

WRITTEN STATEMENT OF
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Good morning, Mr. Chairman and distinguished members of the committee.

Thank you for the opportunity to be here today to highlight how the unique and specialized skills of the Internal Revenue Service Criminal Investigation Division are being deployed to detect, halt and investigate tax fraud and to protect the revenue. Our testimony today will focus on our very limited, but important, piece of the overall IRS efforts involving compliance in the areas of fuel tax credit and fuel excise tax evasion.

The fundamental mission of the Criminal Investigation Division, or CI, is to serve the American public by detecting and investigating criminal violations of the Internal Revenue Code and related financial crimes. Nearly 2,733 of our 4,307 workforce in CI are federal criminal investigators who have accounting or business backgrounds. These highly skilled special agents follow the money in tax and related investigations that involve sophisticated schemes and complex transactions that span the globe.

Equally important to the accomplishment of our mission are the investigative analysts and investigative support in CI. These employees are also highly skilled and trained in the areas of accounting, analytics, statistics and specialized areas such as return processing, budget, computer operations, communications and other programs critical to the delivery of the CI mission. This team of special agents and investigative analysts work together with our partners in the civil divisions of the IRS to address refund fraud, including fuel tax credit (FTC) fraud and fuel excise tax evasion.

Criminal Enforcement and Revenue Protection

In the area of FTC refund fraud and fuel excise tax evasion, CI addresses revenue protection on several fronts. We halt fraudulent FTC refunds from being released at the earliest stage of the crime – at the processing centers; we criminally investigate both fuel excise tax evasion and fuel tax credit refund fraud; we refer questionable fuel tax credit claims for civil exam, and we accept referrals of developed criminal conduct from the Small Business/Self-Employed Division (SB/SE).

Halting Fraud at the IRS Processing Centers

Housed within each of the 10 IRS processing centers (Campuses) is a CI Fraud Detection Center (FDC). CI employs nearly 600 investigative personnel in our FDCs nationwide who use sophisticated data mining techniques, critical investigative analysis and the cooperative work of our civil function co-workers to detect and delete fraudulent claims for refund. From 1999 to present, the CI has stopped nearly \$4 billion in false refund claims.

All returns filed with the IRS requesting a refund are screened at the Criminal Investigation FDCs by a highly sophisticated data mining system known as the Electronic Fraud Detection System (EFDS). EFDS houses more data than any other computer system at the IRS with the exception of the IRS Masterfile and has the capability to combine refund returns with other IRS files into one centralized system. It also contains additional information including prior year tax accounts and employer identifications to conduct comprehensive data scans and fraud detection.

EFDS enables IRS to apply specific fraud criteria against every processed refund return. The criteria are reassessed and refined yearly based upon a profile that identifies prior false returns as well as a representative sample of legitimate returns.

Returns are also evaluated by other data comparison processes to assess anomalies and other filing trends.

All refund returns are assessed by EFDS which, based on its voluminous data including fraud pattern evidence, identifies highly suspicious returns. Those returns are automatically marked for resequencing which delays processing the return and refund issuance. CI has from 2 days to 23 days to review the suspicious returns, verify the questionable return items and stop the issuance of false refunds.

In addition to the EFDS detection, other paper returns are reviewed by submission processing personnel and suspicious returns are culled out for analysis by CI. Returns determined to be false by CI personnel are analyzed and researched using other data available at the campuses in order to detect and stop any related fraudulent returns. Returns are assigned to schemes and developed to determine their full scope which may also provide leads that could help identify the scheme perpetrator or promoter. Whenever a unique or emerging multi-center scheme is identified, a national alert is issued to all IRS campuses where all personnel involved in the return processing cycle are immediately notified of the scheme.

Once a scheme is identified analysts work quickly to determine the scope and characteristics. In processing the returns, we must do everything we can to ensure valid returns are processed and refunds are timely issued to taxpayers. At the same time, however, it is imperative that fraudulent claims for refund are effectively stopped and that taxpayer dollars are safeguarded. The CI analysts therefore must work quickly to determine the scope and characteristics of any fraudulent scheme and get scheme alerts out to other campuses that might be seeing the same type of fraudulent conduct.

False return schemes are referred to CI field offices for possible criminal investigation. Returns with questionable civil issues are referred to other civil functions as applicable. During processing year 2004 CI reviewed nearly 500,000 questionable refund returns. Of those, they identified more than 118,000 fraudulent tax returns and stopped fraudulent refunds totaling more than \$2.1 billion. From Fiscal Year 2002 through March 31, 2005, CI field offices throughout the country initiated 1,885 criminal investigations and recommended prosecution of 1,230 individuals for refund and return preparer fraud. The primary source of these investigations is the data mining and analytical work done in the CI FDCs.

One of the schemes that CI employees are alert to and the EFDS system is programmed to detect is the fraudulent request for a FTC. In this type of scheme, perpetrators utilize a Form 4136 to claim a FTC regarding off highway business use of gasoline when they are not entitled to the credit. In processing year 2004, the CI FDCs identified more than 15,000 returns that questionably claimed the FTC. The most egregious and broad based schemes were referred to CI field offices for investigation and potential prosecution. The remainder are in the referral process to SB/SE for examination.

Emerging Area of Concern – Misuse of Form 4136, Credit for Federal Tax paid on Fuel

During the 2003 filing season, CI identified the fraudulent use of the FTC to be an emerging area of concern and initiated 22 investigations. Nonetheless, the number of schemes continued to rise in 2004 and CI almost doubled the number of criminal investigations involving the misuse of the FTC.

Trends we have seen include individuals and businesses filing for the FTC using both paper and electronic returns. Individuals and entities are either self preparing these returns or are using the services of a paid preparer who is sometimes complicit in the fraud. Some individuals fraudulently claim the FTC in the current year and, at the same time, file multiple previous years' returns and/or amended returns claiming the FTC.

Many of the identified schemes involve individuals who claim to be self-employed and who claim little or no business expenses. The only income reported on the majority of these returns comes from their Schedule C business. Various occupations have been claimed on the fraudulent returns which do not entitle the individual to the credit. Some of these include taxi services, beauticians, babysitters, waitresses and cleaning services. Both legitimate and bogus businesses have fraudulently claimed the FTC.

Some of the characteristics of the schemes include:

- Stolen taxpayer identity
- Schedule C's Multiple years filed concurrently
- Returns filed in different campuses.

Examples of some recent FTC schemes identified by CI include:

- A scheme involving 966 returns claiming in excess of \$1.9 million in FTC utilizing Form 4136. The occupations claimed on the returns for this scheme do not qualify for the credit. This scheme involved a return preparer who utilized this credit to get his clients refunds.
- A scheme involving over 4200 tax returns claiming more than \$6 million in FTC. This scheme is utilizing Schedule C's and being filed in various processing centers. The scheme consists mainly of paper returns.

- An investigation involving over 100 corporate returns, utilizing Form 4136 claiming FTC of approximately \$3.2 million. This scheme utilized a return preparer who prepared these returns.

Fuel Excise Tax Evasion

In addition to the FTC schemes, CI has historically had a vigorous enforcement program to address fuel excise tax evasion. Since the change in the law in 1993, which stemmed the avenues available to commit tax fraud by changing the point of taxation CI has seen a dramatic decrease in the number of criminal fuel excise tax evasion investigations. Prior to 1993, CI uncovered fuel excise tax evasion activity in the hundreds of millions of dollars. While activity has substantially declined, individuals still attempt to thwart the law. For example, CI currently is investigating a fuel excise tax evasion case involving up to four million gallons of untaxed fuel involved in a “cocktailing” scheme. CI continues to be on the alert for this type of evasion activity and currently has a number of open investigations relative to fuel excise tax evasion.

Ongoing Efforts

Based on the emerging fraudulent conduct CI has identified in relation to the FTC as well as our continuing emphasis on fuel excise tax evasion, we have several initiatives underway.

- We are continually improving/updating our EFDS system by adding new information about schemes to the fraud criteria
- The Presidents FY 06 Budget requests \$10.7 million to be used to curtail fraudulent refund crimes including FTC fraud.

- We are working closely with SB/SE to ensure that our processes continue to capture and focus on fuel excise tax fraud.
- IRS is aggressively focusing on fraud referrals, ensuring that revenue agents, revenue officers and special agents know and understand the badges of fraud and work together to ensure that fraudulent activity is criminally investigated.
- We are continually improving our fraud scheme alerts to ensure that all employees associated with returns processing are aware of the emerging schemes involving FTC.

In conclusion, the men and women of IRS CI, some of the most skilled financial investigators and investigative analysts in federal law enforcement, are proud of the role we play in achieving these successes.

Mr. Chairman, I thank you for this opportunity to appear before this distinguished committee and I will be happy to answer any questions you and the other committee members may have.