



**Statement of Colleen M. Kelley**  
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**On**

**“Internal Revenue Service Operations and the Tax Gap”**

Submitted to

**House Ways and Means Subcommittee on Oversight**

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Chairman Lewis, Ranking Member Ramstad, and distinguished members of the Subcommittee, I would like to thank you for allowing me to provide comments on IRS operations and the tax gap. As President of the National Treasury Employees Union (NTEU), I have the honor of representing over 150,000 federal workers in 30 agencies men and women at the IRS.

Mr. Chairman, the National Treasury Employees Union has serious concerns about a number of IRS policies that we believe are undermining the agency's ability to fulfill its tax enforcement mission as well as hampering efforts to close the tax gap. These include ongoing staff cuts of some of the IRS's most productive employees, reliance on outside contractors to handle inherently governmental activities such as the collection of taxes, and a shift in philosophy which focuses enforcement efforts too much on wage earners and not enough on high-income individuals and large businesses and corporations.

### **Tax Gap**

In April 2006, the IRS released updated estimates showing that the tax gap was approximately \$345 billion in Tax Year 2001. As Nina Olson, the National Taxpayer Advocate noted, this amounts to a per-taxpayer "surtax" of some \$2,000 per year to subsidize noncompliance. And while the agency has made small inroads and the overall compliance rate through the voluntary compliance system remains high, much more can and should be done. NTEU believes that in order to close the tax gap, the IRS needs additional employees on the frontlines of tax compliance and customer service. In addition, we believe Congress should establish a dedicated funding stream to provide adequate resources for those employees.

History has shown that the IRS has the expertise to improve taxpayer compliance but lacks the necessary personnel and resources. The President's own fiscal 2008 budget proposal trumpets the increased tax collections produced by IRS's own employees and cites the increased collections of delinquent tax debt from \$34 billion in 2002 to \$49 billion in 2006, an increase of 44 percent. Unfortunately, instead of providing additional resources to hire more enforcement staff, IRS personnel resources have been slashed in recent years resulting in a 36% decline in combined collection and examination function enforcement staff between 1996 and 2003. In addition, these staffing cuts have come at a time when the IRS workload has dramatically increased.

According to IRS's own annual reports and data, taxpayers filed 114.6 million returns in 1995. After a steady annual climb, eleven years later, the Service saw more than 132 million returns filed. In addition, between 1997 and 2005, the number of individual tax returns with \$100,000 in reported income, which are generally more complex returns, increased by more than 52 percent. Yet, between 1995 and 2003, total numbers of employees shrunk from 114,000 to 94,000. Even more alarming is that during that period, revenue officers and revenue agents – two groups critical to reducing the tax gap – shrunk by 40 and 30 percent respectively. Revenue officers who collect large delinquent accounts went from 8,139 to 5,004 and revenue agents who do audits fell from 16,078 to 11,513. Unfortunately, instead of reversing this trend, the IRS has continued efforts to reduce its workforce and has moved forward with downsizing in several different areas which have targeted some of the service's most productive employees.

These include last year's re-organization of the Estate and Gift Tax Program which sought the elimination of 157 of the agency's 345 estate and gift tax attorneys – almost half of the agency's estate tax lawyers—who audit some of the wealthiest Americans. The Service pursued this drastic course of action despite internal data showing that estate and gift attorneys are among the most productive enforcement personnel at the IRS, collecting \$2,200 in taxes for each hour of work.

The IRS decision to drastically reduce the number of attorneys in the estate and gift tax area flies in the face of several reports made to Congress by Treasury and IRS officials over the past few years, indicating that tax evasion and cheating among the highest-income Americans is a serious and growing problem. In fact, an IRS study found that in 1999, more than 80 percent of the 1,651 tax returns reporting gifts of \$1 million or more that were audited that year understated the value of the gift. The study found that the average understatement was about \$303,000, on which about \$167,000 in additional gift taxes was due. This alone cost the government about \$275 million. Consequently, it is difficult to understand why the IRS sought the elimination of key workforce positions in an area that could produce significant revenue to the general treasury.

In addition, the Service continues to move forward with its plan to close five of its ten paper tax return submission facilities by 2011. The IRS originally sought the closings of the five paper return submission centers due to the rise in the use of electronic filing (e-filing) and in order to comply with the IRS Restructuring and Reform Act of 1998 (RRA 98) which established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. But in their recent report to Congress on e-filing, the IRS Oversight Board noted that the IRS will fall well short of the 80 percent goal and urged Congress to extend the deadline to 2012. The report noted that in 2006 just 54 percent of individuals e-filed their returns, well short of the 80 percent goal. Furthermore, the report cited a decline in 2006 in the number of e-file returns received from individual taxpayers who self-prepared their taxes. And finally a recent GAO report on the 2006 filing season noted the year over year percentage growth in individual e-filing slowed to a level lower than any of the previous three years.

While overall use of e-filing may be on the rise, the number of taxpayers opting to use this type of return is not increasing as rapidly as the IRS had originally projected. Combined with the fact that almost a third of American taxpayers do not even have internet access and changes to the IRS Free File Program that are expected to increase the number of paper filing returns, it is clear that paper submission processing facilities are still necessary and that serious thought and consideration must be given before any additional closings are undertaken.

Mr. Chairman, it is clear that drastic reductions in some of the agency's most productive tax law enforcement employees has undermined agency efforts to close the tax gap and directly contradicts the Service's stated enforcement priority to discourage and deter non-compliance, particularly among high-income individuals.

## **NTEU Staffing Proposal**

In order to address the staffing shortage at the IRS and combat the tax gap, NTEU supports a two percent annual net increase in staffing (roughly 1,885 positions per year) over a five-year period to gradually rebuild the depleted IRS workforce to pre-1998 levels. A similar idea was proposed by former IRS Commissioner Charles Rossotti in a 2002 report to the IRS Oversight Board. In the report, Rossotti quantified the workload gap in non-compliance, that is, the number of cases that should have been, but could not be acted upon because of resource limitations. Rossotti pointed out that in the area of known tax debts, assigning additional employees to collection work could bring in roughly \$30 for every \$1 spent. The Rossotti report recognized the importance of increased IRS staffing noting that due to the continued growth in IRS' workload (averaging about 1.5 to 2.0 percent per year) and the large accumulated increase in work that should be done but could not be, even aggressive productivity growth could not possibly close the compliance gap. Rossotti also recognized that for this approach to work, the budget must provide for a net increase in staffing on a sustained yearly basis and not take a "one time approach."

Although this would require a substantial financial commitment, the potential for increasing revenues, enhancing compliance and shrinking the tax gap makes it very sound budget policy. One option for funding a new staffing initiative would be to allow the IRS to hire personnel off-budget, or outside of the ordinary budget process. This is not unprecedented. In fact, Congress took exactly the same approach to funding in 1994 when Congress provided funding for the Administration's IRS Tax Compliance Initiative which sought the addition of 5,000 compliance positions for the IRS. The initiative was expected to generate in excess of \$9 billion in new revenue over five years while spending only about \$2 billion during the same period. Because of the initiative's potential to dramatically increase federal revenue, spending for the positions was not considered in calculating appropriations that must come within annual caps.

A second option for providing funding to hire additional IRS personnel outside the ordinary budget process could be to allow IRS to retain a small portion of the revenue it collects. The statute that gives the IRS the authority to use private collection companies to collect taxes allows 25 percent of collected revenue to be returned to the companies as payment, thereby circumventing the appropriations process altogether. Clearly, there is nothing magical about revenues collected by private collection companies. If those revenues can be dedicated directly to contract payments, there is no reason some small portion of other revenues collected by the IRS could not be dedicated to funding additional staff positions to strengthen enforcement.

While NTEU agrees with IRS' stated goal of enhancing tax compliance and enforcement, we don't agree with the approach of sacrificing taxpayer service in order to pay for additional compliance efforts. NTEU believes providing quality services to taxpayers is an important part of any overall strategy to improve compliance and that reducing the number of employees dedicated to assisting taxpayers meet their obligations would only serve to exacerbate, not shrink, the tax gap. The Administration's own budget proposal for 2008 notes that in FY 2006, IRS' customer assistance centers answered almost 33 million assistor telephone calls and met the 82 percent level of service goal, with an accuracy rate of 91 percent for tax law questions. In

addition, a recent study commissioned by the Oversight Board found that more than 80 percent of taxpayers contacted said that IRS service was better than or equal to service from other government agencies. And while these numbers show that IRS taxpayer services are being effective, more can and should be done.

Mr. Chairman, in order to continue to make improvements in taxpayer services while simultaneously processing a growing number of tax returns and stabilizing collections and examinations of cases, it is imperative to reverse the severe cuts in IRS staffing levels and begin providing adequate resources to meet these challenges. With the future workload expected to continue to rise, the IRS will be under a great deal of pressure to improve customer service standards while simultaneously enforcing the nation's tax laws. NTEU strongly believes that providing additional staffing resources would permit IRS to meet the rising workload level, stabilize and strengthen tax compliance and customer service programs and allow the Service to address the tax gap in a serious and meaningful way.

### **Private Tax Collection**

Mr. Chairman, as stated previously, if provided the necessary resources, IRS employees have the expertise and knowledge to ensure taxpayers are complying with their tax obligations. That is why NTEU continues to strongly oppose the Administration's private tax collection program, which began in September of last year. Under the program, the IRS is permitted to hire private sector tax collectors to collect delinquent tax debt from taxpayers and pay them a bounty of up to 25 percent of the money they collect. NTEU believes this misguided proposal is a waste of taxpayer's dollars, invites overly aggressive collection techniques, jeopardizes the financial privacy of American taxpayers and may ultimately serve to undermine efforts to close the tax gap.

NTEU strongly believes the collection of taxes is an inherently governmental function that should be restricted to properly trained and proficient IRS personnel. When supported with the tools and resources they need to do their jobs, there is no one who is more reliable and who can do the work of the IRS better than IRS employees.

As you may know, under current contracts, private collection firms are eligible to retain 21% to 24% of what they collect, depending on the size of the case. In testimony before Congress, the IRS Commissioner, Mark Everson, has twice acknowledged that using private collection companies to collect federal taxes will be more expensive than having the IRS do the work itself. The Commissioner's admission directly contradicts one the Administration's central justifications for using private collection agencies --- that the use of private collectors is cost efficient and effective.

In addition to being fiscally unsound, the idea of allowing private collection agencies to collect tax debt on a commission basis also flies in the face of the tenets of the IRS Restructuring and Reform Act of 1998. Section 1204 of the law specifically prevents employees or supervisors at the IRS from being evaluated on the amount of collections they bring in. But now, the IRS has agreed to pay private collection agencies out of their tax collection proceeds, which will

clearly encourage overly aggressive tax collection techniques, the exact dynamic the 1998 law sought to avoid. Furthermore, the IRS is turning over tax collection responsibilities to an industry that has a long record of abuse. For example, in 2005 (the latest year statistics are available), the Federal Trade Commission received 66,627 consumer complaints about debt collection agencies – giving debt collectors the impressive title of the FTC’s most complained-about industry.

NTEU believes that a better option would be to provide the IRS with the resources and staffing it needs. There is no doubt that IRS employees are – by far – the most reliable, cost-effective means for collecting federal income taxes. As noted previously, the IRS Commissioner himself has admitted that using IRS employees to collect unpaid tax debts is more efficient than using private collectors. In addition, the 2002 budget report submitted to the IRS Oversight Board, former Commissioner Charles Rossotti made clear that with more resources to increase IRS staffing, the IRS would be able to close the compliance gap.

This is not the first time the IRS has tried this flawed program. Two pilot projects were authorized by Congress to test private collection of tax debt for 1996 and 1997. The 1996 pilot was so unsuccessful it was cancelled after 12 months, despite the fact it was authorized and scheduled to operate for two years. A subsequent review by the IRS Office of Inspector General found that contractors participating in the pilot programs regularly violated the Fair Debt Collection Practices Act, did not adequately protect the security of personal taxpayer information, and even failed to bring in a net increase in revenue. In fact, a 1997 GAO report found that private companies did not bring in anywhere near the dollars projected, and the pilot caused a \$17 million net loss.

Despite IRS assurances that it has learned from its past mistakes, two recent reports indicate otherwise. A March 2004 report by the Treasury Inspector General for Tax Administration raised a number of questions about IRS’ contract administration and oversight of contractors. The report found that “a contractor’s employees committed numerous security violations that placed IRS equipment and taxpayer data at risk” and in some cases, “contractors blatantly circumvented IRS policies and procedures even when security personnel identified inappropriate practices.” (TIGTA Audit #200320010). The proliferation of security breaches at a number of government agencies that put personal information at risk further argue against this proposal. These security breaches illustrate not only the risks associated with collecting and disseminating large amounts of electronic personal information, but the risk of harm or injury to consumers from identity theft crimes.

In addition, a September 2006 examination of the IRS private collection program by the Government Accountability Office (GAO) reveals that like the 1996 pilot, the program may actually lose money by the scheduled conclusion of the program’s initial phase in December 2007. The report cited preliminary IRS data showing that the agency expects to collect as little as \$56 million through the end of 2007, while initial program costs are expected to surpass \$61 million. What’s more, the projected costs do not even include the 21-24 percent commission fees paid to the collection agencies directly from the taxes they collect.

In addition to the direct costs of the program, I am greatly concerned about the potential negative effect that the private tax collection program will have on our tax administration

system. In her recent report to Congress, the National Taxpayer Advocate voiced similar concern about the unintended consequences of privatizing tax collection. Olson cited a number of “hidden costs” that private tax collection has on the tax system including reduced transparency of IRS tax collection operations, inconsistent treatment for similarly situated taxpayers, and reduced tax compliance. Clearly the negative effects of contracting out tax collection to private collectors hampers the agency’s ability to improve taxpayer compliance and will only serve to undermine future efforts to close the tax gap.

NTEU is not alone in its opposition to the IRS’ plan. Similar proposals allowing private collection agencies to collect taxes on a commission basis have been around for a long time and have consistently been opposed by both parties. In fact, the Reagan Administration strongly opposed the concept of privatizing tax collections warning of a considerable adverse public reaction to such a plan, and emphasizing the importance of not compromising the integrity of the tax system. (Treasury Dept. Statement to House Judiciary Comm. 8/8/86). More recently, opposition to the private tax collection program has been voiced by a growing number of members of Congress, major public interest groups, tax experts, as well as the Taxpayer Advocacy Panel, a volunteer federal advisory group—whose members are appointed by the IRS and the Treasury Department. In addition, the National Taxpayer Advocate, an independent official within the IRS recently identified the IRS private tax collection initiative as one of the most serious problems facing taxpayers and called on Congress to immediately repeal the IRS’ authority to outsource tax collection work to private debt collectors (National Taxpayer Advocate 2006 Report to Congress).

Instead of rushing to privatize tax collection functions which jeopardizes taxpayer information, reduces potential revenue for the federal government and undermine efforts to close the tax gap, the IRS should increase compliance staffing levels at the IRS to ensure that the collection of taxes is restricted to properly trained and proficient IRS personnel.

Mr. Chairman, NTEU believes that frontline IRS employees are the best defense against an increasing U.S. tax gap. Unfortunately, the Administration has not requested the funding necessary to close the tax gap. Congress must, therefore, act to provide IRS with the necessary staffing and a dedicated funding stream to support those additional workers.

### **IRS Audits of High-Income Individuals and Large Businesses and Corporations**

Mr. Chairman, I would also like to briefly discuss IRS enforcement efforts with regard to high-income individuals and large businesses and corporations. I previously noted the drastic staff reductions in the estate and gift tax division that occurred last year and will obviously hamper the Service’s ability to achieve greater compliance from the wealthiest Americans. In addition, recent IRS data shows that IRS audits of high-income individuals have dropped dramatically over the past decade. The audit rate for face-to-face audits fell from 2.9 percent of high-income tax filers in FY 1992 to 0.38 percent in FY 2001 and then drifted down to 0.35 percent in FY 2004. While the audit rate has rebounded somewhat in the last two years, it is still far below the level of the mid-1990’s. These facts seem to directly contradict claims by the IRS

that the Service's first enforcement priority is to discourage and deter non-compliance, with an emphasis on high-income individuals.

We are seeing similar troubling trends with respect to large corporations. While this issue has just started receiving public attention in recent weeks, it has long been of concern to IRS employees that believe recent IRS currency and cycle time initiatives are resulting in the premature closing of audits of large companies, possibly leaving hundreds of millions of dollars of taxes owed on the table. IRS data shows the thoroughness of IRS enforcement efforts for the nation's largest corporations — measured by the number of hours devoted to each audit — has substantially declined since FY 2002. IRS data also show that the annual audit rates for these corporations, all with assets of \$250 million or more, while increasing in FY 2004 and 2005, receded in 2006 to about the level it was in 2002 and is much lower than levels that prevailed a decade or more ago.

Although the number of the largest corporations is small, they are a very significant presence in the American economy. In FY 2002, the largest corporations were responsible for almost 75 percent of all additional taxes the IRS auditors said were owed the government. By comparison, low and middle income taxpayers in the same year were responsible for less than 10 percent of the total.

Agency data shows that audit attention given those corporations with \$250 million or more in assets has substantially declined in the last five years. In 2002, an average of 1,210 hours were devoted to each of the audits of the corporations in this category. The time devoted to each audit dropped sharply in 2004 and by 2006 the number of hours per audit remained 20% below what it was in 2002.

But what may be most disturbing is that according to IRS' own data, while the coverage rate of large corporation returns( identified as those with assets of \$10 million and higher) increased in FY 2004 and 2005, the number of audits for these corporations actually *decreased* in 2006. Clearly, the rationale the IRS is using to justify a reduction in time and scope of large corporation audits, that is, to allow for expanding the total number of companies audited is not working.

IRS officials have continued to point to a rise in additional tax recommended for each hour of audit as a sign that the policy is working, but most auditors know that this rise can be primarily attributed to the proliferation of illegal tax shelters which makes it easier to find additional taxes due.

Warnings about the potential negative consequences of such policy decisions were made by a number of IRS employees in a recent New York Times article and are not new. In fact, when the IRS first began limiting the time and scope of business audits through implementation of the Limited Issue Focused Examination (LIFE) process in 2002, the former chief counsel of the IRS said that the IRS' proposed reductions in cycle time of corporate audits would "virtually guarantee that IRS auditors would miss tax dodges, fail to explore suspicious transactions, or even walk away from audits that are on the verge of finding wrongdoing."

In addition, IRS employees have raised concerns about this shift in approach to the auditing of business tax returns since its implementation several years ago. Their concerns are multi-fold. Primarily, employees' feel that their experience and professional judgment is being ignored when the scope of audits is limited and cycle times are reduced. Revenue agents need flexibility to determine the scope of an audit and need the ability to expand the examination time when necessary. The men and women of the IRS that perform these audits are highly experienced employees who know which issues to examine and when more time is necessary on a case. But under current IRS policies, this is just not the case.

Mr. Chairman, we have heard directly from a number of our members about the detrimental effect this policy has had not just on efforts to ensure corporations are in full compliance, but also how this misguided policy is damaging employee morale. In one instance, an IRS agent with 29 years of experience, including 19 as an international specialist examining tax returns of large, multinational corporations was given an unreasonably short period of time to examine three tax years of a very large company. The agent reported being constantly harassed for refusing to further limit the scope of the examination beyond that which was set at the beginning of the audit, even though he had successfully completed two prior examinations of the same taxpayer in a timely manner. The employee knew the issues and how to examine them but also knew they would need more than the allotted time to complete his part of the examination. But, despite past successes, management refused to provide the employee with additional time to complete his portion of the audit and labeled the employee as uncooperative and not a "team player." Although the employee refused to compromise, he believed that other members of the examination team had been pressured into dropping issues which likely would have resulted in additional tax.

Mr. Chairman, in the face of a rising tax gap and exploding federal deficits, it is imperative that the agency is provided with the necessary resources to allow IRS professionals to pursue each and every dollar of the taxes owed by large businesses and corporations. Allowing these corporations to pay just a fraction of what they owe in taxes greatly hinders efforts to close the tax gap and is fundamentally unfair to the millions of ordinary taxpayers that dutifully pay their taxes. Only by increasing the overall number of IRS employees that do this work can the Service ensure that businesses and large corporations are complying with their tax obligations and that the tax gap is being closed.

### **IRS Budget**

Mr. Chairman, the final issue that I would like to discuss is the Administration's FY '08 budget request for the IRS. As you know, the IRS budget forms the foundation for what the IRS can provide to taxpayers in terms of customer service and how the agency can address the ever-increasing tax gap through enforcement. Without an adequate budget, the IRS cannot expect continued improvement in customer service performance ratings and will be hampered in its effort to shrink the tax gap. I would like to applaud the Administration for acknowledging in its FY '08 Budget in Brief (page 65) that "assisting the public to understand their tax reporting and payment obligations is the cornerstone of taxpayer compliance and is vital for maintaining public confidence in the tax system." However, I was disappointed in the Administration for failing to

request a budget for FY '08 that meets the needs of the Agency to fulfill its customer service and enforcement challenges as well as to address closing the tax gap in a meaningful way.

Although it's widely recognized that additional funding for enforcement provides a great return on the investment, the Administration seems reluctant to request an adequate budget for the IRS. In addition, despite citing a lack of resources as the primary rationale for contracting out a number of inherently governmental activities, such as the collection of taxes, the Commissioner of the IRS has told Congress that the IRS does not need any additional funding above the President' budget request.

NTEU believes that Congress must provide the IRS with a budget that will allow the Service to replenish the depleted workforce, particularly with respect to enforcement personnel. And while it is imperative that Congress provide the IRS with sufficient staffing resources, we also believe that the IRS can look at the management to bargaining unit employee ratio to find additional resources for increased frontline tax compliance efforts. As noted previously, while the number of employees at the IRS has decreased by almost 20,000 since 1995, the number of managers who supervise these employees has *increased* over this same period. If the IRS decreased the number of managers and management officials at the same rate as it has decreased its rank and file employees, the Agency could put the savings toward bolstering enforcement staff which would clearly aid efforts to close the tax gap. While the IRS has previously cited concerns about the number of employees that would have to be taken offline to train additional frontline employees, we believe this training could be done with minimal disruption to current operations. One possibility would be to use the increasing number of managers and management officials to do the training. This would ensure that these employees are afforded the best possible training while allowing current operations to continue to run efficiently.