer to the question, I will ask my lawyer and we will get back to you.

I know that a number of States use a Federal—because they piggyback onto the Federal tax system, ask you to file your schedule A or schedule B or whatever with your State return. I think that happens here in the District of Columbia and in the State of the Virginia.

Mr. HANCOCK. Can they require the entire 1040 return be submitted as part of a State return?

Ms. RICHARDSON. I think I really would feel more comfortable finding out and letting you know for sure.

Mr. HANCOCK. Thank you.

Chairman JOHNSON. Thank you.

[The following was subsequently received:]

The Internal Revenue Code neither authorizes nor prohibits a State from having such a requirement. In general, the rules of section 6103 of the code governing the confidentiality and disclosure of Federal returns and return information apply only to information that is submitted to the Federal Government. Therefore, States are free to ask for Federal tax return information directly from their taxpayers.

Section 6103(p)(8) of the code, however, was designed to ensure that States requiring Federal tax information directly from their taxpayers take steps to protect the confidentiality of that information. This section requires these States to adopt confidentiality laws before they can receive any Federal tax information directly from the Federal Government. Because information exchange with the IRS is very important to State taxing authorities, this provision has been an effective incentive for the States to adopt confidentiality laws that are satisfactory to the Internal Revenue Service.

Chairman JOHNSON. There are a couple of precise questions that I think we need to get on the record, Commissioner. We have strayed from the tax systems modernization program into the other areas that are of concern to the subcommittee, and that is acceptable, but there are a few more things we need to follow up on.

First of all, what were the consequences of the $400 million cut in your 1995 budget request for your tax system's modernization—in terms of your timetable for implementing the tax modernization system specifically?

Mr. WESTFALL. We are continuing to do—let me start this way. What we did when we took the major cut in the request that we made for 1995 is we did a complete reevaluation of where we were putting the money and how fast the systems were rolling out. We, basically, for the most part, have done some reprioritization, but geared the program down. The exact impact of what we have done is still somewhat uncertain.

We believe that we are probably slowed by a full year in the implementation of the program. How much of a delay or perhaps even program reductions have to take place will be a product of whether our 1996 request is authorized or not.

Chairman JOHNSON. Are you aware that the GAO believes that you will not be able to spend this year's money?

Mr. WESTFALL. I have read that in the GAO testimony. I believe that my response very clearly would be we will effectively spend the money.

We basically went on a hold last year as a result of the fact that the increase was not authorized. We have several major acquisitions in the system that are about ready to go to closure that require funds. The document processing system needs to be funded for rollout. That project has already been contracted. It may not be capable of being rolled out if funding is not authorized.

The largest single hardware acquisition in the system, the service center support system that provides the corporate hardware platform for the new database environment, is scheduled to be let very soon and is dependent upon funds that would be authorized in the 1996 budget.

Chairman JOHNSON. Thank you.

As to the tax filing season questions specifically, could you clarify for the record exactly when you did inform the public and the tax return preparers of your activities and your plans to curb fraudulent returns? Particularly your decision to be very strict about requiring accurate Social Security numbers. Did you inform clearly about that early?

Ms. RICHARDSON. I believe we did, Madam Chairman, and I can get you the specific chronology of when the announcements were made and what we said. That was clearly part of the tax package that went out to all taxpayers.

Chairman JOHNSON. I want to see if it was highlighted, since it was a change and since it was so important to our efforts to reduce fraud.

[The following was subsequently received:]

REVENUE PROTECTION STRATEGY

1992

October Commissioner and Deputy Commissioner, Assistant Commissioners (RP) and (CI) and Chief Counsel met with representatives from H&R Block, Beneficial Corp., Jackson Hewitt, Mellon Bank, Greenwood Trust, NATP and others to discuss plans to remove the Direct Deposit Indicator (DDI) in the 1994 filing season. The Industry presented IRS with a briefing document entitled, "The Direct Deposit Acknowledgement Issue and It's Relationship to Electronic Filing Fraud."

1993

April Banks submitted a supplement to the October 1992 paper entitled "Electronic Filing: Industry Led Initiatives to Combat Fraud and Improve Electronic Filing."

Creation of the Council of Electronic Revenue and Commerce Advancement (CERCA) to review security of data and privacy issues, and increase the value of electronic filing commerce with all agencies to ensure consistent standards of software and data elements.

June Deputy Commissioner, Assistant Commissioner (RP), Deputy Assistant Commissioner (RP), Director, Office of Refund Fraud and members of their staff met with industry representatives regarding the DDI issue.

IRS announced the decision to retain the DDI for the 1994 filing season along with steps to strengthen fraud detection/deterrence and expectations of the industry. Explained to industry that we will review this decision each filing season based on ongoing trends.

1994

June Presentation to CERCA on changes to Suitability, RAL advertising and Form 8453 requirements.

Refund Fraud Strategy Approved by Treasury.

General Accounting Office briefed on fraud initiatives by the Director, Office of Refund Fraud.

1994 (Con't)

July	**IRS Nationwide Tax Forum - Baltimore (attendance 1,600) Opening executive remarks emphasized refund delays related to inaccurate SSN. Seminar on 1995 Changes to the Electronic Filing Program emphasized importance of TIN accuracy for both paper and ELF. Seminar on Earned Income Credit-Advanced Earned Income Credit emphasized educating the public, compliance initiatives and future plans. Handout on preventing fraudulent filing, prepared by Fraud Task Group, provided to attendees. IRS Nationwide Tax Forum - Sacramento (attendance 1,150), same structure as Baltimore forum.**
	Issued News Release IR-94-73, announcing new fraud control measures and need to verify the accuracy of SSNs prior to release of refunds.
August	IRS Nationwide Tax Forum - Albuquerque (attendance 770), same structure as Baltimore forum.
	IRS Nationwide Tax Forum - Kansas City (attendance 1,200), same structure as Baltimore forum.
	Presentations to NAEA, ABA and NATP by the Director of Practice, discussed filing fraud initiatives, emphasizing DDI, SSN accuracy and refund delays.
	Presentation to FTA Technology Workshop, including description of the Revenue Protection Strategy, ERO requirements, SSN accuracy and refund delays.
	Presentation to North Eastern Tax Officials Association, including a brief overview of the Revenue Protection Strategy.
September	IRS Nationwide Tax Forum - Orlando (attendance 2,000), same structure as Baltimore forum.
	IRS Nationwide Tax Forum - Salt Lake City (attendance 690), same structure as Baltimore forum.
	Briefing of SSA by the Director, Office of Refund Fraud and staff outlining filing fraud initiatives and potential impact on SSA, stressing coordination efforts.
	Advance notification of ERO changes to states with joint electronic filing and national practitioner associations.

1994 (Con't)

National press contacted and News Release (IR-94-100) issued, addressing ERO changes, SSN accuracy and refund delays.

Tax Symposium - Ogden, Utah, brief overview of the Revenue Protection Strategy, emphasized SSN accuracy and refund delay.

Meeting with Commissioner's Advisory Group (CAG) members discussed general issues on filing season strategies, including potential for two payments and potential refund delays due to additional filters.

October Under Secretary Noble, testified before the Oversight Subcommittee - recommended IRS take the time necessary to review refunds before issuance.

CERCA meeting discussed Revenue Protection Strategy.

Meeting with representatives from the Fraud Service Bureau (FSB) to discuss Revenue Protection issues.

Press Conference conducted by Treasury Secretary Lloyd Bentsen, Under Secretary for Enforcement, Ronald K. Noble, and IRS Commissioner Richardson regarding EITC and DDI.

Calls made to industry stakeholders explaining reasons for elimination of DDI.

Correspondence mailed to notify EROs of changes and application procedures.

FTA Board of Trustees Meeting, discussed ELF strategies, emphasis on DDI and Revenue Protection Strategy, emphasis on SSN validity and refund delay.

A news release on SSN accuracy and refund delays, developed jointly with SSA, was distributed to 1300 SSA field offices for local use.

November Commissioner Richardson met with AICPA, discussed Rev. Proc. 94-63 with emphasis on DDI.

Presentation to Texas Society of Certified Public Accountants (TSCPA)/IRS Liaison on changes to Rev. Proc. 94-63, and Revenue Protection Strategy with emphasis on SSN accuracy and refund delays.

1994 (Con't)

Meetings with NATP, NAEA, NSPA - changes to Revenue Procedure 94-63 and filing fraud initiatives discussed SSN accuracy and refund delays emphasized.

Discussion with H&R Block, requested clarification on Responsible Official signature and suitability checks.

Discussion with Bank One on extension of Filing Form 8633.

Fraud Service Board met with Office of Refund Fraud representatives to discuss screening criteria for potentially problematic refunds.

SSA and IRS issued an article on SSN accuracy and refund delays in the "SSA Courier" which is distributed to 14,000 organizations.

Sixty second public service radio spot on SSN accuracy and refund delay provided to over 8,800 radio stations. Through February 20 this spot was aired 92,910 times, by 1,495 outlets, in 828 markets, and 51 states/possessions.

December Presentation to American Institute of Certified Public Accountants (AICPA) on changes to Rev. Proc. 94-63, and Revenue Protection Strategy, emphasis on SSN validity and refund delay.

Federation of Tax Administrators (FTA) Commissioner's Liaison Meeting discussed Revenue Protection and Electronic Filing, emphasis on SSN accuracy and refund delays and new ERO rules.

Meetings with H&R Block and Bank One.

Instructions for tax packages revised to include SSN accuracy and refund delay messages.

Statistician from Office of Refund Fraud met with FSB to discuss statistical data in developing screening criteria.

IRS Executives briefed local Congressional Representatives on Revenue Protection Strategy.

Tax Counseling for the Elderly sponsoring organizations were provided a brief overview on revenue protection initiatives, emphasis on SSN validity and refund delays.

1994 (Con't)

The Commissioner's filing season media and public service campaign kickoff; issuance of Fact Sheet 94-10, "Refund Protection Procedures" and News Release IR 94-119 stressing correct SSNs, refund delays, possibility of split refunds on returns claiming refundable credits. This information was made available on the ELF Bulletin Board and distributed to 43 representatives from general print media, technical tax press, electronic media, financial press and professional associations. Q&As, including information on the split refund and second payment by check, were made available on the ELF Bulletin Board (available to ELF practitioners) and the Public Affairs Bulletin Board (available to IRS offices nationwide). The press conference was attended by 41 media representatives, such as CNN, Cox Broadcasting, ABC, NBC, CNBC, Fox-TV, U.S. News and World Report, Tax Notes, Tax Analysts,, New York Times, Washington Post, Associated Press, Dow Jones News Service, Knight-Ridder Financial News, Standard News Radio Network, McNeil/Leherer and Scripps-Howard. The conference and video news release were sent via satellite and picked up in 47 major markets, with 67 stations within those markets. The Commissioner also held interviews via satellite with about 15 media markets nationwide.

A poster on SSN accuracy and refund delays was published in the SSA/IRS Joint Reporter and distributed to 7 million employers.

Notices issued to taxpayers with known invalid SSNs in the prior filing period.

1995

January — Commissioner's interview with freelance reporters for "Good Housekeeping" and "Working Women" addressed SSN accuracy and refund delays. Publication scheduled for April.

Communication print products addressing overall accuracy, correct SSN and refund delay message include:

- Eighteen different Form 1040 series tax packages (forms and instructions) made available to 86 million taxpayers, also available through FEDWORLD on the INTERNET.

- 1995 Tax Supplement (English and Spanish) This supplement is carried by approximately 3,000 daily and weekly newspapers in its entirety and portions of it are carried by approximately 7,000 other newspapers, throughout the filing season.

1995 (Con't)

- 1995 Filing Season "Ask the IRS" question and answer columns (English and Spanish), used year-round by approximately 10,000 small newspapers as a regular column or filler.

- Public service filing season print drop-in ads are carried by approximately 10,000 newspapers and magazines and over 4300 billboard displays are available.

- 1995 International Clipsheet placed with international companies and overseas media.

- Publication 910, "Guide to Taxpayer Services", six million copies are made available to taxpayers.

CAG Meeting, stressed SSN validity and refund delay, and discussed emerging areas of fraud.

Presentation to the American Bar Association (ABA), ELF changes to Rev. Proc. 94-63.

Presentation to IRS field employees responsible for the Congressional Affairs Program (local Congressional liaison) on Electronic Filing, Suitability, Monitoring, Education and Outreach.

Commissioner Richardson, Deputy Commissioner Dolan, Chief Taxpayer Service, and Electronic Filing Executive met with H&R Block.

AICPA meeting, IRS assisted in preparation of procedural guidelines and addressed the removal of the DDI and SSN validity.

Electronic Filer's Report, ELF Executive provided responses to questions posed by reporter Rob Hamel on RALs, EITC returns, DDI and split refunds with the second payment by paper check.

Industry telephone contacts with NELCO, Drake, Electronic Filing Coalition of America and Beneficial Corp.

Numerous telephone conversations with outside stakeholders re: Revenue Protection and general Electronic Filing. These external stakeholders were primarily practitioners from across the country calling in regards to the DDI decision.

IRS Executives briefed local Congressional Representatives on Revenue Protection Strategy.

1995 (Con't)

February

Commissioner's letter to Industry providing background on Revenue Protection Strategy and delay of refund.

Commissioner's letter to Members of Congress providing background on Revenue Protection Strategy.

Communication audiovisual products addressing overall accuracy, correct SSN and refund delay message include:

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Subcommittee on Oversight, Committee on Ways and Means Hearing, "The 1995 Filing Season and IRS's FY 1995 Budget Request".

Chairman JOHNSON. In the same vein, when did you highlight the bifurcation of the return in the refundable area?

Ms. RICHARDSON. I will get you that specific information.

Again, that——

Chairman JOHNSON. When you notified people and the tax preparers and what kind of advanced notice they actually got.

Ms. RICHARDSON. That specific issue is the subject of a pending lawsuit right now.

[The following was subsequently received:]

Although the potential for two payments was discussed at a meeting with the Commissioner's advisory group in September 1994, information about split refunds was first discussed in a more public forum in the Commissioner's press conference to kickoff the filing season on December 28, 1994. Questions and Answers, including information about issuance of a paper check for the second portion of the refund, were placed on the Electronic Filing Bulletin Board in conjunction with the press conference. (See our previous submission for the chronology of activities.)

Chairman JOHNSON. On a more general plane, going back to your predecessor's letter, which I did not pursue because I thought we would focus first on tax modernization systems, but Commissioner Peterson's letter did go on to very specifically say that in 1994 they would eliminate the DDI (direct deposit indicator).

Now the DDI does seem to be a real culprit in encouraging fraudulent returns and payment of returns in a way and at a pace that makes it very hard for us to retrieve the dollars if they are mistakenly paid.

I understand that your bifurcated system is responding to this, but why did you not just implement the recommendation that had been developed in the IRS to eliminate the DDI, which probably would have solved the problems rather more directly and with less complexity than the bifurcated return?

Ms. RICHARDSON. We did, and last October Secretary Bentsen announced that we would no longer be issuing the direct deposit indicator, and we are not doing that for this filing season.

Chairman JOHNSON. But you did do it for the 1995 filing season. I must have not expressed myself clearly. The original recommendation was for the 1994 filing season. Why was it delayed a year?

Ms. RICHARDSON. I was actually—I did not make that——

Chairman JOHNSON. If it is a transition thing, you may want to yield to one of your——

Ms. RICHARDSON. I did not make that decision at the time, but what we really wanted to do was get an opportunity to look at, as we testified here last year, to take a very principled approach to looking at the fraud, to trying to define what it is before we made any decisions.

Chairman JOHNSON. I agree with that. I do think this is an important point. Because clearly the IRS had determined that there was a real explosion in fraud going on, and that eliminating the DDI would help. I am concerned why that decision was delayed a year and any light you can shed on that would be very useful for us. Because, of course, millions of dollars went out that we will never recoup because the decision was delayed a year.

Mr. DOLAN. Madam Chairman, one of the perspectives I might add is that I participated over a series of about 3 years in a number of discussions both—basically across the constituency base of practitioners, financial industries, others who are involved in this issue. What we had said as an organization from the outset was that we would continue to reevaluate both from filing season to filing season and within filing seasons.

One of the things the industry did in response to a meeting in 1993 was to suggest that the upstepped measures they would take in an industry-financed fraud service bureau would in fact eliminate the issues that the IRS had problems with. We said we would evaluate that. We said we would on a continuing basis determine what effects that other kinds of external stimuli might have had on the fraud.

Probably the time we had the most comprehensive picture of the fact that many of these cures, albeit well-intentioned, had not had the desired outcome was when we were able to do the two statistically valid studies that ran concurrent with the early months of the last filing season. It was coming out of that experience that we were convinced some of the anecdotal evidence and some of the suggestions that systems that had been interposed were going to make a difference in fraud had really not, that we made the judgment that the DDI was as integrally connected to what we were finding as we did.

Chairman JOHNSON. So are you saying that the original decision by the IRS to eliminate the DDI for the 1994 tax season—because this letter to my predecessor, Mr. Pickle, is very specific. It says we plan to eliminate the DDI beginning in the 1994 filing season. Later on it says to provide the time necessary for the discussion with the stakeholders, with other people involved in the system, we will not make the change in the DDI until the 1994 filing season.

So, clearly, this is going on well in advance of that filing season because they are delaying the decision in order to have the discussion with other people involved. With all of that preparation it did not go forward.

Now, you appear to be telling me that information gained from that very filing season indicated that maybe the DDI was not exactly the problem and maybe there were other answers that would be more effective. But that does not explain why the decision was derailed in apparently late 1992–93.

Mr. DOLAN. I am not sure, Madam Chairman, I can speak to all the circumstances that might have been behind the assertion that Commissioner Peterson made in that letter. I do believe that what had been going on and has gone on up until very recently is an active dialog among all the players in this arena with, we believe, the common objective of reducing the amount of fraud.

At almost every juncture steps were taken both by the IRS and by the many, many people in the industry to attempt to minimize the fraud. But on the heels of all those efforts, and given the additional information that came in last year, we believed that the Secretary made the right decision when he concluded, based on our advice, that the correlation was so strong. I think that additional information that came about as a result of early last filing season was what I think carried it over the top, at least from my point of view.

Chairman JOHNSON. Perhaps you, then, could tell me exactly when the IRS did inform people of these changes? The Commissioner referred to the tax package that went out to all filers.

Ms. RICHARDSON. No, I am sorry, on the removal of the direct deposit indicator, or the decision not to provide it any longer, that was made in October. I believe it was toward the end of October of last year by Secretary Bentsen. We can get you the precise date. That was announced at a press conference and widely publicized and the public record is quite—there are people that had a direct interest in it that we actually called and told them that the announcement was being made, but it was also announced to the public by the Secretary at the end of October.

Chairman JOHNSON. At the end of October.

Ms. RICHARDSON. Yes, ma'am.

Chairman JOHNSON. Thank you very much.

Are there other questions from the subcommittee? Yes, sir, Mr. Johnson from Texas.

Mr. JOHNSON of Texas. Thank you, Madam Chairman. I would just like to bring up the issue of the overseas assistance and tours that your department does, which is to some of the more exotic places in the world.

You answered the question about the Service's estimate of additional tax revenues that have been or will be collected by the Federal Government directly attributable to the program, and you say there is no data available to estimate the additional tax revenue attributable to overseas taxpayer assistance.

It would seem to me if we do not know that we are making money, if we do not have a cost analysis, then we ought to stop the program.

Ms. RICHARDSON. I would like Mr. Brand to maybe address that because he has the international operation under his——

Mr. JOHNSON of Texas. Thank you.

Mr. BRAND. Mr. Johnson, I would say this; that we assisted 95,000-plus taxpayers at a cost of $265,000 for travel.

Mr. JOHNSON of Texas. What is the total number of taxpayers in this country?

Mr. BRAND. Two point two million taxpayers are overseas and about half of these are, in fact, military taxpayers that we in fact assist there.

Mr. JOHNSON of Texas. So you saw a very small portion of them, actually.

Mr. BRAND. One could look at that and say that, yes, 1 million out of 2.2 million assisted.

Mr. JOHNSON of Texas. You have volunteers in the military and State Department that help you, do you not?

Mr. BRAND. Part of the purpose for the overseas travel, is, in fact, to train those volunteers, yes, sir.

Mr. JOHNSON of Texas. It would appear to me in some of the instances that you were spending hours, 1 or 2 or 3 hours, with very few people, in some cases. Others you had more there, I would agree.

Mr. BRAND. That is one of the things that you do on an annual basis, is you do probe and look to where there is in fact demand

and where there is in fact need and you change your service on a yearly basis depending on where in fact the need exists.

Mr. JOHNSON of Texas. Well, there are a lot of small countries where there are not any Americans, and I would say we should look at that program. Do you respond just because some Ambassador asks you to come?

Mr. BRAND. No, sir. I think the context here is IRS has been offering overseas assistance at this minimal amount for some 20-plus years. We respond based on where the U.S. Ambassador pleads there is demand, where we see demand, where our own historic record demands exist, and based on where the number of U.S. service people are stationed or where there are other Americans for various——

Mr. JOHNSON of Texas. Well, it seems to me if this thing has been around for 20 years, maybe you should look at that. I notice you have a request from the Ambassador in Haiti to send people down there. Is that a necessity?

Mr. BRAND. I don't know about the request, Mr. Johnson. I would have to take a look and see about a request to Haiti. But, in fact, there is a sizable military presence in Haiti right now.

Mr. JOHNSON of Texas. But the military helps you with their own people. I have been in the military, and I know. I never talked to an IRS person. They never helped at all.

Mr. BRAND. I understand. I hope that is not the case, but, in fact, in our interaction with the military, we are not there to do the direct assistance. We are there to train the individuals who act as volunteers to do the assistance.

Mr. JOHNSON of Texas. Then most of them are in the finance area of the military or the State Department, for that matter. So they rotate back to the United States on occasion. It would seem you could grab them then.

Thank you for your response.

Chairman JOHNSON. Commissioner, in October, you notified the public about the elimination of the DDI. Did you also notify them about the bifurcated return system of the refunds that were going to be electronically filed?

Ms. RICHARDSON. Madam Chairman, I will have to get you that for the record. I am not sure of the precise dates of that.

Chairman JOHNSON. I want to be sure that the notification in October was to all three points.

Ms. RICHARDSON. I am sorry, no, it was to the direct deposit indicator. That was when it was withdrawn in October.

Chairman JOHNSON. But it did not go to the whole system of reforms that you were going to apply to this tax filing period, and to the bifurcation of the refund in the electronic area and also to the second check going directly to the taxpayer. Was that information out there publicly in October?

Ms. RICHARDSON. I don't know exactly when it was out there. I know it was out there by the end of the year. I will get you the precise dates. I have to apologize because we had met with the industry and talked to them about what we were doing.

Chairman JOHNSON. Thank you very much.
[The following was subsequently received:]

The bifurcation of refunds was not discussed when we made notification of the DDI changes. (See our previous submission for the chronology of activities.)

Chairman JOHNSON. Since the EITC was involved in 90 percent of the fraudulent claims in 1994 and because in 1995 the number of people eligible to claim EITC benefits will increase by 6 million, I congratulate you on doing something about the problems in this area. We will follow the effects of your policies very closely, and we will be interested to see if they have any implications for changes in tax law, both in regard to the EITC and in regard to refundability in general and in regard to your process as well.

Ms. RICHARDSON. Again, we would like to work with the subcommittee and the subcommittee staff on any of those proposals.

Chairman JOHNSON. Thank you. I am going to recognize now Mr. Herger for one last question for the record.

Mr. HERGER. Thank you, Madam Chair. I do have another question that with your permission I would like to submit and submit to the Commissioner.

Chairman JOHNSON. Thank you. You certainly are welcome to do so, Mr. Herger, and thank you, Commissioner, and your staff, for your time this morning.

[The following was subsequently received:]

RESPONSE TO OVERSIGHT SUBCOMMITTEE OF THE COMMITTEE ON WAYS AND MEANS REGARDING TAX TREATMENT OF ASSOCIATE MEMBER DUES INCOME RECEIVED BY TAX-EXEMPT FARM BUREAUS

INTRODUCTION

During the House Ways and Means Oversight Subcommittee hearing of February 27, 1995, on IRS Budget Proposal for FY 1996 and 1995 Tax Return Filing Season, Congressman Herger requested that the Commissioner submit additional comments for the record. Congressman Herger requested information relating to a Technical Advice Memorandum issued in 1994. Specifically, the Commissioner was asked whether any change in IRS position evidenced in the 1994 TAM should "come only after careful review at the highest levels." In addition, the Commissioner was asked to provide any other thoughts regarding this matter.

The Technical Advice Memorandum (LTR 9416002) (1994 TAM) involved a farm bureau and the treatment of income derived from the dues of associate members. The 1994 TAM concluded that dues income from associate members resulted from the marketing of access to an unrelated trade or business (i.e., auto insurance) and thus was taxable to the organization.

LEGAL BACKGROUND

Income received by labor, agricultural (including farm bureaus), or horticultural organizations is generally exempt from federal income tax under section 501(c)(5) of the Internal Revenue Code. Section 511(a), however, imposes a tax on unrelated business taxable income received by these otherwise exempt organizations.

Historically, the Internal Revenue Service position has been that the marketing of insurance by exempt organizations generally is an unrelated trade or business and, therefore, income derived from selling such insurance is taxable. This position was ultimately upheld by the Supreme Court in United States v. American Bar Endowment, 477 U.S. 105 (1986).

In 1982, two Technical Advice Memoranda (LTR 8302009 and 8302010) (1982 TAMs) were issued regarding farm bureaus that sold insurance. In the 1982 TAMs, regular membership was open only to those who owned or operated farms. Anyone else could join as an associate member. The organizations' activities included lobbying on agricultural issues, distributing of publications, and sponsoring lectures and seminars. The organizations also supported 4-H clubs and provided educational materials to public schools. Associate members paid the same dues as regular members and had similar access to programs and activities, but could not vote or hold office. The 1982 TAMs concluded that the insurance activities were unrelated trade or business, but that dues payments received from both regular and associate members were not taxable because benefits provided to all members indicated that dues were not clearly attributable to participation in the insurance programs.

Shortly after issuing the 1982 TAMs, the IRS considered associate member dues paid to labor unions and concluded in LTR 8344001 that such associate member dues were taxable. In that situation, associate members were employees outside the collective bargaining unit. They received union bulletins and ancillary benefits from the union's lobbying on workplace matters, but could not vote in any union election or be represented by the union. The union argued that lobbying and other unspecified work-related activities were sufficient to create a nexus between the dues and the exempt functions of the organization. The IRS disagreed.

The IRS took a similar position in then-pending postal union cases. Two of these cases were resolved by United States Courts of Appeal. In American Postal Workers, AFL-CIO v. United States, 925 F.2d 480 (D.C. Cir. 1991), associate members received no benefit other than access to health insurance. In National Association of Postal Supervisors v. United States, 944 F.2d 859 (Fed. Cir. 1991), associate members could attend meetings and serve on committees in an advisory capacity. Educational programs on lobbying, writing and speaking skills were also available to the complete membership. In both cases (Postal Union Cases), dues income from associate members was held to be taxable because access to insurance was found to be the only benefit associate members received in exchange for dues.

As a result of American Bar Endowment and the Postal Union Cases, IRS agents in certain on-going examinations have taken the position that farm bureaus are required to include in unrelated business taxable income the dues received from associate members attributable to the right to purchase insurance.

THE 1994 TECHNICAL ADVICE MEMORANDUM

The National Office of the IRS was asked again to consider farm bureaus and associate member dues in 1994. This resulted in the issuance of the 1994 TAM. The facts of that case were similar to the 1982 TAMs, in that associate members could purchase insurance and had all the rights of regular membership except the right to vote and the right to serve as voting delegates or board members. The IRS viewed the facts as indicating that the farm bureau used the associate member category to boost sales of insurance. The dues income appeared to be a method by which the farm bureau could derive a benefit from its marketing of insurance. Consistent with the development of the case law subsequent to the 1982 TAMs, and in particular, the Postal Union Cases, the 1994 TAM considered (1) whether associate members were bona fide members (that is, whether they were provided anything of substance other than the right to purchase goods or services from the exempt organization); and (2) whether associate members could or were likely to avail themselves of the exempt functions of the organizations. The 1994 TAM concluded that the associate member class was used for the purpose of marketing access to an unrelated trade or business (i.e., auto insurance) and, as a result, dues from that membership class were taxable to the organization. The organization described in the TAM did not provide evidence of significant exempt activities directed at non-farmers.

IMPACT OF 1994 TAM

A technical advice memorandum is requested by either the taxpayer or by an IRS field office and relates only to the facts of the specific case. As such, it is not precedential in nature. The impact of the 1994 TAM is to treat the associate member dues of the farm bureau in that case as unrelated business taxable income. Farm bureaus with similar facts may be similarly impacted, although the facts and circumstances of each case will have to be considered.

PUBLICATION OF REVENUE PROCEDURE 95-21

In response to questions raised about the 1994 TAM, the IRS, in conjunction with the Office of the Assistant Secretary for Tax Policy, published a revenue procedure. Rev. Proc. 95-21 (copy attached) indicates that the IRS will only treat dues paid by associate members as taxable if the associate member class was formed or otherwise availed of for the principal purpose of selling or providing access to goods or services unrelated to the exempt purposes of the organization.

The impact of the revenue procedure on a particular organization will depend upon the facts of that case. In this regard, the Service will look to the purposes and activities of the organization and not the intentions of its members.

This revenue procedure restates and clarifies the IRS position with respect to this issue and will be helpful in explaining that position to section 501(c)(5) organizations that have established associate member categories.

REVENUE PROCEDURE 95-21

SECTION 1. PURPOSE

The purpose of this revenue procedure is to establish when associate member dues payments received by an organization described in section 501(c)(5) will be treated by the Service as gross income from the conduct of an unrelated trade or business under section 512.

SECTION 2. BACKGROUND

An organization exempt from tax under section 501(a) as an organization described in section 501(c)(5) is subject to the unrelated business income tax imposed by section 511(a). Section 501(c)(5) organizations often receive dues payments not only from members that are accorded full privileges in voting for the directors of the organization but also from associate members that are accorded less than full or no voting privileges. Whether associate member dues payments are treated as gross income from the conduct of an unrelated trade or business under section 512 is determined in accordance with the following section.

SECTION 3. TREATMENT OF ASSOCIATE MEMBER DUES PAYMENTS

The Service will not treat dues payments from associate members as gross income from the conduct of an unrelated trade or business unless, for the relevant period, the associate member category has been formed or availed of for the principal purpose of producing unrelated business income. For purposes of this revenue procedure, unrelated business income is income from the sale of, or the provision of access to, goods or services produced by an activity which constitutes a trade or business, regularly carried on, and not substantially related to the organization's exempt purposes other than through the production of income. Consequently, other than where the statute or regulations specifically provide a method of allocating a portion of dues payments to unrelated business taxable income, the Service will treat dues payments from associate members as not including gross income from an unrelated trade or business if the associate member category has been formed or availed of for the principal purpose of furthering the organization's exempt purposes.

In applying this revenue procedure, the Service will look to the purposes and activities of the organization rather than of its members.

EFFECTIVE DATE

This revenue procedure is effective for all open years.

DRAFTING INFORMATION

The principal author of this revenue procedure is Charles Barrett of the Exempt Organizations Division of the Office of the Assistant Commissioner (Employee Plans and Exempt Organizations). For further information regarding this revenue procedure contact Mr. Barrett at (202) 622-8152 (not a toll-free number).

Chairman JOHNSON. I am going to submit for the record Mr. Ramstad's opening statement.

[The prepared statement follows:]

Statement of Rep. Jim Ramstad
Oversight Subcommittee of the Ways and Means Committee
Hearing on FY 96 Internal Revenue Service Budget
February 27, 1995

Madam Chair, thank you for calling today's hearing to discuss the budget proposals for the Internal Revenue Service (IRS).

I have strong concerns about the dramatic increase in this year's IRS budget proposal. As Congress seeks ways to dramatically reduce the federal deficit -- with spending control that should affect every government agency -- the IRS has submitted a request for $7.5 billion, a 10 percent increase over last year.

The IRS, which has 113,963 "full time equivalent" employee positions, has remained isolated from the federal workforce reduction President Clinton hails. Even worse, the agency is requesting funding to add 922 full time equivalents.

Perhaps most disturbing, the IRS intends to spend a massive sum on an expensive computer system, which may not be necessary if this Congress succeeds in simplifying the tax code.

Madam Chair, Dr. James Payne, a leading scholar of our tax system, estimates that the "overhead" costs of operating our current system consume around $65 of every $100 in revenue raised. By continuing to build up a massive IRS, it will becoming increasingly difficult to fundamentally reform our existing tax system.

Thank you again, Madam Chair. I am anxious to exploring these critical issues with our witnesses today.

Chairman JOHNSON. Mr. Portman from Ohio.

Mr. PORTMAN. Just very briefly, Madam Chairman. I appreciate your acknowledging me. I had a good meeting with the Commissioner last week. Sorry I was unavoidably detained this morning. I looked over your testimony briefly. I know you addressed the diesel gas and excise tax issue in your testimony. I would ask on the record that we work on that issue with regard to the refunds.

Ms. RICHARDSON. Right.

Mr. PORTMAN. I told you I had some specific evidence the refunds were not being applied back in a timely fashion. I will get that specific information to you.

Second, just on the tax modernization system, I know you have already had an opportunity to talk about TSM. My only question would be whether it might make sense for us to see a list of the top complaints that the Service gets and that we get from our constituents constantly and then match those with the various TSM projects. This would be a project that I would be happy to work with you on. I could provide you with the complaints; you can provide me with the TSM projects that could address them.

Honestly, I think all of us on this panel do get complaints constantly regarding specific matters, and it might be interesting to see where the various TSM projects line up with the complaints and whether they are in fact addressing them, and I would be pleased to work with you on that.

Ms. RICHARDSON. We would like to work with you on that, too, and we will follow up with you.

Mr. PORTMAN. Thank you.

Chairman JOHNSON. Thank you, Mr. Portman.

Ms. RICHARDSON. Thank you, Madam Chair.

Chairman JOHNSON. Thank you, Commissioner.

As the first panel leaves the witness stand, let me call the second panel.

Jennie Stathis, the director of tax policy and administration issues of the GAO; Lynda Willis, associate director; Hazel Edwards, also of the GAO.

As the panel sits down, let me announce that we will have to begin abiding by the 5-minute rule, both panelists and members. We will begin using the lights.

Welcome, Ms. Stathis.

STATEMENT OF JENNIE S. STATHIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, U.S. GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY LYNDA WILLIS, ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES; HAZEL E. EDWARDS, DIRECTOR, INFORMATION RESOURCES MANAGEMENT/GENERAL GOVERNMENT ISSUES

Ms. STATHIS. Thank you, Madam Chairman.

Chairman JOHNSON. Please proceed with your testimony and then we will move with questions, and I hope with a little more dispatch than we have to this point today.

Ms. STATHIS. Thank you.

We are pleased to be here this morning to participate in your hearing, and as you have introduced them, on my right is Lynda

Willis and on my left is Hazel Edwards. I will briefly summarize my statement, if I may, and submit it for the record.

First, I will talk a little bit about the tax systems modernization program.

We do believe that modernizing IRS' systems is absolutely critical. The tax processing system was designed in the early sixties. It is outdated. It is paper driven. It is labor intensive. It is hard to get information from it, and when you get it, it is often outdated. So this is absolutely a critical program. TSM is intended to change all of that. It is intended to eliminate the reliance on paper and make information available whenever and wherever it is needed.

IRS has been at this for about 8 years and about $2 billion has been invested, and we believe that marginal improvements have been made as a result of it. That is because the systems that have been brought online so far are ones that automate old processes or they make information available out of old systems. While they improve the current environment, they do not get us much closer to the environment of the future, the ultimate objectives that TSM is intended to provide.

Probably more important to us, Madam Chairman, however, is the next point in our testimony. IRS has devoted a great deal of its efforts to getting prepared to build these new systems, and we believe that over the past year they have made some encouraging progress in these areas, but we remain concerned that these future efforts are still at risk for a number of reasons that we list in the testimony: IRS still lacks sufficient technical skills to implement such a large, complex undertaking as TSM; the development of systems is proceeding at the same time as process improvements are being identified; and, third, there are not good priorities for which systems will give us the biggest bang for the buck, if you will. So, as a result, there are lots of things that are going on at the same time. There are also still not the fully established technical guidelines that are so critical to making sure that each piece of this fits together and works.

Now, the 1996 TSM budget request is for more than $1 billion and it is to fund about 41 projects. Given the lack of sufficient skills to really manage such a large effort, and because there are still problems with getting all of the technical guidelines in place, we are recommending that IRS focus its efforts on the critical few, try to identify the particular projects that will give the greatest benefit in terms of the objective where they want to go in the long run, and to try to focus the resources that they have on bringing those systems online in a short period of time. We think that IRS will get closer to the ultimate TSM objective that way and will get there faster.

The second area is refund fraud, which you have talked about a little bit this morning, and IRS has taken a number of steps this year to deal with refund fraud. Those come after our reports and hearings of this subcommittee. We believe that those actions, if they are implemented effectively, could help reduce the number of fraudulent claims and they could help improve the detection of fraudulent claims.

IRS has delayed at this point about 1.5 million returns of taxpayers. They will delay the refunds of many more before the filing season is over. Those delays affect taxpayers who claim the earned income credit or who do not use valid Social Security numbers.

We believe that IRS could have done a better job of giving taxpayers adequate advance notice about the earned income credit refunds being delayed, and we think they still need to do a better job of telling people who have invalid Social Security numbers what they have to do to resolve that problem.

We also have some of our recommendations in here that deal with earned income credits, something you asked us to provide because so many of the refund fraud cases involve the earned income credit.

The third area of our testimony is with telephone assistance, which we believe is an important indicator of the service IRS provides during the tax filing season. This year we tested the access over a 2-week period. We made more than 1,000 phone calls, and we reached IRS 156 times.

With that, I will be pleased to answer your questions.

[The prepared statement and attachments follow:]

TESTIMONY OF JENNIE S. STATHIS, DIRECTOR
TAX POLICY AND ADMINISTRATION ISSUES
GENERAL ACCOUNTING OFFICE

Madam Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in the Subcommittee's inquiry into the administration's fiscal year 1996 budget request for the Internal Revenue Service (IRS) and the status of the 1995 filing season.

Our statement addresses four main issues--the status of IRS' Tax Systems Modernization (TSM) program, IRS' efforts to control tax refund fraud, steps that might be taken to make the Earned Income Credit (EIC) easier to administer and less susceptible to fraud, and the ability of taxpayers to reach IRS by telephone. We also have some discussion of other issues related to IRS' budget request. Each issue is discussed in an appendix and summarized below.

BUDGET OVERVIEW

IRS' budget request is for about $8.2 billion and staff of 114,885 full-time equivalents (FTEs), an increase of about $739 million and 922 FTEs over IRS' expected fiscal year 1995 operating level. This overall increase is a net of various increases and decreases, including (1) increases to enable IRS to maintain current operations, (2) several reductions that represent IRS' share of the administration's initiatives to reduce the size and cost of government, and (3) increases to fund program changes.

Of the $521.3 million in requested program changes, $475.6 million is for automation projects, and the bulk of that ($420.7 million) is for projects that IRS considers part of TSM. The other $45.7 million is intended to help IRS deal with the two most predominant filing season issues so far this year and in the recent past--the need to better control refund fraud and the difficulties taxpayers experience in trying to reach IRS by telephone.

TSM

IRS is requesting $1.03 billion in fiscal year 1996 for TSM development, an increase of 66 percent over IRS' proposed operating level for fiscal year 1995. IRS is also requesting $61.2 million for the operation of completed TSM systems.

IRS initiated TSM in 1986 because its tax processing system, the same system still in use today, was outdated and in desperate need of repair. This processing system has remained virtually unchanged since it was automated in the early 1960s. For instance, most of the 200 million returns that IRS receives each year are still submitted in paper form, and only part of the information from these forms is keyed into computers. The processes that IRS employees use are paper-driven and labor-intensive, and employees must contend with taxpayer data that are sometimes difficult to access and that may be outdated and incomplete. Taxpayers, too, are frustrated by often futile attempts to get information when they contact IRS.

TSM is intended to change all this by creating a new tax processing system that virtually eliminates the reliance on paper and that makes taxpayer information available to IRS employees wherever and whenever it is needed. IRS top management has provided a vision of this new workplace and has redefined the organization to be more responsive to taxpayers' needs and mission demands. In addition, IRS is planning to improve key business processes with a goal of achieving dramatic gains in service and productivity. However, after 8 years and an investment of almost $2 billion in TSM systems, IRS has realized only marginal improvements in its operations.

Some initial systems have been completed with TSM funds, but most of these systems simply automate old processes without substantially improving service to taxpayers. We do not dispute the value such systems could add to the current environment. But we believe that focusing on progress in such systems as part of TSM shifts agency and oversight attention away from the critical path of actions necessary to achieve the ultimate TSM objectives.

IRS made some encouraging progress in the last year in correcting deficiencies in its management and technical infrastructure for TSM. However, we remain concerned that future systems development efforts are still at risk because of a number of factors. These factors include (1) the lack of sufficient technical and management expertise and skills to implement TSM; (2) continued development of systems for TSM without taking into account changes that could occur because of process improvements; and (3) the lack of system development priorities or fully established technical guidelines. Without addressing these factors, IRS risks continuing business as usual, and the opportunity to realize greater service improvements and cost reductions could be lost.

To focus the TSM effort, we believe that IRS should first direct its attention to a small number of projects that address critical gaps in mission performance and are part of the TSM vision. The mission-critical projects include those that would help create a paper-free environment and make taxpayer data uniformly available agencywide. IRS should then devote the full range of its available TSM resources (managerial, technical, financial) to successfully completing these projects within a short period--perhaps 12 to 18 months. By limiting its attention to a few critical projects, IRS could gain control over many of the TSM risks and could begin to move incrementally toward the TSM vision. In light of the need to refocus TSM, IRS may not be in a position, in fiscal year 1996, to effectively use all of the funding it has requested.

These issues are discussed more fully in appendix I.

REFUND FRAUD

As discussed in appendix II, IRS has taken several steps this year in an attempt to better control refund fraud and is asking for additional resources to do more in 1996. This emphasis is in response to serious concerns raised in several GAO reports[1] and congressional hearings and in reports by an IRS consultant and a task force established by the Secretary of the Treasury. These actions, if implemented effectively, could help reduce the number of fraudulent claims being submitted and help improve IRS' chances of detecting fraudulent claims that are submitted.

Some of IRS' new controls are directed at giving IRS more time to ensure the validity of the taxpayer and the claimed refund. As a result, IRS has already delayed the refunds of at least 1.5 million taxpayers and will delay the refunds of many more before the filing season is over. Those delays affect taxpayers who claim the EIC or who do not use valid Social Security Numbers (SSN).

If accounts in the news media are an indication, these delays have caused much confusion and anger among taxpayers and tax return preparers. IRS might have mitigated some confusion and anger if, as discussed in appendix II, it had done a better job of (1) giving taxpayers adequate advance notice of the potential

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[1]Tax Administration: IRS Can Improve Controls over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992); Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season (GAO/GGD-94-65, Dec. 22, 1993); Tax Administration: Electronic Filing Fraud (GAO/T-GGD-94-89, Feb. 10, 1994); and Tax Administration: Continuing Problems Affect Otherwise Successful 1994 Filing Season (GAO/GGD-95-5, Oct. 7, 1994).

delays to EIC-related refunds and (2) telling taxpayers whose refunds were being delayed because of an invalid SSN what they must do to correct the situation and get their refunds.

IRS is asking for an increase of $28.3 million and 323 FTEs in fiscal year 1996 to combat refund fraud. An IRS official told us that the additional resources would be targeted toward prevention rather than detection. We agree with such a focus, because it is less costly and more efficient, in our opinion, to stop a fraudulent return from being filed than to identify and deal with the fraud after the return is filed.

Because most of the refund fraud cases IRS identifies involve the EIC, you asked for our views on what could be done to make the EIC easier to administer and less subject to fraud. Refundable credits, like the EIC, pose a challenge for tax administrators. In addition to the concerns about fraud, there are equally important concerns that not all those eligible for the EIC are receiving it.

We have made several recommendations in the past that could help to make the EIC less of a problem for IRS and taxpayers. As discussed more fully in appendix III, those recommendations called for greater clarity in IRS' forms and instructions; eliminating differences between the definition of a qualifying child for EIC purposes and the definition of a dependent for purposes of claiming a dependency exemption; encouraging the advance payment option, whereby persons eligible for the EIC can choose to receive it in advance as part of their paycheck; and moving toward timely computer matching of employer wage information with tax return data.

TELEPHONE ASSISTANCE

An important indicator of filing season performance is how easily taxpayers who have questions or who want to order forms and publications are able to contact an IRS assistor on the telephone. In reports on past filing seasons, we discussed the inaccessibility of IRS' telephone service (i.e., the difficulty taxpayers had in reaching IRS by telephone).[2] To determine whether telephone service was again a problem during the early part of this filing season, we tested the accessibility of (1) the toll-free system that IRS tells taxpayers to call if they have questions about their account, the tax law, or IRS procedures and (2) the toll-free system IRS tells taxpayers to call if they want copies of tax forms and publications.

Results of both tests showed that accessibility is still a problem. Of the 1,166 calls we placed to the toll-free assistance number, we reached an IRS assistor 156 times--a 13 percent accessibility rate. We were more successful accessing IRS' forms ordering system, but even then we were able to reach an IRS assistor only 47 percent of the time. Our testing methodology and results are discussed in more detail in appendix IV.

IRS is asking for $17.4 million and 239 FTEs in fiscal year 1996 to help it answer 1.3 million more telephone calls. Although these additional resources might help improve accessibility, it will not make an appreciable difference in the large and growing gap between the number of calls coming into IRS and the number it answers. We believe that more taxpayers could get through to an assistor if IRS adopted some of the basic management practices used by other organizations that operate large telephone assistance programs. This is also discussed in more detail in appendix IV.

[2]See, for example, GAO/GGD-94-65 and GAO/GGD-95-5.

OTHER BUDGET ISSUES

In appendix V, we discuss three other issues related to IRS' fiscal year 1996 budget request:

-- IRS' operating plan for 1995 and its budget for 1996 both assume the receipt of at least $92 million from new installment agreement user fees in both years. To the extent the user fees do not generate the expected revenues, activities included in IRS' appropriation for processing returns and assisting taxpayers will be underfunded.

-- A proposed change in legislative language restricting the use of money appropriated for tax law enforcement could have an adverse impact on IRS' continued implementation of its fiscal year 1995 compliance initiatives.

-- If the federal employee pay raise for 1996, including locality pay, exceeds the budgeted 2.4 percent, IRS will have a funding shortfall in fiscal year 1996--just as it has in fiscal year 1995.

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That concludes my summary statement. We welcome any questions that you may have.

TAX SYSTEMS MODERNIZATION

IRS first articulated its plans for modernization in the mid-1980s and laid out a more specific vision in the early 1990s. IRS' vision calls for a work environment that is paper-free and where taxpayer information is readily available to IRS employees wherever and whenever it is needed. The focus of any TSM systems investment, then, should be on delivering the capabilities of this vision, such as paperless processing, rapid update of taxpayer accounts, and instant access to taxpayer data when responding to taxpayer inquiries.

IRS is funding 41 projects in fiscal year 1996 under the auspices of TSM. Thus, TSM has grown to more than double the 18 projects funded in fiscal year 1993. It is reasonable to expect that any project funded under TSM would be focused on providing essential TSM capabilities. Instead, some projects funded under TSM have focused on the current systems environment.

The systems that IRS has delivered to date under TSM, including the Electronic Filing System, the Automated Underreporter System, the Integrated Collection System, and Corporate Files On-Line (CFOL), have marginally improved IRS' current tax processing and compliance operations. However, they were not built to be an integrated part of the comprehensive TSM program and they have not delivered the large increases in capability and customer service that IRS hopes to have in the future.

For example, CFOL, which provides on-line access to taxpayer account information in the existing IRS master files, brings some marginal benefits to IRS. It speeds return processing by permitting electronic verification of taxpayers' names and addresses, and it gives telephone assistors access to taxpayer account information to help answer questions. However, CFOL's information comes from master files only and does not reflect taxpayer data that may be in other systems, such as the collection and examination systems. Thus, a telephone assistor may not have all relevant and current information when answering a taxpayer's questions. A future TSM module is to provide on-line access to complete taxpayer information.

The fiscal year 1996 budget request for TSM includes other systems that will enhance the current environment but not be an integral part of the future TSM program. These systems include the Examination Automated System, which automates the field examination processes; the Integrated Collection System, which automates the field collection process; the Corporate Systems Modernization and Transition, which replaces and upgrades the Martinsburg and Detroit mainframe computer systems; and the Service Center Recognition/Image Processing System, which replaces the current optical character recognition of simple tax returns and documents. The examples cited account for $156 million, or about 15 percent of the 1996 request for TSM development.

We believe that these systems should not be funded as part of TSM. We do not dispute the value these systems could add to the current environment, but as part of TSM, they shift agency and oversight attention away from the critical path of actions necessary to achieve the ultimate TSM objectives. Specifically, progress in the stand-alone, current-environment systems is not a barometer of progress in activities essential to achieving the TSM objectives.

TSM COSTS ARE UNCERTAIN

IRS has been unable to provide us and the Congress with reliable estimates of what the overall cost of TSM will be. As of October 1992, IRS was estimating that TSM would require about $8.9 billion for systems development and a total of $23 billion through 2008 for acquisition, operation, and maintenance. IRS' current estimate of TSM costs, as of February 1994, is $9.4 billion for acquisition and $22.3 billion in total. However, we had some concerns with the cost model that IRS used to develop the 1992 estimates and expressed these concerns to IRS in 1993. IRS' cost model has not been updated to address our concerns or changes in the TSM vision and scope. IRS intends to have a new cost model and revised estimates by September 1995. In the meantime, we continue to use IRS' estimates as an indication of the investment commitment that TSM entails. We would note, however, that all of these estimates include the variety of projects discussed above and many of them do not contribute to the central TSM vision.

TSM RISKS REMAIN HIGH

In the last year, IRS has made some progress in its management and planning of TSM. However, unmanaged risks continue to reduce IRS' chances for long-term success. These risks include

-- IRS' lack of sufficient technical and management expertise and skills to implement TSM;

-- the continued development of systems for TSM without taking into account changes that could occur because of process improvements; and

-- IRS' lack of system development priorities or fully established technical guidelines.

Because of these and other risks, we have placed TSM on our list of high-risk government programs.

In May 1994, we issued a report that identified a number of practices that leading private and public organizations used to manage their information resources more strategically in order to improve performance and better meet customer needs.[3] These practices included measuring the performance of key processes; focusing on process improvement; managing information systems projects as investments; and integrating the planning, budgeting, and evaluation processes. IRS has begun to study how it can use these practices to better manage its information resources and gain greater performance and service improvements.

However, IRS' current approach to TSM contrasts sharply with these practices. For instance, the successful organizations made sure that they had skilled and experienced technicians and managers to guide systems development efforts. According to the National Research Council (NRC), IRS needs to attract new skills to transform its software development staff from one of maintaining antiquated current systems to one that can design and build the modern, integrated systems that TSM requires.[4] The NRC also noted that IRS needs to manage its contractors more aggressively to ensure timely production of high-quality software. In this regard, the NRC advised IRS to hire people experienced in managing software development contractors.

Successful organizations also analyzed their business processes and determined how they could be improved before undertaking related automation projects. IRS has taken an important step in

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[3]Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology (GAO/AIMD-94-115, May 1994).

[4]Continued Review of the Tax Systems Modernization of the Internal Revenue Service (Interim Report), Computer Science and Telecommunications Board, National Research Council. National Academy Press, Washington, D.C., 1994.

this regard by initiating process improvement studies to streamline the tax return processing and customer service functions. However, IRS does not know how the results of these projects will be incorporated into the ongoing systems development efforts for these areas. As a result, IRS could end up with systems that do not meet the requirements of the streamlined or redesigned processes. In such a case, systems that have been developed may have to be retrofitted or scrapped.

Successful organizations prioritized their development projects using an explicit set of criteria that assess the mission benefits, risks, and costs of each project. IRS has not set priorities for any of its development projects, instead it considers all projects to be equally important. Priorities are essential for allocating scarce resources, as well as to establish program and project contingencies. The NRC noted in its report that IRS was unable to respond quickly and effectively to the reduction in TSM funding for fiscal year 1995 because it lacked contingency plans.

Finally, successful organizations ensured that they had a technical framework of standards and guidelines in areas such as data management, telecommunications, and security, that enable project teams to build systems that connect together, operate smoothly, and exchange information. Guidelines are also important because systems developed without guidelines may have to be changed or redesigned later, usually at a higher cost. In the last year, IRS has described its technical approach to integrating its information systems and revised guidance to its TSM system developers that further defines the technical and functional design of TSM. For successful integration of all of the TSM systems, IRS must now establish management controls to ensure that all projects use these guidelines.

One long-standing critical gap in IRS' technical guidelines is security. Technical guidelines for security are particularly important because the TSM environment of on-line access will make taxpayer data even more susceptible to unauthorized access and disclosure. Last year, IRS received a draft security architecture from its Integration Support Contractor, but decided not to accept it and began an effort to develop its own security guidelines. To date, IRS has issued a security policy and a draft of high-level security requirements. IRS has also engaged another contractor to perform a data sensitivity analysis and identify which data elements should be given specific levels of security. IRS expects to issue initial security guidance to TSM project teams by April 1995.

The challenges of completing a complex modernization involving large integrated systems are great, and it is easy to lose sight of the ultimate goal. Therefore, it is important that IRS focus management attention and resources on those opportunities that can best improve mission performance. By working on a wide variety of TSM projects simultaneously, IRS has not had such a focus. As a result, while IRS has invested significant funds in modernization, it is still far from its vision for TSM.

REFUND FRAUD

Over the past few years, more attention has been focused on refund fraud. Fraudulent refund schemes are generally based on false claims of federal income tax withheld or refundable credits, such as the Earned Income Credit (EIC) or the Fuel Tax Credit. Perpetrators of schemes include individuals who make false claims using their true names and Social Security Numbers (SSN) and individuals who make false claims using (1) the names and SSNs of unsuspecting, legitimate taxpayers or (2) fictitious names and SSNs.

Although fraud affects all types of returns, much of the attention has been on electronic filing because the speed with which those returns are processed has made it more difficult for IRS to detect the fraud before the refund is issued. Also, although only about 12 percent of all individual income tax returns were filed electronically in 1994, about 43 percent of the returns IRS identified as fraudulent that year were filed electronically.

Table II.1 shows the growth in identified fraudulent returns and refunds since 1990. From 1990 through 1994, as indicated by the information in the table, $102.6 million in identified fraudulent refunds were issued before IRS could stop them. Of that total, $78.7 million (77 percent) related to electronic returns.

Table II.1: Number of Detected Fraudulent Returns and Deleted[a] Fraudulent Refunds in Calendar Years 1990 Through 1994

Dollars in millions

	Paper			Electronic			Totals[c]		
Year	Returns	Refunds claimed	Refunds deleted	Returns	Refunds claimed	Refunds deleted	Returns	Refunds claimed	Refunds deleted
1990	5,302	$15.9	$14.8	411	$1.2	$0.5	5,713	$17.1	$15.3
1991	5,422	32.3	30.7	5,746	10.7	2.6	11,168	42.9	33.3
1992	12,244	33.2	30.9	12,725	33.6	22.5	24,969	66.8	53.4
1993	51,883	82.8	73.0	25,957	54.0	29.1	77,840	136.8	102.1
1994	44,137	90.7[b]	81.5	33,644	69.8	35.9	77,781	160.5	117.4

[a]A deleted fraudulent refund is one that IRS has detected and stopped before the refund is paid out.

[b]This figure excludes two returns claiming refunds totalling $347 million.

[c]Totals may not add due to rounding.

Source: IRS data.

Although the number of identified fraudulent returns is less than 1 percent of the total number of individual income tax returns filed in any year, we have been concerned about the growth in identified fraud and the uncertainty as to how much fraud is not being identified. Accordingly, we have made several recommendations directed at improving IRS' controls, some of which IRS has implemented, and have included filing fraud on our list of high risk government programs. Because the Subcommittee shared our concern, the Secretary of the Treasury established the Task Force on Tax Refund Fraud. On October 6, 1994, the Task Force testified before the Subcommittee and presented numerous recommendations of its own.

<u>IRS HAS TAKEN STEPS IN 1995 TO DEAL WITH REFUND FRAUD</u>

IRS has taken several steps in an attempt to reduce refund fraud in 1995. For example:

-- To better protect against unscrupulous tax return preparers or transmitters participating in the electronic filing program, IRS now requires new program applicants to provide fingerprints, that can be used to conduct criminal history checks, and to submit to a credit check.[5] It is our understanding that IRS plans to decide, after this filing season, whether to extend this requirement to preparers and transmitters who are already in the program. Implementation of this requirement is consistent with a recommendation we made in 1992 that IRS check the background of electronic filing applicants.

-- To better ensure the appropriateness of refund claims, IRS has said that substantial efforts would be directed toward identifying claims with missing SSNs, invalid SSNs (ones that do not match Social Security records), and/or SSNs that were already used by another taxpayer. IRS has added controls that prevent returns with one or more of those conditions from being filed electronically. If a return with one of these conditions is filed on paper, IRS has said that it will delay any refund until the matter is resolved.

-- According to IRS, most of the refund fraud cases it has detected in the past involved the EIC. With that in mind, IRS is delaying refunds on many returns claiming the EIC to allow time to better assure their validity. This action is being taken on returns determined to be most problematical based on an IRS study last year. Because the delay only applies to that part of the refund attributable to the EIC, some taxpayers may receive two refund checks--one for the nonEIC part of their refund and a second, several weeks later, for the rest, assuming IRS determines that the EIC claim is valid. The notice IRS is sending filers to advise them of the delay says that the refund "may be sent to you within eight weeks". IRS has estimated that about 7 million filers will receive such a notice in 1995.

-- Recognizing that the ability of electronic filers to obtain quick loans in the amount of their refunds (known as refund anticipation loans) might increase the incentive to submit fraudulent electronic returns, IRS took steps to disassociate itself from those loans by no longer providing the direct deposit indicator. The indicator, which signaled that IRS would not be reducing the taxpayer's refund to pay another federal debt of the taxpayer, was being used by financial institutions as a basis for making the loans.

These changes, if implemented effectively, could help reduce the number of fraudulent claims being submitted and help improve IRS' chances of detecting fraudulent claims that are submitted. Over the next several months, we will continue monitoring the implementation of these changes. We have two observations thus far about their potential effect on taxpayers.

First, IRS did not, in our opinion, provide taxpayers with adequate notice of the change involving EIC claims and the resulting delay in EIC refunds. We saw nothing in the Form 1040 tax package or in Publication 17 (<u>Your Federal Income Tax</u>) that explained that refunds involving the EIC could be delayed for

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[5]The fingerprint requirement does not apply to Certified Public Accountants, attorneys, and enrolled agents.

several weeks. Both documents told potential electronic filers that "some refunds may be temporarily delayed as a result of compliance reviews" to ensure that the returns are accurate. Taxpayers who did not intend to file electronically--about 85 percent of the filers--were not even told that much. Also, by advising only potential electronic filers of possible "compliance checks", IRS may be giving the impression that electronically-filed returns are more subject to audit--not the kind of message that helps expand the use of electronic filing.

Second, some delayed refunds may not be resolved quickly and could cause additional taxpayer burden. When IRS identifies a return with an invalid primary SSN, it puts a hold on the refund and sends a notice (CP54B) to the taxpayer. That notice does not make it clear that the taxpayer's refund will not be released until the matter is resolved and, except in certain circumstances, does not require the taxpayer to send anything to IRS to help resolve the matter. This could result in additional correspondence with taxpayers and a further delay in issuing their refunds.

When we prepared this testimony, statistics were not available on the number of fraudulent refund returns identified this filing season. However, other indicators could be related to the new fraud control procedures.

-- IRS had received 24 percent fewer individual income tax returns electronically as of February 17, 1995 (6,720,000 compared to 8,872,000 during that same period in 1994).[6]

-- About 1.5 million taxpayers had been sent notices as of February 17, 1995, advising them that their refunds had been delayed as a result of IRS' fraud-related procedures.

-- At least 3 million reject notices sent out from the electronic filing system as of February 20, 1995, were for conditions that might indicate a questionable refund. Most of the notices related to some problem with the name and/or SSN of the taxpayer or a dependent. Because a return can be rejected for more than one reason, the number of reject notices may be greater than the number of returns rejected. We do not know how many returns were rejected nor how many of the rejected returns were corrected, resubmitted over the electronic filing system, and accepted.

Before the filing season began, many of IRS' 10 service centers expressed some concern about the impact of delayed refunds on their workloads. The only evidence of increased workloads we have seen to date is a 64 percent growth in the workload of the service centers' Error Resolution Units as of February 10, 1995, compared to last year. We do not know how much of the increase is due to IRS' new fraud procedures or whether that workload has become unmanageable. We will be following up on this issue during our continued monitoring of the filing season.

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[6]Some of the decrease in electronic filings has been offset by an increase in returns filed on paper and an increase in returns filed over the telephone as part of IRS' TeleFile program. In total, however, the number of individual income tax returns filed as of February 17 has declined, from 29,203,000 in 1994 to 28,019,000 this year.

IRS' BUDGET REQUEST FOR 1996 INCLUDES ADDITIONAL RESOURCES TO FIGHT REFUND FRAUD

The administration's fiscal year 1996 budget request for IRS asks for 323 FTEs and about $28.3 million for a "cross-functional effort to combat tax refund fraud". IRS says that the additional resources will be used, among other things, to help it (1) detect and stop fraudulent refunds, (2) identify and refer for examination those EIC cases with audit potential, (3) handle the rapidly increasing inquiry calls associated with these cases, and (4) investigate and prosecute the most egregious cases.

IRS said in its budget estimates that, based on the results of past years' refund fraud efforts, the level of resources being requested should enable it to detect fraudulent refund claims amounting to $474.3 million in fiscal year 1996. That estimate is significantly overstated. Using the average results per staff year that IRS achieved in 1993 and 1994, the expected results in 1996 would be about $210.6 million.

However, an official in IRS' criminal investigations function told us that the ideal result would be for the amount of detected fraudulent refund claims to go down. He said that IRS hopes to achieve that goal by targeting additional resources on prevention rather than detection. We agree with that focus because it is less costly and more efficient, in our opinion, to stop a fraudulent return from being filed than it is to identify and deal with the fraud after the return is filed.

EIC CONTINUES TO CAUSE PROBLEMS FOR IRS AND TAXPAYERS

Even excluding the problems with fraud discussed in appendix II, the EIC continues to be a source of many taxpayer errors and additional IRS work.

In 1994, 14.8 million families received over $15 billion in EIC benefits--an increase over the 14.1 million who received $13 billion in 1993. IRS expects that about 6 million more persons will be eligible to receive the credit in 1995 due to provisions in the Omnibus Budget Reconciliation Act of 1993. Individuals without a qualifying child are now eligible for the credit if they (1) are at least 25 but less than 65 years old, (2) are not a dependent of another taxpayer, and (3) have earned income and adjusted gross income of $9,000 or less.

This expansion has created additional work for IRS. During the processing of returns, IRS' computer system identifies taxpayers without qualifying children who appear to be eligible for the EIC but did not claim it. IRS suspends processing of those returns until they can be reviewed by a tax examiner. If an examiner determines from information on the return and by researching Social Security data (to determine the taxpayer's age) that the taxpayer is eligible for the EIC, IRS will calculate the amount and correct the taxpayer's return.

IRS told us that about one-half of the taxpayers whose returns had been suspended in the first few weeks of this filing season were determined to be entitled to the EIC. According to IRS data as of February 10, 1995, failure to claim the EIC has been the most frequent error made by taxpayers and preparers on this year's returns. The second most frequent error involves mistakes in calculating the EIC when it is claimed.

WHAT COULD BE DONE TO MAKE THE EIC LESS OF A PROBLEM?

Refundable credits, like the EIC, pose a challenge for tax administrators. In addition to the concerns about fraud, there are equally important concerns that not all those eligible for the EIC are receiving it. We have made several recommendations in the past that could help to make the EIC less of a problem for IRS and taxpayers.

In September 1993, we recommended that IRS take certain steps that we thought would make the EIC easier to administer[7]. Specifically, we recommended that IRS (1) modify the Forms 1040 and 1040A to collect the data now required by Schedule EIC, thus eliminating the need for taxpayers to complete and IRS to process a separate schedule, and (2) clarify taxpayer instructions on the need to provide complete information for determining EIC eligibility. IRS continues to require the Schedule EIC but has simplified it by moving EIC computations to a worksheet. IRS' Schedule EIC instructions, in our opinion, are still not clear.

IRS objected to modifying the Forms 1040 and 1040A and eliminating the Schedule EIC. It believed that such a change would confuse taxpayers because of differences between the definition of a qualifying child for purposes of claiming the EIC and the definition of a dependent for purposes of claiming a dependency exemption. A key difference in the two definitions is the requirement, for purposes of claiming a dependency exemption, that the taxpayer provide over 50 percent of a dependent's support (referred to as the "support test"). There is no support test in the definition of a qualifying child for EIC purposes.

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[7]Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved (GAO/GGD-93-145, Sept. 24, 1993).

We addressed this problem in a March 1993 report, in which we analyzed four alternatives to simplify the laws on dependent exemptions, including two that would change the support test.[8] On the basis of our analysis, we recommended that Congress consider enacting legislation that would substitute a residency test similar to that used in the EIC program for the dependent support test when the dependent lives with the taxpayer.

Persons eligible to receive the EIC can choose to receive it in a lump sum payment after filing a tax return or in advance as part of their paycheck. In February 1992, we reported that less than 1 percent of EIC recipients in 1989 took advantage of that second option.[9] Although use of the advance payment option would help taxpayers benefit from the credit sooner, it could also create problems for IRS if persons receiving the advance payment later filed a tax return but did not report that they had received the credit in advance. Under IRS' returns processing procedures in place at the time we did our review, those persons could receive the credit again as a lump sum payment. We recommended that IRS take various steps to (1) better ensure that eligible taxpayers are aware of the advance payment option and (2) prevent those who take advantage of that option from receiving the credit a second time. When last we checked, IRS had taken steps to better publicize the availability of the advance payment option but had not revised its procedures to protect against duplicate payment of the EIC.

With respect to fraud on electronically filed returns, we recommended in December 1992 that IRS work toward electronically matching employer wage information with electronic return data[10]. That kind of match is currently beyond IRS' capabilities. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it has processed taxpayers' returns. This is because of the time it takes to verify the information and correct any errors.[11] IRS has begun to test the possibility of getting partial year's wage information from the states and using that to verify that the taxpayer is employed and to have some information on the taxpayer's amount of earned income.

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[8]Tax Administration: Erroneous Dependent and Filing Status Claims (GAO/GGD-93-60, Mar. 19, 1993).

[9]Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public (GAO/GGD-92-26, Feb. 19, 1992).

[10]Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992).

[11]Under the Electronic Management System--one of many planned components of TSM--IRS expects to electronically receive tax returns, tax information documents (like W-2s), and correspondence. Electronic transmission of W-2s would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available to match with data being reported on electronic returns.

TELEPHONE ACCESSIBILITY

An important indicator of filing season performance is how easily taxpayers who have questions or who want to order forms and publications are able to contact an IRS assistor on the telephone. In reports on past filing seasons, we discussed the difficulty taxpayers had in reaching IRS by telephone (i.e., "accessibility").[12] Although IRS answers millions of calls each year, even more calls go unanswered. Many taxpayers receive busy signals, face long on-hold times, or simply give up.

To determine whether accessibility was a problem during the early part of this filing season, we conducted two tests. One test was to determine the accessibility of the toll-free assistance for taxpayers who have questions about their account, the tax law, or IRS procedures. The second test was to determine the accessibility of the toll-free system that IRS tells taxpayers to call if they want copies of tax forms and publications. Results of both tests indicated that again this year taxpayers are having problems reaching IRS by telephone. We plan to repeat both tests later in the filing season.

To conduct the tests, we placed calls at various times during each work day from January 30 through February 10, 1995. We made our calls from seven metropolitan areas--Atlanta; Chicago; Cincinnati; Kansas City; New York; San Francisco; and Washington, DC. If we received a busy signal, we hung up, waited 1 minute, and then redialed. If after four redials (five calls in total) we had not reached IRS, we considered the attempt unsuccessful. If we reached IRS but were put on hold for more than 7 minutes, we abandoned the call.

DIFFICULTIES ENCOUNTERED IN TRYING TO ACCESS TOLL-FREE TELEPHONE ASSISTANCE

In all, we made 344 attempts to contact IRS' toll-free telephone assistance this year. We succeeded in reaching IRS on the first try 79 times. In 20 cases, however, we abandoned the call after being on hold for more than 7 minutes. Thus, in only 59 (17 percent) of the 344 attempts were we successful in reaching an IRS assistor on the first try. In another 97 cases (28 percent), we successfully reached an assistor after one to four redials--an overall success rate of 45 percent. Our 344 attempts to reach an assistor required a total of 1,166 calls. Of those 1,166 calls, we reached an assistor 156 times--a 13-percent accessibility rate. IRS' own data show a nationwide accessibility rate of 12 percent during the same 2-week period.

In conducting our test, we did not ask questions of the assistors because it was not our intent to assess the accuracy of their assistance. IRS does its own test of accuracy, and we have assured ourselves in the past about the reliability of IRS' methodology. IRS' test data for 1995 showed an accuracy rate of about 86 percent as of February 11. That compares to a rate of about 89 percent for the same period in both 1994 and 1993.

LESS DIFFICULTY ENCOUNTERED IN TRYING TO ACCESS TOLL-FREE FORM ORDERING SYSTEM, BUT ACCESSIBILITY STILL LOW

One way taxpayers can obtain tax forms and publications is to place an order through IRS' telephone form ordering system. The order will then be filled by one of IRS' three forms distribution centers. As with the first test, our intent was to determine how easy it is to reach IRS over the telephone. We did not order any materials. We followed the same redialing and on-hold procedures as described in the toll-free telephone assistance test.

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[12]See, for example, GAO/GGD-94-65 and GAO/GGD-95-5.

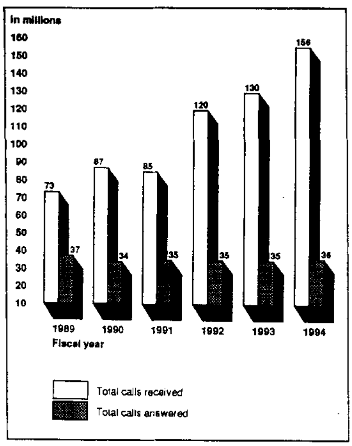
Of 240 attempts to contact the distribution centers, 137 (57 percent) were successful on the first try and 81 (34 percent) were successful after one to four redials--an overall success rate of 91 percent. Our 240 attempts to contact the distribution centers required a total of 465 calls. Of those 465 calls, we succeeded in reaching an IRS representative 218 times--a 47-percent accessibility rate.

We did not assess how well the distribution centers filled orders for tax forms and publications or whether IRS walk-in sites were adequately stocking these materials because (1) our checks in recent years showed that IRS was doing a good job in those areas, (2) IRS contracts for its own test of distribution center performance, and (3) our prior review of the contractor's methodology resulted in changes that have improved its reliability. The contractor's results as of January 27, 1995, showed that the distribution centers filled 96 percent of the test orders correctly.

IRS' REQUEST FOR ADDITIONAL RESOURCES TO IMPROVE TELEPHONE SERVICE WILL NOT APPRECIABLY INCREASE ACCESSIBILITY

The administration's fiscal year 1996 budget request includes an increase of 239 FTEs and $17.4 million to enable IRS to answer 1.3 million additional telephone calls for assistance. Although the increase, if approved, will help, it will not make an appreciable difference in the large and growing gap between the number of calls coming into IRS (which we refer to as "received") and the number it answers, as shown in figure IV.1.

Figure IV.1: Comparison of Total Calls Received and Total Calls Answered for Fiscal Years 1989 Through 1994



Source: IRS data.

We believe that more taxpayers could get through to an assistor if IRS adopted some of the management practices used by other organizations that operate large telephone assistance programs. To maximize the number of calls answered, the four private companies we contacted and the Social Security Administration commonly established (1) challenging program goals for answering as many calls as possible based on customers' needs; (2)

standards for the number of hours employees were expected to be on the telephones and the number of calls answered; (3) standard hours of operation, often extending beyond a 9-hour work day; (4) nationwide standards and uniform ways to measure operations and performance; and (5) nationwide call routing and easy access to customer information.

IRS has not used many of the management practices commonly used by the organizations we contacted. And, in cases where IRS did use a practice similar to those in the other organizations, it was not applied with the same emphasis on customers' needs. For example, IRS has had specific goals for answering more calls for the past 2 years, but these goals are based on the resources IRS has available, not on taxpayers' demand for service. IRS officials believe the gap in the number of calls they are able to answer compared to the number of calls made by taxpayers is so great that it would be unrealistic for them to establish goals based on taxpayer demand.

IRS has, for the first time, provided access to its telephone assistors for 10 hours per work day during the 1995 filing season. This may allow more taxpayers to reach IRS, although there has been no increase in the number of assistors available. IRS has also been working to improve customer service by overcoming the lack of nationwide access to taxpayers' account information. This has been a major barrier to routing calls among IRS call sites. Specifically, in February 1995, IRS provided its assistors the ability to access taxpayers' accounts no matter where the taxpayers filed their returns. Thus, IRS can now route calls to any call site and an assistor will be able to retrieve any taxpayer's account, which should increase taxpayers' chances of being served. These are all positive steps, but it is too early to assess their impact on answering more calls.

Despite the progress made, IRS lacks the capability to centrally monitor and route nationwide call traffic on a real-time basis to available assistors anywhere in the country. IRS also still lacks some basic management practices for its telephone assistance program, including standards for the number of hours assistors should be on the telephone and for measuring performance. We believe that implementing these practices would, over time, allow IRS to answer more taxpayer calls with its existing level of resources, but it is unlikely that IRS would be able to answer all of the calls it receives.

OTHER ISSUES RELATED TO IRS' FISCAL YEAR 1996 BUDGET REQUEST

Beyond those issues discussed already, the most significant questions surrounding the fiscal year 1996 budget request are (1) will IRS receive the expected amount of installment agreement user fees? (2) will IRS successfully implement the fiscal year 1995 compliance initiatives? and (3) is the budgeted increase for a federal employee pay raise sufficient?

WILL IRS RECEIVE THE EXPECTED AMOUNT OF INSTALLMENT AGREEMENT USER FEES?

IRS' operating plan for fiscal year 1995 and its budget for fiscal year 1996 both assume the receipt of $92 million from new installment agreement user fees. Installment agreements allow taxpayers to pay their tax liabilities on an agreed-upon schedule with IRS.

IRS' fiscal year 1995 budget request proposed two new user fees--one for providing a direct deposit indicator associated with the electronic filing program and another for setting up installment agreements. The proposed direct deposit indicator fee became moot when the Department of the Treasury announced in October 1994 that it would no longer provide that indicator. IRS expects to start charging for installment agreements in early to mid-March 1995. The fee is to be $43 for each new installment agreement and $24 for restructured agreements.

In our report on IRS' fiscal year 1995 budget request, we said that it is impossible to predict how taxpayers will react to a fee for installment agreements.[13] For example, some taxpayers may be encouraged to pay their entire tax liability to forego incurring the fee. Others may be discouraged from entering into these agreements because of their cost. According to IRS officials, the $92 million estimate is based on an assumption that IRS will receive about 2 million new installment agreements and 90,000 restructured agreements.

IRS' fiscal year 1995 appropriation act (P.L. 103-329) provided that the Secretary of the Treasury could spend user fee receipts to supplement appropriations made to IRS. Accordingly, IRS' fiscal year 1995 appropriation and fiscal year 1996 budget reflect lower amounts for tax return processing and taxpayer assistance than would have otherwise been the case if there were no user fee provision. If the demand for installment agreements falls short of what IRS expects in 1995 and/or 1996, activities that are included in IRS' appropriation for returns processing and taxpayer assistance would be underfunded.

WILL IRS SUCCESSFULLY IMPLEMENT THE FISCAL YEAR 1995 COMPLIANCE INITIATIVES?

In every year but 1 from 1990 through 1994, Congress has funded compliance initiatives to provide IRS with additional staff with the intent of increasing compliance and producing more revenue. Yet, IRS' compliance staffing declined in that period. For fiscal year 1995, Congress provided IRS with $405 million for more compliance initiatives and restricted IRS' ability to use the compliance funds for other purposes. The fiscal year 1995 appropriation act also said that no funds could be transferred from IRS' Tax Law Enforcement appropriation. These restrictions were imposed because IRS had not fully implemented past initiatives and had used initiative funds to cover budget shortfalls in base operations. In recent testimony before the House Appropriations Subcommittee on Treasury, Postal Service, and General Government, we said that these restrictions increased

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[13]Tax Administration: Analysis of IRS' Budget Request for Fiscal Year 1995 (GAO/GGD-94-129, Apr. 20, 1994).

the prospects that IRS would implement the fiscal year 1995 compliance initiatives.

IRS' fiscal year 1996 budget does not include any funding for new initiatives or additional funding for the fiscal year 1995 initiatives. It does, however, show an annualization of the 1995 initiative for an additional 546 FTEs. According to IRS officials, funds that were used for support costs associated with hiring the new employees in fiscal year 1995, but not needed for that purpose in fiscal year 1996, will be used instead to "buy" additional FTEs for 1996.

The fiscal year 1996 budget also requests a change to the restriction that was imposed in the 1995 appropriation act on the use of compliance initiative funds. In lieu of the language that prohibits any transfer of funds from the Tax Law Enforcement appropriation, IRS is proposing language that would allow funds to be transferred if IRS obtains the advance approval of the House and Senate Appropriations Committees. We believe that the restriction imposed in the fiscal year 1995 appropriations act should be retained to better ensure that IRS uses the compliance initiative funds as Congress intended and to protect against erosion of IRS' enforcement base as occurred in prior years.

IS THE BUDGETED INCREASE FOR A FEDERAL EMPLOYEE PAY RAISE SUFFICIENT?

The President's fiscal year 1996 budget provides for a 2.4 percent federal employee pay raise. For IRS that percentage increase equates to $92 million. It is uncertain whether this amount will be sufficient to cover an across-the-board pay increase and locality pay. IRS' fiscal year 1995 budget provided for a 1.6 percent federal pay raise that was not adequate to cover locality pay. As a result, according to IRS budget officials, IRS needed to absorb an additional $50.7 million for locality pay. If Congress authorizes locality pay for fiscal year 1996 to the levels outlined in the Federal Employees Pay Comparability Act, IRS may need to absorb an additional 2.4 percent average pay increase--$92 million more than the amount provided for in the fiscal year 1996 budget.

Chairman JOHNSON. Thank you very much.

On the efforts that the IRS has made to reduce fraud, you do not appear to be in disagreement; that they are right to focus on the validity of the Social Security number.

Ms. STATHIS. That is a very well-placed effort on their part.

Chairman JOHNSON. Appears to be long overdue as well.

Ms. STATHIS. That is correct.

Chairman JOHNSON. If they had notified as part of the packet to taxpayers that this is a very important matter, frankly, what more is the government required to do? What is the complaint against the IRS in this regard?

I don't care how many times you tell your own children, sometimes they do not listen. Taxpayers are going to figure out that they have to get their Social Security number right when taxpayers do not get their refunds and do not get their filing accepted because they do not have the numbers right.

Ms. STATHIS. Mrs. Johnson, we believe that the IRS has done a very good job of informing people that they have to have a correct Social Security number. That is not an issue. But there are many, many people whose earned income credit is going to be held up who have a valid Social Security number. They are going to be held up because they are caught in one of the predictive profiles that comes out of IRS' study of last year. They appear to be problematic, so the refunds are going to be held.

Chairman JOHNSON. But, again, they are going to wait 2 months. Relative to the billions of dollars that people got last year that they should not have gotten, that were fraudulent, is 2 months a real hardship?

Ms. STATHIS. Well, we do not think so.

Chairman JOHNSON. Or are you saying that the predictive screens were too rigorous and, therefore, were imposing a hardship unnecessarily or irresponsibly?

Ms. STATHIS. No, we are not in disagreement with what IRS is doing.

Chairman JOHNSON. OK.

Ms. STATHIS. In terms of the refund fraud cases, in fact, I think they may have to go beyond where they are and we will see how these work this year. But we may have to go to a system, for example, where we encourage people to get the earned income credit on an advanced basis, to get the 60 percent they can get in their paychecks, and have 40 percent left. We may have to go to a process where they do not get that until May, perhaps. That would allow the entire filing season for IRS to examine all of the patterns that they have.

Chairman JOHNSON. I think we are going to have to take a look after this filing season at even the validity of a lump sum reimbursement when this is actually an income expansion and, logically, should be closely connected to the wage reporting. We do not have the computer capability to do that for several years. So in the interim we may want to really change the system.

But you do not think they are too tough in their screens?

Ms. STATHIS. No, we do not.

Chairman JOHNSON. You agree they absolutely have to screen in order do reduce fraud.

Ms. STATHIS. Yes.

Chairman JOHNSON. So the real issue is, is 2 months too long?

Ms. STATHIS. I think the issue is going to be whether even what they are doing is enough.

Chairman JOHNSON. That may be so, but in terms of the current criticism, would you say 2 months is too long?

Ms. STATHIS. No, I think it is probably not long enough.

Chairman JOHNSON. Now, to get back to the phone system briefly, because your evaluation of their accessibility through their phone system and their evaluation of their accessibility from their phone system are very different. On the other hand, in their testimony they point to a number of things that are fairly recent changes on how they manage phone calls.

Have you talked to them recently? How can you explain to me the discrepancy between your two positions?

Ms. STATHIS. What IRS is telling you is that they have an estimating methodology where they try to estimate the number of taxpayers who are calling in rather than the number of phone calls that are made. That estimating methodology has enough guesswork in it that we quit using it.

But I think our estimates on our 2-week phone call pretty much matched their estimates. So I am warming to their number. If you take the five attempts that we made, our number comes up to about a 45-percent success rate on the five calls. If the same taxpayer tries five times to call at least during the 2 weeks we were testing, they would get in maybe 45 percent of the time according to our test, and that is pretty close to the number that they are using.

But in terms of the absolute number of calls, we got through 156 times out of more than 1,000, which is a 13-percent number. We started using——

Chairman JOHNSON. So behind your 13 percent number is, for an individual taxpayer, a 45-percent shot?

Ms. STATHIS. The 45 percent is probably a good indication of what a single taxpayer would experience if they tried as much as 5 times to get in.

Chairman JOHNSON. Well, we certainly are discussing variations in still an unacceptable range.

Ms. STATHIS. The basic point is the same, which is that telephone access is pretty poor.

Chairman JOHNSON. Last, has GAO made any specific recommendations in terms of modernization of phone services that might address this problem?

Ms. STATHIS. I do not think so, not on modernization alone. Let me have Lynda Willis respond.

Ms. WILLIS. Madam Chairman, the recommendations that we have made to IRS focus on how using management practices we found in companies that we looked at that also have significant telephone operations, how those management practices could actually improve IRS' current level of service without the additional increments that would be brought about by modernization of their equipment, et cetera. These practices included such things as standard hours, more expanded hours of phone coverage, and things that we found companies that depended on the telephone to do their business were routinely implementing right now.

Chairman JOHNSON. Were your calls made before IRS adopted some of these policies, because they reported today that now they have adopted some of these policies for this filing season?

Ms. WILLIS. The calls that we made were made during this filing season. The recommendations that we have made have not been implemented. IRS has expanded its hours this season to 10, as opposed to 24 at the companies that we looked at—on a per day basis. We would expect that based on the improvements IRS has made that accessibility should go up over the entire filing season, and should compare better than last year; but it is still not going to be enough to close the gap.

Chairman JOHNSON. The key thing is using the equipment that they have for more hours than they are currently using it.

Ms. WILLIS. Right, and possibly putting more people on the phone.

Chairman JOHNSON. Last, in terms of the modernization issue, it is difficult from the general description to determine, in a sense, the merit of what you are saying versus the merit of what the IRS is saying. They did give us some very interesting examples of old processes that they have modernized and in the course of modernizing it, not only gotten more taxpayers to pay up but also taxpayers to pay more accurately the amount they owe resulting also in increased collections.

Now, that does matter a lot. Why is that not worth doing?

Ms. EDWARDS. The issue, Madam Chairman, is not that that function is not worth doing; the issue is whether that function represents a part of TSM, which is the objective of providing information on a taxpayer within IRS such that it is the same information, such that it is consistent, such that it is available quickly, and getting rid of paper processes for the broad agency operations within IRS.

When you look at each of those systems, let us go to ICS, which is the integrated collection system, the specific system Mr. Westfall pointed to. The points that he makes are absolutely correct in terms of what that system does in today's environment, in the current environment. However, it is important to understand that that system is an automation of the final process in the collection chain, and the gains that have been identified apply to that very specific component where the revenue officers are engaged.

But the other more significant point about that system is that it is a stand-alone system and does not connect to anything else, which means the information in that system is not available to a tax assister who is answering a question from a taxpayer calling in about their account. The essence of TSM must be to provide uniform information to anyone within the IRS so that they can respond to taxpayers in a way that is reasonable, accurate, and consistent.

I think if there is one thing we have heard, and I am sure you have heard as well from your constituencies, is that there are instances when people call into IRS and they might call on several different occasions.

Mr. JOHNSON of Texas. Madam Chair.

Chairman JOHNSON. Yes, just one moment.

So, in essence, your choice, then, is, given limited resources, that we should dedicate the resources to the TSM goals even at the expense of improving the quality and effectiveness of some of the current systems that are going to be there for a considerable transition period.

Ms. EDWARDS. Actually, Madam Chairman, we are suggesting that for those improvements that need to be made to the current environment, to keep the operations moving along or to make some very essential changes now, that those decisions need to be made on a one-for-one basis; that is to say, if the ICS or integrated collection system is something that is really needed, it needs to stand on its own, not as part of the TSM arena. It should not be presented in that construct because it gives the impression that more is being done for the long term than is actually happening.

So we are suggesting that the IRS focus on those current initiatives that need improvement and for which business decisions would dictate that they make some short-term automation effort, but not justify it in terms of TSM because it is not a contributor to TSM.

In terms of phasing, as we talk about the integrated collection system, it is being perceived in a logical sense as a phasing toward the long term, but, again, that system technically does not fit into the long-term system. So in terms of a technical building block, it is not that.

Chairman JOHNSON. Let me yield to my colleague from Texas, Mr. Johnson.

Mr. JOHNSON of Texas. Thank you, Madam Chairman.

I was interested in the comment you made that this big system we are building is not going to be accessible except right here. Is that true?

Ms. EDWARDS. When I was sharing about the integrated collection system?

Mr. JOHNSON of Texas. Right.

Ms. EDWARDS. I was saying that that system is only available to people in a particular function, so that if it is a taxpayer assister that is at an 800 number, for example——

Mr. JOHNSON of Texas. Right.

Ms. EDWARDS. They would not have access to information which might be——

Mr. JOHNSON of Texas. So they could not help them, in effect.

Ms. EDWARDS. They would help the taxpayer, but if there were significant information in that collection system related to a recent contact, the tax assisters would not have access to that information.

Mr. JOHNSON of Texas. The other question, Madam Chairman, is are there segmented parts of this computer modernization that we are seeing? It is not an integrated system.

Ms. EDWARDS. That is the point we are making with regard to the systems that have been delivered to date.

Now, the objective, the goal as presented by Mr. Westfall earlier, is that ultimately the tax system modernization initiative would be an integrated system. But what we are saying is that based on the systems that have been delivered to date, those systems, ICS as an example, do not integrate.

Mr. JOHNSON of Texas. Thank you very much. Thank you, Madam Chairman.

Chairman JOHNSON. Ms. Edwards, I am far from a computer expert. I am embarrassed at my ignorance in this area. But in preparation for this hearing I had some discussions with businesspeople and computer people, and we are soon going to be able to link far more cheaply and effectively.

So it seems to me if you improve the collection system down the road apiece, as you improve other parts, you link them all together, and the integrated system comes from linking access to the information. The linking capability that is part of the larger project does not in any way compromise the improvement of the collection system. I do not understand why IRS is not right in saying, look, we fix this and later on as we get down the road and we can link together, we have better stuff to link.

Ms. EDWARDS. The distinction, the disconnect, if you will, is that the system that they are building today, the one that they pointed out specifically, will not—that system, that physical system, will not be able to link, as you say. They will essentially be forced to rewrite the system. To take the idea, but to redevelop the system, will cost additional moneys.

The point that we are making is that while we are aware of that right now, let us collectively figure out how to identify the needs within the business and then to identify the systems that are going to be essential to support those needs——

Chairman JOHNSON. Ms. Edwards, are you saying when they modernize the collections program, presumably, they could have rewritten the program at that time so that it would be a part of the larger system?

Ms. EDWARDS. Yes.

Chairman JOHNSON. Now, did they not do this because they are not far enough along in the planning about the major system?

Ms. EDWARDS. I believe——

Chairman JOHNSON. Did they not do it because they did not have time, because it is a much bigger project than tweaking the system that they have? Why did they not do it?

Ms. EDWARDS. There probably are a host of reasons why the systems were not built that way. The ones that have been delivered, at any rate to date, were not built that way.

Some of those systems originated in the field in functions where users decided they needed to have a capability and they started to build a capability to satisfy a current need. Somewhere along the line those systems were adopted as part of the TSM umbrella. The specifics of how the systems were built or how they were going to link together were not modified. So the TSM became a collection of initiatives, if you will.

Chairman JOHNSON. Thank you. You have been very helpful. Mr. Levin.

Mr. LEVIN. I think this has been useful. One of the frustrating aspects of these hearings is we hear these things seriatim, so there is nobody here who testified before, right?

Chairman JOHNSON. No, there is not. But they are going to be talking together and we will have another round about this.

Mr. LEVIN. Because I am not sure that they would agree with this description. They gave the example of laptop computers. I do not quite see why those cannot be plugged into a new system.

Ms. EDWARDS. The hardware may very well be useful. The point that we are making is about the software, if you will, the engine that is going to help the hardware provide that service. It is the software that must integrate. So it is the software, the systems that have been developed and delivered already, that will have to be rewritten.

Mr. LEVIN. Are you saying it could have now been written so it could have plugged into an ultimate system?

Ms. EDWARDS. That is correct.

Mr. LEVIN. Well, it seems to me it is fairly easy to get some back and forth on that.

Chairman JOHNSON. If you will yield?

Mr. LEVIN. Please.

Chairman JOHNSON. But you yourself said that they have not set the technical standards, that there is a lot of this plan that they have not refined and finalized. So I don't know how they could have programmed to the larger plan when the larger plan is not thoroughly developed.

Ms. EDWARDS. That was the point, Madam Chairman, that we made last year, and we had made the year before as well with regard to the need for IRS to focus on more of the fundamentals, the fundamentals being those factors that would allow IRS to build systems that would tie together, and that a lot of attention needed to be placed there.

Over the past year IRS has made some significant strides in getting those technical standards in place, and they are saying now that April of this year they will be able to give those technical guidelines.

They are essentially rulings of the road; how do we build things, how do we write code, what are the norms, if you will, for building the system. Those guidelines will be available to the project teams in April of this year, in a couple of months.

Mr. LEVIN. So you and I are working on the staple points, and while it seems a bit detailed, it is a really a major issue now.

I do not think, then, you are criticizing their transitional efforts as much as you are saying they were not careful to make sure what they are doing transitionally would plug into the ultimate.

Ms. EDWARDS. That is exactly correct.

Mr. LEVIN. Well, why do you not all converse and let us know? I mean, really, give us—you are all part of the same government, eventually, and one would hope you could get your heads together and work this out. You are not so critical of what they have done transitionally, are you, in terms of the steps they needed to take?

Ms. STATHIS. Mr. Levin, let me say that people who reacted to this took our term "marginal improvement" as being a criticism. We are trying to describe to you the facts as we see them in terms of what has been produced to date. It is not necessarily a criticism, it is just describing to you what has been produced with the systems that have been delivered.

Mr. LEVIN. But the systems that have been produced may well deliver much more than they have so far?

Ms. STATHIS. No, I do not think so. I think——

Mr. LEVIN. So it is a criticism, then?

Ms. STATHIS. We are hoping that the modernized environment that IRS is planning will produce far more benefits than what has been delivered to date.

Mr. LEVIN. Everyone acknowledges that they do. But the question is, whether implicit, built into what they have been doing there, are the potentialities for much more. That is the issue.

Ms. EDWARDS. I think it is——

Mr. LEVIN. Strip away all the kind of fancy language. I mean, I do not know how critical—it is hard to read this, how critical you are and what you are criticizing. Sum up—my time is expiring—what you are criticizing in terms of the TSM. You are criticizing the transitional steps they took or that they failed to be sure that it phases in easily enough into the ultimate product or something else? Sum it up for the people—some people do watch this, and they may not all be like my children, born and raised with computers. What are you criticizing?

Ms. STATHIS. Let me focus it in terms of what we think needs to be done. The fiscal year 1996 budget asked for money to fund 41 projects. It is just a massive number of projects, some of which will give a lot of benefit, some of which may not give much benefit at all. We are saying prioritize those projects. Let us identify the ones that are going to give us the biggest bang for the buck and put our efforts on those.

I think that is our main issue, our main suggestion, for dealing with this modernization at this point. It will get us closer to where we want to be sooner.

Mr. LEVIN. All right. Well, I think that is a somewhat different issue than we have just been talking about. I do not see that those are——

Ms. STATHIS. It is——

Mr. LEVIN. Criticisms seem to run through your pages and it is hard to separate out.

Ms. STATHIS. It is related, Mr. Levin, in this way. If you only have so many people and so many resources to build a system, do you spend more of your time improving the really old system that you have, or do you devote more of your efforts to trying to produce the system of the future? If you continue spending all of your time and resources in improving this antiquated system that you have, you may not get to where you want to be.

Mr. LEVIN. Unless you plug in the transition to the ultimate product.

Ms. EDWARDS. That is true, but, Mr. Levin, I think the point we are making is that the transition to the ultimate product is not clearly defined; that there is discussion about it, but that what is happening and what we are seeing out of the current initiatives being completed is that there are systems being completed that essentially reinforce the current operation without giving those dramatic improvements that IRS speaks of and wants to get.

Mr. LEVIN. My time is up.

Chairman JOHNSON. Thank you.

Mr. Herger.

Mr. HERGER. Thank you very much. Ms. Stathis, I believe during your testimony you mentioned we have been 8 years spending about $2 billion marginal improvement. I believe that over the next 5 years we are projected to spend an additional $6.7 billion in taxpayer dollars, but Internal Revenue is indicating that they feel they will be receiving out of that $6.7 billion, $9.2 million in productivity savings. Could you validate these cost estimates and also validate the productivity savings?

Ms. STATHIS. I think we will have to get back to you on that. The $9 billion that you have, is that productivity savings or is that their estimate of the total benefits?

[The following was subsequently received:]

In January 1995, IRS issued a study in which it presented data on the expected costs and benefits of TSM during the 10-year period from fiscal years 1996 through 2005. That study showed (1) costs of $6.8 billion and benefits of $9.2 billion over the next 5 years and (2) costs of $12.6 billion and benefits of $32.3 billion over the full 10 years. Some of the reported benefits derive from investments that were made before 1996, while some of the costs incurred during the 10-year period will continue to yield benefits beyond 2005. For this reason, the report is not a typical cost-benefit analysis.

Of the $32.3 billion in benefits cited in IRS' report, almost all ($30.9 billion) are expected to come from the increased revenue generated by redeploying staff and enhancing compliance efforts. The rest is to come from interest savings ($1.3 billion) and labor savings (.1 billion). Increased revenues are not the same thing as "productivity savings" or savings of public resources. Tax revenues are simply a transfer of resources from taxpayers to the government. If IRS had wanted to show resource savings, it would have reported the dollar savings associated with the staff reductions made possible by TSM. Instead, IRS reports the additional revenue that can be obtained by reinvesting staff savings into expanded enforcement activities. The report, therefore, is essentially a budget-impact analysis rather than a social cost-benefit analysis.

We did not do the kind of work necessary to validate IRS' estimates. However, IRS has acknowledged that its study represented a preliminary, short-term analysis and that it has certain flaws, such as reliance on an outdated cost model. IRS expects to issue an economic analysis in September 1995 that it says will better reflect the costs and benefits that will be attributable to modernization. For one thing, that analysis is expected to cover the complete 18 year TSM life rather than the 10 years covered by the January 1995 study.

Mr. HERGER. Productivity savings.

Ms. STATHIS. If it is productivity savings only, I cannot speak to that number. As each of these systems has been tested in a particular location, IRS has tried to estimate from that what the productivity savings will be. Generally the IRS budget will reflect the savings that they hope to achieve when those systems are going to be implemented.

Mr. HERGER. I think the numbers that we have are total cost of $6.683 billion and total benefits of $9.166 billion.

Ms. STATHIS. I suspect that comes from a new cost-benefit study that was just made available to us on Thursday of last week. I believe that those benefits include more than productivity savings. I think they include efforts to redeploy resources into new compliance functions and all of the benefits that they think might accrue from that.

Mr. HERGER. In another area, GAO published a report in October 1994 titled, "Continuing Problems Affect Otherwise Successful 1994 Filing Season." On page 25 of that report you have a chart on fraudulent refund claims. A footnote to this chart states, "This figure includes two returns claiming refunds totaling about $300 million."

Would you please elaborate on this footnote and what type of refund claims could result in such significant amounts of $300 million.

Ms. STATHIS. I believe both of those were gas tax refund claims. Those refunds are probably more problematical than the earned income credit in that there is not a limit on them, so you can have really huge claims for refunds.

Mr. HERGER. Could you tell me were these identified by the IRS and were they stopped?

Ms. STATHIS. They were identified by the IRS and I believe they were both stopped.

Mr. HERGER. Do we have any indication of what happened to these individuals who submitted these fraudulent returns?

Ms. STATHIS. I do not have that information, but I can seek it.

Mr. HERGER. We would be very interested—were they brought to trial? Were they convicted?

Ms. STATHIS. I know there have been a number of prosecutions of fraudulent gas tax refund claims.

[The following was subsequently received:]

According to IRS, this is still an active investigation. They were reluctant to provide further details.

Mr. HERGER. Just maybe a quick followup to an earlier question that came up, and it had to do with the telephone calling—whether or not we are 13 percent successful or closer to 50 percent. Is this temporary? Are we correcting it?

Even at 50 percent—even if we move up from 13 percent to, I don't know what you had, 45 percent I believe, I don't believe that is acceptable to anyone who is making calls, paying accountants to make calls, or doing the public taxpayer themselves.

Are there any moves that are being made to move this up to a more acceptable level? Particularly in the testimony I understood from the IRS was that it is a savings to us to be able to conduct our business over the phone rather than through the mail. Is there something being done on this?

Ms. STATHIS. There are a number of things being done, but I am not very hopeful that this is going to get better very soon. We have a graph in our statement that shows the past several years the number of phone calls coming in and the number that have been answered. The demand of the phone calls coming in continues to go up and the number of phone calls they are able to answer are pretty static. That is why we are recommending in a draft report that we have been talking with IRS about that they have to make some drastic management changes to try to get more out of the resources that they currently have.

The 1.3 million more calls that they say they will be able to answer with the additional funds they are asking for in 1996 I fear will do little. It may allow them to keep up—given that there will be more calls coming in. I just don't think that it will do a lot to improve the record.

Mr. HERGER. Would you concur that it does save us money to be able to handle these questions by phone rather than through the mail?

Ms. STATHIS. Conceptually, I think that that is probably a correct understanding. Assuming that you can resolve the question on the telephone, that should be more efficient than handling correspondence.

Mr. HERGER. I believe you mentioned earlier that they are going from 8 to 10 hours, and the public sector has perhaps 24 hours.

Ms. STATHIS. That is right. Most private companies that have telephone operations offer that service 24 hours a day.

Mr. HERGER. OK. So there is a great more that we could be doing.

Ms. STATHIS. Yes, there is a lot to be done.

Mr. HERGER. Thank you.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. Thank you, Madam Chairman.

Following up on Mr. Herger's question about the $300 million on two returns, I noticed on a report here that you have the data through June 1994. I am assuming that the data for all of 1994 probably is available now, but just to make a statement, if you analyze that and take the $300 million out and then you add back in another 25 percent, it would appear that there has been very little increase between 1993 and 1994.

Ms. STATHIS. For——

Mr. HANCOCK. For fraudulent returns.

Ms. STATHIS. Of fraudulent returns. I think that is correct. In our statement we have the statistics for the entire year of 1994 and the number of fraudulent returns in 1994 is actually slightly below 1993.

Mr. HANCOCK. OK, fine. Well, I didn't see it. I made analysis of it and that is the way it would calculate.

The question we have here, you know you were talking about the fact that you can't integrate the two systems, but I mean we are putting data into a system that you say can't be integrated, but as long as we have the data in there, that data can be transferred into the system that can be integrated; can it not?

Ms. EDWARDS. I think it is fair to say that the information will be placed in the new system whenever that new system arrives. The data is transferable, but of course it means that it has to be transferred manually very likely.

Mr. HANCOCK. Transferred manually?

Ms. EDWARDS. Yes. I wanted to make the distinction when we say that a system is not integrable. It cannot be integrated. We mean that the information can't flow from one system to the other. I just wanted to clarify that point.

Mr. HANCOCK. Wait a minute. Wait a minute. I am a little confused. I don't know all that much about computers also, Madam Chairman, but the fact is that once the data is in a database it is usually available to pull out electronically and to enter into another form in some manner.

Ms. EDWARDS. You mean electronically.

Mr. HANCOCK. Electronically, yes.

Ms. EDWARDS. That is the notion that is behind integration. When we talk about integration that is what we mean. It means that you should be able to pull the data from the system electronically and electronically pass it to another system.

Mr. HANCOCK. OK.

Ms. EDWARDS. That is why the issue of integration is so crucial to this discussion and what we are saying about these systems that have been developed to date is that those systems do not allow the information to be pulled electronically from one system and passed to another system.

Mr. HANCOCK. Well, let me ask what—maybe it is not a simple question, but have you all talked to the credit card industry? I mean, my goodness, the hundreds of millions of entries that they make daily are probably much bigger than what the Federal Government does, because everybody has got a credit card. If they handle their affairs like we are handling ours, that thing never could have existed. Why can't we take a look at what they are doing, get some of their experts to come in and tell us what we need?

Ms. EDWARDS. Mr. Hancock, the point that you are making is the essence of our suggestion that IRS needs to have the sufficient number of managerial and technical experts, if you will, or people who are skilled in building these systems that link, that integrate, that pass data electronically so——

Mr. HANCOCK. But can they do that in-house? I mean do they have the personnel to do it or do they need to go to the credit card industry and get their people to do it on a contract basis? Give them a figure. Say, look, I wonder what would happen. We are going to spend $9 billion. I wonder what would happen if we would tell the industry we will give you an award of $5 billion if you will do this.

We are not going to give you anything unless you develop a program, but we are going to give you $5 billion if you do it. I bet there would be a lot of computer programmers start trying to figure out how to go about doing it. This guy that took the bank for $1 billion here just recently, I mean that guy could probably figure this thing out.

Thank you, Madam Chairman.

Chairman JOHNSON. I am stunned, Ms. Edwards, by your comment that you can't get the data off of the system electronically. I never heard of a computer system from which you could not take data.

Is that really true that they can't get this data off in order to feed it into another system if they wanted to do that?

Ms. EDWARDS. Let me answer that question by example and maybe this will help to clarify it. IRS tried to integrate some of these systems, the integrated collection system was one of them, and there are several others that I think are highlighted in the Commissioner's and in our testimony.

Their technicians discovered that it was tougher to try to integrate them—to try to make them link up to try to pass the information from one to the other—than to rewrite. So they chose to rewrite. That is the point that we are raising. These systems that have been delivered to date offer value in selected functions, be it collections at the revenue officer's site or be it the identification of underreported income in the AUR application. While they may offer value there or do offer value there, they are not part of a broader, more comprehensive, integrated or linked environment. You can't pass information among them.

Chairman JOHNSON. Are you suggesting that they are going to need to rethink what information they are collecting and what format it is going to be arrayed in this, the new system?

Ms. EDWARDS. That is absolutely part of what they are in the process of doing now and what we are saying they should place even more emphasis on.

Chairman JOHNSON. I can see that. I don't see how they could have improved the collections system in harmony with this larger system since the larger system's criteria are only now being developed.

Ms. EDWARDS. That is true.

Chairman JOHNSON. So it is just a question of you think they shouldn't have spent the money on that when they should have spent the money on some other things.

Ms. EDWARDS. That is correct.

Chairman JOHNSON. Two other things just to get the record clear. First of all, back to the issue of fraud, would you comment on the vulnerability of the tax system in general to fraudulent collection attempts associated with refundable tax credits? In other words, is refundability of tax credits a policy that we should steer clear of because it is hard to implement?

Ms. STATHIS. Refundable credits are a particular problem for a tax administrator. Normally, credits that are applied against a tax liability are deducted from money that is paid in and so you are just returning a portion or evening out, if you will. But a refundable credit entitles the person to money that they wouldn't otherwise be entitled to whether they paid taxes or not. The earned income credit puts IRS in the role of being more of a welfare-benefit agency than a tax administrator. Trying to decide eligibility for that particular benefit is essentially what we are trying to do through the tax system, and that creates a particular vulnerability that isn't there in other parts of the system.

Chairman JOHNSON. It is true that IRS does not at this time have the capability of cross-checking wages and returns?

Ms. STATHIS. There is an experiment this year in one service center in an attempt to use three-quarters of the wage data from one State to see if that, in fact, will work.

Chairman JOHNSON. But it will be several years before they would have the ability to cross-check wage data in a timely fashion to determine refund, correct?

Ms. STATHIS. The so-called up-front matching is one of those benefits that we are hoping to get out of the long-term tax system modernization design.

Chairman JOHNSON. So would it be reasonable to restructure the EITC so that the only benefit available under it was a wage-based refund benefit with no lump sum possibility? Would that eliminate fraud?

Ms. STATHIS. It probably wouldn't eliminate fraud, but it might help. One of the problems——

Chairman JOHNSON. Why would you say it only might help since it only would go back out through the employer and through the earnings system, and it is the earnings system that makes this person eligible for this refund.

Ms. STATHIS. We did a report on the advanced credit as well and it is not without its own concerns, without its own problems. Not the least of which is that a person could work for more than one employer, a person could have other sources of income, so that the eligibility for the credit needs to be determined at the end of the year taking into account all of the earnings and the situation of the employee.

I don't think there is a lot of verification up front that the children really are qualifying children in compliance with the credit provisions. So there are a lot of those eligibility provisions that still have to be taken into account at the end of the year.

At the time we looked at it, there were also no controls in the system that would prevent someone from getting the advanced credit and then after the completion of that year also applying for the full lump sum credit and getting it in addition. So there are some problems with the advanced credit as well.

Chairman JOHNSON. Certainly, it does suggest that we should not pass more refundable credits until we get the problem straightened out with those that we have on the books.

Any recommendations you have in regard to changing the tax law to make it more enforceable in the refundable credits area we would be very interested in, since we will be working in that area in the very near future. Second, we would be interested in any concrete recommendations you might have in terms of improving the phone system and solving the problems of taxpayer access, because I think it is fair to say that all members of the subcommittee believe significant progress needs to be made in that regard and in the near future.

[The following was subsequently received:]

Based on a recently completed review of the accessibility of IRS' toll-free telephone service, we concluded that IRS top management had not exercised its authority to establish and enforce policies necessary to build an effective nationwide telephone assistance program. While acknowledging that more funds would enable IRS to provide more service, we made several recommendations that focused on maximizing service with existing resources.

Specifically, we recommended that the Commissioner of Internal Revenue direct the Chief, Taxpayer Service, in coordination with other appropriate IRS officials, to lead an aggressive effort to (1) identify and define the appropriate telephone assistance program operating practices for IRS that would allow it to optimize the number of calls it can answer and (2) work with the leadership of the National Treasury Employees Union to reach agreement on implementing those practices on a nationwide basis. Those practices should include, although not be limited to, the following:

-- challenging program goals for increasing the number of calls answered that are based, at least in part, on taxpayers' needs;

-- standards for the amount of time assistors should be available to answer taxpayers' calls;

-- hours of operation that offer taxpayers greater opportunity to reach IRS assistors; and

-- uniform reporting definitions for the number of calls answered and other performance measures.

We also recommended that the Commissioner direct the Chief, Taxpayer Service, to take the steps necessary to (1) fully implement the features of IRS' existing call routing technology and (2) pursue opportunities for more effective call routing through IRS' telecommunications vendor.

Let me raise with you one last issue. You have said, or at least implied, that the IRS doesn't actually have the technical capability that they need, the level of experience that they need in planning and implementing this TSM system.

In their testimony, they mentioned that 75 percent of the money goes out for equipment or consultants. It seems to me not only unwise, but probably impossible under our personnel rules to attract the kind of people that you would need to put this kind of plan in transition. Once you get it in place, you can buy sufficient capability to keep it running and to upgrade. But, I am not sure that the criticism, that the Department doesn't have on board the people who could manage a project of these dimensions, is fair when the testimony was that we don't have them on board. We contract to get this expertise and that, indeed, makes more sense. Would you care to comment?

Ms. EDWARDS. Seventy-five percent of the resources being contracted out, I think, refers to 1996 and what they plan to do for 1996. One of the recommendations that had been put forth to IRS last year as part of the appropriations process was that they would focus very seriously on how they used contractor support in order to address this particular issue.

The point that you raise with regard to the likelihood of their being able to attract enough people with the right kind of technical skills, I think, is a very significant point. I would simply offer that even to manage this kind of effort, there is a core of expertise that is required within IRS to effectively manage the contractor support in order to make sure that government gets value for the dollars spent. IRS has hired some people, a few people with more technical expertise in building integrated systems. I emphasize that because IRS does have skill sets in building the stand-alone or stovepipe systems we were talking about earlier, the ones that don't pass information among them. But the integrated system requires a different skill level. Even to manage the development of an integrated system requires a different level of skills. So the point of their expertise is to the management as well as their support of the implementation.

I don't know if the chairman is aware or the subcommittee members are aware, but IRS has somewhere in the vicinity of 2,400 people dedicated to the TSM initiative and there is a range of skills captured by that number. So, yes, there are a lot of people involved with the modernization effort. We are emphasizing the importance of bringing that critical core, if you will, of expertise into place.

Chairman JOHNSON. In your high risk report focusing on accounts receivable of the IRS, you claim their accounts receivable have grown from $87 to $156 billion between 1990 and 1994. The Commissioner indicated that that difference is primarily accounts that will never be receivable, that are either bankrupt or for some other reason are incapable of paying. Would you agree with that?

Ms. STATHIS. IRS pointed to the change from a 6- to 10-year statutory time on collections. We used to adjust those charts to show the difference between the 6- and the 10-year growth to try to level it out, if you will, or to adjust the growth for that. The information is not there to do that very well. Any numbers that IRS has are ballpark estimates. There are some accounts and a fair amount of the dollar growth attributable to the change in the statute. But I wouldn't say that it is the bulk of the growth.

Chairman JOHNSON. That is interesting. Your report did show that their collection of delinquent taxes has declined in dollar amounts.

Ms. STATHIS. It has slightly declined. It has been relatively flat over a period of years, but actually down a little bit since 1990.

Chairman JOHNSON. We have put new resources into this. We have really focused on it. Why hasn't it gone up?

Ms. STATHIS. Actually, the compliance resources between 1990 and the end of 1994 went down. Even though there have been some proposals to increase the staffing, it really did not increase and that is why the 1995 compliance initiative was important to improving the enforcement posture of the IRS.

Chairman JOHNSON. Thank you. If there are no other questions, thank you very much for your testimony, and we look forward to working with you in the months ahead and thank you for your attention.

We will next have Mr. Buckley, the president and CEO of H&R Block. I would like to call Mr. Martin also to the table and we will hear both witnesses.

Mr. Buckley, if you will start.

STATEMENT OF HARRY W. BUCKLEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, H&R BLOCK TAX SERVICES, INC.

Mr. BUCKLEY. Madam Chair and members of the subcommittee, my name is Harry Buckley and I am president and chief executive officer of H&R Block Tax Services, Inc. I appreciate the opportunity to appear before you today to present H&R Block's views on the 1995 tax filing season, IRS' efforts to combat refund fraud and reform of the earned income tax credit.

H&R Block is headquartered in Kansas City, Mo., and we are the Nation's largest income tax preparation firm. We serve approximately one out of every seven U.S. taxpayers. We have over 8,000 company-owned and franchised offices throughout the United States and employ over 89,000 people during the tax filing season.

Last year, we prepared 12 percent of all individual U.S. tax returns for a total of over 13 million returns. We also transmitted over half the returns filed electronically last year with the Internal Revenue Service.

I would like to begin my testimony by stating that H&R Block would recommend the subcommittee support IRS' fiscal year 1996 budget request for both tax systems modernization and funding to combat fraud. After the subcommittee's hearing last year on tax refund fraud, we were pleased to see that the IRS' budget request included additional funding for staffing of refund fraud detection.

We encourage Congress to strongly consider making the investment IRS has requested for the purchase of computer software and hardware. Both refund fraud elimination and tax systems modernization efforts are extremely important investments in future IRS operations and their service to the American taxpayer.

In the 40 years we have been serving America's taxpayers, this is without a doubt the most difficult tax season in terms of our internal preparations and customer dissatisfaction. At H&R Block we believe the reason we were the world's largest tax preparation firm assisting over 18 million taxpayers last year is because of our commitment to providing outstanding service to our clients.

This tax season we have received a substantial number of customer complaints due to the IRS inability to effectively communicate the procedural changes made this tax season. While the purpose of these changes was to eliminate tax refund fraud, millions of innocent taxpayers have been penalized and inconvenienced. It appears that the IRS is out to catch fraud rather than prevent the filing of fraudulent returns.

We are very concerned about tax refund fraud and support the administration's efforts to combat fraud by implementing procedures such as cross-checking of Social Security numbers. Historically, we have worked closely with the Internal Revenue Service criminal investigation officials in preventing and identifying potential fraud before the returns are filed.

Our quality control associates are trained to subject each W–2 brought in by our clients to a stringent review process. Our computer systems are programmed to check reasonableness between wages and withholdings on tax returns.

As I mentioned, millions of taxpayers are finding their tax refunds are being delayed because of changes in IRS policy that have not been effectively communicated. Let me give you some examples of individuals who are unaware of the recent changes in IRS procedure and were negatively impacted by these as a result.

One of our clients in Akron, Ohio, is an earned income tax credit recipient who needed her refund to bury her grandson, but has found out her full refund will be delayed. A taxpayer here in Washington, D.C., who has received EITC every year and uses it to pay his bills and daughter's college tuition received only a $100 refund and is waiting for the EITC portion of $2,000. Meanwhile, his bills are going unpaid and his interest costs are escalating.

Another taxpayer, a single parent, divorced with three children, this individual has moved several times in the last few years, misplaced birth certificates and has to use post office boxes to receive the EITC portion of her refund because her mail has been stolen from her. She is likely to be required to complete a two-page questionnaire and submit pages of documentation including obtaining and making a copy of her divorce decree, obtaining a copy of her post office box application, obtaining and making copies of birth certificates, obtaining and making copies of report cards or other school records for her two school-aged children, obtain a notarized statement from her day care provider, obtain her ex-spouse's Social Security number and address, and then mail all these documents in a package to the IRS within 30 days.

Normally, the filing season is very hectic for H&R Block, but in the past we have had the benefit of knowledge of the IRS rules and procedures well in advance. I want to cite some examples of new procedures we have had to implement this year.

For the first time, we have had to put into service a voice response unit to handle over 5 million phone calls that we haven't had in the past. For the first time, we have to keep copies of all W–2s. I personally had to sign 4,000 form 8633s twice for a total of 8,000 signatures for our company-owned locations to receive their EFIN numbers so we could file electronically.

This year the IRS has decided to cross-check all Social Security numbers and names with the information on record and if a name and Social Security number don't match, then that certainly does create a problem.

In addition to that, the most people that have been severely hampered this year have really been the people who are receiving the earned income tax credit. Our numbers would indicate that approximately 30 percent of the electronically transmitted returns are having the EITC portion of their refund held for an additional period of time.

I also have some other recommendations enclosed in my testimony, Madam Chairman, that will talk about some of the recommendations we have to prevent fraud as well as the administration.

Chairman JOHNSON. We will have time to come back to those, Mr. Buckley.

[The prepared statement and attachment follow:]

Statement of Harry W. Buckley

President and Chief Executive Officer

of H&R Block Tax Services, Inc.

on Internal Revenue Service Budget for Fiscal Year 1996

and 1995 Tax Return Filing Season

Prepared for a Hearing before the House Ways and Means

Subcommittee on Oversight

Madam Chair and members of the Subcommittee, my name is Harry W. Buckley, President and Chief Executive Officer of H&R Block Tax Services, Inc. I appreciate the opportunity to appear before you today to present H&R Block's views on the 1995 tax filing season, IRS' efforts to combat refund fraud, and reform of the earned income tax credit program.

H&R Block is headquartered in Kansas City, Missouri and is the nation's largest income tax preparation firm. We serve approximately 1 out of 7 U.S. taxpayers. H&R Block has over 8,000 company-owned and franchised offices in the United States employing over 89,000 people during the tax filing season. Last year, we prepared 12% of all individual U.S. tax returns for a total of over 13 million returns. We also transmitted over 1/2 of the returns filed electronically last year with the Internal Revenue Service.

We have been serving America's taxpayers since 1955 when Henry Bloch, and his brother, Richard, founded the company. We have more experience working with and listening to middle and low income taxpayers than any other firm. As a result, we are in a unique position to learn of the particular problems and concerns faced by America's taxpayers.

I would like to begin my testimony by stating that H&R Block would recommend the Subcommittee support IRS' FY '96 Budget requests for both Tax Systems Modernization and funding to combat fraud. After the Subcommittee's hearing last year on tax refund fraud, we were pleased to see that IRS's budget request included additional funding for staffing of refund fraud detection. We encourage Congress to strongly consider making the investment IRS has requested for the purchase of computer software and hardware. Both refund fraud elimination and tax systems modernization efforts are extremely important investments in future IRS operations and their service to the American taxpayer.

In the forty years we have been serving America's taxpayers this is without a doubt the most difficult tax season in terms of our internal preparations and customer dissatisfaction. At H&R Block, we believe the reason we are the world's largest tax preparation firm, assisting over 18 million taxpayers last year, is because of our commitment to providing outstanding service to our clients. This tax season we have received a substantial number of customer complaints due to IRS' inability to effectively communicate the procedural changes made this tax season. While the purpose of these changes was to eliminate tax refund fraud, millions of innocent taxpayers have been penalized and inconvenienced. It appears that the IRS is out to catch fraud rather than preventing the filing of fraudulent returns.

H & R Block is very concerned about tax refund fraud and supports the Administrations' efforts to combat fraud by implementing procedures such as cross-checking social security numbers. Historically, we have worked closely with IRS' Criminal Investigation officials in preventing and identifying potential fraud before the returns are filed. Our quality control associates are trained to subject each W-2 brought in by our clients to a stringent review process. Our computer systems are programmed to check the reasonableness between wages and withholdings on tax returns we prepare.

THE 1995 TAX FILING SEASON

As I mentioned, millions of taxpayers are finding that their tax refunds are being delayed because of changes in IRS policy that have not been effectively communicated. Let me give you some examples of individuals who were unaware of the recent changes in IRS procedure and were negatively impacted by these as a result.

One taxpayer served by our Akron, Ohio office is an EITC recipient who needed her refund to bury her grandson, but has found out that her full refund will be delayed.

A taxpayer here in Washington, DC who has received EIC every year and uses it to pay his bills and daughter's college tuition, received only a $100 refund and is waiting for the EIC portion of $2,000. Meanwhile his bills are going unpaid and his interest costs are escalating.

Another taxpayer is a single parent, divorced, with three children (including one pre-schooler in day care). This individual has moved several times in the last few years, has misplaced birth certificates, and has to use post office boxes because her mail has been stolen. For her to receive the EIC portion of her refund, she is likely to be required to complete a two page questionnaire and submit pages of documentation.

This will require her to do the following:

- Obtain and make a copy of her divorce decree.
- Obtain a copy of her post office box application.
- Obtain and make copies of her childrens' birth certificates.
- Obtain and make copies of report cards or other school records for her two school-aged children.
- Obtain a notarized statement from her day care provider.
- Obtain ex-spouse's social security number and address.
- Mail all these documents in a package to IRS within 30 days.

I want to call your attention to the fact that the 9598 form indicates that if IRS does not receive the information they have requested from the taxpayer within 30 days of date of the letter, the credit will be disallowed. The 30-day time frame seems unreasonable considering the paperwork that must be gathered to complete this form and the fact that the clock starts running with of the date on the letter, not upon taxpayer's receipt. We have been unable to find out if IRS is considering EIC validation for documentation received after the 30-day period for taxpayers with extenuating circumstances that prevented them from meeting the deadline.

Normally, the filing season is very hectic for H&R Block, but in the past we have had the benefit of the knowledge of the IRS rules and procedures well in advance. I want to cite some examples of new procedures we have had to implement this tax season.

- For the first time, Block has put into service a Voice Response Unit to handle over 5 million phone calls from clients checking on whether they qualify for a Refund Anticipation Loan (commonly referred to as a RAL).

- For the first time, I personally had to sign 4,000 (Form 8633's twice for a total of 8,000 signatures) for each of our company owned locations to receive an EFIN number, so we could transmit returns automatically. We did not receive numerous EFIN numbers within the 45-day turnaround period as IRS promised, causing a delay in transmitting returns in January.

- For the first time, we must keep copies of all W-2's and supply a copy of the return when the clients signs the 8453 form, despite the fact that the taxpayer receives a copy two days later. This is reducing the productivity level of our tax preparers.

- H&R Block, as well as the rest of the tax preparation industry, is experiencing an increase in the cost of doing business which is attributable solely to changes in IRS procedures. Along with the duties involved preparing our clients returns, our tax preparers must spend additional time: 1) handling clients with problematic EIC returns for at least 6-8 weeks while they are waiting for their refund, 2) explaining new IRS procedures to clients, 3) dealing with clients' additional requests for information from IRS, and 4) helping clients resolve name and social security number problems on returns which have been rejected.

This year IRS has decided to cross-check all Social Security numbers and names with the information on record with the Social Security Administration. If a name and number on a tax return do not match the name and number in the Social Security Administration's records, the tax return is rejected by the IRS. While this may be an excellent procedure to implement to demonstrate IRS' commitment to combatting refund fraud, the message of this change did not get effectively communicated to the American public. As a result, taxpayers with legal changes in name (such as maiden name to married name), who have successfully filed for years, are having their tax returns rejected by the IRS due to a name and number mismatch. Therefore, the refunds are being delayed even though the taxpayers are using the same social security numbers they have used in the past. This is effecting millions of tax returns.

We have noticed two specific problems connected with the new social security number verification procedures:

- The Social Security Administration is not prepared to handle the volume of requests from taxpayers with Social Security number problems. In some cases in which taxpayers have lost their social security card, the wait for information was up to 2 weeks.

- There have been numerous instances of wrong information such as date of birth and spelling errors on last name of the social security records. In many cases, taxpayers are being penalized because of inaccurate data in the Social Security Administration's systems.

We recommend that for those taxpayers who have not yet filed their tax returns, electronic filing may offer a speedier solution as the IRS alerts the tax filer to any social security problems right away, eliminating a significant delay in processing the refund. Unfortunately, there is only one solution for a taxpayer who has already filed and has subsequently been notified by the IRS of a social security number problem. That taxpayer must revise the name with the Social Security Administration. An electronic return must then be retransmitted, when the name change has been verified, or in the case of a paper return, the taxpayer must respond to IRS correspondence about the accuracy of the name and or social security number.

H&R Block's customers with the greatest problem this tax filing season are those taxpayers filing for the Earned Income Tax Credit. Approximately 30% of the electronically transmitted returns are having the EITC portion of their refund held for an additional period of time. This affects millions of taxpayers who qualify for, and depend on, this credit. Only after the IRS examines and verifies the Earned Income Tax Credit claim will they forward the refund to each taxpayer in one of four ways. The IRS will: 1) issue a refund, less the Earned Income Tax Credit amount, right away; 2) delay a refund for up to 8 weeks while they review it; 3) send a questionnaire to be filled out and returned by the taxpayer before issuing a refund; or 4) issue a refund without delay.

As a result of Treasury's decision to eliminate the direct deposit indicator, banks have been forced to increase their Refund Anticipation Loan prices, as well as their credit criteria which has angered many more taxpayers. As with other procedural changes made by IRS this tax year, while the intent of reducing fraud is commendable, the late announcement of such a significant change has caused significant financial hardship for taxpayers who are least able to afford it. This year the fees for RALs depend on the refund size, and on average the amount has doubled and range from a minimum of $29 to a maximum of $89. When the bank denies a RAL request, Block will waive its electronic filing fee of $25 for a Block-prepared return and $35 for a non-Block prepared return. In its place a service fee of $5 and $10, respectively will be charged.

EFFORTS TO FIGHT ELECTRONIC FILING FRAUD

Prior to tax season 1993, H&R Block established our own fraud prevention plan targeted at electronically filed returns. During the 1995 season, Block continues to be diligent in its efforts to maintain the following action plan to prevent the filing of fraudulent tax returns.

- Because so many fraudulent returns include first time Earned Income Credit (EIC) claims, Block does not allow banks making Refund Anticipation Loans (RALs) to Block clients to do so for any taxpayer who is eligible for EIC but did not file a tax return the previous year.

- Block subjects all W-2s to a stringent review process. All electronically filed returns containing a non-standard (substitute, handwritten, typewritten, or altered) W-2s are carefully reviewed before the returns is transmitted to the IRS. The FICA and Medicare withholding amounts are verified for accuracy. When it is suspected that a W-2 is fraudulent, Block verifies the taxpayer's employment with the employer listed on the suspect W-2. If employment cannot be verified, Block notifies the taxpayer that Block will not electronically file the return.

- Block does not allow banks making RALs to do so for any taxpayer whose only income is from Schedule C.

- Block compares the amount of income tax withholding on each Form W-2 with gross wages to determine whether the withholding amount is "reasonable" for the amount of wages.

- If Block detects or suspects fraud on any return, it sends a letter to the taxpayer explaining that the return contains discrepancies that must be cleared up before the return can be electronically filed. If the taxpayer does not respond satisfactory to the request for additional information, Block brings the situation in question to the attention of the Criminal Investigation Division of IRS.

RECOMMENDATIONS FOR REFUND FRAUD PREVENTION

After reviewing the results of this Subcommittee's February

10, 1994 hearing on tax return fraud, Block updated our fraud prevention plan. Because H&R Block shares the IRS' concerns, we have shared our detailed plan with them and are pleased to see some of our suggestions have been implemented. Our recommendations focus on four major points of implementation:

- impose higher standards on Electronic Return Originators;
- produce a cooperative public relations campaign between the IRS, CID, and Electronic Return Originators;
- require additional process controls by Electronic Return Originators; and
- enhance IRS system checking.

SUGGESTIONS FOR EASIER ADMINISTRATION OF EIC AND FRAUD REDUCTION

As you requested in your letter Representative Johnson, I would make some specific recommendations to simplify the administration of Earned Income Tax Credit and to reduce fraud within that program.

- Accounts (SSNs) for taxpayers whose EIC is delayed but ultimately paid, either through back end verification by IRS or acceptance of Form 9598, should be flagged in the IRS system as "good accounts." Based on this "flag," in future years the IRS would accept Schedule EIC as filed, thus eliminating EIC stripping and the requirements to complete Form 9598 and/or refund delays for these taxpayers.

- Advance EIC -- guarantee no delays in processing EIC portion of refund for taxpayers who receive advance payments of EIC from their employers.

- To avoid refund delays while preventing false claims, the IRS could require all taxpayers who are claiming EIC, head of household status, and dependents for the first time to file applicable documentation with their returns. This could include (as applicable) a dependency support worksheet, head of household worksheet, and EIC Questionnaire, as well as copies of proof documents. The confirming data could then be entered in the IRS computers. Once a taxpayers gets a "clean bill of health," he or she should be required only to reaffirm the personal data (and any changes) on a simple, one-page declaration form that would be filed with the return each year.

- Require submission (electronically or in paper format) of Earned Income Credit Worksheet or revise the EIC Form to include that information (similar to a form H&R Block designed and proposed to IRS).

CONCLUSION

I would like to close my remarks by offering H&R Block's technical expertise in tax return preparation to the members of the Subcommittee and Administration. As I have stated, H&R Block is committed to eliminating tax refund fraud, and is available to assist you in these efforts. Thank you.

Schedule EIC | Earned Income Credit | 1994

Name(s) shown on return | Your social security number

You cannot take this credit if:
- your return is for less than 12-month period (unless the short period is due to the taxpayer's death); or
- your filing status is married filing a separate return; or
- you are excluding any foreign earned income by filing Form 2555 or 2555-EZ with your return.

You may be eligible to take an earned income credit if:
- your adjusted gross income (line 16, Form 1040A or line 31, Form 1040) and
- your earned income (line 7, Form 1040A or lines 7, 12, and 15, Form 1040, *plus any nontaxable earned income from your employer) are both* less than:
  - $23,753 if you have one qualifying child; or
  - $25,293 if you have two or more qualifying children; or
  - $ 9,000 if you have no qualifying children.

To determine whether or not you can take an earned income credit:
- Complete Part I if you believe you may have a qualifying child; or
- Complete Part II if you know you don't have a qualifying child.

Part I: Earned Income Credit For Taxpayers With a Qualifying Child

1a Did a child live with you in the United States for more than half of 1994 (all of 1994 if the child is a foster child), or for the part of the year he or she was alive if the child was born or died during the year? . . . . . . Yes ☐ No ☐

b Is the child your son, daughter, adopted child, grandchild, stepchild, or foster child? (Married child must be your dependent or would be except you gave the exemption to the other parent.) . . . . . . Yes ☐ No ☐

c At the end of 1994 was the child under age 19, or under age 24 and a full-time student, or any age and permanently and totally disabled? . . . . . . Yes ☐ No ☐

If you answered *yes* to all parts of question 1, go to line 2. If you answered *no* to any part of question 1, you do not have a qualifying child but, if your income is less than $9,000, go to Part II.

2 Are you a qualifying child of another taxpayer? . . . . . . Yes ☐ No ☐

If *yes*, do not complete the rest of the form. You cannot claim an EIC. If *no*, go to line 3.

3 Did you and another taxpayer (other than your spouse with whom you are filing a joint return) live in the same home for over one-half of 1994 and have the same qualifying child(ren)? . . . . . . Yes ☐ No ☐

If *yes*, enter the amount of the other taxpayer's adjusted gross income ________ and go to line 4.
If *no*, go to line 5.

4 Is your adjusted gross income more than the amount on line 3? . . . . . . Yes ☐ No ☐

If *no*, do not complete the rest of the form. You cannot claim an EIC. If *yes*, go to line 5.

5 Enter the requested information for the eligible child (or for two of the children if you have two or more eligible children). Then, go to Part III to figure your credit.

1(a) Child's name (first, initial, and last name)	(b) Child's year of birth	For a child born before 1976, check if child was (c) a student under age 24 at end of 1994	(d) disabled	(e) If child was born before 1994, enter the child's social security number	(f) Child's relationship to you (for example, son, grandchild, etc.)	(g) Number of months child lived with you in the U.S. in 1994
	19					
	19					

Part II: Earned Income Credit For Taxpayers With No Qualifying Child

6 Are you (or your spouse) a qualifying child of another taxpayer? . . . . . . Yes ☐ No ☐

7 Were you a dependent eligible to be claimed on another taxpayer's 1994 return? . . . . . . Yes ☐ No ☐

8 Was your main home located outside of the United States for 6 months or more during 1994? . . . . . . Yes ☐ No ☐

9 Were you (and your spouse if married) under age 25 or older than age 64 at the end of 1994? . . . . . . Yes ☐ No ☐

If you answered *yes* to any of the above questions, you do not qualify for the credit. Do not complete the rest of the form. If you answered *no* to all of the above questions, go to Part III to figure your credit.

Chairman JOHNSON. Mr. Martin.

STATEMENT OF MICHAEL MARTIN, ENROLLED AGENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. MARTIN. Thank you, Madam Chairman. My name is Michael Martin. I am an EA (enrolled agent) practicing in the Washington, D.C., area. I am representing the National Association of Enrolled Agents of about 9,000 members, all of whom are licensed by the Treasury Department to represent taxpayers before the IRS. If I can digress in this written comment a little bit, I think we can save some time.

I don't think anyone here was on this subcommittee in 1978. I happened to testify before this subcommittee in 1978 when the tax preparer penalties came into being, and they came into being for exactly the reason we are talking about now, and that is refund fraud. What was happening then is financial institutions were offering loans based on a potential refund to taxpayers and it was found out through audit that the tax preparers were inflating the number of exemptions, inflating itemized deductions, claiming dogs, parakeets, and everything else on tax returns in order to get a bigger refund and write a bigger loan. That whole process was stopped in 1978 with the passage of the Internal Revenue Code, section 6694 through 6696 and 6701.

In the nineties, the IRS was desperate to find some way to encourage people to use the electronic filing, and I think that is something you have to realize. There is no benefit to the taxpayer to file their return electronically, per se. It costs them more money. They are charged a fee to file their return electronically.

If they get their refund back faster, that is great. That is the benefit. The industry came to the IRS and proposed the idea of the refund anticipation loan with the direct deposit indicator. So we see that the IRS has come full circle, I think, in stopping what was in 1978 the refund anticipation loan, to in the nineties early nineties encouraging it.

It has gone, so far as it came to my attention last year, that one district office of the IRS sent out a letter to all real estate agents in that district encouraging them to become electronic filing centers. They said the only thing you have to have is a computer and a 2400 baud modem. You don't need to know anything about taxes or have any licensings or anything. Just send us your application and you can file tax returns electronically.

We think there are two solutions to this problem long term. One is the tax system modernization. But I have to tell you, I am appalled to hear that the IRS is looking at a system that doesn't talk to each other. I have to deal with this system every day, a system that doesn't talk to each other.

There is a system called the IDRS, the Information Document Retrieval System, and the ACS system, Automated Collection Service, which is the accounts receivable system. They don't talk to each other. They are not even on the same computer, not on the same terminal. If I am talking to a revenue officer on the telephone and they are in front of the ACS computer, if they can't find my power of attorney, if they can't find my correspondence, they have to go to the IDRS system, which is at the other end of the room. They have one terminal—I am only talking about the Baltimore district now—to access that other computer.

To hear that the collection division is going to have another new system that doesn't talk to the main system, it doesn't help us at all in trying to solve taxpayers' problems with their accounts receivable.

But we also have to bring tax system modernization down to the local level. I am constantly frustrated, as are many of our members, with the fact that many IRS district offices do not have a fax machine readily available so we can fax information to them.

In this day and age, it is unheard of for an office, a business office not to be able to receive a fax. Many of us in my industry, if we have to fax a canceled check to the IRS we can't do so.

The other thing that we think is very important in the long-term solution is the universal licensing of tax return preparers and we have included documents from the Commissioner's advisory group recommending this. Their subgroup, as well as the GAO study based on the 1988 taxpayer compliance measurement program, showed that the amount of tax fraud and tax errors among those people who are licensed EAs, CPAs, and attorneys was much lower than the incidence of fraud among unlicensed commercial preparers.

Short-term solutions—we think that the IRS can do more short term by better screening of the tax returns. If people have a history of filing earned income credit claims, those returns probably should not be scrutinized as carefully as other ones claiming the earned income credit for the first time.

I would be happy to take any questions that you have.

[The prepared statement and attachment follow:]

STATEMENT OF MICHAEL MARTIN, ENROLLED AGENT NATIONAL ASSOCIATION OF ENROLLED AGENTS

Madam Chair, Members of the Subcommittee, thank you for your invitation to testify on behalf of the National Association of Enrolled Agents, regarding the topic of income tax refund fraud, and specifically the delay some taxpayers are experiencing in receiving their refund checks due to the IRS's "Questionable Refund Program".

This testimony is being presented on behalf of approximately 9,000 members of the National Association of Enrolled Agents (NAEA). Members of NAEA are professional individuals whose primary expertise is in the field of taxation. They have established this expertise by either passing the Internal Revenue Service's comprehensive two-day examination on federal taxation or by serving as an IRS employee in an appropriate job classification for at least five years. NAEA members maintain this level of expertise by completing at least 30 hours of continuing professional education each year. As you may know, our members are the only classification of tax professional who are licensed by the Treasury Department. Our members represent more than four million (4,000,000) individual and small business taxpayers annually. It is in our role as the voice for the general taxpaying public that NAEA provides this testimony.

HISTORICAL PERSPECTIVE

In the late 1970's the tax preparation industry was rocked by a scandal in some ways similar to the one disclosed last year. It seems that many financial organizations offered tax preparation services to clients. As an incentive to potential as well as existing clients these institutions offered to loan the amount of the refund to the taxpayer as soon as the return was completed. The taxpayer would then endorse the refund check in favor of the lender in order to satisfy the debt.

It was found that because the tax preparers were paid more for placing loans than preparing the tax returns, they were inflating deductions and exemptions thus producing refunds larger than actually due.

As a reaction to this abuse, Congress enacted the Tax Preparer Penalties sections of the Internal Revenue Code (IRC Sections 6694-96 & 6701) which punishes preparers for filing false returns, negligent preparation or endorsing a refund check.

In the 1990's the IRS was seeking ways to encourage taxpayers and tax preparers to participate in the electronic filing program. The IRS has maintained that the ELF program reduces its expenditures for processing returns and also increases the accuracy of those returns.

Electronic filing gave rise to a new industry composed of many more than the traditional tax return preparers. Rushing to seize this new business opportunity were third party transmitters of returns, collection sites for preparing and transmitting the returns, and what became knows as "refund mills". In fact, as recently as 1993, one District Office of the IRS sent letters to all of the real estate agents in the District encouraging them to offer electronic filing services to their clients. The letter stated that all they needed was a 2400 baud modem on their computer. No tax knowledge was required, nor was any licensing, registration or regulation.

When the concept of the Refund Anticipation Loan (RAL) was conceived by the newly emerging electronic filing transmitter industry, it was not quashed by the IRS. The IRS indeed adopted and supported the program. The IRS agreed to further facilitate the RAL program by issuing Direct Deposit Indicators (DDI) to verify to the lenders that no offsets would reduce the amount of the claimed refund and thus essentially guarantee the loan.

Thus in their zeal to expand the use of electronically filed returns, the IRS promoted the growth of a new industry that was not subject to many of the preparer penalty rules adopted in the late 1970's to preclude the problems we see today. The IRS either did not or could not set up the systems needed to monitor not only the returns being filed but the electronic transmitters of those returns.

PROBLEM

In fifteen years, we have come full circle from the IRS discouraging the use of refund anticipation loans because of the potential for abuse to the IRS creating the environment where refund fraud could exist by encouraging and fostering the use of RALs. The fact that approximately 70% of electronically filed returns request RALs shows the popularity of that program. In fact, because of that popularity, the very future of the Electronic Filing Program may be in jeopardy unless a way is found to bring the program back to its performance of the last two years. The question now is how to curtail the filing of fraudulent tax returns while at the same time meeting the demand that has come into existence for rapid refunds.

LONG TERM SOLUTION

NAEA suggests that there are two solutions to this problem which will work in tandem. The first is enhancing the IRS's ability to perform the necessary checks by computer. The second would be to institute a regulation requirement for all tax preparers.

We realize that this subcommittee is not specifically charged with the IRS budget. However, we wish to take this opportunity to recommend to each member of the subcommittee the real long-term solution to this problem. That is the IRS's Systems Modernization Program. The funding of this program will give the IRS the computer capability to perform SSN matching and verification in a short enough period of time to issue the refunds promptly while simultaneously safeguarding the tax system from the type of refund fraud experienced during the last two years.

We believe the second part of the solution would be the universal regulation of tax return preparers. We cite the report of the Sub Group of the Commissioner's Advisory Group dated January 18, 1995. (A copy of that report is attached.) In that report, the sub group cited the statistics that 96.5% of all accuracy related tax preparer penalties were assessed against commercial tax return preparers who were neither EAs, CPAs nor attorneys. The sub group's report also cited a GAO study based on the 1988 Taxpayer Compliance Measurement Program data which showed compliance by commercial, unlicensed tax return preparers significantly lower than other groups. Finally, the sub group cited the experience of Oregon and California which have tax return preparer licensing programs and have found reduced incidence of fraud.

We, therefore, urge this subcommittee to support the CAG's recommendation to begin a program of registering and regulating commercial tax return preparers.

SHORT TERM SOLUTIONS

The IRS has already taken steps to curtail the opportunities for fraud in the electronic filing program. New this year are procedures requiring those preparers who are not currently regulated and held to the standards of Circular 230, and who participate as electronic filers, to submit fingerprints and pass a credit check.

The IRS has also instituted a program of surprise inspections of offices and files of Electronic Return Originators (ERO) who are electronic filers. These inspections are random and are not predicated on any evidence or suspicion of wrong doing on the part of the ERO. These inspections are very time consuming for the ERO and can completely disrupt a whole day of appointments. We question the IRS's right to "browse" through the records of any taxpayer whose return was prepared by the office being inspected. If these investigations could be focused on practitioners where there was a greater likelihood of uncovering erroneous filing practices, rather than simply at random, they might be more effective. After all, the IRS's examination program focuses on returns where there is a larger possibility of error. Why not apply the same standards to the review of electronic filers?

The IRS has instituted the Questionable Return Program where they are performing more verification on the types of returns which in the past accounted for the preponderance of the refund fraud. This program is causing a great hardship among the legitimate filers of refund returns and those claiming a refund based on the Earned Income Credit. These individuals have come to count on the Rapid Refunds promised to them over the last five years. The IRS created a demand for the product, and has now cut off the availability of that product.

One possible intermediate solution would be to process in an expeditious manner those returns where the taxpayer's are using the same name, address and social security number as on previous returns, where the taxpayer has a history of claiming the Earned Income Credit, has the same employer and has a history of receiving refunds. Thus, only those returns that showed a variation from the normal and customary pattern of filing or were claiming the Earned Income Tax Credit or other refunds for the first time would be selected for greater scrutiny. This would allow the IRS to process refunds to many taxpayers quickly, fulfilling the promise of the Electronic Filing Program while maintaining safeguards against questionable claims.

Another suggestion would be that since several reports show a significantly lower incidence of fraud and negligence among licensed tax professionals, electronic filing originator status should be limited to those practitioners already licensed and supervised by the IRS.

Another alternative would be to require that Electronic Filing Originators, not covered by Circular 230, post a bond as well as be licensed by the IRS.

The effect of this slow down in processing returns has had a dramatic effect on the tax filing system. A recent report states that electronically filed return usage is down 25%-30%. A recent article in the Wall Street Journal reports that rejected return frequency is up 25%. This is occurring even though many of the returns contain information similar to last year and were filed electronically in previous years and accepted.

We do not believe that there is one easy solution to the problem of refund fraud, especially with the age of electronic filing. However, a combination of the above suggestions should serve to stem the hemorrhage of fraudulent refunds that have been issued during the last several years as well as speed the processing and issuance of refunds to those taxpayers most in need.

NAEA supports all efforts to identify and eliminate fraud in the tax filing system. We believe that the tax professional community is the first line of defense in return preparation fraud detection. We are ready to offer our members' support in this effort. Again, the members of NAEA thank you for this opportunity to testify on this important issue. We offer our assistance to provide any additional information raised by these comments or other areas of concern.

REGULATION AND REGISTRATION OF COMMERCIAL TAX RETURN PREPARERS

JANUARY 18, 1995 COMMISSIONER'S ADVISORY GROUP MEETING

In 1989, the Commissioner's Advisory Group studied the matter of regulating and registering commercial tax return preparers. At the time, the reasons for considering this matter included the following:

1. Any person, regardless of training or experience, may prepare income tax returns for a fee.

2. Commercial tax return preparers generally are not required to subscribe to any rules of professional conduct or professional responsibility.

3. The complexities of the tax laws are such that doubts are raised relative to the overall competence of commercial tax return preparers.

All of these concerns are still valid. In addition, the February 1994 hearings on the IRS Refund Fraud Strategy, held by the Subcommittee on Oversight of the House Ways and Means Committee, indicate a strong need to address the competence and integrity of the commercial tax return preparer community. In fact, close examination of the testimony provided at these hearings reveals support for the regulation and registration concept.

In response to questions posed to them during the hearing, two witnesses who were convicted of preparing false Federal income tax returns made the following comments:

> "I am a tax preparer, but I didn't need to apply for any tax preparer (sic)..."
>
> "I filled out 1040s and signed as the preparer of the returns. That is all that is necessary in the system."
>
> "The idea would be for tax preparers, if they (IRS) could oversee them better. I am not an enrolled tax preparer (sic) with the IRS. I can go ahead and sign someone's return. Anyone in this room could sign another person's tax return as information supplied to them to the best of their knowledge and sign a return as a preparer."

The Subgroup also examined preparer penalty data and found the number of return preparer penalties assessed for fiscal year 1993 numbered 2,392. Interestingly, only 80 of these were assessed against Enrolled Agents, attorneys and CPAs (practitioners regulated under Circular 230). Thus, it can be inferred that 96.65% (2,312) of all return preparer penalties assessed for fiscal year 1993 were assessed against commercial tax return preparers. The 1989 CAG looked at similar data from fiscal year 1988 which indicated that 90.30% of all return preparer penalties assessed were assessed against commercial tax return preparers.

The Subgroup likewise took into consideration the recently released General Accounting Office (GAO) report which analyzed the compliance rates of sole proprietors. This report included a break-down of voluntary compliance, reported as a percentage, by type of preparer and was extracted from the 1988 Taxpayer Compliance Measurement Program (TCMP) data. The voluntary compliance percentage for the "other paid preparers" and "National Tax Service" categories, which include commercial tax return preparers, was among the lowest.

Finally, the states of Oregon and California currently have licensing programs in place for tax return preparers. The Ethics in Business Practices Subgroup has solicited input from the administrators of each of these programs to determine their success or failure. The Oregon State Board of Tax Service Examiners responded to several questions we posed to them. These questions and answers are attached to this report as Appendix A. In light of the current concern regarding refund fraud, the statement included in answer #2 "Since licensees can be easily found, fraud is generally low." is particularly interesting.

Having concluded that the regulation and registration of commercial tax return preparers is highly desirable, the Ethics in Business Practices Subgroup presents the following model program to regulate and register commercial tax return preparers.

DESCRIPTION:

Circular 230 would be amended to prescribe rules for the registration of "Commercial Tax Return Preparers".

1. "Commercial Tax Return Preparer" (CTRP) defined:

   The current definition of income tax return preparer found in Internal Revenue Code section 7701(a)(36)(A) would apply. Practitioners currently covered under Circular 230 (Enrolled Agents, attorneys and CPAs) would be exempt.

2. Registration and phase-in period:

   After the approval and implementation of this proposal, anyone meeting the definition of CTRP would have one year to register with the Internal Revenue Service without providing proof of continuing professional education (CPE). This one year period would constitute the phase-in period. The group of CTRPs, who would be grandfathered into the program, would be obligated to meet all the requirements of registration renewal as set forth below.

3. Post phase-in period:

   Persons desiring to register for the first time after the first year of the program would be required to meet the criteria listed below and submit proof of satisfying a minimum of 24 hours of CPE during the 18 months immediately preceding the receipt of the application for registration. Such proof, the completed registration form and required fee would be submitted to the Internal Revenue Service for acceptance.

4. Criteria for CTRPs:

   A. Be not less than eighteen (18) years of age;

   B. Continuing professional education requirements must be adhered to as follows:

      1. A minimum of 48 hours of approved CPE over a three year period with a minimum of 8 hours of CPE in any one year.

      2. Qualifying CPE will be that which meets the definition of "Continuing Professional Education" as found in Treasury Department Circular 230, section 10.6(f).;

      3. Evidence of continuing professional education and a renewal application would have to be submitted every three years commencing with the third anniversary of the initial registration.

   C. The information submitted on each application for the registration would be subject to IRS verification and investigated in a manner consistent with that of applications for enrollment to practice before the IRS;

   D. CTRPs would be subject to the standards set forth in Circular 230;

   E. Violations of ethical standards would result in the assessment of monetary penalties as authorized and/or prohibition from further tax return preparation;

   F. Limited fees would be paid for registration to make the program self-funding. A study is requested to ascertain the minimum fee requirement;

   G. Opportunities for non-English speaking preparers will be made available to accommodate registration and continuing professional education.

   H. The program would be administered by the IRS Office of Director of Practice with strong support and referrals from the District Directors' offices.

SUMMARY:

This proposal has evolved after numerous meetings and extensive discussion and study. We recognize that the individuals covered by this proposal provide a vital service to the public. As a result, this program is not intended to limit or reduce the number of available tax return preparers. We have eliminated the second level of CTRP which appeared in our proposal presented at an earlier CAG meeting. It became obvious that the second tier of Advanced CTRP posed many problems including setting limits and/or assigning different responsibilities to each level. We reached a unanimous conclusion that eliminating the Advanced CTRP would enable the program to achieve its goals, simplify its administration and minimize the disturbance to the present system.

Chairman JOHNSON. Thank you both for your very useful testimony.

Mr. Buckley, if you want to just briefly run through your recommendations, I would be interested in hearing those.

Mr. BUCKLEY. OK. Basically we have a four-step program that we suggest. One is to impose higher standards on electronic return originators which is much similar to what Mr. Martin just mentioned. Also, to produce a cooperative public relations campaign between the IRS, the Criminal Investigation Division, and the electronic return originators; require additional process controls by chronic return originators; and to enhance the IRS system checking.

Chairman JOHNSON. As to the current filing season, are there any changes that could be made midstream that might help straighten out some of the problems without reducing the chances of eliminating fraudulent claims?

Mr. BUCKLEY. I would think at this point in time that the IRS would have sufficient returns there that there would be some that they could start processing a lot quicker than what they anticipate, so that many of these taxpayers who are not used to waiting the 8 weeks to get their refunds or maybe 12 weeks if they get this additional form could possibly be served better.

Chairman JOHNSON. I do think that the wait of 2 months while you do point to some real cases of hardship, in general the wait of 2 months is not nearly as great a hardship as the fraud associated with this program and the cost to the taxpayers. So I think this was a necessary step to go through. Why is it that your industry wasn't better prepared for what was going to happen this season? It does appear that notice was given.

Mr. BUCKLEY. I don't feel that we were given proper notice as to the scope of the problem. We knew that they were going to be looking at earned income credit returns. The magnitude of the number of refunds that they have stopped is obviously a lot larger than what we anticipated. I agree with your former statement, Madam Chairman, that we need to do something to stop fraud and 2 months' wait is not that bad. The problem is I think taxpayers and tax preparers should have been able to warn those people much sooner than having to come into our office and then startling them that there may be a problem.

Chairman JOHNSON. Did the tax preparers underestimate the number of people whose Social Security number was inaccurate? I mean you certainly must have known this from past experience, or did you underestimate the number of people that were involved in the EITC?

Mr. BUCKLEY. I think——

Chairman JOHNSON. Both of which facets, seems to me, you would have known from your past experience.

Mr. BUCKLEY. Well, in the past when a return was submitted to the IRS, the primary Social Security number was checked and verified. This year, not only are they checking the primary, but they are also checking the spouse and the children and everyone else that is on the return. Our experience would show that many, many taxpayers out there are filing returns with the identical Social Security numbers that they have used for years. All of a sudden, they know they have a problem either when the return is rejected when you file electronically or they will receive a notice back from the Internal Revenue Service. So it is very difficult to explain to somebody that you really need to go and check your Social Security cards.

Particularly what we find today are that many spouses who when they got married did not change their name with Social Security records and as a result they have been filing as Mrs. Johnson or Mrs. Buckley all these years, and yet this year they file with that same Social Security number that they have been using and then the return is rejected. So it is not until after the fact that these people understand that they really have a problem.

In regard to your question with the earned income credit, we certainly did underestimate, and I think justifiably from the IRS' point of view, that they would not be stopping as many returns. It just seems incredible that there are so many—such a broad brush has been used to stop the number of fraudulent returns which are currently out there.

Chairman JOHNSON. Well, could you be more specific about this broad-brush issue. Certainly claiming more children, more deductions than you are entitled to, is one cause of a lot of fraud.

Mr. BUCKLEY. Well, Madam Chairman, we have been using the term, "fraud" rather loosely here, as has been indicated from the subcommittee from last year's testimony when I believe it was identified then as problematic refunds rather than fraud, and that problematic does obviously contain some amount of fraud. I think the issues that we have recommended to the IRS—I think some of the things they have done this year as far as having us all get fingerprinted and get an EFIN for each location. I think these are commendable. I think checking Social Security numbers is commendable. But I don't think there is a need out there to stop these millions of returns when you didn't tell the people up front this is what you were going to do.

Chairman JOHNSON. Now, I thought they did tell the people up front this is what they are going to do. The people don't necessarily understand the dimensions of this, maybe they didn't know the dimensions of this, but can you honestly say that people weren't informed?

Mr. BUCKLEY. I can say that in the tax booklet which I think would be the major publication and our major communication that a taxpayer would have a hard time in reading that. There is one small line in there that says that some returns that are filed electronically will be held up to make sure they are accurate. I think that small little blurb in there, as well as in the Commissioner's letter to the taxpayers, which says you must use the proper Social Security numbers, is being taken lightly by taxpayers, as I mentioned, because they have been using these same Social Security numbers for a number of years.

It would seem to me that if they did use these same Social Security numbers this year as they have in the past, that there should have been some way that the IRS could have notified these people last year saying that this Social Security number doesn't belong to you and you are going to have to get this fixed before next filing season.

Chairman JOHNSON. I have seen their letter and it could have been stronger. It could have been stronger in the sense of saying there is a problem with your Social Security number. You are going to have a hard time this filing season. Please check this and this is what you are supposed to do to check it. But many of the people you deal with have never read those directions. They count on you to read those directions. Did you work with your clients to be much more serious about Social Security numbers and about earned income tax credit documentation?

Mr. BUCKLEY. We have worked with our taxpayers on a daily basis in many cases. The problem with the Social Security number issue, as I mentioned, is that until we file electronically and it is rejected, that is when we can tell them they have a problem. It is a very difficult mission to try to tell somebody that there is a possibility that these Social Security numbers are not correct.

Chairman JOHNSON. So it wasn't really a problem for everyone to pick up until the system spit out that yours was not a correct Social Security number.

Mr. BUCKLEY. Right.

Chairman JOHNSON. Nonetheless, it is an important error to correct and will enable us to give a far better quality system. Next season it shouldn't be as much of a problem.

Mr. BUCKLEY. I would hope not.

Chairman JOHNSON. Thank you. Mr. Martin do you have anything you would care to add?

Mr. MARTIN. Well, we—the press release that I saw from the IRS announcing the dual refund system was dated, I believe, December 28. By December 28 most practitioners have already made plans, got our client letters out. Hopefully, our clients read our letters a little bit more than they read the letter from the Commissioner where we alert our clients to things like this. On December 28 our letters are by and large already out. Taxpayers have their information.

Chairman JOHNSON. But you were notified December 28.

Mr. MARTIN. The press release from the IRS that I saw was dated December 28. Yes, ma'am.

Chairman JOHNSON. The IRS was not specific about that earlier, so I was interested.

Mr. MARTIN. I know. The other thing that is possibly unfortunate for one reason or another is that the tax press did not pick up on that press release until around the first of February.

Chairman JOHNSON. That is interesting.

Mr. MARTIN. So most of us read some kind of a weekly journal of tax happenings and when we pick that up, OK, we know there could be a problem here. But, again, by early February we are already seeing clients and clients have been promised—there have been promises. The service has been promising for 5 years what I said in the written statement.

If you file your return electronically, you will have a very short turnaround for your refund. Now all of a sudden, just to turn off that spigot, I think, does create a serious hardship, and it is a hardship that the practitioner community has had to bear, because the taxpayer doesn't go to the IRS and yell and scream at the revenue officer and they don't have a chance to—they won't scream at the Commissioner. They come to my office and they come to the H&R Block office and they yell and scream at their preparer saying, why haven't I gotten my refund check?

Chairman JOHNSON. I think your comments in your testimony about the history of this issue were very, very instructive.

Mr. MARTIN. I think the IRS should take some of its TSM and buy a historian so they don't keep making the same mistake.

Chairman JOHNSON. I assume you think the elimination of DDI is a good thing so that banks do that checking themselves.

Mr. MARTIN. I think so, yes. It complies with the law, though. The code, as it currently says, a practitioner, a preparer cannot endorse a taxpayer's refund check. That is, in fact, a $500 fine. If I would prepare your tax return, receive your refund check and deposit it right in my account, I would be fined $500.

The way the rapid refund or the refund anticipation loan works, that check comes into the taxpayer's bank account and then is electronically debited. It is only one step removed from the practitioner actually endorsing the check. It is a system fraught with danger.

Chairman JOHNSON. Thank you.

Mr. MARTIN. The other thing that we suggested which I think is a short-term solution is bonding. I mean this is—if we are talking about running the government as a business, if I am dealing with a contractor that is handling that amount of money, we have to realize that most of the refund fraud has emanated not from the taxpayer because they don't have access to the system. It is emanating from preparers who have access to the computer and the modem and the EFIN number, so to these people it is only good business.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. Thank you, Madam Chairman.

What percentage of your clients file their returns electronically?

Mr. MARTIN. Of mine?

Mr. HANCOCK. Well, both of you probably have about the same percentage.

Mr. MARTIN. No. I don't participate in electronic filing programs at all, personally I do not. Many of our members, probably 50 percent, a survey we did recently about 50 percent or more of our members do participate in electronic filing programs and of them—of those people, I am trying to remember the statistics, about 40 percent of the returns were filed electronically.

Mr. HANCOCK. Do your clients ask you to participate in it?

Mr. MARTIN. No, sir.

Mr. HANCOCK. Do you have a particular client base of some type?

Mr. MARTIN. My client base is mostly professional upper income. They are not getting refunds, and if they are getting refunds, they are not worried about getting them in 2 weeks, 6 weeks, or 8 weeks. I personally have always had problems with the viability of the system and I elected never to participate in it.

Mr. HANCOCK. OK. Mr. Buckley.

Mr. BUCKLEY. We transmitted last year over 7½ million returns electronically. We transmit about 40 percent of the returns that we actually prepare, and we also transmit several million returns for people who have their returns prepared elsewhere or do it themselves.

Mr. HANCOCK. OK. Now, what do you mean you transmit. They complete their own return and bring it in to you and you transmit it electronically, is that correct?

Mr. BUCKLEY. That is correct.

Mr. HANCOCK. Do you have any idea how many of these clients apply for the refund anticipation loan, what percentage of your clients?

Mr. BUCKLEY. I would say certainly a majority of them, maybe 75 percent.

Mr. HANCOCK. Wait a minute. Are you talking about the one that is filed electronically? Seventy-five percent of them ask for these loans.

Mr. BUCKLEY. Approximately.

Mr. HANCOCK. What percentage of your profitability is determined by your fees that you charge on these loan applications?

Mr. BUCKLEY. We don't—we receive a very small fee off the actual loan. We charge a transmission fee whether you get the loan or you don't get the loan. In other words, for the clients who want to come in and just file electronically, they would pay the same price transmission fee as a client who comes in and wants the loan as well.

Mr. HANCOCK. What is that transmission fee?

Mr. BUCKLEY. We charge $25 transmission fee if the return is prepared by H&R Block and $35 if the return is prepared by themselves or someone else.

Mr. HANCOCK. Do you have any idea about the default rate on these anticipation loans, do you have any information at all on those?

Mr. BUCKLEY. No, sir, that is strictly done by the bank. The banks provide those loans.

Mr. HANCOCK. In December 1994 when they announced that there was going to be a slow down because they were going to be checking into fraud, did your organization take any major steps to start telling people that they might be subject to the slow down on the earned income tax credits?

Mr. BUCKLEY. Starting when we opened our offices in January, at that time even we did not know who or had no idea as far as the filters and screens that were going to be in place this year to be able to tell anybody that their returns could be delayed. In fact, when the first IRS money came back, it appeared to us that none of the clients had been—that none of the EITC had been stripped.

The second week when refunds started to hit, at that time we were notified by the bank who handles our refund anticipation loans that they were seeing refunds—the refunds not containing the earned income credit.

At that time, we immediately provided every customer who has earned income credit a letter which told them of the four possibilities that could exist if they were filing a return containing earned income credit, and we continue to do that today.

Mr. HANCOCK. Well, let me just ask the question. How exactly are you all associated with the Beneficial National Bank?

Mr. BUCKLEY. Beneficial National Bank provides the refund anticipation loans for our offices. For clients requesting refund anticipation loans, those loans go through Beneficial Bank.

Mr. HANCOCK. Do you have any joint ownership or joint board of directors?

Mr. BUCKLEY. No.

Mr. HANCOCK. Thank you, Mrs. Chairman.

Chairman JOHNSON. Thank you and thank both of you for being with us today. I appreciate your comments and your insights, and we hope by the next season that some of these problems will be straightened out and some of your comments will be included. Thank you.

Mr. MARTIN. Thank you for inviting us.

Chairman JOHNSON. The hearing is officially adjourned.

[Whereupon, at 1:49 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Bank One, Columbus, NA
Columbus Ohio 43271 1021

BANK ONE

March 3, 1995

The Honorable Nancy L. Johnson, Chair
Subcommittee on Oversight
Committee on Ways and Means
1102 Long Worth House Office Bldg.
Washington, DC 20515

Dear Ms. Johnson:

Bank One, Columbus, is an affiliate of BANC ONE CORPORATION, located in Columbus, Ohio. BANC ONE CORPORATION has assets of $88.9 billion and common equity of $7.3 billion as of December 31, 1994. BANC ONE now operates 65 banks with 1408 offices in Arizona, Colorado, Illinois, Indiana, Kentucky, Ohio, Oklahoma, Texas, Utah, West Virginia, and Wisconsin. BANC ONE also operates several additional corporations that engage in data processing, venture capital, investment and merchant banking, trust, brokerage, investment management, equipment leasing, mortgage banking, consumer finance and insurance.

Bank One, Columbus, is a major stakeholder in the affairs of the Internal Revenue Service (IRS). As such, we appreciate the opportunity to comment on IRS budget issues, 1995 filing season, and thank the Chairman and the committee members for this opportunity to express our views. Bank One is a member of the Council for Electronic Revenue Communications Advancement (CERCA) who has expressed its views to you but we would like to add comments we have as an individual entity. Bank One uses its 1,400 nationwide Banking Centers as collection points for self prepared tax returns to be filed electronically. In 1994, we processed over 25,000 electronic filings. In addition we offer Refund Anticipation Loans (RAL) through some 6,500 independent tax preparers. Over 8 million individual taxpayers have availed themselves of these loans since we began processing in 1989. The total RAL market approaches 20 million taxpayers. Many of these taxpayers come back for our service year after year.

Bank One supports the efforts of the IRS to upgrade the United States tax system through its Tax System Modernization (TSM) program. We are aware of major efforts going back to the 1960's to modernize and integrate the tax system to take full advantage of state-of-the-art technology. Previous IRS efforts that were frustrated have led to the current problems involving fraud, delayed processing, and the set back in the number of electronic filings in 1995. Bank One feels it is imperative that the TSM plan be funded and implemented.

The present filing season is a testament to the problems caused by the IRS's inability to keep pace with technology. The delayed refunds, the abandoned phone calls, and the mountains of paper still to be processed speak volumes as to the changes that are necessary.

The announcement concerning the Direct Deposit Indicator (DDI) on October 26, 1994 was a major blow to electronic filing and TSM. It was ill-timed and unnecessary. Attempting to blame fraud on a legitimate 20 million person RAL market is a sham. Rather than trying to place blame for past errors, we need to go forward together to achieve a safe, secure, and responsive tax system. Proper funding for TSM and for current IRS operations is a vital necessity.

In addition to obtaining TSM technology, the IRS needs to update their stand-alone philosophy. In this age of cyberspace, no entity can stand alone as the IRS is attempting to do. They need to embrace the help that has been offered through organizations such as CERCA and individual stakeholders such as Bank One. We stand ready with commitment and resources to help maintain the most efficient and fair tax system the world has ever known. Please urge the IRS to let its stakeholders help.

Sincerely,

John R. Galvin

John R. Galvin
Vice President
Bank One, Columbus, NA

cc: Margaret Milner Richardson

STATEMENT OF ROBERT E. BARR, PRESIDENT COUNCIL FOR ELECTRONIC REVENUE COMMUNICATION ADVANCEMENT

On behalf of the Council for Electronic Revenue Communication Advancement (CERCA), I would like to thank the Chair and the members of this committee for the opportunity to express the Council's views on the IRS budget request and on issues that have arisen to date in the current filing season. CERCA is made up of software producers, telecommunications experts, financial institutions, tax practitioner organizations and others committed to responsibly advancing the use of electronic communications with government revenue agencies. In short, this group has come together to work with the federal government and the individual states on the construction and maintenance of the "tax lane on the information superhighway."

As you can see from the above description, CERCA represents a vertical market segment of the tax industry, from the people who prepare the returns through the companies that empower the preparers with software and the financial institutions that participate in the refund process, to the state and federal agencies to which returns are sent. This unique combination of viewpoints allows CERCA to speak from experience on a great variety of topics in the tax filing process. CERCA would like to take this opportunity to express its support for full funding of the Internal Revenue Service's Tax Systems Modernization (TSM) budget request and to note some concerns regarding the early stages of the current filing season.

Internal Revenue Service Budget Request for Fiscal Year 1996

Of all the items in the Internal Revenue Service budget request, the most critical to the American taxpayer and to the return preparation and filing industries is the Tax Systems Modernization (TSM) program. Last year, this program was budgeted for substantially less than the original IRS request and frankly, this cannot be allowed to continue. The IRS needs these funds to more effectively serve the honest taxpayer and to more efficiently track down the fraudulent tax filer.

TSM will improve service to honest taxpayers by enabling the Internal Revenue Service to answer inquiries in one phone call. The new system will more efficiently handle the volume of incoming calls that flood the IRS on a daily basis. Once their calls have been answered, taxpayers will find that the IRS employees answering the phone are better able to serve them with instant on-line access to information that today takes weeks to gather and forward to Service personnel in the field. This new capability will serve to greatly reduce the number of busy signals that taxpayers receive when calling the IRS, a complaint that seems to arise every year under the current system. Through better routing and access features, the technology will allow the Service to answer more incoming phone calls. By reducing the number of second calls needed, the technology will also serve to reduce the overall volume of incoming calls.

The fraudulent tax filer or tax evader, however, will find this new system substantially tougher to get around. TSM will provide IRS collection employees with the data needed to more effectively search for those failing to comply with the tax laws. The new technology will allow the Service to better target their resources to noncompliant taxpayers, through faster and more accurate matching and a greater access to information about the taxpayer. In addition, the technology will free up considerable numbers of full time employees who currently work on inputting paper returns, allowing these individuals to instead review some of the incoming returns for indicia of fraud . All of this together leads to an increase in the effectiveness of collections, which in turn will increase the amount of taxes collected from those taxpayers who do not voluntarily comply with the Internal Revenue Code. The IRS estimates that for each percentage point increase in voluntary compliance, the Treasury collects an additional seven billion dollars. Assuming that the figure is accurate, the Service could more than pay for this program within a year of its full implementation.

As a final note on tax systems modernization, CERCA would like to address some concerns that have been expressed regarding the Service's progress on TSM relative to the money spent to date. The Council's membership includes many software and systems developers who agree that the costliest period for any system is the planning stage, if it is done correctly. Unfortunately, this stage of the process also produces the least short-term tangible benefits. Systems that are not carefully planned or are rushed into implementation invariably fail to perform the tasks for which they are designed. Cautious progress is an indicator of quality systems design, and reducing the funding for the program as a result would amount to punishing the Service for doing the right thing the right way. While it is difficult now to continue funding of this program when few tangible results can be shown, it will be far more expensive to spend years fixing a system that was rushed into use.

For these reasons, the Council for Electronic Revenue Communications Advancement respectfully asks the members of this committee to take whatever steps are necessary to ensure the full funding of Tax Systems Modernization as the budget request makes its way through the approval process in the House of Representatives. While this program may seem expensive now, the cost of inaction or inadequate action could be far higher.

Filing Season Concerns

Because CERCA represents such a broad spectrum of what the IRS considers its "stakeholder community," its members have seen several different types of problems with this filing season and the months that led up to it. Beginning with indecision on the direct deposit indicator (DDI) in the fall and moving forward to the current confusion on earned income credit refunds and taxpayer identification issues, the Service has made a great many changes to the filing system that have inconvenienced many taxpayers this season. While CERCA wholeheartedly agrees that the system must be protected from the fraudulent filer, the Council would like to make this subcommittee aware of some of the consequences, intended or otherwise, that have arisen as a result of actions taken to curb fraud. In addition, the Council would like to make several recommendations for legislative or administrative actions which could remedy the current situations.

Direct Deposit Indicator

Since the inception of electronic filing, the Internal Revenue Service has provided an electronic filer with two valuable pieces of information when it receives a return electronically. First, the Service acknowledges acceptance of the return, which tells the taxpayer and the electronic return originator (ERO) that the taxpayer's obligation to file a return has been met. Second, prior to this filing season, the Service provided a direct deposit indicator on claims for refunds filed electronically. The DDI told the ERO that the taxpayer could expect to receive a full refund because no federal obligations existed that would reduce it. This indicator enabled the ERO's who provided refund anticipation loans (RAL's) to show the lending bank that the loan could be made based on the full refund.

For the last two years, rumors have run rampant that the IRS would no longer be providing the DDI. In 1993, the Service announced that it would no longer provide the indicator shortly after April 15. Within a matter of months, the Service had responded to stakeholder concerns and agreed to issue the DDI for the '94 filing season. These rumors arose again in 1994 out of concern that the IRS had associated the DDI with the filing of fraudulent returns.

On October 6, 1994, Under Secretary of the Treasury Ronald Noble stated before this very subcommittee that in fact the DDI should remain in place for the '95 filing season. While expressing some concern that the speed with which refunds were provided to electronic filers might limit the Service's ability to properly review the claims, the task force which the Under Secretary headed could not find a direct link between provision of a RAL and the filing of fraudulent returns. In fact, the task force reported that, "[T]he DDI may offer some potential for increased fraud control and for increased ELF filing by genuine taxpayers." Mr. Noble went on to state before this committee that the DDI should be studied during the 1995 filing season in order to weigh its benefits against its potential for facilitating fraudulent refund claims.

This position led to the formulation of plans for the '95 filing season based on the availability of the DDI. Advertising campaigns were planned, financial institutions prepared for the influx of the loan applications, approximately 25,000 practitioners readied themselves to provide the RAL service to clients and millions of taxpayers prepared to receive RAL's

Within three weeks, then-Secretary of the Treasury Lloyd Bentsen announced that the DDI would not be available for the 1995 filing season, stating that "a very high number of EITC fraud schemes involve refund anticipation loans, and those loans are based on the direct deposit indicator." As a result, two of the four financial institutions that previously made refund anticipation loans refused to provide the Service this year. The top price of a RAL rose from $34 in 1994 to $89 in 1995. This means that the taxpayers who need their refund most of all will now be receiving less of the money they are due.

The circumstances surrounding the DDI and the 1995 filing season have led CERCA to respectfully make the following two recommendations to this committee. First, set a published date after which no significant changes could be made to the rules affecting the upcoming tax filing season. Such a date would give stakeholders the ability to make definite plans after that date. For instance, had this restriction been November 1, 1994, the Treasury Department could still have changed its position after testifying before this committee and those affected this year would have been on notice that nothing was final until November 1. Such a notice might have saved many stakeholders considerable inconvenience and expense this year. CERCA would prefer a much earlier date, however.

Second, until someone proves the allegations of fraud associated with the RAL, CERCA asks that the direct deposit indicator be reinstated in order to limit the cost of the refund anticipation loan to the taxpayer. Under Secretary Noble never stated that the Treasury's Task Force on Refund Fraud found conclusive evidence to determine whether the loans were a cause of fraud. He recommended further study before taking action on the issue. Under the current circumstances, the IRS is taking halting regulatory steps which are slowly strangling the RAL providers out of the business.

CERCA asks that the study recommended by Under Secretary Noble be conducted during the 1996 filing season. If the RAL is causing fraud, we ask that the industry be given at least one filing season to work with the Internal Revenue Service to correct the problem. If further study shows that the steps taken to correct the problem have failed, we would support action by this subcommittee to eliminate the program completely.

Earned Income Credit Split Payments

Another step taken by the IRS to stem the tide of fraudulent refunds in the 1995 filing season has been the bifurcation of earned income credit refund payments. Many taxpayers qualifying for the credit, particularly those filing as either head of household or single, have found that the Service will provide that portion of their payment which represents the refund of withheld taxes within the normal time period and in the form requested. However, the earned income credit portion of the refund is being held back for eight to ten weeks on as many as seven million returns. This action is necessary to allow the Service to more closely examine the taxpayer's claim. The difficulty arises with the fact that, once authorized, the earned income credit is mailed directly to the taxpayer in the form of a check. This has caused three problems for affected taxpayers.

First, it holds the money that Congress has designated for low income taxpayers out of the hands of those taxpayers for an inordinate amount of time. No one argues with the need for the Service to secure the system, but we are talking about money upon which America's neediest taxpayers have come to rely. Currently, the delay is eight to ten weeks. As the filing season progresses and the Service becomes increasingly busy, who is to say how long it will take to turn the earned income credit refunds around? Something must be done to speed up the process. In the future, full funding of tax systems modernization will make this process much faster and much more responsive to taxpayer needs. For this year, however, faster response on questionable earned income credits will probably require an increased manpower commitment from the IRS.

Second, the current system partially eliminates the direct deposit option for affected taxpayers. We are not talking about the direct deposit indicator now, but simply the option to have your refund deposited directly into your account. Keep in mind that this affects America's poorest taxpayers, individuals for whom the direct deposit represents a secure way to receive a refund, as opposed to simply a convenience. Many taxpayers who receive the earned income credit live in neighborhoods where theft of government checks from mailboxes is a common occurrence and where getting a check to the bank can be a risky venture. These individuals count on direct deposit to avoid the necessity of carrying a substantial check to the bank and making a deposit in person.

Third, it creates an often unforeseen financial obligation on taxpayers who receive refund anticipation loans. These individuals receive their RAL based on the full amount of the refund which the bank believes will be deposited into the taxpayer's account. When the check for the earned income credit goes to the taxpayer, it creates an obligation on the part of the taxpayer to return the money to the RAL lenders. Those who receive the checks often believe that, since it comes from the government, it must be free of encumbrance. Many never bother to contact the ERO who filed the return to find out exactly what has happened. When this obligation goes unpaid, it eventually winds up on a credit report and comes back to haunt the taxpayer at a future time.

In response to these concerns, CERCA respectfully recommends that action be taken to ensure that once a taxpayer qualifies for and requests a direct deposit, the entire refund is deposited directly to the taxpayer's account. If the Service needs extra time to examine claims for the earned income credit, a bifurcated payment system should certainly be allowed. However, the taxpayer's request for a direct deposit should be honored for both segments of the payment.

Social Security Number Scrutiny
The last concern that has arisen out of this tax season is the closer scrutiny of social security numbers by the Internal Revenue Service. Clearly, this increased emphasis on accuracy is a vital part of the efforts to stop the flow of fraudulent refunds out of the Treasury. Nevertheless, some concerns have arisen with the coordination between the Internal Revenue Service and the Social Security database used to verify taxpayer numbers. CERCA would like to request that the communications process between these two agencies should be reviewed in order to determine what measures can be taken to more effectively and efficiently match taxpayer names and social security numbers.

Constructive Congressional Relationship Needed
Finally, CERCA would like to respectfully recommend that this committee take a proactive stance toward the Internal Revenue Service, working to head off difficulties before they grow into nationwide problems. In addition, we would like to offer the Council for Electronic Revenue Communication Advancement as a resource for you in your work with the IRS to make sure that the tax system runs at maximum efficiency and effectiveness. CERCA was created at the behest of the Internal Revenue Service to provide a sounding board that represented every facet of the tax preparation and filing industries. Due to the breadth of its membership, CERCA can provide detailed information on almost any function in the process of filing a return.

Conclusion
In closing, we would like to thank this honorable committee for the opportunity to submit this written statement and we hope that you will consider the Council for Electronic Revenue Communication Advancement as a valuable source of information in your work to improve the administration of the tax system.

Respectfully submitted

Bob Barr

Robert E. Barr
President
Council for Electronic Revenue
Communication Advancement

STATEMENT OF WILLIAM STEVENSON, CHAIRMAN OF FEDERAL TAXATION NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

On behalf of the 20,000 members of the National Society of Public Accountants (NSPA) and the 5 million small businesses and individuals they serve, I would like to thank the Chair and the members of this Subcommittee for the opportunity to express the Society's views on the IRS budget request and on issues that have arisen to date in the current filing season. NSPA's members, individuals providing a variety of accounting and tax services to small businesses and individuals throughout the nation, would like to express their support for the Service's Tax Systems Modernization (TSM) program. The Society would also like to take this opportunity to inform this Subcommittee of several concerns that have arisen as a result of fraud initiatives taken by the Internal Revenue Service this filing season.

Tax Systems Modernization

Of all the items in the IRS budget, TSM is the one program that has the potential to pay exponential dividends for the federal government. While the remainder of the Service's budget request focuses on increasing productivity by increasing staff and resources spent on production in the current system, TSM requests funding for computer systems that will empower Service employees to produce at levels far beyond their current output. The new system, once in place, will greatly improve the Service's ability to administer the tax system, to apprehend fraudulent taxpayers and to serve honest taxpayers.

The Internal Revenue Service needs Tax Systems Modernization because, once implemented, it will greatly reduce the cost of administering the tax system. Processing of returns will be more efficient with the addition of new technologies in optical scanning of paper returns as well as the transmission of electronically filed returns. Examinations will be more effective when the examiners have ready access to prior year returns at the push of a button on their portable computers. Returns and refunds will be more carefully and quickly scrutinized by improved document matching systems, allowing the Service to process legitimate refunds in less time and to identify questionable refunds before fraudulent filers have a chance to take the government's money and run. Finally, TSM will allow the IRS to effectively add much more than the 888 employees they have requested this year, as those employees who currently spend their days processing paper and inputting data can be retrained to spend their time scrutinizing returns for key signs of fraud.

Fraudulent filers would be the first to notice the Service's improved capabilities, as the increasingly effective computer analysis and the increased level of human analysis will weed out more and more of the fraudulent returns that rob the Treasury of an estimated $5 billion annually. Today, the Service is charged with using a vintage 1960's computer system to track down sophisticated tax avoidance schemes born of 1990's technology. With modern technology, the Service could better process and analyze all of the information returns that it receives, a key element in finding fraudulent filers. For every one percentage point increase in voluntary compliance levels, the Department of Treasury estimates that an additional $7 billion dollars in revenue is collected. Given that estimate, this system could pay for its 1996 budget estimate more than five times over by simply raising the compliance level by one point. Given that it has the potential to increase voluntary compliance by far more than one percentage point, TSM represents a great investment in stopping the fraudulent filer and collecting the proper amount of taxes owed to the Treasury.

Aside from the benefit that honest taxpayers receive when fraudulent filers and tax avoiders are brought into compliance, the honest taxpayer will also find a much more responsive Internal Revenue Service once TSM has been fully implemented. The IRS is the only government agency that, by law, all American taxpayers must contact every year. As such, the method in which the IRS provides service to the taxpayer will often form a taxpayer's opinion of the federal government as a whole. Under the current system, Congress hears annually from the General Accounting Office (GAO) about how the Service is unable to effectively answer its telephones and that those taxpayers lucky enough to get through once often find that it takes several calls to resolve their problems.

TSM offers an effective remedy to this currently unacceptable state of affairs first by empowering the Service to answer more telephones and second by enabling Service employees answering those phones to resolve taxpayer issues in only one call. Effective routing of calls to the proper desk within the Service will provide taxpayers with better information on the first call. Making taxpayer information available via computer to the person answering the telephone will provide Service employees with the ability to resolve the question during the course of the first call, rather than having to request paper copies of returns from central filing locations and waiting weeks to receive them.

Because TSM will mean a more efficient Internal Revenue Service, better able to catch the fraudulent filer and the tax evader and better able to serve the honest taxpayer, NSPA respectfully requests that this Subcommittee take whatever steps possible to support the Service's request as the budget process continues over the next few months.

Current Filing Season Concerns

The Internal Revenue Service has gone to great lengths this year to curb refund fraud and the tireless efforts of the individuals charged with developing new safeguards are to be commended. However, NSPA would like to bring to light several concerns that have arisen with these safeguards and with unintended consequences that may affect honest taxpayers and practitioners as well as those that the safeguards were designed to apprehend. These concerns center first around procedures that the Service has implemented which place additional burdens on practitioners during busy season and second around steps that the Service could take to more effectively communicate some of the nonconfidential aspects of the revisions made to the return filing system this year.

Practitioner Concerns

NSPA recognizes that some of the fraud problems that have come to light in recent years have been caused by unscrupulous practitioners exploiting weaknesses in the tax system that they may have discovered in the course of their practices. Nevertheless, the Society's members have expressed a growing concern that the Service's efforts to stop fraudulent practitioners are increasingly hampering the ability of honest practitioners to conduct their practices during busy season. The clearest example of this problem is a procedure known as an "electronic filing compliance check," under which a practitioner who has been accepted to transmit returns electronically to the Service is examined for compliance with the rules governing electronic filing detailed in Revenue Procedure 94-63.

Ideally in an electronic filing (ELF) compliance check, Service personnel will come into a practitioners office, review the signature documents and W-2 forms which the practitioner is required to keep on file, briefly review security measures regarding the use of the electronic filing identification number (EFIN) and leave the practitioner's office in a relatively short period of time. This year the Service has taken several steps toward improving this practice, most notably scheduling appointments with practitioners where no suspicion of criminal activity exists, as opposed to last year's practice of performing all of these visits unannounced.

Two remaining steps are needed in order to make this program fair to the practitioners who are forced to undergo these checks. The Internal Revenue Service needs to publish a clear list of the documents that an agent is allowed to request in these checks and establish a time limit after which Service personnel should have to show reasonable cause for continuing the check. It is only fair that a practitioner undergoing an exam of this nature should be told what he or she is expected to produce and the amount of time allowed for the exam under normal circumstances. If the exam shows signs of fraud that require deeper investigation, a practitioner should be informed of the problem before the exam extends past the designated time.

NSPA does not dispute the Service's right to perform these checks and the Society acknowledges the need to perform them unannounced in certain circumstances. What we need the Service to understand is that practitioners are already swamped at this time of year and the intrusion must be kept to a minimum. If the IRS agents performing these exams have a specific checklist of what to look for and the practitioners know what to produce, these procedures don't need to take more than a few moments. Instead, different Service personnel ask for different documents and some practitioners lose substantial amounts of time to these exams at a time of year when they can least afford it. We ask for this Subcommittee's assistance in working with the Internal Revenue Service to develop a reasonable regulation that will solve this problem.

Communications Issues

The problems that have arisen this year as a result of poor communications regarding the new steps that the IRS has taken to stop refund fraud are best explained by looking first at an example of how well the Service can communicate on these issues when it has the time and the resources. This year, as part of its efforts to control refund fraud, the IRS placed new restrictions on electronic return originators (ERO's), the practitioners who register to transmit returns electronically to the Service. New applicants would have to go through a substantial review process and even those renewing prior year's applications could find themselves submitting substantially more information. The new rules would affect many practitioners and getting the information out to them was of critical importance both to the IRS and to organizations like NSPA.

The day before the IRS made its formal announcement of the new rules, a meeting was held with practitioner organizations in Washington, DC. The Service released to the organizations advance copies of the Revenue Procedure describing the application process and the background check requirements. Several top level IRS staffers familiar with the program made themselves available to answer any questions that arose either at the meeting or later. This outreach effort was successful because it enabled the associations to carry accurate information to our members almost before they heard it anywhere else and it empowered the groups to accurately answer the question of those members who had heard bits and pieces of information elsewhere. It recognized the fact that on many key issues, the IRS and the practitioner community are in fact partners in the administration of the tax system.

Unfortunately, this level of communication on the new fraud control programs this year did not continue. Since the introduction of the new ERO rules, three examples of inadequate communication between the Service and the practitioner community have arisen that clearly demonstrate the importance of this partnership.

One new tool implemented this year was the 1040-V voucher form, designed to help the Service better track payments for balance-due returns filed electronically and for other specialized types of individual returns. The Service has also run several experimental programs in different districts aimed at more efficiently processing payments, including providing different addresses to which taxpayers can mail their return depending on whether they are getting a refund or paying a balance due. The Service did not adequately publicize these programs before filing season began, though, and groups like NSPA have fielded a considerable number of questions from confused practitioners who, after many years in the business, find themselves in the embarrassing position of not knowing where to send their clients' returns.

As a result, the IRS released on February 7 a "Practitioner Alert" attempting to clear up the confusion caused by the new procedures. While the release did answer the questions of most practitioners, the timing makes the release less than fully effective. Many practitioners, even at the beginning of February, are so immersed in tax preparation that few outside sources of information reach them effectively. In order to effectively support these IRS tests, the practitioner community must be brought into the loop much earlier in the development of the new procedures.

Another new procedure that the IRS put into use this year to control fraudulent claims for the earned income tax credit (EITC) is a split payment of refunds that include a questionable claim for the credit. This extra time allows the Service to perform more detailed checks on these questionable claims while still refunding withheld taxes to the taxpayer as quickly as possible. While these new checks will undoubtedly save the Treasury from paying out fraudulent claims, inadequate communication regarding the process has led to considerable confusion among the taxpaying public and the practitioner community.

The Society would like to make perfectly clear that we do not question the right of the Service to perform these additional checks. In fact, we wholeheartedly support the IRS in these critical efforts. We ask only that the Service recognize the role that the tax practitioner plays as a liaison between the taxpayer and the tax system. By informing practitioners early about these new procedures, practitioners can in turn inform their clients and improve their understanding of the filing process. When practitioners are left to find out over the course of filing season what changes are affecting their clients, taxpayers are left feeling victimized by a system that they cannot understand.

Finally, the National Society would like to address the very sensitive issue of matching social security numbers. In this case, it really seemed as though the system was working. As early as last June, Commissioner Richardson made clear to everyone involved with the system that social security numbers should be double-checked by practitioners. NSPA reminded its members no fewer than four times throughout last summer and this fall through newsletter articles.

Nevertheless, the severity of the checks has surprised the preparer community this year. Electronically filed returns that were accepted without question last year are being rejected this year because, among other reasons, middle initials are missing and because married individuals who have filed jointly for years are finding that the Service has no record of a name change after their wedding. These screens are currently causing problems primarily for electronically filed returns, since those returns are typically filed early in the season and the taxpayer finds out more quickly that the return has been rejected. Once the paper filing season picks up, it appears likely that these new procedures will substantially slow the processing of those returns as well. Practitioners are now being forced away from using the mailing label which the IRS provides the taxpayer, an important tool for IRS processing. Under the current system, the information on that label could fail to match the social security numbers on file for the individual, due to missing middle initials, married names and other similar circumstances. In order to protect clients from these potential pitfalls, practitioners are mailing the returns with taxpayer names and identification numbers printed by computer onto the form.

In closing, NSPA would like to note that the Internal Revenue Service has gone to great lengths this year to comply with the mandate from this Subcommittee that the flow of fraudulent refund money out of the Treasury be stopped. Nothing in this statement is intended to imply that the steps taken by the Service are improper or unwarranted, although in the case of social security matching, the Society would submit that the system could have been more taxpayer friendly. The members of NSPA would like to point out, however, that these critical steps could have been more effective for the IRS and less burdensome to taxpayers and tax practitioners around the country if the Service had been more forthcoming with details.

Throughout the fall, NSPA was told by key Service personnel that, "If we tell you everything we are doing to protect the tax system, we cannot effectively protect the tax system." While that statement is true to some extent, the Society respectfully submits that if the IRS does not tell tax practitioners what it is doing to administer the tax system, the Service will hinder its ability to effectively administer the tax system. We ask this Subcommittee to take an active role in making sure that this critical information reaches practitioners and taxpayers in a more timely manner in the future.

On behalf of the National Society of Public Accountants, I would like to thank Madam Chair for providing us with the opportunity to submit comments on these topics which are so critical to our members. NSPA wishes you success in your efforts toward overseeing the tax system, and we hope that you will consider the Society as a valuable resource in support of those efforts.

Respectfully submitted,

William Stevenson

Dr. William Stevenson
Chairman of Federal Taxation
National Society of Public Accountants

HOUSE WAYS AND MEANS OVERSIGHT COMMITTEE HEARING - Monday, February 27, 1995

STATEMENT OF STEVE J. SAFIGAN, PRESIDENT
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The attached statement responds to certain comments made by IRS Deputy Commissioner Michael Dolan during The House Ways and Means Oversight Committee hearing on Monday, February 27, 1995 convened to address Tax Systems Modernization and the 1995 tax filing season. More particularly, Mr. Dolan's comment that there is "statistically valid" data showing the DDI to be material in causing fraud contradicts the findings of the Task Force appointed by the Treasury Department that addressed the DDI under the direction of Under Secretary of the Treasury Ron Noble.

During Mr. Noble's testimony to this Subcommittee on October 6, 1994 as to whether the IRS should abolish the DDI, he stated that The Department of the Treasury was not concerned that the DDI would cause fraud losses to the IRS. Rather, he testified that the DDI could play a role in improving fraud detection and that banks offering refund anticipation loans, rather than the IRS, would be at risk of loss. Mr. Noble also stated that now was not the time to remove the DDI, but rather the impact of the DDI should be continued to be examined during the 1995 filing season.

Despite the above findings, on October 26, 1994 Secretary of the Treasury Lloyd Bentsen announced the elimination of the DDI.

The actions taken during the current filing season regarding the DDI have simply not accomplished the same nor acceptable goals as communicated by the IRS. Nor does the current preemptive EITC withholding program attempt to prevent innocent and honest taxpayers from being unnecessarily and negatively affected.

I would like to thank the Chairman and the members of this Subcommittee for the opportunity to express our views. We are Universal Tax Systems, Inc., a developer of tax preparation software and a third-party transmitter of electronic returns. Last year our software was used to transmit well over one million tax returns electronically to the IRS and 30 state revenue departments. Our software was also used at hundreds of IRS VITA sites, district offices, service centers, and military installations here and abroad. We also file electronically for home users of tax software packages designed for individuals who do not use a preparer. We are in our second year of involvement in the IRS File-from-Home initiative. Our president, Steve Safigan, serves as the Vice-President, Infrastructure for the Council for Electronic Revenue Communication Advancement (CERCA) and is an active member of the Electronic Filing Committee of the National Association of Computerized Tax Processors (NACTP).

We wish to express alarm at some of the statements made by Deputy Commissioner Michael Dolan when questioned by Chairman Johnson about the Direct Deposit Indicator (DDI). If you recall, Mr. Dolan attempted to defend the IRS' decision to retain the DDI during the 1994 processing season, but removed it for the 1995 processing season.

Mr. Dolan claimed that there was "statistically valid" data showing that the DDI indeed caused fraud, and that the data was collected during the 1994 processing season. This was the reason, he claimed, for the decision to remove the DDI. His testimony contradicts the Treasury Department's own findings. As you know, this very Subcommittee directed then-Secretary of the Treasury Lloyd Bentsen to commission a task force to examine refund fraud and to make recommendations. The task force was convened under the direction of Under Secretary Ron Noble. Mr. Noble reported his findings in thoughtful and well-informed testimony to this Subcommittee on October 6, 1994.

Mr. Noble devoted 3 pages of his testimony to the question, "Should the IRS abolish the DDI?" His testimony can be summarized as follows.

> The Task Force found two grounds for concern about the DDI: cost and speed... if the IRS is to continue the DDI, the RAL banks that benefit from it should pay the administrative costs of the DDI check. Were they to do so, the cost concern would not be a major one. With regard to the second issue the speed with which electronic refunds can be delivered, our concern is <u>not</u> that the DDI will cause the IRS to suffer fraud losses. If the IRS pays no refunds until it receives all of the paperwork that must accompany an ELF return and until all of the detection procedures currently planned for the 1995 and subsequent filing seasons have been undertaken, the issuance of a DDI should neither increase nor decrease the likelihood that the IRS will be the victim of ELF fraud. As long as the IRS will run necessary checks on all electronic returns, all will be screened equally without regard to whether a DDI has been issued...the irony is that the speed of the DDI and RAL loans may lead in a relatively short time to improved fraud detection. This irony is attributable to the fact that, if the IRS detects problematic returns and stops refunds, the banks rather than the IRS will be at risk of loss... Thus, the Task Force believes that the DDI may offer some potential for <u>increased</u> fraud control and for increased ELF filing by genuine taxpayers... Accordingly, the Task Force concludes that this is not the time for a firm recommendation either to continue the DDI indefinitely or to kill it immediately. In lieu of either of these extremes, the Task Force believes that Treasury and the IRS should continue to examine the impact of the DDI on electronic filing in the next filing season and to determine what effects it has on fraud control and on incentives for ELF filing.

Twenty days later, on October 26, 1994, then-Secretary of the Treasury Bentsen announced the elimination of the DDI. Mr. Noble and Commissioner Richardson were in attendance. In light of subsequent actions, Mr. Noble might well regret the candor he displayed in his testimony before this Subcommittee.

Unbiased examination of the record would indicate that one of the following must be true: a) no "statistically valid" research exists showing such compelling evidence as Mr. Dolan testified; b) this research was withheld from Mr. Noble's task force; or c) the Task Force reviewed the research and considered it not worth mentioning.

Our conclusion is that the IRS is attempting to strangle the RAL banks out of business by exposing them to unacceptable risk. This strategy encourages tax cheats, deadbeat parents, and other federal debtors to defraud the banks using the U.S. Tax System. The removal of the DDI was only partially successful at eliminating refund loans. The IRS then instituted its EITC withholding program, which delayed payment to millions of eligible EITC recipients. Our examination of this program indicates that the IRS' initial screening criteria consisted primarily of two filters: a) the taxpayer claimed EITC, and b) the amount of the EITC was above a certain dollar threshold. This is hardly a program designed to assure that the honest claimant receives the EITC he/she deserves. More importantly to the financial institutions, the delayed payment was not directed into the taxpayer's account at the RAL bank, as the taxpayer requested.

Private industry knows well what's at stake if the fraud issue is not dealt with decisively. The sad fact, to quote Mr. Noble, is that "EROs and ERTs have the potential to serve as eyes and ears in the problematic refund prevention and detection effort." Instead, the IRS has chosen to demonize the financial institutions and more than 25,000 EROs who offer RALs to clients who appreciate the service. Our experience would indicate that the IRS' Social Security Number verification program is the only fraud prevention measure which was worth its expense and impact. The SSN verification program was tremendously effective in driving most fraud from the system. We certainly believe the IRS has the right to delay any suspicious refunds, so long as the IRS has legitimate reason to suspect that each return is problematic, the public is informed of any severe or widespread impact, and the taxpayer's original instructions are followed concerning where the refund is directed.

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