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United States Senate

COMMITTEE ON FINANCE

WASHINGTON, DC 20510-6200

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KOLAN DAVIS, STAFF DIRECTOR AND CHIEF COUNSEL
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The Honorable Christopher Bond
Chairman, Appropriations Subcommittee on
Transportation, Treasury, the Judiciary
and Housing and Urban Development
130 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Patty Murray
Ranking Member, Appropriations Subcommittee
on Transportation, Treasury, the Judiciary
and Housing and Urban Development
128 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Bond and Ranking Member Murray:

As you develop the Fiscal Year 2007 (FY 07) appropriations for the Internal Revenue Service (IRS) and the United States Tax Court (Tax Court), I hope that you will consider the following concerns and priorities that I have as the Ranking Member of the authorizing committee.

Internal Revenue Service

As a threshold matter, I believe the IRS must deliver an appropriate balance of service and enforcement. With a \$345 billion annual tax gap, I support strong measures to ensure compliance. The IRS also must provide robust taxpayer assistance and cannot be allowed to backslide on the level and quality of service that it provides to America's taxpayers. In addition, its information systems must have the capability and capacity to provide state-of-the-art taxpayer services and to support accurate, efficient and equitable enforcement.

The Administration's FY 07 proposed IRS budget of \$10.726 billion provides an overall increase of 1.4% compared to the restated Fiscal Year 2006 (FY 06) budget after the across-the-board Department of Defense (DOD) appropriations 1% cut. However, because the increase relies on special budget mechanisms and unproven sources of revenue, the actual increase could be smaller, or none at all. For example, Processing, Assistance and Management, which includes the taxpayer service function, would be increased by 1.6%, or \$64.7 million, but this entire increase is generated by new user fees that may not meet projections. Another \$50 million in projected new user fees is built into the baseline amount, for a total of \$114.7 million in new user fees. If the new user fees are not realized, the taxpayer service share of the budget actually *decreases* by 2.39%, or \$84 million.

The Administration's data reports that the tax law enforcement budget is increased by 1.8%, or \$83 million, and that the total enforcement budget is increased by \$137 million. The entire \$137 million increase relies on a budget cap adjustment that is contingent on full funding of the prior year baseline amount before it will be granted. Business Systems Modernization continues its downward funding trend with a significant 15.1% decrease.

Compared to the originally passed FY 06 budget, the Administration's proposal contains no increase in the IRS budget. Funding would remain flat at \$10.7 billion, so after inflationary increases in rents and salaries are absorbed the IRS actually would experience a decrease in nominal funding.

The IRS Oversight Board recommended an \$11.3 billion IRS budget for FY 2007, a 6.9% increase compared to last year, and \$600 million more than the Administration's proposal. The Board's budget would restore toll-free telephone service to FY 2003/4 levels and provide funding for research to better understand customer needs so more effective service can be provided. It also would supply significantly more funding for information technology investments to improve IRS productivity and reduce taxpayer burden.

At the Finance Committee's June 13, 2006 hearing on the corporate tax gap, I asked IRS Commissioner Everson to submit a plan to the Committee by September 30, 2006 to close the tax gap – the difference between the taxes that are legally owed and the taxes that are timely paid. I expect the plan to be comprehensive and to include an analysis of the resources that will be needed to accomplish this goal, including staffing, information systems and other infrastructure. I am hopeful that the Finance Committee will hold a hearing in October to discuss the plan and be able to address additional budgetary needs that may be necessary to implement the plan.

Service

The funding for taxpayer service should not be decreased, nor should the service budget be dependent upon unproven user fees. The taxpayer service budget should cover inflationary increases and be fixed so it does not rely on fees that may not materialize and that impose a burden on taxpayers who may shy away from getting help because they cannot afford the cost to ask a question. Taxpayer service gives taxpayers the opportunity to get their tax obligations right the first time, so expensive enforcement action is unnecessary. It is shortsighted to cut funding for service, or to increase enforcement funding at the expense of service.

Face-to-face assistance for those who need or want help is a cornerstone of effective tax administration and the budget must reflect this. The May 13, 2006 IRS weekly Filing Season Report shows an 11.3% decrease in field assistance walk-in contacts (Taxpayer Assistance Centers). The IRS attributes this to a decline in the number of taxpayers seeking face-to-face assistance. However, the TACs only record those taxpayers who actually are assisted and do not count those turned away due to lack of resources. The Treasury Inspector General for Tax Administration (TIGTA) report number 2006-40-067 found that at least 47 TACs are understaffed. It is important for the IRS to provide an array of on-line services; however, it cannot neglect those taxpayers who do not have computer access, who have language barriers, or who are elderly and are not computer literate. An IRS TAC should be available and accessible within a reasonable distance from every taxpayer's home.

Taxpayer service must be funded sufficiently to eliminate the ongoing battles with the IRS over basic services. In recent months, the IRS has made several efforts to cut back on fundamental services in order to save money. For example, the IRS announced plans in 2005 to close 68 of the 400 TACs and to cut back phone assistance from 15 hours a day to 12 hours a day. These plans were rescinded, at least for the time being, in response to vehement opposition from many quarters, including Congress. A recent report by the TIGTA, 2006-40-061, demonstrated that IRS decisions to close the

TACs were based on inaccurate and unreliable data. Plans to save money at taxpayers' expense are unacceptable and can be avoided with targeted funding. Please consider language similar to that in last year's bill restricting the ability of the IRS to make changes in taxpayer service without first consulting with Congress and supplying reliable data to establish that such decisions will not harm taxpayers or impede their ability to meet their tax obligations.

The service budget also should include sufficient funding for vigorous IRS support and oversight of volunteer and low income taxpayer clinics. TIGTA study number 2004-40-154 found a 100% error rate in a sampling of 35 tax returns prepared at volunteer sites. IRS initiatives to partner with stakeholders to provide taxpayer assistance are desirable; however, it is important that quality and ethical standards are established and maintained through continuous IRS presence and involvement at these sites so that errors, and subsequent enforcement action, are prevented. Quality at the sites should not be sacrificed for an increase in the quantity of the sites.

A strong taxpayer service program that helps taxpayers understand and meet their tax obligations promotes a healthy level of tax compliance that will avert more costly enforcement action later. I urge you to recommend an appropriate taxpayer service budget.

Enforcement

I support a strong enforcement budget to close the \$345 billion tax gap that is not contingent on budget cap mechanisms triggered by complying with other Administration budget proposals.

Last year, the Department of Defense appropriation imposed a 1% budget cut on all discretionary spending, including the IRS budget. The IRS has informed me that the 1% cut resulted in an estimated 88,000 fewer collection closures and 25,000 fewer correspondence audit closures, and a reduction of 605 full-time equivalent positions. Using IRS National Research Product projections of return on investment, this \$100 million budget cut translated into an estimated \$1 billion in lost tax collections. By any standard, a 10 to 1 return on investment is significant.

It is important to provide an adequate budget so the IRS does not lose ground in its fight to combat domestic abusive tax shelters and so it can make inroads against the increasing number of offshore tax schemes. The IRS must have the necessary resources to process and analyze the information it already receives, including tax shelter disclosures and information reports, both foreign and domestic. TIGTA informed my staff that the IRS destroyed paper foreign source information documents that it failed to process because it was too labor intensive and that it currently lacks the technology to process the same type of data that it receives in electronic format. It does no good for Congress to enact laws requiring paper trails if the IRS lacks the resolve or the wherewithal to process and use the information submitted to the agency.

I strongly support funding for paid preparer oversight. Sixty-percent of individual Americans use a paid preparer to file their tax returns, so poor quality preparers have a direct and significant impact on tax administration and the annual tax gap. A recent Finance Committee hearing exposed incompetence and unethical behavior among a group of commercial paid preparers. The results of a Government Accountability Office (GAO) undercover investigation conducted at the request of the Finance Committee found that only 2 of 19 returns prepared by commercial tax preparation firms

showed the correct tax liability, and even the other 2 returns had procedural shortfalls (GAO-06-563T). Yet, the IRS does little to stop this. Moreover, a recent TIGTA report, 2006-10-066, found that up to 22,500 attorneys, accountants and enrolled agents may not be compliant in their own tax matters, yet the IRS Office of Professional Responsibility is unaware of it and has taken no disciplinary action. The IRS needs to be more aggressive and more accountable in protecting innocent American taxpayers from unscrupulous or incompetent preparers who generate inaccurate tax returns and make American taxpayers unwitting contributors to the tax gap.

One of the IRS's primary enforcement objectives is to deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance and other unintended purposes. Funding should be assured to stop abuses in the tax-exempt arena. The Finance Committee has highlighted unscrupulous practices in the charitable area and proposed significant legislation to curb abuse. As these proposals become enacted into law, the IRS must have the ability to implement them. While increased enforcement funding may not be earmarked specifically for charitable reform, it is reasonable to expect that the IRS would direct a portion of any increased enforcement appropriations toward the charitable sector. Further, you should instruct the IRS to devote appropriations to educational programs that enhance governance and compliance of organizations in the tax exempt sector.

I encourage you to provide targeted funding for regular National Research Program studies that cover all types of tax returns so efforts to fight the tax gap are based on reliable and current data and audit coverage is focused on noncompliant taxpayers of all income levels and types of returns. I am concerned that the Administration's budget proposal targets low income taxpayers claiming the Earned Income Tax Credit (EITC) by allocating \$168 million for EITC compliance programs but does not contain comparable targeted resources for high income taxpayers. The IRS's enforcement program should be balanced and fair.

America's taxpayers have a right to expect that IRS employees are knowledgeable and well trained so their tax matters are handled professionally and accurately. Training budgets are among the first to be reduced when funding falls short in another area. Please consider language in your bill that will establish a minimum of twenty-four hours of continuing education training hours and restrict the ability of the IRS to use training funds for other purposes.

I continue to support funding for IRS Criminal Investigation (CI) operations. It is critical that CI be able to maintain or improve its important role in detecting and following the trail of terrorist financing activity.

Business Systems Modernization

During the Finance Committee's corporate tax gap hearing on June 13, 2006, Commissioner Everson identified the shortage in funding for information systems technology as a primary factor in the IRS's inability to process foreign-source information documents and other data. The IRS must receive adequate funding for information technology (IT) development that is tied to specific criteria and subject to stringent milestones and performance measures. The IRS has not made good use of IT funding and its budget for IT work has been reduced steadily over recent years. For example, the IRS has been unsuccessful in implementing a new electronic fraud detection system database for the past

two filing seasons. As a result, millions of questionable refunds will go unchallenged, further increasing the size of the tax gap. Rigorous oversight standards to ensure responsible expenditures of IT funding will help alleviate those problems.

The IRS continues to operate with old information technology. It must be able to keep pace with the rest of the world and to process taxpayer information efficiently. The IRS's modernization efforts must not be stymied by withholding funding that would make it a more effective organization.

The CADE program that will replace 1960s technology to store taxpayer data is being threatened with delays due to lack of funding. The Finance Committee is aware that key tax shelter and information reporting data is not utilized effectively because of outdated systems and shortages in Information Systems staffing. The Questionable Refund Program, identified by the National Taxpayer Advocate as a priority problem in her 2005 annual report to Congress, unnecessarily freezes many taxpayer refunds in part because of systems limitations.

I believe that America's taxpayers should have the right to file their electronic Federal tax returns without cost directly with the IRS, like a paper return. Many states already provide this feature by allowing state returns to be filed electronically via the state website, free of charge. Other Federal agencies allow individuals to file forms using the agency website. For example, the Social Security Administration allows taxpayers to apply for retirement, disability and spousal benefits using the internet. However, individuals are not able to file their Federal tax returns electronically without using a third party because the IRS does not have the necessary technology or infrastructure in place.

Last year the IRS eliminated the Tele-File Program, the sole method of direct electronic filing that was used by approximately 3 million individual low income taxpayers, in order to save \$18 million. IRS hopes that those taxpayers would switch to the Free File Program apparently did not materialize - the use of Free File plummeted 23% during the 2006 filing season compared to last year. Out of 93 million potential users of Free File, only 3.9 million used it. At a recent Committee hearing, serious flaws in the Free File program were exposed. Arbitrary income and age limits, an incomplete array of available tax forms, sales of non-tax products, and hidden fees for additional forms or tax information are just some of the problems detected. This program, intended to provide free electronic filing to low and middle-income Americans, is broken.

I urge you to appropriate funds that will make free electronic filing directly through the IRS website a reality for all American taxpayers and to include language in the bill clarifying this is within the purview of the IRS. I oppose any provision that bars the IRS from using funds to develop or provide free individual tax electronic preparation and filing.

The IRS cannot operate in a 21st Century manner with 20th Century technology. Service and enforcement both are suffering as a result of outdated technology. Last year, you included language in your bill that requires the IRS to design a 5 year taxpayer service strategic plan. I encourage you to include similar language in this year's bill to require a 5 year strategic plan for information services and technology.

Taxpayer Advocate Service

In the *IRS Restructuring and Reform Act of 1998*, Congress increased the independence, authority and stature of the National Taxpayer Advocate (the Advocate). Congress's requirements of the Advocate, including the requirement to report directly to Congress on problems in tax administration, place her in the difficult position of being critical of IRS performance and priorities while being part of the IRS. The Advocate's independence can be curtailed through the IRS Commissioner's control over the Advocate's budget. I support language in the FY 07 appropriations bill similar to that in the FY 06 bill to curtail this institutional conflict and ensure the Advocate's independence.

United States Tax Court

The Administration's fiscal year 2007 budget plan would provide the entire amount requested by the Tax Court, an \$888,000 (1.85%) decrease compared to last year. The Tax Court requested less in FY 2007 because of a decrease in courtroom rentals and the completion of telephone and technology upgrades in fiscal year 2006.

The Tax Court is the largest single Federal trial court, receiving, managing, and closing an annual case inventory of 23,000. The Tax Court estimates deficiency cases comprise 90% of its current caseload. The remainder of the caseload includes cases involving administrative costs, abatement, employment classification, lien/levy and collection due process, TEFRA partnership issues, and section 6015 (relief from joint and several liability, "innocent spouse") cases. In the last few years, the Tax Court has seen an increase in the number of deficiency cases, TEFRA partnership cases, section 6015 "innocent spouse" cases, and lien/levy collection cases, and anticipates its overall caseload will continue to increase for fiscal year 2007 to about 25,000.

Irrespective of type, cases that actually go to trial are the most costly cases for the Tax Court. Cases that involve extensive factual findings, such as valuation cases, often involve lengthy trials. Cases that have large dollars (greater than \$1 million in deficiencies) in dispute also often involve more trial time. The Tax Court currently has about 158 pending cases that have an assessed deficiency of \$10 million or more. Of those cases: 95 cases are in the \$10 to \$50 million range, 36 cases are in the \$50 million to \$100 million range, 21 cases are in the \$100 million to \$500 million range, 1 case in the \$500 million to \$1 billion range, and 5 cases have assessed deficiencies that exceed \$1 billion.

Although the Court maintains records of cases by dollar amount, it does not maintain detailed records of its caseload by specific issues. Being able to track the Tax Court's caseload by the type of issues involved would be an important aid in planning resource allocations, as well as identifying problem areas in tax law and regulations. Please consider including language in the appropriations bill that would require the Tax Court to design and develop a case tracking system that would enable it to maintain better controls on the nature of its caseload.

The Tax Court is requesting funding for an additional presidentially appointed judge and his/her staff, plus an additional 15 positions to allow for a rapid expansion of staffing in anticipation of increased caseload resulting from expanded IRS enforcement efforts. The Court has not expressed any particular concerns about current caseload levels and it does not appear there is an immediate need to

fund an increase in judges and staff. Funding for staffing increases should be considered if the anticipated increase in caseload develops.

The Tax Court should receive adequate modernization funding. In FY 2006, the Court completed the upgrade of its telephone system and replacement of its servers, and began an initiative of cyclical replacement of technology and furniture and rehabilitation of its courtrooms nationwide that needs to be completed. The rehabilitation of its courtrooms includes installing systems cabling to provide networking capability. All of the Tax Court's case information is now electronically stored and must be accessible by the Judges and staff when they are in the field. The Tax Court cannot operate efficiently with outdated technology.

The United States Marshal Service (USMS) has informed the Tax Court that the Tax Court will be expected to bear more of the costs associated with providing courthouse security in Washington, D.C. as well as in each of the cities the Tax Court conducts trial sessions. The USMS informed the Tax Court that the USMS is not required by law to provide outside-of-courthouse security to the Tax Court. The USMS takes the position that the \$11,935,000 supplemental funding provided by the Congress to address increased court security (Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Tsunami Relief, 2005, Pub. L. 109-13) does not authorize protective service expenditures for judicial officers of the Tax Court. In addition, the USMS has informed the Tax Court that starting October 1, 2006, the USMS will no longer be authorized to provide support to the Tax Court's court security officers in Washington, D.C. The Committees on Finance and Judiciary are working on legislation that would authorize USMS protective services for the Tax Court at the same level services are provided to other Federal courts. However, if these efforts are not successful the Tax Court will require further funding for court security.

Summary

I understand the challenges, constraints and competing interests facing you during the development of the appropriations bill. As you make your decisions, please keep in mind that the IRS is unique when compared to other agencies because for every \$1 spent it has a direct yield of approximately \$4, and an estimated indirect yield of \$10, back into the Treasury. The health of the IRS impacts the health of our country and its ability to operate effectively.

I appreciate the opportunity to share my concerns and my priorities. I would be happy to address any questions this letter may raise and work with you to ensure the IRS is appropriately funded.

Sincerely yours,



Max Baucus
Ranking Member

cc: The Honorable Charles E. Grassley, Chairman, Committee on Finance
The Honorable Thad Cochran, Chairman, Committee on Appropriations
The Honorable Robert C. Byrd, Ranking Member, Committee on Appropriations
The Honorable Rob Portman, Director, Office of Management and Budget
The Honorable John W. Snow, Secretary, Department of Treasury
The Honorable Mark W. Everson, Commissioner, Internal Revenue Service
The Honorable John O. Colvin, Chief Judge, United States Tax Court
The Honorable Ray Wagner, Chairman, IRS Oversight Board
The Honorable Russell George, Treasury Inspector General for Tax Administration
Ms. Nina Olson, National Taxpayer Advocate