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IRS Update: Challenging Times To Be Sure

A former IRS commissioner looks at current state of the service -- and its future

March 19, 2013 | BY MARK W. EVERSON
Re-Printed from http://www.accountingtoday.com

Now that we have reached the middle of the filing season and sequestration is a reality, let's take stock of where it is all going at the Internal Revenue Service. My sense is that the service is getting by so far, but that it will be hard pressed to maintain taxpayer service and enforcement levels in the months ahead. This year's filing season was already, by just about any measure, the most challenging faced by the IRS in two decades. Late congressional action; identity theft; healthcare demands; reorganizations; and a change in leadership are all in the mix, making for a bad cocktail. Add in the sequestration and it looks to be a bumpy road at 1111 Constitution for some months to come.

Let's start with the impact of the American Taxpayer Relief Act, passed into law at the start of the year. Because of the time required to update and test systems, the late passage of ATRA forced the IRS to delay the start of the filing season. While the service estimated that over 120 million filers would be good to go at the end of January, others have had to wait additional weeks to file. Such a delay sends a shudder through the IRS, disrupting work flows and increasing taxpayer anxiety.

The problem of stolen identity refund fraud further complicates the filing season. This criminal activity has exploded in the last several years. In 2012 the service stopped several million fraudulent returns. False positives may run well below 10 percent, but this is another area where the IRS just can't win. If computer programs are tightened in order to minimize fraud -- including all too often by incarcerated felons -- legitimate refunds are delayed and taxpayers howl. On the other hand, if standards are too loose, billions more go out the door at a time when we need the money. Of course, cleaning up stolen identities is a further drag on service resources, taking months, and adding to the frustration of honest taxpayers.

All this is unfolding when the service is striving to meet its looming responsibilities under the Affordable Care Act. Many of the act's provisions require extensive systems work with unforgiving delivery deadlines. The new law demands the continuing attention of senior IRS managers at a time when the service is struggling to do its day job.

The IRS is also in the midst of making significant changes in its Large Business & International operating unit, moving to increase examinations in the mid-market. The shifts at LB&I are noteworthy because examiners are transitioning from a world of sophisticated, large businesses with state-of-the-art accounting and documentation systems, to one of smaller and midsized businesses. Smaller financial staffs at the taxpayer and a lack of advanced accounting software and documentation systems may prolong exams. In a period of resource constraints, examiners will have reduced access to subject matter experts who are needed to address unique issues arising over the course of an audit.

In-year budget adjustments are nothing new at the IRS, but the sequestration is more daunting than the norm. While not immediate, the impact will be significant, and it will take a long time for the service to dig out. Like other non-defense, discretionary arms of government, the IRS is taking a 5 percent haircut for fiscal year 2013. With just seven months to absorb the cuts, this really means a reduction of 9 percent for the rest of the fiscal year, assuming steady spending on a month-to-month basis. With a budget of just under $12 billion, the IRS needs to cut almost $600 million. The sequester mechanics reduce each of the service's four funding accounts by the same 5 percent. Because personnel services constitute over 90 percent of total costs in the taxpayer services and enforcement operating accounts, the IRS will not avoid furloughs. Acting Commissioner Steve Miller has indicated that he expects to limit furloughs to no more than seven days through the end of the year. Holding furloughs to less than 3 percent of yearly days worked confirms that the IRS has planned intelligently for the sequester cuts and already significantly reduced spending.

As the service has recently stated, furloughs won't kick in until this summer, protecting the filing season underway. My own guess is that the IRS will do everything it can to maintain its efforts to combat and clean up identity theft, and to successfully meet its obligations under health care reform. This means most taxpayer services and enforcement programs will feel the squeeze before long. It is worth noting that taxpayer service has already deteriorated over the last four to five years, with average wait times on the phones going from 4.6 minutes in 2007 to 17 minutes last year, and overage correspondence increasing from 17 percent to 40 percent during the same period. Don't expect things to get better with these further reductions. The cuts in enforcement will reduce examinations, collections and appeals activities, thus reducing enforcement revenues that would otherwise contribute to deficit reduction. Criminal investigations will also take a hit at a time when there is no shortage of tax and financial crimes.

Finally, there is the question of who will be in charge. I gave Steve Miller his first agency leadership position in 2004 when I asked him to run the Tax Exempt and Government Entities unit. He is a strong executive, highly regarded in Congress, and well-suited for the job of commissioner. The IRS needs a confirmed commissioner and Steve would be an excellent choice. Whatever he does in this regard, the president should move expeditiously to lock in leadership at the IRS. There is too much happening and a lot at stake.

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