

**WRITTEN TESTIMONY OF  
DOUGLAS SHULMAN  
COMMISSIONER OF  
INTERNAL REVENUE  
BEFORE THE  
SENATE FINANCE COMMITTEE  
ON  
IRS OPERATIONS, THE FILING SEASON, THE IRS BUDGET AND  
IRS EFFORTS TO DEAL WITH IDENTITY THEFT**

**APRIL 10, 2008**

**Introduction**

Chairman Baucus, Ranking Member Grassley, and members of the Committee, thank you for the opportunity to appear today. This is my first hearing as the IRS Commissioner, and I would like to begin this morning by thanking the Members of this Committee for their support of my confirmation. I have had productive conversations with many of you individually about the IRS and the direction we should be taking. I appreciate and value the advice and counsel that I have received, and I look forward to working closely with the Members of the Committee during my tenure with the IRS.

Because this is literally my third week on the job and because I want to make sure that, as an agency, we are as responsive as we can be to the questions you may have, I have asked Linda Stiff to accompany me this morning. Linda did an excellent job for six months as the Acting Commissioner and has helped guide the IRS on many of the filing season and economic stimulus issues that I will discuss later in my statement. She has dedicated her career to the IRS, and I am fortunate to have her support as Deputy Commissioner for Services and Enforcement.

I understand that the primary focus of this hearing is identity theft. My overall goal as the IRS Commissioner is that when a taxpayer contacts us with an issue or concern, we have in place a seamless process that gets the issue resolved promptly.

From the perspective of an identity theft victim, that means when the taxpayer calls the IRS that they reach someone who is knowledgeable on the issue and who is able to take care of the problem quickly and permanently.

Because I am new, I frankly cannot tell you this morning how far away we are from achieving that goal. I can tell you from what I have learned in the last three weeks that we are closer than we were at this time last year. I will discuss some of the things we have done in the last year later in my statement.

But before discussing identity theft in depth, I want to update you on several other items including the status of the current filing season, the distribution of the economic stimulus payments, and the President's FY 2009 Budget request for the IRS.

## **Overview**

The IRS and its employees represent the face of U.S. government to more American citizens than any other government agency. We administer America's tax laws and collect over 96 percent of the revenues that fund the federal government each year.

The IRS strategic plan goals are:

- *Improve Taxpayer Service* – Help people understand their tax obligations, making it easier for them to comply with their obligations under the tax law.
- *Enhance Enforcement of the Tax Law* – Ensure taxpayers meet their tax obligations, so that when Americans pay their taxes, they can be confident their neighbors and business competitors are also doing the same; and
- *Modernize the IRS through its People, Processes and Technology* – Strategically manage resources, associated business processes, and technology systems to meet service and enforcement strategic goals effectively and efficiently.

The FY 2009 IRS proposed budget, which I will discuss in detail later in my testimony, supports those strategic goals by retaining the critical balance between taxpayer service and compliance and enforcement.

## **2008 Filing Season**

The biggest challenge we faced at the end of 2007, as we approached the 2008 filing season, was the uncertain status of legislation to address the situation of an additional 21 million taxpayers who otherwise would have become subject to the alternative minimum tax (AMT).

On October 30, 2007, Chairman Baucus, Ranking Member Grassley and their counterparts on the House Ways and Means Committee, sent the IRS a letter assuring the IRS that Congress intended to enact AMT relief (the AMT patch) in a manner acceptable to the Senate, the House of Representatives, and the President. I am told that this letter was very helpful because it allowed the IRS to move forward on certain planning and design aspects of implementing the AMT relief legislation, shortening the implementation process by a number of weeks.

However, the IRS indicated that our key systems could accommodate only one programming option without introducing excessive risk to the filing season. As a result, the IRS was able to proceed only so far without actual legislation being enacted. When the President signed the AMT relief law on December 26, 2007, the IRS immediately

began the detailed reprogramming of systems to accommodate the new law. IRS employees worked diligently to modify systems to implement the changes in a very short time period. My thanks go out to all of those dedicated employees who worked almost around the clock to enable us to implement this AMT relief legislation in record time.

Given their efforts we were able to begin the filing season on schedule for most taxpayers. However, the processing of returns filed by approximately 13.5 million taxpayers that included one of five forms associated with the AMT legislation was delayed. These taxpayers had to wait until February 11, 2008, before having their filed return processed.

The other challenge facing us this filing season is the implementation of the economic stimulus package enacted in early February, specifically the planning for the distribution of the stimulus payments to eligible recipients throughout the country this spring. We will begin immediately after the close of the filing season to distribute those payments with the expectation that the first payments will be sent electronically the first week of May with the first paper checks being mailed by the second week. We have established a distribution schedule that is published on the IRS website on a page dedicated to informing citizens about the economic stimulus payments.

To deliver the 2008 stimulus payments, we must program our systems to calculate the appropriate amount for each eligible taxpayer based on their 2007 returns and then distribute the payments, through Treasury's Financial Management Service, by direct deposit or by paper check, based on the preferences expressed on their return.

However, there are a significant number of economic stimulus recipients who typically do not have an income tax filing requirement. This would include retirees or those who have minimal income and are thus not required to file. But in order to receive the 2008 stimulus payment, the recipient must file a tax return for 2007. To reach these recipients and educate them requires an extensive outreach program that includes the IRS coordinating with the Social Security Administration and Department of Veterans Affairs, along with private groups such as the AARP. We have also mailed information packets to approximately 20 million individuals who we believe may be eligible for the stimulus payment but who are normally not required to file an annual federal tax return.

Despite the challenges presented by the late enactment of the AMT patch and the implementation of the economic stimulus payments, I am proud to report that thus far the filing season has gone very well. Allow me first to give an update on some of the numbers we are looking at approximately one week from the due date for individual tax returns.

### ***Numbers Thus Far***

We expect to process nearly 140 million individual tax returns in 2008, and we anticipate continued growth in the number of those that are e-filed. In the 2007 filing season, almost 60 percent of all income tax returns were e-filed. We fully expect to exceed that

number this year. As of March 29, we have received nearly 63 million tax returns electronically, an increase of 9.3 percent compared to the number of returns that were e-filed during the same period last year.

This increase in e-filing is being driven by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by 17 percent compared to the number of self-prepared returns e-filed during the same period a year ago. Nearly 19 million returns have been e-filed by people from their personal computers, up from just over 16 million for the same period a year ago.

Overall, 71 percent of the returns filed through March 29 have been e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in two weeks or less. That is about half the time it takes us to process a paper return. For the IRS, the error-reject rate for e-filed returns is significantly lower than that for paper returns.

More people are choosing to have their tax refunds deposited directly into their bank account than ever before. As of March 29th, we have directly deposited over 50.7 million refunds, or over 72 percent of all refunds issued this tax filing season.

People are also visiting our web site – IRS.gov – in record numbers. We have recorded almost 122 million visits to our site this year, up over 19 percent from 102 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the IRS.gov web site. The web site:

- Allows taxpayers to obtain information on the economic stimulus package including determining the payment amount that are expected to receive and learning when they can expect their payment based on their Social Security Number (SSN);
- Assists taxpayers in determining whether they qualify for the Earned Income Tax Credit (EITC);
- Assists taxpayers in determining whether they are subject to the Alternative Minimum Tax (AMT);
- Allows more than 70 percent of taxpayers the option to prepare and file their tax returns at no cost through the Free File program. This includes giving a free option for those taxpayers who normally do not file a tax return, but are required to this year in order to receive their stimulus payment;
- Allows taxpayers who are expecting refunds to track the status via the “Where’s My Refund?” feature; and

- Allows taxpayers to calculate the amount of their deduction for state and local sales taxes.

We have issued \$69.8 million refunds as of March 29, for a total of \$172 billion. The average refund thus far is \$2,467. In addition, over 26 million taxpayers have tracked their refund on IRS.gov, up nearly 20 percent over last year.

As of March 22, our Taxpayer Assistance Centers (TACs) are reporting over 1.9 million taxpayers assisted. Our telephone assistors have answered almost 12.1 million calls, and over 16 million callers received automated services.

### *Free File*

Nearly 3.4 million people have utilized Free File as of March 29, 2008, up over 17 percent compared to the number of taxpayers that used Free File during the same period a year ago. This year anyone with adjusted gross income of \$54,000 or less is eligible for Free File, which includes 97 million taxpayers. The number of Free File returns compared to the prior year has been steadily increasing, and we expect to meet or exceed 2007 totals by the end of the filing season. One reason for this increase is that we have committed additional resources to promote the Free File program.

### *VITA/TCE Sites and Other Community Partnerships*

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased over the years. In 2007, over 2.6 million returns were prepared by volunteers. As of March 30, 2008, volunteer return preparation is up almost 22 percent compared to the number of volunteer-prepared returns filed during the same period a year ago. Volunteer e-filing is also up slightly, by 2.5 percent, over the same period in the last tax filing season. This is reflective of continuing growth in existing community coalitions and partnerships.

We have also made a concerted effort to expand outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored EITC Awareness Day on January 31, 2008, in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge them to claim the credit. Over 125 coalitions and partners hosted local news conferences and issued more than 100 press releases highlighting EITC Awareness Day this year.

### **A Commitment to Service, Enforcement and Modernization**

I understand that in FY 2007, the IRS continued making improvements in our service and enforcement programs as well as having significant successes in our IT modernization program.

## *Taxpayer Service*

According to most of our taxpayer service metrics, we continued to see improvement in FY 2007. The numbers in our telephone services, electronic filing, and IRS.gov access have all increased. This is demonstrated by the following FY 2007 business results:

- The IRS helped more taxpayers find out about their refunds through the agency's internet-based system 'Where's My Refund?' The system was accessed 32.1 million times during 2007, up 30 percent from the previous year's usage of 24.7 million.
- In FY 2007, the IRS customer assistance call centers answered 33.2 million assistor telephone calls and 21.1 million automated calls. We maintained a rating of 82.1 percent on level of service on the telephone with an accuracy rate of 91.2 percent on tax law questions.
- The agency maintained a 94-percent customer satisfaction rating for its toll-free telephone service.
- Outreach and educational services were enhanced through partnerships between the IRS and public organizations. Through its 11,922 Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. Over 76,000 volunteers filed 2.63 million returns. Additionally, the IRS established 6 new tax clinics in rural areas to help low-income taxpayers meet their tax obligations.
- The IRS successfully implemented the Telephone Excise Tax Refund (TETR), a one-time payment available on federal income tax returns to refund previously collected long-distance telephone taxes. Approximately \$5.48 billion was paid out in 2006 in telephone excise tax refunds. Some individual and business returns for 2006 are continuing to be filed claiming TETR refunds. In addition, the IRS prevented more than \$538 million in potential erroneous refunds with the aid of a return selection tool created specifically to catch questionable TETR requests.
- The IRS also introduced a split-refund capability, which allowed taxpayers to direct deposit their refund into as many as three financial accounts.

As you know, the IRS, the IRS Oversight Board, and the National Taxpayer Advocate were charged to develop a Taxpayer Assistance Blueprint (TAB), a five-year plan that outlines the steps we should take to improve taxpayer services. As part of the implementation of TAB, the IRS has established the Taxpayer Services Program Management Office and Services Committee to provide senior executive coordination and governance to TAB implementation.

Several notable accomplishments of TAB thus far in FY 2008 include:

- Implementation of an Estimated Wait Time announcement to inform taxpayers about their expected wait time in the telephone queue prior to reaching a customer service representative;
- Implementation of Spanish “Where’s My Refund,” which adds refund status to the Spanish web page on IRS.gov that mirrors English-based refund information;
- Launch of an electronically searchable Publication 17, Your Federal Income Tax on IRS.gov;
- Enhanced training for volunteers in the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs; and
- Release of tax publications in new languages, including Chinese, Russian, Korean, and Vietnamese.

### *Expanding Enforcement Efforts*

The most prominent measure of our success in improving compliance is the increase in enforcement revenue, which has risen from \$33.8 billion in FY 2001 to \$59.2 billion in FY 2007, an increase of 75 percent. These numbers do not include the deterrent effect that an increased enforcement presence has on voluntary compliance.

In FY 2007, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.4 million examinations of individual tax returns in FY 2007, an 8-percent increase over FY 2006. This is over three-quarters more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.6 percent in FY 2001 to 1 percent in FY 2007. This increase was achieved without a significant increase in resources as compared to the previous fiscal year.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over \$1 million. Audits of these individuals increased from 17,015 during FY 2006 to 31,382 during FY 2007, an increase of 84 percent. One out of 11 individuals with incomes of \$1 million or more faced an audit in 2007. Their coverage rate has risen from 5 percent in FY 2004 to 9.25 percent in FY 2007.

In the business arena, the IRS has continued efforts to review more returns of flow-through entities – partnerships and S Corporations. Our business statistics reflect that we have placed more emphasis in the growing area of these flow-through returns. While large corporate audits are down slightly, we have increased our focus on mid-market corporations – those with assets between \$10 million and \$50 million.

The IRS enforcement budget in FY 2007 was similar to the budget in FY 2006, and in times of flat budgets, the agency cannot increase activity across the board but must address the areas where there is growth and potential risk.

- Audits of S Corporations increased to 17,681 during FY 2007, up 26 percent from the prior year's total of 13,984.
- Audits of partnerships increased to 12,195 during FY 2007, up almost 25 percent from the prior year's total of 9,777.
- Audits of mid-size corporations increased to 4,473, up 6 percent from the prior year's total of 4,218.
- Audits of businesses in general rose to 59,516, an increase of almost 14 percent from the prior year's total of 52,223.
- Although the audits of large corporations dipped slightly in FY 2007 to 9,644 audits, the number of audits is up 14 percent from the FY 2002 level.

Finally, examinations of tax-exempt organizations have also risen. In FY 2001 5,342 tax-exempt organization examinations were closed. This number rose to 7,580 in FY 2007.

### ***Delivering Modernization***

Over the past six months, the IRS has had a number of notable accomplishments in its modernization efforts:

1. **Customer Accounts Data Engine (CADE). CADE Release 3.2** was delivered on time (January 14, 2008) for this filing season and is doing well in production. In fact, as of April 1 CADE had processed 21.96 million returns, which is more than 25 percent of all individual returns filed to date for this year. CADE has also issued almost \$34 billion in tax refunds. CADE not only stores the taxpayer data on a modernized data base, but also settles daily (akin to a modern banking institution), which enables CADE to process refunds on average four days faster than the IRS master file. In addition, the updated account information is immediately available for our customer service personnel, unlike the master file, which is only updated on a weekly basis.
2. **Account Management Services (AMS).** AMS is a strategic program designed to deliver improved support and functionality to IRS employees by bridging the gap between modernization initiatives like CADE and existing legacy systems. AMS enables authorized users to access, validate, and update taxpayer accounts on demand.

**AMS Release 1.1** provides on-line address change capability for CADE accounts. The first release of AMS delivered the capability to update authoritative account data on a daily cycle to 33,539 IRS customer service representatives. Release 1.1

was deployed on time and on budget in October 2007, and through February 25, 2008, has completed over 365,000 address changes.

**AMS Release 1.2** provides improved customer support with new inventory and workflow functionalities to automate the assignment, research, resolution, and closure for entity and account transcripts and transition from a paper-based manual process to an automated on-line process. Release 1.2A pilot was deployed on February 18, 2008.

3. **Modernized e-File (MeF).** MeF is the IRS' designated e-File platform (electronic filing system) for the future and provides e-Filing capability for large corporations, small businesses, partnerships, and non-profit organizations. MeF benefits both taxpayers and the IRS by enabling taxpayers to file all of their tax forms electronically, eliminating the need for IRS personnel to match paper documents to electronic returns. Additionally, the enhancements embedded within MeF allow more robust error checking and data validation before returns are processed, reducing the number of returns that need manual intervention and correction.

As of March 31 MeF has accepted 1.5 million corporate (Form 1120), partnership (Form 1065) and tax exempt tax returns (Form 990), a 45-percent increase from this same period a year ago. MeF Release 5 went into production as planned in January 2008 and provides the ability to file electronically Form 1120F (tax returns for foreign corporations) and Form 990N (so called electronic postcard for small tax-exempt organizations to meet their filing requirement).

### **The President's FY 2009 Budget Funds Taxpayer Service and Enforcement**

I understand that the Administration's FY 2009 Budget request for the IRS supports not only the Service's five-year strategic plan, but also the tax compliance strategies addressed in *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* sent to Congress last summer and the *IRS Taxpayer Assistance Blueprint*.

The FY 2009 Budget request supports improving compliance by funding activities that promote better tax administration and compliance with the tax laws. The FY 2009 Budget request for the enforcement program is \$7,487,209,000, an increase of \$489,983,000, or 7 percent, over the FY 2008 enacted level. The Administration proposes to include these enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The enforcement program is funded from the Enforcement appropriation and part of the IRS' Operations Support appropriation.

#### ***Adjustments from FY 2008 Levels to Help Improve Voluntary Compliance***

The IRS total requested funding increase for FY 2009 is \$469,125,000. This increase will go to improving voluntary compliance. These investments fund increased front-line enforcement efforts, enhanced research, and implementation of legislative proposals to

improve compliance. By FY 2011, these investments are projected to increase annual enforcement revenue by \$2.0 billion. In addition, the legislative proposals included in the FY 2008 Budget to improve tax compliance are estimated to generate \$36 billion over the next ten years.

Specific increases to improve voluntary compliance include:

- Reduce the Tax Gap for Small Business and the Self Employed (+\$168,498,000 / +1,608 FTE) – This enforcement initiative will increase enforcement efforts to improve compliance among small business and self-employed taxpayers by: increasing audits of high-income returns, increasing audits involving flow-through entities, implementing voluntary tip agreements, increasing document-matching audits, and collecting unpaid taxes from filed and non-filed tax returns. This request should generate \$981 million in additional annual enforcement revenue once new hires reach full potential in FY 2011.
- Reduce the Tax Gap for Large Businesses (+\$69,488,000 / +519 FTE) – This enforcement initiative will increase examination coverage of large and mid-size corporations, including multi-national businesses, foreign residents, and smaller corporations with significant international activity. It will also enable the IRS to use existing systems further to capture other electronic data through scanning and imaging. The initiative will allow the IRS to address risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for non-compliance is significant. Funding of this request should generate \$544 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011.
- Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance (+\$51,058,000 / +393 FTE) – This enforcement initiative will support and expand ongoing research studies, including the National Research Program, of filing, payment, and reporting compliance to provide a comprehensive picture of the overall taxpayer compliance level. Research allows the IRS to target better specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. Improved research data will also refine workload selection models reducing audits of compliant taxpayers.
- Increase Reporting Compliance of U.S. Taxpayers with Offshore Activity (+\$13,697,000 / +124 FTE) – This enforcement initiative will address domestic taxpayer offshore activities. Abusive tax schemes, reporting of flow-through income, and high-income individuals are prime channels or candidates for tax evasion. This initiative will focus on uncovering offshore credit cards, disguised corporate ownership, and brokering activities in order to identify individual taxpayers who are involved in offshore arrangements that facilitate noncompliance. Funding of this request should generate \$102 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011.

- Expand Document Matching (+\$35,060,000 / +413 FTE) – This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program. This program matches third-party information returns (e.g., Form W-2 and Form 1099 income reports) against income claimed on tax returns. When potential underreporting is discovered taxpayers are contacted to resolve the issue. This request should produce \$359 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011.
- Implement Legislative Proposals to Improve Compliance (+\$23,045,000 / 0 FTE) – While the IRS continues to address compliance by improving customer service and using traditional methods of enforcement, the FY 2009 Budget also includes several legislative proposals that would provide additional enforcement tools to improve compliance. It is estimated that these proposals, if enacted, will generate \$36 billion in revenue over ten years (see the Treasury Blue Book, available on the Treasury Department web site, for more information). The proposals would expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties. This enforcement initiative includes funding for purchasing software and making modifications to the IRS IT systems necessary to implement the proposals. The specific legislative proposals are discussed below.

### *Specific Legislative Proposals*

The President's FY 2009 Budget includes a number of legislative proposals intended to improve tax compliance while minimizing the burden on compliant taxpayers as much as possible. One of the most significant of these is the requirement that there be information reporting on merchant card payment reimbursements. I was pleased to learn that that just last week the Senate Finance Committee staff released a bipartisan discussion draft of proposed legislation that included this proposal.

I appreciate the leadership that Chairman Baucus and Ranking Member Grassley have shown in supporting this important budget proposal to close the tax gap and I look forward to working with you in achieving its enactment.

Other key legislative proposals in the Administration's proposed budget:

- *Expand information reporting* – Compliance with the tax laws is highest when payments are subject to information reporting to the IRS. Specific information reporting proposals would:
  - (1) Require information reporting on payments to corporations;
  - (2) Require basis reporting on security sales;
  - (3) Require a certified Taxpayer Identification Number (TIN) from contractors;

- (4) Require increased information reporting on certain government payments;
  - (5) Increase information return penalties; and
  - (6) Improve the foreign trust reporting penalty.
- *Improve compliance by businesses* – Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:
    - (1) Require electronic filing by certain large organizations; and
    - (2) Implement standards clarifying when employee leasing companies can be held liable for their clients’ Federal employment taxes.
  - *Strengthen tax administration* – The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:
    - (1) Expand IRS access to information in the National Directory of New Hires for tax administration purposes;
    - (2) Permit disclosure of prison tax scams;
    - (3) Make repeated willful failure to file a tax return a felony;
    - (4) Facilitate tax compliance with local jurisdictions;
    - (5) Extend statutes of limitations where state tax adjustments affect federal tax liability; and
    - (6) Improve the investigative disclosure statute.
  - *Expand penalties* – Penalties play an important role in discouraging intentional non-compliance. A specific proposal to expand penalties would impose a penalty on failure to comply with electronic filing requirements.

*Improve Tax Administration and Other Miscellaneous Proposals*

The Administration has put forward additional proposals relating to IRS administrative reforms. Five of these proposals are highlighted below:

- The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.
- The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.
- The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding \$50,000. This proposal requires that the

Secretary of the Treasury establish standards to determine when an opinion is appropriate.

- The fourth proposal extends the IRS authority to use the proceeds received from undercover operations through December 31, 2012. The IRS was authorized to use proceeds it received from undercover operations to offset necessary and reasonable expenses incurred in such operations. The IRS authority to use proceeds from undercover operations expired on December 31, 2007.
- The fifth proposal equalizes penalty standards between tax return preparers and taxpayers, reducing unnecessary conflicts of interest between them. The standard applicable to tax return preparers for disclosed positions would be “reasonable basis,” but for certain reportable transactions with a significant purpose of tax avoidance, the existing standard would persist (i.e., the preparer should have a reasonable belief that the position, more likely than not, would be sustained on the merits).

## **Identity Theft**

### *Background*

Identity theft is a growing national problem. The Federal Trade Commission (FTC), the lead government agency charged with combating identity theft, has called it the number one consumer complaint in the United States. In 2006, the FTC received 246,035 complaints of identity theft.

Identity theft can affect individuals in many ways. According to the FTC, identity theft can victimize people through bank fraud, loan fraud, credit card fraud, and in many other ways. Increasingly, the victims of identity theft find that their identity is being used to allow the perpetrator to receive government benefits for which he would not otherwise be eligible. This can take the form of using identity theft to obtain a fraudulent drivers license or a government benefit to which the recipient is not entitled. It also can affect the fraudulent filing of tax returns.

Recognizing the heavy financial and emotional toll that identity theft exacts from its victims and the severe burden it places on the economy, President Bush, on May 10, 2006 created the President’s Task Force on Identity Theft. This Task Force launched a new era in the fight against identity theft. It created a coordinated approach among government agencies to combat this crime by having a strategic plan that would aim to make the federal government’s efforts more effective and efficient in the areas of identity theft awareness, prevention, detection, and prosecution.

In 2007, the Task Force issued a strategic report noting four major strategies for preventing and deterring identity theft. These were (1) establishing a data breach policy for the public sector, (2) improving data security in the public sector, (3) decreasing the use of social security numbers (SSNs) by the public sector, and (4) publication for a routine use with respect to disclosure of information following a data breach.

### *Identity Theft and Tax Administration*

Generally, victims of identity theft could have their interactions with the IRS affected in two ways. First, someone could steal another person's identity and use it to file a tax return in order to fraudulently obtain a tax refund. Generally, the identity theft perpetrator will use a stolen SSN to file a forged tax return and obtain a refund early in the filing season. The rightful owner of the SSN will be unaware that this has happened until he files his return later in the filing season and we discover that two returns have been filed using the same SSN. We call this type of identity theft a refund-related crime.

The second way a person's stolen identity will affect his interaction with the IRS is if someone uses the stolen identity to obtain employment. This occurs in many instances when an undocumented worker uses someone else's SSN to get a job. In this instance, the IRS would receive a W-2 or a Form 1099 reporting income on the taxpayer's account, which the rightful owner of the SSN had not earned. Identity theft in this instance is referred to as an employment-related crime.

### *IRS Actions to Respond to Identity Theft*

As I stated in the introduction, my overall goal as the IRS Commissioner is that when a taxpayer contacts us with an issue or concern, we have in place a seamless process that gets the issue resolved promptly. While I don't yet know how close we are to that goal, the protection of taxpayer data and other sensitive information will be a top priority during my tenure as Commissioner.

I understand that the IRS has undertaken a number of steps in the last year to both prevent and respond to incidents involving identity theft. In July 2007 the IRS created the office of Privacy, Information Protection, and Data Security (PIPDS) within the IRS.

The creation of this office recognized the importance of having an enterprise-wide approach to address identity theft problems consistently. The Director of PIPDS is a Senior Executive reporting directly to a Deputy Commissioner. This allows PIPDS to reach across all IRS organizations and ensure that proper attention and discipline is given to privacy, identity theft, and security issues.

### *Taxpayer Outreach*

The IRS has undertaken several outreach initiatives to provide taxpayers, employees, and other stakeholders with the information they need to prevent and resolve identity theft issues proactively. For example, the IRS:

- Revised the most widely used documents, such as the Form 1040 instructions and Publication 17, *Your Federal Income Tax*, to include information about identity theft.

- Launched an identity theft website on IRS.gov to provide victims with updated information and links to SSA and FTC and with information on how to contact the Taxpayer Advocate.
- Participated with the Department of the Treasury and the SSA in a multi-agency panel discussion on identity theft, which was held at the IRS nationwide tax forums in 2006 that reached approximately 30,000 tax preparers.
- Developed an internal web communication tool to alert IRS employees to issues of identity theft.
- Led a multi-agency working group (Treasury, FTC, SSA, and Homeland Security) with a goal of providing consistent information and services to victims, consistent with recommendations being made by the President through the Identity Theft Task Force.
- Promoted a consistent message to inform taxpayers that the IRS does not communicate with taxpayers via e-mail, with the goal of reducing the number of identity thefts accomplished by “phishing.”
- Published, jointly with the Treasury Inspector General for Tax Administration (TIGTA), an e-mail address on IRS.gov to serve as a repository for the fraudulent emails so they could be tracked to the source and destroyed, and if appropriate referred for criminal action.

### *Victim Assistance*

The IRS recognizes that outreach alone is not enough and that it also must be prepared to assist victims when identity theft occurs.

- In January 2008, the IRS implemented a new service-wide identity theft indicator that is placed on a taxpayer’s account upon the authentication of identity theft. All applicable IRS functions are now tracking tax fraud identity theft victims using the universal identity theft indicator. Since January, indicators have been placed on more than 3,000 accounts. This new process means that taxpayers should only have to provide identity theft authentication one time.
- Beginning in January 2009, returns filed using SSNs associated with accounts that are coded with a universal identity theft indicator will be filtered to distinguish legitimate returns from fraudulent ones. In this way, the universal identity theft indicator will reduce taxpayer burden and inconvenience by expediting the process for identifying and processing the victim’s return.
- The IRS established a new identity theft policy that provides for more consistent procedures across its functions to ensure timely resolution of identity theft issues affecting taxpayer accounts.

- The IRS has developed new standards for documentation required from taxpayers to validate the identity of the taxpayer and the fact of the identity theft. For example, taxpayers can now fax information to the IRS that verifies their identity rather than appearing in person at an IRS office. These documentation standards are consistent with those required by FTC and SSA.
- The IRS is now able to resolve approximately 95 percent of all duplicate match cases through research and input from the taxpayer. In the other 5 percent of the cases where the IRS cannot easily determine which party is the legitimate owner of the SSN, we must engage in more rigorous procedures including the involvement of SSA to resolve the case. The IRS recognizes that more work is needed to reduce the burden placed on legitimate taxpayers whose cases are not easily resolved.
- In September 2007, the IRS began sending letters to individuals affected by IRS data loss incidents (e.g., lost or stolen laptops or tax returns lost in shipping). While these incidents are not wide-spread, the notification letter to those that are affected includes an offer for one-year free premium credit monitoring that includes credit monitoring, identity theft insurance up to \$20,000, and 24/7 fraud victim assistance. To date, approximately 10 percent of notified individuals have taken advantage of the credit monitoring service, which is consistent with the industry standard.

### *Prevention*

The IRS is also working to prevent identity theft:

- The IRS' Criminal Investigation (CI) division initially identifies many cases of identity theft through its Refund Crimes Unit. This includes instances where a criminal uses another person's tax information to fake a return and steal a refund. CI identifies questionable tax returns using the Electronic Fraud Detection System (EFDS). EFDS screens tax returns, and if certain indicators of fraud are discovered the refund becomes part of the Questionable Refund Program (QRP). In Tax Year (TY) 2007, the IRS identified over 240,000 fraudulent returns and stopped over \$1.2 billion in fraudulent refunds from being made. Of this total, identity theft was suspected in approximately 27,500 returns.
- The IRS is working with the SSA to reduce the incidence of identity theft related to employment by improving the accuracy of SSN reporting.
- The IRS is implementing recommendations from the President's Identity Theft Task Force strategic report and in accordance with an OMB directive to reduce or eliminate the use of SSNs within Federal agencies.
- The IRS has created new specialized personnel positions for detecting and preventing online fraud.

### *Other Identity Theft-Related Initiatives*

- **IRS Efforts to protect personal information for taxpayers interacting with the IRS electronically** – The IRS is continually exploring ways to ensure taxpayers who e-file or seek tax help through IRS.gov or other online tax-related services can be assured their information is safe. We are also working to put in place mechanisms to prevent the use of stolen identities to file electronically. We are also working to promote a comprehensive online fraud awareness, training, and education program within the public and private sectors to reduce vulnerabilities and minimize online fraud.

The IRS is the 24th most “spoofed” brand in the world according to an October 2007 report. Spoofing means to use the brand in such a way as to make the individual think that he is coming to a site owned by the real owner of the brand – such as the IRS. To combat phishing efforts spoofing the IRS brand and other tax-related web sites (e.g. tax preparation services), we identified and took down nearly 900 phishing sites last year and have already taken down half that number in the first two months of 2008.

- **Refund Crime Notification Pilots** -- In February 2008, the IRS began a notification pilot for individuals whom CI has identified as identity theft victims of traditional refund crimes. In these cases, the perpetrator uses the victim’s personally identifiable information (PII) to fabricate a return. The letter to the taxpayer provides that: (1) someone may have attempted to impersonate you by using your personal information; (2) we have adjusted your account to reflect the corrected tax return information; (3) we suggest you monitor your financial accounts; and (4) includes information on how to obtain identity theft assistance.

### **Identity Theft and the Economic Stimulus Payments**

Earlier in my statement, I spoke of the progress we have made in preparing to issue the economic stimulus payments beginning in early May. However, the stimulus program poses some unique challenges directly related to identity theft.

Specifically, in order to receive a 2008 stimulus payment the recipient must have filed a 2007 tax return. This means that millions of senior citizens, railroad retirees, and others who are not normally required to file returns must do so for 2007 in order to receive their stimulus payments. IRS has an aggressive outreach program in place to contact these citizens to let them know that they must file a return to get their stimulus payment.

However by law, all advance stimulus payments must be issued by the end of 2008. Therefore, a victim of identity theft may not be able receive the economic stimulus payment because an identity thief has already filed a return using that individual’s personal information and received the payment.

In these instances, it is critical that the case be resolved quickly so that the appropriate party can get the stimulus payment by the end of the year. This scenario could apply to individuals who otherwise have a filing requirement as well as to individuals who do not. Therefore, IRS is expediting procedures to resolve instances of identity theft related to stimulus payments.

We have created a specialized group of assistors to speed the processing of economic stimulus payments affected by identity theft. We have in place streamlined processes for proof of identity and proof that the identity has been stolen. We are working to develop treatment procedures for victims whose economic stimulus payments are affected by identity theft.

### **Conclusion**

Thank you again, Mr. Chairman, for the opportunity to appear this morning and update the Committee on the filing season, IRS Operations, the FY 2009 proposed IRS Budget, and our efforts on identity theft. In my short tenure, I have found IRS employees to be professional, hardworking, and dedicated.

Despite any progress that we make, I understand that we must continue to work hard everyday to provide taxpayers the high level of service they deserve and to pursue enforcement actions against those unwilling to meet their tax obligations.

The identity theft issue is a good example. We have made progress, but we know we still have work to do. We recognize that we need to strive constantly to improve the policies, processes, and procedures for assisting identity theft victims. And, we have taken steps to develop a more consistent, more efficient, and less burdensome manner for handling identity theft cases.

We also need the resources to do our work. I hope this Committee will support the full funding of the Administration's FY 2009 proposed budget. It will enable us to build on the programs we have started in the past.

I also urge this Committee to support the enactment of the legislative proposals included in the Budget to improve compliance. Collectively, they will generate more \$36 billion over the next 10 years if enacted.

Linda and I will be happy to respond to any questions.