



## Testimony

Before the Subcommittee on Oversight, Committee on  
Ways and Means, House of Representatives

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# INTERNAL REVENUE SERVICE

## Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season

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April 7, 2005, was rescheduled for April 14, 2005.



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Highlights of [GAO-05-416T](#), a report to Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

# INTERNAL REVENUE SERVICE

## Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season

### Why GAO Did This Study

The Internal Revenue Service (IRS) has been shifting its priorities from taxpayer service to enforcement and its management of Business Systems Modernization (BSM) from contractors to IRS staff. Although there are sound reasons for these adjustments, they also involve risks.

With respect to the fiscal year 2006 budget request, GAO assessed (1) how IRS proposes to balance its resources between taxpayer service and enforcement programs and the potential impact on taxpayers, (2) the status of IRS's efforts to develop and implement the BSM program, and (3) the progress IRS has made in implementing best practices in developing its Information Technology (IT) operations and maintenance budget. For the 2005 filing season, GAO assessed IRS's performance in processing returns and providing taxpayer service.

### What GAO Recommends

GAO recommends that the Commissioner of Internal Revenue supplement the 2006 budget request with more detailed information on how proposed service reductions would impact taxpayers. GAO has recommendations still outstanding related to BSM management controls and IT budget justification.

[www.gao.gov/cgi-bin/getrpt?GAO-05-416T](http://www.gao.gov/cgi-bin/getrpt?GAO-05-416T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact James R. White (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov).

### What GAO Found

IRS's fiscal year 2006 budget request of \$10.9 billion proposes increased funding for enforcement, but reduced funding for taxpayer service and BSM. However, the potential impact of these changes on taxpayers in either the short- or long-term is unclear, because IRS has not provided details of proposed taxpayer service reductions, and although it is developing long-term goals, they are not yet finalized. Because of the proposed reductions and new and improved taxpayer services in recent years, this is an opportune time to examine the menu of services IRS provides. It may be possible to maintain the overall level of service to taxpayers by offsetting reductions in some areas with new and improved service in other areas.

Taxpayers and IRS are seeing some payoff from the BSM program, with the deployment of initial phases of several modernized systems in 2004. Nevertheless, the BSM program continues to be high-risk, in part, because projects have incurred significant cost increases and schedule delays and the program faces major challenges in areas such as human capital and requirements management. As a result of budget reductions and other factors, IRS has made major adjustments. It is too early to tell what effect these adjustments will have on the program, but they are not without risk and could potentially impact future budgets. Further, the BSM program is based on strategies developed years ago, which, coupled with the delays and changes brought on by budget reductions, indicates that it is time for IRS to revisit its long-term goals, strategy, and plans for BSM. Because of these challenges, IRS is redefining and refocusing the BSM program.

IRS has generally maintained or improved its filing season performance in 2005. Processing is more efficient, the accuracy of answers provided by telephone assistants is improved, and telephone access is relatively comparable to last year. This is particularly noteworthy, because IRS received less funding for taxpayer service in 2005 than it spent in 2004. Because the filing season is not over, the full impact on taxpayers and IRS operations is not yet known. However, there are indications of slippage in telephone access such as more abandoned calls and longer wait times.

IRS Budget Summary for Key Activities, Fiscal Years 2004-2006 (dollars in millions)

	Fiscal year 2004 (enacted)	Fiscal year 2005 (enacted)	Fiscal year 2006 (request)	Percent change (2004-2005)	Percent change (2005-2006)	Percent change (2004-2006)
Taxpayer service	\$3,710	\$3,606	\$3,567	-2.8%	-1.1%	-3.8%
Enforcement	6,052	6,392	6,893	5.6	7.8	13.9
BSM	388	203	199	-47.6	-2.0	-48.7

Source: GAO analysis of IRS data.

Note: Numbers may not add due to rounding.

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Mr. Chairman and Members of the Subcommittee:

We are pleased to participate in the Subcommittee's hearing on the Internal Revenue Service's (IRS) fiscal year 2006 budget request and performance during the 2005 tax filing season.

IRS is in the midst of making significant adjustments to its modernization strategy to better serve taxpayers and ensure their compliance with the nation's tax laws. It is now seven years since the passage of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)<sup>1</sup> and IRS is shifting its priorities from improving taxpayer service to strengthening tax law enforcement efforts. IRS is also adjusting its strategy for managing its Business Systems Modernization (BSM) effort by shifting significant program management responsibilities from contractor to IRS staff. Although there are sound reasons for these adjustments, they also involve risk.

We have reported that IRS has made progress improving taxpayer service since the passage of RRA 98.<sup>2</sup> For example, IRS's telephone assistance is now more accessible and accurate. Further, IRS is more efficient at processing tax returns, in part, because of the growth of electronic filing, and has cut processing staff. IRS has also implemented some modernized information systems and increased its capacity to manage large systems acquisition and development programs.

However, progress has not been uniform. We have reported on large and pervasive declines in IRS's tax law enforcement programs after 1998. We have also reported that a number of systems modernization projects were over budget and behind schedule.<sup>3</sup>

As noted, IRS is shifting its priorities to better address these problems. The risk, as IRS shifts its priorities towards enforcement, is that some of the gains in the quality of taxpayer service could be surrendered. There are

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<sup>1</sup> Pub. L. No. 105-206 (1998).

<sup>2</sup> See for example, [GAO-05-67](#), *Tax Administration: IRS Improved Performance in the 2004 Filing Season, But Better Data on the Quality of Some Services Are Needed* (Washington, D.C.: Nov. 15, 2004).

<sup>3</sup> GAO, *Internal Revenue Service: Assessment of Fiscal Year 2005 Budget Request and 2004 Filing Season Performance*, [GAO-04-560T](#) (Washington, D.C.: Mar. 30, 2004).

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analogous risks associated with moving more of the management of BSM in-house.

With these risks in mind, our statement discusses both IRS's fiscal year 2006 budget request and 2005 filing season performance to date. To address your request, we assessed (1) how IRS proposes to balance its resources between taxpayer service and enforcement programs and the potential impact on taxpayers, (2) the status of IRS's efforts to develop and implement the BSM program, and (3) the progress IRS has made in implementing best practices for developing its information technology (IT) operations and maintenance budget. With respect to the interim results of key 2005 filing season activities, we compared IRS's performance to past years' and goals it set for this year.

Our assessment of the budget request and BSM is based on a comparative analysis of IRS's fiscal year 2002 through 2006 budget requests, funding, expenditures, other documentation, and interviews with IRS officials. Our assessment of the interim results of the filing season is based on comparing IRS's performance this year to previous filing seasons, viewing operations at a processing center, call sites, and walk-in sites, monitoring various production meetings, interviewing IRS and Treasury Inspector General for Tax Administration (TIGTA) officials and paid tax practitioners and other external stakeholders, reviewing TIGTA and other external reports, and reviewing IRS's Web site. For both assessments, we used historical budget and performance data from reports and budget requests used by IRS, Department of Treasury, and Office of Management and Budget (OMB). In past work, we assessed IRS's budget and performance data.<sup>4</sup> Since the data sources and procedures for producing this year's budget and performance data have not significantly changed from prior years, we determined that the budget data and filing season performance data were sufficiently reliable for the purposes of this report. The budget and performance data for fiscal years 2005 and 2006 are subject to change. Regarding our analysis of IRS's BSM program, we primarily used the agency's BSM expenditure plans to determine the status of the program. To assess the reliability of the cost and schedule information contained in these plans, we interviewed applicable IRS officials to gain an understanding of the data and discuss

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<sup>4</sup> GAO, *Tax Administration: IRS Needs to Further Refine Its Tax Filing Season Performance Measures*, [GAO-03-143](#) (Washington, D.C.: Nov. 22, 2002) and GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, [GAO-05-103](#) (Washington, D.C.: Nov. 10, 2004).

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our use of that data. In addition, we checked that information in the plans was consistent with information contained in IRS internal briefings. Accordingly, we determined that the data in the plans were sufficiently reliable for purposes of this statement. We performed our work in Washington, D.C. and Atlanta, Georgia from December 2004 through March 2005, in accordance with generally accepted government auditing standards.

In summary, our assessment shows that:

- IRS's 2006 fiscal year budget request reflects a continuing shift in priorities from improving taxpayer service to strengthening enforcement efforts, but the potential impact of these changes on taxpayers in both the short- and long-term is unclear. IRS is requesting \$10.9 billion, an increase of 3.7 percent over fiscal year 2005 enacted levels. This includes an 8 percent increase for enforcement, and a 1 percent and 2 percent decrease for taxpayer service and BSM, respectively. IRS has not finalized the details on where reductions in taxpayer service would occur. In addition, IRS is developing, but currently lacks, long-term goals that can help IRS inform stakeholders, including the Congress, and aid them in assessing performance and making budget decisions. In light of the current budget environment and IRS's improvements in taxpayer service over the last several years, this is an opportune time to reconsider the menu of services it provides. It may be possible to maintain the overall level of assistance to taxpayers by changing the menu of services offered, offsetting reductions in some areas with new and improved service in other areas.
- IRS has taken important steps forward towards implementing the BSM program by delivering the initial phases of several modernized systems in 2004 and early 2005. Nevertheless, BSM continues to be high risk because, in part, its projects have incurred significant cost increases and schedule delays, and the program continues to face major challenges. As a result of funding reductions and other factors, IRS has made major adjustments to the BSM program, including reducing the management reserve and changing the mix and roles of contractor versus federal staff used to manage the program. It is too early to tell what effect these adjustments will ultimately have on the BSM program, but they are not without risk, could potentially impact future budget requests, and will delay the implementation of certain functionality that was intended to provide benefit to IRS operations and taxpayers. Finally, the BSM program is based on visions and strategies developed years ago, which,

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coupled with the already significant delays the program has experienced and the changes brought on by the budget reductions, indicates that it is time for IRS to revisit its long-term goals, strategy, and plans for BSM, including an assessment of when significant future BSM functionality would be delivered. According to the Associate Chief Information Officer (CIO) for BSM, IRS is redefining and refocusing this program.

- IRS has made progress toward implementing investment management best practices that would improve its budget development and support for its IT operations and maintenance funding requests. For example, the recent release of a new accounting system included an activity-based cost module, which IRS considered to be a necessary action to implement these best practices. However, Office of the Chief Financial Officer officials stated that IRS needs 3 years of actual costs to have the historical data necessary to provide a basis for future budget estimates. Accordingly, they expect that IRS will begin using the activity-based cost module in formulating the fiscal year 2008 budget and will have the requisite 3 years of historical data in time to develop the fiscal year 2010 budget.

Our assessment of the 2005 filing season to date shows that:

- IRS has generally maintained or improved its 2005 filing season performance compared to last year. Electronic filing continues to increase, allowing IRS to continue reducing resources devoted to processing. However, IRS may not meet this year's electronic filing goal and is likely to not meet its goal of 80 percent of all individual tax returns filed electronically by 2007. Access to telephone assistors remains relatively comparable to last year, although there are other indications of slippage in telephone access such as more abandoned calls and longer wait times. The tax law accuracy rate for answers provided via telephone or IRS's Web site has improved. IRS's performance so far in 2005 is good news, considering IRS received \$104 million less in fiscal year 2005 than 2004 for taxpayer services. IRS plans to absorb this reduction, in part, by consolidating paper-processing operations, shifting resources from service to enforcement, and reducing some services—for example, reducing access to telephone assistors—in 2005. However, the filing season is not over, and whether or not IRS will achieve efficiency increases and the impact on IRS operations and taxpayers is not yet known.

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## IRS's Budget Request Continues to Shift Priority from Taxpayer Service to Enforcement, but the Short- and Long-term Impacts on Taxpayers Are Unclear

IRS's fiscal year 2006 budget request reflects a continuing shift in priorities by proposing reductions in taxpayer service and increases in enforcement activities. The request does not provide details about how the reductions will impact taxpayers in the short-term. Nor does IRS have long-term goals; thus the contribution of the fiscal year 2006 budget request to achieving IRS's mission in the long-term is unclear. Because of budget constraints and the progress IRS has made improving the quality of taxpayer services, this is an opportune time to reconsider the menu of services IRS offers.

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## IRS Is Proposing Reductions in Taxpayer Service and BSM and Increases in Enforcement

IRS is requesting \$10.9 billion, which includes just over a 1 percent decrease for taxpayer service, a 2 percent decrease for BSM, and nearly an 8 percent increase for enforcement, as shown in table 1.<sup>5</sup> As table 1 further shows, the changes proposed in the 2006 budget request continue a trend from 2004. In comparison to the fiscal year 2004 enacted budget, the 2006 budget request proposes almost 4 percent less for service, almost 49 percent less for BSM, and nearly 14 percent more for enforcement.<sup>6</sup>

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<sup>5</sup> IRS is proposing a new budget structure beginning in fiscal year 2006. The proposal would integrate support costs and the IT appropriation into taxpayer assistance and operations appropriation with eight program areas involving both taxpayer service and enforcement. See appendix I for information on the new budget structure.

<sup>6</sup> The Administration proposes to fully fund enforcement efforts and costs as contingent appropriations. This would be achieved by using one of two budgetary mechanisms that would allow for an adjustment to total discretionary spending for fiscal year 2006 of not more than \$446 million for IRS tax enforcement.

**Table 1: IRS Budget Summary for Key Activities, Fiscal Years 2004-2006 (dollars in millions)**

	Fiscal year 2004 (enacted)	Fiscal year 2005 (enacted)	Fiscal year 2006 (requested)	Percent change (2004-2005)	Percent change (2005-2006)	Percent change (2004-2006)
Taxpayer Service	\$3,710	\$3,606	\$3,567	-2.8%	-1.1%	-3.8%
Enforcement	6,052	6,392	6,893	5.6	7.8	13.9
BSM	388	203	199	-47.6	-2.0	-48.7

Source: GAO analysis of IRS data.

Note: Numbers may not add due to rounding.

As table 1 also shows, taxpayer service sustained a reduction of \$104 million or 2.8 percent between fiscal years 2004 and 2005. According to IRS officials, the majority of this reduction was the result of consolidating paper-processing operations, shifting resources from service to enforcement, and reducing some services. IRS officials said that this reduction is not expected to adversely impact the services they provide to taxpayers but added that the agency cannot continue to absorb reductions in taxpayer service without beginning to compromise some services.

For fiscal years 2005 and 2006, table 2 shows some details of changes in both dollars and full-time equivalents (FTE).<sup>7</sup> Both are shown because funding changes do not translate into proportional changes in FTEs due to cost increases for salaries, rent, and other items. For example, the \$39 million or 1.1 percent reduction in taxpayer service translates into a reduction of 1,385 FTEs or 3.6 percent. Similarly, the over \$500 million or 7.8 percent increase in enforcement spending translates into an increase of 1,961 FTEs or 3.4 percent.

<sup>7</sup> According to IRS, an FTE is the equivalent of one person working full time for 1 year without overtime.

**Table 2: IRS Requested Changes in Funding for Taxpayer Service and Enforcement, Fiscal Years 2005 and 2006 (requested)**

Program activities	Fiscal year 2005 (estimated)		Fiscal year 2006 (requested)		Change fiscal year 2005 – fiscal year 2006	
	Dollars (in millions)	Full-time equivalents	Dollars (in millions)	Full-time equivalents	Dollars (in millions)	Full-time equivalents
Assistance	\$1,829	20,798	\$1,806	20,160	- \$23	- 638
Outreach	500	2,473	466	1,905	- 34	- 568
Processing	1,276	15,695	1,295	15,516	19	- 179
<b>Taxpayer service subtotal</b>	<b>3,606</b>	<b>38,966</b>	<b>3,567</b>	<b>37,581</b>	<b>- 39</b>	<b>- 1,385</b>
Research	154	1,119	158	1,119	4	0
Examination	3,478	31,498	3,712	32,284	234	786
Collection	1,826	18,023	1,991	18,815	165	792
Investigation	682	4,899	767	5,250	85	351
Regulatory	253	1,912	265	1,944	12	32
<b>Enforcement subtotal</b>	<b>6,392</b>	<b>57,451</b>	<b>6,893</b>	<b>59,412</b>	<b>500</b>	<b>1,961</b>
<b>Taxpayer service and enforcement total</b>	<b>9,998</b>	<b>96,417</b>	<b>10,460</b>	<b>96,993</b>	<b>462</b>	<b>576</b>

Source: GAO analysis of IRS data.

Note: Numbers may not add due to rounding.

The difference between changes in dollars and FTEs could be even larger because of unbudgeted expenses. Unbudgeted expenses have consumed some of IRS’s budget increases and internal savings increases over the last few years. Unbudgeted expenses include unfunded portions of annual salary increases, which can be substantial given IRS’s large workforce, and other costs such as higher-than-budgeted rent increases. According to IRS officials, these unbudgeted expenses accounted for over \$150 million in each of the last 4 years.

An IRS official also told us they anticipate having to cover unbudgeted expenses in 2006. As of March 2005, IRS officials were projecting unbudgeted salary increases of at least \$40 million. This projection could change since potential federal salary increases for 2006 have not been determined.

**IRS Is Proposing \$39 Million Less for Taxpayer Service, but the Impact on Taxpayers Is Unclear**

The budget request provides some detail on how IRS plans to absorb cost increases in the taxpayer service budget. IRS is proposing a gross reduction of over \$134 million in taxpayer service from reexamining the budget’s base and plans to use more than \$95 million of it to cover annual increases such as salaries. This leaves a net reduction of nearly \$39 million

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or 1.1 percent in the taxpayer service budget. The extent to which IRS is able to achieve the gross reductions will impact its ability to use the funds as anticipated.

Decisions on how the \$134 million gross reduction would be absorbed were not finalized prior to releasing the budget. According to IRS officials, some of the reductions would result from efficiency gains such as reducing printing and postage costs; however, others would result from reductions in the services provided to taxpayers such as shortening the hours of toll-free telephone service operations. The officials also said most decisions have now been made about general areas for reduction and most changes will not be readily apparent to taxpayers.

Although IRS has made general decisions about the reductions, many of the details have yet to be determined. Therefore, the extent of the impact on taxpayers in the short term is unclear. For example, IRS plans to reduce dependence on field assistance, including walk-in sites, but has not reached a final decision on how to reduce services. Table 3 provides further detail on how IRS is proposing to reduce funding and resources for taxpayer service.

**Table 3: IRS Requested Changes in Funding and Full-time Equivalents for Taxpayer Service, Fiscal Years 2005 and 2006**

Program activities	Fiscal year 2005 (actual)		Fiscal year 2006 (requested)		Change fiscal year 2005-2006	
	Dollars (in millions)	Full-time equivalents	Dollars (in millions)	Full-time equivalents	Dollars (in millions)	Full-time equivalents
<b>Assistance</b>						
Electronic	\$1,536	17,745	\$1,557	17,721	\$21	-24
Field	274	2,796	230	2,181	-44	-615
EITC assistance	19	258	19	258	< 1	0
<b>Assistance total</b>	<b>1,829</b>	<b>20,798</b>	<b>1,806</b>	<b>20,160</b>	<b>-23</b>	<b>-638</b>
<b>Outreach</b>						
Publication & Media	291	821	276	520	-15	-301
Taxpayer Education & Communication	203	1,592	184	1,326	-19	-266
EITC Outreach	7	60	7	60	< 1	0
<b>Outreach total</b>	<b>500</b>	<b>2,473</b>	<b>466</b>	<b>1,905</b>	<b>-34</b>	<b>-568</b>
<b>Processing</b>	<b>1,276</b>	<b>15,695</b>	<b>1,295</b>	<b>15,516</b>	<b>19</b>	<b>-179</b>
<b>Taxpayer service total</b>	<b>3,606</b>	<b>38,966</b>	<b>3,568</b>	<b>37,581</b>	<b>-39</b>	<b>-1,385</b>

Source: GAO analysis of IRS data.

Note: Numbers may not add due to rounding.

**IRS Continues to Request Significant Increases for Enforcement to Build on Recent Hiring Gains**

IRS's fiscal year 2006 budget request is the sixth consecutive year the agency has requested additional staffing for enforcement. However, up until last year, IRS was unable to increase enforcement staffing; unbudgeted costs and other priorities consumed the budget increase.

IRS's proposal for fiscal year 2006, if implemented as planned, would return enforcement staffing in these occupations to their highest levels since 1999. Of the more than \$500 million increase requested for 2006, about \$265 million would fund enforcement initiatives, over \$182 million would be used in part for salary increases, and over \$55 million is a proposal to transfer funding authority from the Department of Justice's Interagency Crime and Drug Enforcement. The \$500 million increase would be supplemented by internal enforcement savings of \$88 million. As is the case with taxpayer service savings, the extent to which IRS achieves enforcement savings will affect its ability to fund the new enforcement initiatives.

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The \$265 million for new enforcement initiatives consist of:

- \$149.7 million and 920 FTEs to attack corrosive non-compliance activity driving the tax gap such as abusive trusts and shelters, including offshore credit cards and organized tax resistance;
- \$51.8 million and 236 FTEs to detect and deter corrosive corporate non-compliance to attack complex abusive tax avoidance transactions on a global basis and challenge those who promote their use;
- \$37.9 million and 417 FTEs to increase individual taxpayer compliance by identifying and implementing actions to address non-compliance with filing requirements; increasing Automated Underreporter resources to address the reporting compliance tax gap; increasing audit coverage; and expanding collection work in walk-in sites;
- \$14.5 million and 77 FTEs to combat abusive transactions by entities with special tax status by initiating examinations more promptly, safeguarding compliant customers from unscrupulous promoters, and increasing vigilance to ensure that the assets of tax-exempt organizations are put to their intended tax-preferred purpose and not misdirected to fund terrorism or for private gain; and
- \$10.8 million and 22 FTEs to curtail fraudulent refund crimes.

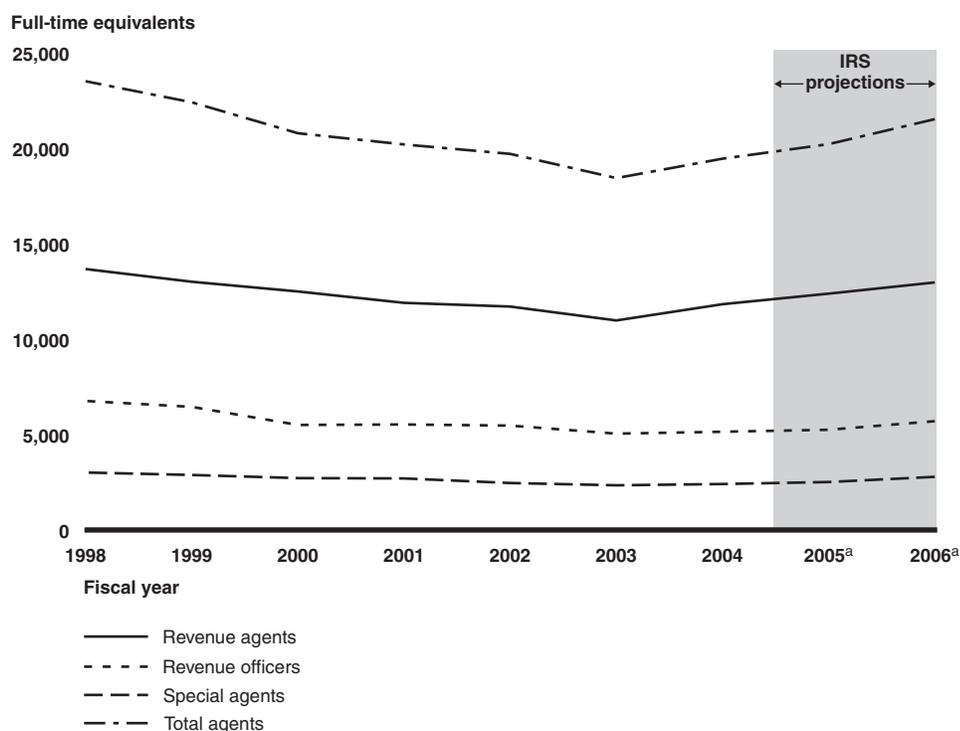
The \$88 million in internal savings would be reinvested to perform the following activities:

- \$66.7 million and 585 FTEs to devote resources to front-line enforcement activities;
- \$14.9 million and 156 FTEs to, in part, address bankruptcy-related taxpayer questions; and
- \$6.7 million and 52 FTEs to address complex, high-risk issues such as compliance among tax professionals.

In the past, IRS has had trouble achieving enforcement staffing increases because other priorities, including unbudgeted expenses, have absorbed additional funds. IRS achieved some gains in 2004 and expects modest gains in 2005. Figure 1 shows that the number of revenue agents (those who audit complex returns), revenue officers (those who do field

collection work), and special agents (those who perform criminal investigations) decreased over 21 percent between 1998 and 2003, but increased almost 6 percent from 2003 to 2004.

**Figure 1: Revenue Agents, Revenue Officers, and Special Agents, Fiscal Years 1998-2006**



Source: GAO analysis of IRS data.

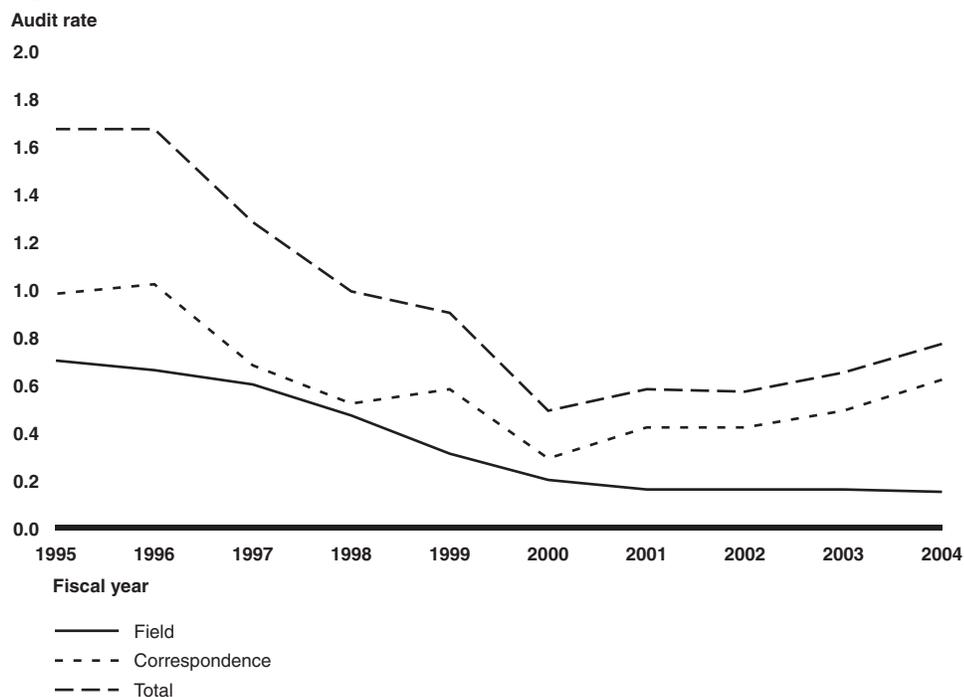
<sup>a</sup>Fiscal years 2005 and 2006 are IRS projections.

IRS's recent gains in enforcement staffing are encouraging, as tax law enforcement continues to remain an area of high risk for the federal government because the resources IRS has dedicated to enforcing the tax laws have declined, while IRS's enforcement workload—measured by the number of taxpayer returns filed—has continually increased.<sup>8</sup> Figure 2 shows the trend in field, correspondence, and total audit rates since 1995. Field audits involve face-to-face audits and correspondence audits are

<sup>8</sup> GAO, *High Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005).

typically less complex involving communication through notices. IRS experienced steep declines in audit rates from 1995 to 1999, but the audit rate—the proportion of tax returns that IRS audits each year—has slowly increased since 2000. The figure shows that the increase in total audit rates of individual filers has been driven mostly by correspondence audits, while more complex field audits, continue to decline.

**Figure 2: Audit Rate of Individual Income Tax Returns, Fiscal Years 1995-2004**



Source: GAO analysis of IRS data.

The link between the decline in enforcement staff and the decline in enforcement actions, such as audits, is complicated, and the real impact on taxpayers’ rate of voluntary compliance is not known. This leaves open the question of whether the declines in IRS’s enforcement programs are eroding taxpayers’ incentives to voluntarily comply. IRS’s National Research Program (NRP) recently completed a study on compliance by individual tax filers based on tax data provided on 2001 tax returns. The study estimated that the tax gap—the difference between what taxpayers owe and what they pay—is at least \$312 billion per year as of 2001 and could be as large as \$353 billion. This study is important for several

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reasons beyond measuring compliance. It is intended to help IRS better target its enforcement actions, such as audits, on non-compliant taxpayers, and minimize audits of compliant taxpayers. It should also help IRS better understand the impact of taxpayer service on compliance.

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### IRS Is Developing Long-term Goals That Can Be Used to Assess Performance and Make Budget Decisions

IRS is developing but currently lacks long-term goals that can be used to assess performance and make budget decisions.<sup>9</sup> Long-term goals and results measurement are a component of the statutory strategic planning and management framework that the Congress adopted in the Government Performance and Results Act of 1993.<sup>10</sup> As a part of this comprehensive framework, long-term goals that are linked to annual performance measures can help guide agencies when considering organizational changes and making resource decisions.

A recent Program Assessment Rating Tool (PART) review conducted by OMB reported that IRS lacks long-term goals.<sup>11</sup> As a result, IRS has been working to identify and establish long-term goals for all aspects of its operations for over a year. IRS officials said these goals will be finalized and provided publicly as an update to the agency's strategic plan before May 2005.

For IRS and its stakeholders, such as the Congress, long-term goals can be used to assess performance and progress towards these goals, and determine whether budget decisions contribute to achieving those goals.

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<sup>9</sup> IRS has one long-term goal set by the Congress in RRA 98 for IRS to have 80 percent of all individual income tax returns filed electronically.

<sup>10</sup> Pub. L. No. 103-62 (1993). The Government Performance and Results Act of 1993 seeks to improve the management of federal programs, as well as their effectiveness and efficiency, by requiring executive agencies to prepare multiyear strategic plans, annual performance plans, and annual performance reports. Under the Act, strategic plans are the starting point for setting goals and measuring progress towards them. The Act requires executive agencies to develop strategic plans that include an agency's mission statement, long-term general goals, and the strategies that the agency will use to achieve these goals. The plans should also explain the key external factors that could significantly affect achievement of these goals, and describe how long-term goals will be related to annual performance goals.

<sup>11</sup> The PART was applied during the fiscal year 2004 budget cycle to "programs" selected by OMB. The PART includes general questions in each of four broad topics to which all programs are subjected: (1) program purpose and design, (2) strategic planning, (3) program management, and (4) program results (i.e., whether a program is meeting its long-term and annual goals). OMB also makes an overall assessment on program effectiveness.

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Without long-term goals, the Congress and other stakeholders are hampered in evaluating whether IRS is making satisfactory long-term progress. Further, without such goals, the extent to which IRS's 2006 budget request would help IRS achieve its mission over the long-term is unclear.

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## This Is an Opportune Time to Review IRS's Menu of Taxpayer Services

For at least two reasons, this is an opportune time to review the menu of taxpayer services that IRS provides. First, IRS's budget for taxpayer services was reduced in 2005 and an additional reduction is proposed for 2006. As already discussed, these reductions have forced IRS to propose scaling back some services. Second, as we have reported, IRS has made significant progress in improving the quality of its taxpayer services. For example, IRS now provides many Internet services that did not exist a few years ago and has noticeably improved the quality of telephone services. This opens up the possibility of maintaining the overall level of taxpayer service but with a different menu of service choices. Cuts in selected services could be offset by the new and improved services.

Generally, as indicated in the budget, the menu of taxpayer services that IRS provides covers assistance, outreach, and processing. Assistance includes answering taxpayer questions via telephone, correspondence, and face-to-face at its walk-in sites. Outreach includes educational programs and the development of partnerships. Processing includes issuing millions of tax refunds.

When considering program reductions, we support a targeted approach rather than across-the-board cuts.<sup>12</sup> A targeted approach helps reduce the risk that effective programs are reduced or eliminated while ineffective or lower priority programs are maintained.

With the above reasons in mind for reconsidering IRS's menu of services, we have compiled a list of options for targeted reductions in taxpayer service. The options on this list are not recommendations but are intended to contribute to a dialogue about the tradeoffs faced when setting IRS's budget. The options presented meet at least one of the following criteria

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<sup>12</sup> GAO, *21<sup>st</sup> Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

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that we generally use to evaluate programs or budget requests.<sup>13</sup> These criteria include that the activity

- duplicates other efforts that may be more effective and/or efficient;
- historically does not meet performance goals or provide intended results as reported by GAO, TIGTA, IRS, or others;
- experiences a continued decrease in demand;
- lacks adequate oversight, implementation and management plans, or structures and systems to be implemented effectively;
- has been the subject of actual or requested funding increases that cannot be adequately justified; or
- has the potential to make an agency more self-sustaining by charging user fees for services provided.

We recognize that the options listed below involve tradeoffs. In each case, some taxpayers would lose a service they use. However, the savings could be used to help maintain the quality of other services. We also want to give IRS credit for identifying savings, including some on this list. The options include

- closing walk-in sites. As the filing season section of this testimony discusses, taxpayer demand for walk-in services has continued to decrease and staff answer a more limited number of tax law questions in person than staff answer via telephone.
- limiting the type of telephone questions answered by IRS assistors. IRS assistors still answer some refund status questions even though IRS provides automated answers via telephone and its Web site.
- mandating electronic filing for some filers such as paid preparers or businesses. As noted, efficiency gains from electronic filing have enabled IRS to consolidate paper processing operations.

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<sup>13</sup> We selected these criteria from a variety of sources based on generally accepted government auditing standards.

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- charging for services. For example, IRS provides paid preparers with information on federal debts owed by taxpayers seeking refund anticipation loans.

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## Progress in BSM Implementation, but the Program Remains High Risk and Budget Reductions Have Resulted in Significant Adjustments

Although IRS has implemented important elements of the BSM program, much work remains. In particular, the BSM program remains at high risk and has a long history of significant cost overruns and schedule delays. Furthermore, budget reductions have resulted in significant adjustments to the BSM program, although it is too early to determine their ultimate effect.

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## IRS Has Made Progress in Implementing BSM, but Much Work Remains

IRS has long relied on obsolete automated systems for key operational and financial management functions, and its attempts to modernize these aging computer systems span several decades. IRS's current modernization program, BSM, is a highly complex, multibillion-dollar program that is the agency's latest attempt to modernize its systems. BSM is critical to supporting IRS's taxpayer service and enforcement goals. For example, BSM includes projects to allow taxpayers to file and retrieve information electronically and to provide technology solutions to help reduce the backlog of collections cases. BSM is important for another reason. It allows IRS to provide the reliable and timely financial management information needed to account for the nation's largest revenue stream and better enable the agency to justify its resource allocation decisions and congressional budgetary requests.

Since our testimony before this subcommittee on last year's budget request, IRS has deployed initial phases of several modernized systems under its BSM program. The following provides examples of the systems and functionality that IRS implemented in 2004 and the beginning of 2005.

- *Modernized e-File (MeF)*. This project is intended to provide electronic filing for large corporations, small businesses, and tax-exempt organizations. The initial releases of this project were implemented in June and December 2004, and allowed for the electronic filing of forms and schedules for the form 1120 (corporate tax return) and form 990 (tax-exempt organizations' tax return). IRS reported that, during the

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2004 filing season, it accepted over 53,000 of these forms and schedules using MeF.

- *e-Services*. This project created a Web portal and provided other electronic services to promote the goal of conducting most IRS transactions with taxpayers and tax practitioners electronically. IRS implemented e-Services in May 2004. According to IRS, as of late March 2005, over 84,000 users have registered with this Web portal.
- *Customer Account Data Engine (CADE)*. CADE is intended to replace IRS's antiquated system that contains the agency's repository of taxpayer information and, therefore, is the BSM program's linchpin and highest priority project. In July 2004 and January 2005, IRS implemented the initial releases of CADE, which have been used to process filing year 2004 and 2005 1040EZ returns, respectively, for single taxpayers with refund or even-balance returns. According to IRS, as of March 16, 2005, CADE had processed over 842,000 tax returns so far this filing season.
- *Integrated Financial System (IFS)*. This system replaces aspects of IRS's core financial systems and is ultimately intended to operate as its new accounting system of record. The first release of this system became fully operational in January 2005.

Although IRS is to be applauded for delivering such important functionality, the BSM program is far from complete. Future deliveries of additional functionality of deployed systems and the implementation of other BSM projects are expected to have a significant impact on IRS's taxpayer services and enforcement capability. For example, IRS has projected that CADE will process about 2 million returns in the 2005 filing season. However, the returns being processed in CADE are the most basic and constitute less than 1 percent of the total tax returns expected to be processed during the current filing season. IRS expects the full implementation of CADE to take several more years. Another BSM project—the Filing and Payment Compliance (F&PC) project—is expected to increase (1) IRS's capacity to treat and resolve the backlog of delinquent taxpayer cases, (2) the closure of collection cases by 10 million annually by 2014, and (3) voluntary taxpayer compliance. As part of this project, IRS plans to implement an initial limited private debt collection capability in January 2006, with full implementation of this aspect of the F&PC project to be delivered by January 2008 and additional functionality to follow in later years.

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## BSM Program Has History of Cost Increases and Schedule Delays and Is High Risk

The BSM program has a long history of significant cost increases and schedule delays, which, in part, has led us to report this program as high-risk since 1995.<sup>14</sup> Appendix II provides the history of the BSM life-cycle cost and schedule variances. In January 2005 letters to congressional appropriation committees, IRS stated that it had showed a marked improvement in significantly reducing its cost variances. In particular, IRS claimed that it reduced the variance between estimated and actual costs from 33 percent in fiscal year 2002 to 4 percent in fiscal year 2004. However, we do not agree with the methodology used in the analysis supporting this claim. Specifically, (1) the analysis did not reflect actual costs, instead it reflected changes in cost estimates (i.e., budget allocations) for various BSM projects; (2) IRS aggregated all of the changes in the estimates associated with the major activities for some projects, such as CADE, which masked that monies were shifted from future activities to cover increased costs of current activities; and (3) the calculations were based on a percentage of specific fiscal year appropriations, which does not reflect that these are multiyear projects.

In February 2002 we expressed concern over IRS's cost and schedule estimating and made a recommendation for improvement.<sup>15</sup> IRS and its prime systems integration support (PRIME) contractor have taken action to improve their estimating practices, such as developing a cost and schedule estimation guidebook and developing a risk-adjustment model to include an analysis of uncertainty. These actions may ultimately result in more realistic cost and schedule estimates, but our analysis of IRS's expenditure plans<sup>16</sup> over the last few years shows continued increases in estimated project life-cycle costs (see fig. 3).

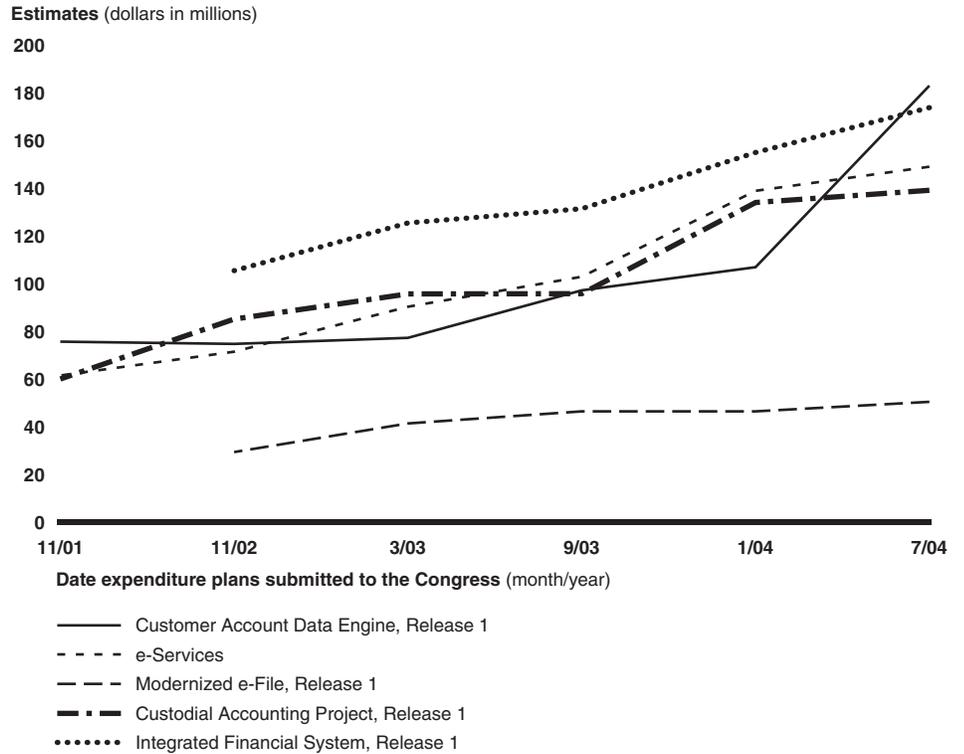
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<sup>14</sup> For our latest high-risk report, please see GAO, *High-Risk Series: An Update*, [GAO-05-207](#) (Washington, D.C., January 2005).

<sup>15</sup> GAO, *Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload*, [GAO-02-356](#) (Washington, D.C.: Feb. 28, 2002).

<sup>16</sup> BSM funds are unavailable until the IRS submits to congressional appropriations committees for approval a modernization expenditure plan that (1) meets the OMB capital planning and investment control review requirements; (2) complies with IRS's enterprise architecture; (3) conforms with IRS's enterprise life-cycle methodology; (4) is approved by IRS, the Department of the Treasury, and OMB; (5) is reviewed by GAO; and (6) complies with acquisition rules, requirements, guidelines, and systems acquisition management practices.

**Figure 3: Life-cycle Cost Estimates for Key BSM Projects**



Source: GAO analysis of IRS data.

The Associate CIO for BSM stated that he believes that IRS's cost and schedule estimating has improved in the past year. In particular, he pointed out that IRS met its cost and schedule goals for the implementation of the latest release of CADE, which allowed the agency to use this system to process certain 1040EZ forms in the 2005 filing season. It is too early to tell whether this signals a fundamental improvement in IRS's ability to accurately forecast project costs and schedules.

The reasons for IRS's cost increases and schedule delays vary. However, we have previously reported that they are due, in part, to weaknesses in management controls and capabilities. We have previously made recommendations to improve BSM management controls, and IRS has implemented or begun to implement these recommendations. For example, in February 2002, we reported that IRS had not yet defined or implemented an IT human capital strategy, and recommended that IRS develop plans for

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obtaining, developing, and retaining requisite human capital resources.<sup>17</sup> In September 2003, TIGTA reported that IRS had made significant progress in developing a human capital strategy but that it needed further development. In August 2004, the current Associate CIO for BSM identified the completion of a human capital strategy as a high priority. Among the activities that IRS is implementing are prioritizing its BSM staffing needs and developing a recruiting plan. IRS has also identified, and is addressing, other major management challenges in areas such as requirements, contract, and program management. For example, poorly defined requirements have been among the significant weaknesses that have been identified as contributing to project cost overruns and schedule delays. As part of addressing this problem, in March 2005, the IRS BSM office established a requirements management office, although a leader has not yet been hired.

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## IRS Is Adjusting the BSM Program in Response to Budget Reductions

The BSM program is undergoing significant changes as it adjusts to reductions in its budget. Figure 4 illustrates the BSM program's requested and enacted budgets for fiscal years 2004 through 2006.<sup>18</sup> For fiscal year 2005, IRS received about 29 percent less funding than it requested (from \$285 million to \$203.4 million). According to the Senate report for the fiscal year 2005 Transportation, Treasury, and General Government appropriations bill, in making its recommendation to reduce BSM funding, the Senate Appropriations Committee was concerned about the program's cost overruns and schedule delays. In addition, the committee emphasized that in providing fewer funds, it wanted IRS to focus on its highest priority projects, particularly CADE.<sup>19</sup> In addition, IRS's fiscal year 2006 budget request reflects an additional reduction of about 2 percent, or about \$4.4 million, from the fiscal year 2005 appropriation.

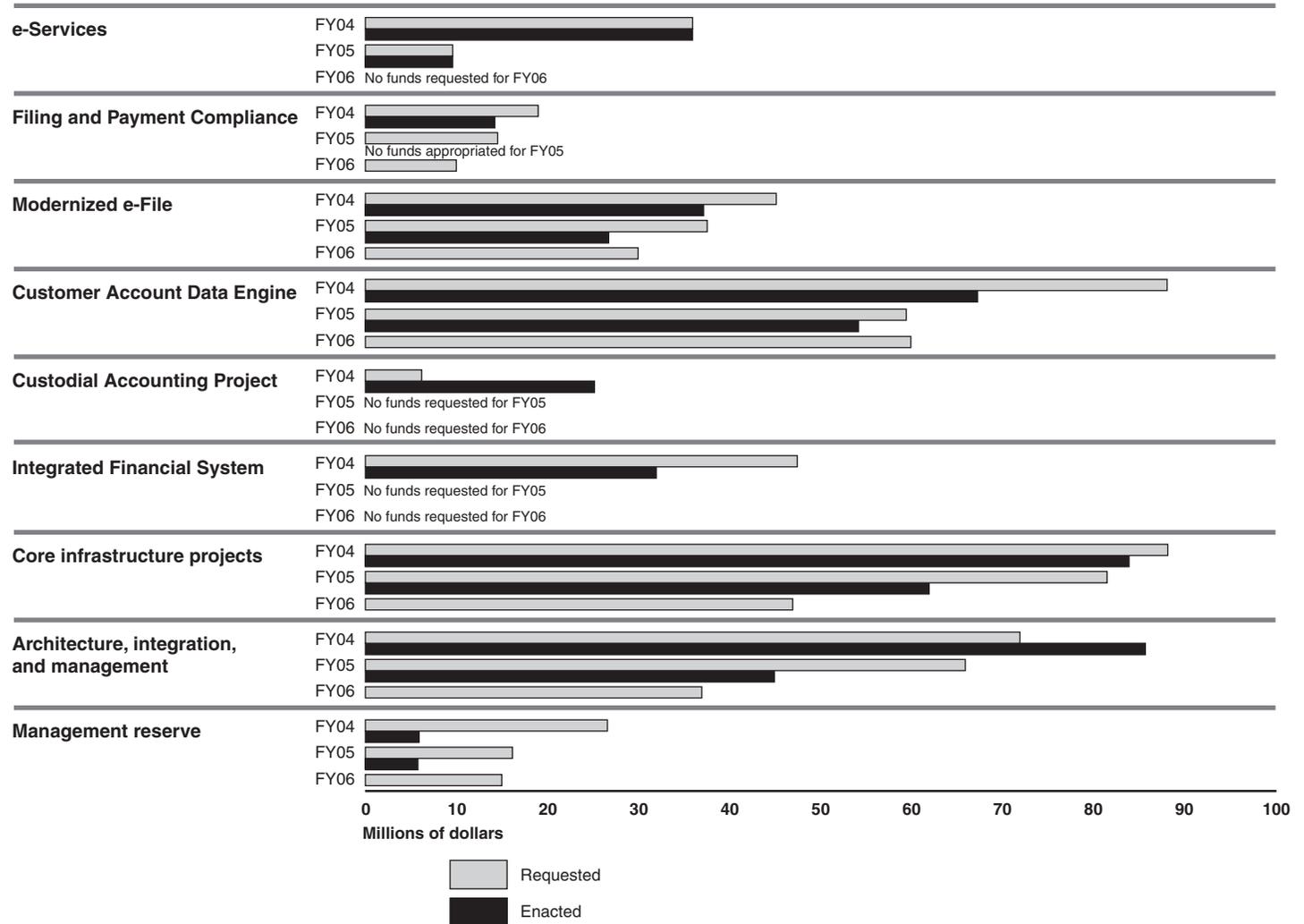
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<sup>17</sup> [GAO-02-356](#).

<sup>18</sup> IRS uses the appropriated funds to cover contractor costs related to the BSM program. IRS funds internal costs for managing BSM with another appropriation. These costs are not tracked separately for BSM-related activities.

<sup>19</sup> U.S. Senate, Senate Report 108-342.

**Figure 4: Changes in the BSM budget (dollars in millions)<sup>a</sup>**



Source: IRS.

<sup>a</sup> The BSM account authorizes funds to be obligated for 3 years.

It is too early to tell what effect the budget reductions will ultimately have on the BSM program. However, the significant adjustments that IRS is making to the program to address these reductions are not without risk, could potentially impact future budget requests, and will delay the implementation of certain functionality that was intended to provide benefit to IRS operations and the taxpayer. For example:

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- *Reductions in Management reserve/project risk adjustments.* In response to the fiscal year 2005 budget reduction, IRS reduced the amount that it had allotted to program management reserve and project risk adjustments by about 62 percent (from about \$49.1 million to about \$18.6 million).<sup>20</sup> If BSM projects have future cost overruns that cannot be covered by the depleted reserve, this reduction could result in (1) increased budget requests in future years or (2) delays in planned future activities (e.g., delays in delivering promised functionality) to use those allocated funds to cover the overruns.
  - *Shifts of BSM management responsibility from the PRIME contractor to IRS.* Due to budget reductions and IRS's assessment of the PRIME contractor's performance, IRS decided to shift significant BSM responsibilities for program management, systems engineering, and business integration from the PRIME contractor to IRS staff. For example, IRS staff are assuming responsibility for cost and schedule estimation and measurement, risk management, integration test and deployment, and transition management. There are risks associated with this decision. To successfully accomplish this transfer, IRS must have the management capability to perform this role. Although the BSM program office has been attempting to improve this capability through, for example, implementation of a new governance structure and hiring staff with specific technical and management expertise, IRS has had significant problems in the past managing this and other large development projects, and acknowledges that it has major challenges to overcome in this area.
  - *Suspension of the Custodial Accounting Project (CAP).* Although the initial release of CAP went into production in September 2004, IRS has decided not to use this system and to stop work on planned improvements due to budget constraints. According to IRS, it made this decision after it evaluated the business benefits and costs to develop and maintain CAP versus the benefits expected to be provided by other projects, such as CADE. Among the functionality that the initial releases of CAP were expected to provide were (1) critical control and reporting capabilities mandated by federal financial management laws; (2) a traceable audit trail to support financial reporting; and (3) a subsidiary ledger to accurately and promptly identify, classify, track, and report

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<sup>20</sup> We did not include in our calculations, reductions to specific project risk adjustment amounts that were made for reasons other than the fiscal year 2005 budget reduction.

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custodial revenue transactions and unpaid assessments. With the suspension of CAP, it is now unclear how IRS plans to replace the functionality this system was expected to provide, which was intended to allow the agency to make meaningful progress toward addressing long-standing financial management weaknesses. IRS is currently evaluating alternative approaches to addressing these weaknesses.

- *Reductions in planned functionality.* According to IRS, the fiscal year 2006 funding reduction will result in delays in planned functionality for some of its BSM projects. For example, IRS no longer plans to include Form 1041 (the income tax return for estates and trusts) in the fourth release of Modernized e-File, which is expected to be implemented in fiscal year 2007.

The BSM program is based on visions and strategies developed in 2000 and 2001. The age of these plans, in conjunction with the significant delays already experienced by the program and the substantive changes brought on by budget reductions, indicate that it is time for IRS to revisit its long-term goals, strategy, and plans for BSM. Such an assessment would include an evaluation of when significant future BSM functionality would be delivered. IRS's Associate CIO for BSM has recognized that it is time to recast the agency's BSM strategy because of changes that have occurred subsequent to the development of the program's initial plans. According to this official, IRS is redefining and refocusing the BSM program, and he expects this effort to be completed by the end of this fiscal year.

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## Additional Actions Needed to Improve Budgeting for IT Operations and Maintenance

IRS has requested about \$1.62 billion for IT operations and maintenance in fiscal year 2006, within its proposed new Tax Administration and Operations account. Under the prior years' budget structure, these funds were included in a separate account, for which IRS received an appropriation of about \$1.59 billion in fiscal year 2005. The \$1.62 billion requested in fiscal year 2006 is intended to fund the personnel costs for IT staff (including staff supporting the BSM program) and activities such as IT security, enterprise networks, and the operations and maintenance costs of its current systems. We have previously expressed concern that IRS does not employ best practices in the development of its IT operations and

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maintenance budget request.<sup>21</sup> Although IRS has made progress in addressing our concern, more work remains.

The Paperwork Reduction Act (PRA) requires federal agencies to be accountable for their IT investments and responsible for maximizing the value and managing the risks of their major information systems initiatives. The Clinger-Cohen Act of 1996 establishes a more definitive framework for implementing the PRA's requirements for IT investment management. It requires federal agencies to focus more on the results they have achieved and introduces more rigor and structure into how agencies are to select and manage IT projects. In addition, leading private- and public-sector organizations have taken a project- or system-centric approach to managing not only new investments but also operations and maintenance of existing systems. As such, these organizations

- identify operations and maintenance projects and systems for inclusion in budget requests;
- assess these projects or systems on the basis of expected costs, benefits, and risks to the organization;
- analyze these projects as a portfolio of competing funding options; and
- use this information to develop and support budget requests.

This focus on projects, their outcomes, and risks as the basic elements of analysis and decision making is incorporated in the IT investment management approach that is recommended by OMB and GAO. By using these proven investment management approaches for budget formulation, agencies have a systematic method, on the basis of risk and return on investment, to justify what are typically substantial information systems operations and maintenance budget requests.

In our assessment of IRS's fiscal year 2003 budget request, we reported that the agency did not develop its information systems operations and maintenance request in accordance with the investment management approach used by leading organizations. We recommended that IRS prepare its future budget requests in accordance with these best

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<sup>21</sup> GAO, *Internal Revenue Service: Improving Adequacy of Information Systems Budget Justification*, GAO-02-704 (Washington, D.C., June 28, 2002).

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practices.<sup>22</sup> To address our recommendation, IRS agreed to take a variety of actions, which it has made progress in implementing. For example, IRS stated that it planned to develop an activity-based cost model to plan, project, and report costs for business tasks/activities funded by the information systems budget. The recent release of IFS included an activity-based cost module, but IRS does not currently have historical cost data to populate this module. According to officials in the Office of the Chief Financial Officer, IRS is in the process of accumulating these data. These officials stated that IRS needs 3 years of actual costs to have the historical data that would provide a basis for future budget estimates. Accordingly, these officials expected that IRS would begin using the IFS activity-based cost module in formulating the fiscal year 2008 budget request and would have the requisite 3 years' of historical data in time to develop the fiscal year 2010 budget request. In addition, IRS planned to develop a capital planning guide to implement processes for capital planning and investment control, budget formulation and execution, business case development, and project prioritization. IRS has developed a draft guide, which is currently under review by IRS executives, and IRS expects it to become policy on October 1, 2005. Although progress has been made in implementing best practices in the development of the IT operations and maintenance budget, until these actions are completely implemented IRS will not be able to ensure that its request is adequately supported.

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**So Far This Filing Season IRS Has Generally Maintained or Improved Performance, Including Telephone Accuracy, with Less Funding**

Results to date show IRS has generally maintained or improved its 2005 filing season performance in key areas compared to last year despite a decrease in the 2005 budget for taxpayer service. These key areas are paper and electronic processing, telephone assistance, IRS's Web site, and walk-in assistance. Table 4 shows performance to date in these four areas.

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<sup>22</sup> GAO-02-704.

**Table 4: IRS Performance in the First Weeks of the Filing Season, 2002-2005**

<b>Volume in thousands</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
<b>Actual returns processed<sup>a</sup></b>				
Paper	24,491	22,117	20,232	17,607
Electronic	35,067	38,627	42,988	45,848
<b>Telephone assistance</b>				
Total calls <sup>b</sup>	34,489	27,905	29,058	23,340
Answered by assistors	9,208	9,434	10,116	9,421
Answered by automation	25,281	18,471	18,942	13,919
Customer service representative level of service	62%	82%	84%	83%
Average speed of answer <sup>c</sup>	227 seconds	183 seconds	199 seconds	235 seconds
Accounts accuracy rate estimates <sup>d</sup>	88% +/- 1%	88% +/- 1%	89% +/- 1%	92% +/- 1%
Tax law accuracy rate estimates <sup>d</sup>	84% +/- 1%	81% +/- 1%	76% +/- 1%	87% +/- 1%
<b>Internet assistance</b>				
Forms and publications downloaded <sup>e</sup>	N/A	N/A	N/A	70,321
Refund status inquiries <sup>f</sup>	N/A	9,300	14,300	16,400
<b>Walk-in assistance</b>				
Total walk-in contacts <sup>g</sup>	N/A	2,740	2,433	2,163
Returns prepared at IRS walk-in sites <sup>h</sup>	436	291	186	145
Returns prepared at volunteer sites <sup>i</sup>	466	594	741	915

Source: IRS.

<sup>a</sup> From January 1 to March 22, 2002; March 21, 2003; March 19, 2004; and March 18, 2005.

<sup>b</sup> Total calls (i.e., calls answered by assistors and automation) and CSR level of service are based on actual counts from January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005. The 2002 totals include increased call demand as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16 (2001)).

<sup>c</sup> From January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005.

<sup>d</sup> Based on a representative sample estimated at the 90 percent confidence level from January to February 2002, 2003, 2004, and 2005.

<sup>e</sup> As of February 28, 2005.

<sup>f</sup> From January 1 to March 20, 2003; 2004; and 2005.

<sup>g</sup> From January 1 to March 15, 2003; March 13, 2004; and March 12, 2005.

<sup>h</sup> From January 1 to March 16, 2002; March 15, 2003; March 13, 2004; and March 12, 2005.

<sup>i</sup> From January 1 to March 9, 2002; March 8, 2003; March 13, 2004; and March 12, 2005.

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Overall IRS's filing season performance to date is good news because, as table 1 shows (page 6), IRS's budget for taxpayer service is \$104 million less than the year before. According to IRS officials, it absorbs this reduction by generating additional internal savings and program reductions. However, because the filing season is not over, the extent to which IRS will achieve efficiency gains and the full impact of reductions on taxpayers in this or future filing seasons is not yet known.

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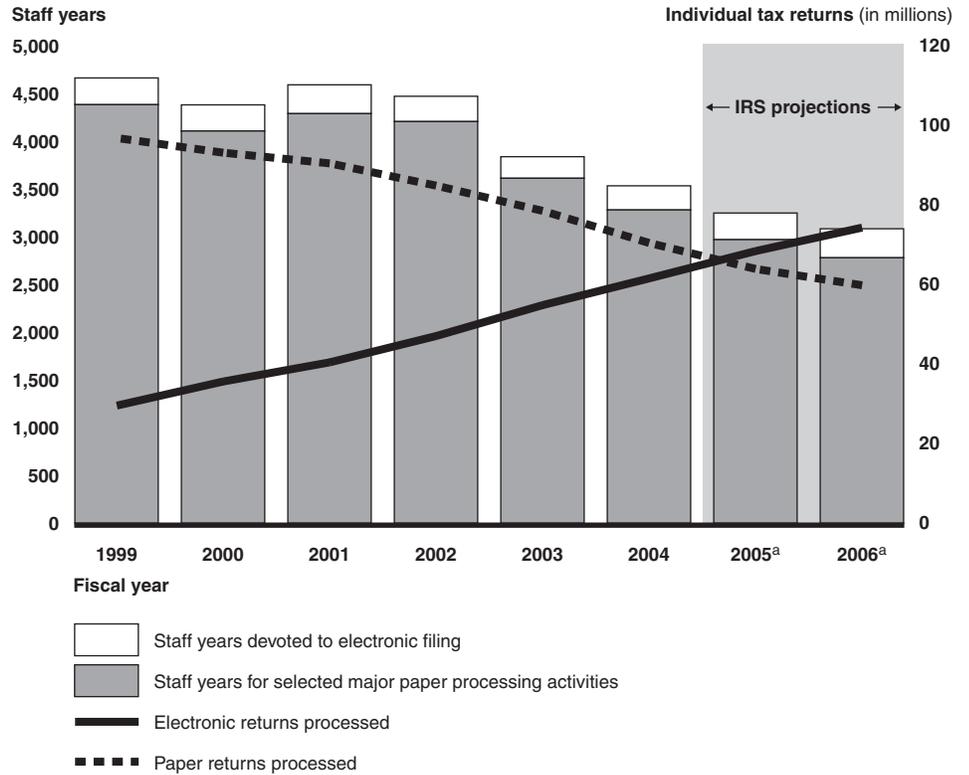
### Processing Has Been Smooth, Staff Continues to Decline, and Electronic Filing Continues to Grow but not at a Rate to Meet Long-term Goal

As of March 18, IRS processed about 63 million individual income tax returns and 57 million refunds. According to IRS data and information from external stakeholders such as paid practitioners, processing has been uneventful and without significant disruptions. IRS officials attribute this year's smooth processing to adequate planning and few tax law changes. This year's processing activities are important, in part, because for the first time during the filing season, IRS is using CADE to process the simplest taxpayer accounts (1040EZ without problems or balance due). As we note in the BSM section, CADE is the foundation of IRS's modernization effort and will ultimately replace the Individual Master File that currently houses taxpayer data for individual filers. As of March 16, 2005, CADE has processed over 842,000 tax returns without significant problems.

Growth in electronic filing (e-filing) helps fund IRS's modernization. Electronic filing allows IRS to control costs by reducing labor-intensive processing of paper tax returns. E-filing also improves taxpayer service by eliminating transcription errors associated with processing paper returns. E-filing also has benefits for taxpayers, primarily by allowing them to get their refunds in half the time of paper filers.

As shown in figure 5, the number of e-filed returns has increased since 1999 and the number of paper returns has decreased. The figure also shows that these changes have allowed IRS to reduce the staff devoted to processing paper returns between 1999 and 2004 by just over 1,100 staff years. As the number of e-filed returns has increased, the number of staff years used to process those returns has not. The decline in paper processing staff allowed IRS to close its Brookhaven processing center in 2003. In addition, IRS is in the process of closing its paper processing operation in Memphis.

**Figure 5: Number of Individual Returns and IRS Staff Years for Individual Paper and Electronic Processing, Fiscal Years 1999-2006**



Source: GAO analysis of IRS data.

\* Fiscal years 2005 and 2006 are IRS projections and, given the current lower e-file growth rates, the estimates may be optimistic.

Note: Staff years and FTEs are units of measurement that are often used interchangeably. According to IRS, an FTE is the equivalent of one person working full time for 1 year with no overtime. A staff year includes overtime. Therefore, the cost of 1 staff year is equal to the cost of one FTE plus overtime. As noted in the figure, staff years for paper filing are for selected major activities only.

Although the growth in e-filing is about 6.7 percent over the same period last year, it is growing at a slower rate than previous years. Based on the current trend and the fact that the percentage of returns e-filed traditionally declines as April 15 approaches, it appears that IRS will not achieve its goal of having 68.2 million individual tax returns e-filed this year (an 11 percent increase over last year).

Over recent years, IRS has undertaken numerous initiatives to increase e-filing. However, neither this year's current growth rate nor the projected annual growth rate will enable IRS to achieve its goal of 80 percent of all

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individual tax returns being e-filed in 2007. This goal has focused attention on increasing e-filing. As we reported last year, IRS officials believe that achieving the goal would require additional measures to convert the tens of millions of taxpayers and tax practitioners who prepare individual income tax returns on a computer, but filed on paper to e-filing. IRS officials also stated that the additional measures might need to include legislation that mandates e-filing for certain classes of returns, such as those prepared by practitioners. Last year we reported five states, including California, that mandated the e-filing of state tax returns, also showed increases in the e-filing of federal returns.<sup>23</sup> This year, three additional states have introduced mandatory e-filing of state returns by tax practitioners.

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### Telephone Access Has Remained Relatively Stable and Accuracy Has Improved

Between January 1 and March 12, IRS received approximately 23 million calls. As shown in table 4, IRS's automated service handled nearly 14 million calls and customer service representatives (CSRs) handled just over 9 million. The percentage of taxpayers who attempted to reach CSRs and actually got through and received service—referred to as the CSR level of service—remained relatively stable at 83 percent compared to 84 percent at the same time last year.

IRS reduced its 2005 goal for CSR level of service from 85 percent in 2004 to 82 percent because of the budget reduction for taxpayer service. However, IRS has been able to achieve a relatively stable CSR level of service of 83 percent since last year. According to IRS officials, this level of performance is due to

- staff plans being made before the level of service goal was reduced;
- the agency receiving fewer calls due to fewer tax law changes than in 2004;
- the agency improving methods for handling calls; and
- an increased use of IRS's Web site.

Although CSR level of service is about the same as last year, down one percentage point, there are other indications of slippage in telephone

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<sup>23</sup> GAO-05-67.

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access. Specifically, taxpayers are waiting longer to speak to a CSR. Wait times have increased by about 35 seconds or 15 percent compared to the same period last year. Additionally, the rate at which taxpayers abandon their calls to IRS increased from 10 percent to 11.5 percent, which translates into about 99,000 calls. The responsible IRS official considers the increase in wait time and increase in abandon rate to be acceptable, in part because IRS data are showing that the agency is using 9 percent fewer FTEs than last year and answering 195 more calls per FTE.

IRS officials said they lowered the CSR level of service goal in response to the reduction in the taxpayer service budget, and will adjust staffing plans after the filing season to address the taxpayer service budget reduction. IRS officials believe the adjustments will likely result in a lower level of service than is currently being achieved.

IRS estimates that the accuracy of CSRs' answers to taxpayers' tax law questions improved compared to last year. Specifically, tax law accuracy increased to an estimated 87 percent as compared to 76 percent at the same time last year. This represents a significant change from last year, when we drew attention to the declining tax law accuracy rate.<sup>24</sup> According to IRS officials and staff, the improvement is primarily due to formatting changes made in 2004 to the guide that CSRs use to help them answer taxpayers' tax law questions that have enhanced the usability of the guide. IRS officials stated that the revised guide is better and more user-friendly, partly because many of the suggested improvements were from CSRs who use the guide daily. In addition, IRS officials stated that the improved tax law accuracy rate reveals that the previous version of the guide was indeed the reason for last year's decline in tax law accuracy, and attributed fluctuations in the tax law accuracy rate to changes in the guide in past years.

IRS estimates that accounts accuracy (the accuracy of answers to questions from taxpayers about the status of their accounts) has improved compared to last year and since 2002. Taxpayers who called about their accounts received correct information an estimated 92 percent of the time, which is an improvement compared to last year's 89 percent rate and the 88 percent rate seen in 2002 and 2003. The responsible IRS official told us that accounts accuracy rates have improved because IRS has improved its

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<sup>24</sup> [GAO-04-560T](#).

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ability to monitor and manage staff, expanded training, and improved its ability to search for account information.

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## Web Site Performing Well and Used Extensively

Various data indicate that IRS's Web site is performing well. We found it to be user-friendly because it was readily accessible and easy to navigate. Problem areas that we reported in the past, such as the search function, were much improved this filing season, thus eliminating our previous concerns about the search function. Furthermore, an independent weekly study done during the filing season has reported that IRS's Web site has ranked in the top 4 out of 40 government Web sites and that users were able to access the IRS Web site in .65 seconds or less. The same independent weekly assessment reported that IRS ranked first or second in response time of downloading data. Finally, the electronic tax law assistance program on IRS's Web site has shown marked improvement this year over last. For example, the average response time is down from 3.8 days to 1.6 days and the accuracy rate has improved from 56.9 percent to 87.5 percent.<sup>25</sup> According to IRS officials, this significant improvement is due to a decrease in the number of tax law questions being submitted—down from about 56,000 to 8,700 for the same time period.

IRS's Web site is experiencing extensive usage this filing season based on the number of visits, pages viewed, and forms and publications downloaded. As of February 28, 2005, the Web site was visited about 83 million times by users who viewed about 628 million pages. This is the first time that IRS has publicly reported the number of visits to and number of pages viewed on its Web site. Further, about 70.3 million forms and publications had been downloaded this fiscal year through February, with about 45 million of those downloads occurring in January and February.

IRS's Web site continues to provide two very important tax service features: (1) "Where's My Refund," which enables taxpayers to check on the status of their refund and (2) Free File, which provides taxpayers the ability to file their tax return electronically for free via IRS's Web site. As of March 20, 2005, about 16 million taxpayers accessed the "Where's My Refund" feature to check the status of their tax refund—about a 15 percent

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<sup>25</sup> These estimates are based on IRS's random samples of electronic tax law assistance questions submitted via IRS's Web site. These estimates have a +/- 4.6 percentage points range and +/- 2.8 percentage points range in 2004 and 2005 respectively, with a 90 percent confidence level.

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increase over the same time period last year. Also, IRS provided new functionality for “Where’s My Refund” whereby a taxpayer whose refund could not be delivered by the Postal Service (i.e., returned as undeliverable mail), can change their address on the Web site. In addition, as of March 16, 2005, 3.6 million tax returns had been filed via Free File, which represents a 44 percent increase over the same time period last year. In the 2005 filing season, all individual taxpayers are eligible to file free via IRS’s Web site.

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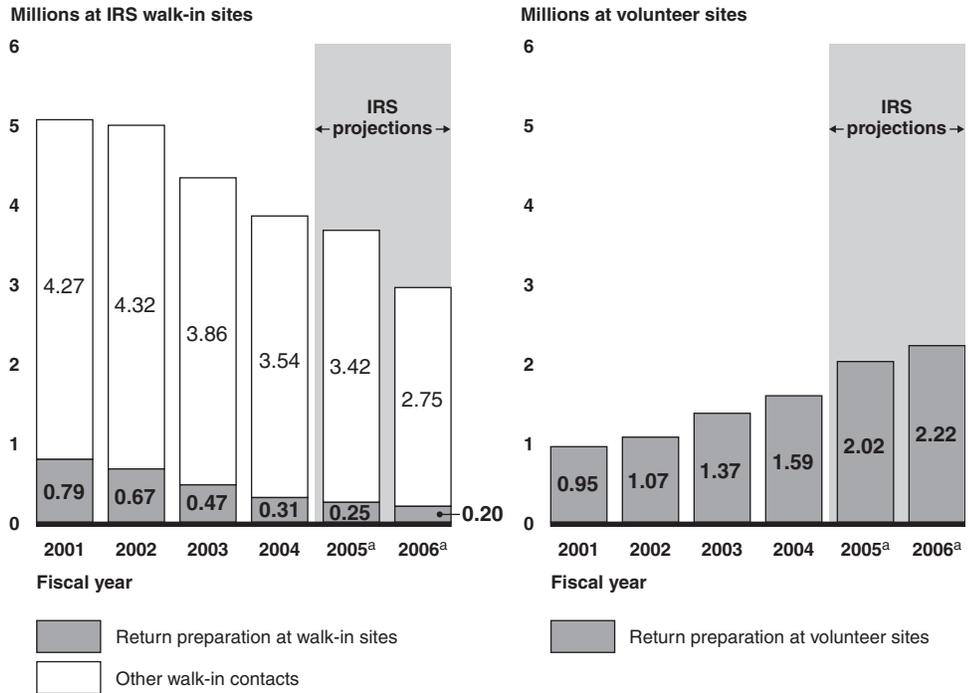
### Use of IRS’s Walk-in Assistance Continues to Decline, While Use of Volunteer Assistance Increases

As of March 12, assistance provided at IRS’s approximately 400 walk-in sites declined by 11 percent compared to the same time last year, with the number receiving tax preparation assistance declining by about 22 percent. Staff at those sites provides taxpayers with information about their tax accounts and answer a limited scope of tax law questions.<sup>26</sup> If staff cannot answer taxpayers’ questions, they are required to refer taxpayers to IRS’s telephone operations or have taxpayers correspond via IRS’s Web site. In combination with decreased demand, IRS reduced the staff used at walk-in sites for return preparation assistance and continues to encourage taxpayers to use volunteer sites for return preparation. These declines are consistent with IRS’s goal to further limit return preparation and tax law assistance at walk-in sites by 2007 and with its 2006 budget request.

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<sup>26</sup> Walk-in site employees are trained and authorized to only answer tax law questions on specific tax topics such as those related to income, filing status, exemptions, deductions, and related credits.

**Figure 6: Assistance Provided by IRS Walk-in and Volunteer Sites, 2001-2006 Filing Seasons (in millions)**



Source: GAO analysis of IRS data.

<sup>a</sup> Fiscal years 2005 and 2006 are IRS projections.

Note: "Other walk-in contacts" includes assistance for account notices, tax law inquiries, forms, and compliance work, but not return preparation. For the walk-in sites, the time periods covered are December 31, 2000, through April 28, 2001; December 30, 2001, through April 27, 2002; December 29, 2002, through April 26, 2003; and December 28, 2003, through April 24, 2004. For volunteer sites, the time period covered for 2001 is January 1, 2001, through April 21, 2001; all other periods are the same as those for IRS walk-in sites.

As reflected in table 4 and figure 6, in contrast to IRS walk-in sites, the number of taxpayers seeking return preparation assistance at volunteer sites has increased this year and every year since 2001. These sites, staffed by volunteers certified by IRS, do not offer the range of services IRS provides, but instead focus on preparing tax returns primarily for low-income and elderly taxpayers and operate chiefly during the filing season. IRS officials estimated that the number of taxpayers receiving assistance at approximately 14,000 volunteer sites has increased over 23 percent compared to the same time last year.

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The shift of taxpayers from walk-in to volunteer sites is important, because it has transferred time-consuming services, particularly return preparation, from IRS to volunteer sites and allowed IRS to concentrate on services that only it can provide such as account assistance or compliance work. As a result, IRS has devoted fewer resources to return preparation. While this shift is important to IRS, others have been more cautious. For example, in her January 2005 report,<sup>27</sup> the Taxpayer Advocate has expressed concern about the reduction of face-to-face services, such as those offered at walk-in sites. She stated that IRS's plan does not adequately provide for the segment of the population that continues to rely on the interaction provided by walk-in sites. At the same time, last year, we<sup>28</sup> and TIGTA<sup>29</sup> called attention to issues related to the quality of service at both IRS walk-in and volunteer sites. IRS has separate quality initiatives under way at both IRS walk-in sites and volunteer sites, although data remain limited and cannot be compared to prior years.

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## Conclusions

As IRS shifts its priorities to enforcement and faces tight budgets for service, the agency will be challenged to maintain the gains it has made in taxpayer service. In order to avoid a “swinging pendulum,” where enforcement gains are achieved at the cost of taxpayer service and vice versa, IRS and the Congress would benefit from a set of agreed-upon long-term goals. Long-term goals would provide a framework for assessing budgetary tradeoffs between taxpayer service and enforcement and whether IRS is making satisfactory progress towards achieving those goals. Similarly, long-term goals could help identify priorities within the taxpayer service and enforcement functions. For example, if the budget for taxpayer service were to be cut and efficiency gains did not offset the cut, long-term goals could help guide decisions about whether to make service cuts across

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<sup>27</sup> National Taxpayer Advocate, *2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004).

<sup>28</sup> GAO, *Tax Administration: IRS Improved Performance in the 2004 Filing Season, but Better Data on the Quality of Some Services Are Needed*, [GAO-05-67](#) (Washington, D.C.: Nov. 4, 2004).

<sup>29</sup> Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Correctly Prepared at Taxpayer Assistance Centers*, Reference No. 2004-40-025 (Washington, D.C.: 2003) and Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites*, Reference No. 2004-40-154 (Washington, D.C.: 2004).

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the board or target selected services. To its credit, IRS has been developing a set of long-term goals, so we are not making a recommendation on goals. However, we want to underscore the importance of making the goals public in a timely fashion, as IRS has planned. The Congress would then have an opportunity to review the goals and start using them as a tool for holding IRS accountable for performance.

In addition, the Congress would benefit from more information about the short-term impacts of the 2006 budget request on taxpayers. The 2006 budget request cites a need for reducing the hours of telephone service and scaling back walk-in assistance but provides little additional detail. Without more detail about how taxpayers will be affected, it is difficult to assess whether the 2006 proposed budget would allow IRS to achieve its stated intent of both maintaining a high level of taxpayer service and increasing enforcement.

BSM and related initiatives such as electronic filing hold the promise of delivering further efficiency gains that could offset the need for larger budget increases to fund taxpayer service and enforcement. Today, taxpayers have seen payoffs from BSM; however, the program is still high risk and budget reductions have caused substantive program changes. IRS has recognized it is time to revisit its long-term BSM strategy and is currently refocusing the program. As we did with long-term goals above, we want to underscore the importance of timely completion of the revision of the BSM strategy.

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## Recommendation

We recommend that the Commissioner of Internal Revenue supplement the 2006 budget request with more detailed information on how proposed service reductions would impact taxpayers.

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# Description of IRS's Proposed Budget Structure

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IRS's proposed new budget structure as depicted in figure 7 combines the three major appropriations that the agency has had in the past— Processing, Assistance, and Management; Tax Law Enforcement; and Information Systems into one appropriation called Tax Administration and Operations. The Business Systems Modernization and Health Insurance Tax Credit Administration appropriations accounts remain unchanged. The Tax Administration and Operations appropriation is divided among eight critical program areas. These budget activities focus on Assistance, Outreach, Processing, Examination, Collection, Investigations, Regulatory Compliance, and Research. According to IRS, as it continues to move forward with developing and implementing this new structure, these program areas and the associated resource distributions will be refined to provide more accurate costing.

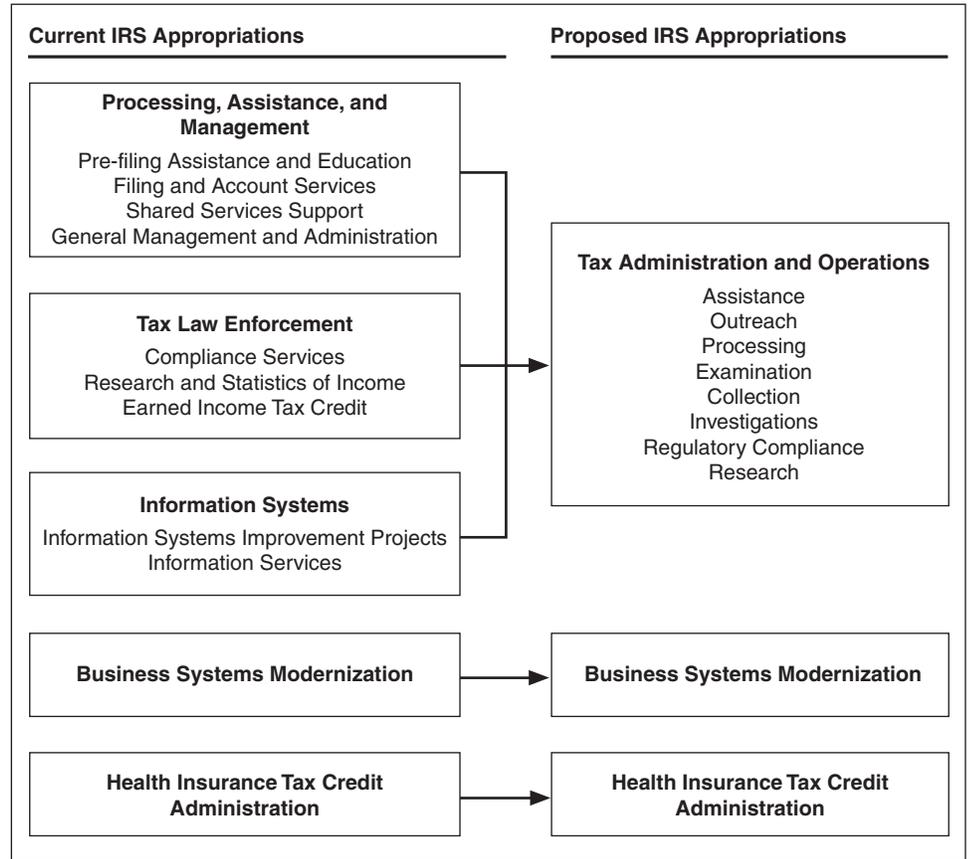
IRS reported that the new budget structure has a more direct relationship to its major program areas and strategic plan. We did not evaluate IRS's proposed budget structure as part of this engagement because it was not within the scope of our review. However, we have recently completed a study on the administration's broader budget restructuring effort. In that study we say that, going forward, infusing a performance perspective into budget decisions may only be achieved when the underlying information becomes more credible and used by all major decision makers. Thus, the Congress must be considered a partner. In due course, once the goals and underlying data become more compelling and used by the Congress, budget restructuring may become a better tool to advance budget and performance integration.<sup>1</sup>

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<sup>1</sup> For a more detailed discussion, see GAO, *Performance Budgeting: Efforts to Restructure Budgets to Better Align Resources with Performance*, [GAO-05-117SP](#) (Washington, D.C.: February 2005).

**Appendix I**  
**Description of IRS's Proposed Budget**  
**Structure**

**Figure 7: IRS's Proposed Budget Structure**



Source: GAO representation of IRS information.

# BSM Project Life Cycle Cost/Schedule Variance and Benefits Summary

The table below shows the life-cycle variance in cost and schedule estimates for completed and ongoing Business Systems Modernization (BSM) projects, based on data contained in IRS's expenditure plans. These variances are based on a comparison of IRS's initial and revised (as of July 2004) cost and schedule estimates to complete initial operation<sup>1</sup> or full deployment<sup>2</sup> of the projects.

**Table 5: BSM Project Life Cycle Cost/Schedule Variance and Benefits Summary**

Project	Cost variance (in thousands)	Reported/revised estimated cost (in thousands)	Schedule variance (in months)	Reported/revised estimated completion date	Reported IRS/taxpayer benefits
<b>Completed projects</b>					
Security and Technology Infrastructure Release 1	+\$8,450	\$45,401	+5	1/31/02 (initial operation) <sup>a</sup>	Provides infrastructure for secure telephony and electronic interaction among IRS employees, tax practitioners, and taxpayers.
Customer Communications 2001	+14,562	60,762	+9	2/26/02 (full deployment)	Improves telecommunications infrastructure, including telephone call management, call routing, and customer self-service applications.
Customer Relationship Management Exam	-721	9,245	+3	9/30/02 (full deployment)	Provides commercial, off-the-shelf software to IRS revenue agents to allow them to accurately compute complex corporate transactions.
Human Resources Connect Release 1	+200	10,200	0	12/31/02 (initial operation) <sup>a</sup>	Allows IRS employees to access and manage their human resources information online.
Internet Refund/Fact of Filing	+12,923	26,432	+14	9/26/03 (full deployment)	Provides instant refund status information and instructions for resolving refund problems to taxpayers with Internet access.
Modernized e-File Release 1	+21,057	50,303	+6.5	5/31/04 (initial operation) <sup>a</sup>	Provides initial electronic filing capability for large corporations, small business, and tax-exempt organizations.

<sup>1</sup> Initial operation refers to the point at which a project is authorized to begin enterprisewide deployment.

<sup>2</sup> Full deployment refers to the point at which enterprisewide deployment has been completed and a project is transitioned to operations and support.

**Appendix II  
BSM Project Life Cycle Cost/Schedule  
Variance and Benefits Summary**

(Continued From Previous Page)

<b>Project</b>	<b>Cost variance (in thousands)</b>	<b>Reported/revise estimated cost (in thousands)</b>	<b>Schedule variance (in months)</b>	<b>Reported/revise estimated completion date</b>	<b>Reported IRS/taxpayer benefits</b>
<b>Ongoing projects</b>					
Modernized e-File Release 2	0	16,325	0	9/30/04 (initial operation)	Provides additional functionality to support corporate electronic filing and other capabilities, including required public access to filed returns for tax-exempt organizations.
Modernized e-File Release 3	+5,300	27,175	0	3/31/05 (initial operation)	Provides additional functionality to support electronic filing for tax-exempt organizations and other capabilities, including the interface with state retrieval systems.
e-Services	+102,271	148,820	+18	4/30/05 (full deployment)	Provides a Web portal and other e-Services to promote the goal of conducting most IRS transactions with taxpayers and tax practitioners electronically.
Customer Account Data Engine – Individual Master File Release 1	+118,129	182,774	+30	6/30/05 (full deployment)	Provides the modernized database foundation to replace the existing individual master file processing systems. Facilitates faster refund processing and more timely response to taxpayer inquiries for Form 1040EZ filers.
Integrated Financial System Release 1	+73,710	173,580	+15	6/30/05 (full deployment)	Provides a single general ledger for custodial and financial data and a platform to integrate core financial data with budget, performance, and cost-accounting data.
Custodial Accounting Project Release 1	+91,789	138,950	+33	11/01/05 (full deployment)	Provides integrated tax operations and internal management information to support evolving decision analytics, performance measurement, and management information needs.

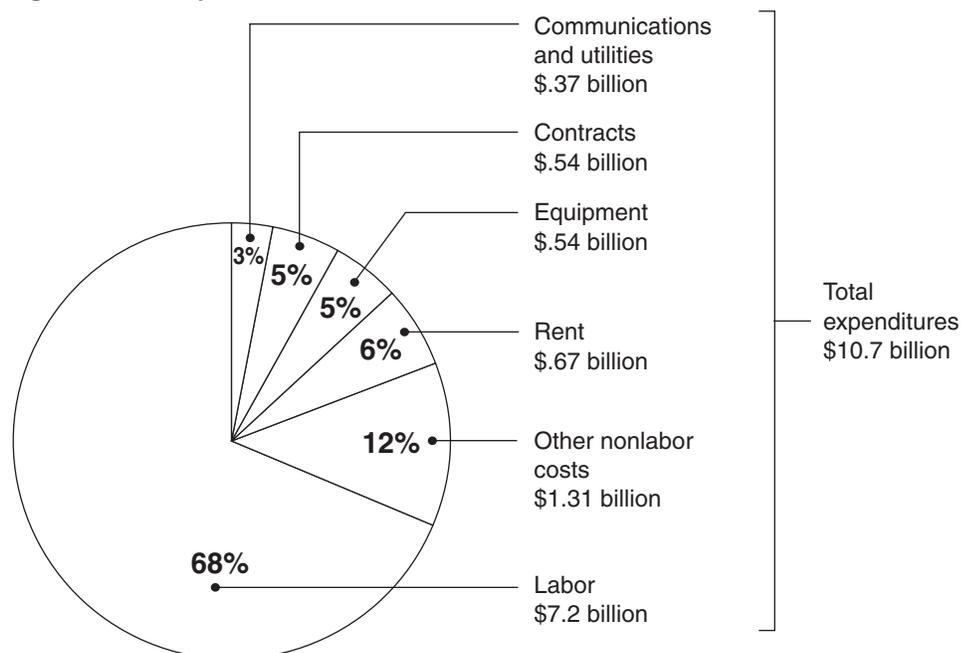
Source: GAO analysis of IRS data.

<sup>a</sup>Information on the costs and schedule for the full-deployment stage of these projects was not available in the BSM expenditure plans.

# How IRS Allocated Expenditures and Full-Time Equivalents in Fiscal Year 2004

Figures 8 and 9 illustrate how the Internal Revenue Service (IRS) allocated expenditures and full-time equivalents (FTE) in fiscal year 2004. Figure 8 shows total expenditures. The percentage of expenditures devoted to contracts decreased from 9 percent in 2002 to 5 percent in 2004, because of fewer private contracts. The percentage of expenditures devoted to other nonlabor costs increased from 8 percent in 2002 to 12 percent in 2004, due to increases in miscellaneous costs.

**Figure 8: IRS Expenditures in Fiscal Year 2004**



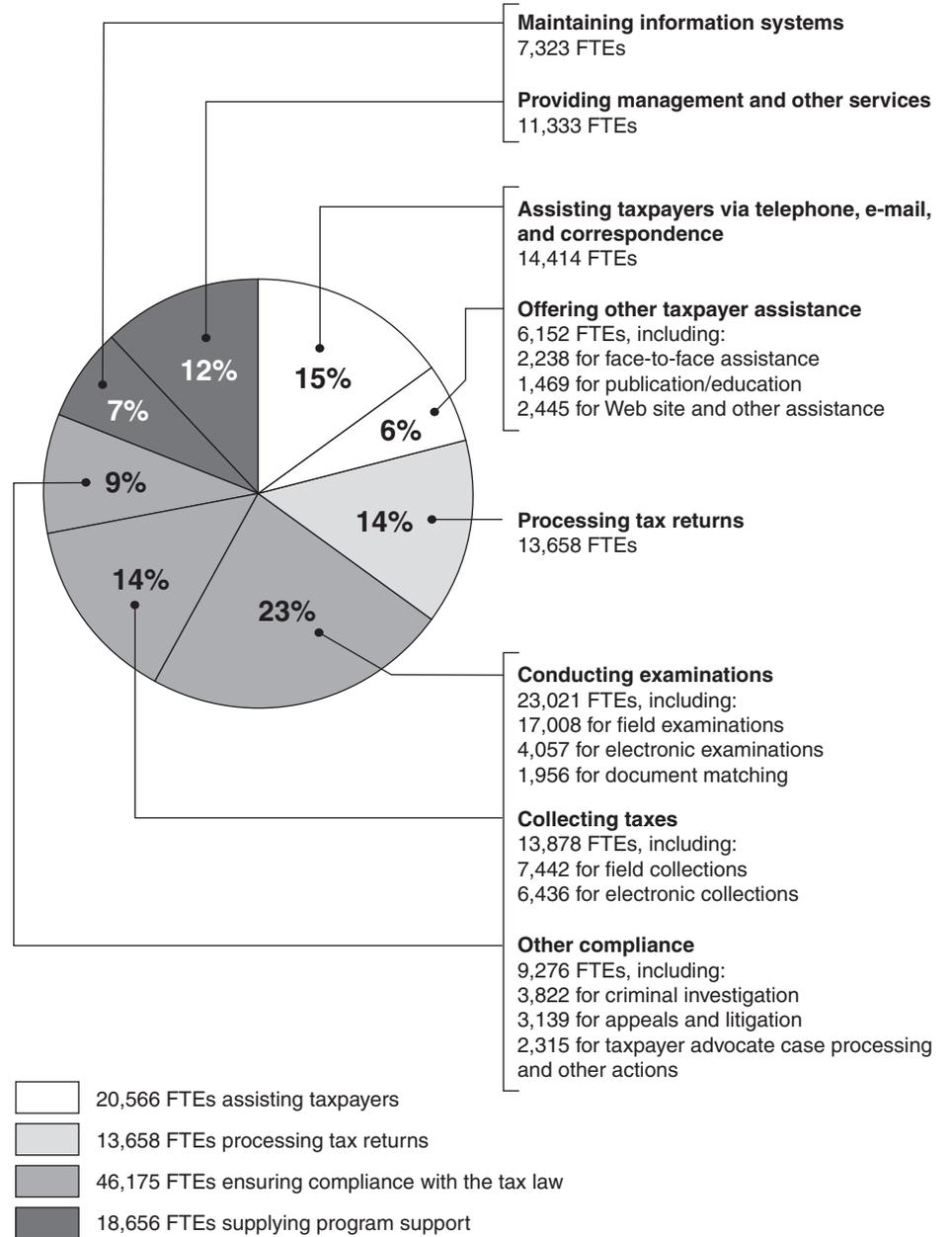
Source: GAO analysis of IRS data.

Note: Numbers do not add to the total and percentages do not add to 100 percent due to rounding.

Figure 9 shows IRS's total FTEs. FTEs have decreased slightly from 99,180 in 2002 to 99,055 in 2004. We previously reported that processing FTEs declined 1 percentage point between 2002 and 2003. Between 2003 and 2004, IRS's allocation of FTEs remained similar with a 1 percentage point increase in conducting examinations, and in management and other services.

**Appendix III**  
**How IRS Allocated Expenditures and Full-Time Equivalents in Fiscal Year 2004**

**Figure 9: How IRS Spent 99,055 FTEs in Fiscal Year 2004**



Source: GAO analysis of IRS data.

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