

June 2009

**INTERNAL REVENUE
SERVICE**

**Review of the Fiscal
Year 2010 Budget
Request**



GAO

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Highlights of [GAO-09-754](#), a report to congressional committees.

Why GAO Did This Study

The financing of the federal government depends largely on the Internal Revenue Service's (IRS) ability to administer the tax laws, which includes providing service to taxpayers and enforcing the law so that individuals and businesses pay the taxes they owe. The President's fiscal year 2010 budget request details how IRS intends to allocate its resources to achieve these goals while also continuing its investment modernizing its tax processing systems.

GAO was asked to (1) describe budget trends, including dollars and full time equivalents; (2) describe legislative proposals that, if enacted, could result in savings or increased revenues; (3) describe the requested increases in funding for new initiatives; (4) assess return on investment (ROI) information; and (5) assess and the status of the Business Systems Modernization (BSM) program. To do this, GAO compared the budget request to prior years, analyzed key documents, and interviewed IRS officials.

What GAO Recommends

GAO recommends that the Commissioner of Internal Revenue develop actual ROIs and compare them to the projected ROIs included in the budget request. While not explicitly agreeing with our recommendation, IRS's Chief Financial Officer said IRS will continue to improve analytical tools used for resource decisions for major enforcement programs.

To view the full product, including the scope and methodology, click on [GAO-09-754](#). For more information, contact Jim White, (202) 512-9110, whitej@gao.gov.

INTERNAL REVENUE SERVICE

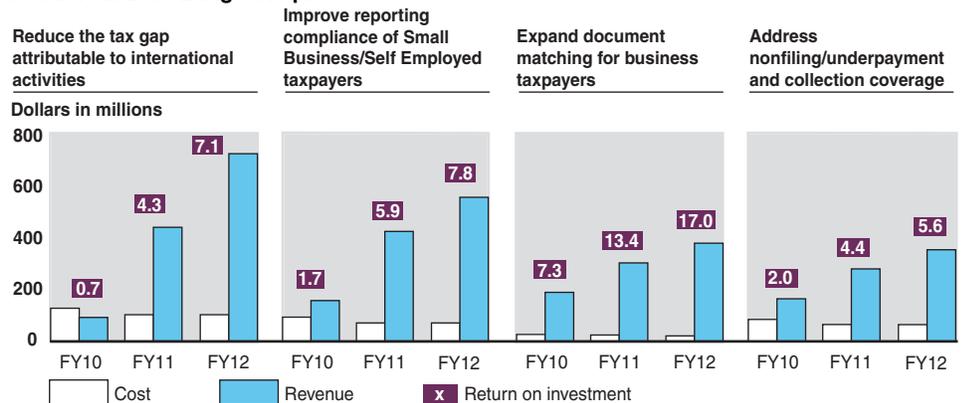
Review of the Fiscal Year 2010 Budget Request

What GAO Found

The President's fiscal year 2010 budget request for IRS of \$12.1 billion is a 5.2 percent increase of \$603 million over the fiscal year 2009 appropriation, with increases for enforcement (7.6 percent), operations support (5.6 percent), and BSM (10.3 percent) and a 1.0 percent decrease for taxpayer services. The President's budget documents include legislative proposals aimed at reducing the tax gap. Five are directly supported by prior GAO work and could result in just over ten billion dollars in savings or increased revenues over the next 10 years, such as requiring information reporting on payments to corporations (potential increased revenue of about \$8.2 billion over 10 years).

The budget request includes \$463 million for program increases, of which about 72 percent is for new enforcement initiatives. Four new initiatives are expected to cost \$332 million in fiscal year 2010 with an initial ROI of 1.8, or a return of \$1.80 on a dollar invested. By fiscal year 2012, the total 3-year investment is estimated to be almost \$900 million and the annual ROI rises to 7.8 when new hires are expected to reach their full potential. IRS also provided a projected ROI for each initiative.

Estimated Costs and Projected Revenue and ROIs for New IRS Enforcement Initiatives in the Fiscal Year 2010 Budget Request



Source: GAO analysis of IRS data.

IRS includes projected ROIs only for new enforcement initiatives, not existing programs. GAO previously reported that such additional information would be useful for funding and resource allocation decisions. While developing actual ROI information could be challenging, IRS does not have plans to compare actual performance results to ROI projections in the budget.

Under BSM, the Customer Account Data Engine (CADE), a taxpayer account database, has so far cost over \$400 million and delivered about 15 percent of the capability intended. IRS is pursuing a new strategy because of increasing complexities in system development and has suspended new work on CADE and another application while exploring the new strategy. A preliminary road map and cost estimates are due June 30, 2009. Until then, it is difficult to determine whether fiscal year 2010 funds are justified or adequate.

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United States Government Accountability Office
Washington, DC 20548

June 3, 2009

The Honorable Richard J. Durbin
Chairman
The Honorable Susan Collins
Ranking Member
Subcommittee on Financial Services and General Government
Committee on Appropriations
United States Senate

The Honorable John Lewis
Chairman
The Honorable Charles W. Boustany, Jr.
Ranking Member
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

The financing of the federal government depends largely on the Internal Revenue Service's (IRS) ability to effectively administer the tax laws—this includes providing taxpayers service to make voluntary compliance easier and enforcing the laws so that individuals and businesses pay the taxes they owe. The President has requested \$12.1 billion to fund IRS's fiscal year 2010 operations, including \$11.9 billion for enforcement, service to taxpayers, and support of IRS's operations. Another \$254 million is for the Business Systems Modernization (BSM) program, IRS's ongoing effort to improve the agency's tax processing systems.

The IRS Strategic Plan 2009-2013 and Phase 2 of the Taxpayer Assistance Blueprint (TAB) Report to Congress guide the fiscal year 2010 budget request. The strategic plan recognizes, among other things, the increasing complexity of tax laws, changing business models, and accelerating growth in international tax activities. The TAB outlines a 5-year plan for taxpayer services that will help IRS enhance the services delivered to taxpayers. Given competing priorities in IRS's spending for its programs, limited resources make it even more important that budget decision makers have sound information on how proposed spending is related to achieving IRS's goals and whether there are opportunities to revise IRS's spending plans so that resources expended achieve maximum impact on desired service and enforcement results.

Based on your requests, our objectives were to (1) describe budget trends, including dollars and full time equivalents for fiscal years 2006 through 2010; (2) describe legislative proposals that, if enacted, could result in savings or increased revenues; (3) describe the requested increases in funding for new initiatives; (4) assess return on investment (ROI) information in the budget and (5) assess the status of the BSM program.

To address these objectives, we compared IRS's appropriations for fiscal years 2006 through 2009 to the budget requests for fiscal year 2010, interviewed IRS officials, and reviewed and analyzed various documents including strategic planning documents, descriptions of IRS's ROI methodology, and the BSM expenditure plan. Based on previous tests of the major data system IRS uses to prepare its budget request, we determined the data in that system were sufficiently reliable for our purposes.

We conducted this performance audit from January 2009 to June 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. For a more detailed discussion of our scope and methodology, see appendix I.

Results in Brief

On May 26, 2009, we briefed the Senate staff and on May 28, 2009, we briefed the House staff on our initial observations of IRS's fiscal year 2010 budget request. This report transmits updated materials we used at the briefings, which are reprinted in appendix II.

In summary, we made the following major points:

- The President's fiscal year 2010 budget request for IRS of \$12.1 billion is a 5.2 percent increase of \$603 million over the fiscal year 2009 appropriation with increases for enforcement (almost 7.6 percent), operations support (5.6 percent), and BSM (about 10.3 percent) and about a 1.0 percent decrease for taxpayer services. While BSM has the largest proposed percentage increase, the dollar increase, about \$24 million, is small relative to IRS's overall budget request. The requests for these appropriations are mostly consistent with trends for the past 4 years, with the main exceptions being for taxpayer services, which has generally remained stable, and for BSM, which has fluctuated during this period. Of

the \$603 million increase, about 23 percent (\$140 million) is for adjustments to the base, including pay raises, inflation, and a governmentwide reduction for productivity improvements. The remaining 77 percent (\$463 million) is for program increases in enforcement initiatives to reduce the tax gap, addressing information technology (IT) operations and security, and modernizing IT systems. The budget request also includes an increase in the number of full time equivalents for enforcement and operation support while taxpayer services would decrease and BSM would remain the same. IRS's workload over the 5-year period has or is projected to increase in terms of total returns filed.

- The President's budget documents include a number of legislative proposals aimed at reducing the tax gap. Five are directly supported by our previous work and could result in just over ten billion dollars in savings or increased revenues over the next 10 years, including (1) requiring information reporting on payments to corporations (potential increased revenue of about \$8.2 billion for detecting underreported income and increased voluntary compliance over the next 10 years), (2) applying the Federal Payment Levy Program to contractors before providing pre-levy collection due process proceedings (potential increased revenue of over \$2 billion over the next 10 years), (3) eliminating the Advance Earned Income Tax Credit (almost \$900 million in savings over the next 10 years), (4) expanding electronic filing requirements for tax return preparers (potential savings of about \$56 million per year, without any consideration of enforcement revenue), and (5) requiring the reporting of additional details of rental real estate activities on tax and information returns (potential increased revenue unknown, but could be substantial based on the estimated \$12.4 billion of net misreported income from tax year 2001).¹ Although no additional funding was requested for these

¹The dollar savings or increased revenues are Joint Committee on Taxation estimates, except for the electronic filing dollar savings which is based on an IRS study. GAO, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, [GAO-09-238](#) (Washington, D.C.: Jan. 28, 2009); *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, [GAO-05-637](#) (Washington, D.C.: June 16, 2005); *Tax Compliance: Thousands of Federal Contractors Abuse the Federal Tax System*, [GAO-07-742T](#) (Washington, D.C.: Apr. 19, 2007); *Advance Earned Income Tax Credit: Low Use and Small Dollars Paid Impede IRS's Efforts to Reduce High Noncompliance*, [GAO-07-1110](#) (Washington, D.C.: Aug. 10, 2007); *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings*, [GAO-07-27](#) (Washington, D.C.: Nov. 15, 2006); *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, [GAO-09-238](#) (Washington, D.C.: Jan. 28, 2009); and *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance*, [GAO-08-956](#) (Washington, D.C.: Aug. 28, 2008).

proposals at this time, if they are enacted there will be associated costs and additional funding may subsequently be requested, according to IRS officials.

- Under the proposed budget request, \$463 million is for program increases, of which about 72 percent is for enforcement initiatives. Four initiatives are expected to cost about \$332 million in fiscal year 2010 with an initial ROI of 1.8, or a return of \$1.80 on a dollar invested. By fiscal year 2012, the total 3-year investment is estimated to be almost \$900 million, and the annual ROI rises to 7.8 when the new hires are expected to reach their full potential. IRS also provides a projected ROI for each initiative. Reducing the tax gap attributable to international activities is the largest of the four proposed enforcement initiatives in terms of costs and potential revenues. Total costs from fiscal year 2010 through fiscal year 2012 are estimated by IRS to be \$336 million. There are eight components to this initiative, and while IRS only has revenue projections for three, expected total revenue from fiscal year 2010 through fiscal year 2012 is about \$1.3 billion for these three. Although IRS does not have a tax gap estimate for international noncompliance, IRS justified the investment for this initiative using a variety of trend data. The cost and revenue projections for the international initiative show that in the first year, fiscal year 2010, it will cost more than the revenue it will generate, but that by fiscal year 2012, IRS projects the initiative will generate seven times more revenue than the cost.
- As in the fiscal year 2009 budget request, the fiscal year 2010 budget request for IRS includes projected ROIs only for enforcement initiatives, but not existing programs—even though we previously reported that such information would be useful for funding and resource allocation decisions.² The fiscal year 2010 budget request includes some new ROI information, such as references to the indirect effect that enforcement activities have on voluntary compliance and a description of the methodology used to compute the labor component of the estimated ROIs. Comparing projected ROIs to actual ROIs is consistent with the concepts of project management and internal control standards and guidance from the Office of Management and Budget, GAO, the Government Performance

²GAO, *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, [GAO-08-567](#) (Washington, D.C.: Mar. 13, 2008).

Results Act of 1993, and nongovernmental entities.³ IRS does not have plans to compare actual performance results to projected ROIs in the budget request, according to IRS officials. However, while challenging to develop and perhaps not initially complete, actual ROIs would provide information about how programs and initiatives are performing and the possible need to adjust ROI methodologies to more effectively project results of future proposed initiatives.

- Since 1999, IRS has spent about \$2.6 billion on BSM. The fiscal year 2010 budget request proposes about a 10.3 percent increase, or \$24 million, in BSM funding. The major changes include an increase of \$25 million for the Modernized e-File project to support the incorporation of additional forms to expand its reach to a greater number of taxpayers; another almost \$8 million for the new Customer Account Data Engine (CADE) strategy, which arose as a result of increasing complexities and questions of scalability with the system; and a decrease of about \$11 million for core infrastructure activities. After nearly 5 years and over \$400 million, CADE has only delivered about 15 percent of the full capability intended. All new work on CADE and the Accounts Management System, a related application, has been suspended while IRS explores the new strategy. IRS has established a leadership team and a preliminary road map and program cost estimates are targeted for completion on June 30, 2009. Until these and additional analyses currently under way have been completed, it will be difficult to determine whether the funds requested for fiscal year 2010 are adequate or justified.

Conclusions

By presenting ROI projections for the proposed enforcement initiatives in its budget request, IRS is providing important information about estimated costs and potential revenues. Such information should be useful to Congress for budgeting and oversight. However, without actual ROI information, Congress, IRS management, and the public will not know whether the approximately \$900 million investment from fiscal year 2010 through fiscal year 2012 for enforcement initiatives actually realized the projected results.

³OMB Circular A-11, Part 6 Preparation and Submission of Strategic Plans, Annual performance Plans, and Annual Program Performance Results (Washington, D.C.: June 2008); OMB Circular A-94 Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs (Washington, D.C.: undated); GAO, *Cost Estimating and Assessment Guide: Best Practices for Developing and Managing Capital Program Costs*, [GAO-09-3SP](#) (Washington, D.C.: March 2009); Pub. L. No. 103-62; and Bill Whittmore, "The Business Intelligence ROI Challenge: Putting It All Together," *The Business Intelligence Journal*, vol. 8 no. 1 (Winter 2003).

Recommendation for Executive Action

We recommend that Commissioner of Internal Revenue take steps to develop ROIs for IRS's enforcement programs using actual revenue and full cost data and compare the actual ROIs to the projected ROIs included in the budget requests.

Agency Comments and Our Evaluation

IRS's Chief Financial Officer provided comments via email on June 1, 2009. While not explicitly agreeing with our recommendation, she wrote that IRS will continue to improve the analytical tools it uses to inform its resource decisions for major enforcement programs. She noted that IRS already uses cost/benefit analysis, ROI, and other techniques for a wide range of resource allocations decisions, such as service and enforcement initiatives included in the President's budget. She also noted that ROI is but one tool that can be used to improve resource allocation decisionmaking and that IRS currently uses a broader set of tools, such as cost/benefit analysis that incorporates a wide range of tangible and intangible costs and benefits. She further wrote that while the IRS believes the responsible course of action would be to continue the development and application of a wide range of analytical tools to improve resource allocation decisions, the development process is complex and is dependent on funding of research projects.

We agree that ROIs are one important tool for resource allocation decisions and that they can be challenging to develop. However, IRS has no plans for developing actual ROIs. Having actual ROI data would provide important program information on the results of investments.

IRS also made technical comments to a draft of this report and we made changes where appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We are also sending copies to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Chairman of the IRS Oversight Board, and the Director of the Office of Management and Budget. Copies are also available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staffs have any questions or wish to discuss the material in this report further, please contact me at (202) 512-9110 or whitej@gao.gov.

Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff members who made major contributions to this report are listed in appendix III.

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive style with a large, prominent initial "J".

James R. White
Director, Tax Issues
Strategic Issues

Appendix I: Objectives, Scope, and Methodology

Our objectives related to our review of the President's fiscal year 2010 budget request for the Internal Revenue Service (IRS) were to (1) describe budget trends including dollars and full time equivalents for fiscal years 2006 through 2010; (2) describe legislative proposals that if enacted, could result in savings or increased revenues; and (3) describe the requested increases in funding for new initiatives; (4) assess return on investment (ROI) information in the budget request; and (5) assess the status of the Business Systems Modernization (BSM) program.

To address these objectives, we compared IRS's appropriations for fiscal years 2006 through 2009 to the budget request for fiscal year 2010. We identified and analyzed legislative proposals in various budget documents, such as the IRS Congressional Justification and the Office of Management and Budget's Terminations, Reductions, and Savings report. We compared the legislative proposals to our previous work to determine which, if any, we had determined would result in savings or increased revenues.¹ We reviewed the funding requests for new initiatives, including the ROIs and the ROI methodology. In addition, we reviewed pertinent IRS documents, such as the IRS's Strategic Plan 2009-2013, the 2007 Taxpayer Assistance Blueprint Phase 2, and Phase I of the Advancing E-File Study dated September 30, 2008. We interviewed officials at IRS's National Office including officials in the Chief Financial Officer's Office; the Office of Research, Analysis, and Statistics; and the headquarters of the Wage and Investment Division in Atlanta. Based on previous tests of the major data system IRS uses to prepare its budget request, we determined the data in this system were sufficiently reliable for our purposes.

To provide a status of the BSM program, we relied on the results of our recent BSM expenditure plan review.² We also received briefings on the status of the new CADE strategy from BSM officials including the Chief Technology Officer, the Deputy Chief Information Officer for Modernization, and members of the leadership team established to guide the work on the new strategy. We also reviewed documentation supporting these officials' statements.

¹Legislative proposals, other than those described in this report, may also result in savings or increased revenues.

²GAO, *Business Systems Modernization: Internal Revenue Service's Fiscal Year 2009 Expenditure Plan*, [GAO-09-281](#) (Washington, D.C.: Mar. 11, 2009).

We conducted this performance audit from January 2009 to June 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Updated Slides from the May 26 and May 28, 2009 Briefings

Briefing

Prepared for the
Subcommittee on Financial Services and General Government, Committee
on Appropriations, U.S. Senate
and the
Subcommittee on Oversight, Committee on Ways and Means, House of
Representatives

A Review of the Internal Revenue Service's (IRS)
Fiscal Year (FY) 2010 Budget Request

May 26, 2009 (Senate)

May 28, 2009 (House)

1

Objectives, Scope, and Methodology

- For the FY 2010 Treasury budget justification submitted for IRS,
 - describe trends for budget and full time equivalents (FTE), for FY 2006 through 2010,
 - describe legislative proposals,
 - describe requested increases in funding for new enforcement initiatives,
 - assess return on investment (ROI) information, and
 - assess the status of Business Systems Modernization (BSM).
- We conducted our work at IRS headquarters in Washington, D.C., and its offices in Atlanta. We based our work, in part, on comparisons of prior fiscal year appropriations and the FY 2010 requested budget for IRS; reviews of other documents, such as strategic plans; and interviews with IRS officials. Our BSM work was based, in part, on our expenditure plan analysis.

Results in Brief

- The President's FY 2010 budget request for IRS is \$12.1 billion, which is a 5.2 percent increase over FY 2009 levels. The requested FTEs are 95,081, which is less than a 1.0 percent increase from the prior year.
 - Various FY 2010 budget documents contain several legislative proposals, supported by prior GAO work that, if enacted, could result in just over ten billion dollars in savings or increased revenues over the next 10 years.
 - About 72 percent, or \$332 million of the \$463 million requested for program increases is for new enforcement initiatives, including international activities, Small Business/Self Employed (SB/SE) taxpayers, document matching for business taxpayers, and nonfiling/underpayment and collection.
-

Results in Brief, continued

- The FY 2010 budget request provides ROI projections for the new proposed initiatives. While some new ROI information is included, such as references to the indirect effect that enforcement activities have on voluntary compliance, IRS does not have any plans to compare actual performance results to projected ROIs in the budget.
 - The FY 2010 budget request proposes about a 10.3 percent increase in BSM funding, although the dollar increase is relatively small, at about \$24 million. The bulk of this increase is to continue development on Modernized e-file and to support a new Customer Account Data Engine (CADE) strategy.
-

Budget Trends, FY 2006 through FY 2010

Table 1: FY 2006 through FY 2009 IRS Amounts Appropriated and FY 2010 Requested Budget (Dollars in Thousands)

Appropriation	FY 2006 enacted	FY 2007 enacted	FY 2008 enacted ^a	FY 2009 enacted ^b	FY 2010 requested
Enforcement	\$4,708,441	\$4,686,477	\$4,780,000	\$5,117,267	\$5,504,000
Taxpayer services	2,142,042	2,138,238	2,191,085	2,293,000	2,269,830
Operations support	3,461,205	3,544,835	3,841,109	3,867,011	4,082,984
BSM	242,010	212,659	267,090	229,914	253,674
Health insurance tax credit (HITC) administration	20,008	14,856	15,235	15,406	15,512
Total	\$10,573,706	\$10,597,065	\$11,094,519	\$11,522,598	\$12,126,000

Source: IRS data.

Notes: FY 2006 appropriation account structure has been adjusted for comparability across fiscal years. Dollars are not adjusted for inflation.

^a FY 2008 includes supplemental funding for Economic Stimulus payment of \$202.1 million.

^b FY 2009 amounts exclude the \$123 million IRS received to implement the American Recovery and Reinvestment Act (Recovery Act) as well as the \$80 million for HITC.

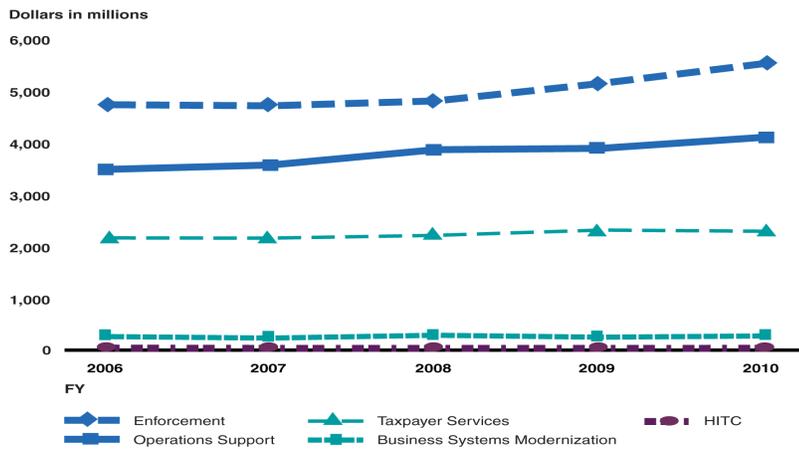
Budget Trends, FY 2006 through FY 2010

- The President's FY 2010 budget request for IRS is \$12.1 billion, a 5.2 percent increase of \$603 million over FY 2009 levels. Changes in the amounts requested include the following:
 - Enforcement increases by almost 7.6 percent, or about \$387 million, with nearly 86 percent of the increase going toward the Exam and Collections account.
 - Taxpayer services's around 1.0 percent decrease, or about \$23 million, comes from an approximate 2.3 percent decrease of about \$38 million in Filing and Account Services in combination with about a \$15 million increase for Pre-Filing Taxpayer Assistance and Education.
 - Operations support's nearly 5.6 percent increase, or about \$216 million, is largely for Information Services.
 - BSM increases by around 10.3 percent; however, the dollar increase, about \$24 million, is small relative to IRS's overall budget.

 - Of the \$603 million increase, about
 - 23 percent (\$140 million) is for base adjustments that include raises, inflation, and a governmentwide reduction for productivity improvements and
 - 77 percent (\$463 million) is for program increases in new enforcement initiatives, addressing information technology (IT) security, and modernizing IT systems.
-

Budget Trends, FY 2006 through FY 2010

Figure 1: FY 2006 through FY 2009 Amounts Appropriated and FY 2010 Budget Request for IRS



Source: IRS data.

Note: Dollars are not adjusted for inflation.

The enforcement and operations support appropriations generally increased over the last 4 years, while taxpayer services and HITC remained more stable. BSM has fluctuated.

FTEs, FY 2006 through FY 2010

Table 2: IRS FY 2006 through FY 2009 FTEs and FY 2010 Requested FTEs

Funding FTEs	FY 2006	FY 2007	FY 2008	FY 2009^a	FY 2010 requested
Enforcement	49,534	48,307	47,596	48,939	51,200
Taxpayer services	32,050	31,557	31,949	32,652	31,217
Operations support	13,468	12,890	12,495	12,270	12,316
BSM	317	317	358	333	333
HITC	17	17	17	15	15
Total	95,386	93,088	92,415	94,209	95,081

Source: IRS data.

Note: FY 2006 appropriation account structure has been adjusted for comparability across fiscal years.

^aThe \$123 million that IRS received in FY 2009 to implement the Recovery Act generally assumed the extension of seasonal employees or increased overtime, rather than new hires. HITC's FTEs for FY 2009 and requested for FY 2010, shown above, do not include FTEs provided by the \$80 million Recovery Act funding.

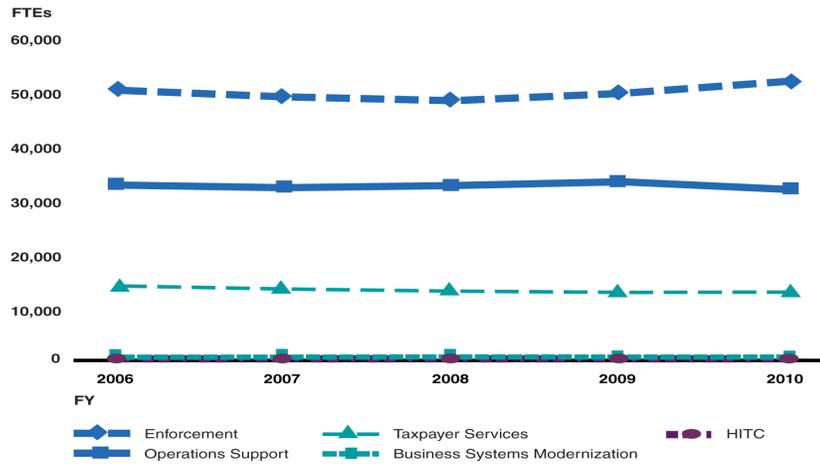
FTEs, FY 2006 through FY 2010

- Under the proposed budget, IRS's overall FTEs increase by less than 1 percent for FY 2010 with
 - Enforcement increasing nearly 5 percent,
 - Taxpayer services decreasing about 4 percent,
 - Operations support increasing less than 1 percent, and
 - both BSM and HITC remaining the same.

- IRS expects HITC to expand by almost 50 percent, or an additional seven FTEs in FY 2011 as a result of changes provided through the Recovery Act.

FTEs, FY 2006 through FY 2010

Figure 2: IRS FY 2006 through FY 2009 FTEs and FY 2010 Requested FTEs

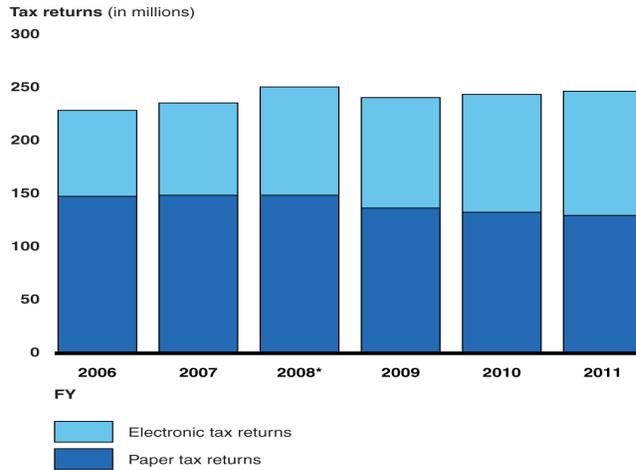


Source: IRS data.

Enforcement FTEs have generally fluctuated with an upward trend in FY 2009 and requested in FY 2010. Taxpayer services has fluctuated with a downward trend through FY 2010 and operations support FTEs generally declined, while BSM and HITC FTEs remained fairly stable. HITC's FTEs for FY 2009 and requested for FY 2010 do not include FTEs provided by the Recovery Act.

Total Number of Returns Filed FY 2006 through FY 2008 and Projected, FY 2009 through FY 2011

Figure 3: Paper and Electronic Tax Returns Filed, FY 2006 through FY 2008 and Projected Filings for FY 2009 through 2011



The total number of actual returns filed increased from FY 2006 through FY 2008, with a significant increase in FY 2008, which IRS attributes to the 2008 Economic Stimulus Payment.

Legislative Proposals Could Reduce the Tax Gap

• Various FY 2010 budget documents contain several legislative proposals, supported by prior GAO work that, if enacted, could result in just over ten billion in savings or increased revenues over the next 10 years, as follows.¹

- Requiring information reporting on payments to corporations could increase tax revenue by about \$8.2 billion over 10 years, in part because of increased voluntary compliance and IRS's ability to detect underreported payments received by businesses.²

- Applying the Federal Payment Levy Program to contractors before providing pre-levy collection due process proceedings could increase revenues by over \$2 billion over the next 10 years.³

¹ Budget documents include Office of Management and Budget, *Terminations, Reductions, and Savings: Budget of the U.S. Government, Fiscal Year 2010*; Department of the Treasury, *General Explanations of the Administration's FY 2010 Revenue Proposals, May 2009*; and Treasury's *FY 2010 Congressional Budget Justification*.

² GAO, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238 (Washington, D.C.: Jan. 28, 2009).

³ GAO, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, GAO-05-637 (Washington, D.C.: June 16, 2005) and *Tax Compliance: Thousands of Federal Contractors Abuse the Federal Tax System*, GAO-07-742T (Washington, D.C.: Apr. 19, 2007).

Legislative Proposals Could Reduce the Tax Gap, continued

- Eliminating the Advance Earned Income Tax Credit (AEITC) could save almost \$900 million over the next 10 years.⁴
 - Requiring electronic filing (e-filing) for tax return preparers who file over 100 returns per calendar year could save about \$56 million in processing each year. In addition, it could improve IRS's enforcement strategy, as more return data are captured from e-filed returns.⁵
 - Requiring the reporting of additional details of rental real estate activities, such as expense payments, on tax and information returns could improve taxpayer compliance and increase tax revenue.⁶
- No additional funding was requested for these legislative proposals to improve tax compliance in FY 2010. IRS officials stated that if the proposals are enacted, there will be associated costs and additional funding may subsequently be requested.

⁴GAO, *Advance Earned Income Tax Credit: Low Use and Small Dollars Paid Impede IRS's Efforts to Reduce High Noncompliance*, GAO-07-1110 (Washington, D.C.: Aug. 10, 2007).

⁵GAO, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings*, GAO-07-27 (Washington, D.C.: Nov. 15, 2006).

⁶GAO, *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

Generally, Payments to Corporations Are Not Subject to 1099-MISC Reporting

(Potential Increased Revenue: About \$8.2 Billion Over the Next 10 Years)

- Certain payments to unincorporated persons or businesses are subject to information reporting on Form 1099-MISC, but payments to corporations generally are not, requiring payers to determine the status of their payees.
 - IRS data suggest payees are more likely to report income on their tax returns if IRS receives third-party information returns.
 - Removing the general exemption on reporting payments made to corporations lessens the burden of determining payee business status and also provides IRS with information to help detect underreported miscellaneous income.
 - GAO recommended expanding reporting requirements for payments to corporations on the Form 1099-MISC. Projected increases in revenue are \$8.2 billion, in part because of increased voluntary compliance and IRS's ability to detect underreported payments received by businesses.
-

Many Federal Contractors Are Delinquent in Federal Taxes

(Potential Increased Revenue: Above \$2 Billion Over the Next 10 Years)

- Thousands of federal contractors abuse the federal tax system and owe billions in unpaid taxes.
 - Currently, a government payment cannot be reduced until all debt collection administrative procedures are complete—a lengthy process, often resulting in a lost opportunity to collect unpaid taxes.
 - Additionally, technical issues impair IRS's ability to fully implement the legal provision to increase the continuous levy on federal payments from 15 percent to 100 percent.
 - Legislative proposals are aimed at (1) levying payments before all debt collection administrative procedures are complete by providing the taxpayer the opportunity for a collection due process hearing within a reasonable time after levy and (2) obtaining a technical correction to allow levies up to 100 percent.
-

The AEITC's Low Use and Small Dollars Paid Impede IRS's Efforts to Reduce High Noncompliance

(Potential Savings: Almost \$900 Million Over the Next 10 Years)

- Only about 3 percent of Earned Income Tax Credit recipients potentially eligible for the AEITC received it in tax years 2002 through 2004, or about 514,000 of the 17 million potentially eligible individuals each year.
- Of those who did receive it, most got relatively few dollars with about half of all recipients receiving \$100 or less in AEITC and 75 percent receiving \$500 or less for the year.
- Furthermore, as many as 80 percent of AEITC recipients did not comply with at least one of the program requirements reviewed, and some were noncompliant with more than one during the 3 years reviewed.
- GAO recommended steps to improve AEITC compliance, but suggested the Department of the Treasury inform Congress as to whether the AEITC should be retained.

Efficiency Savings Result with Increases in Electronic Filing *(Potential Savings: About \$56 Million per year, without Any Consideration of Enforcement Revenue)*

- Processing paper returns cost IRS \$2.52 more per return than processing e-filed returns.⁷
- Increases in e-filing move IRS closer to a time when it might be able to capture all tax return data to use for enforcement purposes.⁸
- As of the 2009 filing season, 20 states have mandated that preparers e-file state tax returns if they met certain filing thresholds.
- GAO asked Congress to consider mandating that certain paid preparers e-file client returns. The Electronic Tax Administration Advisory Council also made a similar recommendation.
- The legislative proposal requests to expand electronic filing requirements for tax return preparers.
- Requiring tax preparers filing more than 100 tax returns to e-file could save IRS about \$56 million in processing each year, result in more than 22 million additional e-filed returns, and bring IRS closer to meeting the 80 percent e-file goal.

⁷Internal Revenue Service, *Advancing E-file Study Phase I Report: Achieving the 80% E-file Goal Requires Partnering with Stakeholders on New Approaches to Motivate Paper Filers*, 0206.0210 Mitre Corp (Sept. 30, 2008).

⁸GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should Be Evaluated*, GAO-08-38 (Washington, D.C.: Nov. 15, 2007).

Over Half of Taxpayers with Rental Real Estate Misreport Associated Income

(Potential Increased Revenue: Unknown but Expected to Be Substantial)

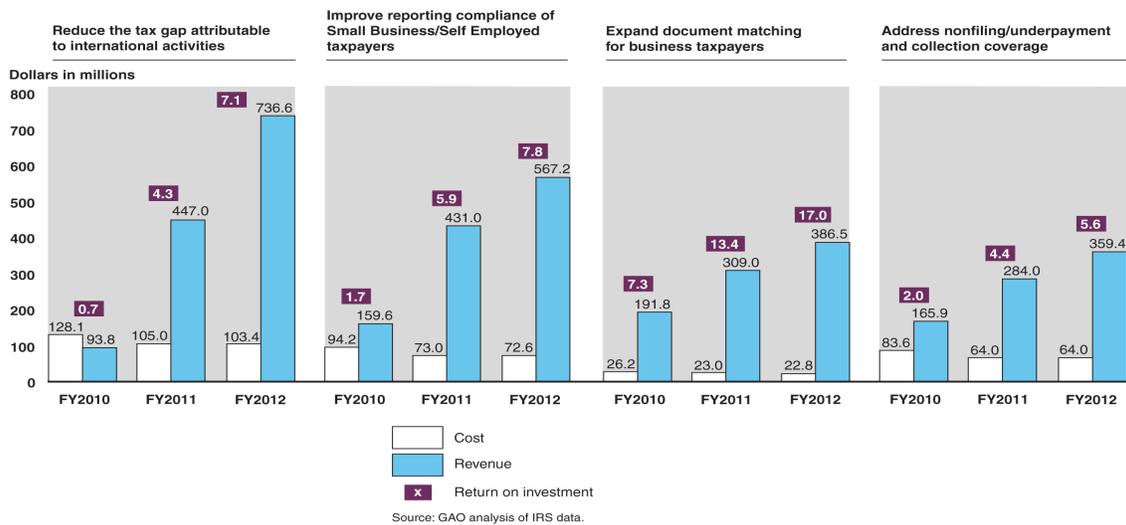
- For tax year 2001, misreporting by an estimated 53 percent of individual taxpayers with rental real estate resulted in an estimated \$12.4 billion of net misreported income.
- Misreporting of rental real estate expenses was the most common type of rental real estate misreporting.
- Given the magnitude of underreporting, even small improvements in taxpayer compliance could result in substantial revenue.
- GAO recommended that IRS require the reporting of additional details of rental real estate activities on tax and information returns and that Congress consider that expense payments be included.
- This proposal would require rental income recipients making payments of \$600 or more to a service provider to send an information return to IRS and the service provider.

Requested Increases in Funding for New Enforcement Initiatives

- The President requested \$463 million for IRS program increases, of which about 72 percent is for new enforcement initiatives, focusing on
 - international activities,
 - SB/SE taxpayers,
 - document matching for business taxpayers, and
 - nonfiling/underpayment and collection coverage.
- For FY 2010, the total planned cost for these initiatives is about \$332 million and they are expected to generate about \$611 million in revenue. The initial ROI is projected to be 1.8 to 1.
- The total estimated investment from FY 2010 to FY 2012 is about \$900 million and IRS projects the ROI to rise to 7.8 to 1 in FY 2012 when the new hires are expected to reach their full potential.
- If IRS falls behind on its hiring plans, staff may not reach their full potential as quickly as anticipated, which ultimately could delay projected revenue gains.

ROI Calculations for Proposed Enforcement Initiatives in the FY 2010 Budget Request for IRS Predict Program Performance

Figure 4: Estimated Costs and Projected Revenue and ROIs for New IRS Enforcement Initiatives in the Fiscal Year 2010 Budget Request



Reducing the Tax Gap Attributable to International Activities

- This is the largest new initiative in the budget in terms of cost, \$336 million, and potential revenues, about \$1.3 billion, to be realized from FY 2010 through FY 2012.
- It has eight components, such as increasing withholding compliance regarding foreign person's US source income.⁹
- The revenue estimates for this initiative—\$94 million in 2010, \$447 million in 2011, and \$737 million in 2012—represent estimates for only three of the eight components. IRS does not have revenue estimates for other components.
- IRS has no tax gap estimates for international noncompliance and justifies the investment using a variety of trend data.
- First year projections are that this initiative will cost more than it generates with a ROI of 0.7 to 1, but that by 2012 when new hires reach their full potential, the ROI will increase to 7.1 to 1.

⁹GAO, *Tax Compliance: Challenges in Ensuring Offshore Tax Compliance*, GAO-07-823T (Washington, D.C.: May 3, 2007).

Treasury's Budget Justification for IRS Provides ROI Estimates for Proposed Enforcement Initiatives

- As in last year's budget justification, the FY 2010 justification
 - provides projected ROIs only for new enforcement initiatives, but
 - there are no ROI projections for existing enforcement program.
- IRS has no plans to include ROI for existing programs.
- We have previously recommended that IRS expand its use of ROI projections for all enforcement programs. In such, we recognize that ROI projections have limitations, such as the indirect effects of an enforcement program on voluntary compliance and that some enforcement activities on all tax issues, despite ROI estimates, positively affect voluntary compliance.¹⁰
- However, even limited ROI projections for existing programs and activities would provide useful information for funding and resource allocation decisions.

¹⁰An even greater challenge is to determine ROI for service programs, which do have a compliance benefit. GAO, *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, GAO-08-567 (Washington, D.C.: Mar. 13, 2008).

Treasury's Budget Justification for IRS Contains New ROI Information

- New ROI information includes
 - references that enforcement activities yield indirect revenue by deterring noncompliance, estimating it to be at least three times the direct revenue impact,¹¹ and
 - a description of the methodology used to compute the labor component of projected ROIs in the budget.

¹¹Jeffrey A. Dubin, "Criminal Investigation Enforcement Activities and Taxpayer Noncompliance," *Public Finance Review*, vol. 35, no.4 (July 2007).

Use of ROI Information to Evaluate Programs Provides Benefits

- While challenging to develop and perhaps not initially complete, comparing projected ROIs to actual ROIs is consistent with the concepts of project management and internal control standards and guidance from the Office of Management and Budget (OMB), GAO, the Government Performance Results Act of 1993, and nongovernmental entities.¹²
- Comparing the projections with actual data can help decision makers evaluate performance.
- IRS has or is in the process of calculating actual cost benefit analyses for some existing enforcement activities and programs, such as Automated Underreporter and Field Exam, using full costs and actual collected revenues.
- Actual ROIs provide information about
 - how programs and initiatives are performing compared to estimates and
 - the possible need to adjust ROI methodologies to more effectively project results of future proposed programs.
- However, IRS officials told us that there are no plans to compare actual performance results to projected ROIs in the budget.

¹²OMB Circular A-11, Part 6 Preparation and Submission of Strategic Plans, Annual performance Plans, and Annual Program Performance Results (Washington, D.C.: June 2008); OMB Circular A-94 Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs (Washington, D.C.: undated); GAO, *Cost Estimating and Assessment Guide: Best Practices for Developing and Managing Capital Program Costs*, GAO-09-3SP (Washington, D.C.: March 2009); Pub. L. No. 103-62; and Bill Whittmore, "The Business Intelligence ROI Challenge: Putting It All Together," *The Business Intelligence Journal*, vol. 8 no. 1 (Winter 2003).

FY 2010 Business Systems Modernization

- Since 1999, IRS has spent about \$2.6 billion on BSM.
- The FY 2010 budget request proposes an increase in BSM funding of about \$24 million.

Table 3: Changes to BSM Funding (Costs in Millions)

Project	BSM initiative	FY 2009 enacted	FY 2010 request	Change
CADE Update (Modernized Taxpayer Account Program)	Accelerate CADE data conversion in accordance with recent replanning efforts and accommodate tax law changes. (Includes Account Management Service (AMS) and elements of previous CADE plan.)	78.100	85.654	+7.554
AMS	AMS functionality will be included under CADE.	0.000	0.000	0.0
Modernized e-File	Complete 122 additional forms to reach 93.7 million taxpayers or 99 percent of the e-file population.	25.000	50.000	+25.000
Core Infrastructure	Provide services in architecture, engineering and deployment of standardized, consolidated, virtual, and secure development environments.	43.250	32.000	-11.250
Architecture, Integration, and Management	Provide system engineering management capabilities across IT infrastructure. Provide management processes and tools, including governance, life cycle support, cost estimation, configuration and risk management, etc.	35.000	35.000	0.0
	Management Reserve	3.358	5.020	+1.662
	Subtotal Capital Investments	184.708	207.674	+22.966
	BSM Labor	45.206	46.000	+0.794
	Total BSM Appropriation	229.914	253.674	+23.76

Source: IRS data.

Current Status of New CADE Strategy

- According to IRS increasing complexity and questions regarding the scalability of CADE, a taxpayer account database intended to replace the current Individual Master File, led IRS to stop work and reconsider approach for modernization of taxpayer accounts.
 - After nearly 5 years and over \$400 million, CADE has only delivered about 15 percent of the full capability intended.¹³
- The new strategy is to
 - establish a relational database for taxpayer accounts,
 - populate it with data available from the current Individual Master File (IMF) and CADE,
 - move from IMF weekly processing to a daily cycle,
 - modify downstream business applications,
 - better address financial management and security weaknesses, and
 - define a target end state solution.¹⁴

¹³This figure was derived from data contained in IRS's BSM expenditure plans through fiscal year 2008 and IRS's reported obligations for fiscal year 2009 as of March 2009.

¹⁴This responds to a GAO recommendation. See GAO, *Business Systems Modernization: IRS's FY 2005 Expenditure Plan*, GAO-05-774 (Washington, D.C.: July 22, 2005).

Current Status of New CADE Strategy

- All new development on CADE and Account Management Service, a related application, is suspended while new direction being formulated.¹⁵
 - Until the new direction has been defined, the number of additional taxpayers who would benefit from CADE processing in the near-term is uncertain.
- Leadership team and work teams have been established.
- Preliminary road map and program cost estimates targeted for June 30, 2009.
 - Until these and additional analyses currently under way have been completed, it is difficult to determine whether the funds requested for fiscal year 2010 are justified or adequate.

¹⁵ The funds originally intended for the suspended portions of CADE and AMS were allocated toward the CADE replanning and additional efforts to support the core infrastructure.

Budget Language Proposes Change in GAO Review of BSM Spend Plans

- Prior appropriation acts prohibited IRS from obligating funds for the BSM program until, among other things, GAO **reviewed** an expenditure plan.
- Language proposed in the FY 2010 budget request would allow for obligation after GAO **receives** (not reviews) the expenditure plan.

Conclusions

- By presenting ROI projections for the proposed enforcement initiatives in its budget request, IRS is providing important information about estimated costs and potential revenues. Such information should be useful to Congress for budgeting and oversight. However, without actual ROI information, Congress, IRS management, and the public will not know whether the approximately \$900 million investment from fiscal year 2010 through fiscal year 2012 for enforcement initiatives actually realized the projected results.

Recommendation for Executive Action

- We recommend that Commissioner of Internal Revenue take steps to develop ROIs for IRS's enforcement program using actual revenue and full cost data and compare the actual ROIs to the projected ROIs included in the budget request.

Agency Comments and Our Evaluation

- IRS's Chief Financial Officer provided comments via email on June 1, 2009. While not explicitly agreeing with our recommendation, she wrote that IRS will continue to improve the analytical tools it uses to inform its resource decisions. She noted that IRS already uses cost/benefit analysis, ROI, and other techniques for a wide range of resource allocations decisions. She further wrote that the process to develop analytical tools is complex and is dependent on funding of research projects.
- We agree that ROIs can be challenging to develop. However, IRS has no plans for developing actual ROIs. Having actual ROI data would provide important program information on the results of investments.
- IRS also made technical comments to a draft of this report and we made changes where appropriate.

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact:

James R. White, (202) 512-9110 or whitej@gao.gov.

In addition to the contact named above, David Powner, Director; Libby Mixon, Assistant Director; Sabine Paul, Assistant Director; and Amy Bowser, Ray Bush, William Cordrey, Bertha Dong, Charles Fox, Carol Henn, Paul Middleton, Amanda Miller, Donna Miller, Audrey Ruge, Shellee Soliday, Joanna Stamatiades, and Diana Zinkl made key contributions to this report.

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