

**HEARING BEFORE THE
COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON
FINANCIAL SERVICES AND GENERAL GOVERNMENT
UNITED STATES SENATE**

**“Fiscal Year 2012 Budget Request for the
Internal Revenue Service”**



June 8, 2011

Washington, D.C.

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

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THE HONORABLE J. RUSSELL GEORGE
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION
before the
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“Fiscal Year 2012 Budget Request for the Internal Revenue Service”

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Chairman Durbin, Ranking Member Moran, and Members of the Subcommittee, I thank you for this opportunity to provide a written statement regarding the Fiscal Year 2012 budget request for the Internal Revenue Service (IRS).

OVERVIEW OF THE IRS’S FISCAL YEAR 2012 BUDGET REQUEST

The IRS is the largest component of the Department of the Treasury and has primary responsibility for administering the Federal tax system. Since the Federal tax system is a system that relies upon voluntary compliance, almost everything the IRS does in some way relates to fostering compliance with tax laws. The IRS provides taxpayer service programs that help millions of taxpayers to understand and meet their tax obligations and administers enforcement programs aimed at deterring taxpayers who are inclined to evade their responsibilities. The IRS is charged with vigorously pursuing those who violate tax laws.

The IRS must strive to enforce the tax laws fairly and efficiently while balancing service and education to promote voluntary compliance and reduce taxpayer burden. To accomplish these efforts, the proposed Fiscal Year 2012 IRS budget requested approximately \$13.3 billion¹ in total appropriated resources. The total appropriations amount is an increase of \$1.138 billion, or 9.4 percent, more than the Fiscal Year 2010 enacted level.

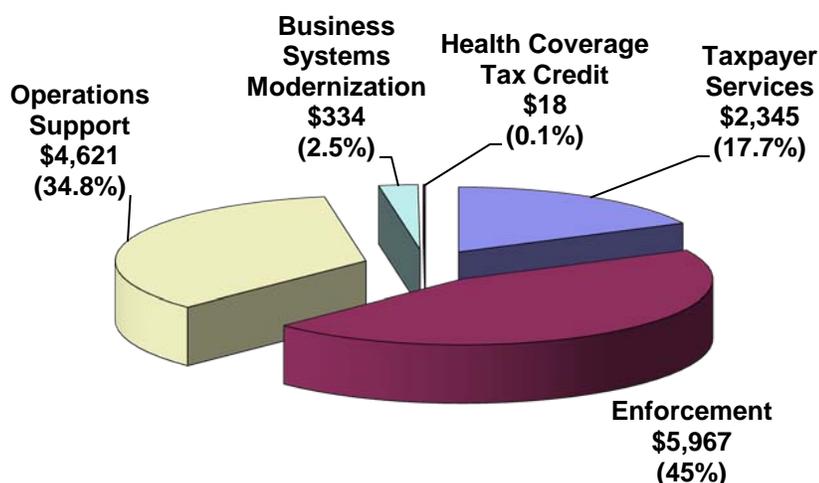
¹ The Fiscal Year 2012 budget request also includes approximately \$138 million from reimbursable programs and \$204 million from user fees for a total operating level of \$13.6 billion.

Program Summary by Appropriation Account

The IRS Fiscal Year 2012 budget request includes appropriations for five IRS budget accounts, as depicted below:

IRS Fiscal Year 2012 Budget Request by Appropriation Account (in Millions)

Note: Percentages total more than 100 percent due to rounding.



Generally, these five appropriation accounts fund the IRS's tax administration functions. The three primary appropriation accounts are Taxpayer Services, Enforcement, and Operations Support. The Taxpayer Services account funds programs that focus on assisting taxpayers with understanding and meeting their tax obligations, while the Enforcement account supports the IRS's examination and collection efforts. The Operations Support account funds functions essential to the overall operation of the IRS, such as infrastructure and information services. The Business Systems Modernization account provides funding for the development of a new taxpayer account database and investments in electronic filing. Finally, the Health Coverage Tax Credit Administration account supports the administration of the Health Coverage Tax Credit.²

The Administration seeks to increase funding over Fiscal Year 2010 enacted operating levels for all of the appropriation accounts, ranging from 3 to 26 percent

² The Health Coverage Tax Credit is a refundable credit for health insurance available to qualified individuals, enacted as part of the *Trade Adjustment Assistance Reform Act of 2002*, Pub. L. No. 107-210, 116 Stat.933 (2002).

increases (see chart below). The budget request includes a net increase in IRS staffing of over 5,100 employees, for a total of more than 100,500 IRS employees.

**IRS Fiscal Year 2012 Budget Request Increase
Over Fiscal Year 2010 Enacted Budget
(in Thousands)**

Appropriation Account	Fiscal Year 2010 Enacted	Fiscal Year 2012 Request	\$ Change	% Increase
Taxpayer Services	\$2,278,830	\$2,345,133	\$66,303	2.91%
Enforcement	\$5,504,000	\$5,966,619	\$462,619	8.41%
Operations Support	\$4,083,884	\$4,620,526	\$536,642	13.14%
Business Systems Modernization	\$263,897	\$333,600	\$69,703	26.41%
Health Insurance Tax Credit Administration	\$15,512	\$18,029	\$2,517	16.23%
Total Budget Appropriated Resources	\$12,146,123	\$13,283,907	\$1,137,784	9.37%

IRS Fiscal Year 2012 Priorities

The IRS will focus efforts on the following priorities in Fiscal Year 2012 (these priorities are reflected in multiple appropriation accounts):

Enforcement – A serious challenge confronting the IRS is the Tax Gap.³ Despite an estimated voluntary compliance rate of 84 percent and IRS enforcement actions, a significant amount of income remains unreported and unpaid. The IRS estimated the gross Tax Gap for Tax Year 2001, the most current figure to date, to be approximately \$345 billion. The IRS's strategy for reducing the Tax Gap is largely dependent on funding for additional compliance resources as well as legislative changes.

³ The Tax Gap is the difference between the estimated amount taxpayers owed and the amount they voluntarily and timely paid each year.

In Fiscal Year 2012, the IRS will continue to invest in compliance programs, including its relatively newly enhanced international enforcement initiatives to address offshore tax evasion. These initiatives are designed to address the underreporting of income associated with international financial activities and expand enforcement efforts to address noncompliance by corporate and high-wealth taxpayers and the complex business enterprises they control (including corporations, partnerships, and trusts). The IRS plans to use audit results and intelligence from ongoing offshore initiatives to refine case identification and selection methods to identify promoters, facilitators, and participants in abusive offshore arrangements.

In addition, the IRS will continue to pursue other significant initiatives, such as the Compliance Assurance Process program, industry issue resolution projects, and fast track settlements, aimed at earlier and speedier issue resolution and greater efficiency. These initiatives are a major part of the overall retooling of the IRS's relationships with large corporate taxpayers.

The IRS also plans to continue to implement the recommendations of the Tax Return Preparer Strategy by addressing the challenges associated with the implementation of registration, continuing education, and testing requirements for tax return preparers that are scheduled to go into effect in Fiscal Year 2011. The IRS took a major step forward in launching its new Preparer Tax Identification Number online registration process. The process gives the IRS an important and improved line of sight into the return preparer community. The IRS plans to use the information to analyze trends, spot anomalies, and potentially detect fraud. In addition, the IRS will continue to develop and implement legislation to increase the use of electronic filing among the paid preparer community.

Taxpayer Services – Assisting taxpayers with their tax questions before they file their tax returns helps prevent inadvertent noncompliance and reduces the need for the IRS to send burdensome post-filing notices and other correspondence. In Fiscal Year 2012, the IRS plans to increase its service level by adding resources to meet the ever-increasing demand and by continuing to make efficiency improvements, such as automated self-service applications that allow taxpayers to obtain information on less complicated issues (e.g., refund inquiries). The IRS believes that these improvements will allow staff to address the more complex tax-law issues stemming from the passage of new legislation. In addition, the IRS continues to study the services it offers to taxpayers on the Internet, at walk-in sites, and on its toll-free telephone lines. IRS officials are also exploring the

relationships between taxpayer errors and unclear correspondence to guide them in the development of new approaches to service.

Business Systems Modernization – Data and technology are central to the future of tax administration. For the 2012 Filing Season, the IRS plans to complete the new taxpayer account database and continue to make investments in its electronic filing systems. Completion of the core taxpayer account database is the cornerstone of IRS modernization that is expected to expedite refunds to millions of individual taxpayers. It is also a prerequisite for other major initiatives, such as the expansion of online paperless services. The ability of the IRS to support increasingly complex taxpayer service and compliance initiatives will be severely limited until the new taxpayer account database is completed.

The Fiscal Year 2012 Business Systems Modernization (BSM) budget request is \$333.6 million and 453 Full-time Equivalents (FTE).⁴ This is an increase of \$69.7 million (26.4 percent) and 120 FTEs over the Fiscal Year 2010 enacted level of \$264 million and 333 FTEs. Almost half of the budget request will fund continued development of the Customer Account Data Engine 2 (CADE 2).⁵ While the current BSM is in its 12th year, the IRS's modernization efforts started in the 1980s. The IRS originally estimated that the BSM effort would last up to 15 years and incur contractor costs of approximately \$8 billion. To date, the current BSM has received \$3.24 billion in contractor services, plus an additional \$474 million for internal IRS costs.

The BSM funding is intended to improve taxpayer service and enforcement, and reduce the costs and risks of operating parallel tax processing systems.⁶ The IRS plans to update and settle individual taxpayer accounts in 24 to 48 hours with current, complete, and authoritative data which should facilitate expanded opportunities for compliance, increase analytical capabilities, and accelerate the identification of fraudulent trends.

The increases over the Fiscal Year 2010 budget seem reasonable considering the investments in developing and rolling out the CADE 2 during Fiscal Year 2012. Because the IRS is taking more responsibilities for program management,

⁴ A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year.

⁵ CADE 2 creates a modernized processing and data-centric infrastructure that will enable the IRS to improve the accuracy and speed of individual taxpayer account processing, enhance the customer experience through improved access to account information, and increase the effectiveness and efficiency of agency operations.

⁶ The IRS operates parallel tax processing systems that require updates to all systems when tax legislation is changed or updated. These parallel systems include Customer Account Data Engine (CADE), CADE 2, and the Individual Master File.

there are more IRS resources and fewer contractor resources devoted to BSM, thus the increase in labor costs. Finally, the other major BSM projects (e.g., Modernized e-File⁷) have reduced budgets for Fiscal Year 2012 as they are winding down.

In the area of information technology systems operations, the Fiscal Year 2012 IRS budget request presents several budgetary increases related to maintaining and improving information technology operations and taxpayer service, including \$33 million to expand online options through IRS.gov improvements, \$25 million for portal migration, and \$27.5 million to update the Integrated Financial System.

The portal initiative funds the second year of a three-year effort to replace the aging infrastructure of the portals and complete the migration of the two portals by August 2013, when the existing contracts expire. This will result in significant enhancements to online capabilities for tax preparers and other registered users. Failure to complete the portal migration by this date will result in increased portal operating costs and increased risk under existing sole source contracts. In addition, taxpayer and tax practitioners will continue to use more expensive, labor-intensive service delivery channels such as calling the 1-800 telephone number or visiting an IRS taxpayer assistance center.

Implementation of the Affordable Care Act

The implementation of the *Patient Protection and Affordable Care Act of 2010*⁸ (Affordable Care Act) presents a major challenge to the IRS. The Affordable Care Act represents the largest set of tax law changes in more than 20 years, with more than 40 provisions that amend the tax laws. Although the new law goes into effect gradually over many years, several provisions required immediate action by the IRS, including the Small Business Health Care Tax Credit, the Qualifying Therapeutic Discovery Credit, and the expanded Adoption Credit. To enact the range of retroactive provisions, the IRS focused on developing new systems and business processes for near-term provisions, conducting initial planning for long-term provisions, and defining appropriate outreach activities for each affected group.

⁷ The Modernized e-File project develops the modernized, web-based platform for filing approximately 330 IRS forms electronically, beginning with the U.S. Corporation Income Tax Return (Form 1120), U.S. Income Tax Return for an S Corporation (Form 1120S), and Return of Organization Exempt From Income Tax (Form 990). The project serves to streamline filing processes and reduce the costs associated with a paper-based process.

⁸ Pub. L. No. 111-148, 124 Stat. 119.

ANALYSIS OF THE REQUESTED FISCAL YEAR 2012 BUDGET INCREASE

The Fiscal Year 2012 budget request of \$13.3 billion for the IRS is a \$1.138 billion (9.4 percent) increase over the Fiscal Year 2010 enacted budget. The \$1.138 billion consists of the following:

Changes to the Base

- Adjustment to Reach Fiscal Year 2011 President's Budget Level⁹ – Increase of \$402 million, including a \$123 million increase related to the Business Systems Modernization appropriation.
- Maintaining Current Levels – Increase of \$86 million.
- Program Reinvestment – Increase of \$1.5 million (one-time cost).

These increases are offset by a decrease of \$190 million in efficiencies and savings, including a \$1 million decrease related to the Modernization appropriation.

Program Changes

- Program Increases – Increase of \$839 million, including an increase of \$52 million in the Operations Support appropriation for costs related to maintenance of deployed Modernization systems. This \$52 million increase is offset by a corresponding decrease of \$52 million in the Modernization appropriation for Fiscal Year 2012.

Adjustment to Reach Fiscal Year 2011 President's Budget Level

The IRS is requesting about \$402 million to reach the Fiscal Year 2011 President's budget request adjusted for the proposed pay freeze. The IRS has not issued new guidance for the Fiscal Year 2012 budget regarding the impact of the full-year Fiscal Year 2011 Continuing Resolution signed by the President on April 15, 2011. Therefore, we are presenting the information as reflected in the IRS's Fiscal Year 2012 budget request dated February 14, 2011.

The Fiscal Year 2012 budget request does not specify which initiatives are included in the \$402 million increase. However, we reviewed the IRS's Fiscal Year 2011 budget request, and identified the following program changes in addition to changes to the base:

- \$21 million to increase the telephone level of service.
- \$25 million to improve and redesign the IRS.gov website.

⁹ The initiatives included in the Fiscal Year 2011 budget submission are separate from the \$839 million in program increases included in the Fiscal Year 2012 budget submission.

- \$247 million to reduce the Tax Gap. The three largest initiatives associated with this effort are \$121 million for international enforcement to address offshore tax evasion; \$78 million for under-reporting by corporate and high-wealth taxpayers, tax abuse, and other underreporting issues; and \$38 million to broaden collection coverage.
- \$168 million to complete development of the new taxpayer account database and continue investments in electronic filing systems. This includes continuing development and deployment of BSM projects such as Modernized e-File, core infrastructure (such as portals, hardware, software, and security), and system engineering management capabilities (including project planning and monitoring).
- \$3 million program reinvestment of a portion of the electronic filing savings to fund the one-time separation costs associated with the September 30, 2011, closure of the Atlanta Submission Processing Site.

Additionally, the IRS identified \$9 million in program reductions to the Taxpayer Advocate Service case processing activities, Low-Income Taxpayer Clinic grants, Tax Counseling for the Elderly program, and Volunteer Income Tax Assistance grants to realign the programs to the Fiscal Year 2009 enacted levels.

Maintaining Current Levels

The IRS is requesting about \$86 million to fund non-labor inflation adjustments and an increase in Federal Employment Retirement System participation. Non-labor inflation adjustments include rent, postage, supplies, and equipment. No inflation adjustment is requested for pay in Fiscal Year 2012.

Program Reinvestment

The increased use of electronic filing has led to the consolidation of sites that process paper individual returns. Resources from electronic filing savings will be reinvested to fund one-time separation costs associated with the September 30, 2011, closure of the Atlanta Submission Processing Site. The IRS Fiscal Year 2012 budget request includes a net increase of \$1.5 million related to this effort.

Efficiencies and Savings

The IRS Fiscal Year 2012 budget request includes a net reduction of about \$190 million related to efficiency savings. This \$190 million reduction represents a total of 523 FTEs. The four largest areas of cost savings are outlined below.

- **\$75 Million Decrease From Reduced Information Technology Infrastructure.** The IRS intends to reduce its infrastructure through the use of the Capability Maturity Model (a process improvement approach that yields efficiencies in software engineering); the use of the Information Technology Infrastructure Library, which will allow the IRS to improve the quality of its information technology services; and further consolidate its security activities to leverage security best practices.
- **\$27.3 Million Decrease From Reduced Training, Travel, and Programs.** The IRS intends to reduce non-technical training and non-case related travel, and plans to implement various program efficiencies. The IRS expects to achieve program efficiencies in the Business Systems Modernization, Health Insurance Tax Credit Administration, and various taxpayer communication and education programs. The IRS also projects this efficiency initiative will lead to a reduction of 41 FTEs.
- **\$22.4 Million Decrease From Increased Electronic Filing Savings.** This decrease results from savings from increased electronic filing. Savings are based on projected growth in electronic filing and continued modernization efforts. As a result of this efficiency initiative, the IRS projects it would need 416 fewer FTEs in submission processing.
- **\$22 Million Decrease From Non-Recurring Savings.** These savings would result from the net reduction of non-recurring, one-time costs associated with various Fiscal Year 2011 enforcement initiatives (e.g., information technology equipment and training).

Program Increases

The IRS is requesting an increase of about \$839 million for (a) enforcement initiatives; (b) infrastructure initiatives; and (c) taxpayer service initiatives. The largest component of the \$839 million increase is \$606 million related to enforcement initiatives. The \$606 million for the enforcement initiatives includes \$243 million for activities the IRS believes will yield direct measurable results through a return on investment (ROI). The IRS estimates that the activities funded by the \$243 million increase will generate \$1.3 billion annually in additional enforcement revenues in Fiscal Year 2014. As stated earlier, many of the initiatives affect more than one appropriation account. Additionally,

the \$839 million in Fiscal Year 2012 program increases are in addition to the increases requested for all five appropriation accounts to reach the Fiscal Year 2011 budget request.

The Fiscal Year 2012 budget request does not separately align the various program increases to the Tax Gap; however, many of the initiatives refer to the Tax Gap. The IRS also states that helping taxpayers understand their obligations under the tax law is critical to improving compliance and addressing the Tax Gap.

IRS Enforcement Initiatives - \$606 million increase¹⁰ focuses on activities targeted at improving compliance through nine multi-year initiatives. These activities form the backbone of the IRS's approach to address the Tax Gap.

The five largest enforcement initiatives are summarized below.

- \$260.3 Million to Ensure Accurate Delivery of Tax Credits. This initiative calls for 834 new FTEs. The IRS expects this initiative will improve the delivery of existing credits through a combination of improved technology tools and increased enforcement staffing. The initiative also funds the information technology and other systems required to implement the new Affordable Care Act's Premium Assistance Tax Credit, which becomes effective in 2014. The IRS expects that this initiative will produce additional annual enforcement revenue of \$183.3 million (an ROI of 4 to 1) in Fiscal Year 2014.
- \$96.7 Million to Increase Coverage to Address Tax Law Changes and Other Compliance Issues (Tax Gap). This initiative calls for 497 new FTEs. The IRS anticipates this initiative will address compliance issues and new responsibilities arising from recent tax law changes included in major legislation such as the *American Recovery and Reinvestment Act of 2009*¹¹ and the Affordable Care Act. This initiative will fund compliance programs needed for new provisions such as direct-pay bonds, new requirements on tax-exempt hospitals, a new fee on manufacturers and importers of branded prescription drugs, and the excise tax on indoor tanning. It will also increase audits of specialty programs (*i.e.*, employment tax, excise tax, and estate and gift tax). The IRS believes this initiative will produce additional annual enforcement revenue of \$80.8 million (an ROI of 3 to 1) in Fiscal Year 2014.
- \$72.6 Million to Increase International Service and Enforcement. This initiative calls for 377 new FTEs. The IRS expects it will be able to implement changes required by enactment of the *Hiring Incentives to Restore*

¹⁰ IRS enforcement initiatives are funded from a variety of appropriations. Therefore, the requested \$606 million increase in enforcement initiatives will not equal the requested \$462 million increase in enforcement appropriations identified on page 3.

¹¹ Pub. L. No. 111-5, 123 Stat. 115.

Employment (HIRE) Act of 2010,¹² with funding for this initiative. The IRS will implement the reporting, disclosure, and withholding requirements and expand coverage of international filings; conduct more in-depth international compliance work; strengthen compliance efforts related to offshore activity; and expand the Global High-Wealth Compliance Group. The IRS predicts that this initiative will produce additional annual enforcement revenue of \$467.1 million (an ROI of 8 to 1) in Fiscal Year 2014.

- **\$58.5 Million to Administer New Statutory Reporting Requirements.** This initiative calls for 187 new FTEs. Recent legislation established significant new information reporting and sharing requirements from third parties (such as employers and health insurance providers), and the exchanges to administer the Affordable Care Act's Premium Assistance Tax Credit, the individual coverage requirement, and the employer responsibility payment. Effective implementation requires significant enhancements to existing information returns systems to handle the additional volumes and new information reporting categories. This initiative also includes resources to implement provisions that allow the IRS to share tax data with State and Federal entities to determine eligibility for the Credit and to ensure the secure exchange of information.
- **\$52 million to Increase Collection Coverage.** This initiative calls for 413 new FTEs. The IRS expects this initiative will expand work on the collection inventory and improve collection processes to bring taxpayers who fail to pay their debt into compliance and produce additional annual enforcement revenue of \$398.3 million (an ROI of 9 to 1) in Fiscal Year 2014.

Infrastructure Initiatives - \$119 million increase focuses on enhancing employee security, developing disaster recovery system capability, and establishing systems to implement various provisions of the Affordable Care Act through four initiatives. The three largest initiatives are summarized below.

- **\$62.5 Million to Implement Individual Coverage Requirement and Employer Responsibility Payments.** This IRS initiative supports the development of information technology, infrastructure, and systems to implement the provisions of the Affordable Care Act that establish shared responsibility payments for both individuals and employers. The IRS requested an additional 65 FTEs for this program initiative. Beginning in 2014, the Affordable Care Act requires individuals who are able to afford health insurance to obtain minimum essential coverage or pay a penalty. If affordable coverage is not available, certain individuals may be eligible for an exemption.

¹² Pub. L. No. 111-147, 124 Stat. 71.

- \$27.5 Million to Update the Integrated Financial System (IFS). The IRS believes updating the IFS will ensure compliance with future Federal accounting requirements; eliminate current work-around processes necessary to support adjustments and reimbursable receivables activities not provided in the current system; eliminate the year-end blackout period and multiple budget versions; and eliminate the month-end accrual process because liabilities would post upon receipt. This initiative calls for five new FTEs.
- \$15.5 million to Enhance Physical Security for Federal Employees. The February 2010 attack against the Austin, Texas, IRS office killed one IRS employee and injured several others. As a result of this attack, this initiative will provide the investments needed to update and/or upgrade the physical security of IRS facilities. The investments are designed to enhance the overall security of IRS employees in the workplace. This initiative calls for 10 new FTEs.

Taxpayer Services Initiatives - \$114 million increase focuses on improving taxpayer service and the IRS.gov website through two initiatives as summarized below.

- \$81.3 Million to Improve Taxpayer Service. The IRS expects this initiative and the \$25.9 million increase requested for Fiscal Year 2011 will provide additional staffing of at least 519 FTEs to address rising demand and increase the customer service representative level of service from the planned target of 71 percent in Fiscal Year 2010 to 80 percent in Fiscal Year 2012, while maintaining a 93 percent customer satisfaction rate for toll-free telephone services. This initiative also includes funding to help taxpayers understand the new tax law provisions and to make related call center and infrastructure changes to handle anticipated inquiries, including questions regarding the Affordable Care Act.
- \$33 Million to Expand Online Options Through IRS.gov Improvements. This IRS initiative will continue the multi-year effort to replace the outdated web portal environment and provide additional online services to taxpayers. This initiative will allow the IRS to continue the replacement of an outdated web portal environment that has reached the end of its useful life with the help of 15 additional FTEs.

Chairman Durbin, Ranking Member Moran, and Members of the Subcommittee, I thank you for the opportunity to provide this statement regarding the Fiscal Year 2012 budget request for the IRS.